Submission on Productivity Commission Draft Report: Competition in the Financial System

March 2018

EXECUTIVE SUMMARY

The key findings of the PC Draft Report are that the Australian banking sector is a strong oligopoly with four major banks holding substantial market power as a result of their size, strong brands and broad geographical reach. This is further supported by regulatory settings which contribute to the major banks' structural advantages.

"As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability — without losing market share," the Draft Report finds.

These findings have been reinforced this month by the ACCC in its *Residential mortgage price inquiry interim report* which drills into the detail of how the major banks' cosy oligopoly is working against the long-term interests of Australian consumers. (See box below.)

COBA supports the PC Draft Report's finding that APRA and the Government should prioritise reforms that reduce regulatory barriers to entry and expansion in banking.

Policymakers should make a concerted effort on multiple fronts to promote competition in banking. The state of the market, as described in the PC Draft Report and the ACCC's mortgage pricing report, demands a committed, systematic response to reducing barriers that hamper the banking sector's "long tail of smaller providers".

Action to create a more level playing field, with due care to retain strong prudential and consumer protection frameworks, will empower second-tier lenders to challenge the major banks and their cosy oligopoly.

COBA endorses the view expressed this week by the Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP "that ultimately it is competition – not regulation – that is the best means of ensuring consumers get value for money in financial services."

Regulatory policy issues currently under active consideration that will affect the customer owned banking sector's competitive capacity include:

- improved access to capital for mutual companies
- modification or removal of APRA's 10 per cent cap on investor lending growth
- implementation of unquestionably strong and final Basel III capital framework
- implementation of the Banking Executive Accountability Regime
- implementation of mandatory Open Banking, and
- implementation of mandatory Comprehensive Credit Reporting.

In addition, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is currently examining the adequacy of existing laws and codes to address misconduct. COBA notes that the Royal Commission, in making recommendations, is to have regard to the implications of any changes to laws for access to and the cost of financial services for consumers and for competition in the financial sector.

COBA's view is that there is a clear need to increase APRA's accountability about the impact of its decisions on competition. This can be achieved by elevating the status of competition as a clear secondary objective for APRA, behind financial safety and stability.

Currently, APRA's mandate mentions competition but the regulator is not obliged to report on how its balances competition with its other objectives.

Providing an explicit 'secondary competition objective' does not mean APRA would have to sacrifice its primary objectives in pursuit of a more competitive environment but APRA would be more accountable about its approach to competition.

A major concern of our members and a key factor influencing the competitive capacity of smaller challengers to the major banks is the regulatory compliance burden. The fixed costs of complying with regulation fall more heavily on smaller firms. The regulatory compliance burden provides yet another advantage to major banks because they can spread their costs over a vastly bigger revenue base.

Regulation should be targeted, proportionate, risk-based and, where possible, graduated. Decisions to impose new regulation should be co-ordinated and the cumulative impact should be assessed. Seen in isolation, a particular regulatory measure may appear relatively benign but the continual introduction of new measures can amount to death by a thousand cuts to smaller players in the market.

Every new regulatory policy proposal needs to be considered through the lens of competition: will the cost, including the opportunity cost and the diversion of resources from other priorities, of implementing this measure affect the competitive capacity of smaller banks?

Highlights of ACCC 'Residential mortgage price inquiry Interim report' March 2018

Accommodative oligopoly
"Our report reveals signs that the price competition between the Inquiry banks, particularly the big four banks, has been less than vigorous. There are signs of accommodative oligopoly behaviour among the big four banks. We observe:

- the intense focus the big four banks have on each other when setting variable interest rates and the little regard they give to smaller lenders, and
- the way in which pricing strategies are often used to accommodate, rather than challenge, rivals which has likely affected residential mortgage interest rates."

Mutually beneficial pricing
"One of the big four bank's accommodating approach to pricing to avoid disrupting mutually beneficial pricing outcomes is reflected in some of the language used when its executives contemplated changes to mortgage interest rates. For example, in various documents prepared by senior executives at the bank during 2015 there are explicit references to *'encouraging rational market conduct', 'maintaining orderly market conduct'*, and maintaining *'industry conduct'*."

