



Australian Government
Productivity Commission

Competition in the Australian Financial System

Productivity Commission
Inquiry Report
Overview & Recommendations

No. 89, 29 June 2018



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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

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The full report is available from www.pc.gov.au

OVERVIEW

Key points

- The Australian economy has generally benefited from having a financial system that is strong, innovative and profitable.
- There have been past periods of strong price competition, for example when the advent of mortgage brokers upset industry pricing cohesion. And technological innovation has given consumers speed and convenience in many financial services, and a range of other non-price benefits.
- But the larger financial institutions, particularly but not only in banking, have the ability to exercise market power over their competitors and consumers.
 - Many of the highly profitable financial institutions have achieved that state with persistently opaque pricing; conflicted advice and remuneration arrangements; layers of public policy and regulatory requirements that support larger incumbents; and a lack of easily accessible information, inducing unaware customers to maintain loyalty to unsuitable products.
- Poor advice and complex information supports persistent attachment to high margin products that boost institutional profits, with product features that may well be of no benefit.
 - What often is passed off as competition is more accurately described as persistent marketing and brand activity designed to promote a blizzard of barely differentiated products and ‘white labels’.
- For this situation to persist as it has over a decade, channels for the provision of information and advice (including regulator information flow, adviser effort and broker activity) must be failing.
- In home loan markets, the mortgage brokers who once revitalised price competition and revolutionised product delivery have become part of the banking establishment. Fees and trail commissions have no evident link to customer best interests. Conflicts of interest created by ownership are obvious but unaddressed.
- Trail commissions should be banned and clawback of commissions from brokers restricted. All brokers, advisers and lender employees who deliver home loans to customers should have a clear legally-backed best interest obligation to their clients.
- Complementing this obligation, and recognising that reward structures may still at times conflict with customer best interest, all banks should appoint a Principal Integrity Officer (PIO) obliged by law to report *directly* to their board on the alignment of any payments made by the institution with the new customer best interest duty. The PIO would also have an obligation to report independently to ASIC in instances in which its board is not responsive.
- In general insurance, there is a proliferation of brands but far fewer actual insurers, poor quality information provided to consumers, and sharp practices adopted by some sellers of add-on insurance products. A Treasury working group should examine the introduction of a deferred sales model to *all* sales of add-on insurance.
- Australia’s payment system is at a crucial turning point. Merchants should be given the capacity to select the default route that is to be used for payments by dual network cards — as is already possible in a number of other countries. The New Payments Platform requires a formal access regime. This is an opportunity — before incumbency becomes cemented — to set up regulatory arrangements that will support substantial competition in services that all Australians use every day.
- More nuance in the design of APRA’s prudential measures — both in risk weightings and in directions to authorised deposit-taking institutions — is essential to lessen market power and address an imbalance that has emerged in lending between businesses and housing.
- Given the size and importance of Australia’s financial system, and the increasing emphasis on stability since the global financial crisis, the lack of an advocate for competition when financial system regulatory interventions are being determined is a mistake that should now be corrected. The ACCC should be tasked with promoting competition inside regulator forums, to ensure the interests of consumers and costs imposed on them are being considered.

Overview

Australia's financial system must be strong and stable. But equally, it should ensure that the households and businesses who use the financial system are well served.

It is most often competition that can deliver the price rivalry between providers that is necessary for consumers to share fully in the benefits of having a strong financial system.

More than just price rivalry, competition drives innovation and overall value for customers.

Some innovation in Australian financial services is clear. Australians have ready access to funds at all hours of the day, can get rapid home loan approvals, quickly and safely move money between accounts, pay for products with the tap of a card, smartphone or watch, and have investment portfolios managed by robo-advisers.

Value for customers is less obvious. Prices are not transparent and product choice is often vague or overwhelming. Regulation is dense and it may act against customers' interests. Those who advise and assist customers face conflicting, unclear incentives.

In brief, we find that households and businesses may be paying, through unnecessary fees and low-value products, for a system that is exposed to use of entrenched market power.

This Inquiry focusses on competition in Australia's financial system as a means to improve consumer outcomes, enhance the productivity and international competitiveness of the financial system and the broader economy, and support ongoing innovation — without undermining financial stability objectives. Our recommended reforms are aimed at getting Australia's financial markets to be workably competitive, with higher standards of respect for customer interests.

Competition is inevitably constrained

Financial markets are inevitably regulated. From a consumer's perspective, financial products are both complex and critically important to their welfare — trustworthy deposit, loan and insurance products and a reliable payments system are all critical. Regulation of the businesses that sell and advise consumers on financial products helps deliver a financial system that both protects consumers and is stable.

However, regulation is present in all markets and need not undermine workable competition. In contrast, competition is poor in many of the financial markets we have examined. We investigate why this is the case: what are the drivers of poor competition and how can the situation be improved. In some key markets — for small business credit, consumer product

insurance, and consumer credit insurance — competition and beneficial consumer appear particularly constrained by factors that may be alleviated by regulatory reform.

Current state of competition

Australia's financial system is dominated by large players — four major banks dominate retail banking, four major insurers dominate general insurance, and some of these same institutions feature prominently in funds and wealth management. A tail of smaller providers operate alongside these institutions, varying by market in length and market share (figure 1). Market shares of major banks are highest (over 75%) in markets for loans to small businesses, housing loans, personal deposits and issuance of credit cards. Among general insurers, market shares are highest (80% or higher) for lenders mortgage insurance, reinsurance and travel insurance.

Australia's smaller financial institutions (such as some regional and customer-owned banks and foreign-owned banks) achieve comparatively high market shares in targeted markets — consumers in their home state, employees in a particular profession, or dual nationals from their base country. Focussing on such groups allows institutions to overcome the disadvantages of potentially limited scale, higher funding costs, or in the case of foreign-owned banks, limited public-facing branches.

High market concentration does not necessarily indicate that competition is weak, that community outcomes will be poor or that structural change is required. Rather, it is the way market participants gain, maintain and use their market power that may lead to poor consumer outcomes.

Indeed, the Commission has concluded that changes to the structure of Australia's financial markets are not very prospective as a means for improving market outcomes. Too many regulatory imposts — most readily displayed by persistent attachment to the Four Pillars policy — act against that. Nor are forced divestitures likely to improve competition. Instead, they risk creating unviable businesses that are 'unscrambled' from existing businesses as regulators are never able to check that the parent entity has relinquished control of the key customer information, intellectual property, technology and staff that are needed to make the separated entity competitive.

Rather, reforms that alter incentives of Australia's banks, brokers, insurers, and advisers, aimed directly at bolstering consumer power in markets, and reforms to the governance of the financial system, should be the prime focus of policy action.

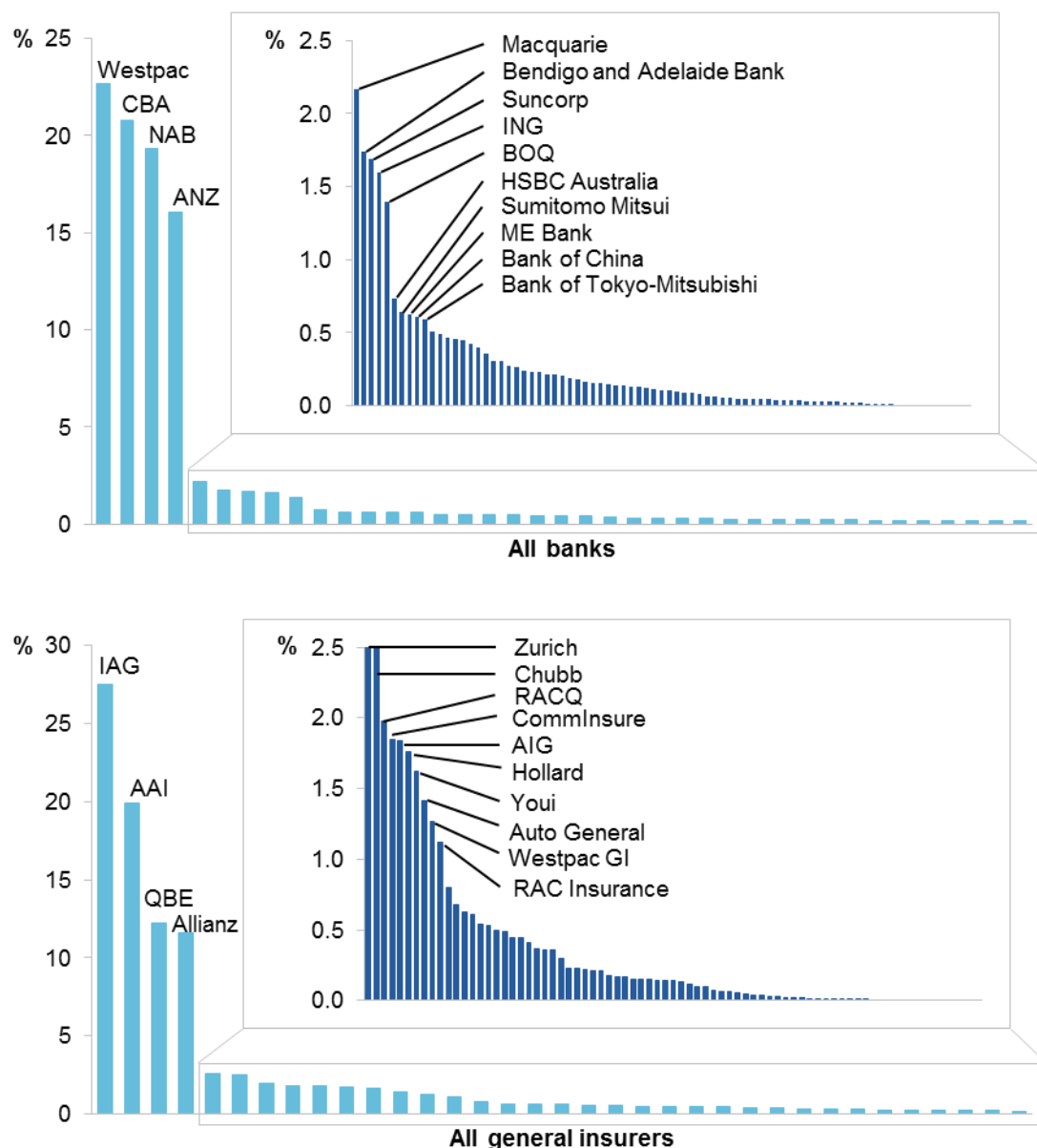
The major banks' market power is a defining feature of the financial system

While some of the major banks argued that they do not, individually, exercise market power, they have been able to insulate themselves from competition and sustain returns despite the massive system-wide shock of the global financial crisis. There is evidence that they have sustained prices above competitive levels, offered inferior quality products to some groups of customers (particularly those customers unlikely to change providers), subsumed much of the

broker industry and taken action that would inhibit the expansion of smaller competitors in some markets. All are indicators of the use of market power to the detriment of consumers.

What follows is not a list of failings, but rather features of the Australian market that must not be ignored if we are to ever develop workable solutions to improve competition.

Figure 1 Banking and insurance are dominated by large players — and long tails of other providers^{a,b}



^a Bank share of assets held on banks' domestic books, as at end-2017. ^b Insurer share of gross written premium, as at end-2017. Calculations based on level APRA 1 insurers, with level 1 IAG insurers aggregated. For the purposes of this chart, 'general' includes direct general insurance only, and excludes reinsurance and lenders mortgage insurance.

What allows market power to be sustained in Australia's financial system is a combination of features evident in the way providers, consumers and regulators operate:

- *Market power as a result of established presence:* The substantial geographic reach of the major banks — which account for 60% of all branches — along with their scale and longevity contributes to their brand recognition and the perception that they are safe, stable institutions compared to smaller rivals, and that the government will step in to help them if needed. This is despite the Government's (little known) Financial Claims Scheme, which protects retail deposits at all authorised deposit-taking institutions (ADIs) — large and small institutions alike. The major banks are also strongly represented in other distribution networks, including being on the vast majority of mortgage aggregator panels. This widespread presence can make it more difficult for small institutions to be seen by consumers as a practicable alternative source of financial services.
- *Market power as a result of regulatory arrangements:* Regulatory arrangements can further entrench the market power of those incumbents that have the expertise and resources to cope with regulatory requirements. The cost of regulatory capital for major banks compared with smaller competitors is one instance of this. On one hand, the major banks (as well as Macquarie and ING) use internally developed risk models, approved by Australian Prudential Regulation Authority (APRA), that in effect lower their funding costs compared with all other ADIs, which use APRA's standard risk weighting. On the other hand, it is only the major banks that are required by APRA to hold additional capital because of their size and complexity. This requirement can be costly for the major banks, but it can also support them to the extent that it is viewed by international credit rating agencies as an indirect recognition of their 'too big to fail' status.

The net result of these regulatory measures is a funding advantage for the major banks over smaller Australian banks that rises in times of heightened instability.

