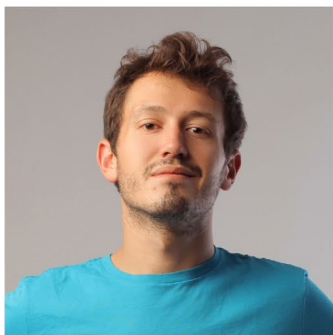
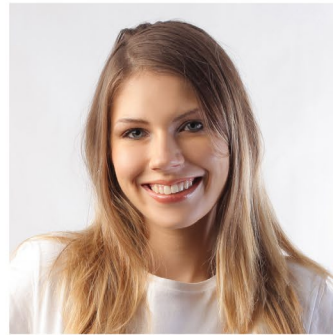


REGIONAL BANKS
SEPTEMBER 2017
COMPETITION



LEVELLING THE PLAYING FIELD IN RETAIL BANKING

SUBMISSION TO THE PRODUCTIVITY COMMISSION





Mr Peter Harris AO
 Chairman
 Productivity Commission
 e-mail: financial.system@pc.gov.au

22 September 2017

Dear Mr Harris

Regional Banks - Submission to the Productivity Commission

We are pleased to provide this submission to the Productivity Commission's Inquiry into Competition in the Australian Financial System. Our submission reflects the collective views of Australia's regional banking sector, represented by Bendigo Bank, Bank of Queensland, Suncorp, AMP Bank and ME Bank.

This inquiry provides the right forum to develop reforms that will support a productive, competitive and sustainable banking sector in this country. Smaller banks bring vital competition and choice to the market, and drive innovation which ultimately produces better customer outcomes.

While the Financial System Inquiry (FSI) made a number of positive recommendations, which have improved the competitive neutrality of the banking sector, the playing field is still tilted in favour of the major banks and more needs to be done. Our submission highlights our assessment of five key structural failings that are stifling competitive neutrality, and fair and sustainable competition:

The artificial funding cost advantages which the major banks continue to enjoy, even after accounting for the introduction of the new Major Bank Levy;

The risk weight disparity that remains between the major banks (that use the internal ratings based approach to risk weighting) and smaller banks (that use the standardised approach to risk weighting), which is particularly pronounced in the case of low risk lending;

Macroprudential rules which have effectively 'locked-in' market share at current levels, leaving smaller banks no room to challenge the already dominant position of major banks;

Limited transparency and disclosure around mortgage aggregators which limits the capacity for consumers to make informed decisions; and

The unprecedented pace and volume of new regulation and compliance which is having a disproportionate impact on smaller banks.

As you will see, we have made five recommendations for addressing these structural failings. The underlying premise of our submission is to align the needs of consumers, the community, and shareholders, and make recommendations that are based on realistic and sound policy principles that seek to level the playing field and to ensure competitive tension, while preserving the stability of the system. Reforms in these areas will help support a sustainable, competitive and diverse banking sector in Australia, which will undoubtedly deliver better outcomes for customers.

We are also strongly supportive of the ABA's calls for closer scrutiny of the shadow banking sector, which continues to compete free of many regulations and APRA oversight. We believe this issue is fundamental to ensuring all market players are able to compete more fairly.

We look forward to working with the Productivity Commission to further explore the issues raised in this submission.

Sally Bruce
 Group Executive
 AMP

Mike Hirst
 Managing Director
 Bendigo Bank

Jon Sutton
 MD & CEO
 BOQ

Jamie McPhee
 CEO
 ME Bank

David Carter
 CEO, Banking and
 Wealth
 Suncorp

CONTENTS

CONTENTS	4
EXECUTIVE SUMMARY	5
LIST OF RECOMMENDATIONS	7
INTRODUCTION	8
1 CONTEXT	9
1.1 Historical overview	9
1.2 Summary of Murray Report Key recommendations	16
1.3 Reflection on pressures/conditions leading to Government calling for PC inquiry	18
1.4 Observations/reflections on terms of reference	19
2 COMPETITION	21
2.1 Definition, market structure, new entrants	21
2.2 What constitutes sustainable competition	22
2.3 Efficiency and capital formation	23
2.4 Competitive neutrality (barriers/issues)	25
2.5 Market power and customer/consumer choice /sovereignty	25
2.6 Innovation/technology	26
2.7 Regional bank conclusion on competition	26
3 DATA: MARKET SHARE, PROFITS, MARGINS	27
3.1 Market share/trend analysis	27
3.2 International comparison	32
3.3 Bank /non-bank market share	33
3.4 Market share by segment/product	34
3.5 Domestic/global trends	35
3.6 Domestic markets: Herfindahl–Hirschman Index estimates	39
3.7 Funding costs and margins	40
4 INDIVIDUAL REGIONAL BANK BUSINESS MODEL/S	48
4.1 Regional banks and connection to customer/community/diversity	48
4.2 Alignment to customer interest	52
4.3 Regional banks set the “competitive frontier” while majors achieve higher ROE’s	52
4.4 Growing but crowded out by regulatory arbitrage	52
5 KEY POLICY ISSUES/RECOMMENDATIONS	53
5.1 TBTF / Levy	53
5.2 Possible levy design changes	55
5.3 Capital/RWA	57
5.4 Macroprudential complexity	62
5.5 Broker (vertical integration)	63
5.6 Regulatory burden	64
CONCLUSION	65
REFERENCES	66
APPENDIX 1: Terms of Reference	68

EXECUTIVE SUMMARY

Australia's financial services system is the envy of the developed world.

Our banks continue to be the backbone of our national economy, which has grown for 27 consecutive years, defying international trends, driving strong employment and ultimately improving the standard of living for Australians.

A key ingredient of Australia's economic success has been the resilience and strength of our banking sector which has withstood market shocks and disruption, particularly the Global Financial Crisis.

However, regional banks believe the economy is being held back and Australian consumers are substantially disadvantaged by characteristics of the current system, which are inhibiting innovation and fair competition and creating an uneven playing field.

The highly concentrated Australian banking system has developed as a by-product of a policy orthodoxy that has largely favoured stability over competition and consumer choice.

Regional banks strongly contend that the system can have an appropriate level of stability and, at the same time, allow for fair competition in order to achieve balanced outcomes. This is ultimately in the best interests of consumers and the economy.

The only sustainable competitive model is one which ensures competitive neutrality. That is, a system in which the rules are neutral to the size and complexity of a market player.

With a level playing field, the success of individual players would depend upon the extent and quality of their service to customers. In contrast, it is arguable that the current lack of competitive neutrality allows some institutions to leverage scale advantages despite recent demonstrable flaws in consumer outcomes.

Regional banks compete fiercely for market share, but are constrained in respect to some products and services and this impacts the ease with which customers can switch between financial institutions.

Regulatory policy settings have allowed the banking sector to become increasingly concentrated, and this has had consequences for customers and the economy in general.

Over the five years to 2016, Australia's four major banks were close to the most profitable in the world. Depending on the definition of the market, they hold up to 85% market share of total assets held by deposit-taking institutions, up from 75% just 10 years ago.

In fact, since 2007, the major banks have improved their position in all product markets:

- Share of total domestic resident assets has grown from 64% to 79%;
- Total deposits, 61% to 77.3%;
- Household deposits, 68% to 80%;
- Business deposits, 70% to 78%;
- Household credit cards, 80% to 82%;
- Housing investment loans, 77% to 85%; and
- Housing owner-occupied, 75% to 81%.

During approximately the same time, the number of Authorised Deposit-taking Institutions (ADIs) in Australia has more than halved from over 200 to 95.

Regional banks will remain on the competitive fringe while the market is dominated by the commercial decisions and the largely homogenous business models of the big four banks.

While the Financial System Inquiry (FSI) made a number of positive recommendations, which have improved the competitive neutrality of the banking sector, the playing field is still tilted in favour of the major banks and more needs to be done.

In particular, there are five fundamental areas that require policy reform if we are to realise a truly competitive sector and address what undoubtedly remains an uneven playing field. They are:

- 1. Further policy reform is needed to reduce the artificial funding cost advantages enjoyed by the major banks.** While the recent Major Bank Levy has reduced this advantage, it only recoups a small proportion of the overall credit rating uplift enjoyed by the majors, and further reform should be considered.
- 2. Further reform of risk weights is needed, to address the significant gap that still exists between the capital requirements of the major banks and standardised banks.** While there has been some risk weight narrowing following the FSI, the gap remains significant, and is particularly stark for loans with the lowest risk.
- 3. APRA should engage with regional banks to design macroprudential rules that better balance macro outcomes such as stability, without undermining banking competition. One option would be for APRA to give greater policy weight to minimum capital requirements.** Macroprudential rules set by APRA have effectively 'locked-in' market share of loan books at current levels, leaving smaller banks with no room to challenge the already dominant position of major banks.
- 4. Mortgage aggregators and brokers, owned by major banks should publicly report on the proportion of loans they direct to their owners.** While we do not suggest that major banks should be restricted from owning broker networks, we do believe that where this occurs, it should be managed in an open and transparent way to ensure customers are able to make fully informed decisions.
- 5. Before any new regulations are introduced, greater consideration should be given to the impacts on smaller banks.** The unprecedented pace and volume of new regulation and compliance has a disproportionate impact on smaller banks which stifles sustainable competition.

The regional banks also support the ABA's submission to the Productivity Commission calling on greater regulation for the shadow banking sector, which we believe is fundamental to ensuring all market players are able to compete fairly.

A strong banking system is good for all Australians. Smaller banks bring vital competition and choice to the market and drive innovation, which ultimately produces better customer outcomes.

It is vital that competition in the sector not only be fair but productive and sustainable.

The bottom-line test must be: what is good for customers is good for the economy.



LIST OF RECOMMENDATIONS

- Recommendation: A. Regional Banks support the Government's levy on the major banks and Macquarie as a means of partly addressing the "too big to fail" funding advantage. As the levy only recoups a proportion of the "too big to fail" funding benefit, further policy interventions to reduce the benefit should be considered. _____ 56
- Recommendation: B. Regional banks advocate further reform of risk-weight setting as per the set of key principles. _____ 61
- Recommendation: C. APRA should engage with regional banks to design macroprudential rules that better balance macro outcomes and banking competition, and consider greater policy weight being given to minimum capital requirements. _____ 62
- Recommendation: D. Mortgage aggregators and brokers owned by major banks should publicly (and regularly) report on the proportion of loans they direct to their owners. _____ 63
- Recommendation: E. That before any new regulations are introduced, greater consideration should be given to the impacts on smaller banks. _ 64



INTRODUCTION

This submission has been prepared by Bendigo and Adelaide Bank, Bank of Queensland (BOQ), ME Bank, Suncorp Bank, and AMP Bank. The five banks collectively represent the perspective of 'regional banks'.

The need for a regional bank submission stems from the desire of these institutions to make a policy contribution with the aim of ensuring a healthy and sustainable future for Australia's financial system, with a particular focus on the banking sector. A competitive, multi-tiered banking sector is the best model to guarantee Australian consumers and businesses will be able to access innovative and better value financial products and services into the future.

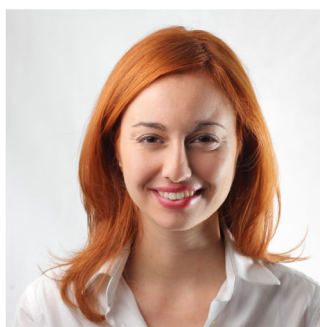
A multi-tiered banking system in which each tier brings a different perspective and vigorously competes for customers, on a level playing field, will ensure consumer benefits are protected and enhanced. The regional banking sector has consistently delivered a better service for all Australians as reflected by superior customer satisfaction and trust ratings. The regional banks bring essential competitive tension to the market through an extensive and complete range of quality products and services for consumers, businesses and regional communities. Regional banks provide genuine and credible choice for customers and there is a clear link between the banks' performance and good customer outcomes.

Regional banks view this link as critical for Australian consumers and the long-term contribution of the banking system. Ensuring genuine competitive neutrality is key to this outcome.

The regional banks believe the primary aim of this Competition Inquiry is to ensure the end-users of financial products are the central focus. Banking system design must identify what is best for the mums and dads, businesses and everyday Australians who rely on safe, efficient and innovative services: to save money, purchase a house, start a business and carry out all the other transactions that people need a banking system to do.

The banking system has served the market over time. While other sectors of the financial system, such as superannuation funds, may play an increased role in the provision of capital to the economy in the future, the banking system will continue to play a significant and critical role in the intermediation of capital and provision of efficient payment systems. Regional banks will also continue to contribute to this process by providing competitive tension in the delivery of quality products and services to consumers, small businesses and regional communities.

The Global Financial Crisis (GFC) is the main backdrop to the Productivity Commission's (PC's) Competition Inquiry. The crisis is a pivotal event in the economic and social history of many countries. While the Australian economy and financial system proved relatively robust, the GFC has led to significant changes to the motivations and actions of consumers, businesses, financial institutions and Government. In turn, these have re-shaped much of the competitive and regulatory landscape. Up until the GFC, a relatively level playing field existed for large banks, regional banks, foreign-owned banks, credit unions, building societies and non-ADIs.



1 CONTEXT

1.1 HISTORICAL OVERVIEW

The financial sector has grown consistently since the 1970s. Whereas traditionally manufacturing has been Australia's largest industry (as assessed by gross value added), financial services has emerged as Australia's most important industry.

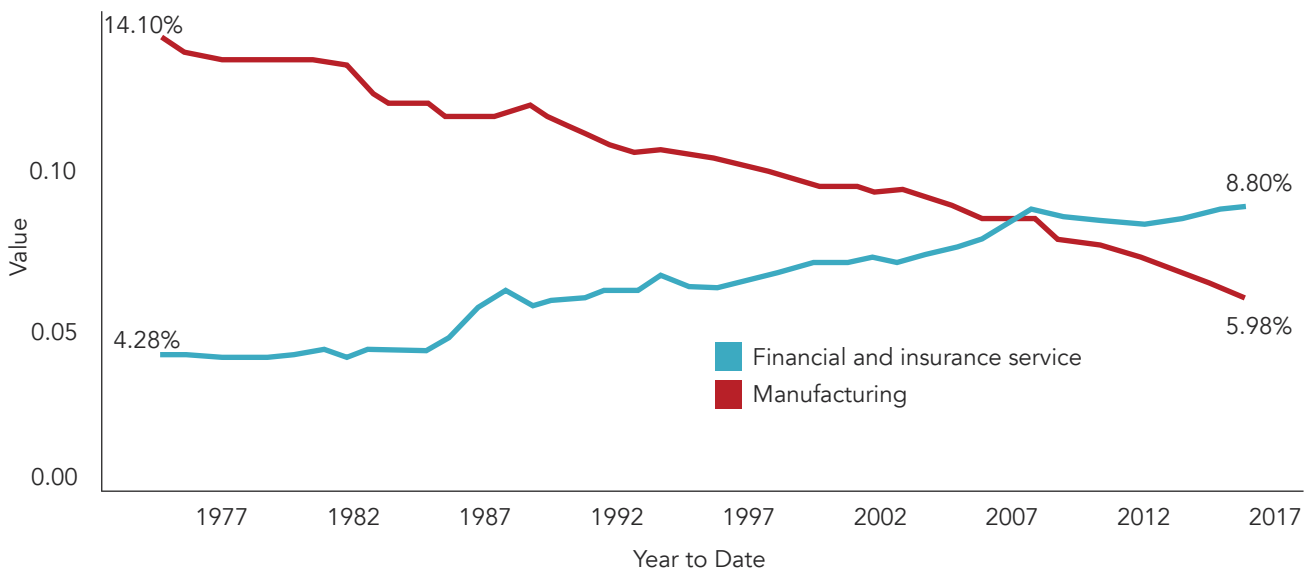
Gross value-added (GVA) measures the extent to which an industry uses the resources of labour and capital. It is equivalent to the dollar value of the cost of wages, profits and taxation.

