ASIC

Australian Securities & Investments Commission

Productivity Commission Inquiry into competition in the Australian financial system

Submission by the Australian Securities and Investments Commission—Appendices

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Appendices

1 ASIC welcomes the opportunity to further contribute to the Productivity Commission's Inquiry into competition in the Australian financial system.

2 This supplementary document accompanies ASIC's submission to the inquiry, and presents appendices that describe specific sectors and markets. In some cases, in the course of our regulatory work, we have identified poor consumer outcomes that relate to issues including a lack of effective competition.

3 However, we are not a competition regulator. In some markets we have limited visibility of competition issues. Consequently, we have not identified issues related to competition across all of our regulated markets.

4 The sectors we have assessed in this submission include:

(a) the deposit-taking and credit sector (see Appendix A);

(b) the insurance sector (see Appendix B);

(c) the funds management sector (excluding superannuation) (see Appendix C);

(d) the financial advice sector (see Appendix D);

(e) the investment banking sector (see Appendix E); and

(f) financial market infrastructure (see Appendix F).

Appendix A: Credit and deposits sector

Key points

The banking system plays a vital role in supporting sustainable economic growth and meeting the financial needs of all Australians.

In addition to APRA's role as the prudential regulator of the Australian financial services industry, ASIC is the national regulator of consumer credit, and also licenses entities that provide deposit products.

5 The banking system plays a vital role in supporting sustainable economic growth and meeting the financial needs of all Australians.

6 Banks transform short-term liabilities into long-term assets. In doing so, they must manage the liquidity, credit and other risks associated with this activity. This intermediation process is an important mechanism by which funds are channelled from savers to borrowers to facilitate business investment and household purchases of major assets, and to help businesses and households manage their liquidity requirements.[1]

7 At June 2017, the total value of deposits held by Australian residents on the domestic books of licensed authorised deposit-taking institutions (ADIs), including foreign subsidiary banks and branches of foreign banks,[2] was $2.1 trillion, with $851 billion worth of household deposits. Total loans and advances provided by banks was $2.5 trillion, with the largest contributor, housing loans, totalling $1.6 trillion.[3]

8 The banking system must be resilient, having the capacity to adjust to both the normal business cycle and a severe economic shock. Consumers should be treated fairly, and must have appropriate redress to protect them from poor conduct.

9 ASIC is the national regulator of consumer credit. Businesses that provide and intermediate credit must have an Australian credit licence and comply with obligations contained in the *National Consumer Credit Protection Act 2009* (National Credit Act). In addition, if entities provide deposit products they must hold an Australian financial services (AFS) licence. ASIC does not regulate commercial credit.

[1] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014.
[2] Total deposits comprises transaction deposit accounts, non-transaction deposit accounts, certificates of deposit and foreign currency deposits. This item excludes intra-group deposits.
[3] APRA, *Monthly banking statistics*, July 2017.

10 Some competition issues that may exist in parts of the credit and deposits sector include concentration, vertical integration (through the combination of credit provision and distribution), a lack of transparency through multi-branding and white-labelling strategies, and low switching rates among consumers.

Deposit and saving accounts

Key points

The household deposit market is concentrated, with the major banks holding around 80% of deposits and the largest 10 ADIs accounting for 92% of the market.

Switching in this market may be influenced by complex factors.

Overview

11 Entities offering deposit-taking services in Australia must hold an ADI licence from APRA. There are currently 144 licensed ADIs permitted to take deposits in Australia. After obtaining a banking licence from APRA, an ADI will also need to obtain an AFS licence with an authorisation to deal, or arrange for a person to deal, in a financial product by issuing deposit products.

12 Deposits form a substantial portion of household finances. In 2014, an estimated 98% of households held some of their wealth in deposits, with a median deposit value of $12,000.[4]

Major players and concentration

13 As at 2 August 2017, ADIs permitted to take deposits in Australia total 144 and include 33 Australian-owned banks, seven foreign subsidiary banks, 44 branches of foreign banks, four building societies, 54 credit unions and two other ADIs.[5]

14 The household deposit market is concentrated, with the major banks holding around 80% of deposits, and the 10 largest ADIs accounting for 92% of the market.[6] Since the global financial crisis, a number of the major banks have acquired smaller banks (e.g. CBA’s acquisition of Bankwest and Westpac Bank’s acquisition of St George in 2008) or established an alternate branded

[4] RBA, *Statistical table E5*, June 2016.
[5] APRA, *List of authorised deposit-taking institutions*, accessed 30 August 2017.
[6] APRA, *Monthly banking statistics*, July 2017.

bank (e.g. NAB's online bank brand UBank). This has further concentrated market shares.

Competition issues

Market concentration

15 The market for household deposits is concentrated with the four major banks holding around 80% of deposits.

16 Due to their size, the stability of these entities is intrinsically linked to the stability of the Australian financial system. This may have resulted in some consumers perceiving that an implicit government guarantee of solvency exists and that these ADIs are 'safer' than others.

17 The introduction of protection to deposit holders in all ADIs via the Financial Claims Scheme (FCS) may have moderated these perceptions; however, there remains a risk that consumers may still perceive the four major banks as 'less risky' than their smaller counterparts, ultimately providing them with a competitive advantage.

Barriers to entry

18 There are high barriers to entry for entities providing deposit-taking services in Australia, including both commercial barriers and regulatory requirements.

19 New ADIs must develop consumer trust and brand recognition in order to grow their market share and generate the economies of scale that are required for profitability. In addition, existing ADIs (particularly the major banks) have sophisticated distribution and branch networks that are expensive to replicate. Technological developments have to an extent lowered entry costs by allowing new entrants to forgo physical branch networks in favour of digital-only strategies. Despite this, establishing brand presence remains a significant barrier to entry and expansion in the deposit market.

20 Additionally, regulatory requirements to enter the deposit market are high as the financial safety of these ADIs is key to financial stability and the economic wellbeing of financial consumers. As a result, these institutions are subject to higher standards than in many other sectors of the economy.[7]

21 Regulatory requirements include obtaining a banking licence from APRA, complying with APRA's prudential requirements on an ongoing basis, meeting the ownership requirements in the *Financial Sector (Shareholdings)*

[7] APRA, *Guidelines: ADI authorisation guidelines*, April 2008.

Act 1998, having adequate governance and risk management capabilities and having sufficient financial resources to conduct business in a prudent manner.[8] In addition, these entities must acquire an AFS licence from ASIC with an authorisation to deal, or arrange for a person to deal, in a financial product by issuing deposit products.

22 APRA is consulting on options to refine its licensing approach to accommodate new entrants to the banking industry, including those with innovative or otherwise non-traditional business models or those leveraging greater use of technology. This would allow applicants that meet certain eligibility requirements to commence limited operations while still developing the full range of resources and capabilities necessary to meet the prudential framework. These proposals align with global trends whereby regulatory agencies have introduced, or are in the process of considering, changes to their licensing frameworks to adjust to the changing nature of financial services providers in their jurisdictions.[9]

Barriers to switching

23 Switching or even the threat of consumer switching can have a positive influence on competition. Switching in the deposits market may be hampered by consumer ‘inertia’, whereby consumers do not switch because of the lack of a ‘trigger event’ to motivate the switch, the perception that switching will not bring any tangible benefit, or because they are comfortable with their current bank.[10]

24 In 2012, the Government introduced a ‘tick and flick’ service aimed at supporting consumers through the account switching process. The service allows the consumer’s new ADI to obtain a list of regular payments made by the consumer over the past 13 months from their existing ADI, and allows the consumer to decide which of these are transferred to their new account. We are not aware of any formal review of the service’s usage or outcomes at this stage.

Multi-branding strategies

25 A number of ADIs use multi-branding strategies, including CBA’s use of the Bankwest brand and Westpac’s use of the St George and Bank SA brands.

26 It is possible that consumers may not always be aware of these multi-branding strategies and this may have some implications for market

[8] Ibid.
[9] APRA, *Licensing: A phased approach to authorising new entrants to the banking industry*, discussion paper, 15 August 2017.
[10] FCA, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability* (PDF 928.65 KB), March 2015.

transparency: see Section B of ASIC’s main submission to the Productivity Commission’s inquiry.

International insights

United Kingdom

27 In 2013, the Current Account Switch Service (CASS) was introduced in the UK. It enables banks to act on behalf of consumers and transfer activity from an old account to a new one, and also offers an automated redirection service for up to 36 months.

28 The service is backed by a guarantee that the new bank will reimburse interest (paid or lost) or charges incurred on the old account as a result of switching. The FCA’s review of the CASS in March 2015 found satisfaction with the service was high and that it had led to a small increase in switching rates.[11]

29 The UK’s Competition and Markets Authority (CMA) retail banking market investigation made recommendations to improve competition in deposit and transaction accounts. Recommendations include:

(a) requiring providers to prominently display service quality indicators;

(b) requiring providers to give customers switching prompts, at appropriate times; and

(c) improving customer awareness of the CASS.[12]

ASIC’s work and regulatory reforms

30 We support initiatives to improve consumer outcomes through promoting account switching and making account switching easier.

31 The House of Representatives Standing Committee on Economics’ review into the four major banks recommended that following the implementation of the new payments platform, the Government should consider whether additional account switching tools are required to improve competition in the banking sector. The Government agreed to the recommendation in May 2017, indicating that it would consider account switching issues further once the new payments platform is well established.

32 In the 2017 Federal Budget, the Government announced that it will introduce an ‘open banking’ regime in Australia, which will give customers greater access to, and control over, their banking data. The Government has

[11] Ibid.

[12] CMA, *Retail banking market investigation: Summary of final report* (PDF 642.87 KB), 9 August 2016, p. 36.

commissioned an independent review to recommend the best approach to implementing this regime. The report is due by the end of 2017.

33 APRA is consulting on options to refine its licensing approach to accommodate new entrants to the banking industry, including those with innovative or otherwise non-traditional business models or those leveraging greater use of technology. This would allow applicants that meet certain eligibility requirements to commence limited operations while still developing the full range of resources and capabilities necessary to meet the prudential framework.[13]

The mortgage market

Key points

The dynamics between lenders, aggregators and brokers have a significant impact on competition in the mortgage market.

Vertical integration, white-labelling and access to aggregator panels are key forces that are influencing competition in the mortgage market.

Overview

34 ASIC has primary responsibility for the regulation of consumer credit, including the sale and distribution of mortgage products. Businesses that provide and intermediate mortgages must have an Australian credit licence (credit licence) and comply with obligations contained in the National Credit Act.

35 The mortgage market consists of lenders (including ADIs and other non-ADI lenders), aggregators, brokers, comparison websites and referrers.

36 Concentration among lenders has increased over the past decade. This has been primarily driven by the major banks acquiring a number of smaller lenders and having access to lower funding costs relative to competitors in the period since the global financial crisis: see paragraph 44.

37 Despite high concentration among lenders, there have been a number of positive developments in the mortgage market, encouraging both price-based and non-priced-based competition. These include increased use of mortgage brokers, the removal of early termination fees on mortgages reducing

[13] APRA, *Licensing: A phased approach to authorising new entrants to the banking industry*, discussion paper, 15 August 2017.

barriers to switching, and greater access to online services, including comparison websites increasing transparency and comparability.

38 The dynamics between lenders, aggregators and brokers have a significant impact on competition in the mortgage market. Our report to the Government on mortgage broker remuneration[14] identified a number of areas, including vertical integration and the sale of white-label loans, broker remuneration structures and access to aggregators' panels, which affect competition in the mortgage market.

39 Our proposals in REP 516 address some of these concerns related to competition. The Government is currently consulting on those proposals.

Major players in the mortgage market

40 Major entities in the mortgage market include lenders, aggregators and brokers. Below we describe the entities in each group and how they affect competition in the mortgage market.

Lenders

41 Lenders in the home loan market include ADIs and non-ADI lenders. Non-ADI lenders only engage in lending activities (i.e. they do not offer deposit-taking activities). As at March 2017, ADIs held 93.8% of residential term loans with securitisation vehicles and other lenders held the remaining 6.2%.[15]

42 Although there are competing players in the lending market within the Australian banking industry, there is a high degree of concentration of market share and market power among the big four banks.[16]

43 The major banks held 80.6% of ADI's stock of residential term loans in July 2017: see Figure 1. Other domestic banks held 13.1% of residential term loans, foreign subsidiary banks 3.9%, and credit unions and building societies 2.4%.[17]

44 Concentration among the big four banks has increased over the past decade, reflecting two primary factors:

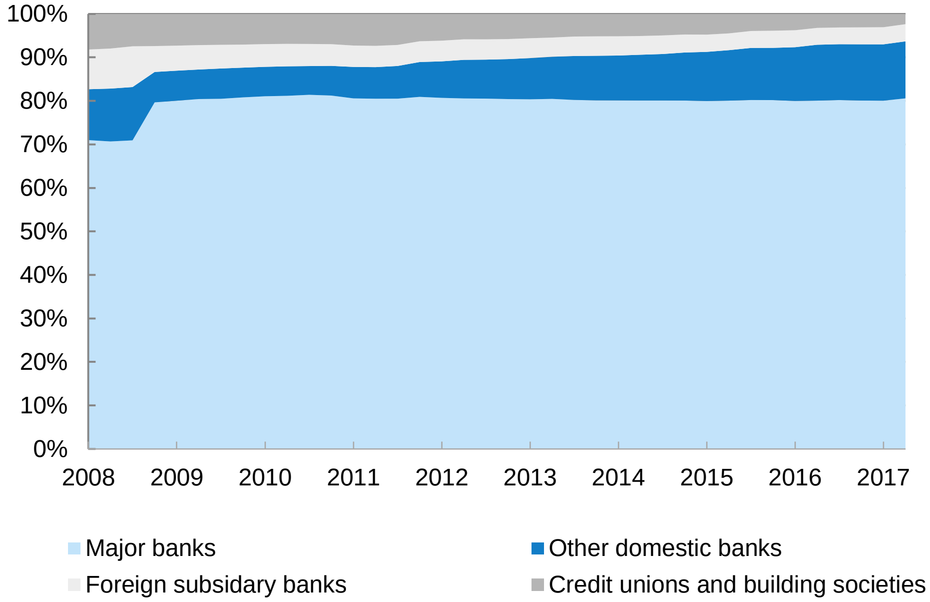
(a) in 2008, Westpac and CBA acquired St George and Bankwest respectively, which together accounted for 10.8% of mortgages at the time of their acquisition;[18,19] and

[14] ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.
[15] ABS, *Housing finance: Australia*, Cat. No. 5609.0, June 2017.
[16] ASIC, *Briefing on competition and tracker mortgages* (PDF 460.57 KB), October 2016, p. 1.
[17] APRA, *Quarterly ADI property exposures statistics*, June 2017.
[18] ACCC, *Westpac Banking Corporation: Proposed acquisition of St George Bank Limited: Public competition assessment*, 13 August 2008, p. 11.

(b) since the global financial crisis, the major banks have benefited from better access to funds and lower funding costs than their competitors, allowing them to grow faster.[20] This was due to a collapse in securitisation markets, which had previously allowed the non-major banks to access wholesale funding.[21]

45 However, since reaching a peak in the third quarter of 2010 at 82.6% of ADI residential term loans, the market share of the major banks has fallen slightly: see Figure 1.

Figure 1: Share of residential term loans



Source: APRA, Quarterly ADI property exposures statistics, June 2017; ASIC calculations.

46 Recently, the *Review of the four major banks: First report* noted:[22]

> The evidence suggests, and the ACCC Chairman agrees, that the major banks have significant pricing power. They have effectively lifted average interest rates across the economy; have passed increased costs on to consumers; and do not always compete aggressively for increased market share.

47 The review noted that the pricing power of the major banks is observable in the net effect of their changes to mortgage standard variable rates (SVRs). Since 2000, the major banks have made changes to their SVRs that have left

[19] ACCC, Commonwealth Bank of Australia: Proposed acquisition of Bankwest and St Andrew’s Australia: Public competition assessment (PDF 167.10 KB), 10 December 2008, p. 8.
[20] RBA, Submission to the Financial System Inquiry (PDF 2.98 MB), March 2014.
[21] Financial System Inquiry: Interim report (Murray Inquiry interim report), July 2014.
[22] House of Representatives Standing Committee on Economics, Review of the four major banks: First report, November 2016, p. 26.

mortgage holders with rates at least 195 basis points higher than they would been if the interest rate had simply tracked the cash rate.[23]

Aggregators

48 Within the mortgage broking market, businesses known as aggregators act as intermediaries between brokers and lenders.

49 Lenders establish contractual relationships with aggregators to distribute their loans. Brokers also contract with aggregators to gain access to a selection of lenders. Lenders that have these arrangements with aggregators are considered to be on an aggregator's 'panel'. If a lender is not on an aggregator's panel, a broker will generally not be able to place business with that lender.

50 Lenders generally pay commissions to aggregators, rather than directly to brokers. Aggregators charge brokers for access to their panels and other services such as infrastructure and administrative support, training and development opportunities, and the option to operate under the aggregator's licence as a credit representative. Broker businesses and brokers usually have arrangements with only one aggregator.

51 Findings from REP 516 show that, in 2015, the 19 lenders included in our review received $185 billion of home loans through aggregator channels and only $1.2 billion of home loans directly from brokers (where an aggregator was not involved). The aggregator channel was also the largest channel for new loans in 2015: see Figure 2.

52 A number of lenders also have vertically integrated ownership structures with aggregators. These include:

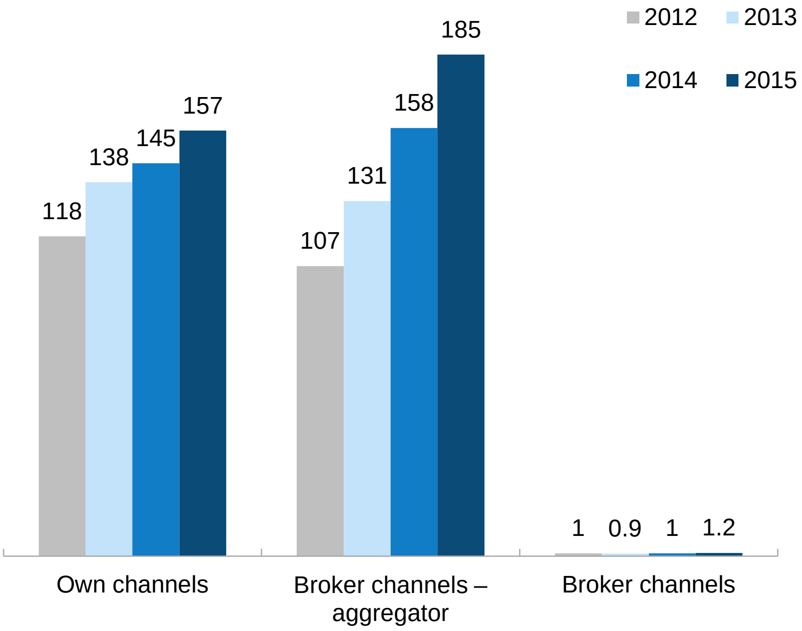
(a) CBA owns 100% of AHL Investment Pty Ltd (Aussies Home Loans) and a minority share (16.6%) of Mortgage Choice Limited (Mortgage Choice);

(b) NAB owns 100% of three large aggregator businesses (Finance & Systems Technology Pty Ltd, Professional Lenders Association Network of Australia Pty Ltd and Choice Aggregation Services); and

(c) Macquarie Bank owns minority shareholdings of Connective Credit Services Pty Ltd (Connective) and Yellow Brick Road (including Vow Financial Pty Ltd).

[23] Ibid., p. 30.

Figure 2: Total value of loans written by lenders for each channel ($billions)



Source: ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.

Brokers

53 Brokers play an important role in the home loan market. They are responsible for arranging around half of all home loans in Australia. Consumers are increasingly turning to brokers to get help in obtaining a home loan. In 2012 brokers arranged 47.7% of home loans for the lenders in our REP 516. In 2015, this increased to 54.3%.

54 There are over 5,000 broker businesses operating in the mortgage broking market and close to 20,000 individual brokers.

55 From a competition perspective, brokers have the potential to:

(a) play a valuable role in providing a distribution channel for lenders—especially smaller lenders—without their own distribution network (e.g. branches); and

(b) exert downward pressure on home loan pricing, by forcing lenders to compete more strongly with each other for business.

56 Brokers are also the primary distribution channel for non-major and regional lenders, allowing them to compete with larger lenders that have their own direct distribution channels.

57 There are a growing number of fintech businesses aiming to assist consumers with choosing and applying for a more competitive home loan; however, their market penetration has been limited to date.

Products and services in the mortgage market

58 The mortgage market has seen a notable degree of product innovation over the past two decades, including home equity loans, 'low-doc' loans, interest-only loans, white-label loans, and offset accounts.

59 There are more than 3,600 mortgage products available in the market for consumers, with a range of different features and pricing structures. More than 85% of consumers hold variable rate products.[24]

Competition issues in the mortgage market

Vertical integration and white-labelling

60 REP 516 identified that a number of lenders have 'white-labelling' arrangements in place with aggregators. This enables the aggregator to offer consumers its own-branded mortgage products, which are funded by the lender. White-label loans as a proportion of total loans increased from $5 billion (4.4% of the market) in 2012 to $10 billion (5.7% of the market) in 2015.[25]

61 As noted above in paragraph 52, a number of aggregators are owned, to varying degrees, by lenders. This is a form of vertical integration, where the manufacturer of the product (the lender) also owns part of the distribution network (the aggregator).

62 Over the last 10 years, there has been an increase in the degree of vertical integration of lenders, aggregators and brokers.[26] Examination of the loan flow between vertically integrated aggregators and their lender–owners revealed that they provide a proportionately larger number of loans to their lender–owners than the rest of the market. For example:

(a) The share of Aussie Home Loan mortgages that was funded by CBA was 37.3%, compared to CBA's overall market share of 20.9%. Most of the additional loan flow sent to CBA by Aussie Home Loans was from the sale of CBA-funded white-label loans. The share of Mortgage Choice loans that was funded by CBA was 25.1%.

Note: CBA-funded loans include Bankwest loans and Aussie Home Loans-branded products.

(b) The share of loans funded by NAB originating from its vertically integrated aggregators was 22%, compared to NAB's overall market share of 13.2%. For each of the NAB aggregators, the additional loan flow sent to NAB resulted mostly from NAB-funded white-label loans

[24] Australian Bankers' Association (ABA), *Banks support wide choice in mortgage market*, media release, 6 October 2016.
[25] ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.
[26] Ibid.

sold by the aggregator. NAB also has white-label arrangements with aggregators that it does not own. The share of the NAB-funded white-label mortgages sold by this group was much smaller than that of the NAB-owned aggregators—ranging between 0.3% and 2.3% (compared to between 8% and 10% for NAB-owned aggregators).

(c) The share of loans funded by Macquarie that originated from aggregators in which it held ownership stakes was 23.4% for Yellow Brick Road (entirely white-label), 6.3% for Vow Financial Pty Ltd, 5.2% for Australian Finance Group Ltd[27] and 4.4% for Connective, compared to its overall market share of 4.8%.[28]

Lenders used by aggregators and brokers

63 While there are generally a large number of lenders available on aggregator panels, REP 516 found that brokers generally distributed loans to a significantly smaller number of lenders.

Aggregators

64 On average, aggregators sent loans to 29 lenders in 2015, with a range of between 17 and 42 lenders. These figures remained stable from 2012.

65 However, a reasonably small number of lenders accounted for most of the loans provided by each aggregator. On average, in 2015 aggregators sent approximately 22% of loans to their most commonly recommended lender. The second and third lenders received 17% and 12% of loans, respectively. Overall, 80% of loans (by value) were distributed across seven lenders.

66 The lenders that received the most loans from aggregators tended to be major banks.

Brokers

67 Broker businesses on average sent almost 40% of loans to their most commonly recommended lender. The second and third lenders received 21% and 13%, respectively. Overall 80% of loans (by value) were distributed across four lenders. These figures are calculated at the broker business level; the concentration at an individual broker level may be higher.

68 This indicates that, while an aggregator may have a large panel of lenders, brokers are more likely to send loans to a small number of lenders. Broker

[27] Macquarie previously owned a minority shareholding in Australian Finance Group Ltd; however, it divested this share in September 2016.

[28] ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.

businesses' most commonly recommended lenders tended to be the major banks.[29]

69 The major banks accounted for 74% of brokers' most commonly recommended lender, and 61% of the second most commonly recommended lender.

Access to aggregator panels

70 REP 516 identified that customer-owned banking institutions (mutual banks, credit unions and building societies) appear on fewer aggregator panels than larger lenders.

71 This may reflect a number of factors, including the cost and/or resources required from lenders to join a panel or the choice of an aggregator to limit its panel to a selection of lenders. On this basis, the customer-owned banking institutions will have access to fewer brokers.