- *Market power as a result of funding advantage and operational efficiency:* The cost of sourcing funds is the single largest expense for all lenders in the Australian financial system. It is, in turn, a key influence on institutions' ability to compete in the market for lending (or to increase profits). With their better credit ratings and a perception of being 'too big to fail', the major banks are able to source funds from investors and depositors at lower interest rates than are smaller institutions. The smaller entities (especially non-ADIs that are unable to accept deposits) both compete against the larger institutions and at the same time rely on them to access some of the funds that allow them to continue competing. A substantial gap also remains between the average operating costs of Australia's major banks and its smaller institutions.
- *Market power reinforced by integration:* Australia's largest financial institutions have in the past leveraged their incumbency and scale to move into parallel markets and activities either side of them in the supply chain (such as financial planning), allowing them even more control over pricing, as well as entry into and exit from some markets (figure 2). Cross-product (horizontal and conglomerate) integration gives the larger institutions the opportunity to cross-subsidise and offer consumers an integrated bundle of services, which can also bind customers to them.

Figure 2 The major bank networks^{a,b}
Select subsidiaries and other entities of major banks



^a Percentages are total assets of major bank group as % of total assets of all authorised deposit-taking institutions and Registered Financial Corporations. Banks include Australia and New Zealand Banking Group (ANZ), Commonwealth Bank Group (CBA), National Australia Bank Group (NAB), Westpac Banking Corporation (WBC). ^b Entities listed may fall within more than one category and may not reflect investment or divestment activity since annual reports were released. The listed entities do not comprise an exhaustive list, do not show exclusive contracts, and are generally entities incorporated in Australia.

- *Market power reinforced by consumer inertia:* Little switching occurs — one in two people still bank with their first-ever bank, only one in three have considered switching banks in the past two years, with switching least likely among those who have a home loan with a major bank. Low levels of consumer switching and a general disengagement of consumers from financial services are a clear sign that current information provision (by regulators, advisers and brokers) is failing. This makes it harder for new competitors to gain significant market share. Competition is most apparent in those product markets

in which holding multiple versions of the product (such as transaction accounts and some credit cards) is of low cost to consumers, and so whether or not switching is possible is of less relevance.

The market power of Australia's large general insurers is similarly entrenched by operational efficiencies and very low levels of consumer switching on products for which switching would be a key source of consumer pressure for competitive outcomes. The prudential requirements (including capital requirements) for insurers similarly contribute to the premiums insurers charge. We have not, however, observed similar issues in the regulatory arrangements for insurers of different size.

Price rivalry in banking is — and will remain — constrained

At a fundamental level, the setting of the cash rate in response to market conditions, as well as capital holding requirements and other prudential interventions mean that the Reserve Bank (RBA) and the APRA indirectly determine and broadcast the costs of funds for ADIs. This form of price leading is not evident in many industries. From a competition standpoint, it means ADIs' ability to compete on price is constrained, and this is unlikely to change.

In setting prices in the Australian banking system, smaller institutions generally behave as market 'followers' and mirror the major banks' pricing decisions.

While some small institutions offer consistently higher interest rates to attract deposits, history suggests that even when Australia's smaller ADIs are given a regulatory advantage over the major banks, they do not noticeably take advantage of rises in major bank loan interest rates by holding down their own loan interest rates in an attempt to gain market share. Rather, they seek to also raise prices in near lock-step, and improve margins earned from their existing customer base. That this occurs is evident in the margins earned.

Although there is no explicit encouragement for banks to cluster around a particular level of return or interest rate, their observed tendency to do so is a persistent feature of the market. Wherever possible, rate movements are couched with reference to regulator actions.

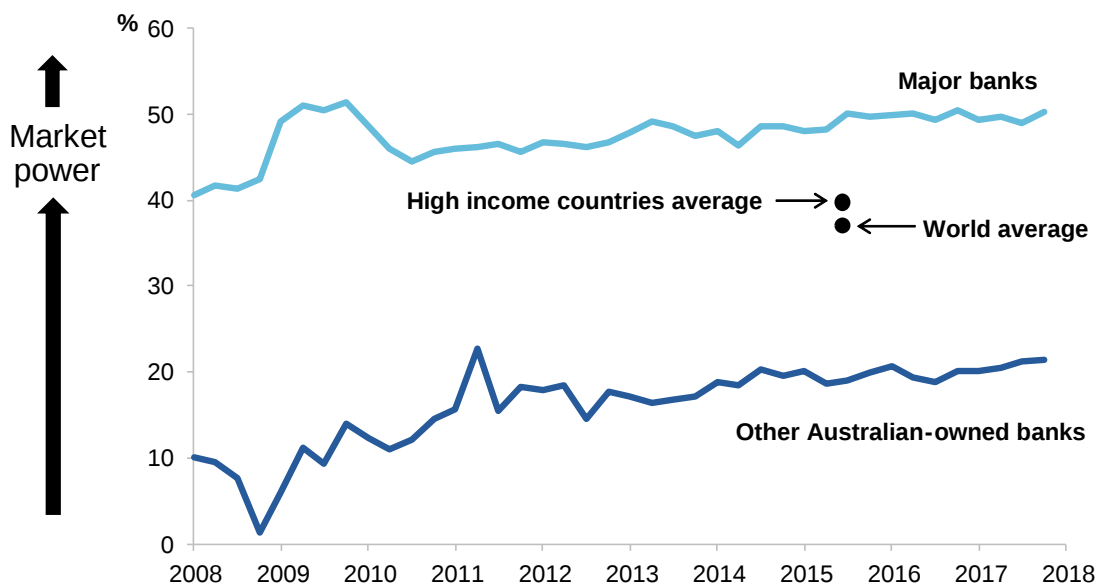
This approach is unlikely to result in prices that are reflective of the cost incurred by the most efficient institution; at best, it will result in prices that reflect the costs of the least efficient major bank (or in some markets, the higher marginal cost of smaller, competitive fringe institutions). For competition analysis it is significant that the market is in a state that persistently allows this.

An exception may be the *mutual* ADIs, which do not face the same shareholder pressures as other ADIs. The Customer Owned Banking Association reports its members' standard variable rate on home loans averages 0.4 to 0.8 percentage points lower than the major banks' rates. However, their scope to lower lending rates further is potentially more limited than other ADIs simply due to narrower sources of funding.

Consistent with these observed outcomes, the data shows that both the major banks and some other-Australian owned banks hold a degree of pricing power. But the major banks are the

dominant force in the market — able to charge higher premiums above their marginal costs, compared with other institutions. Approximately half of the average loan price that major banks charge is estimated to be a premium over the marginal cost — double the margin that other Australian-owned banks have and well above that of banks in other high income countries (figure 3).

Figure 3 The major banks are using their market power to keep interest rates high on loans and low on deposits^a



^a This chart shows the Lerner Index, calculated by the Productivity Commission for groups of different banks. The Lerner index shows the extent to which prices (or in the case of banking, interest rates) exceed marginal cost. In a competitive market, prices are expected to equal marginal cost, and therefore the value of the index would be zero. Any number above zero indicates pricing power. High income countries average and world average are World Bank estimates.

Barriers to entry are falling — but new entrants will not induce a widespread improvement in outcomes

Australia's banking industry has experienced substantial consolidation over recent decades, with numerous mergers of small or struggling institutions. But this is not necessarily a concern for competition. Periods of heightened competition in the financial system in the past have typically been driven not by established providers but by new entrants. For example, Aussie Home Loans provided home loan competition in the 1990s and early 2000s, foreign banks such as ING introduced online-only banking, and Rabobank provides services dedicated to medium/large agribusinesses.

Almost all new entrants to the banking system over the past decade have been foreign bank branches, usually targeting important but niche markets (and these have evidenced only limited growth in market share). Similarly, many of our fintechs are small, focusing on niche

areas of the financial system, making it difficult for them to compete against incumbents with full service offerings. Indeed, many fintechs are looking to collaborate with incumbent banks rather than compete against them.

For now, neither foreign entrants nor fintechs appear to pose a substantial threat to major banks' dominant positions: more entrants alone are not a panacea to drive sustained competition across Australia's financial system.

In recent years, the Australian Government and APRA have progressed reforms to reduce unnecessary barriers to entry: ADIs no longer need to hold \$50 million in safe capital before they can call themselves a 'bank'; and prospective banks can more easily apply for a new (restricted) banking licence.

The reduction or removal of similar barriers should be high on the Australian Government's and regulators' priority lists. This includes initiatives already in train, such as proposed changes to the ownership cap under the *Financial Sector (Shareholdings) Act 1998* (Cth) and the introduction of Open Banking.

Protection against takeover can shelter poor practices

Australia's Four Pillars policy, aimed at ensuring that whatever other consolidations occur in retail banking, the four major banks will remain separate, has been an underlying feature of the financial system policy landscape throughout this period of considerable consolidation.

It is an ad hoc policy that, at best, is now redundant, as it simply duplicates competition protections in the *Competition and Consumer Act 2010* (Cth) and governance protections in *Banking Act 1959* (Cth) and the *Financial Sector (Shareholdings) Act 1998* (Cth). And the existence of the policy has allowed some to believe, unwisely, that competition is somehow enhanced because of it.

Together with other restrictions on bank ownership, the policy minimises the threat of takeover — the most direct form of market discipline for inefficiency and management failure — and so encourages complacency. Raising the cap on ownership would offer a greater threat of market discipline, while maintaining strong general protections from anticompetitive acquisitions.

Poor market outcomes are evident

Prices are used to maintain returns

Banks, and in particular the major banks, exhibit substantial pricing power. The major banks' market power has allowed them to set interest rates to borrowers and depositors that enable them to remain highly profitable — without significant loss of market share. This has continued to occur even in the face of market shocks (such as the global financial crisis) and notable regulatory changes that have increased their costs and would otherwise have eroded the return

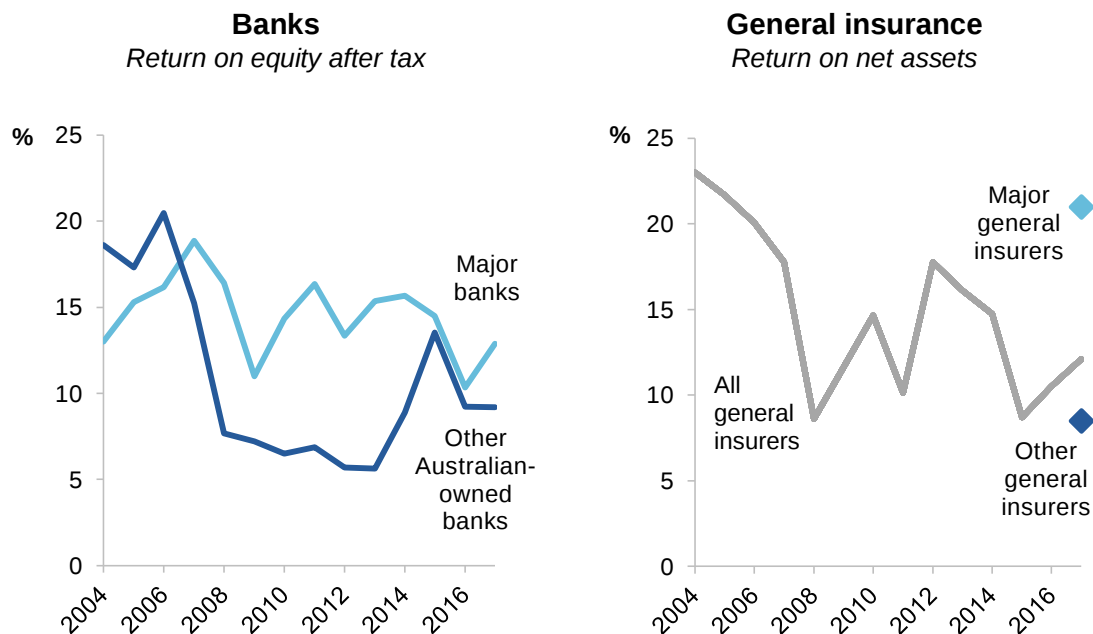
on equity (figure 4). Australia's large general insurers have similarly maintained very high returns compared with their smaller competitors.

The consistently high returns of Australia's largest financial institutions are over and above those of many other sectors in the economy and in excess of banks in most other developed countries post GFC. In recent times, regulatory changes have put pressure on bank funding costs, but by passing on cost increases to borrowers, Australia's large banks in particular have been able to maintain consistently high returns on equity (ROEs).

Banks and insurers alike almost invariably argue that price shifts are tied to a shift in costs. But the ability across a sub-set of firms in a market to maintain prices and profitability in all market conditions (changes in not just industry-wide costs but also business-specific cost changes) is a very clear sign of market power.

Some have suggested that competitive pressures prevent lenders from passing on increased costs as a result of regulatory changes, but apart from some ADIs choosing to exit product areas that offered lower returns (such as wealth management), the evidence is that this has not eventuated.

Figure 4 **Profitability**



Simply accepting lower returns on equity is uncommon among Australia's financial institutions — banks in particular. Rather, it appears that achieving ROE targets is an important factor in major banks' interest rates decisions, and one that has tended to lead to higher rates charged to existing borrowers, rather than aggressive discounting intended to expand market shares. And the standard loan documentation makes the repricing of all loans

convenient for the bank, an issue of significance in recent attempts at targeted macroprudential intervention.

The ACCC has concluded that the major banks would need to win a significant number (and value) of additional new borrowers to achieve the same revenue as they can generate simply by increasing their headline variable interest rates, which affects both existing and new borrowers.