Manufacturing has declined steadily since the 1970s as can be seen in Figure A. This chart traces how the decline of manufacturing is replaced by the increasing importance of the financial sector. Finance has increased in relative size from 4.28% of total GVA to that of nearly 9% today.

FIGURE A

GROSS VALUE ADDED

% of GDP



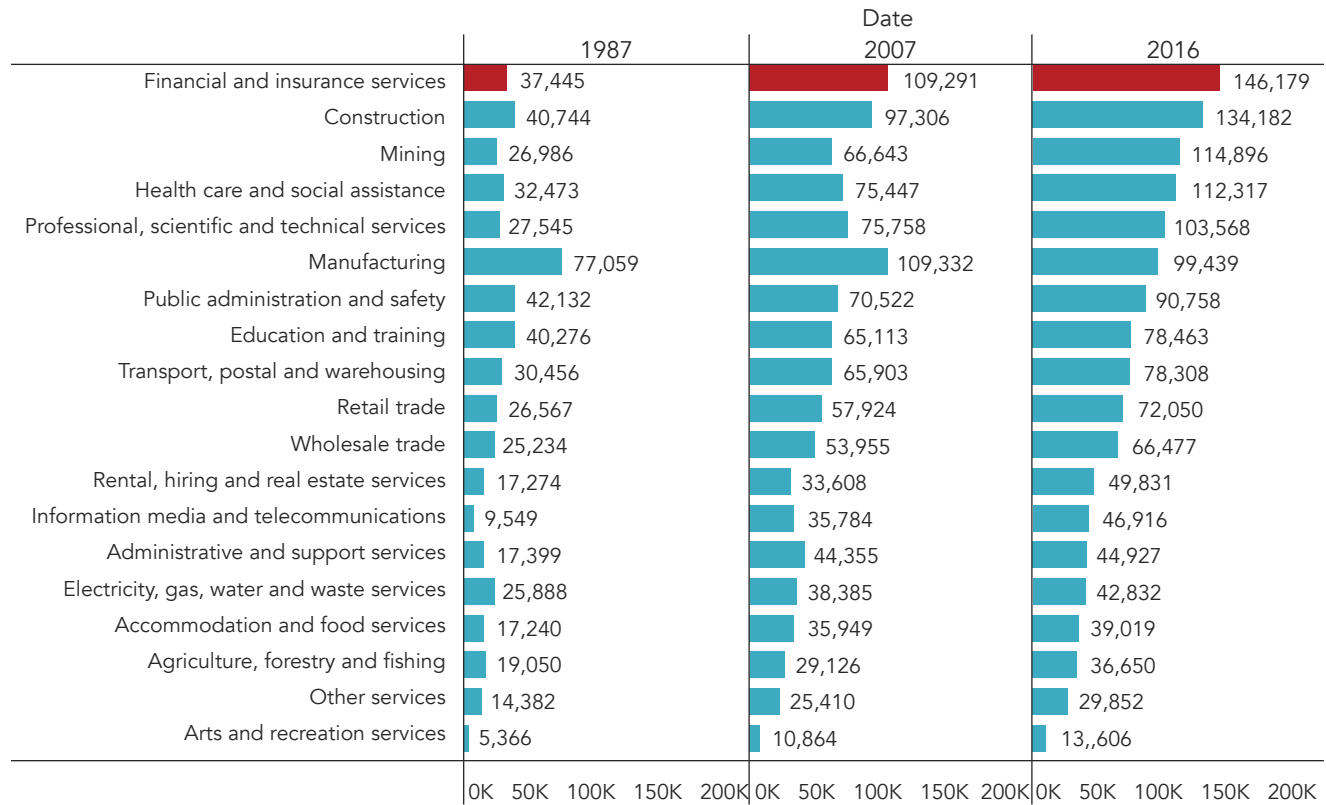
Source: Underlying data from ABS. Calculations and visualisation by Benchmark Analytics.

In 1987, the financial services sector was the sixth largest industry behind construction, manufacturing, public administration, and public education. When the GFC hit in 2007, financial services had grown to be Australia's second largest industry. On most recent annual data (2016), the financial sector stands as the largest industry by gross value added (see Figure B).

FIGURE B

INDUSTRY GROSS VALUE ADDED

\$m, ranked in year 2016



Source: Underlying data from ABS. Calculations and visualisation by Benchmark Analytics.

The growth in the financial sector has emerged in a deregulatory environment. While the financial sector has always been regulated to some degree, particularly depositor safety and disclosure, the prevailing policy orthodoxy since the late 1970s has been to regulate the industry through fostering competition.

This orthodoxy is evident in the recommendations of the three major financial sector inquiries held in Australia since the 1970s. The 1979 Campbell Inquiry recommended the floating of the dollar, and the deregulation of the banking sector, including the granting of licences for foreign banks.

The 1997 Wallis Inquiry similarly put a policy emphasis on competition. To improve competitive neutrality, it recommended a 'twin peaks' regulatory model aimed at removing regulatory distortions. Under this model, regulatory objectives are aligned with identified potential market failures, and the intensity of regulation is tailored to the degree of risk involved.

In the wake of foreign bank entry in the 1980s, a period of intense competition for commercial property loans led to unsustainable price increases and, ultimately, was a major factor in the deep recession of the early 1990s.

Back then, the over extension of commercial property lending by Westpac and ANZ led to significant financial losses. Some Government-owned state banks also collapsed. This disturbance came against a period of financial stability through the 1950s, 1960s and 1970s. Hence, some commentators saw deregulation as a contributing factor to the financial difficulties of the late 1980s and early 1990s.

More recently, the banking sector has been criticised for the rise in household debt, particularly that used to purchase housing. Credit to households is now very high by historical and international standards.

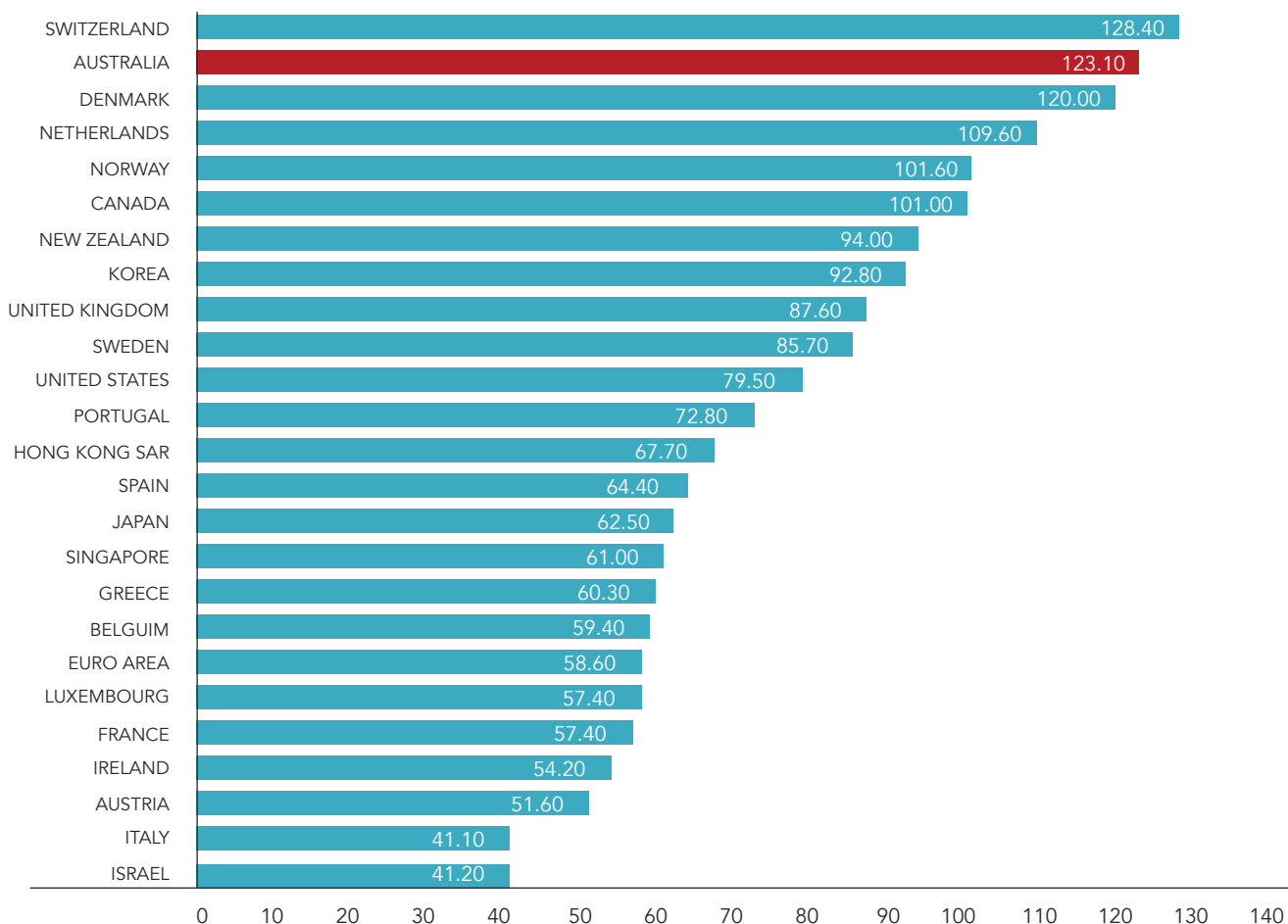


This is seen in Figure C. It shows countries split by total household credit (debt) relative to the country's annual gross domestic product (GDP). The data only lists the top 25 countries.

As shown by the highlighted bar, as of December 2016, Australia has the second highest household debt levels in the world.

FIGURE C

HOUSEHOLD CREDIT OUTSTANDING
% of GDP, as at 31/12/2016, top 25 countries



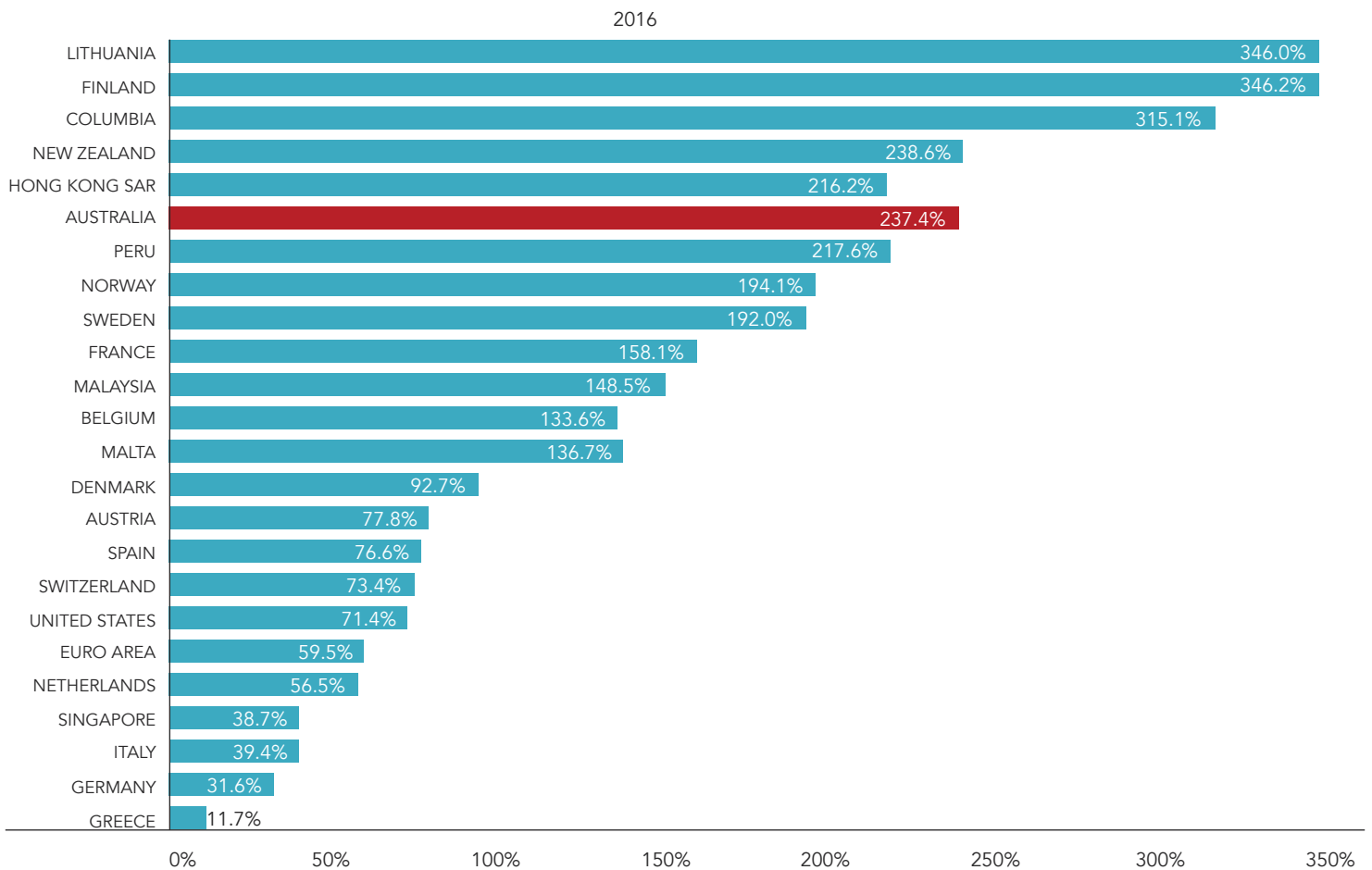
Source: Underlying data from BIS. Calculations and visualisation by Benchmark Analytics.

As expected, with large volumes of credit directed towards housing and constraints in housing approval and construction, house prices in Australia have grown substantially. Since the year 2000, residential property prices have increased by an average of 237% throughout Australia. This is high by international standards, but it is noteworthy that other countries have also experienced high residential property price growth, see Figure D.

FIGURE D

RESIDENTIAL PROPERTY PRICES

% growth between 2000 and 2016, averaged



Source: Underlying data from BIS. Calculations and visualisation by Benchmark Analytics. Indexes are averaged across available data series. Only series that have data in 2000 and 2016 are included in the averaged methodology.

For some time, analysts have predicted that this level of household debt and house prices are unsustainable and ripe for a correction, in the order of price declines of 25%. So far, this has not materialised. One positive factor is the underlying strength of the Australia's economy which has not experienced a recession for more than 25 years.

Notwithstanding, the level of household debt and house prices remains a risk to the economy. It makes the economy more vulnerable to an external shock as any increase in unemployment, or a loss of confidence would result in households aggressively cutting their consumption expenditure. Household consumption currently accounts for around 60% of GDP¹.

High house prices also make it difficult for young people to save an adequate deposit to buy a house, particularly when permanent work is less available, and there is less security in most employment. Wage growth has also been sluggish since 2007 as the impacts of globalisation and technology have reduced the bargaining power of workers in nearly all private sector industries.

One significant factor driving household debt and house prices since the early 1990s has been the increase in lending into the Australian household sector at the expense of business lending². This change in business strategy was driven by an economically rational view that superior risk-adjusted returns were available through funding mortgages on residential property. This view was vindicated with the introduction of Basel II and advanced accreditation.

¹ ABS Australian National Account, June 2017, Cat. No. 5206.0

² This change in strategy is evident from the increasing share of mortgage assets as a proportion of total assets. The RBA website has balance sheet data on an individual bank basis going back to 1991, and APRA's monthly banking statistics includes balance sheet data from June 2004.