Little regard for smaller lenders
"The big four banks have largely focused their attention on each other (including some of their other brands) when making decisions on variable interest rates. Other lenders, of which there are over 100, appear to have rarely been central considerations in their decisions on headline variable interest rates. For example, one of the big four bank's home loan pricing strategy paper from March 2015 notes:

> *[We] will not compete nationally above the line with the headline pricing of the second tier lenders as this would generate a main bank response and lead the market down.*

"Other lenders were generally a lesser consideration for the big four banks in their approach to discounting. For example, in around 2016 one of the big four banks provided internal guidance to staff to match any interest rate offer from a big four bank (including one of their other brands) but to only offer rates 10-20 basis points higher than interest rate offers of other lenders."

FINANCIAL SYSTEM REGULATORS

COBA agrees with the Draft Report's call to increase the focus on competition in prudential regulatory decision-making.

We generally agree with draft recommendations 15.1, 17.1, 17.2 and 17.3 that cover:
- Statements of Expectations for regulators
- a competition champion on the Council of Financial Regulators
- transparency of regulatory decision-making, and
- analysis and evaluation of macro-prudential policies.

APRA does currently give some consideration to competition and its performance in this regard has improved since the Financial System Inquiry. However, there are multiple examples of where APRA has not given enough consideration to the impact on competition.

We support the use of Statements of Expectations to deliver further improvement but a more effective way forward is to change APRA's legislative mandate to introduce an explicit 'secondary competition objective' (SCO).

Secondary competition objective
APRA's mandate currently mentions competition but elevating the status of competition as a clear secondary objective behind financial safety and stability will increase APRA's focus on competition.

This would be consistent with the recent amendments to the *Banking Act 1959* to insert an objects clause saying the main objects of this Act are:

> (a) to protect the interests of depositors in ADIs in ways that are consistent with the continued development of a viable, competitive and innovative banking industry; and
> (b) to promote financial system stability in Australia.

Requiring APRA to report on its secondary competition objective would also be valuable in assessing the regulator's use of its new rule-making powers over non-ADI lenders.

Providing a 'secondary competition objective' does not mean APRA would have to sacrifice its primary objectives in pursuit of a more competitive environment but APRA would be more accountable about its approach to competition.

As noted in COBA's September 2017 submission to this inquiry, APRA's peer regulator in the UK, the PRA, was given a secondary competition objective in 2014 and the outcome is:
- a "material change of gear" where "competition is gaining airtime and traction at all levels", and
- "there are numerous instances where competition considerations have influenced policy outcomes."[1]

When discharging its general functions in a way that advances its primary objectives, the PRA must, so far as is reasonably possible, act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying out regulated activities.[2]

[1] Bank of England Independent Evaluation Office, Evaluating the PRA's approach to its Secondary Competition Objective, March 2016
[2] The Prudential Regulation Authority's secondary competition objective, Bank of England Quarterly Bulletin 2015 Q4

"The SCO does not require the PRA to act in a manner that is incompatible with its primary objectives," the Bank of England says. "In many cases the PRA's primary and secondary objectives will be fully aligned: for example, reducing 'too big to fail' distortions appear to have made both the financial system safer and competition more effective. Nevertheless, cases might exist where, within the range of prudential regulation options available to the PRA, there may be some which would deliver greater benefits to competition and others which would deliver greater benefits to safety and soundness or policyholder protection. The existence of the SCO means that the PRA should consider — but is not necessarily required to adopt — those options which would deliver greater benefits to competition for a given objective of safety and soundness or policyholder protection."

APRA's current consideration of competition, as outlined in its 31 January 2018 information paper *APRA's Policy Priorities*[3], includes matters such as:

- focus on risk alignment rather than product-specific requirements
- consideration of level playing field in policy options, and
- simpler options for smaller entities.

