Australian Government
Productivity Commission

Australian Government Competitive Neutrality Complaints Office

Draft Findings regarding the Australian Business Growth Fund,

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Feedback is due by 16 July 2021

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Competitive neutrality policy

Competitive neutrality is a policy which aims to promote efficient competition between public and private businesses. The Australian Government's approach is set out in its *Competitive Neutrality Policy Statement* (Australian Government 1996):

> Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership. (p. 4)

In particular, competitive neutrality policy:

> … requires that governments should not use their legislative or fiscal powers to advantage their own businesses over the private sector. (p. 5)

While the policy recognises that there are a number of advantages and disadvantages of government ownership, it does not seek to ameliorate all of these. Instead, it focuses specifically on those competitive advantages enjoyed by government businesses that are widespread and relatively easy to observe and correct (Australian Government 1996, p. 6), including:

- exemptions from various taxes (taxation neutrality)
- access to borrowings at concessional interest rates (debt neutrality)
- exemptions from complying with regulatory arrangements imposed on private sector competitors (regulatory neutrality)
- other benefits associated with not having to achieve a commercial rate of return on assets (commercial rate of return requirements).

The policy is applied to significant government businesses where the benefits from doing so outweigh the costs. For the purpose of competitive neutrality policy, a business activity is defined as one where:

- there is user charging
- there is an actual or potential competitor (that is, users are not restricted by law or policy from choosing alternative sources of supply)
- managers of the activity have a degree of independence in relation to the production or supply of the good or service and the price at which it is provided.

Competitive neutrality policy deems the following organisations as significant as they have been specifically structured to operate along commercial lines:

- all government business enterprises (listed under the *Commonwealth Authorities and Companies Act 1997*) and their subsidiaries
- other share-limited trading companies
- all designated business units.

Other activities which operate in accordance with the definition of a business and generate in excess of $10 million in revenue from commercial activities are also considered to be significant.

Summary

In late 2020, the Australian Government Competitive Neutrality Complaints Office (AGCNCO) received a complaint by OnMarket BookBuilds Pty Ltd relating to alleged breaches of competitive neutrality connected with the Australian Business Growth Fund (ABGF). Launched in 2020, the ABGF is a company that provides ‘patient capital’ to small and medium enterprises. The Australian Government is a minority shareholder alongside a number of major financial institutions. That part ownership is sufficient to render the fund subject to competitive neutrality policy.

Among other matters, the complainant alleged that under the direction of the Australian Government, the Australian Prudential Regulation Authority (APRA) lowered the capital adequacy requirements that would normally apply for investments made by authorised deposit-taking institutions (ADIs) in an equity fund with the structure and investment profile equivalent to the ABGF. The complainant’s concern was that this reduced the cost of capital relative to other financial entities competing in the same market (namely, providing equity finance to small and medium-sized businesses). The core of the complaint is that APRA’s capital adequacy requirements for ADIs investing in the fund arose *because* of the Australian Government’s part ownership of the fund, rather than because of the inherent features underpinning the fund’s risk. If correct, this would be contrary to the principle of regulatory neutrality, which requires that governments do not use regulation to advantage their own businesses over the private sector.

However, following questions put to it by AGCNCO, APRA indicated that the capital treatment for investments made by ADIs in the fund was not based on its part ownership by the Australian Government, with the treatment determined prior to knowledge of the Australian Government’s stake. APRA noted that the capital adequacy requirements used were broadly consistent with the internationally-agreed Basel III capital framework, and that similar growth funds operating in the United Kingdom (UK) and Canada have comparable requirements despite no government shareholding. This is borne out by the evidence. The implication is that the capital adequacy rules applied to the ADIs investing in the ABGF cannot be attributed to the presence of the Australian Government as a part owner of the fund. In that context, the AGCNCO finds no breach of competitive neutrality policy.

FINDING 1

The risk treatment afforded by Australian Prudential Regulation Authority to investments made by authorised deposit-taking institutions in the Australian Business Growth Fund, in which the Australian Government is a minority shareholder, does not constitute a breach of regulatory neutrality under competitive neutrality policy.