In some cases, the high profitability is a (possibly unintentional but entirely predictable, as we discuss below) result of regulatory intervention. Interest rates on home loans are a case in point. The ROE on interest-only home loans doubled, to reach over 40% after APRA's 2017 intervention to stem the flow of new interest-only lending to 30% of new residential mortgage lending (reported by Morgan Stanley). This ROE was possible largely due to an increase by banks in the interest rate applicable to *all* interest-only home loans on their books, even though the regulator's primary objective was apparently to slow the growth rate in *new* loans. Competing smaller banks were constrained from picking up dissatisfied customers from this re-pricing of the loan book because of the direct application of the same lending benchmark to them. Profit-taking was locked in. This behaviour should have been anticipated. The additional cost to the community was unnecessary.

A highly profitable financial system is not a bad thing. Consistently strong and profitable institutions can be beneficial for consumer and investor confidence, which, in turn, lowers the cost of funds and return required on investment. But if the market were workably competitive, keeping prices high in order to deliver profits would cause a significant number of consumers to switch and encourage a lower price provider, with profits shifting along with shareholder expectations. It is, at least in part, the stickiness of consumers with their current bank, insurer or adviser that allows these providers to maintain profits without loss of market share.

A blizzard of barely differentiated products

Many consumers find financial product information somewhat less enthralling than other consumer products and, in most of Australia's financial system, face difficulties in readily finding and/or understanding the product information presented to them. This reduces the scope for consumers to collectively apply competitive pressure on providers to improve product offerings.

With some financial and credit products, there is a large array of options presented for individuals to choose between. For example, there are nearly 4000 different residential property loans on offer and over 250 different credit cards. Many general insurance lines are similarly characterised by a large number of products, which are ultimately all underwritten by the same insurers — for example, the largest four general insurers underwrite more than 30 brands, while two of the smaller insurers underwrite more than 50 brands between them, with the Hollard Insurance Company underwriting 23 of 25 identified brands of pet insurance on the Australian market.

While the existence of a large number of marginally different products can allow a closer tailoring to consumer needs, it typically is a choice overload for consumers. It also creates an illusion of choice, and the perception of a greater degree of competition among providers than actually exists.

In some parts of the financial system (such as insurance and funds management), the proliferation of products with slight variations in features has, over time, become a burden not just for consumers but also for providers. The Financial Planning Association of Australia noted that, with a lack of transparency around product features and performance objectives, it has become increasingly difficult for its planners to compare products for each client.

The costs for providers of product proliferation become magnified where dated products, often on legacy IT systems, are used by a comparatively small number of customers with contracts that cannot readily be varied. This burden does not yet appear to have deterred most institutions from creating yet more product variations, though some are now seeking to simplify their range.

Exploiting customer loyalty

The huge product variety combined with price obfuscation provides latitude for exploitative price discrimination, with associated profit opportunities for the relevant financial institutions. Typically, it is existing customers that get a poor offer, as institutions jostle to attract new customers with products that offer temporary benefits (such as discounted interest rates and fee-free periods) to consumers — relying on their lassitude for switching to generate high margins off them in the years to come.

For example, insurers may offer policies with relatively high premiums to existing customers compared to new customers posing a similar level of risk. In the banking industry, the variable interest rates paid by existing home loan customers have been reported by the RBA to average about 0.3 to 0.4 percentage points higher than rates on new home loans. These higher rates are paid by about 15% of existing customers and equate to an extra \$66 to \$87 per month on the average home loan balance.

Exploitation of existing customers is supported by the very low levels of customer switching of either the financial products held or their relative use of them and a reticence of consumers to negotiate with providers.

Satisfaction of consumers with their own financial institutions is still high. This is a positive characteristic, but when considered in conjunction with what we know about a lack of responsiveness to better offers, it indicates a substantial failure in financial product information and advice. With the relative explosion in advisory services in the last decade or so, this is surprising and suggests an important avenue for potential reform.

Improving scope for competition

Australia's financial system has no real voice that can mount the case for competition, when regulatory interventions aimed at enforcing system stability are deliberated.

The vital importance of financial services to the ongoing operation and the growth prospects of the economy, as well as the extent of information asymmetry, build a strong case for a high level of regulatory intervention. The objective of intervention is to reduce risk, generally. The objective of competition is to take risk, in an attempt to satisfy consumers. One objective is much more heavily emphasised in regulators' activities than the other.

Australia's key financial regulators — the RBA, APRA and the Australian Securities and Investments Commission (ASIC) — work together to create a stable financial system, coordinated, where required, through the Council of Financial Regulators (CFR).

Regulators worldwide have (particularly since the GFC) been emphasising stability over competition, which has been viewed at times as a source of risk. This view has taken root in the Australian regulatory culture, to the point that the lack of competition is viewed at the very top level as a positive factor, said to have insulated us from the worst of the GFC.

Competition and stability can, and should, co-exist, but this is unlikely at the extremes of market structures. A market composed of a plethora of small banks may be competitive, but is unlikely to have the reserves to cope with sudden serious adverse circumstances, while a single or dominant entity may survive a shock, but only at an unacceptable ongoing cost to the economy in order to maintain its dominance. Australia, with an oligopolistic banking system, is not at either extreme and so can (and should) seek to give genuine attention to both competition and stability.

While this requires careful fine-tuning of financial regulation, other countries have taken steps to realign the regulatory balance towards competition, without losing sight of the need for stability. Countries such as the UK and the US that were badly affected by the GFC — much more so than Australia — have been changing their regulatory structures. Prudential regulators in Canada, the UK and Europe have followed the Basel standards closely and so have a wider range of risk weights than does Australia. In Australia, however, while there is much hand-wringing about competition, there has been little shift in the regulatory culture. The emphasis on stability — best represented by the repeated use of the phrase 'unquestionably strong' — persists.

An important step towards addressing this imbalance is for regulators themselves to recognise better the effects that their actions may have on competition, and take steps to minimise them where closer study may show that scope exists to do so. The current processes of policy development include consultation between the regulators, but there is no counterweight that can advance the benefits of competition and possibly influence regulators before they intervene in the financial system. Discovery of alternatives relies entirely on in-club thinking, amongst whose members the strongest legislated mandate for competition is simply to 'balance' it with other objectives while promoting financial system stability.

Yet we do not argue for legislated change. If regulators cannot be convinced by the existence of thoughtful alternatives put forward by a well-considered submission, black letter law will not alter their thinking either.

A competition champion must be appointed amongst the financial regulators who shape policy. The purpose of this change is to create an opportunity to stress test the competitive implications of an intervention before it is made. This can help preserve as much competitive spirit as is possible, even as intervention occurs. There are additional reforms (described further below) needed to improve simple, reliable information flows to consumers and align reward with customer best interest. The effectiveness of these will be magnified in their impact if there is a designated competition champion in place.

A competition champion

It is a fundamentally important fact that no Australian financial system regulator has the responsibility of putting competition first. Indeed, ASIC does not yet even have competition in its objectives. Nor, until this Inquiry, did other members of the Council of Financial Regulators emphasise that interest in a discernible fashion. Quite reasonably, they all have other purposes, that are often more pressing (figure 5). But the existence of a competition mandate provides a powerful incentive to consider the damage to competition, and thus to consumers. No regulator is specifically tasked by the Treasurer with challenging the others, although we accept that this does happen from time to time.

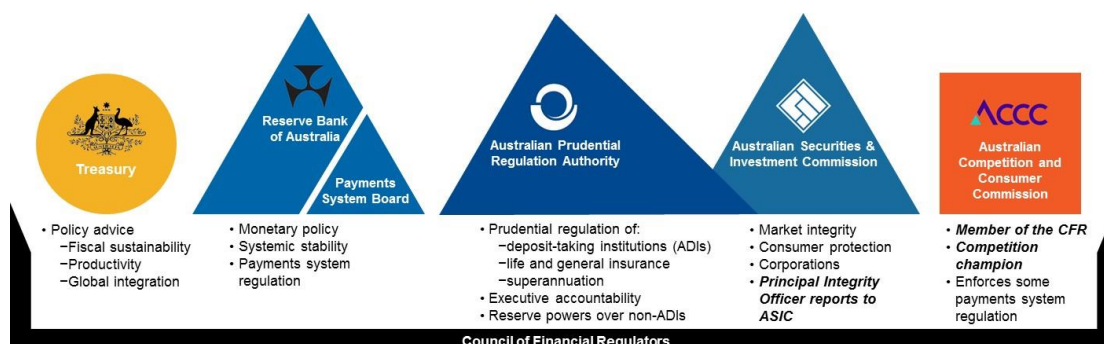
**Competition must
be given serious
consideration
when regulators
intervene in
financial markets**

In the absence of a competition advocate in the financial system, the role of juggling competition and financial stability falls mainly to APRA — but is not a role that it is well placed to fulfil. In every marginal judgment — and most judgments will by their nature be finely-balanced (crises are an exception) — APRA must surely favour its overarching requirement to promote stability. An entity such as APRA can never reasonably be challenged by outsiders for being too conservative. But it might be badly damaged if it were ever shown to be too liberal.

Thus, we do not propose to change the nature of APRA's obligations with regard to competition — it is unrealistic to expect a regulator tasked with maintaining financial stability to actively encourage competitive outcomes in all circumstances.

Yet the benefits of competition need to be heard. In the current environment of emphasis on maintaining 'unquestionably strong' institutions, and with macroprudential interventions likely to feature more notably in regulator activity for some years to come, it is evident that finesse in the application of regulatory decisions that impact on competition can and should be improved.

Figure 5 Embedding competition and consumer interests into financial system regulatory structures^a



^a Text in bold and italic denotes recommended reforms to current arrangements

Both the Wallis and Murray financial system inquiries (FSIs) considered that there was no need for an agency dedicated to advancing competition in the financial system (the Murray FSI made other recommendations intended to promote competition, but progress on these has proved slow).

Given the size and importance of Australia's financial system, and the increasing emphasis on stability since the GFC, the lack of an advocate for competition when financial system regulatory interventions are being determined is a mistake from the Wallis FSI outcomes that should now be corrected.

The Commission envisages that a designated competition champion would not be a new regulator. The role we have in mind for the chosen regulator is to champion the interests of competition for its benefits to consumers and aspirant firms alike. This proactive behaviour is not a role needed in many other markets, but here the influence of regulators is so pervasive in manoeuvring product prices and limiting the ability of firms to take risks (a necessary part of innovation and competition) that a competition champion is required to offset monological thinking.

Such an entity should undertake functions that include analysis of impacts of prudential and other regulatory measures on competition before such measures are implemented; publishing regular analyses and reports on financial system competition; and ex-ante testing of the impacts on competition and community outcomes from additional provider integration.

The ACCC as a competition champion in the financial system

The Australian Competition and Consumer Commission (ACCC) is a natural fit for the role due to its long standing expertise in competition issues and its emerging skill set in the financial system. It has an enthusiasm for the role and that will be important to sustaining it in the face of a regulatory culture of indifference or hostility to competition. The ACCC will also be able to recognise the distinction between competition and competitive neutrality —

markets may be competitively neutral and yet impede innovation and effective competition (evenly) across all players.

There is no legislative change required for the ACCC to take on such a role. Its ability to act effectively in the financial system will depend substantially on the co-operation of existing regulators. APRA has indicated to this Inquiry that it has recently found discussion with ACCC prior to CFR and decision-making to be beneficial. The appointment of ACCC as a competition champion would supplement this and give substance to an interaction that will endure beyond MoUs, current appointees and internal structures in each organisation. The ACCC would require explicit support from the Treasurer to take a role within the formal and informal forums that shape financial system regulatory activity.

The primary forum for cooperation between the financial regulators is the CFR, of which the ACCC is currently not a permanent member. The CFR, with the inclusion of the ACCC, would be a key avenue through which consideration of competition impacts could be promoted, analysed and made more transparent. It would be tasked with providing an assessment that examines in depth the competition implications of a proposed regulatory intervention. This would be discussed at the CFR meeting prior to the intervention design being finalised.

The sheer size of the financial system makes the role of champion a matter of gradual change. Serious capability needs to be maintained by the champion, including obtaining a high level of awareness of commercial market thinking.

Why not others?

In the Inquiry Draft Report, we considered two possible candidates for the champion competition: the ACCC and ASIC. APRA and the RBA were not included as options since in our competition analysis, their primary focus is, and should remain, financial stability.

ASIC, as the financial product regulator (in the way we have categorised regulator roles) would, in principle, be well placed to become the champion. However, both stakeholders and ASIC itself appeared to have reservations. ASIC did not express any active interest in taking on such a role, but simply emphasised instead the need for regulators to work together to consider competition issues.

Even without being the designated competition champion, ASIC's role in considering competition is set to expand; and desirably so. In early 2018, the government introduced legislation to expand ASIC's mandate to consider the effects its regulatory interventions will have on competition in the financial system. APRA is already required to consider competition alongside a number of other factors in the pursuit of financial stability. Given no regulator presently has any primary responsibility for competition, ASIC's objective of working together with other regulators in support of competition is likely to fit better once the ACCC is the designated competition champion.

The Treasury has suggested it already fulfils this role in the CFR deliberations and so there is no need for a champion as such. The desire for other parties at CFR to fulfil this role is a welcome development. But the Treasury's mandate is to develop advice for government, taking into account and balancing the views with a much wider-angle lens than the ACCC, ASIC or even the RBA.

Moreover, the role of competition champion is intended to be overt at times, with the CFR confirming via its minutes that a debate was held. The Treasury must publicly stand above the adoption of a contending position in any such debate.

Likewise, the RBA — which offered important assurances to this Inquiry that the CFR discussions do give weight to competition — cannot be tasked with this role, as its primary role is ensuring financial stability. And as CFR Chair, it would need to sum any discussion to a conclusion.