72 Where small lenders do appear on an aggregator's panel, the remuneration practices used by larger lenders make it difficult for small lenders to compete. Large lenders were found to offer larger volume-based commissions and soft-dollar benefits to brokers.[30] In contrast, small lenders were found to offer more campaign-based commissions[31] compared to larger lenders.[32] While this helps smaller lenders gain market share, this may result in conflicts of interest in brokers' choice of lender.

73 Our proposal (see proposal 5 in REP 516) to implement a new public reporting regime may help improve competition in the home loan market by providing increased transparency into the operations of the market. We have proposed that public reporting data should be introduced on remuneration received by aggregators, the pricing of mortgages originated through brokers, the pricing of mortgages funded by lenders through each distribution channel, and the distribution of broker-originated mortgages across all lenders.

International insights

United Kingdom

74 In December 2016, the UK's Financial Conduct Authority (FCA) commenced a market study, due to be released in early 2018, into

[29] In this context, the sub-divisions of major banks count as a separate lender. A white-label home loan offered by the aggregator also counts as a separate lender.

[30] ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.

[31] Campaign-based commissions are additional commissions paid by lenders or aggregators on top of the usual upfront and trail commissions.

[32] ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.

competition in the mortgage sector. The FCA will examine whether mortgage brokers, price comparison websites[33] and mortgage calculators help consumers to make better decisions. Analysis will also review whether commercial arrangements between lenders, brokers and other market players (e.g. real estate agents) lead to conflicts of interest or misaligned incentives that are detrimental to consumer outcomes.

75 In 2015, mortgage brokers in the UK were responsible for around 70% of home loan sales by value (67% by number). Mortgage broker remuneration models include upfront commissions from the lender, fees for service from the consumer, or a combination of both. Fees for service paid by the consumer of between £200 and £500 have become more common, often together with an upfront commission paid by the lender. The typical upfront commission amount in the UK is lower than in Australia (at around 0.4% of the loan value) and, unlike Australia, there are no trail commissions.[34]

Regulatory reform

76 In REP 516, we made several proposals to address our concerns relating to ownership and remuneration structures in the mortgage market. The Government consulted on the proposals until 30 June 2017 and is currently reviewing submissions.

77 In 2016, the *Retail banking remuneration review* (the Sedgwick review) made 21 recommendations, some of which relate specifically to mortgage brokers. It recommended that lenders cease providing volume-based commissions, non-transparent soft-dollar payments, and bonus commissions linked to sales campaigns. It also recommended that lenders adopt remuneration structures that are not directly linked to loan size.

78 In March 2017, APRA announced measures to moderate the growth in interest-only loans, which are perceived to be more risky than principal and interest loans. APRA also restated its expectations that lenders ensure the loan serviceability metrics they use are set at appropriate levels for current conditions. Our REP 516 found that many lenders utilise benchmark expense measures such as the Household Expenditure Measure, which tends to understate the average consumer’s expenses. The Government also announced new powers for APRA over the provision of credit by non-ADI lenders and to issue geographically based restrictions on the provision of credit where it deems appropriate.

79 In May 2017, the ACCC received a Ministerial direction to conduct an inquiry into residential mortgage products. As part of the inquiry, the ACCC

[33] Price comparison websites are a type of online search engine that consumers can use to search, filter and compare products based on price, features, reviews and other criteria. They are generally a free service to consumers.
[34] ASIC, Report 516 *Review of mortgage broker remuneration* (REP 516), March 2017.

can require relevant ADIs to explain changes or proposed changes to residential mortgage pricing, including changes to fees, charges or interest rates.

Credit cards

Key points

The credit card market has a large number of competing providers and products. However, the four major banks account for around three-quarters of credit card transactions.

Reforms in 2015 opened up access to MasterCard and Visa systems, reducing barriers to entry.

Competition among credit card providers has focused on balance transfers, rewards programs and sign-on bonuses, and not ongoing interest rates.

Overview

80 ASIC has primary responsibility for the regulation of consumer credit, including the sale and distribution of credit card products. Businesses that provide credit cards to consumers must have an Australian credit licence and comply with obligations contained in the National Credit Act.

Products and services in the market

81 Credit cards can be broadly categorised as low-rate cards or rewards cards. Low-rate cards offer a simple credit facility and are significantly cheaper than rewards cards. Rewards cards generally have higher rates and fees than low-rate cards, but also offer additional features such as insurance and frequent flyer miles.

82 A wide array of promotional features are offered by credit card providers, including discounted balance transfers, introductory interest-free periods, and a large number of rewards programs.

83 As of June 2017, there were approximately 16.7 million credit card accounts in Australia. Over the previous 12 months there were on average 218.4 million credit card transactions per month, with an average monthly value of $26.6 billion.[35]

[35] RBA, *Payments data—C1: Credit and charge statistics*, June 2017.

Major players and concentration

84 As at June 2017, Bankcard, MasterCard and Visa transactions accounted for 87% of the number of transactions and 81.3% of the value of purchases. American Express and Diners Club accounted for the remaining 13% of transactions and 18.7% of the value of purchases.[36]

85 Based on credit card debt outstanding with ADI lenders as at June 2017, the four major banks account for 82.5% of the market, with Citigroup (11.6%), HSBC (2.2%) and Macquarie (1.4%) holding smaller market shares. The 10 largest providers account for 99% of credit card debt outstanding with ADIs.[37]

86 Large non-bank credit card providers include American Express and Latitude Finance. However, there is limited data on the market share of non-ADI providers.

87 Reforms implemented in 2015 allowed non-ADI lenders to access MasterCard and Visa systems, significantly reducing barriers to entry for new card providers.

88 A number of comparison websites are available for consumers to compare credit card pricing and features. Comparison websites are generally free to use for consumers and contribute to reduced search costs. However, consumers may not be aware these sites may not compare all products in the market, and in some cases are remunerated by participating lenders based on click-throughs and successful conversions.

Competition issues

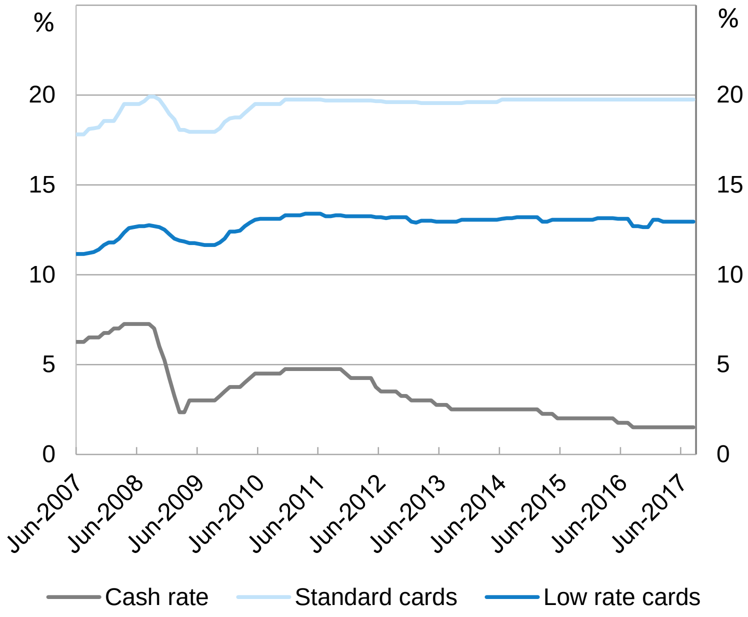
Lack of price-based competition

89 Treasury's consultation paper released in May 2016[38] found a lack of competition regarding ongoing interest rates in the credit card market. The consultation paper noted that competition appears most intense around product features such as balance-transfer offers, interest-free periods on purchases and rewards programs.[39] To attract new business, many card providers also offer to waive annual fees for the first year or give sign-on bonuses in the form of frequent flyer points. These are typically funded by interchange fees, which are often passed on to merchants and consumers.

[36] RBA, *Payments data—C2: Market shares of credit and charge card schemes*, June 2017.
[37] APRA, *Monthly banking statistics*, Table 2, June 2017.
[38] Treasury, *Credit cards: Improving consumer outcomes and enhancing competition*, May 2016.
[39] Ibid.

90 The lack of competitive pressure on interest rates is at least in part due to consumers' disengagement with this feature, and/or their optimism that they will always pay off their credit card debts.[40] Furthermore, the widening margin between credit card interest rates and the cash rate does not appear to have placed significant pressure on credit card balances: see Figure 3. In fact, the growth in credit card repayments has significantly outstripped growth in total credit card balances in recent years. This is also reflected by the flat to falling value of total balances accruing interest.

Figure 3: Credit card interest rates and the cash rate



Source: RBA, *Interest rates: Indicator lending rates—F5*, August 2017.

91 As at June 2017, year-on-year growth in average monthly repayments was around 4.5%, compared with 1.2% for the overall balance and a small drop of 0.1% in interest-accruing balances. The situation was quite different in late 2007, as the global credit crunch was unfolding. At that time, repayments were increasing at a rate of around 10%, compared with around 12% for both interest-accruing and total balances.[41]

92 There is also some research that consumers tend to exhibit bimodal tendencies in their credit card repayment behaviour. One study in the US found that only 10% of all repayments fell between 20% and 99% of the balance outstanding, indicating that the majority of consumers either only paid close to the minimum required amount or the full amount.[42]

[40] Ibid.
[41] RBA, *Payments data—C2: Market shares of credit and charge card schemes*, June 2017.
[42] B Keys & J Wang, 'Perverse nudges: Minimum payments and debt paydown in consumer credit cards', meeting papers (323), *Society for Economic Dynamics*, 2014.

Product complexity and bundling

93 The complexity of credit card product features such as discounted balance transfers, annual fees, interest-free periods, and rewards programs can render product comparison extremely difficult.

94 Many credit cards represent a bundle of products and services, including transaction and borrowing services, insurance products (travel, payment protection and extended warranties), and loyalty programs such as frequent flyers or other rewards. This results in higher complexity for consumers when comparing products. While the increasing prevalence of comparison websites may assist consumers in comparing credit card products, these websites may not compare all products in the market, and in some cases are remunerated by the credit card providers for successful conversions.

International insights

95 The UK's Financial Conduct Authority (FCA) completed a credit card market study in 2016.[43] The study found that competition between credit card providers in the UK was focused on product features such as introductory promotional offers and rewards, with less competitive pressure on interest rates outside of promotional offers.

96 It was noted that a large segment of consumers had persistently been in debt for three or more years, making only minimum repayments for that time, and suggested that card providers lacked incentives to help customers out of persistent debt. A range of potential remedies and improvements to the existing regime were proposed, including legislative changes, industry-led actions, and testing behavioural nudges for consumers.

ASIC actions and regulatory reforms in this market

97 We are currently conducting a review in relation to credit cards, with a focus on consumer outcomes and the repayment experience (including for balance transfers). Data will be collected from 12 credit card lenders during 2017–18.

98 Following the Senate Inquiry into Credit Card Interest Rates in 2015, the Australian Government announced two phases of proposed reforms to improve consumer outcomes in the credit card market. Phase 1 includes:

(a) requiring credit licensees to assess the suitability of the credit card (for responsible lending purposes) based on the consumer's ability to repay the credit limit within a reasonable period specified by ASIC;

[43] FCA, *Credit card market study: Final findings report* (PDF 1.3 MB), MS 14/6, July 2016.

(b) prohibiting all unsolicited offers of credit limit increases;

(c) simplifying interest calculations, particularly where a consumer previously had the benefit of an interest-free period; and

(d) requiring lenders to provide online options for cancelling cards and reducing credit limits.

99 Phase 2 consists of a range of behavioural interventions, with the Government undertaking behavioural testing with consumers to determine efficacy in the Australian market and to ensure they are designed for maximum effect. The phase 2 proposals (subject to consumer testing) include requiring issuers to:

(a) provide information on the annual cost of a consumer's credit card use and to prominently display annual fees;

(b) clearly disclose in advertising and marketing material a card's interest rate and annual fee;

(c) provide information about potential savings when switching to lower cost products;

(d) provide consumers with timely electronic notifications regarding the expiry of introductory offers and credit use; and

(e) provide consumers with alternative payment tools, and proactively contact consumers who are persistently making small repayments.[44]

Payday loans

Key points

In 2015 the Government commissioned an independent panel to review the small amount credit contract (SACC) laws, with the panel being asked to take into account competition issues. The Government has accepted many of the recommendations, which it is looking to progress through this year.

The Government announced that it will conduct a further review of the SACC laws three years after the commencement of the new legislative changes.

Overview

100 SACCs, a form of high-cost short-term lending, are unsecured loans to consumers of up to $2,000 where the term of the contract is between 16 days and 12 months and the credit provider is not an ADI.

[44] Treasury, *Credit cards: Improving consumer outcomes and enhancing competition*, May 2016, p. 2.

Note: In this submission we refer to 'small amount credit contracts' as 'payday loans' and the Australian credit licensees that provide these loans as 'payday lenders'.

101 In 2010 responsible lending provisions commenced which prescribe that credit licensees (including payday lenders) must not enter into a credit contract with a consumer, suggest a credit contract to a consumer or assist a consumer to apply for a credit contract if the credit contract is unsuitable for the consumer. ˙

102 To address 'specific risks of financial detriment or harm to consumers through the use of high-cost credit,'[45] the *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (the Enhancements Act) introduced caps on costs for credit contracts. This included a cap on the maximum amount a consumer can be charged under a payday loan (an establishment fee of 20% and a monthly fee of 4% of the amount of credit provided when the loan is established).

103 In 2015, the Government commissioned an independent review of the payday lending laws (the SACC review), as required under the National Credit Act. The terms of reference for the review included that it take into account competition.[46]

104 The Government will conduct a further review of the SACC laws three years after the commencement of the new legislative changes

The current payday lending market

105 The SACC review found there is little price competition in the payday lending market, with most payday lenders charging the maximum allowable rate and consumers more likely to be attracted to advertising on the speed they will receive funds.[47]

106 While data is limited, our review into the payday lending market in 2014 assessed 13 lenders who accounted for more than 75% of payday loans made to consumers.[48]

107 ASIC's review of the payday lending sector in 2014 found that approximately 70% of payday lenders included in the review indicated that they had diversified their business since the Enhancements Act commenced in 2012. This diversification includes expanding their loan book to provide credit products such as medium amount loans, and operating another

[45] Revised Explanatory Memorandum to the Consumer Credit Legislation Amendment (Enhancements) Bill 2012 (revised Explanatory Memorandum), paragraph 5.6.
[46] Treasury, *Terms of reference: Review of certain provisions of the National Consumer Credit Protection Act 2009 (Review of the small amount credit contract laws)*.
[47] Treasury, *Review of the small amount credit contract laws: Interim report* (PDF 601.14 KB), December 2015.
[48] ASIC, *Review of the small amount credit contract laws: Submission by the Australian Securities and Investments Commission*, October 2015, p. 13.

business such as pawn broking or gold buying (which are not regulated under the national credit regime).[49]

108 In 2015 ASIC collected data on the payday lending industry covering the 2014–15 financial year. This data indicated that:

(a) Over $831 million was provided via nearly 1.5 million payday loans; and

(b) The average payday loan was for $568 with an average term of 50 days.

109 ASIC has observed a continuation of this diversification with payday lenders continuing to increase their focus on medium amount loans, albeit to a similar consumer base to those it provides payday loans to.

Regulatory reform

110 In August 2015, the Government announced an independent review of the SACC laws, including in its terms of reference that the review take into account competition.

111 The final report was presented to the Government in March 2016. The Government supported the majority of the recommendations of the Review, which are expected to be progressed through 2017.[50]

112 Key recommendations accepted by the Government include:

(a) the protected earnings amount, which limits repayment amounts (relative to the consumer’s income) that payday lending consumers can be required to make, be extended to cover all consumers and reduced from 20% of gross income to 10% of net income;

(b) payday lenders be prohibited from making unsolicited payday loan offers to current or previous customers; and

(c) ASIC be given power to modify the requirements for the warning statement that payday lenders are required to display to maximise its impact on consumers.

113 The Government has also announced that it will conduct a further review of the SACC laws three years from the commencement of these legislative changes.

[49] ASIC, Report 426 *Payday lenders and the new small amount lending provisions* (REP 426), March 2015, p. 8.
[50] The Hon Kelly O’Dwyer MP, *Government response to the final report of the review of the small amount credit contract laws*, media release, 28 November 2016.

Consumer leases

Key points

Competition issues in the consumer lease market include a lack of price competition, price dispersion, a lack of transparency regarding pricing and add-on services.

The Government supports the proposal of the review of the small amount credit contract laws and regulated consumer leases to introduce a cap on total payments on a consumer lease. This should alleviate some concerns regarding the lack of price competition.

Overview

114 The Australian consumer leasing industry provides consumers with access to a range of household and electronic goods. Consumer leases allow consumers to lease an item, with ownership resting with the provider of the lease, until the term of the lease finishes and the item is returned to the lessor.

115 Consistent with other credit providers, providers of regulated leases must meet the requirements of the National Credit Act, including licensing, responsible lending and external dispute resolution scheme membership.

116 In 2015, the Government announced a review of the small amount credit contract laws contained in the National Credit Act and regulated consumer leases (small amount credit contracts review).[51] For consumer leases, the Government has announced its support for the recommendations, including:

(a) introducing a cap on the total payments on a consumer lease;[52] and

(b) lessors cannot require consumers to pay more than 10% of their net income in rental payments for consumer leases.[53]

117 These changes are expected to come into effect in 2018. The cap on total payments should alleviate some concerns regarding the lack of price competition, which we identified in the course of our regulatory work: see paragraph 127.

[51] Treasury, *Review of small amount credit contract laws*.

[52] The cap on the total payments that can be charged on a consumer lease are based on a multiple of the base price of the goods, determined by adding 4% of the base price for each whole month of the lease term to the amount of the base price. This will mean, for example, a cap of 1.48 times of the base price of the goods for a 12-month lease and 1.96 times the base price of the goods for a two-year lease. Leases of four years or more would be subject to a cap of 2.92 times the base price of the goods.

[53] The Hon Kelly O’Dwyer MP, *Government response to the final report of the review of the small amount credit contract laws*, media release, 28 November 2016.

Products and services provided by the market

118 The key characteristics of a consumer lease are:

(a) it is a contract for the hire of goods (hired wholly or predominantly for personal, domestic or household purposes) where the consumer will pay more than the cash price of the goods;

(b) the lease term is for a defined period and is for a term longer than four months; and

(c) the consumer does not have a contractual right or obligation to purchase the goods at the end of the lease period.[54]

119 Consumer leases for household goods generally have a term between two and four years. At the conclusion of the lease consumers have the option to continue the lease, enter into a new lease arrangement or return the goods to the lessor.

Major players and concentration

120 In 2016, approximately 155 credit licensees identified as being a consumer lease provider.

121 IBISWorld estimates the consumer lease industry will generate revenues of $636 million in 2017–18, up 6.7% from the $596 million generated in 2016–17. Profit is estimated to be around $113 million in 2017–18.[55]

122 The small amount credit contracts review noted a large portion of consumer leases of household goods are provided to financially vulnerable consumers through Centrepay,[56] which accounts for more than half of the Australian consumer leasing market. Centrepay deductions for consumer leases of household goods in the six months to December 2015 were equal to around $160 million.[57]

123 The consumer lessor market is concentrated with the largest player holding an estimated 30% of market share, by account numbers; the largest three players hold an estimated 60% market share.

124 Consumer lessors generally have one of the following business models:

(a) operating lessors are self-branded stores from which consumers can lease goods, with operating lease providers offering real leases in the

[54] If there is a right or obligation to purchase the goods at the end of the lease this would be the sale of goods by instalment and the contract is considered a credit contract.

[55] IBISWorld, *Home appliance rental in Australia*, IBISWorld industry report OD5467, August 2017.

[56] Centrepay is a voluntary deduction service for Centrelink recipients. It deducts certain payments, such as payments for consumer leases of household goods, before the consumer receives their Centrelink income.

[57] Treasury, *Review of the small amount credit contract laws: Final report*, March 2016, p. 45.

sense that they have goods for consumers to lease, and provide delivery and repair services; or

(b) finance lessors enter into arrangements with retailers (e.g. Harvey Norman) for the lessor's services to be offered in-store to finance goods purchased by consumers.

125 The differences between these two business models mean that financing lease providers have lower operating costs, higher margins and higher profitability.

Competition issues

126 In the course of our regulatory surveillance work of the consumer lease market we identified a number of competition-related concerns. The recommendations from the review into small amount credit contracts may mitigate some of the concerns regarding a lack of price-based competition and price dispersion.

Lack of price competition

127 There appears to be little price competition in the consumer lease market. Our review of the cost of consumer leases for household goods found that total lease costs by some lessors were up to five times the value of the leased good.[58] The small amount credit contracts review found in almost all instances lessors charge in excess of the 48% annual percentage rate cap that applies to most credit contracts (but not to consumer leases).[59]

Price dispersion

128 In a well-functioning market, the gap between prices offered by different suppliers should be small, with consumers favouring lessors who charge lower prices over those charging higher prices.

129 Our market surveillance of the consumer lease industry, shown in REP 447, found that there was significant variation in the prices charged by lessors. For example, we found household goods with a retail price of:

(a) less than $100—fortnightly rental payments ranged from $2.10–$11.90 (representing a 467% difference in costs);

(b) $479–$500—fortnightly rental payments ranged from $21–$49.90 (a 138% difference in costs); and

[58] ASIC, Report 447 *Cost of consumer leases for household goods* (REP 447), September 2015.
[59] Treasury, *Review of the small amount credit contract laws: Final report*, March 2016, p. 46.

(c) $997–$1,000—fortnightly rental payments ranged from $45.50–$61.90 (a 36% difference in costs).[60]

130 Our previous experience with small amount credit contracts suggests the charging of high costs by some lessors is partly driven by the inability of consumers to exert competitive pressure on lessors through informed choice and switching to more cost effective leases.

131 Our surveillance of the consumer lease market also identified that consumers in remote communities had been subject to higher prices due to a lack of local competition. Some lessors operate in remote and Indigenous communities where consumers have limited access to other suppliers (and financiers) of goods.

132 The proposed introduction of a cap on costs for consumer leases, if implemented, should prevent outlier lessors from charging exorbitantly high amounts. However, it is likely that all lessors will charge the maximum amount the cap allows, as has been observed in the payday lending market.

Non-transparent pricing

133 Information asymmetries exist in the consumer lease market, with lessors having access to information about the retail cost of the items and the additional amount that they are charging to the consumer. This information is not transparent or readily available to consumers, impeding informed choice and decision making.

134 In addition, lessors have an incentive to exploit consumers’ biases in their marketing by focusing on short-term costs rather than overall costs. This makes it difficult for consumers to compare prices and opt for cheaper leases.

135 The current disclosure requirements in the National Credit Code facilitate this because:

(a) lessors are not required to disclose the retail price of the leased goods—so the consumer cannot, without making further inquiries, assess the total amount payable relative to the retail price;

(b) lessors are not required to disclose a comparative cost—there is no obligation to disclose the cost of a lease as an interest rate, which would otherwise enable consumers to compare the cost of different leases;

(c) lessors are not required to provide consumers with a comparison of how changing the lease term affects the total cost; and

[60] ASIC, Report 447 *Cost of consumer leases for household goods* (REP 447), September 2015.

(d) lessors are required to only inform consumers of the total cost in the lease agreement, which typically occurs just before entering into the contract (i.e. the point when the consumer has already made a purchasing decision and is largely committed to entering into the lease).[61]

136 This lack of pricing transparency and exploitation of consumer biases inhibits informed decision making and reduces the ability of consumers to apply competitive pressure on the lessor through switching or purchasing goods outright.

Add-on services

137 Many lessors require consumers to purchase add-on insurance or similar add-on services (such as delivery, installation, ongoing maintenance and repairs) as a condition of entering into the lease.[62]

138 Our research into add-on products in other markets indicates that consumers can often be sold add-on products that they do not need or understand, and may offer poor value.

139 We have concerns because:

(a) many add-on insurance or warranty products have very low claims ratios and are likely to be of limited value to consumers;[63]

(b) the add-on insurance products may hold limited benefits to consumers who already hold other insurance products, such as home contents insurance;

(c) the risk of poor or unfair practices at the point of sale can have a higher impact on low-income consumers who may be less likely to negotiate the terms of the transaction; and

(d) there is little information available for the consumer to assess the value offered by any add-on products (e.g. by understanding the extent to which they may need to rely on these services) or whether that value is proportionate to the retail price of the goods.[64]

End-of-lease options

140 Many consumer leases provide the leased goods to the consumer at the end of the lease without actually giving the consumer a right or obligation to purchase the goods.