In undertaking its functions, APRA is required by its legislation to balance competitive neutrality against other objectives. The complaint also alleged that APRA failed to do this. However, APRA's obligations relate only to the entities that it *directly* regulates, which in the case of the ABGF are all private ADIsI. (Indeed, there are currently no government-owned banks in Australia at all.) Accordingly, APRA does not have responsibility for regulating the ABGF. Had the creation of ABGF breached competitive neutrality policy — which it has not — the Australian Government, not APRA, would bear responsibility for any breach of competitive neutrality and its resolution.

FINDING 2

The Australian Prudential Regulation Authority's obligation to consider competitive neutrality relates solely to any difference in its regulatory treatment of authorised deposit-taking institutions that are wholly private versus those with at least some level of government ownership. The obligation does not extend to entities in which such institutions are investors. As there are currently no government-owned authorised deposit-taking institutions, the Australian Prudential Regulation Authority's obligations are met. In the case of the Australian Business growth Fund, the Australian Government, not the Australian Prudential Regulation Authority, would bear responsibility for any breach of competitive neutrality and its resolution.

Nonetheless, there has been considerable confusion about APRA's responsibilities with regard to competitive neutrality. It may be useful for APRA to publicly clarify that its consideration of competitive neutrality applies only to the entities that it regulates, and not to other entities that are the recipients of any investments by APRA-regulated entities.

Uniquely, the ABGF is only partly owned by the Australian Government, rather than being a standalone government business, which is a more typical target of concerns about competitive neutrality. Assessing and addressing any breach of competitive neutrality in a business only partly-owned by government involves additional complexities and accentuates the imperative for particularly close scrutiny of such arrangements before their establishment.

FINDING 3

Remedying a breach of competitive neutrality may be more difficult for a partly-owned government business than one fully-owned by government. This increases the imperative for a careful assessment of competitive neutrality prior to government becoming a part owner of a business.

1 About the complaint

In late 2020, the Australian Government Competitive Neutrality Complaints Office (AGCNCO) received a complaint by OnMarket BookBuilds Pty Ltd relating to alleged breaches of competitive neutrality connected with the Australian Business Growth Fund (ABGF). Launched in 2020, the ABGF is a company that provides 'patient capital' to small and medium-sized enterprises (SMEs). The Australian Government is a minority shareholder alongside a number of major financial institutions.[1] This chapter outlines the nature of the fund and the complaint, and the role of the AGCNCO in investigating the complaint.

The Australian Business Growth Fund

The Australian Government established the ABGF in October 2020 to provide equity finance to SMEs. Shareholders have initially committed to contribute $540 million to the fund: this consists of commitments of $100 million from the Australian Government,[2] ANZ, the Commonwealth Bank, the National Australia Bank and Westpac, alongside $20 million each from HSBC Australia and Macquarie Bank.

The investment aims of the ABGF are to:

- increase the availability of patient capital to Australian SMEs
- increase the level of investment in SMEs across Australia
- facilitate interstate and overseas trade and commerce
- support job creation and economic growth in response to the COVID downturn. (Frydenberg 2020)

The ABGF will invest in established SMEs with annual revenue between $2 million and $100 million and three consecutive years of revenue growth and profitability (Frydenberg 2020). Investments 'must be commercially viable and make a return appropriate to the underlying risk of the investment'. Further, the ABGF will only assume a minority (non-controlling) stake of between 10 and 40 per cent of share capital in those businesses. Shareholders anticipate expanding the fund to $1 billion, with a requirement that there be a spread of investments across industries and regions (Frydenberg 2020). The fund

1 The ABGF should not be confused with the Business Growth Fund, which is a grant program for small business run by the Queensland Government.

2 The Australian Government has so far contributed $2 million to the fund, with plans to contribute a further $9.53 million in 2021-22 (Commonwealth of Australia 2021).

is similar in design to business growth funds in the UK and Canada, although these funds have no government shareholding.

Notwithstanding the Australian Government's shareholding, the ABGF is constituted as a private business. There is therefore limited public information concerning the fund's investment mandate, operation, management and governance, and the shareholder agreement made in establishing the fund has not been published (Senate Economics Legislation Committee 2020a, p. 30).

Nature of the complaint

In December 2020, the AGCNCO received a complaint regarding the ABGF. The complainant, OnMarket BookBuilds Pty Ltd, is an equity-raising platform that provides equity finance to a range of businesses, including SMEs.