APRA's obligation to "balance" various objectives necessarily involves judgements and consideration of various options in any given prudential regulatory context. An explicit secondary competition objective with an associated reporting obligation would greatly increase accountability and transparency about consideration of competition in APRA's decision-making on the prudential framework.

For example, the Draft Report notes that APRA's new capital holding requirements for banks that offer warehouse funding take a comparatively blunt approach — focused on the prudential outcome for the major banks with little apparent consideration of the impacts on those institutions (and lending) that rely on warehouse funds. "At the margin (the only area where price competition seems a reasonable probability, in a highly regulated market), competition is consequently likely being suppressed," the Draft Report says. APRA's decisions on APS 120 affecting warehouse funding may or may not have changed if APRA had to take into account and report against an explicit SCO, but all stakeholders would be better informed about how APRA balanced its objectives. Several COBA members that use warehouse funding have noted increases in costs stemming from the new capital treatment.

As noted in Draft Finding 2.2, financial system stability has increased since the global financial crisis but competition has suffered. An explicit secondary competition objective for APRA will help ensure that the essential role of competition in economic growth is not eroded further by having stability as the default regulatory position.

Competition champion

The PC Draft Report's proposal for a competition champion on the Council of Financial Regulators (CFR) is welcome but would not necessarily address all the problems we have identified (see five examples of these problems in our first-round submission).

The Council of Financial Regulators is concerned with macro-prudential policy but many of APRA's micro-prudential decisions can and do affect competition. These decisions would not typically be matters for consideration by the Council of Financial Regulators. Examples include mortgage risk weight settings, treatment of warehouses and definitions of capital.

The ACCC notes in its report this month on mortgage pricing that: "Aspects of the level and structure of residential mortgage interest rates have been influenced by the prudential and macro-prudential measures imposed by APRA."

[3] http://www.apra.gov.au/AboutAPRA/Documents/Policy-Priorities-Information-Paper-January2018.pdf

Our proposal for an adjustment to APRA's mandate to introduce an explicit SCO would supplement the concept of another regulator – the ACCC or ASIC – having the role of competition champion on the Council of Financial Regulators.

The ACCC is more naturally suited to the role of competition champion and would therefore become a permanent new voice on the Council, while ASIC is to have an obligation to consider competition added to its mandate.

We agree that the lack of an advocate for competition is a mistake that should be corrected. APRA's excessively blunt macro-prudential intervention into the home loan market has harmed competition and unfairly affected smaller banking institutions.

One of the major issues on the agenda of the Council of Financial Regulators that will affect competition is tackling the 'too big to fail' problem that gives the major banks an unfair funding cost advantage over their smaller competitors.

COBA agrees with the Draft Report's finding that ratings agencies exacerbate the perception of 'too big to fail', i.e. by incorporating perceived government support in their relative ratings of Australia's banks, ratings agencies embed the major banks' 'too big to fail' status, with consequent advantages to these banks in the costs of funds.

The Government endorsed the Financial System Inquiry recommendation to reduce any implicit government guarantee and the perception that some banks are too big to fail. The recommendation was made in 2014 and accepted by government in 2015.

FSI Recommendation 3 called for implementation of a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian ADIs and minimise taxpayer support.

The Government's response said: "We endorse APRA as Australia's prudential regulator to implement this recommendation in line with emerging international practice."

APRA announced in its recent policy priorities paper that it expects to commence consultation later in 2018 on proposals to implement this Financial System Inquiry recommendation.

As noted above in relation to the UK PRA's SCO, tackling the 'too big to fail' problem will make the financial system safer and promote competition by reducing an unfair advantage enjoyed by the biggest banks.

Macro-prudential measures

We support the need for APRA to conduct and publish annually quantitative post-implementation evaluations of its macro-prudential policies.

Under Draft Recommendation 17.3, there would also be pre-implementation analysis of potential measures through the CFR. The need for these processes highlights that it may be time to consider a more formal approach to the macro-prudential toolkit.