[61] See s174(1)(f) of the National Credit Code.

[62] Treasury, *Review of the small amount credit contract laws: Interim report*, December 2015.

[63] One lessor advised ASIC that only 95 claims were paid in relation to over 77,000 debt waiver products sold during one calendar year.

[64] Treasury, *Review of the small amount credit contract laws: Interim report*, December 2015.

141 Typically, lessors arrange for the consumer to retain possession of the goods at the end of the lease contract, using three approaches:

(a) a rent-to-buy model, under which there is an expectation, but not a contractual right, that the consumer will be able to buy the goods at the end of the lease for a token or nominal amount (sometimes $1);

(b) a gift model, under which the lessor agrees that the leased goods can be gifted to a third party nominated by the consumer; and

(c) an upgrade model, under which the consumer upgrades to a new contract and is able to keep the goods leased under the previous contract.

142 The distinction in the credit legislation between consumer leases (currently with no cost cap), and contracts for the sale of goods by instalment (with a 48% cost cap), has led to regulatory arbitrage and creates an uneven playing field for lease providers compared to other credit contract providers.

143 It is uncertain whether the proposed cap on consumer leases will address this issue because there are still different rates that apply between consumer leases and credit contracts.

144 We are currently requesting data from lessors to consider how different end-of-lease options affect consumers and will look to measure any harms resulting from these different options.

Book up: Credit provision in remote communities

Key points

Book up is an informal form of credit, particularly used by those living in regional and remote communities across Australia.

A key component in the prevalence of book up in remote communities is the lack of access to a range of more suitable financial products that can be accessed easily, quickly and at low cost.

We think it is important to consider how to increase the availability of fair and affordable financial products and services in regional and remote areas across Australia.

Overview

145 Book up is an informal form of credit, particularly used by those living in regional and remote communities across Australia. It allows customers to obtain goods or services immediately, and pay for them later. This is often provided in communities where other sources of financial services are not available.

146 Book up is most commonly available at general stores for the purchase of inexpensive items, like groceries. However, it is sometimes used to purchase more expensive items, such as cars.

147 Assessing the true extent of book up is difficult because it may be provided covertly. Our regulatory surveillance indicates book up is found across most states and territories in Australia, predominantly in remote communities, and is entrenched in the communities in which it is found.

Products and services

148 Although book-up practices vary from store to store, commonly book-up providers:

(a) require customers using book up to leave their debit card at the store at which the book up is taking place;

(b) sometimes ask a customer to disclose their PIN;

(c) enter into a book-up agreement verbally only, with little or no documentation involved;

(d) reduce outstanding balances by using the debit card and PIN to deduct payments as funds become available in the customer’s account; and

(e) allow a customer to book up further items while previous book-up debts remain outstanding.

Regulatory and licensing regime

149 There is no specific legislation that prescribes the manner in which book-up services in Australia must operate. Depending on the way a particular book-up service operates it may be captured by legislation, including the ASIC Act or the National Credit Act.

150 Most forms of book up will meet the relatively broad definition of a financial product under the ASIC Act. This means that the provision of a book-up service is usually subject to a prohibition on engaging in unconscionable conduct and a prohibition on harassment and coercion in connection with the supply of credit or financial services.

151 In contrast, the types of credit activities subject to regulation under the National Credit Act are strictly defined. For a book-up service to be captured by the provisions of the National Credit Act, the debt must:

(a) be deferred for a period of at least 62 days; and

(b) attract credit fees and charges that exceed 5% of the amount of credit provided or have interest charges that exceed an amount equal to the amount payable if the annual percentage rate were 24%.[65]

152 There are substantial evidentiary barriers to ASIC establishing that a book-up provider is offering credit that is regulated by the National Credit Act. Where book-up providers have minimal or no record-keeping practices it can very difficult to establish:

(a) the terms of the agreement; or

(b) that there is charge being imposed for providing credit.

Competition issues

Location and lack of access to alternatives

153 A key component in the prevalence of book up is the lack of access to a range of more suitable financial products that can be accessed easily, quickly and at low cost.

154 Where a book-up service is the only financial service available for a consumer to access, there is little opportunity for the consumer to negotiate the terms of the credit facility.

155 Our review of book up in Indigenous communities in Australia[66] noted a number of respondents to our survey mentioned that payday loans are available in their communities, but these tended to be very high cost. They also had the effect of leading people into a cycle of debt. Other respondents noted the availability of Centrelink lump sum advance payments as a very useful service. However, this advance has eligibility and availability criteria and therefore might not be an option for many people.[67]

156 REP 451 found book-up customers are also often reluctant to complain about poor book-up service for fear of losing access to the only financial service available to them and the lack of information regarding customers' rights and provider obligations contribute to the persistence of book up.[68]

157 In our enforcement action against book up providers for unconscionable practices, we have seen consumers often being sold low quality items at prices far above fair market value.

[65] Nathan Boyle, 'Book up: Current regulation and options for reform', *Indigenous Law Bulletin*, vol. 8(22), 2016, pp. 4–5.
[66] ASIC, Report 451 *Book up in Indigenous communities in Australia: A national overview* (REP 451), October 2015.
[67] Ibid., p. 23.
[68] Ibid., p. 24.

Potential reforms

158 We think it is important to consider how to increase the availability of fair and affordable financial products and services in regional and remote areas across Australia. This could be done by incentivising the provision of financial services in underserviced regions, or by increasing the availability of government and community sector lending programs in these regions.

Small business loans

Key points

The small business lending market is concentrated, with the big four banks holding around 85% of market share.

There was a notable slowdown in small business lending during the global financial crisis, reflecting, among other things, higher interest rates for small businesses and tighter lending standards. Small business lending growth is slower than in the period before the global financial crisis.

The market for small business loans generally has higher interest rates than large business lending. In addition, it has more impediments to competition than most other lending markets, including greater information asymmetries, difficulty in comparing lending products, and impediments to switching.

Overview

159 In Australia, there are more than two million small businesses that employ more than seven million people and account for more than half of total non-financial business income.[69,70] The growth and success of the small business sector is integral to the ongoing prosperity of the Australian economy.

160 Small businesses tend to have access to fewer sources of financing than large businesses as information asymmetries make it more difficult and costly to assess the risks involved in lending to small business.[71] In addition, small business lending is more concentrated than large business lending and most types of consumer lending.

[69] ABS, *Counts of Australian businesses, including entries and exits, June 2012 to June 2016*, Cat. No. 8165.0, 21 February 2017.

[70] RBA, *Small business conditions and finance*, March 2015.

[71] RBA, *First round submission to the Financial System Inquiry*, 2014.

Regulation of small business lending

161 Small business lending is regulated by ASIC and the ACCC. ASIC is responsible for the enforcement of the Corporations Act and is governed by the ASIC Act. The ACCC is responsible for the enforcement of the *Competition and Consumer Act 2010*.

162 The law provides the highest level of protection to individual consumers borrowing for household and domestic purposes and the lowest level of protection to commercial loans, including loans to small businesses.

163 Lenders that provide loans to consumers must have an Australian credit licence, and must be a member of an external dispute resolution (EDR) scheme. Lenders that only provide commercial loans are not required to have a credit licence, and are not required to be a member of an EDR scheme. The ASIC Act does provide some general protections for commercial borrowers. In particular, it prohibits unconscionable conduct (actions or behaviour that go against good conscience) and misleading or deceptive conduct.

Trends in small business lending

164 There is no universally accepted definition of a ‘small business’ and consequently there are multiple measures of small business lending in Australia.[72] For this analysis we have adopted a measure used by the RBA based on the size of loans to businesses, where it is assumed that business loans provided by banks of less than $2 million are generally provided to small businesses, while loans larger than $2 million are assumed to finance larger corporations.[73]

165 Based on this definition, as at March 2017, total small business loans by banks amounted to roughly $272 billion, about 29% of total business lending.[74]

166 There was a notable slowdown in small business lending during the global financial crisis,[75] reflecting among other things higher interest rates for small

[72] Definitions that have been used to define small businesses include characteristics like legal structure, number of employees, revenue, size of balance sheet, and other financial and economic characteristics. For example, in the context of the unfair contract term protections for standard form small business contracts, a small business means a business that employs fewer than 20 people at the time the contract is entered into, where the upfront price payable under the contract does not exceed $300,000—or $1 million if the contract is for more than 12 months; the ABS defines a small business as all entities that are independent and privately owned, are managed by an individual or a small number of people, and have less than 20 employees; and the Australian Taxation Office defines a small business entity as an individual, partnership, company or trust that is carrying on a business and has less than $2 million in aggregated turnover.

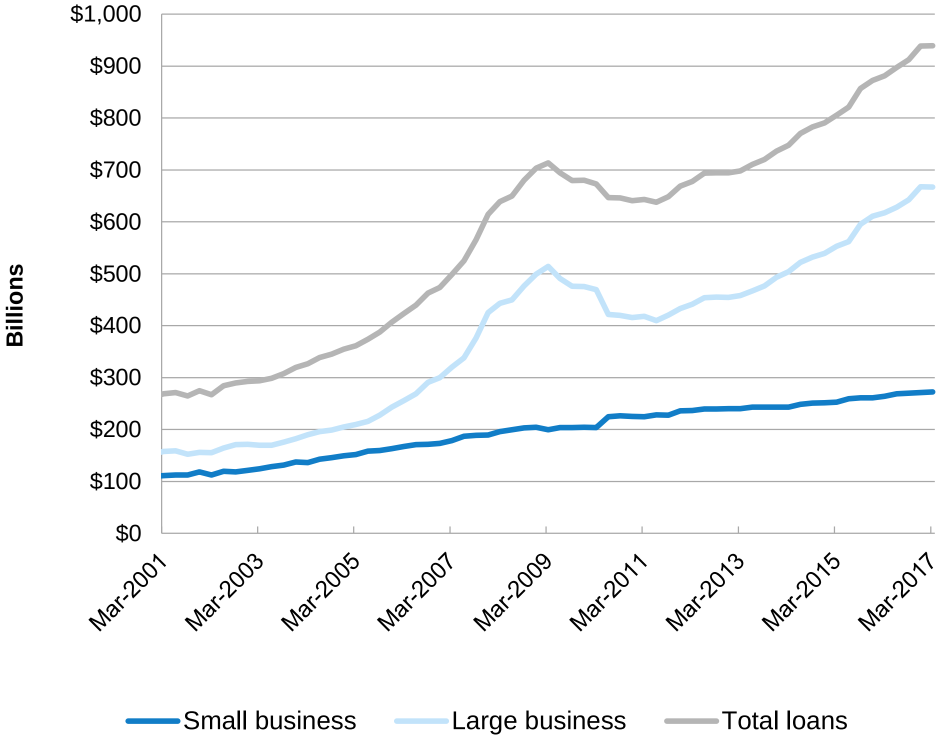
[73] RBA, *Submission to Parliamentary Joint Committee on corporations and financial services inquiry into access for small and medium business to finance*, 2011.

[74] RBA, Money and credit statistics, *Bank lending to business: Selected statistics—D8*, March 2017.

[75] Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into access for small and medium business to finance*, 2011; RBA, *Submission to Parliamentary Joint Committee on corporations and financial services inquiry into access for small and medium business to finance*, 2011.

business and tighter lending standards. Small business lending growth is still slower than before the global financial crisis.

Figure 4: Bank lending to small and large business ($billions)



Source: RBA, Money and credit statistics, Bank lending to business: Selected statistics—D8, 15 June 2017.

Products and services provided by the market

167 Businesses use a combination of debt and equity to fund their operations. Small businesses rely mainly on loans from banks and other financial institutions for their debt funding because it is difficult and costly for them to raise funds directly from debt capital markets. Most lending to small businesses is secured against residential property.[76]

168 Nearly half (around 49%) of small business loans from banks are variable loans, 36% are fixed rate and 15% are bank bills.[77]

169 The Australia Bankers' Association (ABA) estimates that around 70% of small businesses have some credit facility, and there are about 1 million loans provided to small businesses.[78]

[76] RBA, *Submission to Parliamentary Joint Committee on corporations and financial services inquiry into access for small and medium business to finance*, 2011.
[77] RBA, Money and credit statistics, *Bank lending to business: Selected statistics—D8*, March 2017.
[78] ABA, *The small business sector in Australia: Economic report*, May 2016.

170 The most commonly utilised sources of credit by small business are credit cards (used by 53% of small business), overdrafts (24%), long-term loans (15%), property mortgages (14%) and lines of credit (9%). Other types of small business lending include, but are not limited to, commercial bills, short-term loans, trade finance, and debtor and invoice finance.[79]

171 The RBA's submission to the Financial System Inquiry noted that individual consumers have access to an extensive range of products and providers. For example, there are more than 500 standard variable mortgage products from more than 100 providers available, and more than 1,500 term deposit products from over 80 providers. In contrast, small businesses have significantly less choice, with only about 35 small business loan products from around 20 providers.[80]

Major players and concentration

172 While there is limited data on the market share of small business lending, as at September 2010, the big four accounted for about 86% of the total value of business loans smaller than $2 million, compared with 74% of larger loans (greater than $2 million). The smaller domestic banks account for most of the remaining lending to small businesses, while foreign-owned banks provide only a small share, in part because they do not have a substantial branch network.[81]

173 The major banks' share of outstanding loans rose following the global financial crisis as they continued to lend to small businesses, while other financial institutions scaled back their operations. Moreover, during the global financial crisis a number of major banks acquired smaller lenders, leading to higher concentration in the business lending market.[82]

Marketplace lending

174 Marketplace lending offers consumers and small to medium-sized enterprises (SMEs) an alternative source of funding to traditional bank loan channels.

175 The marketplace lending sector is relatively new in Australia, with most marketplace lending operators having commenced operations after 2014.[83]

176 Based on ASIC's 2016 survey of nine marketplace operators (representing the majority, but not a census of the industry), we found that:

[79] Ibid.
[80] RBA, *First round submission to the Financial System Inquiry*, 2014.
[81] RBA, *Submission to Parliamentary Joint Committee on corporations and financial services inquiry into access for small and medium business to finance*, 2011.
[82] RBA, *First round submission to the Financial System Inquiry*, 2014.
[83] Deloitte, *Marketplace lending: A temporary phenomenon? An analysis of the UK market*, 23 May 2016.

(a) marketplace lenders operate in varying loan markets—some focused on consumer loans, some on business loans to Australian SMEs and others lending to particular industry sectors;

(b) over 2015–16, approximately $156 million in loans were written to borrowers, consisting of approximately $130 million to consumer borrowers and $26 million to business borrowers;

(c) loan terms ranged from three months to 15 years and loan amounts for businesses ranged from $2,001 to $3 million, while loans to consumer borrowers typically ranged from $5,000 to $80,000;[84]

(d) approximately 80% of the total loans outstanding attracted interest rates on both business and consumer loans of between 8% and 14.99%; and

(e) as at 30 June 2016, there were a total of 7,448 borrowers, (consisting of 7,415 consumer borrowers and 33 business borrowers).[85]

Competition issues

177 The market for small business loans generally has higher interest rates than large business and mortgage lending. In addition, it has more impediments to competition than most other lending markets, including greater information asymmetries, difficulty in comparing lending products and impediments to switching.

178 Technological advances and financial innovation can help to increase transparency and reduce information asymmetries. Additionally, growth in market-based financing, such as marketplace lending and crowd-sourced equity funding, may provide alternatives for the funding of small businesses.

Information asymmetry

179 The Murray Inquiry noted that information asymmetry is the most significant structural factor contributing to the higher cost and lower availability of credit for SMEs and is a significant barrier to competition in SME lending.[86]

180 Lenders typically have limited information regarding the performance of the small business borrower, may lack specialist knowledge of the conditions and industry the small business operates in, and the behaviour of the owners is difficult to assess. Banks may have to invest resources to acquire sufficient information to make a well-informed lending decision, which increases the cost of assessing and approving a loan application. When lenders are unable

[84] Small amount credit contracts are loans to consumers of up to $2,000, where the term of the contract is between 16 days and 12 months and the credit provider is not an ADI.

[85] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.

[86] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014, p. 2–62.

to access sufficient information to make a proper assessment, this leads to higher provisioning and higher loan costs for the borrower.[87]

181 In addition, this information asymmetry is a barrier to entry because new small business lenders are required to build knowledge and networks across a number of diverse markets to accurately price small business loans.

Barriers to switching

182 There is limited data on small business credit switching rates, both among credit products and providers.

183 ASIC's 2008 consultation with small business representative groups highlighted that small business may have problems accessing credit for a variety of reasons, including:

(a) a concern that small business credit products are complex and difficult to understand and compare;

(b) some stakeholders commented on the difficulty in accessing small amounts of finance; and

(c) concern that barriers exist to switching banks, with stakeholders commenting that these barriers were both perceived and actual with many practical obstacles such as costs and time delays.

184 The UK's Competition and Markets Authority (CMA) review into retail banking services found that search costs are high and switching rates are low for SME lending: see paragraphs 185–190.[88]

International insights

185 The CMA review into retail banking found that competition in the UK for both business current accounts (BCAs) and SME lending is not working well for customers, partly due to weak levels of engagement and switching.

186 For SME lending the review found:

(a) around 90% of SMEs went to their main bank for overdrafts, general purpose business loans and credit cards;

(b) over two-thirds of SMEs went to their main BCA bank for invoice discounting and factoring, and more than three-quarters for commercial mortgages; and

(c) over half of SMEs considered only one provider when seeking lending.[89]

[87] Ibid.
[88] CMA, *Retail banking market investigation: Summary of final report* (PDF 642.87 KB), 9 August 2016, pp. 25, 32 and 33.
[89] Ibid., pp. 25–6.

187 The review noted that a number of factors contributed to low engagement and limited switching with SME lending, including:

(a) SMEs value the relationship with their bank and believe that loyalty to their main bank will help them obtain finance. In addition, an SME's main bank will have more information on its customers, which enables the main bank to price credit more accurately, and potentially make lending decisions more quickly.

(b) SMEs may not consider providers other than their main bank because of the time and effort involved in applying for finance from other providers, particularly when finance is needed at short notice.

(c) It is difficult for SMEs to compare prices, eligibility and other terms across banks. Prices are opaque and lending products are complex. In addition, there is a lack of tools to help SMEs make comparisons, which may particularly affect smaller SMEs without specialist financial capability.[90]

188 The combination of these factors mean there is weak customer response to price and quality, weakening the constraints on banks from customer switching, or the threat of switching.

189 The CMA's report noted that the level of innovation in SME banking is low compared to consumer banking services and there has been little product innovation. Where there has been, innovation has tended to focus on the digitalisation of banking and reducing customer reliance on branches.[91]

190 The review recommended, among other things, a number of remedies to address these concerns, including:

(a) development of comparison services for SMEs;

(b) publication of SME lending product providers; and

(c) the development of an SME loan price and eligibility tool.[92]

ASIC's work and regulatory reform

191 Small businesses often have limited power in negotiating credit contracts and limited ability to vary 'take it or leave it' contracts. This may reduce small business demand for credit and their ability to access credit on fair terms.

[90] Ibid., p. 26.
[91] Ibid., pp. 32–3.
[92] Ibid., p. 51.

192 In recognition of this, the unfair contract term protections for consumers were extended to cover standard form small business contracts entered into, or renewed, on or after 12 November 2016, where:

(a) the contract is for the supply of financial goods or services;

(b) at least one of the parties is a 'small business' (i.e. a business employing fewer than 20 people, including casual staff employed on a regular and systematic basis); and

(c) the upfront price payable under the contract does not exceed $300,000 (or $1 million if the contract is for longer than 12 months).

193 In May 2017, the big four banks committed to a series of comprehensive changes to ensure all small business loans entered into or renewed from 12 November 2016 will be protected from unfair contract terms, following a round table hosted by ASIC and the Australian Small Business and Family Enterprise Ombudsman (ASBFEO).[93]

194 In August 2017, ASIC and the ASBFEO welcomed the changes agreed to by the big four banks to eliminate unfair contract terms from their small business loan contracts.[94]

195 After working with ASIC, the big four banks agreed to make the following changes to their small business loan contracts:

(a) ensuring the loan contracts do not contain 'entire agreement clauses' or similar terms that absolve the bank from responsibility for conduct, statements or representations they make to borrowers outside the written contract;

(b) a limitation on the operation of the banks' indemnification clauses—for example, the banks will now not be able to require their small business customers to cover losses, costs and expenses incurred due to the fraud, negligence or wilful misconduct of the bank, its employees or a receiver appointed by the bank;

(c) removal of clauses that gave banks the power to call in a default for an unspecified negative change in the circumstances of the small business customer (known as 'material adverse change event' clauses), so that the banks will not have the power to terminate the loan for an unspecified negative change in the circumstances of the customer; and

(d) a limitation on the banks' ability to vary contracts to specific circumstances, and where such a variation would cause a customer to want to exit the contract, the banks will provide a period of between 30 and 90 calendar days for the small business customer to do so.

[93] ASIC, Media Release 17-139 *ASIC and ASBFEO hold banks to account on unfair contract terms*, 16 May 2017.
[94] ASIC, Media Release 17-278 *Big four banks change loan contracts to eliminate unfair terms,* 24 August 2017.

196 The four banks agreed to take slightly different approaches in relation to:

(a) specific events of non-monetary default—that is:

(i) whether certain specific events are remediable by the small business customer; and

(ii) how to adopt a material credit risk threshold—by either including a credit risk-related materiality element in the definitions of specific events and/or by applying the materiality credit risk filter (i.e. so that a breach of a specific event creates a material credit risk or a material security loss to the lender before the breach can be treated as a default event); and

(b) financial indicator covenants (FICs) (e.g. loan-to-valuation ratio)—and whether they will apply the materiality credit risk filter to the use of the FICs so that a breach of an FIC presents a material credit risk to the lender (i.e. the risk of a monetary default or of the lender being unable to recover the amount of the facility from the secured property), before the lender can treat that occurrence as an event of default.

197 ASIC also supports the recommendations made by the Khoury review in relation to small business loan contracts. The additional protections for small business borrowers proposed by the Khoury review are consistent with the recent ASBFEO's inquiry into small business loans.[95]

[95] ASBFEO, *Inquiry into small business loans*, February 2017.

Appendix B: Insurance

Key points

The general insurance industry is concentrated. Concentration has increased over the past two decades in line with the decline in the number of general insurers. The life insurance market is less concentrated than the general insurance market; however, the number of life insurers has nearly halved over the past two decades.

Technology, innovation and access to granular customer data are changing the nature of risk pricing in many insurance markets and may be a key driver of competition in insurance markets in the future.

198 The role of insurance is to assist individuals and corporations to price, manage and transfer risk. Insurance companies also aggregate savings and allocate these funds toward entities in need of capital.

199 The insurance sector includes:

(a) general insurance—104 general insurers covering personal and commercial lines;

(b) life insurance—28 life insurers offering risk products (death, disability and income protection) and investment products; and

(c) a reinsurance market.[96,97]

200 Insurance companies manage risk, through risk pooling and sharing individual risks among a group of similarly exposed individuals and companies. Risks may also be mitigated by preventive action, sold into capital markets, absorbed by government or simply borne by individuals themselves.[98]

201 For the year ended 30 June 2017, general insurers reported net earned premiums of $31.8 billion (up 5.3% over the previous corresponding period (pcp)) and generated a return on net assets of 10.8% (up 0.4 percentage points over the pcp).[99]

[96] APRA, *Quarterly general insurance performance statistics*, June 2017, and APRA, *Quarterly life insurance performance statistics*, June 2017.
[97] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014.
[98] Insurance Council of Australia, *Submission to the Financial System Inquiry.*
[99] APRA, *Quarterly general insurance performance statistics*, June 2017.

202 For the year ended 30 June 2017, life insurers reported total revenue of $34.0 billion (21.3% higher than the pcp), and generated a net return on assets of 9.5% (down 2.6 percentage points over the pcp).[100]

203 APRA is the Commonwealth authority responsible for licensing and prudential regulation of general and life insurance companies, and supervises the industry through prudential standards and prescribed reporting.

204 ASIC regulates conduct and disclosure of insurance product issuers and distributors. The Corporations Act—administered by ASIC—requires general and life insurance product issuers and distributors (insurance brokers) to hold an AFS licence.

205 Competition issues in the insurance sector may include high concentration (particularly in general insurance), high barriers to entry (commercial and regulatory), multi-branding and white-labelling which could reduce transparency for consumers, and low product comparability. However, innovations and an increasing amount of granular data on consumers are also changing the nature of the insurance industry and warrant consideration.

206 Below we describe various competition issues relating to insurance, noting the limited scope of the Productivity Commission's inquiry in relation to insurance.[101]

General insurance

Key points

The general insurance market, particularly for personal insurance lines, is concentrated; however a number of newer entrants into the sector have grown their market share in recent years. They have done this by focusing on innovative product design and customer service.