The complaint raised four concerns about the design and operation of the ABGF, namely that:

1. the 'Government caused its agency, APRA, to change prudential regulations for the purpose of lowering the cost of capital supplied by bank shareholders to the ABGF … lowering the ABGF's cost of capital to a fraction of the commercial cost of capital of competitors … [and providing] … an unassailable competitive advantage in the market for financing equity investments in SMEs' (OMBB 2020, p. 1). The complaint further noted that ' … but for the Government's shareholding, APRA would not grant this new prudential concession' (OMBB 2020, p. 4). This was seen as contravening competitive neutrality policy.
2. APRA did not consider competitive neutrality when making this regulatory change, despite their apparent requirement to do so under section 8(2) of the *Australian Prudential Regional Authority Act 1998* (Cth) (APRA Act)
3. the fund breaches provisions of the *Competition and Consumer Act 2010* (Cth), including prohibitions against: cartels (ss. 45AF-45AG), arrangements that have the purpose or effect of substantially lessening competition (s. 45) and misuse of market power (s. 46)
4. the fund is invalid under the Australian Constitution.

Of these, (3) and (4) are outside of the remit of the AGCNCO. (However, the AGCNCO notified the ACCC of the allegations concerning potential breaches of the Competition and Consumer Act.)

Claim (1) squarely falls under the scope of the AGCNCO, while (2) has indirect relevance. Whether APRA adequately considered its competitive neutrality obligations under section 8(2) of the APRA Act is not per se a question directly relevant to the existence of a breach. However, it is relevant to an understanding of responsibilities for implementing competitive neutrality policy more generally.

What did APRA do?

In December 2019, APRA adjusted its general capital framework for authorised deposit-taking institutions (ADIs)[3] to allow those that invest in the ABGF to apply a risk weight of 250 per cent to their investment, compared to usual treatment of a full deduction from Common Equity Tier 1 (CET1) capital. (The details of this adjustment are outlined in box 1).

Box 1 What treatment did APRA provide to investments in the ABGF?

To minimise risks to the stability of the financial system, the Australian Prudential Regulation Authority (APRA) requires authorised deposit-taking institutions (ADIs) to hold a specified capital reserve (regulatory capital). This reserve is designed to ensure that the ADI can absorb potential losses, such as loan defaults, without jeopardising the broader system. The amount (and type) of regulatory capital that an ADI must hold depends on the amount (and type) of an ADI's liabilities — riskier investments generally require ADIs to hold larger reserves.

One prudential capital requirement is the ratio of Common Equity Tier 1 capital reserves (CET1; the most secure type of capital reserve) to total risk-weighted assets held by an ADI. If an ADI makes an equity investment, APRA generally requires a full deduction from their CET1 regulatory capital reserves, requiring a bank to hold an equivalent amount of CET1 capital to maintain the prudential capital ratio. That is, in normal circumstances, for every dollar a bank invested in an equity product it would be required to hold a dollar in its liquid capital reserve. This treatment reflects a principle that equity risk should be fully borne by an ADI's shareholders, rather than depositors or other creditors.

An ADI must maintain a CET1 ratio of 10.5 per cent to meet the capital requirement associated with APRA's implementation of the 'unquestionably strong' framework (APRA 2017). Without special treatment, this ratio means that an equity investment is effectively subject to a 952 per cent risk weighting. This is the weighting consistent with a requirement that every dollar of equity investment be matched by an increase in CET1 of a dollar.

On 9 December 2019, APRA issued a letter to all ADIs notifying them that any investments they make in the Australian Business Growth Fund (ABGF) will receive revised treatment compared to other equity investments. Investments in the ABGF are instead subject to a risk weight of 250 per cent and, to manage risks from the lower reserve requirement, the amount that can be invested in the ABGF is limited to 2 per cent of the ADI's CET1 capital holdings.

A risk weight of 250 per cent significantly reduces the amount of additional CET1 capital required to be set aside to meet the required capital ratio. With a CET1 ratio of 10.5 per cent, an investment with a risk weight of 250 per cent requires an ADI to only set aside 26.25 per cent of the investment value as CET1 capital. Accordingly, the opportunity cost of undertaking an investment in the ABGF using the revised prudential treatment is considerably less than under the default treatment, making such investments more appealing for ADIs compared to alternatives. However, a 250 per cent risk weighting is still higher than many other potential investments, such as an unsecured small business loan (100 per cent risk weighting).