FIGURE E: PERSPECTIVES ON COMPETITION

	COMPETITION	COMPETITIVE NEUTRALITY
1979 Financial System Inquiry (Campbell)	The Committee started from the view that the most efficient way to organise economic activity is through a competitive market system which is subject to minimum regulation and government intervention. (p1)	...the principle is clear – investor protection arrangements, including Reserve Bank liquidity support arrangements, should aim to involve the minimum disturbance to competitive neutrality. (p.289)
1997 Financial System Inquiry (Wallis)	The efficiency of the financial system affects every business and individual in the nation. There are very large efficiency gains and cost savings which could be released from the existing system...Markets can only deliver these outcomes where competition is allowed to thrive and where consumers have confidence in the integrity and safety of the system. (p.2)	The principles of regulation which have guided the Inquiry are competitive neutrality, cost effectiveness, transparency, flexibility and accountability (p.176)... Competitive neutrality requires that the regulatory burden applying to a particular financial commitment or promise apply equally to all who make such commitments. (p.196)
2014 Financial System Inquiry (Murray)³	Competition and competitive markets are at the heart of the Inquiry’s philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system’s efficiency. Although the Inquiry considers competition is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time. (p.xvi)	The Inquiry considers that absent other policy objectives, competitive neutrality is an important regulatory principle. (p.61)

³ In addition to the Murray Inquiry, at the same time Professor Ian Harper completed a Competition Policy Review where he presented a ‘forward-looking’ package of reforms to reinvigorate competition in Australia (Harper, Anderson, McCluskey, & O’Byrne, March 2015). While the financial sector was not explicitly covered in his review, the emphasis on competition was consistent with Murray Report findings.

In summary, while competition has been the prevailing orthodoxy in financial regulation since the 1970s, some commentators have questioned its legitimacy.

From a regional bank perspective, competition drives optimal outcomes for consumers and the wider economy. We believe that recent flawed outcomes for consumers are the result of shortcomings in competition, particularly inadequate competitive neutrality.

Another consideration is the issue of sustainable competition. Competition law has long prohibited practices which may appear consumer-friendly in the short-term, but have adverse long-term implications. One such practice is pricing under cost. This can drive out suppliers and cause prices to be higher than otherwise in the future.

This risk is heightened where one supplier has market power and, further, where that supplier has an unwarranted cost advantage, such as lower funding costs (as is the case with banks that are treated by the Government as “too big to fail”).

1.2 SUMMARY OF MURRAY REPORT KEY RECOMMENDATIONS

The 2014 Financial System Inquiry (FSI) was a key event in the post-GFC era for Australian banks. The Inquiry took two rounds of public submissions. The first round received 280 submissions and the second round 6,500 submissions. The latter being dominated by submissions relating to credit card surcharging.

The final report made 44 recommendations to improve the efficiency, resilience and fairness of Australia’s financial system. It also provided sets of principles to guide policy setting over an extended timeframe, up to 20 years. It made 13 observations relevant to broader taxation policy.

The Murray Inquiry’s Terms of Reference (TOR) required the review panel to recommend how Australia’s financial system can be positioned to support economic growth and meet the needs of end users. They also consider how the system had changed since the Wallis Inquiry, including the effects of the GFC. (<http://fsi.gov.au/2014/12/08/address-to-ceda/>)

Regional banks made two submissions to the FSI. The main recommendation of the regional banks was to secure changes to the system of setting risk-weighted assets in Australia given the unjustified dichotomy that existed between ‘standardised’ and IRB banks. This issue was addressed by David Murray in recommendation number 2.

Recommendation 2 was partially implemented in June 2016. It resulted in major banks having to materially increase capital levels, which has not only improved competition but also increased overall system resilience, consistent with David Murray’s recommendation number 1 which was for the banking system to have unquestionably strong capital levels.

1.2.1 Murray recommendations and regional bank position

Regional banks were pleased that the Murray Inquiry highlighted that an uneven playing field that had emerged as a result of prudential regulation and other initiatives such as the differential pricing of the Government Guarantee during the GFC. After the final report was released, the regional banks assessed each recommendation as per the details set out in Figure F. Note – only relevant recommendations are listed in the table.



FIGURE F: MURRAY'S RECOMMENDATIONS AND REGIONAL BANK POSITION (ONLY RELEVANT RECOMMENDATIONS LISTED)

MURRAY REC	DETAILS	REGIONAL BANK POSITION
1	<p>Capital levels</p> <p>Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.</p>	Supported
2	<p>Narrow mortgage risk weight differences</p> <p>Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.</p>	Strongly supported
3	<p>Loss absorbing and recapitalisation capacity</p> <p>Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.</p>	Supported
4	<p>Transparent reporting</p> <p>Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.</p>	Supported
5	<p>Crisis management toolkit</p> <p>Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.</p>	Supported
6	<p>Financial Claims Scheme</p> <p>Maintain the ex-post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.</p>	Strongly supported
7	<p>Leverage ratio</p> <p>Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.</p>	Supported
15	<p>Digital identity</p> <p>Develop a national strategy for a federated-style model of trusted digital identities.</p>	Supported
19	<p>Data access and use</p> <p>Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.</p>	Neutral
20	<p>Comprehensive credit reporting</p> <p>Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.</p>	Supported

MURRAY REC	DETAILS	REGIONAL BANK POSITION
22	Introduce product intervention power Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.	Neutral
23	Facilitate innovative disclosure Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.	Supported
24	Align the interests of financial firms and consumers Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.	Neutral
25	Raise the competency of advisers Raise the competency of financial advice providers and introduce an enhanced register of advisers.	Supported

1.3 REFLECTION ON PRESSURES/CONDITIONS LEADING TO GOVERNMENT CALLING FOR PC INQUIRY

The Government announced a PC Inquiry into the banking system as part of its 2017 Budget announcement. The specific recommendation was in response to the Coleman Committee recommendation for a competition inquiry – see Figure G.

The Coleman Inquiry was itself a reflection of the issues discussed in the previous section.

FIGURE G: COLEMAN RECOMMENDATION ON COMPETITION THAT WAS ACCEPTED BY THE TURNBULL GOVERNMENT

Recommendation 3

The committee recommends that the Australian Competition and Consumer Commission (ACCC), or the proposed Australian Council for Competition Policy, establish a small team to make recommendations to the Treasurer every six months to improve competition in the banking sector.

If the relevant body does not have any recommendations in a given period, it should explain why it believes that no changes to current policy settings are required.

The Government agrees with this recommendation.

We have tasked the Productivity Commission to undertake a review of competition in the financial system, commencing 1 July 2017.

To complement the Productivity Commission review, we will provide the ACCC \$13.2 million over four years to establish a dedicated unit to undertake regular in-depth inquiries into specific financial system competition issues from mid-2018.



1.4 OBSERVATIONS/REFLECTIONS ON TERMS OF REFERENCE

Regional banks strongly support the PC review of the financial sector. We understand that this is the first time the PC has been tasked to examine competition in financial services.

Regional banks acknowledge that the PC, as an agency, has a focus on 'efficiency', and this is appropriate given that ultimately the purpose of public policy is to ensure a country's resources, including workers and capital, are used in the most efficient means possible.

1.4.1 Regional bank high-level observations on TOR

In [Figure H](#), regional banks detail reflections on the TOR that may be useful for the inquiry in understanding our perspective.

FIGURE H

PC TOR NO.	DETAILS	REGIONAL BANK HIGH-LEVEL COMMENT
1	Consider the level of contestability and concentration in segments of the financial system (including the degree of vertical and horizontal integration, and the related business models of major firms), and its implications for competition and consumer outcomes	Strongly agree with inquiring into contestability and concentration. Regional Banks note the primary issue with vertical and horizontal integration is with banks that have actual market power.
2	Examine the degree and nature of competition in the provision of personal deposit accounts and mortgages for households and of credit and financial services for small and medium sized enterprises	Support, credit for small business is an issue for long-term productivity. Major banks have the balance sheet size and risk management capability to do more small business lending.
3	Compare the competitiveness and productivity of Australia’s financial system, and consequent consumer outcomes, with that of comparable countries	Supported. Note that efficiency comparisons must recognise differences in business models. For example, banks that do a lot of commercial lending will have higher costs than banks with large commoditised businesses like housing loans or credit cards.
4	Examine barriers to and enablers of innovation and competition in the system, including policy and regulation	Supported. Note innovation will come from genuine competitive neutrality.
5	Prioritise any potential policy changes with reference to existing pro-competition policies to which the Government is already committed or considering in light of other inquiries.	Supported. Regional banks are keen to ensure regulatory changes are kept to the minimum needed to achieve the policy objective.
Other	<p>The Commission should have regard to the Government’s existing wide-ranging financial system reform agenda and its aims to:</p> <ul style="list-style-type: none"> • strengthen the resilience of the financial system • improve the efficiency of the superannuation system • stimulate innovation in the financial system • support consumers of financial products being treated fairly • strengthen regulator capabilities and accountability. 	Supported. Regional banks underscore the importance of ensuring competition is given appropriate policy weight given Australia’s long record of financial security.

2 COMPETITION

2.1 DEFINITION, MARKET STRUCTURE, NEW ENTRANTS

Competition is a process of rivalry between firms, each seeking to win a customer's business.

The primary objective of competition policy is to promote efficiency which in turn boosts and stimulates economic growth. According to the 1993 independent committee of inquiry into National Competition Policy (Hilmer, Rayner, & Taperell, 1993):

Competition policy is not about the pursuit of competition per se. Rather, it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives. (Hilmer, Rayner, & Taperell, 1993, p. xvi).

For merchants, the retail price of a product they charge is brought into some relationship with cost through the competitive process (Adelman, 1957, p. 266). As the 1997 Financial System Inquiry (Wallis Report) observed:

In markets where the degree of competition among suppliers is high, prices are likely to reflect the underlying cost of production. Suppliers pricing above this cost will be undercut by other suppliers, thereby losing market share. (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 601)

Thus competition forces prices down towards the cost of production which enhances allocative efficiency. Competition promotes productive efficiency by forcing firms to cut their costs in order not to lose sales to more efficient rivals (Kolasky & Dick, 2003, p. 208).

If firms cannot maintain productive efficiency with their rivals, they risk losing market share and possibly going out of business altogether.

Competition also provides a spur for dynamic efficiency. Firms undertake innovation through research and development (R&D) to improve their competitiveness. R&D can help a business lower its costs of production and/or produce better products, giving it a competitive advantage over its rivals in the marketplace.

The benefits firms seek to capture through R&D, namely lower costs, higher productivity and better products, if realised, will ultimately generate higher rates of economic growth.

Because of the demonstrated success of competition in driving economic efficiency and, therefore, rising living standards, Governments frequently champion its importance and use it as a primary principle to guide decision-making. The current FSI identified competition as a

key objective as did the two previous financial system inquiries.

The 1981 Australian Financial System Inquiry (Campbell, et al., 1981) and the 1997 Wallis Report (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997) placed considerable weight on the importance of competition as the most efficient means of organising financial activity. In addition to the general concept of competition, they advocated the need to achieve competitive neutrality. These perspectives are summarised in the recommendations of both the Campbell and Wallis reports, where the authors recommended policy initiatives to bring about genuine improvements in the competitive operation of markets.

The Wallis Report led to the wholesale restructuring of financial regulation, establishing a dedicated prudential regulator, the Australian Prudential Regulation Authority (APRA), and a dedicated regulator to supervise market disclosure and conduct, the Australian Securities and Investments Commission (ASIC).

Both inquiries also recommended against allowing a financial system to have intermediaries that are "too big to fail".

2.2 WHAT CONSTITUTES SUSTAINABLE COMPETITION

Regional banks have a strong position that the only sustainable competitive model is one which ensures competitive neutrality. So long as the regulatory settings are neutral to size and complexity, then success will depend upon the extent to which customers are satisfied.

At the core of regional banks' concerns is the status of major banks as being "too big to fail". This designation by definition violates the competitive neutrality principle.

APRA's December 2013 media release

In December 2013, the Australian Prudential Regulatory Authority (APRA) issued a media release declaring that there were four banks in Australia assessed as being domestically systemically important (D-SIBs).

A widely-used term to describe systemically important institutions is "too big to fail".

APRA's statement confirmed and crystallised what had been well known but never officially recognised, that the largest four banks had a special status in that failure would have severe economic impacts. In effect, they had an implicit subsidy from taxpayers.

Regional banks believe this APRA media release symbolises the core problem in Australian banking, that four institutions have a special status, and that this gives them a true competitive advantage over banks that do not have this status. The most obvious manifestation of this being the differential pricing of the Government Guarantee during the GFC.



2.3 EFFICIENCY AND CAPITAL FORMATION

Efficiency refers to the optimal use of resources. The issue of efficiency is complex when considering financial services. We know that Australia's financial sector is one of the largest in the world, equating to around 9% of total gross value added.

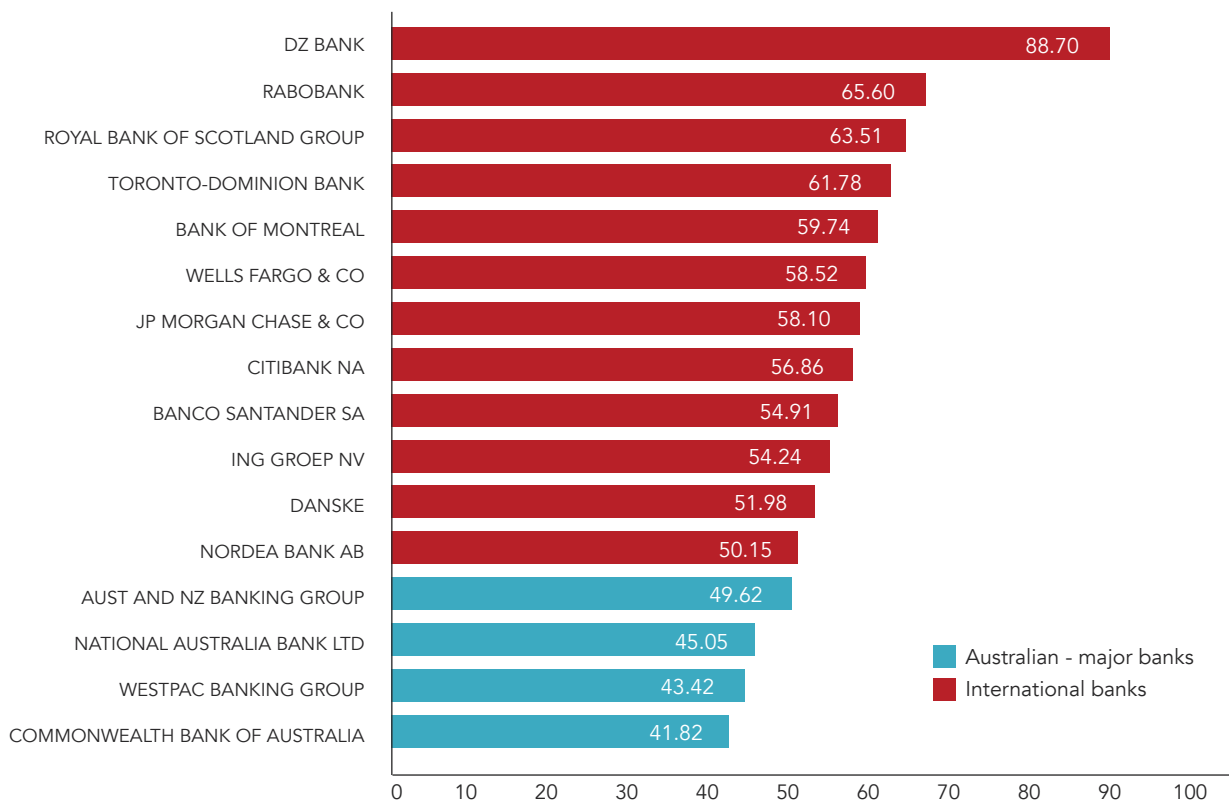
In one respect, this could indicate we have an inefficient system given the amount of capital and labour resources utilised in the process of intermediation and provision of payment facilities.