Technology, innovation and access to granular data are changing the nature of risk pricing in insurance markets and will affect the nature of competition in insurance.

In addition to concentration, barriers to entry, and a lack of transparency and comparability, are important competition issues to consider.

[100] APRA, *Quarterly life insurance performance statistics*, June 2017.

[101] The consultation paper noted: 'to avoid overlap with other active reviews, this inquiry will consider superannuation and insurance products only in so far as they affect competition between banks and other financial service providers, including as part of vertically and horizontally integrated business models'.

Regulation and licensing

207 APRA is responsible for licensing and prudential regulation of general insurers and supervises the industry through prudential standards and prescribed reporting. ASIC is the conduct and disclosure regulator for general insurance product issuers and product distributors.

Products and services provided by the market

208 The major general insurance cover types are domestic and commercial motor vehicle insurance, home and contents insurance, fire and industrial insurance, compulsory third party (CTP) motor insurance, public and product liability insurance, professional indemnity, employers liability insurance and mortgage insurance.

209 Domestic motor vehicle insurance is the most common form of insurance accounting for almost 25% of net earned premiums over the year to June 2017. This is followed by home and contents insurance (21%), CTP motor vehicle insurance (12%), fire and industrial insurance (9%), and commercial motor vehicle insurance (7%).[102]

Major players in the market and concentration

210 As at August 2017 there were 104 general insurers licensed to operate in Australia (94 direct general insurers and 10 reinsurers). This is down from 133 direct insurers and 31 reinsurers 20 years ago.[103]

211 The general insurance industry is concentrated, and concentration has increased over time in line with the decline in the number of general insurers.

212 The four largest firms, Insurance Australia Group Limited, Suncorp Group Limited, QBE Insurance Group Limited and Allianz Australia Limited, accounted for approximately 77% of the market by gross earned premiums for the calendar year 2016. The top 10 institutions in terms of net earned premiums make up 97% of the market.[104]

213 Concentration is more evident in the personal-line insurance market compared to the commercial insurance market. In addition, competition in the general insurance market varies notably across geographic territories. For example, there is significantly more competition in low claim markets such as the northern Sydney motor insurance market compared to low

[102] APRA, *Quarterly general insurance performance statistics*, multiple tables.
[103] APRA, *Quarterly life insurance performance statistics*, June 2017.
[104] APRA, *Quarterly general insurance performance statistics*, Table 1A.

competition in high claim markets such as the North Queensland home insurance market (north of the so-called 'Bundaberg line').

214 While the overall general insurance market is quite concentrated, there has been increased competition from newer players in recent years, including Youi, Hollard and Progressive.[105] These entities focus on innovation in product design, distribution and customer experience. They are leveraging evolving customer expectations and digital technology to differentiate their products.[106]

General insurance distribution

215 As at 31 December 2016, there were 1,645 intermediaries licensed to conduct general insurance business. Of these, 814 intermediaries (49%) placed business with underwriters between 1 July 2016 and 31 December 2016.[107]

216 Intermediaries placed $7.8 billion in premiums with APRA-authorised general insurers in the six months to 31 December 2016. This represented approximately 41% of the $18.8 billion total premiums written by APRA-authorised general insurers in the same period.[108]

217 IBISWorld estimates that of the $12.5 billion revenue in the insurance brokerage sector, 47.5% ($5.94 billion) relates to private and commercial general insurance products.[109]

Innovation

218 'Insurtech' refers to those firms creating new platforms for underwriting, claims handling, distribution and brokerage, as well as enhancing customer experiences and software-as-a-service to help incumbents deal with legacy IT issues.[110] Although insurtech has been relatively slow off the mark in Australia, globally it has begun to attract significant amounts of venture capital funding (up to US$2.5 billion in the 2015 calendar year, and US$1 billion in the first half of 2016).[111]

219 The growing trend towards the use of 'telematics' in insurance (i.e. technology that allows for the long distance transmission of computerised information) is giving insurance companies access to large amounts of data on their policy holders in real-time. Wearable health technology and devices

[105] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014, p. 2–39.
[106] PwC, *Insurance facts and figures*, May 2016.
[107] APRA, *Intermediated general insurance statistics*, December 2016.
[108] Ibid.
[109] IBISWorld, *General insurance in Australia*, IBISWorld industry report K6322, September 2017.
[110] CB Insights and KPMG, *The pulse of fintech, Q2 2016* (PDF 2.71 MB), 17 August 2016.
[111] Ibid.

placed inside automobiles are able to transmit information to insurers on policy holder habits, thereby enhancing insurers' ability to profile a customer, and accordingly re-price their insurance policy more efficiently.

220 As technology evolves, the nature of competition in the insurance industry is being altered. Some of the challenges include:

(a) big data and robo-advice have the potential to disrupt many distribution channels;

(b) the shifting of liability—for example, driverless car technology will shift liability from drivers to manufacturers; and

(c) telematics, and big data more generally, will enable granular individual-based pricing but will flatten the spread of insurance premiums and may undermine risk pooling, and for some consumers, especially those predisposed to higher risk factors, affordability could become an issue.

Considerations on competition

Barriers to entry

221 As with banking, the main barriers to entry in insurance are commercial rather than regulatory.[112] Incumbents benefit from well-established brands, large customer bases and distribution networks.

222 It is often difficult for potential entrants to distribute their own insurance due to the costs involved in establishing their own distribution channels. Gaining access to broker channels can also be difficult. Commercial lines of insurance do not have the same features as personal insurance, as business is dominated by intermediary distribution channels such as brokers.

223 Consequently, new entrants will need to approach the broker market, establish a relationship and offer highly competitive terms to acquire new business. Furthermore, since the major players and their respective brands have built up many years of goodwill and brand loyalty in Australia, new entrants may face difficulty in building a customer base.

224 Accessing and maintaining adequate capital is another barrier to entry. Insurers need considerable capital to underwrite risk and APRA imposes capital requirements on insurers as part of the prudential regulation regime.

Multi-brand strategies

225 The major insurance product issuers operate primarily as insurance groups, with each owning a portfolio of brands. This can give consumers the

[112] Ibid.

perception of having choice despite the products actually being controlled by a few key players. Many major brands are ultimately controlled by just two companies: Suncorp and Insurance Australia Group who, for example, account for 70% of market share for motor insurance between them.

Lack of transparency and comparability

226 The general insurance industry in Australia is characterised by a large number of policies which include varied conditions, inclusions, exclusions and definitions. In addition, policy terms are not consistent among insurers. This lack of standardisation makes it more difficult for retail customers to compare prices and level of cover.

227 In addition, the *Financial System Inquiry: Interim report* noted the main issue in submissions regarding insurance sector competition relates to aggregator access to information. Insurers in the home and contents and car insurance markets have been reluctant to share their product information with aggregators, slowing their growth. As a result, consumers in these markets must compare products without the assistance of aggregators, which may reduce price competition.[113]

International developments

228 The FCA's market study into general add-on insurance products found, among other things, that consumers have substantial difficulty comparing different insurance policy terms and insurer practices (with both add-on insurance products and some stand-alone general insurance products).

229 To address this, the FCA has piloted the publication of value measures data, which includes claims frequencies, claims acceptance rates and the average claims pay-out by insurer. This applies to four general insurance products: home insurance, home emergency insurance, personal accident insurance and key cover insurance. The FCA expects that the use of the published data by consumer groups, market commentators and the firms themselves will improve transparency in these markets.[114]

[113] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014, p. 2–40.
[114] FCA, *Financial Conduct Authority publishes general insurance value measures scorecard*, 25 January 2017.

Add-on insurance sold through car dealerships

Key points

Add-on insurance refers to insurance products that are added to the sale of another product that is the primary focus of the consumer.

For add-on insurance products, particularly those sold through car dealerships, we have identified a number of competition issues. These include high levels of concentration among product issuers, reverse competition, a lack of transparency around products and pricing, and sales tactics that limit a consumer's ability to compare products.

In August 2017 we released a consultation paper proposing a range of possible regulatory reforms to promote effective competition for the benefit of consumers in the add-on insurance market. These proposals include a deferred sales model, minimum product features to be provided by each type of product, and a cap on sales commissions paid to distributors.

230 Where add-on insurance is sold through car dealerships, the dealerships act as authorised representatives of an insurer, and function as a distribution channel for insurance products.

231 Car dealerships determine the insurers whose products will be offered to consumers. Dealerships typically have distribution agreements with only one or two insurers, with the primary insurer having first right of refusal—that is, the application for an add-on product should only be directed to another insurer if they refuse to accept the risk.

232 In 2016, ASIC undertook a review into the sale of add-on insurance through car dealerships.[115] This review focused on add-on insurance sold to consumers when they purchase a new or used car, covering risks related to the car itself or to a credit contract where the consumer took out a loan to buy the car.[116]

233 The review identified a number of issues that indicate competition is not delivering good consumer outcomes. These include evidence of reverse competition, little price competition, and the sales process inhibiting informed choice and decision making by consumers (see paragraphs 45–58 of REP 492). Insurers sell add-on products under general advice or no-advice distribution models, which means their representatives are under no obligation to sell a product that meets the needs of the consumer.

[115] ASIC, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492), September 2016.
[116] Ibid.

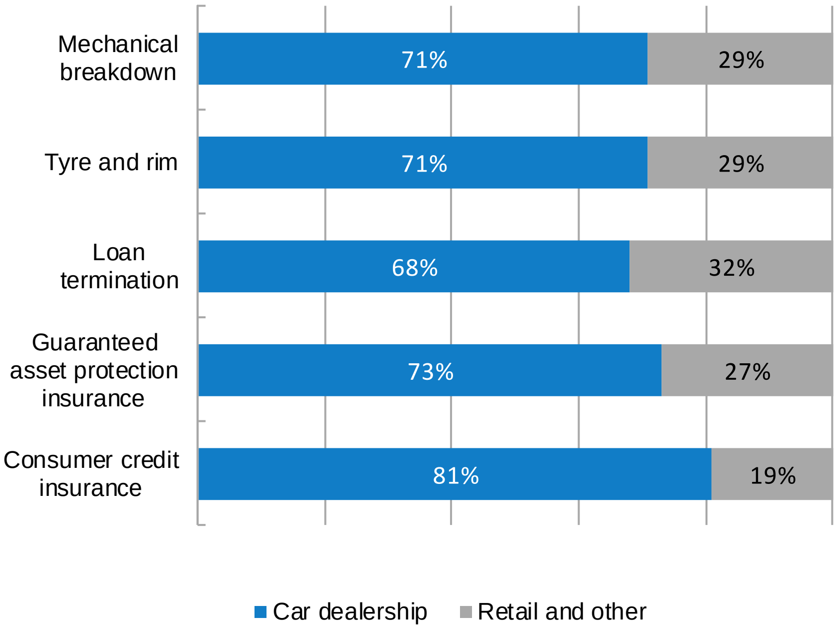
234 We have proposed a number of regulatory reforms to deliver better consumer outcomes and improve competition in the market for add-on insurance products. These include a deferred sales model, as discussed in detail in Consultation Paper 294 *The sale of add-on insurance and warranties through caryard intermediaries* (CP 294), released for public comment on 24 August 2017.

Major players and concentration

235 The add-on insurance market is concentrated. In REP 492, we reviewed seven insurers who issue add-on insurance products, which were estimated to account for over 90% of the add-on insurance market.[117]

236 The sales of add-on insurance products are typically arranged by car dealers that are paid commissions by insurers. Of the five main add-on insurance products in the market, we found that, on average, 75% (by dollar value) was distributed through car dealerships: see Figure 5.[118]

Figure 5: Proportion of add-on insurance products sold through car dealers (by dollar value, FY2013–15)



Source: ASIC, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492), September 2016.

[117] Ibid. These insurers include: Aioi Nissay Dowa Insurance Company Pty Ltd, Allianz Australia Insurance Limited, Eric Insurance Limited, Swann Insurance (Aust) Pty Ltd (part of Insurance Australia Group), MTA Insurance Limited (part of AAI Limited, which is owned by Suncorp Group Limited), NM Insurance Pty Ltd (acting as an agent for AAI Limited) and QBE Insurance (Australia) Limited).

[118] ASIC, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492), September 2016, p. 5.

Products and services

237 The most common add-on insurance products sold through car dealerships are, in order of total premiums paid during FY2013–15 (largest to smallest): guaranteed asset protection (GAP) insurance, consumer credit insurance (CCI), mechanical breakdown insurance, loan termination insurance, and tyre and rim insurance.

238 Our review found for these five add-on insurance products, sold by the seven largest add-on insurance providers, premiums were $1.6 billion and claims paid to consumers were $144 million over FY2013–15. This represents a claims ratio of 9%,[119] which is substantially lower than other general insurance products, such as car insurance (85% claims ratio), home insurance (55% claims ratio) and travel (44% claims ratio): see Table 1.[120]

Table 1: Premiums, claims and claims ratios for add-on insurance products FY2013–15

Product	Premiums ($)	Claims ($)	Claims ratios
CCI	$506.8 million	$25.3 million	5.0%
GAP insurance	$631.1 million	$39.9 million	6.3%
Loan termination insurance	$98.1 million	$4.3 million	4.4%
Tyre and rim insurance	$42.7 million	$3.7 million	8.6%
Mechanical breakdown insurance	$321.4 million	$70.8 million	22.0%

Source: ASIC, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492), September 2016.

Note: Some products were excluded as sales had only commenced after the 2013 financial year, which does not allow sufficient time to reflect claims for a multi-year product. Due to this, CCI data is based on 12 products across six insurers (two products excluded); GAP insurance data is based on nine products across six insurers (three products excluded); and loan termination insurance is based on two products across two insurers (one product excluded).

Competition issues

Reverse competition

239 In the add-on insurance market, we identified reverse competition occurring. This is where insurers compete on commission payments to car dealers to

[119] The claims ratio is the percentage of premiums paid in claims.

[120] ASIC, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492), September 2016, p. 14.

buy access to distribution channels, rather than competing on price and product features for the benefit of consumers.

240 Car dealerships generally have exclusive distribution agreements with one or two insurers. This arrangement generates a monopoly or duopoly setting for consumers at the point of sale. Consumers are often unaware that they can buy add-on insurance products from other providers at a later date.

241 Where reverse competition becomes embedded throughout an industry it is very difficult for any one firm to not participate, as they will suffer a competitive disadvantage if they refuse to pay commissions at similar levels to those of other firms. It is highly unlikely that these collective practices will cease unless there is a motivated and strong industry body or regulatory intervention.

242 REP 492 noted for add-on insurance products sold through car dealerships, insurers paid very high commissions (including up to 79% of the premium) to car dealers arranging the sale of add-on insurance products. In total, of the $1.6 billion of add-on insurance premiums generated, insurers paid $602.2 million in commissions to car dealers and only $144 million to consumers in claims. Car dealers earned four times more in commissions than consumers received in claims.[121]

243 ASIC also identified concerns regarding reverse competition in our review of CCI products sold through car dealerships.[122] We found the effect of this competition would be to increase the price paid by the consumer (as insurers would need to recoup the commissions paid to car dealers).

244 We note that the effect of reverse competition in the CCI market has been a long-standing issue. In Australia its impact was identified as early as 1991, with a review by the former Trade Practices Commission finding that competition tended to take the form of insurers increasing CCI delivery costs (including agents' commissions), rather than reducing premiums.[123]

Low price competition

245 Our review into the sale of add-on insurance products sold through car dealerships (REP 492) also found evidence of little or no competition on price. Insurers were able to charge significantly different prices for the same product. The sales environment for these products inhibits informed consumer decision making.

[121] Ibid., p. 7.
[122] See ASIC, Report 471 *The sale of life insurance through car dealerships: Taking consumers for a ride* (REP 471), February 2016.
[123] Trade Practices Commission, *The market for consumer credit insurance*, June 1991, p. 61. In the American context, see G Fagg, *Credit life and disability insurance*, Clico Management, Springfield, Ohio, 1986, p. 503.

246 For example, the lack of price competition for add-on insurance products resulted in the following practices:

(a) *dual pricing*: four of the seven insurers charged higher premiums to consumers using a product for business use, while also paying higher commissions to car dealers (an average of 36% for CCI and 46% for loan termination insurance, compared to 20% for personal-use products), even though the insurance product was exactly the same; and

(b) *discretionary pricing*: we found one insurer charged consumers different prices for the same product with the price varying between different car dealers (so consumers could pay nearly 10 times more for the same product). [124]

247 ASIC has also measured differences in price between add-on insurance products and those for products where insurers are selling products in a competitive market. We compared the cost of two similar life insurance products:

(a) life cover under a CCI product, based on a loan of $50,000 over four years; and

(b) term life insurance based on the cost of purchasing insurance of $50,000 for a four-year period.

248 CCI and term life insurance can be compared in this way because they are similar products in that they:

(a) insure the same risk (of the insured person dying) with similar exclusions; and

(b) have similar, straightforward application processes with minimal eligibility requirements.

249 The cost of term life insurance varies according to age, gender and smoking habits. We therefore used the cost of term life cover for:

(a) a low-risk insured person (a 20-year-old female non-smoker); and

(b) a medium-risk insured person (a 40-year-old male smoker).

250 These similarities minimise any distortions in the price comparison based on the type of cover being offered. Table 2 summarises the findings from REP 471 on the price difference between these two products in dollar terms and with the cost of the cheaper product (term life) as a percentage of the cost of CCI life.

[124] ASIC, Report 492 *A market that is failing consumers: The sale of add-on insurance through car dealers* (REP 492), September 2016, p. 14. We identified similar concerns in our review into life insurance sold through car dealerships: see REP 470.

Table 2: Price comparison of products sold in competitive and non-competitive markets (FY2013–15)

Pricing	Personal-use CCI life cover	Term life: 20-year-old female non-smoker	Term life: 40-year-old male smoker
Cheapest	$1,120	$147 (13%)	$537 (47%)
Most expensive	$1,675	$382 (22%)	$1,278 (76%)
Average	$1,373	$243 (17%)	$763 (55%)

Source: ASIC, Consultation Paper 294 *The sale of add-on insurance and warranties through caryard intermediaries* (CP 294), August 2014.

251 The findings in Table 2 show that the absence of any need to compete on the cost of CCI sold through caryard intermediaries means that:

(a) for a low-risk insured person, the term life product is between 13% and 22% of the price of CCI life cover; and

(b) for a medium-risk insured person, the term life product is between 47% and 76% of the price of CCI life cover.

252 The price comparison is subject to qualifications in that:

(a) some insurers have subsequently reduced their prices, as a result of our review; and

(b) the level of cover under a CCI life policy reduces over time as the loan balance goes down (so that, for example, in the last month of the policy, if the insured dies the insurer will probably only have to pay a few hundred dollars to discharge the loan), whereas the level of cover under a term life policy remains constant (so that if the insured dies the same amount will be paid, irrespective of the date of death).

Lack of transparency and ability to compare products

253 We have concerns about the sales practices used to sell add-on insurance products, given the conflicts of interest created by high commissions and the lack of information to assist consumers in making informed decisions. This is exacerbated because all insurers sell add-on products under general advice or ‘no advice’ distribution models, where sales staff can promote the product but cannot tell the consumer whether or not it is suitable or meets their needs.

254 REP 492 found the sales process used by insurers was complex, requiring the consumer to make multiple decisions on minimal information without the cost of the cover being clearly disclosed. For example, consumers were asked to make decisions about buying up to nine different products with up to 41 different combinations of cover available within those products.

255 REP 470 also found that add-on insurance products were generally discussed with consumers after vehicle selection, after they have made an emotional investment in the purchase. Consumer decision fatigue and information overload inform how delaying the offer of add-on insurance works to 'nudge' consumers to purchase this insurance.

256 For consumers, this sales context limits their capacity to assess the value of the products or seek out alternative, less expensive products. In particular, the consumer is focused on the purchase of the car, rather than associated insurance. This limits the consumer's ability to place demand-side pressure on providers of add-on products sold through insurance channels.

International insights

257 A study by the FCA found that delaying the offer of add-on insurance can impact on, among other things, the take up of, and price paid for, insurance.[125] Having expended significant time and cognitive resources reaching the decision to buy a vehicle, consumers are faced with many (often unexpected) subsequent offers for add-on products, and are generally not made aware that add-on products are available from alternative providers, and can be purchased at a later date.

258 In the UK, a deferred sales mechanism has been introduced in relation to a single add-on insurance product, gap insurance. Consumers are provided with specified disclosures at the point of sale and only contacted after they leave, so as to allow time for the consumer to consider their need for the offered products.[126] This mechanism seeks to increase competition in the add-on insurance market by reducing the market power of point-of-sale distributors, while also supporting consumer decision making.

259 Since the deferred sales model was introduced, we understand that:

(a) it has had a negligible impact on the price of GAP insurance, with the amount charged for the average premiums largely unchanged (premiums in the UK are typically lower than in Australia);

(b) it has resulted in a minor reduction in the volume of face-to-face sales through car dealerships (with a fall in sales of approximately 6% in 2016 against small increases in the number of cars sold);

(c) some insurers have increased the cover offered, so that there may be an increase in the claims ratios over time; and

(d) there has been little change in the volume of online sales.

[125] FCA, *How does selling insurance as an add-on affect consumer decisions? A practical application of behavioural experiments in financial regulation*, Occasional Paper No. 3, March 2014.

[126] Competition Commission (now located at National Archives UK), *Market investigation into payment protection insurance* (PDF 2.56 MB), January 2009, p. 9.

ASIC actions and regulatory reforms in this market

260 In early 2017, ASIC chaired an Add-on Insurance Working Group to analyse current industry practices. Following the publishing of ASIC's reports, insurers accepted that there was a need for change and voluntarily lowered the sales commission rates and premiums on their add-on insurance products.

261 In August 2017 we released Consultation Paper 294 *The sale of add-on insurance and warranties through caryard intermediaries* (CP 294) proposing a range of possible regulatory reforms in this market to address the identified consumer harm and promote competition to work for the benefit of consumers in the add-on insurance market. These reforms include:

(a) a deferred sales model that inserts a pause between the sale of the motor vehicle and the insurance to facilitate improved consumer decision making; and

(b) enhanced supervision obligations on product providers.

262 Our objectives in proposing these reforms are that:

(a) add-on products should offer improved value;

(b) premiums for add-on products should be more competitive;

(c) sales processes should be fairer and assist consumers to make better decisions;

(d) add-on products that offer no benefits to consumers should not be sold and products that offer minimal benefits should be reduced; and

(e) changes should be market-wide and competitively neutral.

263 Given the limits in the impact of the UK deferred sales model in promoting online sales, CP 294 explicitly seeks a response from stakeholders addressing how consumers can be better engaged (e.g. through the use of interactive devices or technology).

264 We have specifically asked questions about the relationship between CCI and alternative products that offer similar cover and are available in competing markets (e.g. term life insurance, trauma insurance and income protection insurance): see paragraphs 230–233 of CP 294.

265 The market for term life insurance, trauma insurance and income protection insurance is well developed, with a large number of insurers offering products where the consumer can apply online. The cost of alternative products may be significantly cheaper. As noted above (see Table 2), we found that the cost of life cover under CCI products sold through caryard intermediaries compared to the price of a term life product was between:

(a) 13% and 22% of the price of CCI life cover for a low-risk insured person; and

(b) 47% and 76% of the price of CCI life cover for a medium-risk insured person.

266 We have therefore asked stakeholders to address:

(a) whether an insurer offering CCI who also offers alternative products that offer similar cover (e.g. term life insurance, trauma insurance and income protection insurance) should be required to disclose the cost of those products to the consumer; and

(b) whether all providers of add-on products should be required to inform consumers about the availability of products that are cheaper or that may offer better coverage.

Life insurance

Key points

There has been a significant decline in the number of life insurers over the last 20 years. At the start of 1997 there were 51 life insurers; however, this had almost halved to 28 life insurers at the end of 2016.

The life insurance market is less concentrated than the general insurance market and concentration has remained relatively unchanged in recent years.

We have an ongoing focus on direct life insurance sales, personal advice about life insurance and claims handling practices.

267 Life insurance is an important risk management tool for consumers, helping them to provide for their families and themselves in the event of illness, injury, disability or death. Life insurance provides support each year for thousands of consumers and their families at times of significant financial stress.

268 ASIC has an ongoing focus on direct life insurance sales, personal advice about life insurance, and claims handling practices.

Regulation and licensing

269 APRA is the prudential regulator of the Australian financial services industry, including life insurers. APRA jointly administers the *Life Insurance Act 1995* and the *Superannuation Industry (Supervision) Act 1993* with ASIC. Prudential supervision by APRA, including a licensing regime, aims to ensure that life insurers are financially sound, appropriately capitalised and have sound risk management to meet obligations to policyholders.