Sources: APRA (2019b, 2019c, p. 11); PC (2018); Commission estimates.

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3 ADIs are financial entities that are licenced by APRA to carry on banking business, including accepting deposits from the general public. They include banks, credit unions and building societies. To maintain the financial soundness of individual institutions, as well as the stability of the financial system, ADIs are subject to minimum capital and liquidity requirements, relative to the size and risk of their lending and investment activities.

Jurisdiction of the AGCNCO

Is competitive neutrality policy relevant to the ABGF?

In the first instance, there is a question over whether the ABGF, as a private fund, is subject to the Australian Government's competitive neutrality policy and, as a consequence, subject to the Government's competitive neutrality complaints process.[4]

In accordance with the Australian Government's *Competitive Neutrality Policy Statement* of June 1996, competitive neutrality policy will apply to 'significant government business activities' (Australian Government 1996, p. 7). The policy provides guidance on what constitutes a *business*, a *significant activity*, and a *government activity*.

Under the policy guidelines, the ABGF clearly constitutes a *business*, and is of a scale to be considered as a *significant activity*. On the matter of whether the Australian Government's partial shareholding in the ABGF is sufficient to qualify it as a *government activity*, the 1996 policy does not specify how this is determined. It does, however, note that 'Commonwealth share-limited companies are generally expected to comply with all competitive neutrality requirements' (Australian Government 1996, p. 10).

The 1996 competitive neutrality policy applies to government business activities, not to wholly-owned government businesses (Australian Government 1996). Were 100 per cent ownership a requirement, competitive neutrality principles would be sidestepped through the trivial involvement of a private party. The National Competition Council made its position on this issue clear:

> An emerging competitive neutrality complaints issue is the appropriate treatment of complaints about businesses which are partially privatised. Given that the agreed objective of competitive neutrality reform is the 'elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities', the Council believes that complaints mechanisms need to address all complaints which arise as a result of a business's government ownership connections. This would include businesses which are part-owned by governments (NCC 1997, p. 24)

Accordingly, even part Australian Government ownership in a significant business activity is sufficient to render it subject to competitive neutrality policy and the complaints mechanism. Previously, the AGCNCO has twice accepted complaints involving businesses in which the Australian Government was only a part owner: National Rail (CCNCO 2000) and ARRB Transport Research Limited (CCNCO 2001).

4 The AGCNCO provided preliminary advice to the Senate inquiry into the provisions of the *Australian Business Growth Fund Bill 2019* in February 2020 (AGCNCO 2020).

Decisively, the Australian Government Treasury has also made this observation in respect of the ABGF:

> The Government's policy of Competitive neutrality applies to the ABGF because of the Commonwealth's shareholding and the commercial nature of [the ABGF's] activities. (Treasury 2020)

Consequently, the ABGF is subject to competitive neutrality requirements and, where there is a complaint, resort to the competitive neutrality complaints mechanism.

Is the complaint within the scope of the AGCNCO?

The *Productivity Commission Act 1998* (Cth) empowers the AGCNCO to investigate complaints that an Australian Government business or business activity is not being conducted in accordance with the competitive neutrality arrangements that apply to it.

In deciding to investigate any complaint the office must have regard to the *Productivity Commission Act 1998* (part 4, division 2) and the 1996 *Competitive Neutrality Policy Statement* (Australian Government 1996) and ensure that the complaint:

- is not better handled by another body
- does not relate to competitive neutrality policies that are being finalised or are currently the subject of review by government
- is not vexatious
- raises issues of substance and with non-trivial resource allocation effects.

The AGCNCO decided to proceed with its investigation as all these conditions are met. The relevant matter (claim 1 above) relates to competitive neutrality and so is appropriately addressed by the AGCNCO. It does not relate to the finalisation or review of any competitive neutrality policies. The complaint is not vexatious as the creation of the ABGF is directly competing in the market in which the complainant is operating. The size of the ABGF is large and therefore so too are its potential effects.

2 Competitive neutrality issues associated with the Australian Business Growth Fund

A breach or not?

The key question is whether APRA would have provided the *same* risk treatment for investments in the ABGF if the Australian Government were not a shareholder, in which case there is no breach of regulatory neutrality. Regulatory neutrality would hold, for example, if any comparable fund owned by ADIs, with a similar profile and structure but without Government shareholding, would be eligible for the same risk treatment.