The RBA has also expressed concern that adding competition analysis to CFR deliberations may slow down decision making. This is unrealistic. It is highly unlikely that when a financial crisis occurs, any emergency measures would be delayed due to concerns about competition. Debates in forums such as these occur in the time available. But crisis is uncommon and (as we know from many other policy reform processes involving the Productivity Commission) uncommon events are not a sound basis for choosing not to improve the thinking when the opportunity is there to do so.

Transparency can assist in managing market expectations

As part of the broader adjustment in regulatory focus, transparency around decision-making by the financial regulators, including the CFR, is likely to prove valuable.

As a matter of priority for the Government, the Statement of Expectations for APRA needs to be updated from its 2014 version; and the recently updated Statement of Expectations for ASIC should be published.

In both cases, actions taken to fulfil government expectations should be reported annually. Such statements provide financial regulators with the Government's perspective on their strategic direction and most crucially, allow assessment after the fact to see if performance matched expectations. This report should influence those documents.

The discussions at the CFR that underpin regulator decisions are profound in their impact on the financial system and the economy but there is no public transparency around them. As central banks have discovered and effectively applied over the past twenty years or so, publication of minutes can assist in managing market expectations. What can be achieved by press release may save tens of millions in additional cost.

The fact of the CFR's consideration of competition analysis (and other market interventions) should be minuted and published, as the RBA Board meetings are. Simple confirmation that

the competition versus stability conundrum is under regular consideration would improve both market and regulator behaviour, if as we expect, conditions of significant market power among the largest banks persist. Transparency gives confidence that competition still matters.

Regulators should, in their Statement of Expectations, be required to consider amending policies to alleviate adverse impacts on competition.

Finally, the ACCC should publish a bi-annual financial system competition report, which would be the competition equivalent of the RBA's Financial Stability Review.

Achieving better outcomes for consumers in home loan markets

The competition benefits of mortgage brokers have become compromised

From a relatively small industry in the 1990s, mortgage broking has grown such that just over 50% of all new home loans now originate through a broker. The competitiveness of Australia's home loan market is now substantially dependent on the decisions of home loan providers, brokers and aggregators (intermediaries between lenders and brokers). The intimidatingly complex and confusing nature of the home loan market, and the absence of a direct cost to consumers from using brokers, are strong motivators for consumers to increasingly choose brokers over direct contact with lenders.

For smaller lenders and those without widespread branch networks, brokers enable diversification and growth in their loan portfolio. For example, non-bank lenders and foreign banks operating in Australia rely on brokers for over 90% of their loan book. We calculated that, on average, each smaller lender would have needed to open 118 new branches to generate the equivalent market share achieved through use of brokers.

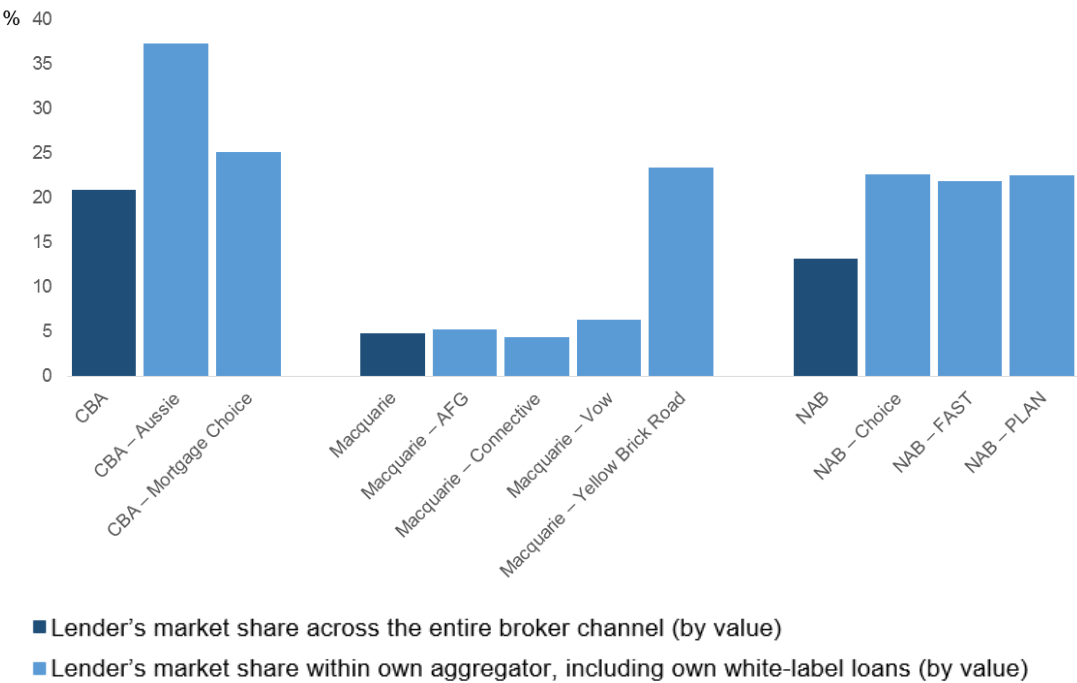
For the major banks with large branch networks and brand recognition that motivates customers to initiate contact with them, brokers are generally *not* a cheaper distribution channel for their loans (except perhaps in some regional markets).

Lenders controlling loan distribution networks

Yet the major banks have not only survived the emergence of the broker model, they have leveraged their market positions to, quite literally, make it their own. The major banks source around 40% of their loans through brokers, are represented on the vast majority of broker panels, and account for just over 60% of the total loans that brokers generated. And all the major banks, except ANZ, have an ownership stake in at least one mortgage aggregator.

Examining market outcomes, it is not apparent that aggregator ownership *alone* has granted a market advantage. Yet (according to ASIC survey data) through use of white label loans, lenders *do hold a disproportionate share* of loans placed through those aggregators that they own — suggesting that other lenders have disproportionately lower access to consumers through those aggregators owned by lenders (figure 6). For example, CBA has just over 20% market share across the broker channel, but represents around 37% of the loans written through one of its aggregators, Aussie Home Loans. In terms of loan interest rates, there is no consistent and significant difference in the rates the major banks have charged between the aggregators they own and do not own, and for loans via direct channels.

Figure 6 **Market shares with bank ownership of mortgage aggregators**



The benefits to lenders of aggregator ownership appear to be gaining market share (largely through white label loans), potentially greater control of the broker distribution channel and competitors’ use of it, and the scope to recoup a portion of commissions paid.

Lenders were not forthcoming when we asked them to explain further the basis for aggregator ownership. But regardless of whether their ownership allows them to exercise influence over the aggregator, the potential for them to do so is unchallenged and the consequent adverse ramifications for competition and consumer outcomes should not be underestimated.

A broken model of broker remuneration

Mortgage brokers are remunerated through commissions, which are paid by lenders. Commissions are determined as a proportion of the loan value and include both upfront payments and trail payments that are paid over the life of the loan. Industry participants have committed to removing bonus commissions (that increase motivation for a broker to maximise loan size beyond a customer's need), but this has not yet been widely implemented.

Our primary concerns about broker remuneration, from a competition perspective, include that recovery of such payments by lenders (for example, through higher mortgage interest rates across their portfolios) may be imposing additional costs on all home loan borrowers, and that current structures are at times highly likely to motivate brokers (and possibly lenders) to act in ways other than in the consumer's interests. Unlike in wealth management (a similar advisory business, involving serious financial cost), mortgage brokers are not presently obliged by law to act in the best interest of the customer. And as we have seen with wealth management, a shift in that law may not be sufficient — CEO or board-level interest in its application is needed. The best place to start is simpler and open remuneration structures aligned as far as practical with customers' best interests.

Conflicts in broker remuneration

Inquiry participants put forward a range of views as to why trail commissions are paid and what their effect is on broker behaviour. These claimed purposes included providing an incentive for brokers to achieve good outcomes for their customers; influencing the level of refinancing and reduce 'churn'; aligning the interests of the broker with those of the lender; and remunerating brokers for providing ongoing services to clients.

We remain unconvinced that trail commissions serve any such purposes. The evidence is not there, certainly not from the banks that pay the commissions nor from the brokers' associations. It is most likely that a traditional form of remuneration common in the 1990s, when brokers emerged as a competitive force, has simply persisted long after it has been found detrimental to consumers in other financial product markets.

Despite industry-led initiatives to reform broker remuneration structures, it is apparent that little change is occurring and the principal commission structures continue to create conflicting incentives for brokers.

At its simplest, brokers have a strong incentive — regardless of what may be in their customer's best interest — to give preference in their loan recommendations to lenders that pay higher commissions. This may be uncommon, but there is no obligation for transparency of the payment to prove it.

Remuneration structures must also motivate at least some brokers to prefer advising new customers (with a new stream of trail commissions and potential referrals), particularly

during the clawback period for an existing loan. Compounding this, many brokers and the Combined Industry Forum (where changes to remuneration structures are being debated by lenders and brokers) agree that brokers prefer to negotiate with a customer's existing lender before considering refinancing with another lender. This preference for loyalty is demonstrably often not in a customer's interest. And without any ability to withhold payment as an incentive to receive competitive offers, a consumer is actually in a poorer position to receive quality on-going advice as long as trail commission persist.

To the extent that brokers' business models rely on them maintaining ongoing (if infrequent) interaction with customers, they are likely to provide on-going advice irrespective of commissions. We see no case for paying for something (that is, through trail commissions) that is going to happen anyway.

Fewer conflicting incentives likely if commissions are upfront only

The current structures of mortgage broker remuneration appear to have become entrenched more because lenders are reluctant to be a first mover in negotiating alternative approaches than because they are delivering desirable market outcomes. Evidence to the Royal Commission indicated as much.

Fixed fees paid by customers rather than commission structures have been proposed, and would eliminate conflicts, but the cost to competition would be high. Consumers would desert brokers, and smaller lenders (and regional communities with few or no bank branches) would suffer much more than larger lenders, if customers were required to pay for broker advice. But change is required — to the role of the lender in being the paymaster — to reduce the scope for damage from conflicted advice.

Thus, while we propose that up-front commissions remain paid by lenders, we consider that going forward, trail commissions must be abolished — as they have already been in other parts of the financial system.

We accept that up-front commissions may rise as a consequence of such action. Broking businesses would need to remain commercially viable.

Industry agreement to abolish volume-based commissions (commissions based on the volume of loans written by an aggregator) must be implemented by all lenders without further delay. The absence of evidence that this is occurring affects industry credibility.

Current industry practice of restricting commission clawback arrangements to 18 months to two years should be imposed by ASIC in an enforceable Code across all lenders and include a ban on commission clawback being passed on to borrowers. Lengthy clawback periods act against consumer interests, inducing a costly form of loyalty.

In the absence of shifting broker remuneration from lenders to customers, which as we note above would diminish competition emanating from brokers, a formal best interest obligation is required as an offset to conflict, and it should be comprehensive.

A best interest obligation in the home loans market

With lenders owning a stake in mortgage aggregators and conflicted broker remuneration structures, the interests of providers in the home loan market are not often aligned with those of the customer. It is the bank as paymaster that triggers conflicts. So a best interest obligation must cover ADIs, as well as brokers.

**A best interest
obligation on all who
provide home loans
or home loan
services**

Removing trail commissions and restricting commission clawback will be important to reducing conflicts around remuneration. But placing remaining payment arrangements within a broader legal structure that realigns remaining incentives towards customers is needed to offset any scope for conflict.

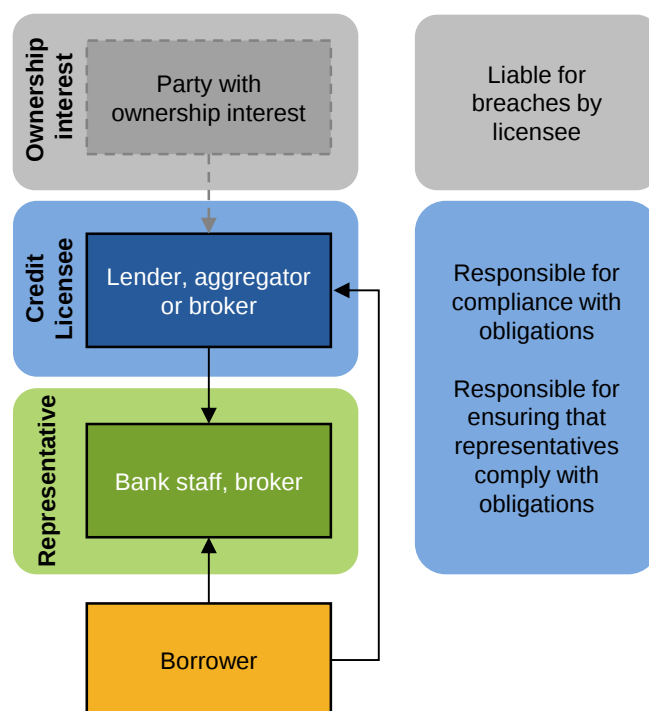
The Commission recommends the introduction of a best interest obligation for all providers in the home loans market — whether as a lender or mortgage broker — who interact directly with consumers seeking a home loan. The proposed obligation is intended to build on the existing regulatory framework in the *National Consumer Credit Protection Act 2009* (Cth), which governs the licensing and conduct regime that applies to providers in the credit market.