It is clear from global experiences that these kinds of macro-prudential measures are now a permanent feature of the prudential toolkit, or at least a greatly increasing part of it with the Draft Report noting that "macro-prudential supervision [is] likely to dominate regulator behaviour for some years to come". However, as the PC has highlighted, it is important to recognise the potential impact of these measures and ensure that they are appropriately targeted.

There should be greater consultation with industry ahead of implementing certain macro-prudential measures. Some measures in the macro-prudential toolkit such as leverage ratios, countercyclical buffers, interbank exposures and liquidity-related tools have been heavily consulted on and formalised in the prudential framework but others, such as the investor lending cap and interest-only benchmark, have not had the same degree of consultation.

Consultation would help smooth the application of measures and provides the opportunity to reduce unintended consequences while clearly reinforcing the intended consequences.

The Draft Report highlights this 'different' approach taken by others, noting: "The Reserve Bank of New Zealand, for example, released consultation papers and asked for submissions before it set restrictions around high LVR lending in 2013, and then prior to changing these restrictions in 2015 and 2016. A Regulatory Impact Statement was also published in 2013." A Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank of New Zealand[4] states that "[RBNZ] will consult with the registered banks prior to deployment of a macro-prudential policy instrument in the manner required under Section 74(3) of the Act."

COBA accepts that macro-prudential measures play an important role in managing systemic risk. However, there must be greater consultation with industry ahead of implementation. Consultation can also inform the pre-implementation analysis at the CFR level and minimise unnecessary operational issues in implementing the measures. COBA believes that consultation could have avoided disproportionate impacts on smaller ADIs. This would allow APRA and other regulators to "keep costs to the least necessary to achieve their objectives in all material future macro-prudential actions."

Consultation can also be used to build wider policy legitimacy across the public and the regulated community – something that would support individual interventions as well as the broader macro-prudential toolkit.[5]

Similarly, such an approach could be extended to outlining a macro-prudential toolkit. For example, RBNZ consulted in July 2017 on adding Debt to Income restrictions to its macro-prudential toolkit.[6] This would not limit the potential measures available to APRA but provide more certainty about the potential future 'rules of the game' and hence allow ADIs to plan for them.

Several COBA members have had time 'out of the market' due to the risk of breaching macro-prudential limits. Customer-owned banks, due to their small size relative to the major banks, are subject to greater volatility in their lending flows. This makes it much more difficult to manage a predictable growth path within the 10% limit.

Having to temporarily exit the investor lending market has significant impacts on customer and broker relationships. New and existing customers are turned away as institutions are unable to provide a product that is part of the standard offering of modern banking institutions. For example, an existing borrower with an owner-occupied loan may seek to move both their current loan and new investor loan to another ADI if the current ADI is unable to provide the investor loan. This creates reputation and trust issues.

Similarly, the measurement of the investor lending benchmark as a 12-month rolling average is appropriate for those who can constantly increase their stock (i.e. the major banks) but not for smaller ADIs where it is possible to have a decrease in the lending stock. For example, if the investor lending stock falls from $100 million in July 2017 to $90 million in August 2017 (for example due to refinances to competitors or cut backs to meet

[4] https://www.rbnz.govt.nz/financial-stability/macro-prudential-policy/mou-between-minister-of-finance-and-governor-of-rbnz
[5] See Deputy RBNZ Governor Grant Spencer's speech to INFINZ, Auckland, 13 March 2018 https://www.bis.org/review/r180315b.htm
[6] https://www.rbnz.govt.nz/news/2017/06/debt-to-income-limit-consultation

APRA's caps), this implies that that maximum lending stock in July 2018 is $110 million but only $99 million in August 2018. It is difficult to manage this kind of change and introduces regulation-induced seasonality into lending flows.

Industry consultation prior to implementation could have ironed out some of these issues.

Standardised risk weights

COBA supports Draft Recommendations 9.1 and 16.1 for greater risk sensitivity in standardised risk weights for SME lending and mortgages.