Some statements previously made by APRA regarding the ABGF are open to the interpretation that the risk treatment of ADI's investments in the ABGF can be causally related to the Australian Government's partial ownership. APRA's letter to banks outlining the capital treatment of investments in the ABGF noted that 'the inclusion of the Australian Government as a founding shareholder in the ABGF *supports* APRA providing a special treatment' (APRA 2019b) (emphasis added). On face value, this appears to lend credence to the complainant's concerns.

However, APRA has made other statements indicating that it supported the establishment of the fund on broader grounds, particularly because of its benefits in increasing the availability of finance for SMEs in supporting the overall financial system, not because of the Australian Government's shareholding per se:

> This revised treatment recognises the wider financial system benefits from increasing access to financing for SMEs. (APRA 2019b)

Moreover, in response to queries from the AGCNCO, APRA has explicitly stated that (a) it did not take government ownership into account, (b) that it developed the capital adequacy test *prior* to its knowledge that the Australian Government would have an ownership stake, and (c) that the same capital adequacy principles would apply to any decisions made over investments in new funds without a government stake, subject to their structure and design:

> In determining the appropriate capital treatment, APRA did not take into account Government ownership. The capital treatment was developed internally prior to APRA understanding that there would be a Government ownership stake. (APRA 2021, pp. 2–3)
>
> The capital treatment announced on 9 December 2019 applied to the ABGF, providing clarity to ADIs and setting the limits for such investments. This capital treatment is available to all ADIs that invest in the ABGF. APRA would apply the same principles in determining the appropriate

> capital treatment in any similar funds, but the exact level of the capital treatment would depend on the specific structure and design. (APRA 2021, p. 2)

APRA also noted that an approach to develop a fund similar to the ABGF, but without any government stake, had occurred well before the proposal for the ABGF, and that APRA had considered a capital treatment similar to that ultimately provided to investments in the ABGF.

> … APRA has been approached in the past by stakeholders seeking to establish funds with a similar design and purpose to the ABGF, without government involvement. The most notable example of this was in 2015 when an international bank approached APRA seeking to replicate similar structures in place internationally. One option preliminarily considered by APRA at that time was a similar capital treatment to that eventually determined for ADI investments in the ABGF. Ultimately, those proposals did not proceed beyond the discussion stage. To the best of APRA's knowledge, that proposal did not include a Government ownership stake. (APRA 2021, p. 2)

The information provided to the AGCNCO reiterates APRA's previous testimony to the Senate Economics Legislation Committee. APRA noted that the Australian Government's ownership stake in the fund 'certainly wasn't a requirement' for the capital treatment provided (Senate Economics Legislation Committee 2020b, p. 13).

That APRA would consider the appropriate capital treatment of ADIs investing in ABGF with no expectation of the Australian Government as a part owner is also consistent with the origins of the ABGF. The fund was championed by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO 2018) and did not envisage any government ownership stake. The ASBFEO cited banks' concerns that a factor behind the hitherto small role played by ADIs in patient capital were APRA's restrictive regulations. The Reserve Bank of Australia also noted the more restrictive nature of APRA's regulatory capital framework for equity investment by banks compared with that of the UK Prudential Regulation Authority (Connolly and Bank 2018). Accordingly, the issue of prudential standards was recognised as a general inhibitor to provision of equity finance by ADIs.

The international precedent

APRA indicated that its choice of the risk weight in the capital requirement test is consistent with the level of diversification of risk, international regulatory frameworks (Basel III), the structure and objectives of the fund, and precedents set by the UK and Canadian business growth funds.

Such international precedents provide suggestive evidence about the appropriate capital treatment of ADIs that invest in a fund like the ABGF. APRA has noted, both publicly and in its response to the AGCNCO, that its capital requirements for the ADIs investing in the ABGF were broadly consistent with global standards:

> APRA's capital requirements for investments in the fund … [are] consistent with a discretionary option for equity investments in financial institutions under the internationally agreed Basel III

capital framework. It is also broadly consistent with the approach taken in other jurisdictions that have comparable business growth funds, such as the UK and Canada. (Senate Economics Legislation Committee 2021b, p. 3)

The Basel Framework allows for a 250 per cent risk weighting for substantial non-controlling equity investments[5] and the investment is less than 10 per cent of the bank's regulatory capital (box 2). APRA's requirement that the ABGF be limited to 2 per cent of an ADI's CET1 capital further limits their exposure to risk.