On the other hand, our financial institutions are relatively efficient regarding cost-to-income ratios. For every dollar of income, the operating costs of Australian banks are small by international standards, as per Figure I. The efficiency ratio in the chart is defined as the operating costs as a proportion of total income.

FIGURE I

EFFICIENCY RATIO

Selection of international banks



Source: Data provided by Suncorp.

When comparing financial institution efficiency ratios, an ‘apples to apples’ comparison requires an understanding of the various business structures. Australia’s major banks are very unusual in that the largest component of their assets is residential mortgages. Big banks in most countries have a much higher proportion of commercial lending.

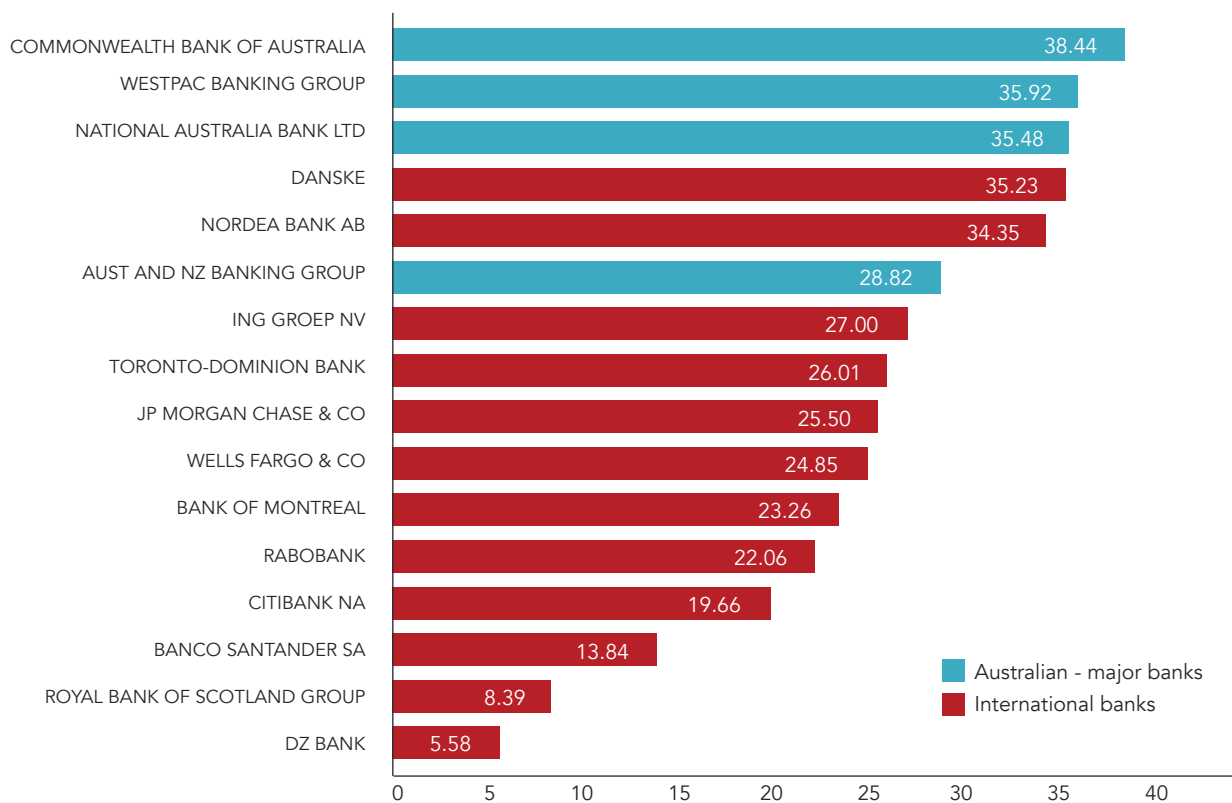
Commercial lending is higher cost because the risks associated with business lending are typically more idiosyncratic and require much greater credit analysis than does the homogenised nature of mortgage lending. Given this, it is not surprising that Australia’s major banks are relatively efficient in terms of cost-to-income.

However, the large size of our financial sector means that, as a country, Australia is spending more money on financial services than most other countries. One factor is the return to shareholders. Australia’s major banks are highly profitable - see Figure J for a comparison of profit margins across banking systems. Profit margin is defined as the before tax profit divided by total income.

FIGURE J

PROFIT MARGIN

Selection of international banks



Source: Data provided by Suncorp.

Caution is needed when drawing conclusions about the efficiency of the major banks in Australia. The cost-to-income ratio is calculated by two variables – income and costs. A low cost to income ratio will result if income is high, costs are low, or a combination of both.

By benchmarking costs and income against total assets and then comparing these benchmarks to banks in other countries, the conclusion is that Australia’s largest banks have lower cost-to-income ratios due to balance sheet size and diversity.

While costs are not especially high by international standards, this can be partially explained by the commoditised nature of major bank’s assets – with a heavy weighting towards residential mortgages.

2.4 COMPETITIVE NEUTRALITY (BARRIERS/ISSUES)

While market concentration can provide guidance as to which markets are likely to raise competition concerns, other factors also warrant consideration. These other factors include the height of barriers to entry and the extent of sunk costs incurred by new entrants.

A prominent industrial organisation economist (Bain, 1956) considered the force of potential competition as a regulator of price and output is just as important as actual competition. Bain focussed on the height of barriers to entry as the critical determinant of the price level. According to Bain, the extent of barriers to entry in an industry indicated the advantage that existing sellers enjoyed over potential entrants.

Any entry cost that is unrecoverable is a sunk cost. The need to sink costs into a new firm imposes a difference between the incremental cost and the incremental risk that is faced by a new entrant and an incumbent firm (Baumol & Willig, 1981, p. 418). In the case of an incumbent, such funds are already spent, and they are exposed to whatever risks the market entails. In contrast, the new firm must incur any entry costs on entering the market that incumbents don't bear.

The entry of new firms into a market can provide competitive constraint on incumbents (Australian Competition and Consumer Commission, 2008, p. 38). If new entrants can offer customers an appropriate alternative source of supply at the right time, any attempt by incumbents to exercise market power will be unsustainable since their customers will switch to the new entrants. The existence of sunk costs, which increases the risks of, and costs associated with, failed entry, may deter new entry altogether.

2.5 MARKET POWER AND CUSTOMER/CONSUMER CHOICE /SOVEREIGNTY

The economic and legal literature provides several definitions of market power. A commonly-used definition is the following:

"A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a business facing otherwise similar cost and demand conditions." (Kaysen & Turner, 1959, p. 75)

Another definition of market power is *"...the ability of a firm to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded"* (Landes & Posner, 1981, p. 937)

An oligopoly is a market structure characterised by a few participants. It may include a *"competitive fringe"* of numerous smaller sellers who behave competitively because each is too small individually to affect prices or output (Areeda, Solow, & Hovenkamp, 2002, p. 9)

The provision of financial services in Australia – that is dominated by the four large banks – could be characterised as an oligopoly that is supplemented by a competitive fringe that includes regional banks and customer-owned banks (credit unions and building societies).

Committee chairman, David Coleman: *"Australia's banking sector is an oligopoly. The major banks have significant market power that they use to protect shareholders from regulatory and market developments."* (House of Representatives Standing Committee on Economics, 2016)

Treasurer, Scott Morrison: *"...the banking system in Australia – with a small number of large and highly profitable banks at its core – is highly concentrated... The House of Representatives Economics Committee's 'Review of the Four Major Banks', commissioned by the Government last year, concluded that Australia's banking sector is an oligopoly and that Australia's largest banks have significant pricing power which they have used to the detriment of everyday Australians."* (Morrison, 2017)

Some theories of oligopoly predict that once firms recognise their interdependency, their most rational course of action would be to behave in a manner reminiscent of a monopoly. The outcome from these models has been described as tacit collusion, also known as coordinated effects. While firms are not necessarily part of a formal cartel arrangement, the firms can coordinate their conduct so that an outcome similar to cartel or monopoly is achieved.

However, just because a market is characterised as having an oligopoly structure does not necessarily mean that it will be prone to coordinated effects and the abuse of market power. Identifying firms that have substantial market power enables one to distinguish between conduct that might harm consumers and conduct that cannot. (Bork & Sidak, 2013, p. 511)

Unfortunately, there is no definitive test. Instead, one must rely on a series of partial indicators to determine whether firms participating in a market are exercising market power. According to competition law expert Robert Bork and Professor Gregory Sidak of Tilburg University (Bork & Sidak, 2013, p. 512): “Courts and competition authorities around the globe typically rely on indirect evidence of market power, such as market share and barriers to entry.”

2.6 INNOVATION/TECHNOLOGY

Innovation has the potential to transform the banking and financial system. We have already seen considerable developments in mobile banking, cloud computing internet delivery, and payment services. Contactless payments, for example, are quickly displacing cash.

As found by the Murray Inquiry, innovation has the potential to deliver significant efficiency benefits and improve outcomes for consumers and businesses generally, but it also raises financial risks.

Financial innovation can undermine regulatory objectives by shifting risks outside the regulatory perimeter, the so-called problem associated with ‘Shadow Banks’.

Regional banks have a particular concern over macroprudential rules placing limits on investor lending and how the uneven implementation of these rules is shifting credit supply into the non-regulated space. By doing so, competitive neutrality is undermined as is the macro-objective.

2.7 REGIONAL BANK CONCLUSION ON COMPETITION

Regional banks have been around for more than 150 years and compete fiercely for market share but in some markets have limited ability to influence /compete. This has consequences for customers and consumers generally.

Regional banks are the competitive fringe, but the market is very much controlled by the commercial decisions of the largest institutions, and the business models of the big four are very similar.

When regional bank executives give briefings after results announcements, it is common for them to refer to market conditions as ‘very competitive’.

What this really means is that the product markets, from their own business perspective, are very competitive. One key reason they find it competitive is that the playing field is tilted against them for the reasons discussed above.

The dominant market power of a small number of players is a consequence of;

- “Too big to fail” driving funding advantages;
- Risk-weight capital differences; and
- Insufficient disclosure around the ownership of non-branch distribution networks and the proportion of loans they direct to their owners.

3 DATA: MARKET SHARE, PROFITS, MARGINS

3.1 MARKET SHARE/TREND ANALYSIS

Depending on the definition of market, the major banks in Australia have up to 85% market share of total assets held by deposit-taking institutions. This is seen in Figure K below which shows market share using APRA's quarterly performance statistics.

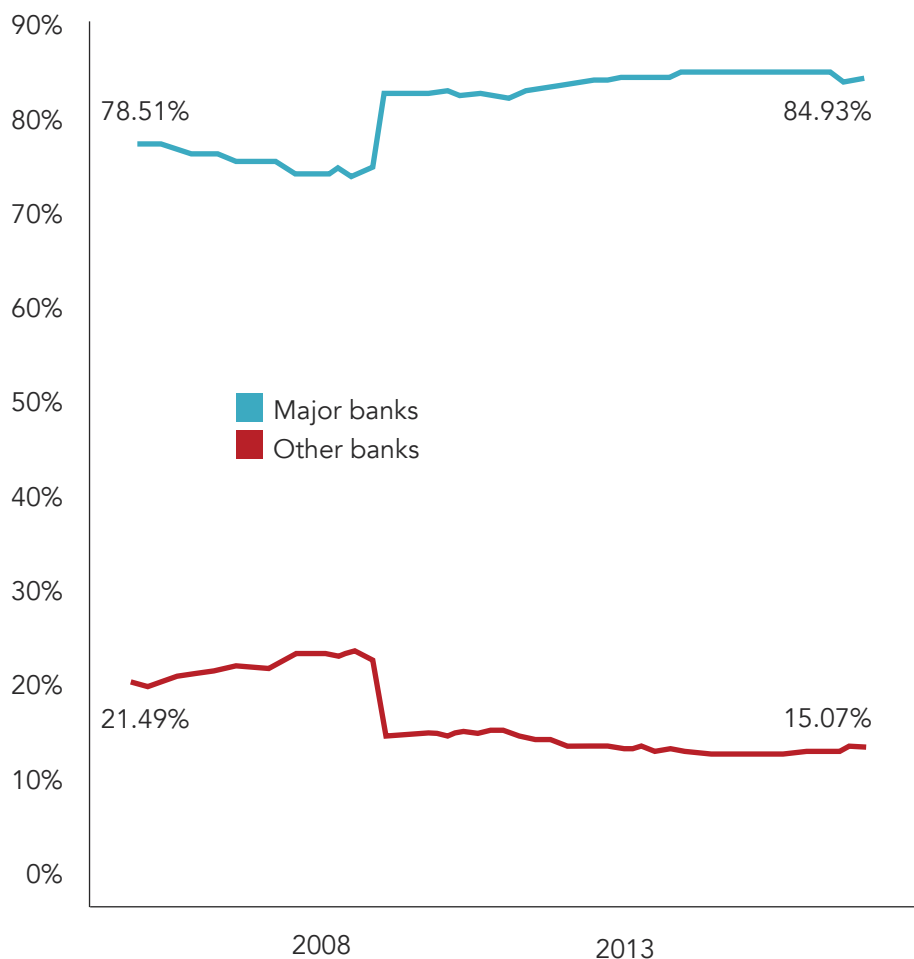
These figures include data for major banks, regional banks, credit unions, building societies and foreign-owned subsidiaries. Assets of foreign branches are excluded. This data set represents consolidated assets of all banking businesses, including Australian-owned foreign operations.

In 2004, the major banks share of total assets was 78%, but the major banks' market share steadily declined to less than 75% before the GFC commenced in 2007 and subsequent mergers of CBA/BankWest and Westpac/St.George.

FIGURE K

TOTAL ASSETS

% Share of total (domestic and os books)

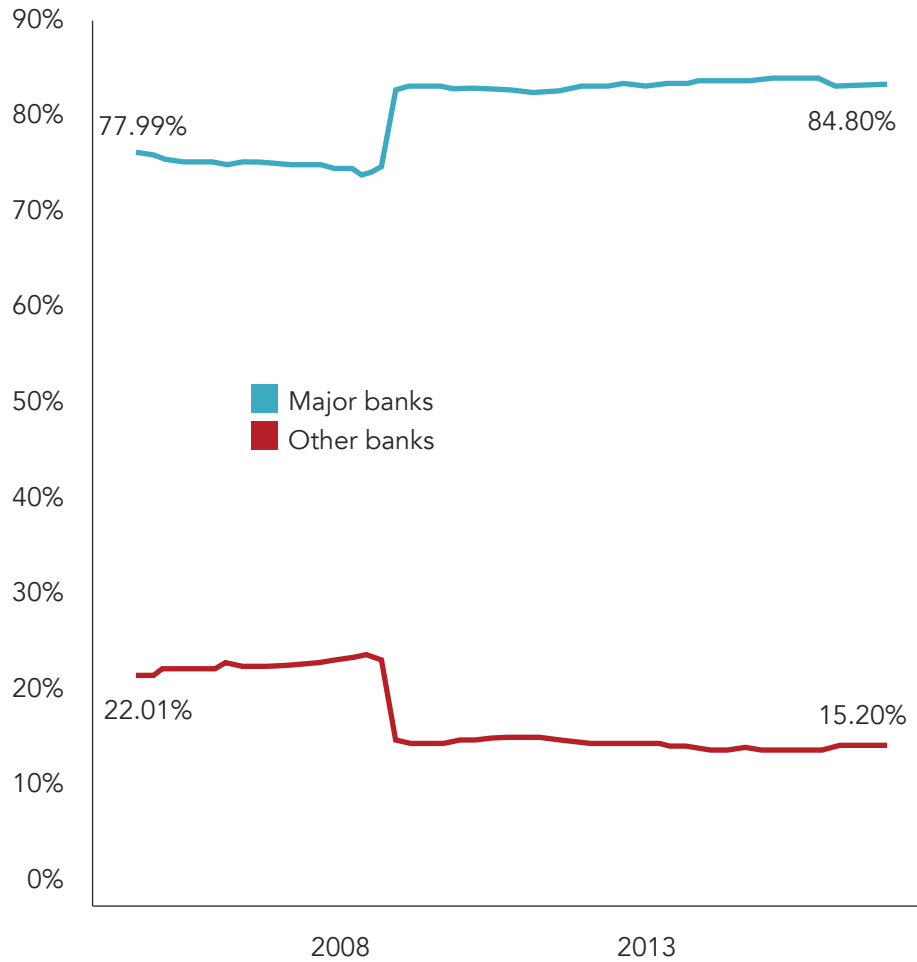


Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

The market share of major banks in total loans and advances mirrors that of total assets – see Figure L. This is not surprising as loans and advances are the largest components of total assets. Once again, major banks saw a declining market share between 2004 and 2007. Current market share stands at 84.5%.