270 ASIC's regulatory framework for life insurance includes a licensing regime, disclosure requirements, and the requirement for parties to an insurance contract to act with the utmost good faith. Life insurers and life insurance product distributors must hold an AFS licence under the Corporations Act.

Players and concentration

271 At the end of 2016, there were 28 registered life insurers (including seven reinsurers) who generated $34.3 billion in revenue in that year.[127] These firms held approximately $224.5 billion in assets as at 30 December 2016.[128]

272 There has been a significant decline in the number of life insurers over the last 20 years. At the start of 1997 there were 51 life insurers, almost halving to 28 life insurers at the end of 2016.[129]

273 However, the life insurance market is less concentrated than the general insurance market. The level of concentration has remained relatively unchanged in recent years. The four largest life insurers accounted for 40% of net policy revenue over the 12 months to December 2016 and hold 71% of assets. The largest 10 life insurers accounted for 75% of net premium revenue and 91% of assets.[130]

274 The big four banks and a number of mid-tier banks have prominent positions in the life insurance market. This was established through a combination of organic growth and the aggregation of other life insurers, either by direct purchase or through acquisition of smaller banks that had earlier established their own life insurer brands.[131] However, recently there has been a move by some banks to reduce their exposure to underwriting life insurance risk (although they remain distributors of life insurance products).[132]

Products and services

275 The four most common types of life insurance products are life cover (also known as term life insurance or death cover), total permanent disability (TDP) cover, trauma cover (sometimes called critical illness cover or recovery insurance) and income protection. Although these policies can be purchased as stand-alone products, they are often bundled. Other types of

[127] This comprised $16 billion in net policy revenue, $15 billion in investment revenue, $2.6 billion in management service fees, and $781 million in other revenue.

[128] APRA, *Life insurance institution level statistics*, June 2017.

[129] APRA, *Submission to the Financial System Inquiry*, p. 104.

[130] APRA, *Life insurance institution level statistics*, June 2017.

[131] APRA, *Submission to the Financial System Inquiry*, p. 106.

[132] For example, in June 2016, NAB sold its 80% stake in MLC Life Insurance (the rebadged joint venture of NAB/MLC's Life insurance Business) to Nippon Life. In October 2016, Macquarie Life was closed and its risk business (circa $250 million of annual inforce premiums) was sold to Zurich (the remainder of Macquarie Life's business and funds were transferred to Macquarie Group). In November 2016, ANZ announced it is looking to sell its life insurance division, OnePath, which held 8% of the life insurance market based on net policy revenue in the 12 months to December 2016.

life insurance products include funeral insurance, consumer credit insurance, investment policies, whole-of-life insurance, endowment policies and life annuities. [133]

276 As at May 2017, there were approximately 209 products in the life insurance market—158 stand-alone and 51 rider (add-on) products. These include 45 life insurance products, 22 TDP products, 32 trauma products, 42 income protection products, 22 accidental death products, 23 accidental injury products and 23 funeral insurance products.[134]

Distribution channels for life insurance in Australia

277 Life insurance is distributed in three main ways:

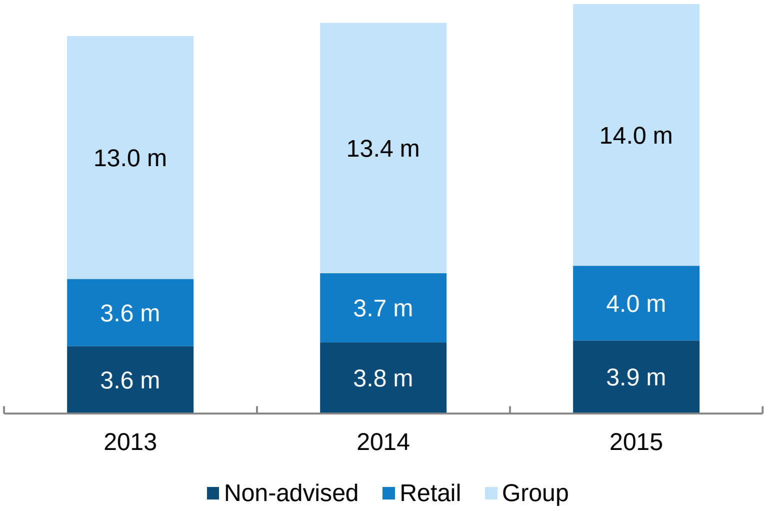
(a) *Group*: this is the most common form of distribution and is usually available through superannuation. Under this arrangement, the superannuation trustee takes out a group policy that supports the benefit provided to members of the superannuation fund. The contract, or policy, of life insurance is between the life insurer and the superannuation trustee.

(b) *Retail*: these policies are distributed by insurance brokers and financial advisers. Under this distribution model, the broker or adviser typically provides personal advice to a retail client, taking into account their situation, including their financial needs and the risks that the life insurance product should cover. The adviser also typically receives payment from the insurer in connection with the policy sale, under an arrangement that involves upfront and ongoing commissions.

(c) *Non-advised (general financial product advice and factual information only)*: a policy holder may purchase life insurance directly from a life insurer, or through a sales partner or affiliate. This distribution model includes online through websites or other digital technology, telephone sales, in branches or life insurers' partners or affiliates or other forms of advertising (e.g. mail outs):[135] see Figure 6.

[133] ASIC, Report 498 *Life insurance claims: An industry overview* (REP 498), October 2016.
[134] Strategic Insight, *Direct insurance report*, May 2017.
[135] ASIC, Report 498 *Life insurance claims: An industry overview* (REP 498), October 2016.

Figure 6: Number of policies (non-advised and retail) and members (group) by distribution channel (2013–15)



Source: ASIC, Report 498 *Life insurance claims: An industry overview* (REP 498), October 2016.

Competition issues

278 ASIC’s work on life insurance, particularly retail life insurance advice[136] and life insurance claims handling,[137] has identified concerns related to competition in the life insurance market.[138]

Product bundling and product innovation

279 While most life insurance policies can be purchased as stand-alone products, they are often bundled. For example, TDP cover is usually bundled with life cover.

280 Our review into retail life insurance advice (REP 413) noted there are sound commercial reasons for insurers to redesign policies and offer them as new bundled product combinations. An insurer may redesign policies with revised definitions and promote them to their distribution channels to win market share or attract a new segment of the market.

281 These new products may benefit the insurer by replacing high-cost legacy policies, which may have been poorly designed or underwritten, or which had unsustainably broad definitions or conditions.

[136] See ASIC, Report 413 *Review of retail life insurance advice* (REP 413), October 2014.
[137] See ASIC, Report 498 *Life insurance claims: An industry review* (REP 498), October 2016.
[138] Due to the scope of the Productivity Commission’s Inquiry, we have not included analysis on competition issues for life insurance within superannuation. Our competition concerns relate to the retail (advised) and non-advised distribution channels.

282 In addition, product innovation and bundling can be a positive for consumers. It may mean that consumers can:

(a) access new products with tailored cover; or

(b) access a broader class of products perhaps at a lower cost (e.g. if an insurer applies multi-cover discounts on premiums).

283 However, product bundling can make it more difficult for consumers to understand the cost of each product separately and compare them to other products in the market.

284 Bundled products can also inhibit switching. Consumers may not be able to exit one policy (e.g. to purchase a more affordable policy) and continue the other bundled policy (or they may lose their multi-cover discount). This is likely to lead to less switching by consumers and limited demand-side pressure for bundled life insurance products.

285 Insurers also have commercial incentives to write more business, and product innovation and bundling is seen as an important tool to gain, or re-gain, market share. [139]

Multi-branding and white-labelling

286 A number of life insurers use multi-brand strategies (e.g. Westpac Banking Group owns St George Bank and BankSA who both offer life insurance products). Others offer white-label insurance products where they are labelled with the brand of the product distributor (e.g. Swiss Re Life & Health Australia Limited is the underwriter for the Woolworths life insurance product). To consumers, there may appear to be a wider number of insurance products available in the market than there are.

Life insurance comparison websites

287 Comparison websites are a type of online search engine that consumers can use to search, filter and compare products based on price, features, reviews and other criteria.

288 For life insurers, comparison websites are a source of lead generation or the initiation of consumer interest. Insurers generally have arrangements with comparison websites under which the insurer will pay the website for click-throughs by consumers to the insurer’s website, or if a sale occurs on the comparison website the insurer may pay an upfront and trailing commission to the comparison website provider.

[139] ASIC, Report 413 *Review of retail life insurance advice* (REP 413), October 2014.

289 For consumers, comparison websites are generally a free service and are used as a primary research and reference tool when familiarising themselves with insurance products and what prices are available in the market. Comparison websites can reduce search costs and increase transparency of pricing and product features.

290 However, consumers may not be aware of the limitations of some of these services. In 2012, ASIC's review of insurance comparison websites found:

(a) Some websites only compare a limited number of brands/products from a limited number of providers. This may not be clearly disclosed, which creates the impression that the extent of comparison is much broader than it actually is. For example, Choice's review of six of Australia's largest comparison websites found these comparison websites on average compared 14 life insurers, with one comparing only six insurers, while another compared all 28.[140]

(b) In some cases, there was insufficient disclosure relating to website operators who were related to the issuer of the insurance brands being compared. For example, Choice's review found comparison website Choosi.com.au is associated with Hollard Financial Services, a major provider of life insurance, which issues 11 out of the 13 insurance brands available on the site.[141]

(c) Comparisons were provided on the basis of price without any warning that different products may have different features and levels of coverage.[142]

291 If consumers believe they are comparing all products or are unaware of the relationships between the comparison websites and product issuer, this may limit informed choice and switching among consumers and limit demand-side pressure consumers place on suppliers.

ASIC's work and regulatory reform

292 We commenced a review of direct life insurance sales in early 2017, focusing on sales practices and design features, to identify poor conduct and risks to consumers, as well as identifying 'best practice' where it is observed. We will publish the findings of our review in mid-2018.

293 Our review into life insurance claims handing (REP 498) found there is an important need for better quality, more transparent and more consistent data on life insurance claims. ASIC and APRA will work with insurers and other stakeholders during 2017 to establish a consistent public reporting regime

[140] Jodi Bird, *Comparing the comparers,* Choice, June 2017.
[141] Ibid.
[142] ASIC, Media Release (12-304MR) *ASIC warns comparison websites*, 5 December 2012.

for claims data and claims outcomes, including claims handling timeframes and dispute levels across all policy types. Data will be made available on an industry and individual insurer basis. This will help improve transparency for consumers.

294 In recent years, there has been a considerable focus on the life insurance advice industry. In response to concerns raised about the life insurance advice industry, the Government announced that it would support a reform package put forward by industry to better align the interests of consumers and advisers. The *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017* was passed by Parliament on 9 February 2017. It will commence on 1 January 2018. The Act removes the exemptions for life insurance from the ban on conflicted remuneration and gives ASIC the power to set maximum commission levels and clawback arrangements.

295 The Government has also asked ASIC to conduct a review in 2021 to establish whether the reforms have been successful in realigning the interests of advisers and consumers. If the review shows that problems continue in the life insurance advice industry, the Government will mandate a level commission structure.

296 On 14 September 2016 an inquiry into the life insurance industry was announced. The following matters were referred to the Parliamentary Joint Committee on Corporations and Financial Services for inquiry and report by 30 June 2017:

(a) the need for further reform and improved oversight of the life insurance industry;

(b) the assessment of relative benefits and risks to consumers of the different elements of the life insurance market, being direct insurance, group insurance and retail advised insurance;

(c) whether entities are engaging in unethical practices to avoid meeting claims;

(d) the sales practices of life insurers and brokers, including the use of approved product lists;

(e) the effectiveness of internal dispute resolution in life insurance; and

(f) the roles of ASIC and APRA in reform and oversight of the industry.[143]

[143] Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into the life insurance industry.

Appendix C: Funds management

Key points

Concentration varies across markets in the funds management sector. The platform, marketplace lending, and custodial service markets are quite concentrated, while the retail funds management market is less concentrated.

The wealth management sector has a high degree of vertical integration. The major banks and AMP, and a number of other wealth managers including Macquarie Group, IOOF and Perpetual, provide services including financial advice, platforms and funds management.

Funds management sector

297 The funds management sector plays an important role in Australia's financial system and broader economy.

298 Australia's managed funds sector (including superannuation) is the fourth largest in the world.[144] Funds under management grew by 9.1% ($239.2 billion) over the year to March 2017, and have increased by 53.6% ($1,002.8 billion) over the past five years, to reach $2.9 trillion.[145]

299 In Australia, 'managed funds' generally refer to 'managed investment schemes'. This is a broadly defined term under the Corporations Act encompassing most arrangements involving passive investors contributing money to be pooled, or used in a common enterprise, to produce a financial or property-related benefit to the contributor. Managed investment schemes include investor directed portfolio service-like (IDPS-like) schemes and marketplace lenders.

300 The funds management sector also includes investor directed portfolio services (IDPS) and entities that provide support and ancillary services to managed funds, such as custodians and investment consultants.

301 In the course of our regulatory work, particularly market surveillances,[146] we have identified a range of competition issues across the funds management

[144] Financial Services Council (FSC), *State of the industry 2017*, FSC/UBS Asset Management.

[145] Australian Bureau of Statistics, *Managed funds, Australia, March 2017* and *Managed funds, Australia, 8 June 2017*, Cat. No. 5655.0.

[146] See ASIC, Report 408 *Review of the implementation of RG 148: Platforms that are managed investment schemes* (REP 408), September 2014, Report 474 *Culture, conduct and conflicts of interest in vertically integrated businesses in the funds management industry* (REP 474), March 2016, and Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.

sector. These include high concentration, vertical integration—through the combination of advice, platforms and funds management into a single business—barriers to entry, and a lack of transparency around fees and pricing.

302 We have not detailed competition issues relating to the retirement savings, pensions and annuities markets as they are outside the scope of the Productivity Commission's inquiry. [147]

Retail funds

Key points

As at 30 June 2017, the retail funds market had approximately 466 responsible entities and 3,632 registered managed investment schemes. The market is not particularly concentrated with the largest 10 responsible entities holding approximately 43% of funds under management.

The wealth management sector has a high degree of vertical integration. The major banks and AMP, and a number of other wealth managers including Macquarie Group, IOOF and Perpetual, provide financial advice, platforms and funds management services.

Licensing and regulatory requirements

303 ASIC registers all managed investment schemes, except for 'private' schemes and 'wholesale schemes',[148] as 'retail' or registered schemes. ASIC also issues AFS licences to responsible entities, which are public companies that hold an AFS licence authorising them to operate schemes.[149] A retail managed investment scheme cannot operate without a responsible entity.

304 ASIC is responsible for overseeing the disclosure regime for retail managed investment schemes. Interests in a registered scheme must generally be offered to retail investors through a Product Disclosure Statement (PDS).

Products and services

305 As at 30 June 2017, the retail funds management market has approximately 3,632 registered managed investment schemes[150] spanning all asset

[147] The consultation paper noted: 'to avoid overlap with other active reviews, this inquiry will consider superannuation and insurance products only in so far as they affect competition between banks and other financial service providers, including as part of vertically and horizontally integrated business models'.

[148] 'Private' schemes are schemes with less than 20 members: see s601ED of the Corporations Act. The process of registration with ASIC is set out in Pt 5C.1 of the Corporations Act.

[149] ASIC, Regulatory Guide 166 *Licensing: Financial requirements* (RG 166), September 2017, and Pro Forma 209 *Australian financial services licence conditions* (PF 209).

[150] Some of these funds are closed to new investment.

classes.[151] Most of these assets classes are available over the counter (OTC), while a smaller number are exchange traded (ASX, Chi-X or AQUA) as ‘exchange traded products’.

Market participants and concentration

306 There are 466 responsible entities operating 3,632 registered managed investment schemes.[152]

307 For the financial year ending 2016, the annual accounts lodged with ASIC by responsible entities show the retail funds market totalled $914 billion of assets under management.[153] The largest 10 responsible entities held 43% of assets under management, while the top 20 responsible entities held approximately 61%.[154] IBISWorld estimates Australia’s big four banks account for over 60% of total funds management industry revenue.[155]

308 Larger funds benefit from economies of scale, including operational cost savings and lower expense ratios. These benefits can be passed on to investors. In addition, larger funds can often access investment opportunities that are not available to smaller funds.

309 The continuing pressures of financial advice and superannuation regulatory reforms, fee competition and emerging digital players may result in further consolidation of small fund managers and superannuation funds.

Forces affecting competition

Regulatory settings

310 Australia is a small open economy and any significant differences in our regulatory approach from overseas jurisdictions may create barriers for Australian businesses seeking to expand their operations offshore. This may also limit opportunities for investors in Australia to access international investments and reduce the sources of finance available for Australian business.

There have been recent regulatory initiatives encouraging greater competition within Australia and enabling Australian entities greater access to international markets. These include the government’s proposed Asia Region Funds Passport and the corporate collective investment vehicle

[151] These include financial assets (equities, fixed income, cash), real property, infrastructure, private equity, and more, as well as a combination of asset classes, such as diversified funds.
[152] ASIC data as at 30 June 2017 (excluding managed investment schemes in wind up or strike off).
[153] ASIC data.
[154] ASIC data.
[155] IBISWorld, *Funds management services in Australia (K6419a)*, January 2017

regime.[156] These are likely to create increased competition in the medium term as more funds under management enter Australia through international investors (through non-Australian fund managers) and as investors have access to a larger number of offshore funds.

Active and passive management

311 Consistent with the global trend, Australia is experiencing significant growth in passive investment strategies. Over the last five years Australian passive funds under management grew by approximately 84%, while actively managed funds under management grew by approximately 63%.[157] However, as at July 2017 passive investments only accounted for a relatively modest 10% of Australian funds under management.[158]

312 If the passive funds sector continues to expand, additional pricing pressure will be placed on actively managed funds.

Vertical integration

313 The Murray Inquiry noted that vertical integration is increasing in the wealth management sector, with the major banks and AMP at the forefront of this trend, combining advice, platforms and funds management into a single business. Other wealth managers, including Macquarie Group, IOOF and Perpetual, have replicated this strategy to varying degrees.[159]

314 The Murray Inquiry also that noted competition in the wealth management sector appears to be focused more on securing distribution channels and improving product features, rather than reducing fees,[160] which is limiting the benefits of competition flowing to investors.

> Note: See Section B of ASIC's main submission to the Productivity Commission's inquiry for a further discussion of vertical integration, and its benefits and challenges.

Transparency in fund objectives, performance and choice

315 Due to the large number and diverse range of retail funds available, it may be difficult for investors to compare fees and performance across funds,

[156] The Hon Kelly O'Dwyer MP, *Consultation on Asia Region Funds Passport and corporate collective investment vehicle bills*, media release, 25 August 2017.

[157] The 'managed funds market' figure includes investment trusts, investment bonds, superannuation funds and pensions, and annuities, as per Morningstar categories. 'Passive' funds were identified as per Morningstar's data field of 'index fund'. This is defined as 'a fund that tracks a particular index and attempts to match returns'. Source: © 2017 Morningstar, Inc. All rights reserved. Morningstar Direct, data accessed 4 September 2017. This information: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damage or losses arising from any use of this information.

[158] Ibid.

[159] *Financial System Inquiry: Final report* (Murray Inquiry final report), November 2014, p. 2–37.

[160] *Financial System Inquiry: Final report* (Murray Inquiry final report), November 2014, p. 2–38.

particularly with differing underlying investments and investment management styles.

316 In the UK context, the FCA's asset management market study noted that tools available to assist retail investors in identifying outperforming products, such as best-buy lists and investment consultant recommendations, often do not allow investors to identify products that on average, after fees, outperformed the stated benchmark.[161]

International insights

317 New EU legislation, MFID II, provides a revised Markets in Financial Instruments Directive (MiFID) and a new Markets in Financial Instruments Regulation (MiFIR).[162] MFID II aims to promote increased transparency of markets, a shift in trading towards more structured marketplaces, lower cost market data, improved best execution, orderly trading behaviour within markets, and more explicit costs of trading and investing.

318 Australian firms will need to ensure they are able to provide additional data for transaction and best execution reporting, and to adapt their research and compliance management, so as to meet additional disclosures and reporting demanded by their European clients and counterparts.

319 The FCA has also indicated it will undertake further competition work on the retail distribution of funds, particularly in relation to the impact financial advisers and platforms have on value for money.[163]

ASIC's work and regulatory reform

320 We have updated our main guidance (RG 97) and clarified the regulatory requirements to help improve the quality of disclosure, which will also assist to improve transparency to consumers and product comparability.[164]

321 We have also commenced a project to better understand the performance reporting practices of superannuation trustees and responsible entities to identify whether there are problems, such as inconsistencies in how fund performance is calculated and reported.

[161] Ibid.

[162] The European Parliament and the Council of the European Union, *Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU*, 15 May 2014.

[163] FCA, *Asset management market study: Final report,* Market Study 15/2.3, June 2017.

[164] ASIC, Regulatory Guide 97 *Disclosing fees and costs in PDSs and periodic statements* (RG 97), March 2017.

Platforms

Key points

As at 31 March 2017, it is estimated that the top five master fund administrators accounted for approximately 76.5% of the total $748 billion in platform funds under management.

Concentration and vertical integration is high in the platforms market. This is partly due to the high level of investment and economies of scale required to operate a successful platform in Australia.

Licensing and regulatory requirements

322 Platforms are a form of custodial, transaction and consolidated reporting services that allow investors (or their adviser) to manage and control their entire investment portfolio through one service provider.

323 Commercially, industry and investors generally refer to and understand the term ‘platforms’ to mean investor directed portfolio services (IDPSs) and IDPS-like schemes, as well as superannuation master trusts and certain other superannuation funds.[165]

> Note: ‘Platform’ is not a structure specifically recognised in legislation. Most platforms fall within the definition of a ‘managed investment scheme’. In this submission, the term ‘platform’ refers to master trusts and wrap accounts. It does not extend to nominee and custody services, superannuation master trusts or other superannuation funds, and managed discretionary accounts.

324 IDPSs are unregistered managed investment schemes for holding and dealing with one or more investments selected by investors. IDPSs allow investors the sole discretion to decide what assets will be acquired, disposed, held (by a custodian) and realised (or transferred in specie to them) through the IDPS.[166] IDPS-like schemes operate similarly to IDPSs in that investment decisions are generally made in accordance with specific member instructions, but are registered managed investment schemes.[167]

Platform products and services and competing structures

325 When a person invests through an IDPS or IDPS-like scheme, they will generally establish a personal account incorporating any chosen new investment options (and any existing investments they wish to transfer through a wrap service), and any cash into a working IDPS cash account. The IDPS cash account is then used to handle various flows of money,

[165] ASIC, Regulatory Guide 148 *Platforms that are managed investment schemes and nominee and custody services* (RG 148), September 2017.
[166] Ibid.
[167] Ibid.

including distributions of capital gains from managed funds, dividends from shares, proceeds from the sale of investments, and any payment for purchases or fees.

326 While IDPSs vary across products, generally their key features include:

(a) access to a wide variety of managed funds (including wholesale funds not easily accessible by individuals);

(b) ease of switching (between asset classes and fund managers);

(c) consolidated reporting; and

(d) flexibility to make regular contributions.[168]

327 The role of platforms is changing, with many platforms now also providing ancillary services such as risk profiling tools for analysing clients' asset allocation preferences.[169] Recent research by Investment Trends found that 80% of financial planners surveyed are looking for greater efficiency from their platforms, and around two-thirds are looking to have planner software engagement tools made available on platforms.[170]

Platform operators and concentration

328 Strategic Insight estimates the top five master fund administrators accounted for approximately 76.5% of the total $748 billion platform funds under management as at 31 March 2017. [171]

329 The Financial System Inquiry's interim report noted that the platform market had high concentration and vertical integration.[172] This high level of concentration has largely remained stable between 2014 and 2017.

330 In comparison, the FCA's recently published asset management market study reported that the top five platforms in the UK account for 62% of the UK adviser platform market, as at March 2016.[173]

331 Over the year ended 31 March 2017, Strategic Insight also estimated the top five master fund administrators accounted for approximately 45% of the approximately $16 billion total net flows to master fund administrators.[174]

[168] Ibid.
[169] FSC, *State of the industry 2017*, FSC/UBS Asset Management, 28 February 2017.
[170] Investment Trends, *Planner technology report*, June 2016.
[171] Strategic Insight defines master funds to include wraps, platforms and master trusts; wraps are master funds through which investors can invest in direct shares and generally charge one consolidated fee; platforms are master funds that have multiple divisions—generally superannuation, allocated pension and investment divisions; master trusts encompass the remaining master fund products. The top five master fund administrators are BT Financial Group, AMP Group, CBA/Colonial Group, National Australia/MLC Group, and Macquarie Group. Source: Strategic Insight, *Market overview: Analysis of wrap, platforms and master trust managed funds at March 2017*, June 2017 (ASIC internal use only).
[172] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014.
[173] FCA, *Asset management market study: Final report*, Market Study 15/2.3, June 2017.