Notably, in the UK and Canada the relevant growth funds do not have a government shareholder. In Canada, the Government amended the *Bank Act 1991* to clarify certain aspects of how investments in the CBGF are to be treated (for example, in terms of limits on the investments by any single entity, the extent of controlling power, and on the involvement of foreign entities) — all of which reduced the risk exposure for any given investor. But the key point is that these regulations did not differentiate between government and private ownership. Therefore, in both the UK and Canadian funds, the regulatory framework allows other funds similar to the ABGF to receive comparable treatment if they meet certain conditions.

In addition, APRA has noted that its capital adequacy test was more conservative than the comparable funds in the United Kingdom and Canada:

> … the other two funds we looked at were those in the United Kingdom and in Canada. Generally speaking, they had an equivalent risk weight approach, but they actually had a lower risk weight for these types of equivalent exposures than Canadian banks. We were a little bit more conservative and our capital framework for banks in Australia is based on an international framework, and we looked to that framework to better align what we're considering in Australia, and we used that framework and looked at what that framework proposed, and that's where we landed on the 250 per cent risk weight. So, it's a little bit more conservative than other jurisdictions, but it is aligned to the international framework. (Senate Economics Legislation Committee 2020b, p. 12)

Conclusion

As discussed at length in the Productivity Commission's inquiry into banking (PC 2018), competition in Australian financial markets is imperfect. ADIs receive preferment through depositor guarantees but face stringent regulatory oversight through prudential requirements that heavily restrict their activities. Non-ADIs face far less regulation, but without the stable base of deposits to lower the cost of capital for their investments. The precise effects of these differences for patient equity in the market targeted by the ABGF is unclear.

5 The Basel framework stipulates that this would apply where a bank's non-controlling investment exceeds 10 per cent of the ABGF's overall investment pool, which is met by the big four banks.

Box 2 International prudential treatment of equity investments

Basel Framework

The default treatment of substantial minority equity investments under the international Basel Framework is that:

> Significant minority investments in banking, securities and other financial entities, where control does not exist, will be excluded from the banking group's capital by deduction of the equity and other regulatory investments. (Basel Framework, SCO30.4).

However, sections 30.29-30.34 of *CAP30 – Definition of capital* allow for a regulatory adjustment where a bank's non-controlling investment exceeds 10 per cent of that entity's (in the relevant case here, the ABGF) available ordinary shares (Basel Committee on Banking Supervision 2021). While these would usually be deducted from regulatory capital, they can be risk weighted at 250 per cent (30.34) if the significant investment (30.32(1)) does not exceed 10 per cent of the bank's CET1 regulatory capital (30.33).

UK Business Growth Fund

The UK Business Growth Fund was established in 2011 with a £2.5 billion commitment from five major banks (DBIS (UK) nd). The UK Government supported development of the fund but is not a shareholder.

Bank investments in the fund are treated as risk-weighted asset 'subject to the scale and diversity of the portfolio' (Bank of England 2015, p. 37). Amendments were made to prudential rules in 2011 to confirm this treatment (FSA (UK) 2011, p. 9). The amendment is drafted as a general rule for particular investment vehicles, rather than being an adjustment available only to the UK Business Growth Fund.

Canadian Business Growth Fund

The Canadian Business Growth Fund was established in 2018, with funding commitments of C$1 billion over ten years (Department of Finance Canada 2018). No Government is a shareholder: in proposing the fund, the Advisory Council on Economic Growth viewed the role for government as '(a) highlighting the potential capital need; (b) convening and coordinating the different sources of capital, and (c) clarifying the capital treatment for investments in this fund' (Advisory Council on Economic Growth (Canada) 2017, p. 24).

The Fund was not provided any specific treatment by the prudential regulator. The report proposing the fund noted that a lower risk weighting was already available for 'non-substantial' equity investments (defined as representing less than 10 per cent ownership) (Advisory Council on Economic Growth (Canada) 2017, p. 36). Where those investments are less than 10 per cent of regulatory capital, Canadian banks can risk-weight those holdings based on credit or market risk rather than capital deduction (OSFI (Canada) 2018, paragraph 75).