FIGURE L

TOTAL LOANS AND ADVANCES
% Share of total (domestic and os books)



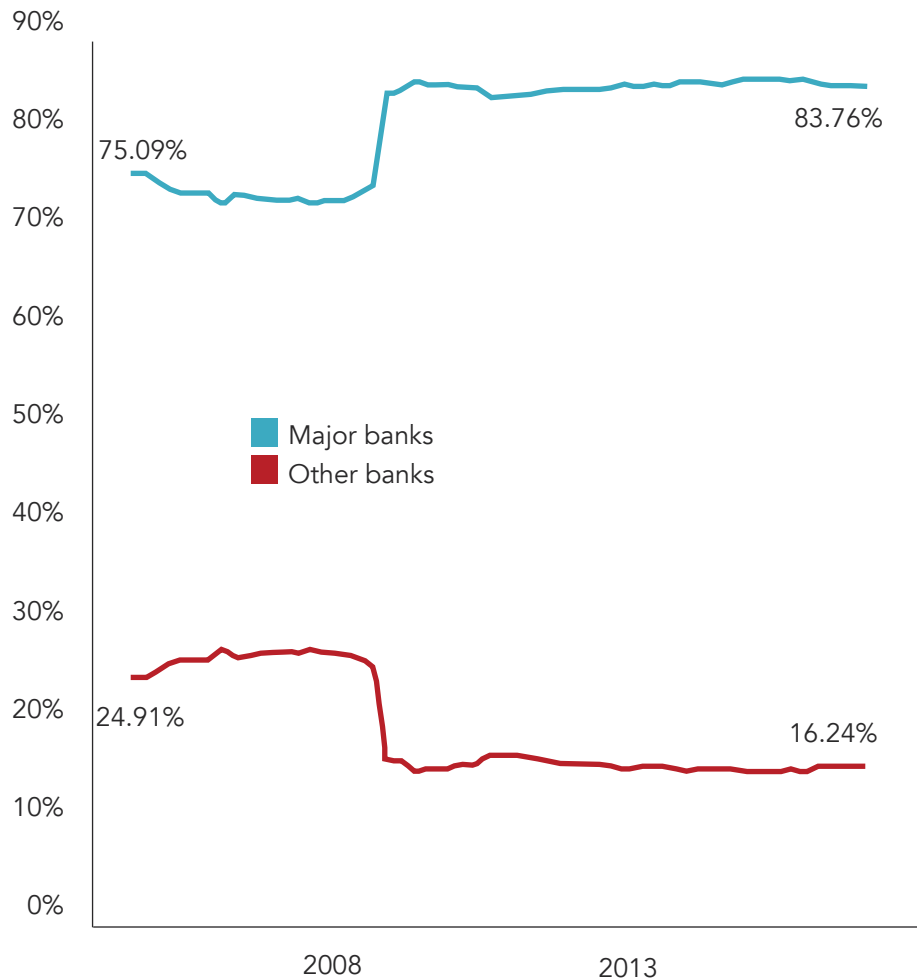
Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

Major banks' share of total deposits is marginally below that of total assets and total loans. Currently, collective market share is 83.7%. Since the GFC, competition for deposits has intensified. The major banks share of deposits pre-GFC fell to the low 70s.

FIGURE M

TOTAL DEPOSITS

% Share of total (domestic and os books)



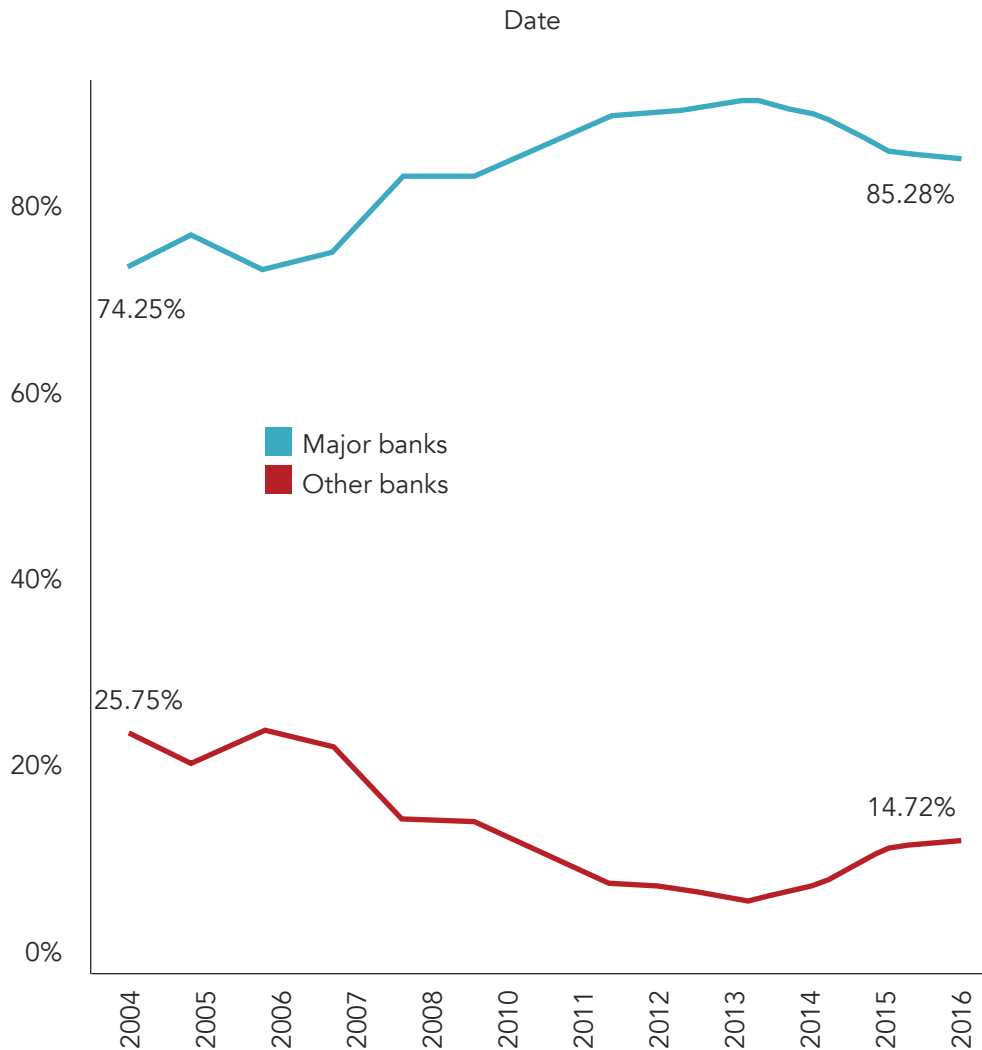
Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

The major banks have 84% of total assets, and a higher proportion (over 85%) of industry total profits. In 2004, the share of profits was 74%. A shift from 74% to 85% in share of profits represents a significant change in the relative importance of these four banks – see Figure N.

FIGURE N

TOTAL PROFITS

% Share of total (domestic and os books)



NOTE: Some data changes due to going from quarterly to smoother annual data.

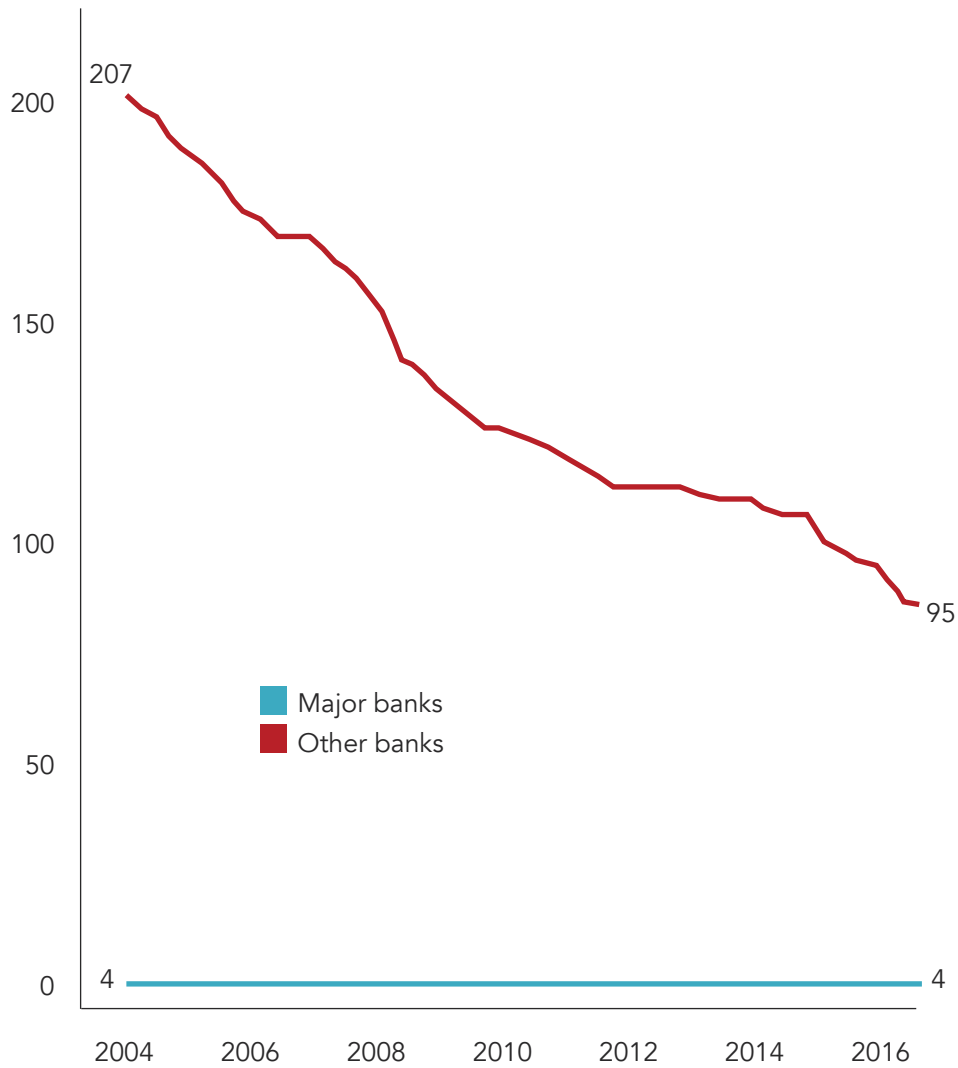
Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

It should be stressed that this rise in industry profit share is not the result of organic growth built on winning customer market share. Between 2004 and 2007, major banks lost market share to smaller banks. It was only the mergers of BankWest and St.George, in addition to the pricing advantages inherent in Basel II risk-weighting method and differential pricing of the Government Guarantee in the GFC that has put the big four banks into this strong market position (see policy discussion in Section 5).

One of the key developments over the last 13 years in Australia's financial system is the decline in the number of deposit-taking institutions. It has in fact halved, mainly driven by consolidation in the credit union industry. Australia currently has 99 registered deposit-taking institutions.

FIGURE O

NUMBER OF DEPOSIT-TAKING INSTITUTIONS



Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

3.2 INTERNATIONAL COMPARISON

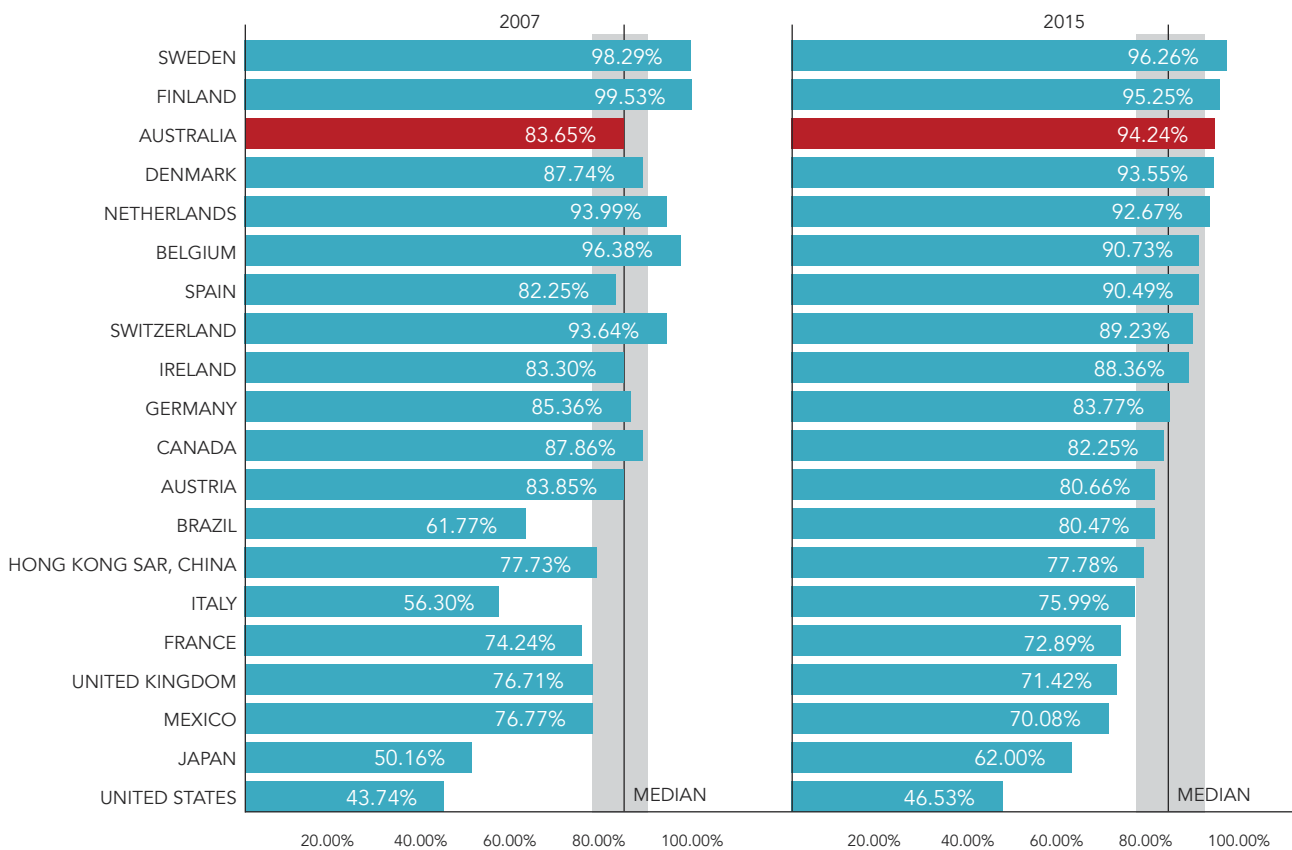
The World Bank’s Global Financial Development database publishes a market share estimate of the total assets held by the five largest banks in a domestic market. As can be seen from Figure P, of the 20 modern industrial countries selected, the five largest Australian banks in 2015 have the third highest market share of banking assets (94.25%), behind Sweden and Finland.