The new best interest obligation should comprise several distinct but complementary components:

- a duty to act in the best interest of the client
- a requirement that any resulting recommendations must be appropriate to the client, having regard to the duty to act in the best interest of the client
- a duty to prioritise the interests of the client, in the event of a conflict
- a duty to ensure that certain information is disclosed to the client.

The obligation should apply to credit licensees who provide home loans or home loan services, such as firms (aggregators) with mortgage brokers operating under their credit licence. Credit licensees should also be responsible for ensuring that their representatives comply with the obligations. The Commission also recommends that legal responsibility be extended to lenders who have an ownership interest in firms that hold a credit licence (figure 7).

Figure 7 **The best interest obligation**



Principal Integrity Officer for all banks

Principal Integrity Officer to ensure reward structures do not conflict with consumer interests

As noted above, commission-based remuneration structures create conflicts that may limit competition and mean that at times the money flow is at odds with acting in a consumer's best interest. These conflicts are particularly apparent where banks, as the creators of a financial product, are integrated with other entities that market, sell or advise on these same products.

It will not suffice to put in place standards that collectively reflect the rules of good practice, if they are out-of-step with where the entities' leadership and management consider their interests to lie. To this end, the parties best placed to directly manage these risks — senior management and boards of directors — must also be obligated to their consumers, to ensure that transparency around commissions' impact on incentives is not an afterthought.

APRA should impose on all ADIs, as a condition of their banking licence, the appointment of a Principal Integrity Officer to act as the source of both internal and external accountability for payments that could compromise consumer best interests. For this Inquiry, payments related to finding or placing mortgage products (including referral fees) have been the primary focus. However, reporting obligations *should* equally apply to other potentially conflicted payments

(those that may adversely affect, or be seen to affect, the delivery of a service in a customer's best interest) — such as in financial advice and wealth management.

The Principal Integrity Officer role, as we envision, would: (i) minimise risks of negative customer outcomes from remuneration structures, including conflict with the requirement to act in the customer's best interest; and (ii) constantly re-evaluate the impact of integrated supply chains on fulfilling customer best interests. The Officer would act, in the first instance, via direct reporting to ensure a board is well-informed on the subject, but (as a fail-safe device) have an obligation to report to ASIC where advice is ignored.

Many banks claim to put the customer first. A formal, accountable reporting line to both board and regulator would put substance to this marketing. There will be a cost, but savings for banks may be inherent in other aspects of our remuneration reform. Design details of this notable addition to accountability amongst ADIs should be determined through a consultation process.

Shedding light on opaque practices that harm consumers

Knowing how your home loan rate stacks up

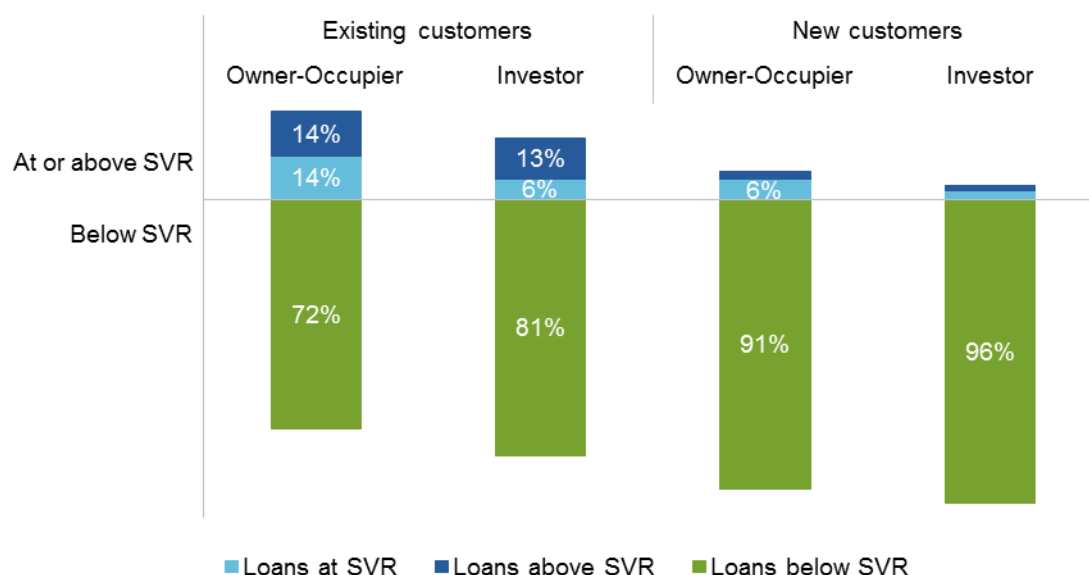
The absence of public data on *actual* prices is a distinguishing feature of Australia's banking industry that is not usually sustainable in competitive markets.

For example, the standard variable home loan interest rate advertised by ADIs bears no resemblance to the actual interest rates offered to potential borrowers: the vast majority of consumers pay less than this rate (figure 8).

Actual home loan interest rates and the discounts offered on the standard variable rate are generally not publicly available to consumers and the interest rate offered to a borrower is only revealed once they are well into the application process. Home loan packages that bundle home loans with other financial and credit products, such as offset accounts and credit cards, further obscure the actual value and comparability of individual components.

This opaque pricing is a significant factor in keeping consumers unsure of their position and more dependent on advice — some more professional than others. And brokers are often also not able to offer a full range of products. Even where they are able to present a wide variety of options to consumers, in the case of mortgage brokers and aggregators, they currently remain under no legal or contractual obligation to act in the customer's best interest.

Figure 8 **Most people do not pay the standard variable rate (SVR)**
Share of the number of home loans in 2016-17



A new home loan interest rate tool so borrowers can compare with actual rates paid by others

Shining a light on home loan interest rates would better allow mortgagees to see how their rate compares with other *actual* rates in the market for equivalent borrowers. Current comparators used by banks and brokers are not representative of rates actually paid. This is an unusual market indeed, when consumers are conditioned to expect a discount (of an uncertain size) from a published comparison rate, but that rate is *not* usually the market price for that borrower.

With access to digital data, *actual* home loan interest rates recently negotiated can and should be continuously collected by APRA, and made accessible to consumers via an online calculator, by ASIC (with an elapsed time of no more than 6 weeks). Consumers would be able to see the market median interest rate offered to all home loan borrowers in similar circumstances to them. The specific loan and borrower characteristics that are included in the online calculator should be developed through consultation and consumer testing.

Concerns about abuse of actual price information for price signalling are real, but capacity to do this already exists today via the broker channel. Moreover, use of a single median price across lenders limits scope for gaming of the pricing material supplied by individual lenders.

LMI — refunds or periodic payments

Lenders mortgage insurance (LMI) is a form of insurance for lenders that some borrowers, who are considered to be higher risk, are required by lenders to pay for (on a take it or leave it basis) in order to get a home loan.

Although it is seen as a benefit to first-home owners, data shows its greatest application is to higher income home-buyers.

Some lenders receive non-claim payments (including rebates for low claims) from LMI insurers and, in aggregate, these are not fully passed on to borrowers. Instead, the overall market price of LMI is inflated by the existence of these non-claim payments.

We see merit in intervention by ASIC to ensure that the interests of borrowers are adequately safeguarded in the LMI market. In particular, the Commission recommends that all lenders be required to offer borrowers the option of:

- (i) paying for LMI up-front, with the ‘unused’ portion refundable in the event that they switch to a new home loan provider, and the refund schedule provided at the start of the loan, or
- (ii) paying for LMI periodically (as in fact occurs for most other types of insurance), with no refund schedule necessary.

Clarifying and expanding what your financial adviser can do for you

To ensure consumers are able to clearly distinguish between general promotional effort related to products and actual personal advice, use of the term ‘advice’ should be limited to effort that is undertaken on a client’s behalf by a professional adviser. Currently, the terminology of advice requires consumers to intuitively understand that general advice is like marketing; and personal advice is actually tailored to their situation and carries with it some protection against misuse.

Rebadging of existing ‘general advice’ products to implement this will involve some cost to the industry, but we would expect that some documentation is electronic, most would be updated regularly and the marginal costs of this change would not be substantial. The important shift is to training in the use of this term (and the culture that accompanies it).

While financial advisers cannot advise consumers on specific credit products, they are permitted to provide general credit advice. Where financial advisers do provide specific product advice on credit products, they must be licensed as an adviser (under the Corporations Act) as well as hold an Australian credit licence (under *National Consumer Credit Protection Act 2009* (Cth)) or be authorised representatives under both regimes. Currently, only 4% of Australian financial services licensees also hold a credit licence, and around 10% of representatives are authorised to provide both financial advice and credit assistance.

Allowing financial advisers to compete with mortgage brokers in offering personal advice on home loans would both expand sources of competition in home loan distribution and provide more holistic personal financial advice services to consumers. But there are impediments that are likely to limit the effectiveness of this proposal in the immediate future. These impediments include: the current conduct standards in the financial advice sector; the different means by which financial advisers and mortgage brokers are remunerated; and the level and nature of training and experience necessary to advise on both credit and investment products. ASIC should assess the feasibility of financial advisers providing advice on home loans and other credit products.

Addressing poor outcomes from financial add-on products

Add-on insurance is insurance that is sold alongside (and in relation to) another product. Examples include consumer credit insurance (sold alongside credit cards and loans), guaranteed asset protection insurance (sold alongside car loans) and lenders mortgage insurance (sold with higher risk home loans to protect the lender in the event of loan default). Add-on insurance is generally not a financial product that consumers actively seek, but is typically sold to them in addition to another purchase. The nature and context of the sale can mean that consumers are unable to exercise their normal competitive pressure on prices and quality.

On average, consumers receive back in claims only a small share of what they pay in premiums — about 9 cents in every dollar for add-on insurance sold by car dealers and 21 cents in every dollar for consumer credit insurance. This is far below the comparable figures for car insurance (83-98 cents) and home insurance (42-71 cents).

ASIC has exposed very poor consumer outcomes in some add-on insurance markets that include: insurers competing for intermediaries (and driving up premiums paid by consumers); policies where claims are less than or similar to the premium paid; policies that have exclusions broad enough to rule out most potential claims; and policies that offer cover that duplicates other already existing protections (such as warranties). Reforms in this area have proceeded at a glacial pace.

ASIC should proceed with its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships. Even with this, however, the Government should look to extend the model to all add-on insurance products. There should be a clear break period between such sales and an extended cooling off period.

The exemption of retailers— such as vehicle and white goods retailers — that offer finance to customers, from compliance with the *National Consumer Credit Protection Act 2009* (Cth) was to be reviewed by Treasury within 12 months of its introduction in 2009. We see little justification for maintaining such an exemption nine years beyond its introduction and consider that consumers should be protected by the National Consumer Credit Protection Act when taking up finance from retailers. But we have not been able to examine this issue in detail in this Inquiry. Accordingly, Treasury should complete and publish its 2013 review

into the current exemption of retailers from the *National Consumer Credit Protection Act 2009* (Cth), with a view to removing or reforming the exemption unless there are compelling justifications for retaining it.

Insurance premium transparency

In contrast to many banking products, consumers are reminded annually of their option to renew general insurance policies. This provides a ready opportunity for getting information to consumers that would prompt consumer re-evaluation of their product decisions and improve competitive outcomes in insurance markets. In particular, we recommend that insurance renewal notices should transparently include the previous year's premium and percentage change to the new premium.

Further supporting greater clarity around insurance products on offer and removing the illusion of competition where none exists in reality, insurers should provide an up-to-date list of the brands they underwrite to ASIC, for publication on the regulator's website.

Action on the payment system is needed before incumbent positions become more entrenched

The New Payments Platform — hotbed for innovation or tool of incumbents?

The payment system is one area where innovation, and new entrants, have had an impact on market dynamics. Australians now have more payment options than ever before, and technology continues to evolve at a rapid pace. Regulation has not always kept pace with the rate of change, and this can have negative consequences for competition in future.

The New Payments Platform (NPP) requires an access regime. This is a rare opportunity to set up regulatory arrangements that will support substantial competition in services that all Australians use every single day.

The NPP, which became operational in early 2018, is set to replace the current technology through which over \$1 trillion moves between banks each month. It was set up, and is mutually owned, by 13 initial shareholder participants (including the major banks and the RBA). Regulators should act now to facilitate fair access to the NPP in its early days — which will likely determine whether the platform will become a hotbed for innovation and competition, or yet another payment system subject to the market power of incumbents.

The NPP is expected to reduce *technical* barriers for new financial institutions to enter the payments system, and enable existing institutions to provide more efficient services through real time transfers of funds. It provides a rich set of payment data, which could be used by fintechs and incumbents alike to develop new applications.

Institutions that are not currently connected to the NPP can access it either through one of its existing participants or directly, by application to the NPP's governing body — New Payments Platform Australia Limited (NPPA). It is, however, up to the board of the NPPA (which includes representatives of 7 banks) to determine whether or not to accept an applicant.

In effect, this access model requires new competitors to be accepted by the initial participants, which could reasonably be expected to involve conflicts of interest. A recent survey of Australian fintechs indicated that over 80% were unconvinced about the ease of access to the NPP and believed that there should be more transparent access points for fintechs to connect. The NPP is a significant piece of national infrastructure and more transparency and rigour around the process for access is needed to avoid conflicts of interest that would potentially restrict competition.