However, competitive neutrality policy is not concerned with competition policy generally, but with the narrower question of whether the Australian Government has used its legislative or fiscal powers to advantage a government business compared with private businesses operating in the same market.

Nor is competitive neutrality concerned with the desirability of government ownership per se. Some have criticised the need for and appropriateness of the government's ownership role in the ABGF and its governance arrangements, as in the paper produced by the Parliamentary Library (Bogaards and Ramesh 2020). However, broader consideration of the justification for government ownership is outside the remit of the AGCNCO.

On the basis of information provided by APRA to the AGCNCO, reinforced by evidence put to the Senate Economics Legislation Committee and overseas experience with like funds, the AGCNCO finds no breach of competitive neutrality policy resulting from the Australian Government's ownership stake in the ABGF.

FINDING 1

The risk treatment afforded by Australian Prudential Regulation Authority to investments made by authorised deposit-taking institutions in the Australian Business Growth Fund, in which the Australian Government is a minority shareholder, does not constitute a breach of regulatory neutrality under competitive neutrality policy.

Did APRA comply with its legislative requirement to balance competitive neutrality?

The complaint also claimed that APRA did not comply with their legislative requirement to consider competitive neutrality in making their decision. This concern has no bearing on any finding on compliance with competitive neutrality policy, but is relevant to the general understanding of the allocation of responsibilities for competitive neutrality.

Section 8(2) of the APRA Act states that:

> In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and **competitive neutrality** and, in balancing these objectives, is to promote financial system stability in Australia. (emphasis added)

APRA considers its obligation to competitive neutrality as 'ensuring state-owned and private businesses compete on a level playing field' (APRA 2019a, p. 20).[6] It seeks to avoid creating advantages for public sector entities, relative to other market participants, but furthers notes that competitive neutrality 'is the most straightforward of APRA's balancing considerations to assess, as there is limited public sector involvement in prudentially regulated markets' (APRA 2019a, p. 20).

It is clear that APRA does have *some* responsibility to consider competitive neutrality, which it acknowledges. The question is whether those responsibilities extend to the ABGF, an issue subject to debate (box 3). There are two views on APRA's responsibilities:

1. One view is that the required competitive neutrality assessment under section 8(2) would only arise were APRA to privilege an at least partly-owned Australian Government ADI

6 As noted above, competitive neutrality would also apply to any ADIs that are partly owned by government.

over a private one. Regulatory decisions involving ADIs that had indirect competitive consequences for non-ADIs would not be a trigger for APRA's consideration of competitive neutrality. Were, for example, the Australian Government to provide a 100 per cent guarantee to the ABGF to meet any losses made by its ADI members, APRA could legitimately reduce prudential requirements because bank risks were lower. It would not have to consider competitive neutrality so long as it adopted the same capital adequacy tests for all ADIs regardless of their ownership. In effect, any breach of competitive neutrality that such a policy might have entailed would be a matter for Government not APRA.

2. An alternative view is that APRA is required to consider the *indirect* impacts on competitive neutrality in the broader financial system of its capital adequacy decisions for ADIs, and not just to consider competitive neutrality in respect of ADIs alone.

Box 3 **APRA's perspectives on the application of competitive neutrality to the ABGF**

In their appearance at the Committee hearing, APRA was asked whether they had considered competitive neutrality in making their decision:

> Senator PATRICK: We were talking before about some of these risk ratios and how much money the bank has to put in. The government has a competitive neutrality policy. Is it APRA's role to examine that — or is that a question outside of your remit?
>
> APRA (Ms Richards): I think it's outside of our remit. It was the government that determined the structure and the approach for this fund and conducted consultation on it, so our view is that those issues are more a matter for them. (Senate Economics Legislation Committee 2020b, p. 14)

In additional information provided to the Senate Economics Legislation Committee, APRA clarified that:

> … in reaching this view on the appropriate capital treatment, APRA considered competitive neutrality. APRA notes that ADI investments are limited through an ARA-imposed cap and that the capital treatment in consistent with that applied by peer jurisdictions internationally. In addition, APRA has published the capital treatment for transparency and applied this approach consistently to any ADI that invests in the fund. As per Ms Richards' evidence on 13 February 2020, competitive neutrality considerations related to the design of the fund itself, including the Government's decision to invest, were outside APRA's remit (Senate Economics Legislation Committee 2021b, pp. 6–7).