Australia’s ranking is currently well above the median and, indeed, well into the top quartile. This current position is considerably stronger than in 2007. In that year, the top five banks had an estimated share of assets of 83.65% which was about the median of the top 20 countries.

FIGURE P

ASSET CONCENTRATION - 5-BANK

Share of assets of five largest banks



Source: Underlying data from The World Bank.

3.3 BANK/NON-BANK MARKET SHARE

Australian regulatory authorities keep little data on the financial assets and liabilities of non-regulated entities. The ABS have some information as part of its national accounts.

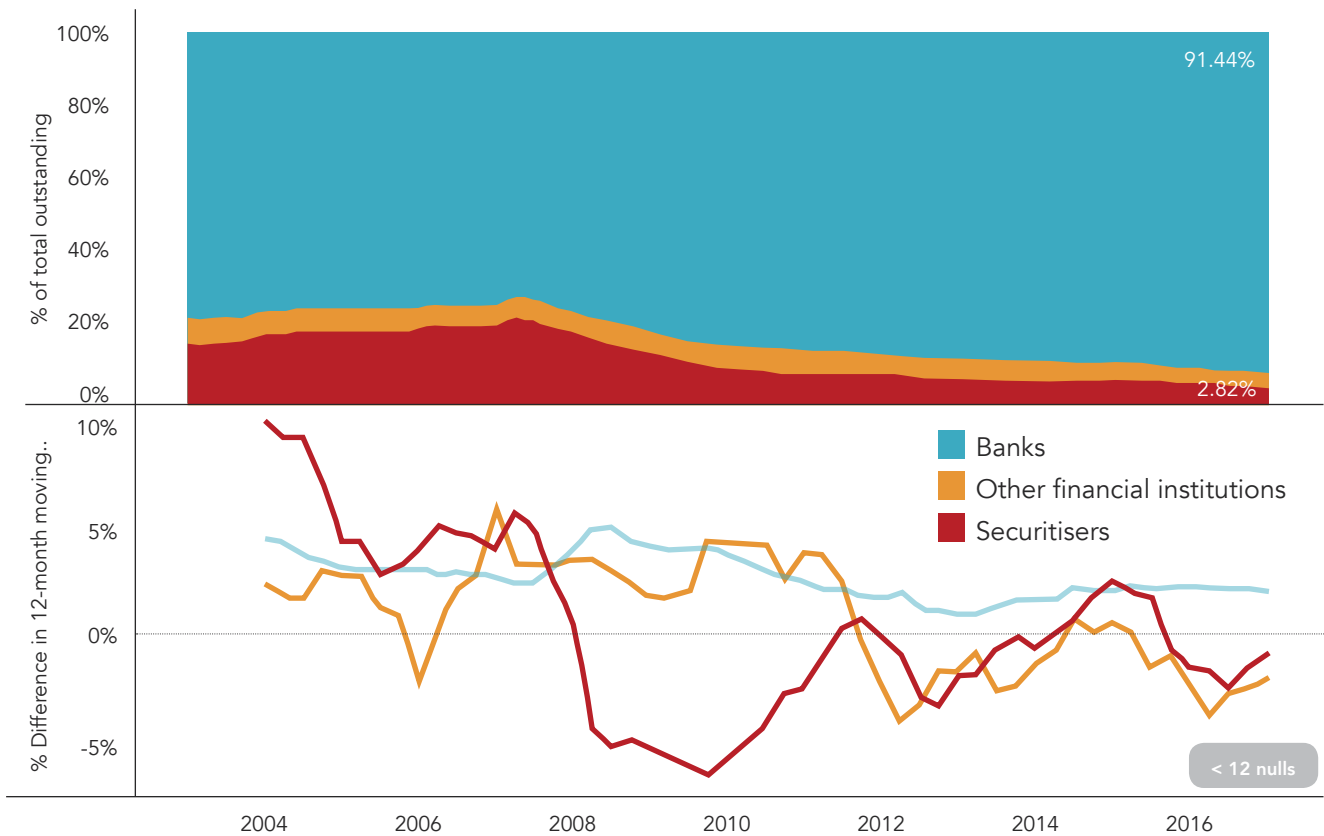
The dominant lending market in Australia is that of residential mortgages. ABS statistics show that banks and securitisation vehicles dominate the market. Banks, including major banks and all other banks, hold around 91% of total housing assets. Securitisation entities account for 5.74% of total loans, with the balance (2.82%) held by other non-bank entities.

However, while current levels are low, regional banks note that strong recent growth rates in lending have been achieved by some unregulated entities in response to APRA's limits of investor loans. These macroprudential restrictions only apply to APRA-regulated ADIs. In recent months, some growth in non-bank loans has reflected in the data – see bottom panel of Figure Q.

FIGURE Q

TOTAL HOUSING ASSETS OUTSTANDING - BY INSTITUTION CATEGORY

% Share of total housing loans



Source: Underlying data from ABS. Calculation and visualisation by Benchmark Analytics.

3.4 MARKET SHARE BY SEGMENT/PRODUCT

APRA's monthly banking statistics enable a reasonably detailed breakdown of market share by product category. The data series commenced in 2004, and the figures are only for the domestic market.

As can be seen in Figure R, the big four banks have substantially improved market share in all product markets since 2007:

- Share of total domestic resident assets has grown from 64% to 79%;
- Total deposits, 61% to 77.3%;
- Household deposits, 68% to 80%;
- Business deposits, 70% to 78%;
- Household credit cards, 80% to 82%;
- Housing investment loans, 77% to 85%; and
- Housing owner-occupied, 75% to 81%.

FIGURE R

MARKET SHARE IN KEY PRODUCT MARKETS					
% SHARE OF DOMESTIC MARKET					
		2004	2007	2017	Change 07-17
Total deposits	Major banks	66.7%	61.6%	77.4%	25.7%
	All other banks	33.3%	38.4%	22.6%	-41.1%
Total deposits from households	Major banks	68.8%	67.6%	79.9%	18.2%
	All other banks	31.2%	32.4%	20.1%	-37.9%
Total deposits from non-financial corporations	Major banks	73.6%	69.8%	78.2%	12.0%
	All other banks	26.4%	30.2%	21.8%	-27.8%
Total loans to households: Credit cards	Major banks	82.7%	80.1%	82.9%	3.5%
	All other banks	17.3%	19.9%	17.1%	-14.1%
Total loans to households: Housing: Investment	Major banks	77.2%	76.8%	85.4%	11.1%
	All other banks	22.8%	23.2%	14.6%	-37.0%
Total loans to households: Housing: Owner-occupied	Major banks	75.2%	75.0%	81.1%	8.2%
	All other banks	24.8%	25.0%	18.9%	-24.5%
Total resident assets	Major banks	68.6%	64.0%	79.1%	23.5%
	All other banks	31.4%	36.0%	20.9%	-41.8%

Source: Underlying data from APRA MBS. Calculations and visualisation by Benchmark Analytics.

3.5 DOMESTIC/GLOBAL TRENDS

The Bank of International Settlements (BIS) published annual data comparing the major banks in advanced and emerging countries against performance metrics (caution is needed when assessing the significance of international comparisons due to definitional differences).

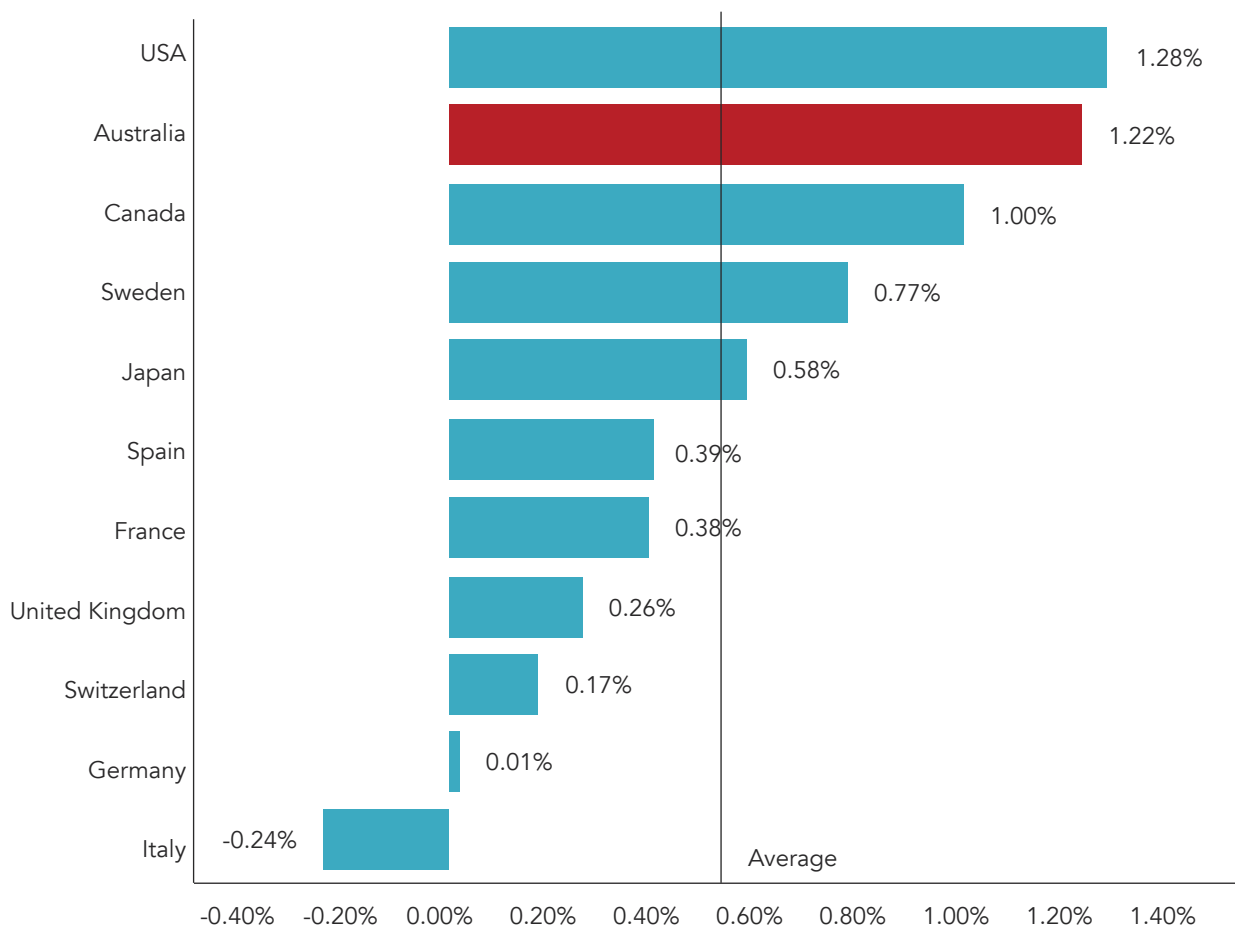
The countries covered are the United States (US), Australia, Canada, Sweden, Japan, Spain, the United Kingdom (UK), Switzerland, Germany and Italy. The 2017 annual report has sufficient data to allow a five-year average calculation.

Net income to assets is a key profitability indicator. Net income is net interest plus other operating income, minus costs. As a ratio to total assets, it provides a sound profitability comparison.

Over the five years to 2016, Australia's major banks are the second most profitable with 1.22%. The most profitable is the US with a ratio of 1.28%. On this measure, Australia's large banks are more than twice as profitable as the average of advanced countries in the data set – see Figure S.

FIGURE S

NET INCOME TO ASSETS 5 year average (2012-2016)



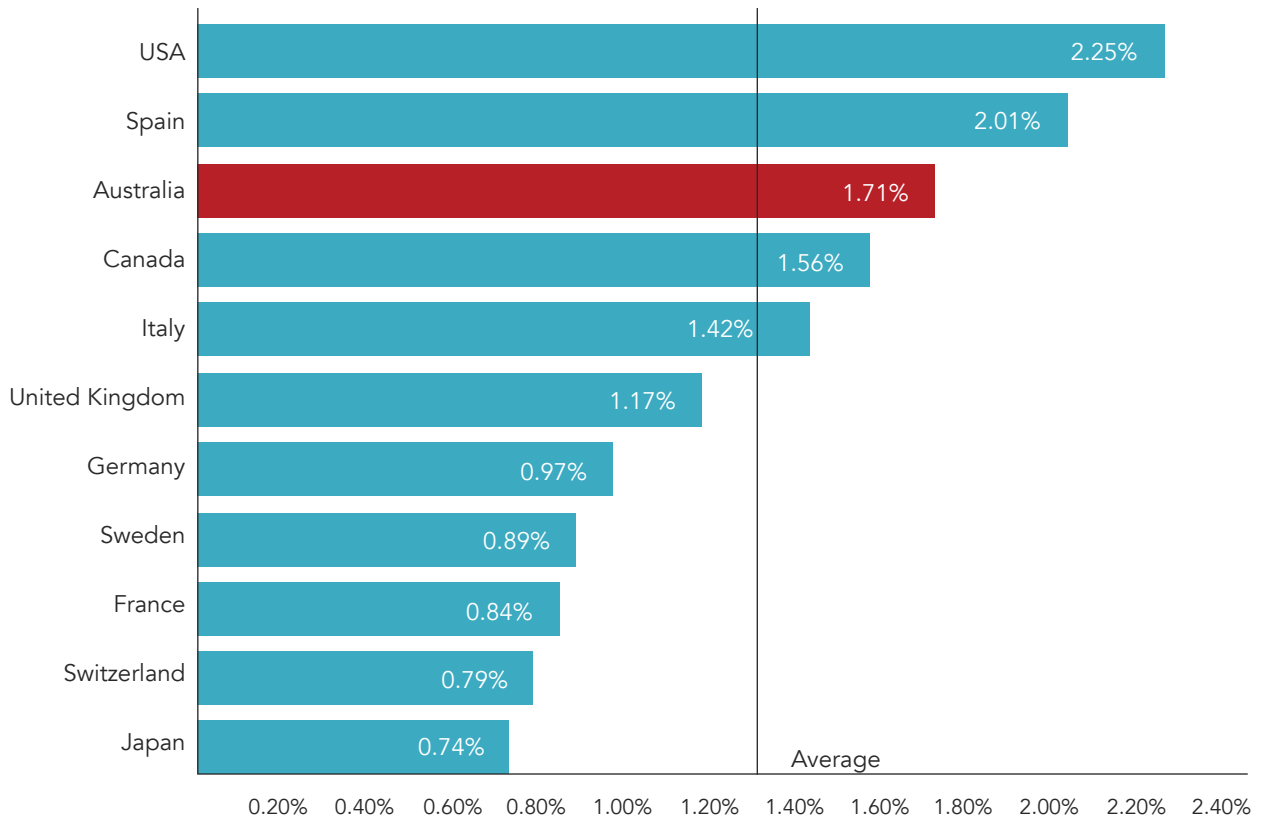
Source: Underlying data from Bank of International Settlements (BIS). Calculations and visualisation by Benchmark Analytics.

Australia's high profitability is due to many factors, including a preference by the industry for margin income relative to fees. This can be seen in Figure T which compares net interest income to total assets. Over the last five years, Australia's major banks have averaged a margin of 2%.