Forces affecting competition

Barriers to entry

332 To establish a new platform, high levels of investment are required and profitability often relies on achieving economies of scale. This investment includes:

(a) significant IT infrastructure investment;

(b) regulatory costs, which include:

(i) the cost of obtaining an AFS licence;

(ii) the requirement to hold net tangible assets of $10 million or 10% of average responsible entity and IDPS revenue (whichever is greater); and

(iii) the requirement to maintain adequate insurance for the functions of a platform operator which must cover claims up to, and in aggregate, $5 million or the value of scheme assets (whichever is less); and

(c) investment in marketing to gain access to distribution channels such as access to advisers' approved product lists.[175]

Vertical integration

333 There is a high level of vertical integration in the platform industry. Advice, platforms and fund management often operate under a single entity. This is creating increased challenges for both new and smaller operators, as well as raising concerns about whether the benefits of competition will flow to consumers and end users.[176]

334 The Murray Inquiry interim report noted that the strong relationship between advisers and non-compliant advice in vertically integrated business models is leading to an increased focus on distribution channels and improving product features, rather than reducing fees, to the detriment of competition in the wealth management industry.[177]

335 Further, new and smaller platform providers may experience difficulty in having their platforms listed on approved product lists of advisers, due to aligned platform operators having the financial capacity to offer larger incentive payments.[178]

[174] Strategic Insight, *Market overview: Analysis of wrap, platforms and master trust managed funds at March 2017*, 19 June 2017 (ASIC internal use only).
[175] ASIC, Regulatory Guide 166 *Licensing: Financial requirements* (RG 166), September 2017.
[176] ASIC, Report 408 *Review of the implementation of RG 148: Platforms that are managed investment schemes* (REP 408), September 2014.
[177] *Financial System Inquiry: Final report* (Murray Inquiry final report), November 2014.
[178] ASIC, *Financial System Inquiry: Submission by the Australian Securities and Investments Commission*, 4 April 2014.

336 Our 2016 review into the culture, conduct and conflicts of interest in vertically integrated business in the funds management industry (REP 474) found that many vertically integrated funds management organisations had poor management of conflicts of interest. The report also found that many platform operators that are also advisory dealer groups are able to direct many clients to in-house products.[179]

> Note: See Section B of ASIC's main submission to the Productivity Commission's inquiry for a further discussion of vertical integration, and its benefits and challenges.

Multi-brand strategies and real consumer choice

337 White labelling and private labelling constitute a feature of the platforms market. In white-labelling arrangements the platform operator enters into contractual arrangements with a third party (typically a licensed dealer group), who rebrands the platform as its own and may use a different pricing structure.

338 Private-labelling arrangements differ from white-labelling arrangements in that the third party itself becomes a platform operator and must fulfil its obligations in this capacity, although it typically outsources the administration of the platform to a leading platform operator.

339 These ownership structures may not always be transparent and well-understood by consumers.

Innovation and competition

340 Traditional platform operators and other OTC funds are facing increased competition from the non-platform services, such as exchange-traded funds (ETFs) and ASX's mFund settlement service, which has grown to 176 funds and total funds under management of $399 million as at July 2017.[180]

341 The competitive advantage of non-platform services such as mFunds includes both the reduced time required for investors to invest (similar to buying shares), and the reduced costs to fund managers (who are able to offer their own fund and PDS direct to investors without a platform/wrap and the associated fees).

342 Within the industry, smaller platform operators are showing innovation and placing competitive pressure on incumbents. Investment Trends' planner technology report ranked two relatively smaller platforms, Netwealth and HUB24, first and third respectively for overall platform functionality.[181]

[179] ASIC, Report 474 *Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry* (REP 474), March 2016.
[180] ASX, *ASX investment products monthly update*, July 2017.
[181] Investment Trends, *Planner technology report*, May 2016.

Their high performance was attributed to their ability to provide both customisable metric tiles and decision support tools desired by advisers.

International insights

343 In June 2017, the FCA published its asset management market study final report, which found, among other things:

(a) few investors sufficiently engaged with their fund charges, which was exacerbated by a large number of platform fees making it difficult for investors to understand the full cost of investment; and

(b) there were significant concerns about the impact of increasing vertical integration in the market, the growth of model portfolios and the role of third party rating providers on competition and value for money.[182]

344 In July 2017, the FCA released the terms of reference for its proposed investment platforms market study. This market study will investigate how to promote effective competition in the investment platforms market. This will explore issues including:

(a) how 'direct to consumer' and intermediated investment platforms win customers, and whether any competitive bargaining power and discounted distribution costs are passed on to investors;

(b) whether platforms enable retail investors to access investment products that offer value for money; and

(c) causes of any competition problems in this market and assess what can be done to improve competition between platforms and improve consumer outcomes.[183]

ASIC's work and regulatory reform

345 In September 2014, ASIC published Report 408 *Review of the implementation of RG 148: Platforms that are managed investment schemes*. The report found that while operators have taken good steps to comply with the updated RG 148 requirements, some transitional issues and emerging challenges to competition remain, including:[184]

(a) poor management of conflicts of interest, particularly in vertically integrated structures;

(b) practical issues relating to the calculation of fees and costs required in Sch 10 of the Corporations Regulations 2001;

[182] FCA, *Asset management market study: Final report*, Market Study 15/2.3, June 2017.
[183] FCA, *Investment platforms market study terms of reference*, July 2017.
[184] ASIC, Report 408 *Review of the implementation of RG 148: Platforms that are managed investment schemes* (REP 408), September 2014.

(c) the white-label platform operators reviewed by ASIC offered products from a range of platform operators but distributed the products only through their own representatives—with the operators acknowledging that conflicts of interest are potentially more likely with any vertically integrated business model, and that it was necessary to have a policy in place to address these conflicts; and

(d) as technology advances in the industry, encouraging greater interdependence between operators and dealer groups (with the latter taking on more administration and funds management responsibilities).

346 We are also currently reviewing conflicts of interest in financial advice as a result of vertically integrated institutions both providing personal advice to clients and selling financial products; the report is planned to be published late this year.

Marketplace lending

Key points

For the financial year ended 30 June 2016, approximately $156 million in loans were written through marketplace lending providers.

Network externalities (presenting a barrier to entry and expansion) and low price transparency and product comparability may inhibit competition among marketplace lenders.

Licensing and regulatory requirements

347 Marketplace lending generally describes a new type of technology-based arrangement through which retail or wholesale investors invest money, which is then lent to borrowers (consumers or businesses).[185] Some forms of marketplace lending have been referred to as ‘peer-to-peer lending’ or ‘P2P’. However, neither marketplace lending nor peer-to-peer lending is a defined legal term.[186]

348 There is no bespoke regulatory regime for marketplace lending in Australia. The regulations that apply to marketplace lending depend on how the business is structured, what financial services and products are being offered and the types of investors and borrowers involved. Through ASIC’s engagement with existing and potential marketplace lending providers, the

[185] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.

[186] Some consider marketplace lending is not a separate market but rather a part of the managed funds market. We agree there is substantial substitutability between interests in marketplace lending schemes and managed funds, particularly mortgage schemes.

different business models that may be used to provide marketplace lending products include managed investment schemes, the issue of derivatives, and the operation of a financial market and the issue of securities.[187]

349 In most cases, the provision of marketplace lending products involves:

(a) the operation of a registered managed investment scheme, which would require the marketplace lending provider to hold an AFS licence, and the associated operator (i.e. the responsible entity) of the scheme to be a public company holding an AFS licence authorising it to operate the scheme and any other financial services provided in operating the scheme;[188] and

(b) where the loans made through the platform are consumer loans,[189] the marketplace lending provider must hold a credit licence and must comply with the requirements set out in the National Credit Act and the National Credit Code. [190]

Marketplace lending products and services

350 Marketplace lending offers to consumers and small to medium enterprises (SMEs) an alternative source of funding to more traditional bank loan channels. The main competitive advantage for marketplace lenders is the lower regulatory requirements compared to incumbents in the banking sector.

351 Given the relatively small size of the marketplace lending market compared to traditional forms of bank loans, many jurisdictions view marketplace lending as a complementary service rather than an alternative to the core banking model.[191]

352 Our 2016 survey of nine marketplace lending operators[192] (representing the majority, but not a census of the industry) indicated that of those surveyed:

(a) Five respondents were registered managed investment schemes and four were unregistered managed investment schemes.

(b) All respondents operated an online platform to match investors and borrowers. The matching of investors and borrowers and the allocation of loans varied across operators. Some operators matched investment orders on a real-time basis, some used a pre-determined agreement with the investor, while others allowed investors to directly or indirectly

[187] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017; since its establishment in March 2015, ASIC’s Innovation Hub has engaged with 34 potential marketplace lending providers.
[188] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.
[189] Consumer loans are loans to individuals for domestic, personal or household purposes.
[190] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.
[191] Deloitte, *A temporary phenomenon? Marketplace lending, an analysis of the UK Market*, 23 May 2016.
[192] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.

choose their loans, based on their risk criteria and/or preferred loan terms.

(c) The respondents operated in varying loan markets, with some focusing on consumer loans, some on business loans to SMEs and others lending to particular industry sectors.

(d) In most cases, investors invest in loans on a fractionalised basis or part of a whole loan, but do not have broad exposure to all loans. Generally, the investor is not the lender on record for the loans; instead the loan contract is between the marketplace lending provider (or their custodian) and the borrower.

(e) Loan terms ranged from three months to 15 years. Loan amounts for consumer borrowers typically ranged from $5,000 to $80,000, while for business and other non-consumer borrowers, the amounts ranged from $2,001 to $3 million.

(f) For interest rates charged on loans, approximately 80% of the total consumer loans outstanding were between 8% and 14.99% per annum. For business loans, 84% of the total loans outstanding had an interest rate between 8% and 14.99% per annum.

(g) Around 96% of the total number of loans outstanding as at 30 June 2016 were unsecured loans with the remaining 4% secured loans.

(h) Marketplace lending providers employ a range of methods to promote their platform to borrowers. These include digital and traditional forms of media, as well as lead generation from introducers. Provider arrangements to distribute their products to borrowers also vary greatly—some have payment-free referral partners, some have fee-based arrangements with online comparison sites and others have arrangements with merchants (of non-finance products). Marketplace lending providers also use direct engagement with professional (institutional) investors, and licensed advisers.

Market participants and concentration

353 The marketplace lending sector is relatively new in Australia, with most marketplace lending operators having commenced operations since 2014. Based on our survey:[193]

(a) In FY2015–16, approximately $156 million in loans were written to borrowers, consisting of approximately $130 million to consumer borrowers and $26 million to business borrowers. The top two

[193] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017. Of the nine entities surveyed for REP 526, one respondent was unable to provide responses to the quantitative part of the survey because it had not operated for the full period. The survey only covered marketplace lending that involves the provision of a financial product or service. There are some entities that fall under the marketplace lending banner, but are not under the remit of ASIC’s regulation.

marketplace lending operators surveyed accounted for approximately 90% of all loans written (with the largest operator alone holding 63%).[194]

(b) in FY 2015–16, approximately $176 million was invested by investors, consisting of approximately $39 million from retail investors, $114 million from wholesale investors and $23 million from trustee investors (including self-managed superannuation funds);

(c) As at 30 June 2016, there were a total of 7,448 borrowers (consisting of 7,415 consumer borrowers and 33 business borrowers).

(d) As at 30 June 2016, there were a total of 3,201 investors (consisting of 2,664 retail investors, 239 wholesale investors and 298 trustee investors).

Competition issues

Price transparency

354 There is little transparency for how different providers set interest rates, fees, loan amounts and terms. For consumers this creates difficulties in comparing products in the market and choosing or switching to the product that offers the best value.[195]

Barriers to entry and contestability in network market

355 Marketplace lending platforms are fully exposed to credit risk. As such investors may prefer more popular and/or larger marketplace lending operators over new or smaller operators, in the belief that they have more liquid funds available for prompt withdrawals. This may present a notable barrier to entry for new players.

356 In addition, marketplace lending is a market that is subject to network externalities or demand-side economies of scale. A product or service displays positive network effects when an actual or potential consumer places greater value on the platform or network with the largest number of users.[196] The network nature of marketplace lending means a single marketplace lender or a small group of marketplace lenders may emerge as the dominant provider. These network effects could present a significant barrier to entry for new players and expansion for smaller players.

[194] ASIC data.

[195] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.

[196] ML Katz & C Shapiro, ‘Systems competition and network effects, *Journal of Economic Perspectives*, vol. 8, no. 2, Spring 1994, pp. 93–115.

International insights

357 Since the FCA's 2014 introduction of new rules to protect investors on loan-based crowd-funding platforms, the FCA has published a review on the state of crowd-funding (February 2015), and interim feedback on its post-implementation review of crowd-funding rules (December 2016).[197]

358 The 2015 report cited concerns around promotions to retail clients, such as cherry-picking information displayed on websites, and social media promotions being financial promotion subject to regulation.[198]

359 The post-implementation review in 2016 noted:

(a) it is difficult for investors to compare platforms or to compare marketplace lending with other asset classes due to complex and often unclear product offerings;

(b) it is difficult for investors to assess the risks and returns of investing on a platform;

(c) financial promotions do not always meet the FCA's requirement to be 'clear, fair and not misleading'; and

(d) the complex structures of some firms introduce operational risks and/or conflicts of interest that are not being managed sufficiently.[199]

360 Furthermore, the post-implementation review flagged proposals to restrict cross-platform investment, require firms to implement 'wind-down plans' in case platforms fail, and introduce more prescriptive rules regarding content and timing of risk disclosures to investors.[200]

ASIC's work and regulatory reform

361 Since its establishment in March 2015, ASIC's Innovation Hub has engaged with 34 potential marketplace lending providers helping them navigate the regulatory requirements that may apply to their business.[201]

362 In October 2015, the government in its response to the Murray Inquiry supported (but did not legislate) the inquiry's Recommendation 20, to expand credit data sharing under the new voluntary comprehensive credit reporting.[202] As access to comprehensive credit reporting data improves, this

[197] FCA, *A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media*, February 2015, and FCA, *FS16/13: Interim feedback to the Call for Input to the post-implementation review of the FCA's crowdfunding rules*, December 2016.

[198] FCA, *A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media*, February 2015.

[199] FCA, *FS16/13: Interim feedback to the Call for Input to the post-implementation review of the FCA's crowdfunding rules*, December 2016.

[200] Ibid.

[201] ASIC, Report 523 *ASIC's Innovation Hub and our approach to regulatory technology* (REP 523), May 2017.

[202] Treasury, *Government response to the Financial System Inquiry*, October 2015.

will drive further innovation and competition in marketplace lending products.[203]

363 In May 2017, the Government announced $28.6 million in funding (over four years from 2017–18) to allow APRA to exercise new powers in relation to the provision of credit by lenders that are outside the traditional banking sector.[204]

364 In June 2017, we published our report on marketplace lending providers, which was based on a 2016 limited cross-section survey of marketplace lending providers.[205]

Custodial services

Key points

As at 31 December 2016, it is estimated that the Australian custodial and administration sector totalled $3 trillion assets under custody, with the top five custody services providers (out of 12 reported) representing approximately 77% of total assets under custody in Australia.

There are high barriers to entry in the custodial services industry. These are largely due to high regulatory costs (commensurate with the nature, scale and complexity of the financial service provided) and high IT investment costs. This has made it difficult for small custodians to enter the market and compete against well-established incumbents.

Licensing and regulatory requirements

365 The term ‘custodial or depository services’ (collectively referred to as ‘custodial services’ in this submission) refers to the service provided under an arrangement between the provider and the client (or their arranged representative), under which a financial product (or beneficial interest in a financial product) is held by the provider in trust on behalf of the client.[206]

366 Apart from the largely passive function of safekeeping of assets, custodians may also provide value-add services (not financial services, within the meaning of s766E), such as trade settlement, reconciliations, fund accounting, unit pricing and reporting.

[203] Treasury, *Backing Australian FinTech*, March 2016.
[204] Treasury, *Building an accountable and competitive banking system*, media release, 9 May 2017.
[205] ASIC, Report 526 *Survey of marketplace lending providers* (REP 526), June 2017.
[206] ASIC, Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets*, (RG 133), November 2013, and ASIC, Regulatory Guide 166 *Licensing: Financial requirements* (RG 166), September 2017.

367 Custodians, as an asset holder, must meet certain minimum standards, either directly as an AFS licensee or through requirements that the responsible entity imposes on them. These include:

(a) having adequate organisation structures, staffing capabilities, capacity and resources to perform core administrative activities;

(b) documented compliance measures ensuring complying obligations relating to client assets;

(c) minimum net tangible assets of $10 million (with certain exceptions); and

(d) holding assets on trusts for the client (and separate assets from own or other client assets).[207]

368 It is common practice for fund operators, such as responsible entities and registrable superannuation entities to outsource certain functions (e.g. custody, investment management, investment administration, and fund administration services) to specialist firms. Custodians, along with investment and fund administrators, therefore have a systemically important role; together, they are responsible for the operational administration of wholesale and retail superannuation and non-superannuation investment money.[208]

Products and services

369 The core role of custodians is to hold assets on behalf of trustees. However, the role of custodians is changing, and now includes such areas as informational services and 'value-add' services. For example, more custodians are now providing performance analytics, as both superannuation funds launch their own internal funds management capabilities and APRA requires greater transparency about portfolio holdings and risk.[209]

Market participants and concentration

370 The Australian Custodial Services Association reported that the Australian custodial and administration sector grew to a total of $3 trillion assets under custody for Australian investors, as at 31 December 2016.[210]

371 Of the 12 custody service providers reported, the top five custody service providers (JP Morgan, NAB Asset Servicing, BNP Paribas, State Street and

[207] ASIC, Regulatory Guide 133 *Managed investments and custodial or depository services: Holding assets* (RG 133), November 2013.
[208] ASIC, *Financial System Inquiry: Submission by the Australian Securities and Investments Commission*, April 2014.
[209] Centre for Law, Markets and Regulation, *Bank custodians and systemic risk in the Australian superannuation system*, July 2014.
[210] Australian Custodial Services Association, *Custody sector hits $3 trillion milestone: Growth picks up in second half of 2016*, 1 March 2017.

Citigroup) represent approximately 77% of total assets under custody in Australia.[211] Given the size of the managed funds sector, this is a relatively small number of custodians providing the vast bulk of these services (although vertically integrated wealth management investment platforms are more likely to use an in-house administrator).

372 Furthermore, apart from the high market concentration of custodial service providers, custodians are also linked through the common usage of other service providers or through co-investment in investment vehicles.

373 Of the total $3 trillion assets under custody, the on-shore bias remains strong, with $2.14 trillion of total assets under custody comprising Australian assets, and the remaining $973 billion relating to non-Australian assets. However, off-shore assets have been growing at a faster pace (7.6%), compared to on-shore assets (4.3%), over the second half of the 2016 calendar year.[212]

Competition issues

Barriers to entry

374 ASIC sets minimum financial requirements for AFS licensees to promote appropriate financial risk management, taking into account the nature, scale and complexity of an AFS licensee's business. Our requirements are intended to help ensure that cash shortfalls do not put compliance with the licensee obligations at risk. Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) places an obligation on custodians to hold, at all times, net tangible assets of $10 million, unless the custodian is an ADI.[213] The high regulatory costs, combined with high IT investment costs, means that economies of scale are required for profitability.

375 This significant level of investment makes it difficult for small custodians to enter the market and compete against well-established incumbents. For example, in 2011, Northern Trust was able to enter the Australian custody market, but this was due to funding from the existing Northern Trust Canadian banking business.

[211] In this submission, assets under custody is used to measure market share. However, this measure does not capture the range of other services provided by custody service providers, including compliance and valuation checking and report, which would instead be captured by a revenue-based measure.

[212] Australian Custodial Services Association, *Custody sector hits $3 trillion milestone: Growth picks up in second half of 2016*, 1 March 2017.

[213] ASIC, Regulatory Guide 166 *Licensing: Financial requirements* (RG 166), September 2017.

Review of outsourced providers

376 APRA's requirement that funds review significant outsourced providers (e.g. custodial and investment administration arrangements) at least every three years has resulted in a degree of competitive discipline among custodians.

Service bundling

377 The practice of bundling custodial services with administration services may make it difficult for fund operators to negotiate on the costs of individual services that make up the bundle. This may also make it difficult for stand-alone service providers to compete with multi-service providers.

International insights

378 The FCA's interim report on the asset management industry market study found that:

(a) despite fund managers' in-built periodic re-tenders, ancillary service providers are not frequently switched, resulting in some entities having not switched custody service providers within the last 10 years;[214]

(b) for services with less customisation and more easily comparable across providers (e.g. standardised custody services), price is a feature of negotiations for ancillary service providers;

(c) the top three custody banks represent approximately 55% of assets under custody in the UK, evidencing a relatively concentrated industry; and

(d) generally, the likelihood of new entrants in the custodial industry is low, given the capital intensive major IT infrastructure and economies of scale required to compete. Furthermore, asset managers have indicated preferences for custody banks with a presence in multiple jurisdictions.[215]

[214] FCA, *Asset management market study: Interim report*, Market Study 15/2.2, November 2016.

[215] Ibid.

Appendix D: Financial advice

Key points

The financial advice industry has undergone significant change over the last few years. This has been driven by law reform, including a ban on conflicted remuneration, the growth of digital advice, and a number of Parliamentary inquiries into poor conduct in the sector.

The advice market is concentrated with a high degree of vertical integration. Vertical integration occurs where financial advice providers, platforms and product manufacturers are controlled by a single institution.

Improving competition in the financial advice market involves both supply-side and demand-side considerations. The high cost of advice is a barrier to seeking advice for many Australian adults. Increasing the deployment of digital advice and the use of scaled advice may improve the affordability of, and demand for, financial advice.

379 For consumers and investors to engage effectively with the financial system and have their financial needs met, they need access to affordable and high quality financial advice to make informed decisions.

380 High quality financial advice is increasingly important given growing household wealth, the high level of complexity of some financial products, mandated superannuation, and the increasing numbers of consumers that are entering retirement with substantial retirement savings.[216]

381 Competition in the advice market plays an important role in delivering high quality and affordable advice for consumers. An effective advice market should accommodate the diverse needs and different financial circumstances of consumers, deliver advice in a cost-efficient manner and be accessible through a variety of channels.

382 Improving competition in the financial advice market involves both demand-side and supply-side factors. As the UK's financial advice market review identified, low consumer demand and a lack of consumer engagement are important factors that can inhibit the development and growth of the advice market.[217]

[216] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014, p. 1–21.
[217] Financial Conduct Authority, *Financial advice market review: Final report* (PDF 1.04 MB), March 2016.

State of the financial advice industry

383 The financial advice industry has undergone significant change over the last few years, primarily driven by law reform to address persistent poor conduct by AFS licensees and advisers, and conflicts of interest.

384 The advice industry is still in the process of adjusting business models to respond to these regulatory changes, many of which are reshaping competitive forces in the advice market. The last four years has seen:

(a) law reform, including the introduction of the future of financial advice (FOFA) reforms, life insurance advice reforms (which will commence in January 2018), the new professional standards regime (which will commence in January 2019),[218] and the regulation of accountants providing advice about acquiring or disposing of an interest in a self-managed superannuation fund;

(b) a change in the revenue and business models of financial advice firms, with a shift away from commission-based models to asset-based fees and flat fee-for-service business models—driven by the prospective ban on conflicted remuneration introduced as part of the FOFA reforms;

(c) the introduction of the financial advisers register, which is an important tool to improve transparency for consumers. All advisers must be listed on the financial advisers register and consumers can use the register to find out where an adviser has worked, their qualifications, training, memberships of professional bodies and what products they can advise on;

(d) a number of major scandals involving the financial advice industry driven by poor culture and conduct, which has eroded community trust;

(e) the growth of digital advice in Australia; and

(f) a change in ownership structures of a number of financial advice businesses. While there was considerable consolidation of AFS licensees a few years ago, some major players have recently signalled their intention to exit from the financial advice industry.

Regulatory and licensing requirements

385 The requirement to hold an AFS licence, or be an authorised representative of an AFS licensee, is triggered when a person carries on a business of

[218] The new professional standards regime will commence on 1 January 2019. From this date, new advisers entering the industry will be required to hold a relevant degree. Existing financial advisers will have access to transitional arrangements, allowing them two years, until 1 January 2021, to pass the exam, and five years, until 1 January 2024, to meet the education requirements. The government will establish an independent standards body, as a Commonwealth company, to administer the regime.

providing financial product advice under the Corporations Act, unless an exemption applies.