The NPPA considers that having the RBA on its board will be a sufficient safeguard to stop the eligibility criteria disadvantaging prospective entrants. The RBA, in turn, is taking a wait-and-see approach to NPP access regulation. But there are risks from a passive approach at the time a new market is created, as it can cement incumbency.

Accordingly, the RBA should establish a formal access regime for the NPP. As part of this regime, the RBA should: broaden access to the NPP for specialist payment providers, without the need to become an ADI; review the fees set by participants of the NPP and transaction fees set by NPPA; and require all transacting participant entities that use an overlay service to share de-identified transaction-level data with the overlay service provider.

To ensure positive consumer outcomes are maintained as innovative products and services expand in the payment system, subscription to the ePayments Code (which sets out basic rules for who pays for unauthorised transactions and establishes a regime for recovering unauthorised payments) should be made mandatory for any organisation that sends or receives electronic payments, with more clearly defined liability provisions.

Distorted incentives in card payments

Card payments and bank transfers have grown in Australia and are dominated by Visa, MasterCard and the major banks (which enable over 80% of credit card payments). Australia has the highest level of contactless card use in the world and the fourth highest number of non-cash payments per person, with non-cash payments growing at about 10% per year.

Consumers get benefits from using cards — convenience, interest-free periods, rewards points — but do not face the full costs. Instead, the cost of a consumer's choice of payment is (in part or in full) borne by merchants, who pay interchange fees each time a consumer pays them using a card. In some cases these fees are used to fund reward points that are, in effect, a payment to the consumer for using the card. These fees are usually recouped through higher prices paid by all consumers. This means that financial institutions and card schemes have the

opportunity and incentive to grow their networks by competing to subsidise the benefits to cardholders — at merchant’s expense.

Rewards and other benefits may be useful to expand card networks in their infancy (and thereby enhance the value of the network for all), by increasing the incentive for individuals to use cards. With mature card scheme networks and ubiquitous use in Australia and worldwide, it reflects significant market power to suggest (as the major card schemes have) that in order for them to survive, merchants should be required to pay higher fees to cross-subsidise consumer reward programs. The case for interchange fees to fund reward programs or to redistribute benefits on a transactions basis from the merchant’s bank to the customer’s bank is feeble.

Regulation of bank interchange fees and surcharging has proved complex. The Payments System Board of the RBA should ban, by end-2019, all card interchange fees as a way to reduce distortions in payment choices and the flow-on costs of these distortions to merchants. Given the potential for three-party card schemes to avoid such regulation and further distort the mix of payment instruments, the ACCC should investigate whether further intervention — such as the direct regulation of merchant service fees — is necessary.

More choice for merchants in their use of the payments system

Merchants choose which payment methods to accept given the costs and benefits they face. Currently, contactless transactions using dual network cards (such as ‘tap and go’ facility at point of sale) are mainly processed through the generally higher-cost Visa or MasterCard networks by default, rather than through eftpos.

**More control for
businesses over
their payment
system costs**

Merchants are likely to prefer that their financial institution routes payments through lower-cost network by default, but most merchants are simply not given this choice. In many overseas countries, either the merchant or the card holder is given the choice of payment pathway for dual network cards. For example, in Europe and Malaysia, merchants have first choice of the default pathway but the customer can override it.

To give merchants some control over their payments system costs, merchants should be given the capacity to select their own default route that is to be used for payments by dual network cards. The technology is readily available to offer dual payment choice in Australia and we consider this must now be mandated.

Supporting competition and reducing the costs of stability

Improving access to finance for small businesses

Reducing bank reliance on homes as security for SME lending

The ability of small and medium sized enterprises (SMEs) to access the necessary finance to establish and grow their business has been an issue for policymakers and previous reviews and inquiries, particularly since the GFC. Continued reliance on having a home as security for a business loan — in an era when home ownership in the key entrepreneurial period of life is at a low — will increasingly inhibit SME growth. Around one third of major bank SME loans, and often a higher proportion of smaller lender SME loans, are secured by a home.

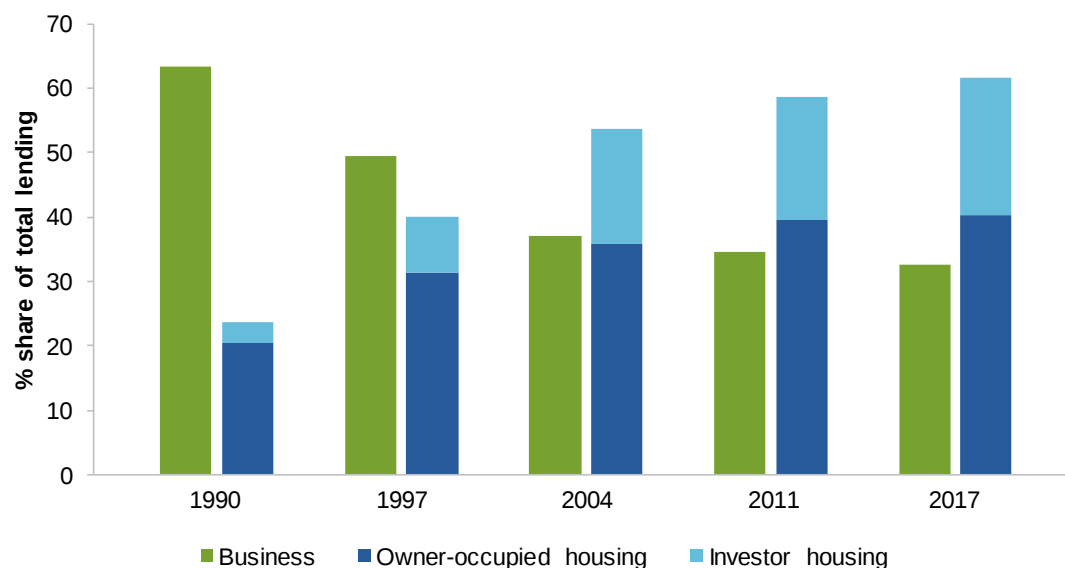
Reforms to address the ongoing issue of provision of credit to SMEs on terms that are commercially viable have the potential to significantly improve the market for SME lending. Improved access of banks to information about businesses seeking credit, particularly new businesses — for example, through Comprehensive Credit Reporting, Open Banking and business accounting software — should better inform lenders of the risk represented by SMEs seeking access to finance. But we consider the reform that would most significantly improve SME access to finance to be changes to the underlying prudential requirements for SME business lending compared with lending for residential mortgages.

For SME loans, APRA currently applies a single risk weight (of 100%) to all SME lending not secured by a residence, with no delineation allowed for the size of borrowing, the form of borrowing (term loan, line of credit or overdraft) or the risk profile of the SME borrowing the funds (box 1). This means that most lenders are generally required to hold more regulatory capital than are lenders using IRB models and more than that required under the internationally agreed Basel requirements.

As a consequence, for a SME loan that is not secured by a residence, Australia's smaller banks need to hold up to twice as much capital as the major banks — in effect, paying up to twice as much to be able to offer loans to their customers. This difference is smaller for loans secured against a residence. This approach to risk weights skews competitive opportunity away from consumer interests and provides strong incentives for both lenders and SME borrowers to secure a business loan with a residence as collateral. More generally, it creates a strong preference for home loan lending over business lending (unless secured by residential property) (figure 9).

Instead of applying a single risk weight to all SME lending not secured by a residence, APRA should provide a schedule of risk weights that takes into account alternative forms of loan security (such as commercial property) and differing loan to value ratios on this security.

Figure 9 **Lending has skewed away from business toward housing**



A more granular approach to regulatory interventions

A more granular approach is likely to be feasible in APRA's other interventions to reduce the costs on the economy of achieving stability objectives.

For example, in 2017, APRA informed ADIs that it expects them to limit the flow of new interest-only lending to 30% of their new residential mortgages. This is a further example of a blunt intervention with detrimental effects on market competition. It followed a similarly blunt intervention (in 2014) to impose a 10% benchmark on investor home loan growth.

These interventions had significant consequences across the economy. Lenders interpreted APRA's benchmarks as hard limits on lending. Competition was curtailed, as market shares had to remain static for providers to comply, and some lenders temporarily stopped offering products such as interest-only home loans. Interest rates increased on both new and existing investment loans, boosting lenders' profit on home loans. Up to half of the increase in lenders' profit was in effect paid for by taxpayers, as interest on investment loans is tax deductible. We estimated that the cost borne by taxpayers as a result of changes in home loan investor rates following APRA's intervention on interest-only loans in 2017, was up to \$500 million per year (which may be partly offset by increased tax paid by the lending institutions on their profits).

The benchmark on investor loans imposed in 2014 is to be removed from August 2018, where APRA is assured by ADI boards that risk policies are in place and adhered to. However, there is nothing in the removal of the APRA benchmark to cause lenders to reduce the interest rates that they raised in order to comply with the benchmarks, and it is unlikely

that competitive pressures will force them to do so. Borrowers and taxpayers will continue to pay the price.

In future, APRA should consider basing such interventions on the differences in the underlying risk of an ADI's loan book. As much as possible, APRA should use targeted interventions to the risks it identifies (either at the institution level or groups of similar institutions), rather than imposing blanket rules across all institutions and geographic regions. The appointment of a competition champion, to assist APRA on the expected consequences of its actions, would be a valuable tool to achieve more targeted interventions and potentially have a lower impost on consumers.

Further, APRA should evaluate the effects of its prudential standards and interventions. For example, the recently introduced capital holding requirements for banks that offer warehouse funding have affected the availability of funds for small ADIs as well as non-ADI lenders. At the margin (the only area where price competition seems a reasonable probability in a highly regulated market), competition could be suppressed. APRA should monitor the impact of its changes on warehouse funding on not just those ADIs that offer warehouse funding but also on those that use it (including non-ADI lenders).

Box 1 APRA risk weights on different types of loans

Risk weights are a cornerstone of prudential standards, as they determine the amount of regulatory capital that a bank must hold against each loan it makes.

Some of APRA's standardised risk weights have been set at higher values than those recommended by the international Basel guidelines (see below table). For example, for SME loans, APRA currently applies a single risk weight (of 100%) to all SME lending not secured by a residence. In contrast, Basel III risk weights for SME lending vary from 75% (for SME retail lending up to €1 million) to 150% (for lending for land acquisition, development and constructions).

These risk weights are used by all ADIs other than the major banks, Macquarie and ING, which operate — for part (in the case of ING) or all of their credit portfolios — internal risk-based (IRB) models approved by APRA. The comparatively higher risk weights mean that most lenders are generally required to hold more regulatory capital than are lenders using IRB models.

From a prudential perspective, changing weights to more closely reflect the inherent risk of different types of loans would help prevent excessive provisioning of regulatory capital for low risk assets and under-provisioning for riskier assets. Thus, it would contribute to a more efficient banking system. From a competition perspective, increased granularity for risk weights would reduce the gap between IRB and non-IRB banks, as well as help achieve better competitive outcomes through lower costs for safer, low LVR loans.

APRA is consulting on changes to the standard risk weights, to allow for more targeted risk signals. The new proposed risk weights are lower for loans that pose less risk to the lender, such as owner occupier loans with low loan-to-valuation ratios, but increased for higher-risk lending.

Reviews of prudential standards take a considerable amount of time — it will be three years until the new framework APRA is working on is finalised and implemented. In a market that can change as dramatically and as quickly as banking, regulatory responses should be much more timely. Risk weights should be reviewed regularly, particularly given the increasing amount of data collected and generated by lenders and borrowers (for example, through comprehensive credit reporting).

How Australia's risk weights compare with Basel

Type of lending	Basel II Standard	Australia (based on Basel II)	Basel III Standard	Australia (proposed – based on Basel III)	Australia IRB
Home loans ^a	35%	35 - 75%	20 - 70%	20 - 85%	Avg 26%
e.g. Low risk mortgage ^b	35%	35%	20%	20%	
e.g. High risk mortgage ^c	35%	50%	50%	75%	
SME lending not secured by property	75 - 100%	100%	75 - 150%	85%	Avg 48 - 55%
Lending for/secured by commercial real estate	100% ^d		80 – 100% ^e 130% ^f		

^a After consideration of any lenders mortgage insurance. Assumes repayment is not materially dependent on cash flows from property. ^b 50% LVR, owner occupier, principle and interest. ^c 95% LVR, investor, interest only. ^d Lending on office or multi-purpose/ multi-tenanted commercial premises can receive a risk rating of 50% where the value of the loan does not exceed 60% of the mortgage value of the property ^e LVR ≤ 80% ^f LVR > 80%, where repayment is materially dependent on the cash flows generated by the property.

Findings and recommendations

The state of competition

FINDING 2.1 KEY FEATURES OF WORKABLE COMPETITION IN THE FINANCIAL SYSTEM

The key features of *workable competition in Australia's financial system* at which we can aim, include:

- a high awareness of changes in market opportunities along with low costs for consumers when switching to preferred products
- active support for consumers by public advice or private advisers to conveniently make informed decisions in their best interests
- an Open Banking regime that gives consumers perpetual access to their data, with the capacity to see that data safely moved from one provider to another
- minimal limits to either entry by new providers or expansion or exit of existing providers, in regulated product markets (subject to other regulatory objectives such as prudential outcomes)
- regulators who anticipate that financial products and the ways of delivering them will change with technology and consumer preferences, and be willing and able to change regulation as required
- effective and timely scrutiny of the adverse use of market power, including as a response to regulator interventions.

FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST

Competition and stability are both important to the Australian financial system.

Since the global financial crisis there has been a focus on requiring prudentially regulated institutions to be unquestionably strong. It is important to ensure that the essential role of competition in economic growth is not eroded by having stability as the default regulatory position, to the exclusion of competition. Competition can support stability, checking irresponsible behaviour of providers and improving outcomes for consumers, and must be allowed to flourish.

FINDING 3.1 STATE OF COMPETITION IN THE BANKING SYSTEM

Price competition in the banking system is limited. Although institutions claim that they compete in loan markets by discounting, such behaviour is not indicative of a competitive market when price obfuscation is common and discounts are specific to groups of customers.

Competition on product features and service is more evident. But the large number of marginally different products appears more reflective of a capacity for price discrimination than of competition.

FINDING 3.2 THE STRUCTURE OF THE BANKING SYSTEM

Australia's banking sector is an established oligopoly with a long tail of smaller providers.

The four major banks as a group hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is substantially 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 — with minimal loss of market share.

The smaller banks and non-bank financial institutions typically follow the pricing trend set by the major banks, and are not a significant competitive constraint on the major banks' market power.

Adding cost to the larger banks without altering their market power does not lift competition, harms consumers and is counter-productive. Policy measures aimed at addressing either conflicts of interest or regulatory interventions that disregard competition, can mitigate adverse outcomes for consumers even if the current industry structure remains largely intact.

FINDING 6.1 BETTER RATINGS AND COST OF FUNDS FOR 'TOO BIG TO FAIL' BANKS

The major banks in Australia benefit from a 'too big to fail' status reflecting an expectation of government intervention if one or more of these banks were in financial difficulties. This status lowers the cost of funds for these banks.

By incorporating perceived government support in their relative ratings of Australia's banks, rating agencies further embed the major banks' 'too big to fail' status.

FINDING 8.1 COST OF FUNDS FOR DIFFERENT SIZE BANKS

Larger banks benefit from lower costs of funding, compared with smaller institutions. Size, scope and incumbency have enabled them to increase their share of the deposit market, retain better access to offshore funding markets and raise funds at relatively cheaper rates due to their higher credit ratings, which in part reflect an expectation of government support.

Risk weights determined by the prudential framework have a substantial impact on the cost of funds. The major banks have invested in approved internal risk management models, gaining a further cost advantage from being allowed to use risk weights that are generally lower than APRA's standard requirements.

Cost interventions (such as changes to risk weights) have been presented as targeting both stability and competition. While such interventions may have achieved stability objectives, they have had adverse consequences for competition. Interventions that raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and will harm consumers.

FINDING 8.2 NEW WAREHOUSING RULES COSTLY FOR NON-ADIS

Prudential regulations (Prudential Standard APS 120) affecting warehousing activities (temporary lines of credit provided by larger banks to other lenders) that came into effect on 1 January 2018 take a one-size-fits-all approach to risk ratings for smaller authorised deposit-taking institutions (ADIs) and non-ADIs. These have increased the costs of warehousing and reduced the competitiveness of those (generally small) institutions that rely on warehouse funding.

RECOMMENDATION 8.1 COMPETITION IMPACTS OF APS120 SHOULD BE ASSESSED

Consistent with recommendation 19.3, APRA should conduct a post-implementation review on how the changes in Prudential Standard APS 120 have affected the costs of funds and competitiveness of non-authorised deposit-taking institutions.

New entrants in banking

FINDING 4.1 A CONSOLIDATION IN BANKING

There has been substantial consolidation in Australia's banking system. From 2005 to 2017, the number of organisations with a banking licence fell by almost 40%. This was largely a result of mergers between institutions, rather than exits.

FINDING 4.2 FOREIGN BANKS TEND TO OPERATE IN SELECT MARKETS

Foreign banks have shown that they are willing to enter Australia's banking system — between 2007 and 2018, the vast majority of new entrants to the banking system were foreign bank branches.

The regulatory framework incentivises foreign banks to enter and compete in the wholesale banking sector, rather than compete for household deposits. While they are important to innovation and to price competition in certain market segments, foreign banks remain focused on specific market segments and are not likely to prove a competitive threat in the broader retail banking sector.

FINDING 4.3 MOST FINTECHS ARE FOCUSING ON LESS-REGULATED SERVICES

Australia's fintech sector has grown substantially in recent years and offers a range of financial services.

However, few fintechs consider themselves to be challenger banks. The vast majority are focused on providing services in areas of the financial system with less onerous prudential regulation, such as small-scale funds management and lending, and payments systems.

Global technology companies, said to be the potential disruptors, are yet to make a mark in banking and the broader financial system in Australia.

FINDING 4.4 FINTECH COLLABORATION AND COMPETITION

Fintechs are not, on present indications, likely to have the kind of competitive disruptive effect that would alter the market power of major banks in the foreseeable future.

In the long term, lowering barriers to entry and growth, including greater access to consumer data, may lead fintechs to favour competition against incumbents over collaboration.

We must look further afield for substantial offsets to current market power.

RECOMMENDATION 4.1 EXPANDING ASIC'S REGULATORY SANDBOX

The Australian Government, in consultation with ASIC, should expand the scope of products eligible for testing under ASIC's regulatory sandbox, beyond the proposed enhanced regulatory sandbox, to include prudentially regulated fintechs that want to hold household deposits and issue or provide other financial products or services.

At the same time, ASIC should take a more hands-on approach to approving and supporting fintechs in testing their products or services, particularly to help with judgments on whether and how products may harm consumers.

ASIC should also consider requests from existing institutions to access the sandbox on a case-by-case basis.

An ongoing program of regulatory improvement in support of the sandbox should be a standing item for the Commonwealth Treasury's legislative program.

The role of integration

FINDING 9.1 COMPETITION ISSUES NOT CLEARLY CAUSED BY INTEGRATION

The Productivity Commission has not found any competition issues in either mortgage or wealth management markets that are clearly associated with integration. Where poor consumer outcomes arise in these markets, these outcomes may be compounded at times by integration, but are more likely associated with poor transparency and adverse remuneration incentives that arise even absent integration.

FINDING 9.2 FORCED SEPARATION IS NOT A PANACEA

Forced structural separation is not likely to prove an effective regulatory response to competition concerns in the financial system, specifically not in either home loan or wealth management markets.

RECOMMENDATION 9.1 UNDERSTANDING THE EFFECTS OF INTEGRATION

The ACCC should undertake 5-yearly market studies on the effect of vertical and horizontal integration on competition in the financial system. The first of these studies should commence in 2019 and include establishing a robust evidence base of integration activity in the financial system.

Consumers

FINDING 5.1 CONSUMERS' CAPACITY TO PUT COMPETITIVE PRESSURE ON PROVIDERS IS OFTEN LIMITED

For many financial products, consumer responses to variations in price and service are limited. Consumers lack meaningful transparent information and face switching barriers; and they perceive insufficient ongoing difference between providers and product offerings to make the process worthwhile.

FINDING 5.2 VARYING PRODUCT USAGE RATHER THAN PRODUCT HOLDINGS

Multiple account holdings (such as transaction accounts and credit cards) allow consumers to change their product usage but not switch their product holdings. Whether this translates to demand-side pressure depends on the extent to which financial service providers are responsive to the volume of business that they receive, or just the number of customer accounts that they have.

Where multiple products that are very similar can be held at a relatively low cost, a switching (of product holdings) and the long history of reforms aimed at this, become less important as policy objectives.

FINDING 5.3 MARKET SEGMENTATION CURTAILS CONSUMER COMPETITIVE PRESSURE

Financial service providers are able to selectively offer products, prices or terms to different customers, using the information they have about individual consumers. This curtails the ability for an active subset of consumers to drive increased competition in the broader market.

RECOMMENDATION 5.1 DATA ACCESS TO ENABLE CONSUMER CHOICE

The Open Banking system proposed for Australia should be implemented in a manner that enables the full suite of rights for consumers to access and use digital data (as set out in the Productivity Commission Inquiry report, *Data Availability and Use*).

Mortgage brokers and home loan markets

FINDING 11.1 BROKERS ARE NOT CONSISTENTLY FINDING LOWER INTEREST RATES FOR CONSUMERS

While many consumers believe that mortgage brokers can secure them a lower interest rate, interest rates on home loans obtained through brokers are not significantly different to those obtained directly from lenders.

FINDING 11.2 BROKERS ARE A COST-EFFECTIVE WAY TO DISTRIBUTE HOME LOANS FOR LENDERS WITHOUT WIDESPREAD BRANCH NETWORKS

For smaller lenders without national branch networks, brokers tend to be a more cost-effective distribution channel than branches, since branches involve a significant investment. Competition is thus assisted by the presence of brokers.

Larger lenders with established branch networks generally find brokers less cost-effective than existing branches.

FINDING 11.3 TRAIL COMMISSIONS ARE NOT CONSISTENT WITH BORROWERS' INTERESTS

There is little if any evidence to substantiate the claim that trail commissions are a payment for the ongoing provision of services to borrowers.

In practice, trail commissions have the effect of aligning the broker's interests with those of the lender, rather than those of the borrower.

RECOMMENDATION 11.1 BROKER REPORTING THAT ACCORDS WITH IT BEING THE DOMINANT HOME LOAN DISTRIBUTION CHANNEL

As part of the process of issuing credit licences, ASIC should provide clear definitions for, and collect information from licensees about whether they operate as mortgage aggregators, mortgage broker businesses or individual mortgage brokers. This information should be collected in a way that can be reliably used for analyses of the mortgage broking industry.

Aggregators should be required to report to ASIC annually on the number of individual brokers operating under them, whether as credit representatives of the aggregator, credit representatives of another credit licensee, credit licence holders or direct employees of a broker business.

RECOMMENDATION 11.2 REFORMING MORTGAGE BROKER COMMISSION STRUCTURES

An enforceable Code applying to all mortgage lenders should be created and imposed by ASIC, to implement the following reforms to broker remuneration structures:

- ban the payment of trail commissions in mortgage broking for all loans originated after end-2018
- require upfront commissions to aggregators and brokers to be paid based on the funds limit drawn down by customers, net of offset, instead of the limit of the loan facility
- ban the payment of volume-based commissions, campaign-based commissions and volume-based payments
- limit to two years the period over which commissions can be clawed back from aggregators and brokers.

RECOMMENDATION 11.3 REFORMING COMMISSION CLAWBACK ARRANGEMENTS

The Australian Government should extend the ban on early exit fees to explicitly prohibit commission clawbacks being passed on to borrowers. ASIC's powers should be expanded to allow it to enforce the ban.

RECOMMENDATION 11.4 BEST INTEREST OBLIGATION FOR CREDIT LICENSEES THAT FACILITATE HOME LOANS

The Australian Government should amend the *National Consumer Credit Protection Act 2009* (Cth) to impose best interest obligations on licensees that provide credit or credit services in relation to home loans.

These best interest obligations should comprise:

- a duty to act in the best interest of the client
- a requirement that any resulting recommendations must be appropriate to the client, having regard to the duty to act in the best interest of the client
- a duty to prioritise the interests of the client, in the event of a conflict
- a duty to ensure that certain information is disclosed to the client.

Where the lenders have an ownership interest in firms that provide the credit assistance services, those lenders should also have a legal responsibility to ensure that the licensee discharges its best interest obligations.

RECOMMENDATION 9.2 A PRINCIPAL INTEGRITY OFFICER

The Australian Government should mandate the appointment of a Principal Integrity Officer (PIO) in parent financial entities — authorised deposit-taking institutions in the first instance, but with potential extension to other Australian Credit Licensees and Australian Financial Service Licensees. The PIO should have independent status within the entity and would have a direct reporting line to its board.

Once created, the position must not be vacant for more than a minimal period defined in legislation.

The PIO should have a statutory duty to advise the entity's board on performance related to remuneration and practices that may be inconsistent with serving a customer's best interests, including breaches of commission or other remuneration benchmarks and regulations. The PIO should also review internal business practices as they develop over time that may be inconsistent with the entity's obligation to act in the customer's best interests.

The PIO would be required to report independently to ASIC on unsatisfactory responses to its reports, including persistent failure of its board to observe standards supporting consumer best interest obligations. The PIO should be protected from adverse action by statute where they do so report.

Details of the PIO, related legislative changes and penalties, should be determined through a consultation process starting by end-2018.

RECOMMENDATION 12.1 INTEREST RATE TRANSPARENCY FOR HOME LOANS

APRA should continuously collect data from mortgage lenders (authorised deposit-taking institutions (ADIs) only) on interest rates of new residential home loans by borrower and loan characteristics. Consideration should be given to adding non-ADIs to the data set, once the collection process from ADIs has become streamlined.

Using this data, ASIC should develop an online calculator that reports, with an elapsed time of no more than 6 weeks, median interest rates for loans issued according to different combinations of loan and borrower characteristics.

The underlying data should be published in a way that is accessible to third parties such as web application developers. At a minimum, data should be published in a machine-readable format.

RECOMMENDATION 13.1 LENDERS MORTGAGE INSURERS SHOULD DISCLOSE INFORMATION ABOUT PAYMENTS TO LENDERS

APRA should update its disclosure requirements for lenders mortgage insurers to require them to disclose the amount and purpose of all payments made to lenders.