FIGURE T

NET INTEREST INCOME TO ASSETS

5 year average (2012-2016)



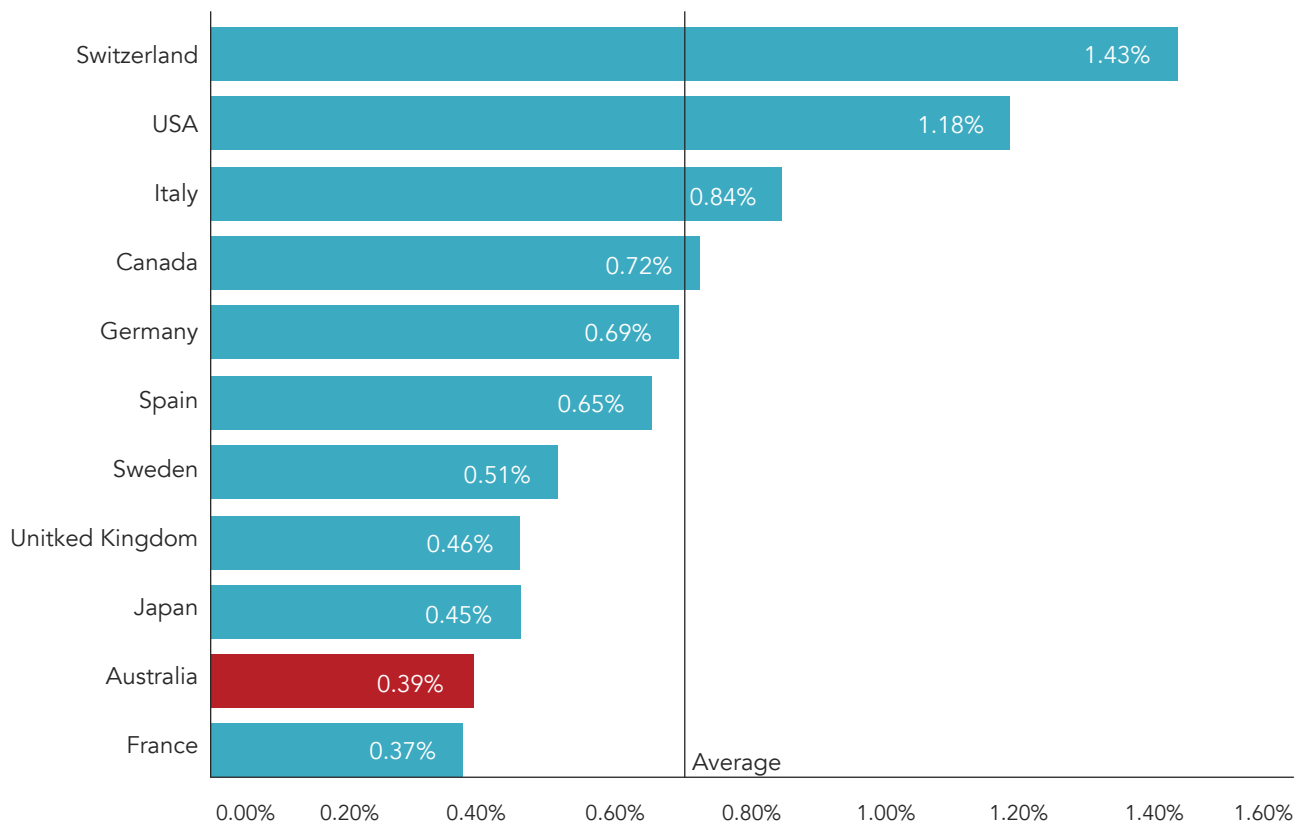
Source: Underlying data from Bank of International Settlements (BIS). Calculations and visualisation by Benchmark Analytics.

In contrast to lending margins, Australia’s major banks earn a relatively small amount of their income from fees – see Figure U. This chart shows relative banking system’s share of fees relative to assets. Low levels of fees appeal to customers that do not like paying account fees or who are net savers, but on the other hand, a low rate of non-interest revenue puts a greater burden on housing and business borrowers to support bank profitability.

FIGURE U

NET FEES AND COMMISSIONS TO ASSETS

5 year average (2012-2016)



Source: Underlying data from Bank of International Settlements (BIS). Calculations and visualisation by Benchmark Analytics.

The BIS data also shows that Australia’s major banks have non-performing loan rates that are well below the average of major banks in other industrialised countries. Over the last five years to 2016, loan loss provisions to assets have averaged just 0.13%. This, of course, reflects the relative strength of the Australian economy during the period of the GFC.

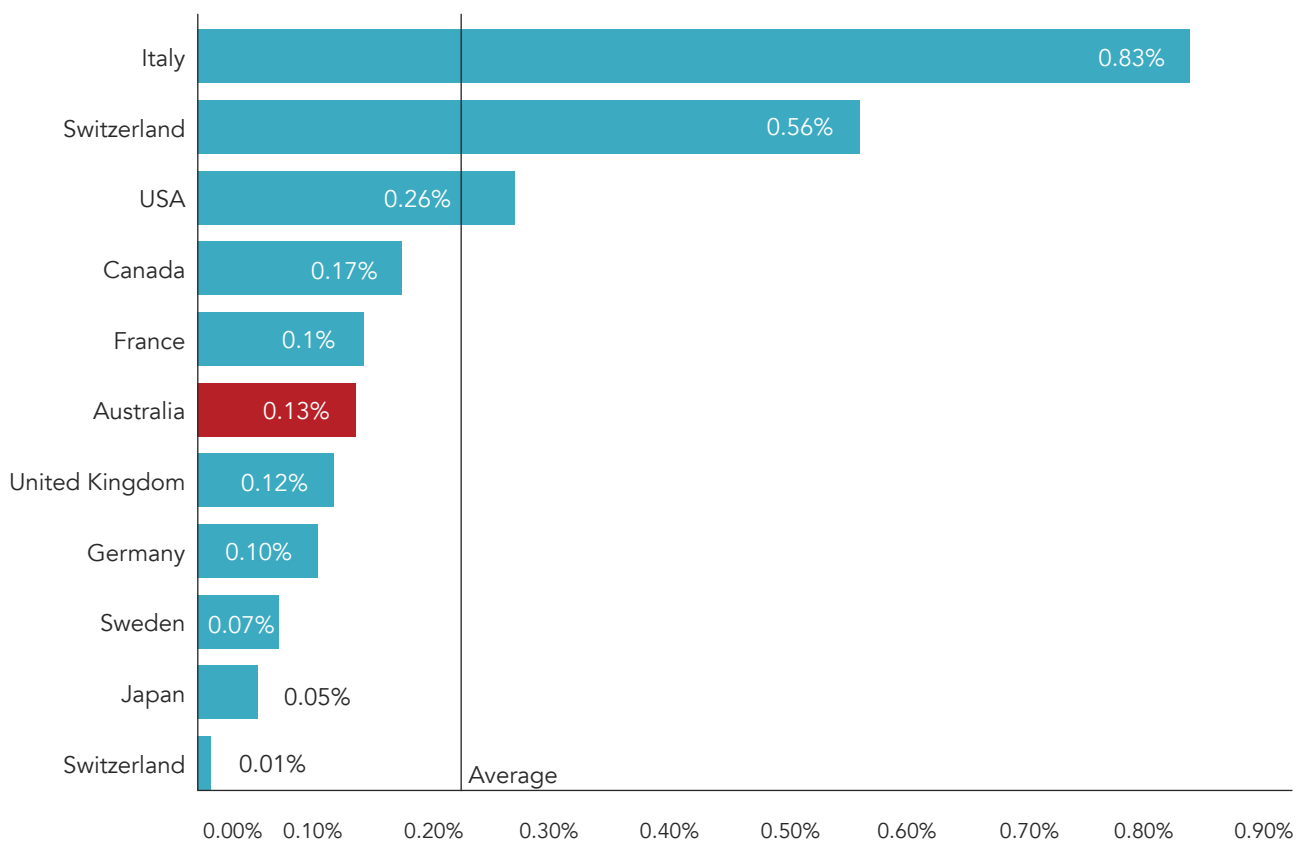
It is noteworthy that while a low figure, large banks in five other countries have recorded lower levels: UK (0.12%), Germany (0.10%), Sweden (0.07%), Japan (0.05%), Switzerland (0.01%). See Figure V.

Australian banks appear to have high margins despite low defaults. In other words, the explanation for high margins is not a high risk environment, but rather likely to be the ability of these banks to artificially raise them due to pricing power.

FIGURE V

LOAN LOSS PROVISIONS TO ASSETS

5 year average (2012-2016)



Source: Underlying data from Bank of International Settlements (BIS). Calculations and visualisation by Benchmark Analytics.

3.6 DOMESTIC MARKETS: HERFINDAHL–HIRSCHMAN INDEX ESTIMATES

The Herfindahl-Hirschman index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers, and can range from close to zero to 10,000. The U.S. Department of Justice uses the HHI for evaluating potential mergers issues.

The U.S. Department of Justice considers a market with an HHI of less than 1,500 to be a competitive marketplace, an HHI of 1,500 to 2,500 to be a moderately concentrated marketplace, and an HHI of 2,500 or greater to be a highly concentrated marketplace. (<http://www.investopedia.com/terms/h/hhi.asp>)

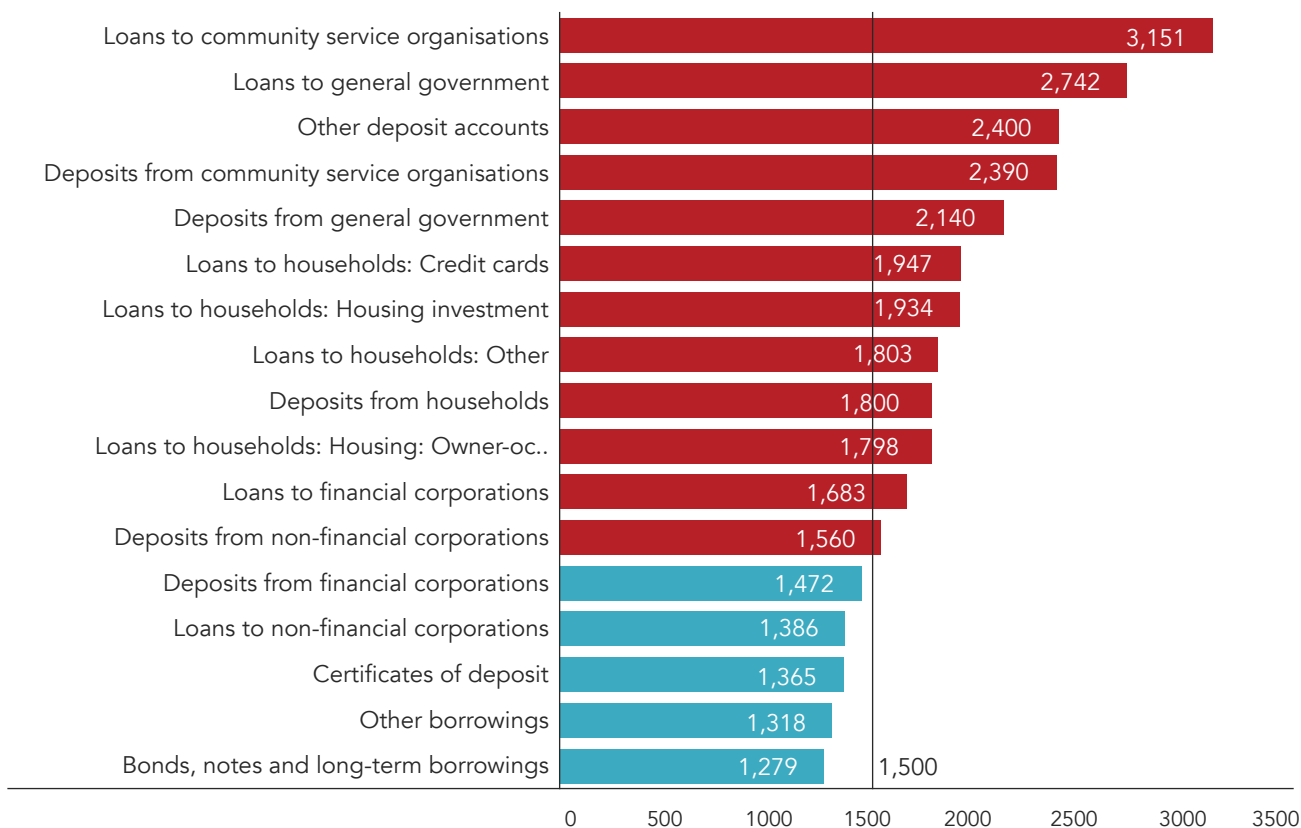
Figure W shows the HHI estimates for the domestic banking markets in Australia. Underlying data for these markets is derived from APRA's monthly statistics publication. These statistics do not include credit unions or building societies, although including these institutions is unlikely to change the estimates by any material amount given the small market shares of individual credit unions.

Those markets represented by a 'red' bar have an HHI estimate above 1500, which is the level where competition concerns start to emerge. One of the key markets is that of housing investment lending where the HHI is 1,934. This is an important domestic market that is now subject to macroprudential rules limiting credit growth to 10% and also restricting interest-only lending. The effect of the prudential rules is to make it almost impossible for any non-major banks to increase market share.

FIGURE W

HHI ESTIMATES - BY PRODUCT CATEGORY (2017)

('Red' = HHI above 1500)



Source: Underlying data from APRA MBS. Calculations and visualisation by Benchmark Analytics.

3.7 FUNDING COSTS AND MARGINS

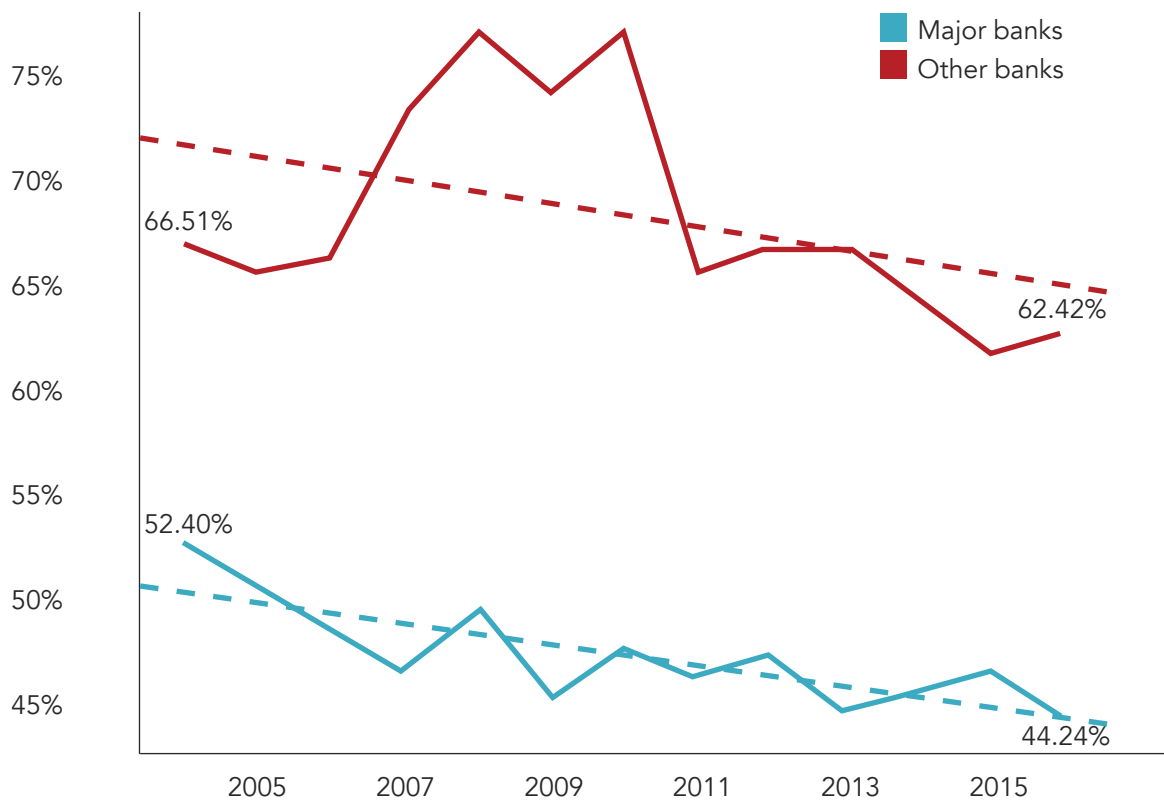
Funding costs and margin data are derived using APRA’s quarterly performance statistics. Missing data has been estimated using trends over the previous two years of data.