386 As at 1 June 2017, there are 5,822 AFS licensees that offer financial advice services to consumers in Australia. Of this, 4,168 licensees are authorised to provide personal advice, while 1,655 are authorised to provide general advice.[219]

Products and services

387 Financial product advice is a recommendation or a statement of opinion, or a report of either of these things, that is intended to (or can reasonably be regarded as being intended to) influence a client in making a decision about a particular financial product or class of financial product.[220]

388 Under the Corporations Act, all financial product advice is either ‘personal advice’ or ‘general advice’. Personal advice is provided if the adviser has (or could reasonably be expected to have) considered a person’s objectives, financial situation or needs. All other advice is general advice.[221] Factual information about financial products is not financial product advice under the Corporations Act.

389 In addition, personal financial advice can either be comprehensive advice, which looks holistically at a client’s financial circumstances, or scaled advice which is advice that is limited in scope to a single topic or multiple topics and is often a lower cost option.

Market share and concentration

390 As at 30 June 2017, there were 25,379 financial advisers listed on the financial advisers register.[222]

391 The five largest entities—the big four banks and AMP—account for over 40% of the advice market measured by the number of advisers operating under a licence they control. The largest 10 entities have close to 60% of advisers operating under a licence they control.[223]

392 The Murray Inquiry noted that the wealth management sector has undergone considerable consolidation since the Wallis Inquiry and many financial

[219] ASIC Registry data, 1 June 2017.
[220] See s766B of the Corporations Act.
[221] General advice includes guidance, advertising, and promotional and sales material highlighting the potential benefits of financial products. It comes with a disclaimer stating that it does not take a consumer’s personal circumstances into account.
[222] ASIC calculations—data extracted 1 August 2017.
[223] Ibid.

planners have merged with or moved in-house to work directly for wealth management institutions.[224]

393 IBISWorld estimates that the five largest players in the financial advice industry—the big four banks and AMP—hold a market share of 48.4% based on revenue from their financial advice business segments.[225] This has increased from a market share of 43% of industry revenue in 2012–13.[226]

394 While the market is concentrated among the largest major players, 83% of advice licensees operate a firm with less than 10 advisers. These smaller financial advice licensees place competitive pressure on larger players.[227]

Access to financial advice

395 Despite the increasing importance of financial advice due to growing household wealth, mandated superannuation, and the increasing numbers of consumers that are entering retirement,[228] Investment Trends estimates that the number of active financial planning clients[229] has declined from 3 million in 2007 to 2.3 million in 2016.[230]

396 Investment Trends estimates that 48% of Australian adults have unmet advice needs,[231] and the largest two barriers to seeking advice are the perception of insufficient funds (reported by 27% of survey respondents) and the high cost of advice (reported by 20%).[232]

397 Before the FOFA reforms, the price of personal advice was often hidden by opaque pricing structures and indirect payments. The FOFA reforms introduced a number of changes to address this, including:

(a) a prospective ban on conflicted remuneration structures, including commissions and volume-based payments, which has shifted the financial advice industry from a commission-based model to asset-based fees and flat fee-for-service models; and

(b) an opt-in obligation that requires advice providers to renew a client's agreement to ongoing fees every two years and the requirement to provide an annual fee disclosure statement, which has improved

[224] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014, p. 2–38.
[225] IBISWorld, *Financial planning and investment advice in Australia*, IBISWorld Industry Report K6419b, January 2017.
[226] Ibid.
[227] ASIC registry data, 1 June 2017.
[228] *Financial System Inquiry: Final report* (Murray Inquiry final report), November 2014, p. 3–69.
[229] Active clients are those that have seen their financial planner in the past 12 months.
[230] Investment Trends, *Financial advice report*, July 2017.
[231] Investment Trends, *Financial advice report*, July 2016.
[232] Ibid.

transparency for consumers who receive ongoing services and fees from their advisers.[233]

398 However, there continues to be a significant disconnect between what consumers are willing to pay for financial advice and the cost of providing advice. Investment Trends found that financial planners estimate the cost of providing comprehensive advice to be on average $2,500 and scaled advice on average to be $1,250. However, Australian adults were only willing to pay, on average, $780 to receive financial advice.[234]

399 Encouraging competition to promote affordable and high quality advice to consumers should be an important consideration of the Productivity Commission's inquiry.

400 The UK's financial advice market review noted low levels of consumer demand were due to a number of factors, including high cost, a lack of consumer engagement, little trust in the industry, and slow growth of direct-to-consumer and self-service models. These factors were holding back the development of the UK advice market.[235]

401 We believe digital advice and increasing the use of scaled advice (which can be a lower cost alternative) may improve the affordability and demand for advice.

Forces shaping competition in the financial advice market

Vertical integration

402 Vertical integration is a business model where activities at two different stages of production are combined. It is a model that exists across the financial services sector in various forms. In the case of large banking and financial services institutions, it is most prevalent where financial advice providers, platforms and product manufacturers are controlled by a single institution.

403 The Murray Inquiry noted that vertical integration is increasing in the wealth management sector, with the major banks and AMP at the forefront of this trend. They are combining advice, platforms and fund management into single businesses. Other wealth managers, including Macquarie Group, IOOF and Perpetual, have replicated this strategy to varying degrees.[236]

[233] ASIC, *FOFA: Background and implementation—Overview of FOFA reforms*, October 2014.

[234] Investment Trends, *Financial advice report*, July 2016. Note that the cost that planners estimate to provide advice may differ from the price the financial planner actually charges.

[235] Financial Conduct Authority, *Financial advice market review: Final report* (PDF 1.04 MB), March 2016.

[236] *Financial System Inquiry: Interim report* (Murray Inquiry interim report), July 2014, p. 2–38.

404 A number of smaller financial advice businesses also have vertically integrated business models, where they manufacture their own products or partner with a product issuer to distribute the issuer's products under the branding of the advice licensee.

405 The extent of vertical integration in large banking and financial institutions is subject to constant change. Recently, some large financial institutions have signalled their intention to leave certain markets in the wealth management sector. For example, ANZ is seeking to sell its wealth management business, including its life insurance, superannuation, financial advice and investment arms, and, in 2015, NAB sold 80% of its life insurance arm to Japan's Nippon Life Insurance Company and Westpac sold part of its share in BT Investment Management Limited to reduce its ownership. Westpac has now announced its intention to sell its remaining 10% holding in BT Investment Management Limited by May 2018.

Note: See Section B of ASIC's main submission to the Productivity Commission's inquiry for a further discussion of vertical integration, and its benefits and challenges.

Digital advice

406 Digital advice (also known as 'robo-advice' or 'automated advice') is the provision of automated financial product advice using algorithms and technology without the direct involvement of a human adviser.

407 Since 2012, digital advice has been growing in popularity in the US and in Europe. Australian licensees have observed the growing popularity of digital advice models offshore and are now actively developing their own digital advice models.

408 Since 2014, the interest in providing digital advice has grown rapidly in Australia with many start-up licensees and existing licensees developing or launching digital advice models. This growth is expected to continue as a number of start-up businesses have approached ASIC through our Innovation Hub asking for assistance.

409 Digital advice has the potential to increase competition in the financial advice industry. This is because:

(a) a number of new advice providers are entering the financial advice market;

(b) overseas digital advice providers are likely to offer their services in the Australian market in the coming years; and

(c) the costs associated with starting a digital advice business in comparison with a traditional advice business are relatively low, reducing barriers to entry—typically, a digital advice business will require fewer staff and will not require a large physical presence.

410 The entry of new players into the advice industry with a lower cost base has the potential to offer convenient, low-cost advice to a large number of consumers. This may place competitive pressure on incumbents to offer their own innovative digital advice offerings and improve their face-to-face advice offerings to ensure consumers see the value provided through these services.

411 The key risk associated with digital advice is the potential to provide poor quality advice on a large scale to Australian consumers. This could undermine consumer confidence in the advice sector and, in particular, digital advice.

412 Investment Trends estimates that while around 12% (2.2 million) of the Australian adult population are open to using automated investment services, the uptake in Australia remains low (in line with UK, France and Germany) compared to the US. Encouraging the development and use of robo-advice may assist in improving competition in the advice market.[237]

Changing remuneration structures

413 The financial advice market has experienced notable changes in business models driven by legislative reform to address conflicted remuneration. This has seen the advice industry move from a largely commission-based model to a fee-for-service model. These regulatory changes include:

(a) the FOFA reforms, which became mandatory on 1 July 2013 and introduced, among other things, a prospective ban on conflicted remuneration structures, including commissions and volume-based payments for the distribution of, and advice about, a range of retail investment products; and

(b) the *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017* reforms, which will commence on 1 January 2018, and which remove the exemptions for life insurance from the ban on conflicted remuneration and give ASIC the power to set maximum commission levels and clawback arrangements.[238]

414 The Government has also asked ASIC to conduct a review in 2021 to establish whether the reforms have been successful in realigning the interests of advisers and consumers. If the review shows that problems continue in the

[237] Investment Trends, *Robo-advice report*, December 2016 .

[238] The legislation will give effect to the industry-agreed reform package and set a commission cap of 60% of the first year premium and 20% of the premium in subsequent years commencing 1 January 2020, with a transitional arrangement of 80% commission cap from 1 January 2018 and 70% commission cap from 1 January 2017. It will also require the repayment of 100% of the first year's commission (clawback) if the policy is cancelled or not continued, or the policy cost is reduced in the first year, and 60% of the first year's commission if the policy is cancelled or not continued, or the policy cost is reduced in the second year.

life insurance advice industry, the Government will mandate a level commission structure.

International insights

United Kingdom

415 The financial advice market review was launched in August 2015 in light of concerns that the market for financial advice in the UK was not working well for all consumers. The review explored ways in which Government, industry and regulators can take individual and collective steps to stimulate the development of an advice market that offers:

(a) good availability of affordable, high quality advice and guidance;

(b) greater innovation in the interests of consumers;

(c) advice delivered through a range of channels that consumers are able to pay for; and

(d) increased consumer engagement with their financial affairs.

416 The report set out recommendations intended to reduce barriers to consumers accessing advice. The recommendations fell into three mains areas:

(a) *affordability*, which includes steps to make the provision of advice and guidance to the mass market more cost-effective, and to set up a dedicated team to help firms develop mass-market automated advice models and bring them to the market quickly;

(b) *accessibility*, which includes a range of proposals to help consumers engage more effectively with advice; and

(c) *liabilities and consumer redress*, which includes proposals to increase clarity and transparency about the ways in which the financial complaints ombudsman operates and assisting advisers to pay for industry levies.[239]

417 A progress report on implementation was delivered in April 2017.

[239] Financial Conduct Authority, *Financial advice market review: Final report* (PDF 1.04 MB), March 2016.

ASIC's work and regulatory reform

418 We have either recently completed, or have ongoing work, on a number of issues that touch on competition in the financial advice industry. Our work includes:

(a) *facilitating digital advice*—in 2016, we released RG 255: Providing digital financial product advice to retail clients. We will continue to meet with digital advice providers on a regular basis;

(b) *reviewing the quality of advice provided by vertically integrated businesses*—we expect to release a report containing our findings later this year;

(c) *working with the Government and industry on the life insurance advice reforms*; and

(d) *establishing the Financial Advisers Consultation Committee*—the committee is made up of practising financial advisers and will contribute to our understanding of issues in the financial advice industry and improve our capacity to identify, assess and respond to emerging trends.

Appendix E: Investment banking

Key points

The investment banking sector supports activity in corporate finance, wealth management, capital markets and advisory services. This section examines competition issues in relation to facilitating trading and primary market activity, including mergers and acquisitions, and equity and debt capital markets services.

We have identified a number of issues that are impeding effective competition in investment banking markets. These are regulatory arbitrage, switching impediments, and bundling of primary market services, particularly research.

419 Australia's investment banking sector plays an important role in facilitating the efficient allocation of capital within the economy by assisting businesses seeking to raise funds in linking with investors seeking to invest in line with their risk profile. Investment banks predominantly service large businesses and government by acting as an intermediary between these entities and institutional investors.

420 The functions of an investment bank include (but are not limited to) corporate finance, wealth management, capital markets and advisory services. Investment banks earn income by charging fees for their services, and commissions on trading activities and the sale of securities. A key determinant of the viability of the sector is the performance of financial markets.

421 The Australian investment banking and securities brokerage sector generated revenue of $6.1 billion in 2016–17, representing a 5.2% increase from the previous year. Over the past few years, resilience in capital markets and merger and acquisition-focused departments, have offset weakness in securities brokerage departments.[240]

422 In the course of our market supervision work we have identified some issues that are impeding effective competition for investment banks and market participants. Specifically these concerns relate to:

(a) regulatory arbitrage creating an uneven playing field;

(b) contestability and resulting switching impediments in the investment banking sector; and

(c) bundling of primary market services, particularly research.

[240] IBISWorld, *Investment banking and securities brokerage in Australia*, industry report K6411a, July 2017.

423 Below we describe some competition issues that relate to the investment banking sector.

Market participants and securities dealers

424 ASIC supervises market participants and securities dealers to ensure they comply with the Corporations Act and meet their obligations as AFS licensees (to the extent that a market participant holds an AFS licence).

425 Additionally, in August 2009, the Government announced its decision to transfer the responsibility for supervision of domestic licensed financial markets from market operators to ASIC. Responsibility for market supervision was transferred to ASIC on 1 August 2010.

426 After the transfer of supervision, ASIC took over the responsibility for:

(a) undertaking real-time market surveillance and post-trade analysis to detect market misconduct;

(b) making market integrity rules and monitoring compliance by market operators and market participants; and

(c) administering the disciplinary framework for breaches of the market integrity rules (which includes the Markets Disciplinary Panel, enforceable undertakings, and infringement notices).

427 As a result, market participants are currently subject to:

(a) the operating rules of the markets of which they are a participant; and

(b) for participants of certain markets, the ASIC market integrity rules related to that market.

428 Securities dealers are not subject to ASIC market integrity rules or the operating rules of a market, but must comply with the Corporations Act and their AFS licence obligations.

Major players and concentration

429 There are currently 121 market participants across Australia’s seven licensed exchanges. Many market participants participate in multiple exchanges.

430 Concentration in this market is low. In equities trading, the largest market participant (UBS) has less than 15% market share of turnover and the top five participants have market share of around 48%.[241]

[241] IRESS data.

431 There are approximately 700 securities dealers that actively provide services similar to market participants under their AFS licence. As securities dealers access the market through a market participant, their market share is captured by that market participant. While the share of securities dealer turnover captured by market participants is unclear, it is believed to be concentrated in a small number.

Competition issues

Regulatory arbitrage

432 Where different entities offer similar services or functions, but are subject to differing regulatory regimes and requirements, this can cause distortions in competition and promote regulatory arbitrage.

433 The regulatory framework that applies to market participants is substantially different from that which applies to securities dealers, even though market participants and securities dealers play similar roles within our financial markets.

434 As market participants directly access the market, they are regulated under ASIC's market integrity rules. Securities dealers must access the market through market participants' systems, which does not constitute direct access, meaning securities dealers are not subject to the rules. This distinction does not take into account that securities dealers can provide largely the same suite of services to clients (e.g. dealing, advisory, underwriting services) as market participants.

435 Market integrity rules impose a range of specific obligations to protect the integrity and efficiency of licensed markets. In many cases, the risks that are addressed by ASIC's rules may arise from the operations of both market participants and securities dealers.

436 From a retail client's perspective, a securities dealer's services may be indistinguishable from those of a market participant. Clients place trades with securities dealers in a very similar manner to market participants.

437 As the market integrity rules do not apply to securities dealers, ASIC has no power to take administrative action against securities dealers through the Markets Disciplinary Panel, depriving ASIC of an important and effective regulatory mechanism. Decisions of the Markets Disciplinary Panel have a high level of recognition and large impacts on the markets and market participant businesses.

438 ASIC has made a submission to the Government to expand the scope of firms subject to the market integrity rules and address concerns about an uneven playing field.

Wholesale financial services providers

439 Wholesale financial services providers service wholesale clients in the over-the-counter (OTC) market. These markets consist of a broad range of mostly derivative and foreign exchange products, which are often used by clients to facilitate offshore transactions and manage risk in areas including interest rates, foreign exchange, credit, equities and commodities.

440 Providers in the market offer trading services in these products, along with additional services, which may include advice, market making and risk management.

441 Generally, entities that provide these services in Australia must hold an AFS licence unless they are otherwise exempted.[242] Foreign financial services providers (FFSPs) that are regulated by an approved offshore regulator, and provide financial services to wholesale clients can rely on an ASIC legislative instrument that provides relief from having to hold an AFS licence.[243] Similar relief may be available if the FFSP has a limited connection to Australia.[244]

442 As a result, wholesale clients in Australia may receive OTC market services from a domestic provider holding an AFS licence or from an exempt provider, such as an FFSP.

Major players and concentration

443 ASIC OTC derivatives data suggests that there are hundreds of wholesale financial services providers active in the above markets. Concentration is low in each market and no provider has significant market share across all markets.

444 The extent of FFSP participation in the Australian market is unknown because there are currently no activity reporting requirements for these entities.

Competition issues

445 Some FFSPs may obtain a significant competitive advantage over Australian domiciled service providers due to different operating conditions in their home jurisdictions. The extent to which the Australian activities of FFSPs are supervised by their home regulator is unknown, while FFSPs also have fewer local obligations (such as regulatory filings) when compared to AFS licensees, although we note that they are still required to comply with their

[242] See s911A of the Corporations Act.
[243] ASIC Corporations (Repeal and Transitional) Instrument 2016/396.
[244] ASIC Corporations (Foreign Financial Services Providers—Limited Connection) Instrument 2017/182.

home jurisdiction's regulatory requirements. These entities may be subject to lighter regulation in Australia and may operate under a lower cost foreign business model.

446 We are undertaking a review of our relief for FFSPs (with relief currently extended for two years) and we have publicly consulted on ending this relief.[245]

Primary market services

447 Corporations may issue securities on primary markets as a means of raising capital. These corporations are serviced by institutions that arrange and structure primary markets deals. Service providers in the primary markets industry include large investment banks, market participants, boutique service providers and specialist corporate advisers.

448 Primary market services incorporate a broad range of functions. This section focuses on:

(a) merger and acquisition advice

(b) equity capital markets services; and

(c) debt capital markets services.

449 The market comprises a variety of services, many of which rely on human capital and relationships that have been developed within investment banks. Investment banks offer clients advisory, pricing and negotiation services, as well as financing and distribution services. The existence of longstanding relationships between corporate advisers such as investment banks and the end investors is considered important to offering competitive primary services.

450 Apart from large investment banks and market participants, the primary markets industry also includes boutique service providers. These providers often focus on merger and acquisition advice, equity capital markets services, or debt capital markets services—or on specific region or market sectors. As these firms rarely have lending or institutional departments, their revenue is sourced solely from the primary markets service offered. While this may decrease apparent conflicts of interest, corporations engaging these providers for merger and acquisition deals may encounter higher prices for financing sourced externally.

[245] See ASIC, Consultation Paper 268 *Licensing relief for foreign financial services providers with a limited connection to Australia* (CP 268), September 2016.

451 Alongside the primary markets industry, specialist corporate advisers provide services analysing and negotiating with the institutions vying for their clients' business. These advisers may help lower prices and reduce information asymmetries between bankers and their clients.

Major players and concentration

452 Concentration appears to be low for primary markets activity in Australia. There is a wide representation of international investment banks, as well as local and boutique providers competing for business.

453 The Australian merger and acquisition deals market is not concentrated. Over the 2017 year-to-date, the market leader, UBS, holds a market share of 13% of deal value and has completed four deals in total, while the next largest competitor, Macquarie Bank, holds a market share of 11% of deal value and has completed five deals.[246]

454 In debt capital markets services, the big four domestic banks are the largest players. Over the 2017 year-to-date, each of the big four banks has contributed over 10% of the total issuance value, with Westpac holding the greatest share at around 12%. The largest competitor outside of the big four is Citibank with a 6% market share.[247]

455 Equity capital markets services have been slightly more concentrated than other primary markets services over the year-to-date. Macquarie Bank and UBS account for 25% and 22% of the total issuance value, respectively. Patersons Securities has arranged the largest number of deals at 16, but only represents 0.7% of the total issuance value.[248]

Competition issues

Contestability

456 Large investment banks can leverage their global networks in facilitating primary market raising and merger and acquisition activity. These institutions are able to provide deep liquidity though their multinational distribution networks, as well as financing and underwriting services. As a result, large investment banks tend to dominate the 'league tables' for merger and acquisition advice, equity capital markets services, and debt capital markets services.

[246] Bloomberg, *Australia and New Zealand capital market league tables*, Q1 2017.
[247] Ibid.
[248] Ibid.

457 The power of these international networks can represent a material ‘barrier to contestability’ in the industry, despite barriers to entry being perceived as low.

458 The contribution of boutique service providers in primary markets services has increased since the global financial crisis of 2008; however, they still represent a relatively small portion of the overall deal flow.

Switching costs

459 The network effect described as a barrier to contestability above may also act as an impediment to switching between primary markets service providers, especially if the company was previously serviced by a full-service large investment bank. By switching to boutique service providers these companies may be looked over when funding opportunities arise because they no longer belong to the network.

International insights

Bundling

460 Offshore regulators have expressed concerns about the bundling of primary markets services. Large investment banks and market participants may bundle services under their client-facing ‘front-office’ function, but it is difficult to ascertain how these services and costs are bundled.

461 An example of this concern and a potential conflict of interest is in the area of research. Currently, in Australia, investment banks and market participants may provide research reports, insights and presentations as part of a bundle with the core services provided to clients. By bundling these services in this manner, clients may be unable to easily discern the value attained against the cost of receiving each discrete service, impeding their decision-making ability.

462 The presence of corporate advice firms and the sophistication of clients alleviate some of the concern surrounding bundling, as we expect that strong competitive pressure from the demand side can offset the impact of bundling to some extent.

463 In Europe, regulators have moved to address the concern posed by bundling by proposing to unbundle research payments from execution payments under its MiFID II reforms, which seek to enhance investor protection and transparency.

464 As part of these reforms, investment firms will need to make explicit payments for investment research in order to demonstrate that they are not being induced to trade. While at this stage no equivalent reforms are planned in other jurisdictions, non-EU investment banks will be bound by MiFID II

when providing execution and research services to EU-based clients. The legislation is due to go live in January 2018.

United Kingdom

465 In October 2016, the FCA released its investment and corporate banking market study,[249] focusing on primary markets activity in the UK. The FCA noted that a wide range of banks and advisers offer primary markets services in the UK and concerns around competition were low, similar to what we have observed in Australia.

466 However, the FCA did note some major concerns in the investment and corporate banking market, including:

(a) *Restrictive contracts*—Some banks use restrictive contracts when floating companies, requiring clients to continue using their services for further funding rounds. This allows large banks to offer lower fees for initial public offering (IPO) services compared to boutique offerors. The FCA has proposed to ban these clauses in contracts.

(b) *League tables*—The FCA found that banks could manipulate league tables to inflate their standings. Banks may sort the tables by the metric that reflected them best, such as choosing the number of deals over the dollar value of deals. Policies regarding criteria used in identifying league table data could be exploited to increase a bank's standing in the table. Banks may even enter into unprofitable deals to increase their standing, which is often used in determining bonuses. The FCA proposed to further consider ways to make league tables more reliable, to help clients make well-informed decisions.

(c) *IPO allocations*—Allocations of shares during IPOs may be skewed to high volume, high fee clients. The FCA found that although banks had policies to address conflicts of interest in the allocation process, most lacked sufficient specificity as to be actionable. The FCA noted that MiFID II implementation would require allocation policies to ensure effective arrangements are in place to prevent current or future relationships influencing the allocation process.

(d) *Barriers to entry expansion and innovation*—Equity capital markets services and debt capital markets services were perceived to have the highest barriers to entry because they required origination, sales, trading and research capabilities. Cross-selling between primary markets activities, lending and corporate broking allows these firms to charge lower fees, which decreases the competitiveness of firms without those functions.

[249] FCA, *Investment and corporate banking market study*, MS15/1, October 2016.

Appendix F: Financial market infrastructure

Key points

Centralised financial market facilities underpin key elements of economic activity in Australia. As such, the long-term interests of consumers in relation to competition in centralised market facilities also includes considerations of their financial soundness, the integrity, security and transparency of their operations, and the consumer's ability to rely on these facilities for risk management without undue disruption.