RECOMMENDATION 13.2**OFFERING BORROWERS MORE CHOICE FOR LENDERS
MORTGAGE INSURANCE**

ASIC should require all lenders to provide those borrowers that are levied with lenders mortgage insurance (LMI) with the option of being levied once at the commencement of their home loan (whether paid as a lump sum or as deferred payments) or being levied annually over the first 6 years of their loan, with transparency around the comparison of these options.

Where LMI is levied at the commencement of the home loan, all lenders should be required to set a schedule of refunds on the cost of LMI when borrowers choose to refinance or pay out their loan within 6 years of the loan being originated. The refund schedule should be made available to the borrower before any fee or charge is levied.

General insurance

FINDING 14.1 MARKET POWER IN GENERAL INSURANCE PROVISION

General insurance markets are concentrated. In the home insurance, domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets, the largest four firms (which are not always the same four) hold market shares in excess of 70%. This concentration has increased slightly in recent years, mostly as a result of consolidation activity.

The domestic motor insurance, travel insurance, lenders mortgage insurance and reinsurance markets are particularly concentrated, and while the domestic home insurance market is less concentrated, the two largest firms still account for more than half the market.

But because many insurers supply their products under multiple brands, consumers may see more an illusion of robust competition than a reality.

RECOMMENDATION 14.1 COMPARATIVE PRICING INFORMATION ON INSURANCE RENEWAL NOTICES

Renewal notices for general insurance products should transparently include the previous year's premium and the percentage change to the new premium. This policy should commence by the end of 2019 and be enforced by ASIC.

RECOMMENDATION 14.2 TRANSPARENCY ON INSURANCE UNDERWRITING

In addition to specifying which insurer underwrites their products, each insurance brand should specify on their website any other brands that are underwritten by the same insurer, for that particular form of insurance.

Insurers should provide an up-to-date list of the brands they underwrite to ASIC. ASIC should transparently publish this information as a list on its website.

RECOMMENDATION 14.3 PHASE OUT DISTORTIONARY INSURANCE TAXES

Consistent with the Productivity Commission's 2014 *Natural Disaster Funding Inquiry* (recommendation 4.8), state and territory taxes and levies on general insurance should be phased out.

RECOMMENDATION 15.1 DEFERRED SALES MODEL FOR ADD-ON INSURANCE

ASIC should proceed as soon as possible with its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships.

The deferral period should be a minimum of 7 days from when the consumer applies for or purchases the primary product.

Following implementation, the Australian Government should establish a Treasury-led working group with the objective of comprehensively extending the deferred sales model to all other add-on insurance products, with the model set in legislation and ASIC empowered to offer exceptions on a case-by-case basis.

RECOMMENDATION 15.2 REVIEW OF NCCP ACT EXEMPTIONS

The Treasury should complete its 2013 review into the current exemption of retailers from the *National Consumer Credit Protection Act 2009* (Cth), with a view to removing or reforming the exemption. The report should be made publicly available on completion.

Financial advice

RECOMMENDATION 10.1 ASIC TO ASSESS A NEW LICENCE TO ALLOW FINANCIAL ADVISERS TO ADVISE ON HOME LOANS

ASIC should assess the feasibility of financial advisers providing advice on home loans and other credit products, via a new Australian Financial Services Licence that would not require a separate Australian Credit Licence to be obtained.

This assessment should examine the costs and benefits of a new licence, the consequences of various remuneration models and the applicability of a Principal Integrity Officer.

RECOMMENDATION 10.2 RENAME GENERAL ADVICE TO IMPROVE CONSUMER UNDERSTANDING

General advice, as defined in the *Corporations Act 2001* (Cth), is a misleading term and should be renamed. Any replacement must ensure that the term ‘advice’ can only be used in association with ‘personal advice’ — that is, advice that takes into consideration personal circumstances.

Consumer testing of alternative terminology is required to ensure that misinterpretation and excessive reliance on this type of information is minimised. Including time for consumer testing and a transition period to enable industry training and adjustment, a new term should be in effect by mid-2020.

RECOMMENDATION 10.3 GREATER TRANSPARENCY OF PRODUCTS ON THE APPROVED PRODUCT LIST

Australian Financial Service Licensees should disclose to ASIC (for each broad class of financial product):

- the number of products on their approved product list (APL)
- the proportion of in-house products on their APL
- the proportion of products recommended that are in-house
- the proportion of products recommended that are off-APL

ASIC should publish this information annually.

ASIC should also conduct selected audits of the information received to facilitate assessment of the effectiveness of advisers in meeting clients’ best interests.

Payments system

RECOMMENDATION 17.1 BAN CARD INTERCHANGE FEES

The Payments System Board should introduce a ban on card payment interchange fees by the end of 2019. Any other fees should be made transparent and published.

RECOMMENDATION 17.2 ANALYSIS AND ASSESSMENT OF THREE-PARTY SCHEMES

The ACCC, with input from the Payments System Board, should investigate:

- whether current or recommended interchange fee regulation favours three-party card schemes and, if such a distortion exists, whether it is significant enough to require further regulatory intervention; and
- if further regulatory intervention is desirable, the nature of such intervention, including, but not limited to, the possibility of regulating merchant service fees as an adjunct to the interchange fee ban.

This investigation should be completed by no later than mid-2019.

RECOMMENDATION 17.3 MERCHANT CHOICE ROUTING FOR DUAL-NETWORK CARDS

The Payments System Board should set a regulatory standard that gives merchants the ability to choose the default network to route transactions for dual-network cards. As the technology is readily available, this reform should be in force by 1 January 2019 at the latest.

RECOMMENDATION 17.4 REVIEW TRANSPARENCY OF FEES ON FOREIGN TRANSACTIONS

By end-2019, the ACCC, in consultation with ASIC, should investigate what additional disclosure methods could be used to improve consumer understanding and comparison of fees for foreign transactions levied by authorised deposit-taking institutions and other payment providers.

This should include determining the feasibility of using benchmark exchange rates to improve transparency of international money transfers, as well as measures to improve transparency for fees on overseas purchases.

RECOMMENDATION 17.5 REVIEW REGULATION OF PURCHASED PAYMENT FACILITIES

The Council of Financial Regulators should review the current regulation of Purchased Payment Facilities (PPFs).

The review should develop an approach to simplify the regime, develop clear thresholds for regulatory responsibility and reduce barriers to growth in this sector. The review should consult on and design a tiered regulatory structure for PPFs, including one tier that does not attract prudential regulation.

The review should be completed by end-2018 at the latest and provide a path forward for regulators by mid-2019.

RECOMMENDATION 17.6 UPDATING AND MANDATING THE EPAYMENTS CODE

The Australian Government should give ASIC the power, by end-2018, to make the ePayments Code mandatory for any organisation that sends or receives electronic payments.

ASIC should review the ePayments Code and update it to reflect changes in technology, innovative business models and developments in Open Banking. ASIC should more clearly define the liability provisions for unauthorised transactions when third parties are involved, including participation in financial dispute resolution schemes.

ASIC should update the ePayments Code by end-2019 and commit to 3-yearly reviews.

RECOMMENDATION 17.7 ACCESS REGIME FOR THE NEW PAYMENTS PLATFORM

As a significant piece of national infrastructure for which the competition benefits hinge on widespread access of both financial system providers and consumers, the New Payments Platform (NPP) should be subject to an access regime imposed by the Payments System Board (PSB). As part of the regime, the PSB should:

- allow specialist payment providers that hold an Exchange Settlement Account to connect to the NPP without the need to be an authorised deposit-taking institution
- review the fees set by NPP institutions and transaction fees set by New Payments Platform Australia Limited
- require all NPP institutions that use an overlay service to share de-identified transaction-level data with the overlay service provider. The PSB should consult the ACCC on the final design of the data sharing obligations, having regard to impending Open Banking reforms.

RECOMMENDATION 17.8 IMPROVING FUNCTIONALITY OF THE NEW PAYMENTS PLATFORM

The ACCC, in consultation with the Payments System Board, should investigate different ways that New Payments Platform Australia Limited and its participating financial institutions can improve the functionality of the New Payments Platform (NPP) to promote competition within the NPP and across the payments system more broadly.

This includes investigating the feasibility of additional functionality for PayID to give customers the ability to both send and receive recurring bank transfers, direct debits and card payments.

The investigation should be completed by mid-2019, with a view to implementing additional functionality by end-2019.

Regulators

FINDING 6.2 THE FOUR PILLARS POLICY IS REDUNDANT

The Four Pillars policy is a redundant convention.

There are sufficient provisions within the *Competition and Consumer Act 2010* (Cth), the *Banking Act 1959* (Cth) and the *Financial Sector (Shareholdings) Act 1998* (Cth) that give the government or the designated regulators power to intervene to ensure competition, prudential outcomes and the broader public interest are protected.

There is no evidence that the Four Pillars policy has enhanced competition; and far more reasons to conclude that it may have dissuaded it by embedding a fixed market structure.

RECOMMENDATION 18.1 STATEMENTS OF EXPECTATIONS FOR REGULATORS

Updated Statements of Expectations for regulators, as agreed in the response by the Australian Government to the Murray Financial System Inquiry, should be published as a matter of priority. They should be written in clear language and updated at regular intervals thereafter.

Regulators should publish Statements of Intent within three months of receiving the Statements of Expectations.

In their annual reports, the financial regulators should provide information on the actions they have taken in line with their Statements of Intent and outcomes on performance measures.

RECOMMENDATION 18.2 ASIC TO PUBLISH DATA

The financial regulators already collect large amounts of data, which is a valuable public resource. Subject to privacy requirements, much more such data should be made publicly available.

As a first step towards improving the availability of data, ASIC should publish a list of the datasets collected and used in its research projects and reports and release any non-sensitive datasets.

FINDING 7.1 COST OF APRA INTERVENTIONS IN THE HOME LOAN MARKET

APRA's actions to slow interest-only lending on residential property in early 2017 resulted in banks imposing higher interest rates on both new and existing residential investment loans, despite the regulatory objective being to slow only new lending.

This led to a windfall gain for the banking sector.

Up to half of this gain is in effect being paid for by taxpayers, as interest on investment loans is tax deductible. The Commission estimates that the cost borne by taxpayers as a result of APRA's intervention was up to \$500 million a year, depending on various tax permutations.

Competition between lenders was restricted, and there was limited competitive variation in lenders' responses to the regulatory intervention.

FINDING 18.1 APRA NOT WELL PLACED TO CONSIDER COMPETITION EFFECTS

APRA is not well placed to balance the cost to competitive behaviour in its regulatory actions. Although the legislation that requires APRA to give weight to competition is valuable, its remit quite reasonably must favour system stability — even where its actions could impose a significant cost to competition.

The capacity to generate timely and trusted debate among relevant regulators on the question of whether the public interest is served by restricting competition is a desirable addition to the regulatory structure. This is particularly the case given our finding that key financial markets are characterised by large institutions that hold substantial market power. The Council of Financial Regulators is a valuable forum with the scope and leadership in which to deliver this debate.

In the absence of such a debate, consideration of competitive effects will inevitably continue to be subordinate to stability.

RECOMMENDATION 19.1 COMPETITION CHAMPION FOR THE FINANCIAL SYSTEM

To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, the ACCC should be given a mandate by the Australian Government to champion competition in the financial system, including in decisions taken by regulators that have or may have the outcome of restricting competition.

To minimise cost and disruption, this role should be implemented in substantial part through the Council of Financial Regulators (CFR) by making the ACCC a permanent member of the CFR.

There should be no change under this recommendation to the current legislated responsibilities of the regulators. Rather, the Australian Government should include in its Statement of Expectations for each of the financial regulator members of the CFR that the ACCC should be given the opportunity as a member of the CFR to advise the Council on regulator actions that may have material effects on competition, before they are implemented.

The functions of the ACCC within the CFR would be:

- preparing transparent analysis of competition impacts of material market interventions by financial market regulators
- publishing a bi-annual financial system competition report which would be the competition equivalent of the RBA's Financial Stability Review.

RECOMMENDATION 19.2 TRANSPARENCY OF REGULATORY DECISION MAKING

The Council of Financial Regulators (CFR) should apply the ACCC analysis in a discussion amongst members on interventions that may have a material impact on competition in a product market.

The ACCC assessment of competition impacts should be published in a simple form and timely manner as part of a new commitment to publish Minutes of CFR meetings.

RECOMMENDATION 19.3 ROBUST AND TRANSPARENT ANALYSIS OF MACROPRUDENTIAL POLICIES

APRA should conduct and publish annually quantitative post-implementation evaluations of its material prudential interventions, including costs and benefits to market participants and the effects on competition.

RECOMMENDATION 16.1 STANDARDISED RISK WEIGHTINGS FOR SMALL BUSINESS LENDING

Instead of applying a single risk weight to all small and medium business lending not secured by a residence, APRA should provide for a broader schedule of risk weights in its Australian Prudential Standard (APS 112).

It should take into account the different risk profile and the type of lending (such as the value of the loans made to an individual business and alternative forms of loan security including commercial property and differing loan to value ratios on this security) to better reflect the Basel Committee's standardised risk weightings.

In light of apparent major improvements in the collection and use of data (including via the New Payments Platform), APRA should also consider proposals by authorised deposit-taking institutions (ADIs) for variations from the standardised risk assessment for small and medium enterprise lending, based on the ADI improving its data and risk management systems. International best practice should be closely considered as APRA reviews proposals from ADIs.