This view was further elaborated in an appearance before Budget Estimates in June 2021:

> APRA (Mr Lonsdale): In terms of APRA's role in the Business Growth Fund, I think it's important to point out that it is not an APRA measure; it is a government measure. … APRA does not regulate the fund. APRA regulates the entities that are putting money into the fund — in particular, the major banks. … So, in making a decision on what should be the appropriate capital treatment, we looked first of all at safety, as per our mandate, and we also looked at efficiency, competition, and neutrality. (Senate Economics Legislation Committee 2021a, p. 75)

Finally, APRA responded to queries put by the AGCNCO in June 2021 categorically indicating that the capital treatment of ADIs investing in the ABGF were not influenced by the Australian Government's ownership stake, and indeed had been formulated prior to APRA's awareness of that stake.

APRA clearly considers that its obligations are consistent with (1), hence its references to the design of the fund and the Government's part ownership of it as matters for Government and outside its control. While on face value, (2) seems a reasonable alternative perspective, it does not consider the constraints on the regulatory functions of APRA, which mainly relate to ADIs (but also includes general, life and health insurers, reinsurance companies and most superannuation funds). From 2018, APRA has had some regulatory powers over non-ADIs through the *Treasury Laws Amendment (Banking Measures No. 1) Act 2018* (Cth), but these relate to lending only and their intent is to ensure the financial stability of the Australian financial system and do not include consideration of competitive neutrality.

Accordingly, the AGCNCO's assessment is that APRA's role was to consider any competitive neutrality issues that arose from its revised capital adequacy tests for *those to whom the tests applied*, which were ADIs alone. Since all the ADIs are fully privately owned, and APRA does not regulate the fund itself, the competitive neutrality aspect of section 8(2) did not require a detailed assessment. That does *not* mean competitive neutrality policy is irrelevant for the ABGF — it just means that the responsible party for any assessment would lie more broadly with Government.

Nonetheless, it would be useful for APRA to publicly clarify the narrow application of section 8(2) to avoid any future confusion about its scope. (Such a clarification could simply be on APRA's webpage or in any re-issued information paper on APRA's objectives, which was last published in 2019.)

FINDING 2

The Australian Prudential Regulation Authority's obligation to consider competitive neutrality relates solely to any difference in its regulatory treatment of authorised deposit-taking institutions that are wholly private versus those with at least some level of government ownership. The obligation does not extend to entities in which such institutions are investors. As there are currently no government-owned authorised deposit-taking institutions, the Australian Prudential Regulation Authority's obligations are met. In the case of the Australian Business growth Fund, the Australian Government, not the Australian Prudential Regulation Authority, would bear responsibility for any breach of competitive neutrality and its resolution.

Australian Government joint ventures present a unique challenge for competitive neutrality

Given the dual involvement of the Australian Government and private banks, the ABGF case presents a unique challenge for competitive neutrality. Where a fully government-owned business has failed to meet the requirements of competitive neutrality, the remedy is elimination of the regulatory advantage directly or a competitive neutrality payment by the business to the Australian Government, calibrated to remove the competitive advantage. This is readily achieved.

However, where the Australian Government is in a joint venture with private entities and subsequently a competitive neutrality breach becomes apparent, restoring competitive neutrality would require that the venture bear additional costs. By design, the remedy for a breach of competitive neutrality must change the relative price of the outputs of the joint venture compared with competitors, with commercial consequences that would extend to the private joint partners. Contract provisions between parties in the venture may further add to the complexity of addressing any such breach.

For example, *if* the prudential guidelines for the ABGF had been driven by Australian Government ownership, the remedy would involve tougher adequacy requirements, either directly applied by APRA or put in place by APRA following government divestiture from the ABGF. This would increase the required rate of return to investments made by the ABGF. That could precipitate the sale of (some) equity holdings or even the closure of the fund — potentially costly changes that would be borne by private businesses. These issues have not emerged in the ABGF case, but it might in some subsequent instance.

This provides an additional imperative for scrutiny by the Australian Government of the compliance of government-private joint ventures with competitive neutrality policy prior to their establishment.

FINDING 3

Remedying a breach of competitive neutrality may be more difficult for a partly-owned government business than one fully-owned by government. This increases the imperative for a careful assessment of competitive neutrality prior to government becoming a part owner of a business.

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