The regulatory framework for centralised financial market facilities contemplates competition between providers. In the case of financial market facilities, the Government has introduced significant law reform that enables ASIC to take actions to ensure long-term consumer interests are maintained. In the case of clearing and settlement facilities, ASIC and the Council of Financial Regulators have undertaken significant work to establish the regulatory setting for facilitating safe and effective competition, should market forces result in a competitor to single service providers.

The regulators have identified further law reforms that would strengthen the regulatory regime's ability to facilitate safe and effective competition. These are also set out in this section.

467 Centralised market facilities provide a number of important benefits to their users and to the financial market more broadly. In their absence, each entity needed to assess and make decisions, or take actions, that duplicated the decisions and actions taken by other entities. Centralised market facilities have the economies of scale to introduce cost and process efficiency. The Government and regulators in Australia and overseas have encouraged—and in limited cases mandated—the use of centralised market facilities. Where decisions to mandate have been taken, they have sought to reduce risk, and to increase transparency and oversight for the Australian financial markets as a whole.

468 The effectiveness of centralised market facilities affects a wide range of economic sectors and underpins the viability of commercial activity and prosperity of households. The stability, integrity and transparency of centralised market facilities, and the way in which they discharge their gatekeeper roles, are also critical for the preservation of issuer and investor confidence in Australian financial markets.

469 As discussed in Section A of ASIC's main submission to the Productivity Commission's inquiry, the purpose of competition in the financial system should be to promote the long-term interests of consumers. In relation to

centralised market facilities, the long-term interests of consumers include specific additional considerations, such as:

(a) Clearing and settlement facilities are used to provide risk management services for high value financial contracts over the lifetime of the contract (e.g. up to 50 years). The failure of a facility can impose significant costs on its users—the long term interests of consumers include having the confidence that the facilities will remain financially viable and therefore able to perform these key risk management services for the duration of the financial contracts.

(b) Market facilities provide infrastructure that assists listing companies in elements of the capital raising process. They help to bring together buyers and sellers of financial contracts, which in turn helps users to determine the market price of those financial contracts, and in doing so also centralises oversight of those activities. In addition to direct considerations of issues like service fees, the long-term consumer interests also include having the confidence that:

(i) the facility is effectively bringing together a critical mass of the trading interests;

(ii) the trading interests are brought together in a way that is fair to all buyers and sellers; and

(iii) the prices for the financial contracts are not subject to manipulation.

(c) Similar types of longer term consumer interest apply to other forms of market infrastructure. For example, trade repository facilities provide centralised storage of commercially sensitive financial trading data. The long-term interests of consumers include having the confidence that the data is not susceptible to security breaches, and the facility has robust controls to ensure data is only being provided to authorised recipients.

470 The entry of new centralised market facility competitors has the potential to improve consumer and competition outcomes. In many of these cases, new competitors can also create different dynamics in service fees, quality of service delivery and incentives to innovate. And because of their nature as centralised facilities, the entry of new competitors can also create additional costs, which include, for example:

(a) the costs of connecting to a new facility to access the dispersed liquidity that previously existed in a centralised venue;

(b) meeting ongoing prudential and other financial requirements; and

(c) reduced economies of scale or other efficiencies.

471 For example, central clearing introduces significant financial efficiencies through the ability to ‘cancel out’ transactions with equal and opposing

economic value ('netting'). Should multiple clearing facilities operate there could be additional costs.

472 Issues such as interoperability between competing facilities would need to be addressed in order to deliver the kinds of centralised risk management and efficiencies that were previously provided by the one central single provider.

473 The regulatory settings for centralised market facilities contemplate competition. Since 2012, ASIC has worked within the Council of Financial Regulators (CFR)[250] and with the Australian Competition and Consumer Commission (ACCC) to establish a robust framework for facilitating safe and effective competition for centralised clearing and settlement facilities. Similarly, ASIC has worked with the Government to implement significant regulatory reforms that help to facilitate effective competition between financial market operators and other types of centralised facilities.

474 The competition policies and settings for centralised market facilities seek to provide the conditions for safe and effective competition. This concept seeks to ensure the economic benefits accrue to all users of a stable, fair and transparent foundation for economic activity. The conditions for safe and effective competition are closely linked to the regulatory objectives of maintaining financial stability, combating malfeasance and predatory practices, encouraging non-discriminatory access to services and products, and promoting access to relevant and timely information.

Recent developments in the global and domestic environment

475 Over the last 15 years, the regulatory settings for safe and effective competition for centralised market facilities have developed in the context of a dynamic global and domestic environment affected by overseas regulatory change and industry innovation.

476 Factors influencing the competitive environment include:[251]

(a) Financial markets are increasingly interconnected and global in nature. Investor access to global capital markets has been facilitated by market intermediaries offering access to overseas markets, and by overseas markets gaining regulatory authorisations to operate in Australia. The international nature of market facilities has seen increasing numbers of cross-border listings, access to overseas futures exchanges, and the entry and growth of a range of non-exchange trading facilities.

[250] The CFR comprises ASIC, the Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA) and Treasury: see the Council of Financial Regulators website.

[251] J Gapper, 'The death and rebirth of the stock exchange', *Financial Times*, 10 March 2016.

(b) Technological developments have delivered significant improvements in the efficiency and fairness of financial markets and the infrastructure that underpins them. For example, the increased offering of electronic trading paved the way for centralised trading of more financial products, increased liquidity and more timely dissemination of pricing and other information. We have observed increased complexity in the technology used by centralised facilities, as well as how that technology is used.

(c) There has been ongoing product and service development in centralised market facilities, with many using technology products. Some technologies are more established (i.e. use of algorithms and automation to match market orders more efficiently, or reduce the time taken to settle financial obligations arising under financial contracts), while others are still under review by market entities (e.g. distributed ledger technology).

(d) Innovations have resulted in the introduction of new types of market facilities. For example, there has been a proliferation of alternative forms of financial market facilities. Some offer services once exclusively provided by exchanges (e.g. capital raising). Some use social media or other technologies to create new forms of market venue-like platforms. Some provide the commercial efficiencies of organised trading for financial products that traditionally have not been traded on centralised exchanges.

477 These trends are also observed in overseas markets.

478 Technology plays a key role in recent competition developments in centralised market facilities. Centralised market facilities can be considered to be technology businesses, and the ways in which they compete differ from physical infrastructure owners and operators. Many centralised market facilities seek to gain a competitive advantage over their peers through more efficient and cost effective services by adopting newer forms of technology, or seek to create new ways of connecting to participants and users that are enabled by new technology (including social-media-like platforms).

479 In broad terms, this environment has fostered increased use of centralised market facilities. In some cases, increased use of centralised facilities was the result of regulatory requirements. In many cases, it was the result of industry entities seeking to reduce costs and increase process efficiency in their financial market businesses by taking advantage of the economies of scale offered by centralised market facilities.

480 These demand-side pressures have fostered an increase in competitive forces from existing and new facilities, from domestic and overseas operators. Over the past 15 years, this has resulted in an increase in the number of centralised

market facilities that are permitted to provide services in Australia. Currently, there are:

(a) 44 authorised financial market operators;

(b) seven licensed clearing and settlement facility operators and one exempt clearing and settlement facility operator; and

(c) two licensed trade repositories, six licensed credit rating agencies and (subject to regulatory reform) financial benchmark administrators.

481 The specific competition developments and ASIC actions taken for each type of centralised market facility are described in turn, along with pending recommendations from ASIC, the RBA and the ACCC, to strengthen the regulatory settings to promote safe and effective competition.

Clearing and settlement facilities

482 A clearing and settlement facility is a regular mechanism for parties to certain transactions in financial products to meet their obligations to each other. Specifically:

(a) Clearing is the process of intermediation between the counterparties in a transaction. The clearing facility guarantees the payment of funds to the seller of the securities even if the buyer in the transaction defaults. Conversely, it also guarantees delivery of the securities to the buyer if the seller is unable to fulfil its obligations.

(b) Settlement refers to the process of transfer of ownership of the securities from the seller to the buyer and transfer of funds in the opposite direction.

483 Traditionally, Australia has had single facilities operated for certain clearing and settlement services, particularly services connected with domestic exchanges. This reflects market factors such as economies of scale, the ability to 'net' economically offsetting obligations within a single facility, and the initial and ongoing costs of being a user of centralised market facilities.

484 However, ASIC and the RBA recognise that a competitor has emerged in some types of clearing services, and competition can emerge in other types of clearing and settlement services. We consider that whether there should be a competitor and the nature of the competing business model should be a market-led solution.

Competition in clearing of non-exchange derivatives

485 Since the global financial crisis, there has been a global push to increase central clearing of OTC derivatives. In 2015, a mandatory central clearing

regime was introduced in Australia covering certain types of OTC interest rate derivatives denominated in Australian dollars, US dollars, euros, British pounds and Japanese yen. Broadly comparable mandates have also been introduced in key overseas markets, including in the Asia–Pacific region, the US and the EU.

486 There is a global market for this type of clearing service, reflecting the fact that transactions in non-exchange-traded derivatives commonly involve overseas entities such as the global investment banks or large offshore fund managers. Due to the global nature of this type of clearing service, established overseas clearing facilities can have a competitive advantage over less well-established domestic clearing facilities.

487 For example, in the European market, around 97% of US dollar denominated swaps and 75% of euro denominated swaps are cleared in London. The largest British clearing house is LCH.Clearnet, which holds 50% of this market, with the remainder being spread throughout smaller competing clearing houses.[252] In the US, there are 15 registered or exempt derivative clearing houses (excluding dormant or vacated registrations).[253] Of these, the largest are the Chicago Mercantile Exchange (CME), ICE Clear, and LCH.Clearnet.

488 Reflecting the extent of established global competition, ASX's derivatives clearing facility only competes for non-exchange-traded interest rate derivatives denominated in Australian dollars. It holds about 20% of the centrally cleared OTC derivative contracts, with London-based LCH.Clearnet responsible for almost 80% of this market and 1% or 2% cleared through the US-based CME.

Competition in cash equity clearing and settlement

489 ASIC and the CFR have invested significant effort in developing the regulatory settings for facilitating safe and effective competition in cash equity clearing and settlement. This reflects the importance of the cash equity market to the Australian economy, and therefore the critical long-term consumer interest in ensuring this market continues to function effectively.

490 Cash equities clearing in Australia is performed by ASX Clear, a subsidiary of the ASX Group. All equities traded through ASX and Chi-X are cleared through ASX Clear. It also clears a number of other types of transactions and contracts traded in other platforms. However, cash equity clearing only accounts for a small proportion of the Group's operating revenues. In 2016, 7% of ASX Group's operating revenue came from cash equity clearing,

[252] The Economist, *The EU wants to supervise London clearing houses after Brexit*, 15 June 2017.
[253] US Commodity Futures Trading Commission, *Derivatives clearing organizations (DCO)*.

while 26% came from clearing futures contracts and OTC derivative transactions.[254]

491 On 7 September 2017, the CFR, in collaboration with the ACCC, released a policy statement setting out the *Minimum conditions for safe and effective competition in cash equity settlement in Australia* (minimum conditions (settlement)). This statement follows the *Minimum conditions for safe and effective competition in cash equity clearing in Australia* (minimum conditions (clearing)), published in October 2016. The work recognises that competition in settlement is intrinsically linked with the clearing framework.

492 These statements set out the minimum regulatory requirements that would apply if a competitor should emerge for some or all parts of the clearing and settlement services currently provided by a single service provider, to ensure the long-term interests of consumers are met.

493 Some of the minimum conditions that would apply if a competitor emerges for the cash equities settlement service include:

(a) adequate regulatory oversight arrangements (including to ensure legal certainty of transfer of title for financial collateral used on the facility, and for markets that trade the relevant cash equities);

(b) access on transparent, non-discriminatory, and fair and reasonable terms; and

(c) appropriate links between competing securities settlement facilities (to reduce the costs that may result from the loss of economies of scale).

494 Some of the minimum conditions that would apply if a competitor emerges for the cash equities clearing service include:

(a) adequate regulatory arrangements (including appropriate supervision of cross-border facilities or of multiple competing facilities, and appropriate interoperability arrangements between competing cash equity central counter parties); and

(b) additional requirements relating to the settlement of cash equities, including safeguards that seek to preserve the economic efficiencies of a single clearing service provider, and providing access to relevant data on non-discriminatory, transparent, fair and reasonable terms.

495 Also in October 2016, the CFR published the *Regulatory expectations for conduct in operating cash equity clearing and settlement services in Australia* (regulatory expectations). These regulatory expectations would apply to the clearing and settlement services provided by a single service provider if no competitor emerges.

[254] ASX, *Annual report 2016* (PDF 6.88 MB).

496 The regulatory expectations for the conduct of ASX's single provider cash equity clearing and settlement services are intended to support the long-term interests of the Australian market by delivering outcomes that are consistent with those that might be expected in a competitive environment. In particular, the regulatory expectations seek to ensure that ASX remains responsive to users' evolving needs and provides access to its cash equity clearing and settlement services on a transparent and non-discriminatory basis, with terms and conditions, including pricing, that are fair and reasonable.

497 Together, the minimum conditions (clearing), the minimum conditions (settlement) and the regulatory expectations establish a flexible policy framework underpinning the government-endorsed policy stance of openness to competition. If competition in clearing or settlement were to emerge, the relevant minimum conditions would apply to those services, while the regulatory expectations will continue to apply to the services for which ASX remains a single service provider for cash equities clearing and settlement services.

498 The CFR and the ACCC expect to review the regulatory expectations, minimum conditions (clearing) and the minimum conditions (settlement) periodically, including in the event of material changes to the operating environment or the market structure for these services.

Recommendations for law reform

499 Elements of the regulatory expectations, minimum conditions (clearing) and minimum conditions (settlement) are not enforceable under the existing Australian regulatory framework. In March 2016, the government announced its commitment to legislative changes to grant the relevant regulators rule-making (ASIC) and arbitration powers (ACCC) to impose requirements on clearing and settlement facilities in Australia.

500 Details of proposed law reform are to grant:

(a) the relevant regulators (including ASIC) rule-making powers that would enable enforceable requirements to be imposed on ASX consistent with the regulatory expectations if these expectations were either not being met or were not delivering the intended outcomes, and/or implement the minimum conditions (clearing) if and when a competitor emerged; and

(b) the ACCC an arbitration power that would provide for binding resolution of material disputes arising where a user was seeking access to any aspect of ASX's cash equity clearing and settlement services, consistent with the regulatory expectations and the minimum conditions (clearing). The ACCC may therefore have regard to the regulatory expectations and the minimum conditions (clearing) when making a binding determination under the proposed arbitration powers.

501 We consider it would be highly desirable for the proposed law reform to be implemented in a timely way so that the regulatory settings to enable competition would be completed for clearing and settlement facilities.

502 Additionally, as broadly similar competitive dynamics and considerations apply to competition relating to financial market facilities, we see a case for these proposals to also apply to financial markets (see below).

Financial markets

503 A financial market is a facility through which offers and invitations to acquire or dispose of financial products are regularly made. Financial markets promote the efficient and transparent allocation of investment resources through price discovery and dissemination of information.

504 Exchanges centralise trading in highly standardised financial contracts that typically attract a deep pool of buying and selling interests. Reflecting the types of financial contracts traded, exchanges have historically remained operational when trading in non-exchange markets has been disrupted by economic or financial events.

505 Non-exchange trading occurs for a wide range of financial contracts. Many of the participants in non-exchange trading are institutions who need to negotiate large and bespoke contracts. Trading may occur bilaterally between participants (i.e. by phone). Trading also increasingly occurs on a range of non-exchange market facilities.

Introduction of exchange competition

506 In 2010, the Government introduced significant law reform to implement a framework that facilitates the entry of new financial market competitors. Key aspects of the reforms included giving ASIC the power to write enforceable rules about the conduct of market operators and their participants, and ASIC taking over supervision of financial markets (previously market supervision was performed by the single provider exchange).

507 The Government considered this to be a necessary step in the process of facilitating competition between market operators, which began in October 2011 with the introduction of Chi-X Australia offering trading services in ASX-listed securities. This step allowed important elements of centralised market infrastructure to be maintained through alternative means—specifically, centralised supervision by ASIC of market-wide secondary trading in exchange-traded products.

508 Chi-X commenced operations in 2011 and currently has a market share of approximately 20% of cash equity turnover.[255] The average daily turnover in the Australian cash equity markets was around $6 billion in the financial year 2016–17.[256]

509 ASIC has applied the legal framework to facilitate the emergence of competitors to the single provider, in a way that still seeks to achieve the long-term consumer interests for financial markets, including:

(a) We have licensed new exchange markets, including new domestic securities exchanges and overseas futures exchanges. Licensed overseas futures exchanges include the Chicago Mercantile Exchange, Eurex and ICE Futures Europe.

(b) We currently have responsibility for market surveillance of ASX, ASX 24 and a number of other domestic market operators, including the National Stock Exchange of Australia and the Sydney Stock Exchange.

(c) We have made market integrity rules to set conduct standards for certain domestic markets and their participants (in many cases, drawn from the operating rule books that the individual exchanges maintained before the transfer of market supervision to ASIC—with the addition of a number of further rules to support fair and effective competition between the exchanges).

(d) We administer provisions of the law that are designed to address potential conflicts of interest where an exchange’s competitor (i.e. a competing facility operator) is also a participant on that exchange.

(e) We have made market integrity rules that are tailored to the business model of non-exchange ‘dark pools’ and enable them to trade the same securities as are traded on the licensed securities exchanges. These rules are designed to reduce the likelihood of market liquidity fragmentation, and require brokers to only send retail consumers’ orders to dark pools if that would result in a meaningful price improvement for the retail consumer.

510 These changes have occurred against a background of exchange diversification or consolidation in overseas markets. There has been a series of proposals for mergers and acquisitions over the last decade. Some proposals have gone forward, such as the NYSE–Euronext–InterContinental Exchange deals. Others were vetoed by regulators, as was the case with the LSE–Deutsche Börse merger.

[255] ASIC, *Equity market data for quarter ending June 2017*, June 2017.
[256] This includes the ASX and Chi-X markets, including the dark liquidity facilities of these operators.

511 The emergence of competition had some immediate impact. For example:

(a) Before Chi-X's entry in 2011, ASX almost halved its headline trading fee from 0.28 basis points per trade to 0.15 basis points per trade.[257] On-order book and off-order book crossing fees were also reduced. The emergence of competition has also created greater incentives for innovation, with the introduction of new trading platforms, products and order types.

(b) In response to competition from off-market trades including trading in dark pools (comprising approximately 20% of all cash equity turnover), ASX and Chi X also offer competing dark trading services, ASX Centre Point, Chi-X Hidden and Chi-X Market on Close. These innovations have competed with off-market trades growing to more than 7% of total equity market turnover.

Exchange competition: Meeting long-term consumer interests

512 We have applied the regulatory regime to facilitate competition in relation to financial market facilities. We consider the actions taken in Australia have helped to ensure financial market facilities are still able to meet long-term consumer interests, compared to the experience in key overseas markets.

513 For example, competition in equity market trading in the US and EU have brought some benefits such as a decrease in trading fees and investment in technologies. However, the cost savings from relatively small fee decreases are argued by some to have been offset by the impact of having a large number of competing markets, such as the fragmentation of liquidity and market data.

514 Another area where we have taken action to preserve long-term consumer interests is in ensuring high quality listings on exchanges. In capital raising there is information asymmetry between issuers and investors. Regulators impose strict disclosure requirements both for IPOs (through a prospectus) and secondary raisings (via continuous disclosure rules) to mitigate this asymmetry.

515 Through our supervisory activities, we have sought to ensure listing markets are properly vetting the qualification process for listing and to ensure that, once listed, companies operate with high ethical standards and effective business practices. Operators also need to ensure that entities comply with their obligations to investors under the listing rules.

516 Greater economic integration has increased the supply of overseas-based firms willing to list in the Australian market, as well as Australian

[257] ASIC, Report 215 *Australian equity market structure* (REP215), November 2010, p. 27.

companies that are willing to list offshore to access larger overseas capital markets. It is critical that market operators continue to uphold the listing standards applicable to local and foreign-based companies to preserve investor confidence in Australian markets. This has been increasingly important as global exchanges compete on listing standards to attract companies and has been highlighted in recent ASIC regulatory activity,[258] including assessments.[259]

517 Maintaining high quality listing standards supports investor trust and confidence in the Australian equities market. This helps reduce the risk premium investors require to invest in Australian businesses, making these businesses more efficient in the longer term and Australians more prosperous.

518 Lastly, we also consider ASIC's ability to take timely and appropriate action to facilitate safe and effective competition can be enhanced if the CFR's proposals relating to cash equity clearing and settlement were also applied to financial markets.

Competition in non-exchange market facilities

519 ASIC has applied the legal framework to facilitate domestic and global competition for non-exchange trading venues. In many cases, the total turnover in non-exchange markets is significantly higher than exchange markets. For example, we estimate the average daily (gross open notional of new contracts entered into each day) of non-exchange-traded derivatives was around $671 billion in 2016–17.[260] Exchange-traded derivatives and debt securities markets together had an average turnover of $226 billion per day in 2015–16.[261]

520 The ability to facilitate the entry of competing non-exchange trading facilities has become more prominent in recent years, as technology and user demand have led to changes in business models. Some markets have become increasingly comparable to, and in some important areas indistinguishable from, traditional exchanges. This has resulted in a blurring of the division between traditional exchanges and non-exchange facilities.

521 Recent law reform has strengthened ASIC's ability to continue to support safe and effective competition in non-exchange markets.

[258] Bloomberg, *Index giants clash with exchanges over shareholder rights*, 3 August 2017.
[259] ASIC, Report 538 *Assessment of National Stock Exchange of Australia Limited's listing standards* (REP 538), August 2017.
[260] This figure is calculated from data reported under the Australian OTC trade reporting regime to the trade repository Depository Trust and Clearing Corporation. It excludes commodity derivatives, OTC trading in physical securities (equities and bonds) and spot foreign exchange transactions.
[261] Australian Financial Markets Association, *2016 Australian financial markets report* (PDF 2.21 MB), 2016.

522 Australia’s market licensing regime was essentially an exchange-like licence regime and has remained broadly unchanged since 2002. The *Corporations Amendment (Crowd-sourced Funding) Act 2017* introduced greater flexibility into the licensing regime. In July 2017, ASIC commenced consulting on proposals to facilitate competition in non-exchange market facilities through a more flexible two-tiered licensing regime.[262] Under the proposals, ASIC is seeking to facilitate the oversight of traditional market models and to adapt regulatory obligations for specialised and emerging market venues.

Long-term consumer interests

523 An important feature of non-exchange traded markets is the global nature of capital flows and therefore the global nature of competition for non-exchange markets. ASIC has sought to ensure Australian entities have access to global financial markets, which includes ensuring that Australian market facilities can attract and retain overseas market participants, as well as ensuring that Australian market participants face no barriers to accessing oversea market facilities.

524 This has been done in part by seeking mutual recognition or other forms of recognition from overseas regulators, so that Australian market facilities and participants do not face barriers to entry under overseas regulatory regimes. Industry feedback indicates these forms of recognition have resulted in tens of millions of dollars of cost savings for market facility operators, their participants and users.

525 Other forms of markets are emerging, many of which use technology to bring together buyers and sellers in novel ways outside of the traditional arrangements (i.e. crowd-sourced funding or social-media-type platforms). These allow retail buyers and sellers to directly interact with each other without having to rely on intermediaries such as brokers. We will similarly apply the framework for safe and effective competition for these financial markets and facilitate market-driven competition outcomes.

Other forms of market facility

526 Regulatory and market-driven changes have also led to the development of other forms of market facility. In addition to trade repositories described in paragraph 469(c), there are:

(a) *Credit rating agencies*—these typically opine on the credit risk of issuers and their financial obligations. By assessing a range of

[262] ASIC, Consultation Paper 293 *Revising the market licence regime for domestic and overseas operators* (CP 293), July 2017.

information available about each issuer, credit rating agencies can help consumers to assess the credit risk they face when lending to a particular borrower or when investing in an issuer’s debt securities.

(b) *Administrators of financial benchmarks*—these are indices or indicators used as reference prices for financial instruments or contracts, or to measure the performance of investment funds. Financial benchmarks can affect the pricing of a range of financial products, other investments, as well as risk management decisions.

527 For these forms of centralised market facility, the long-term consumer interests commonly include having confidence that the facility operator is held to a high standard of service, has a business model that is sustainable in the longer term, has robust arrangements for business continuity and orderly transition, and the services provided are not marred by conflicts of interest.

528 As for markets and clearing and settlement facilities, the legal regimes for these centralised market facilities also have a setting that is open to competition. We similarly consider the requirements for safe and effective competition for these types of facilities as a core component of our regulatory activity.