Since the release of the Draft Report, APRA has released a paper outlining its proposed approach to implementing "unquestionably strong" capital settings, final Basel III requirements and the revisions to address higher risk mortgage lending. These proposals focus on changes to the standardised approach to credit risk. This effectively begins the review process identified in Recommendation 16.1.

COBA agrees with the PC's observation that "increasing the precision of the standardised risk weights is more likely to create the environment for improved competition without detracting from prudential outcomes". However, COBA notes that proposals to more finely calibrate risk weights need to preserve the relative simplicity of the standardised approach.

COBA and its members are examining APRA's proposals and we note that APRA will also carry out further analysis of the impact of the proposed changes on banking institutions.

We want to see a further narrowing in the capital requirements for mortgages held by smaller banks compared to the major banks. The Financial System Inquiry identified this as a significant anti-competitive problem and APRA has since taken interim steps to reduce the gap. There is still some way to go but we are encouraged by APRA's statement that "the revised risk weight framework is likely to reduce any competitive differential in regulatory capital requirements between large and small ADIs, improving the competitive position of the latter."

SME Lending

COBA supports draft recommendation 9.1 for APRA to provide a broader schedule of risk weights for SME lending not secured by a residence. Being able to incorporate the different risk profiles and types of lending will increase the ability of standardised ADIs to provide SME lending.

All COBA members are subject to the standardised approach to credit risk (APS 112). In terms of SME lending, most of our sector's SME lending is done as lending secured by residential real estate. COBA members have noted that subject to potential revisions, they may diversify in the way they lend to SMEs in the future.

As above, COBA recognises that there is a need for simplicity in the standardised approach as unnecessary complexity runs counter to the underlying intention of the approach. However, the PC's suggestions to incorporate loan values, non-residential securities and loan-to-value ratios (LVR) as parts of the risk profile appear straightforward. On a related note, COBA members have also raised concerns about the framework making no distinction between unsecured personal loans and those secured by alternative non-residential securities (e.g. secured car loans).

Mortgage Risk Weights

APRA's recently released proposed framework for residential secured mortgages has increased its risk sensitivity with separate risk weight schedules for higher and lower risk loans, and risk weights below the current 35 per cent minimum for certain lower LVR loans. For most mortgages, a lower LVR leads to a lower risk weight.

However, APRA's recent paper proposes a flat 100 per cent risk weight for 'non-standard' mortgages (subject to APRA's final calibration). This flat application is a distinct departure from APRA's existing risk sensitive approach for 'non-standard' loans and it is not clear why APRA is proposing this approach.

Comparison of non-standard risk weights

LVR %	0-50	50.01-60	60.01-80	80.01-90	90.01-100	> 100.01
Current APS 112	35	35	50	75	75	100
Proposed	100	100	100	100	100	100

CARD INTERCHANGE FEES

COBA is opposed to Draft Recommendation 10.3 'Ban card interchange fees'.

Interchange fees are a mechanism to enable sharing of costs of certain benefits that card issuers provide to merchants. These benefits include processing transactions, preventing fraud and authorising transactions.

Merchants should bear at least some of the cost of benefits provided to them by card issuers.

Banning interchange fees would affect competition by having a disproportionately greater impact on smaller card issuers that do not participate in the merchant acquiring market. Major banks dominate both the card issuing and merchant acquiring sides of the payment card market. The loss of compensation for costs sustained by the card issuing side of their business could be balanced by not having to pay interchange fees from the merchant acquiring side of their business.

The Payment System Board carried out a comprehensive review of card payment interchange fees in 2015 and 2016 and the new benchmarks commenced only last year.

CONTACT US

Thank you for the opportunity to inform your deliberations and please don't hesitate to contact COBA if would like to discuss any aspect of this submission.

Michael Lawrence **CEO, COBA**	**Luke Lawler** **Director – Policy, COBA**

CUSTOMER
OWNED
BANKING
ASSOCIATION

www.customerownedbanking.asn.au