Expenses to income ratio is a standard measure of overall efficiency. On this measure, it appears the major Australian banks have ratios materially below other banks (see Figure X), building societies, and credit unions.

Other data suggests the major banks have low rates compared to international banks. This is primarily driven by a large volume of business due to market share dominance and the ability to spread fixed costs across a large customer base.

FIGURE X

EXPENSES TO INCOME RATIO



Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

Interest paid is another key indicator, it is a proxy for overall average funding costs. The APRA data does not enable a current price calculation, but an average funding cost can be estimated from the income and asset statistics.

Figure Y traces average interest paid (funding costs) by banks since 2004. As is well known, the interest rates paid on borrowing has been consistently lower for major banks since the GFC in 2007. Combined with relatively low expenses due to scale, this gives major banks a dominant market advantage.

FIGURE Y

INTEREST RATE PAID



Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

With lower expenses due to scale and lower funding costs, the major banks can use that cost advantage to price their products marginally under the average of other banks in the market. Latest data shows the major banks charge customers an average of 3.93% interest rate, compared to other banks at 4.17%. This enables major banks to partly mitigate potential market share loss due to reputational and service levels.

Figure Z shows that pre-GFC and pre-Basel II, the major banks on average priced products above that of other deposit taking institutions. Note - between 2004 and 2007 the major banks lost market share to smaller rivals.

Care needs to be used in interpreting Figure Z as the average interest received is not adjusted for asset composition. For example, some ADIs will have a higher proportion of business assets which are typically riskier and have higher interest rates to compensate for that risk. (For a more apples to apples comparison of pricing, see housing rate comparisons in Figure AA.)

Since 2007, however, the major banks have been able to hold average interest rates below other banks. Basel II (introduced in 2008) is likely to be a key driver of this as it enabled the major banks to simultaneously reduce margins and maintain the return on equity.

FIGURE Z

INTEREST RATE RECEIVED

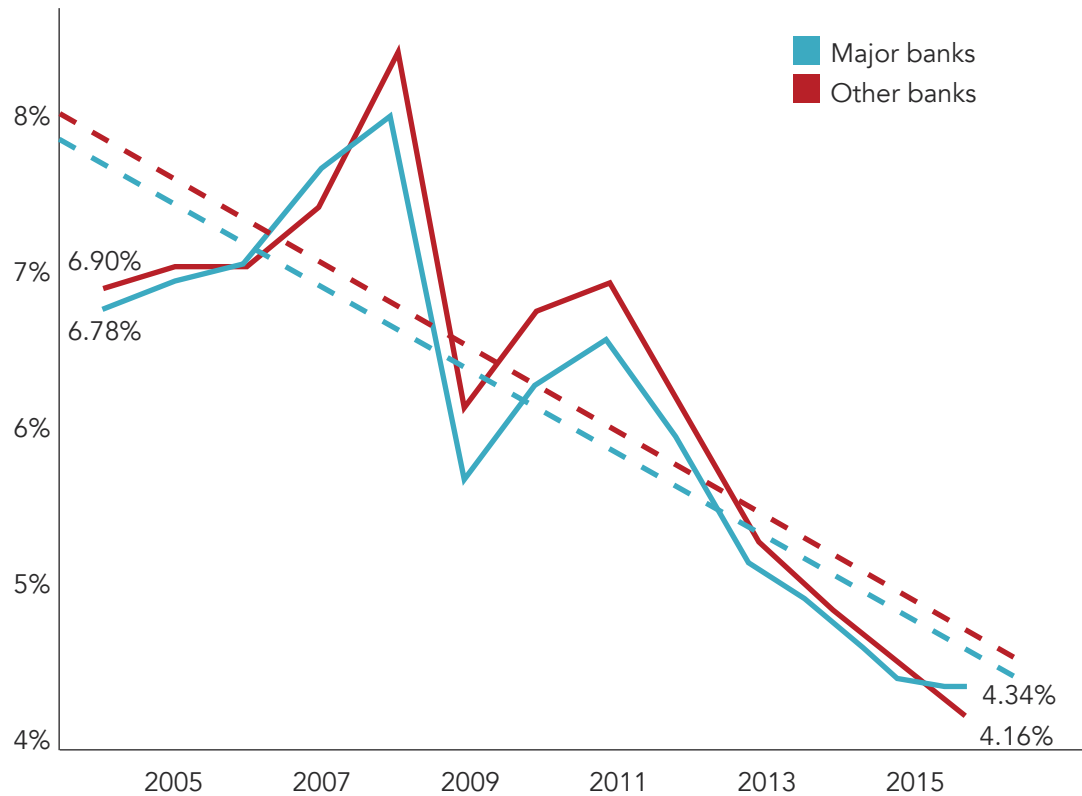


Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

In the housing lending market, the data shows the major banks are pricing housing loans at roughly the same average rate as other deposit-taking institutions – see Figure AA. Indeed, the latest data, which reflects changes to mortgage risk weights, shows the major banks have started to price average mortgages above other banks.

FIGURE AA

INTEREST RATE RECEIVED (HOUSING)

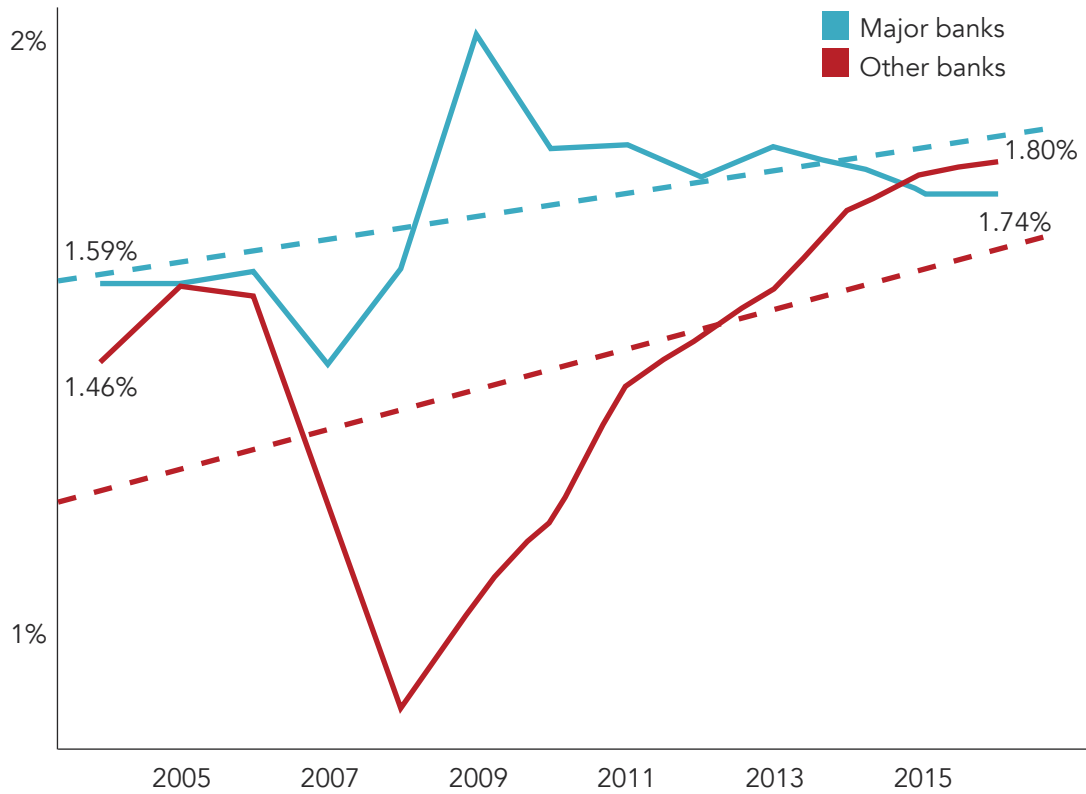


Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

The story of the major banks' relative profitability can be seen in Figure BB. Here we see that the derived net interest margin (NIM) of the major banks has been consistently above other banks since 2004. The gap was widest during the GFC as a result of the differential pricing of the Government Guarantee, and has only recently converged.

FIGURE BB

INTEREST MARGIN (ALL LOANS)

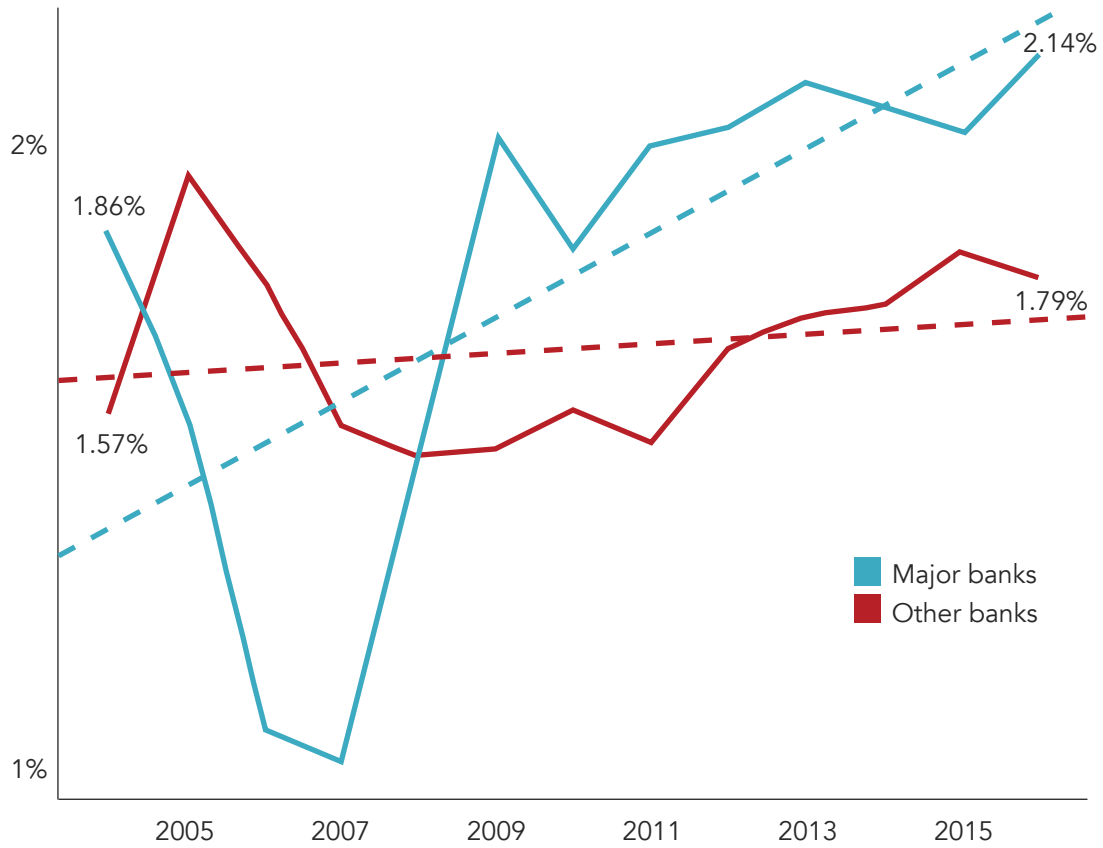


Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

Importantly, the convergence in the interest margin in lending overall has not been seen in the housing market. The major banks maintain a net interest margin in housing loans at 2.14 %, compared other banks at 1.79%. This shows the extent of profitability of mortgage lending for the major banks.

FIGURE CC

INTEREST MARGIN (HOUSING LOANS)



Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

As a result of this superior net interest margin and the increased leverage available to advanced accredited banks pursuing lower risk-weighted assets i.e. housing mortgages, the major banks have returned considerably higher returns on equity since 2006 as seen in Figure DD. (Of course, analysis of NIM ideally also takes account of lending composition.)

FIGURE DD

NET PROFIT TO SHAREHOLDERS EQUITY

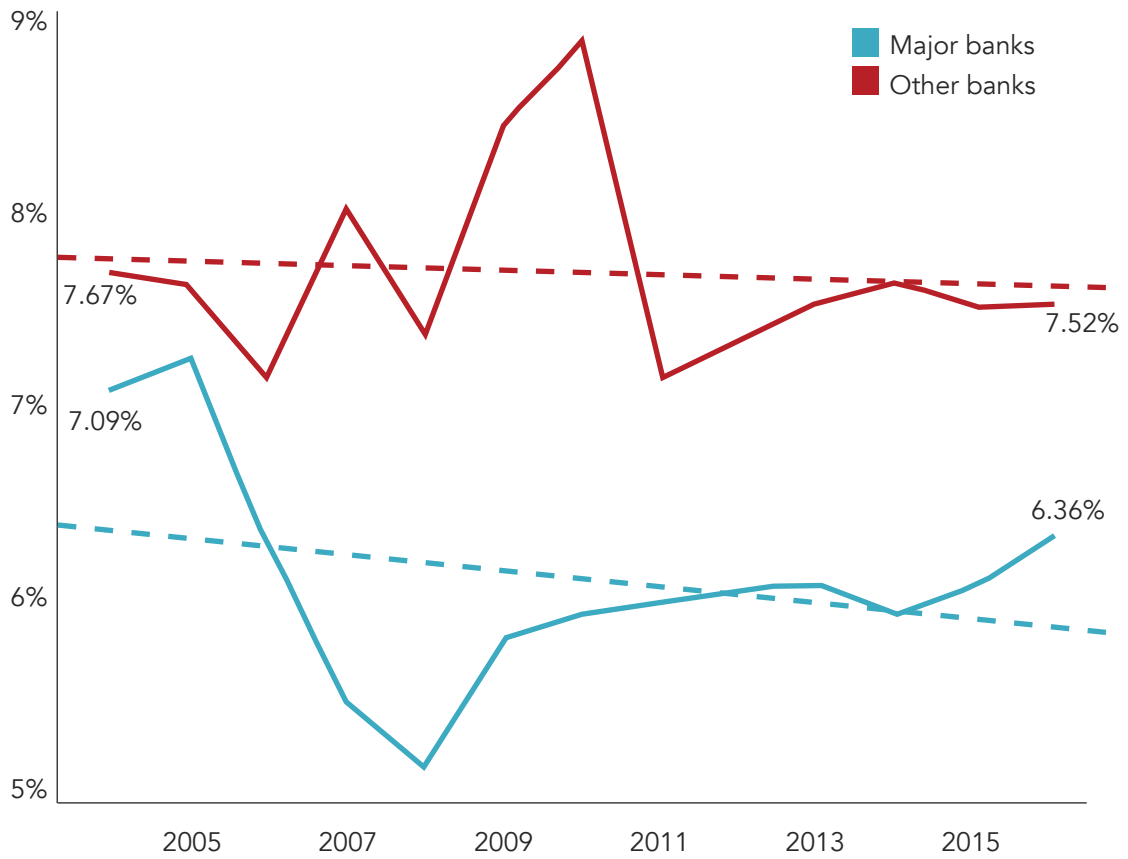


Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

Net income is a function of the amount of revenue derived from a bank's assets, and then this income is compared to total shareholders' capital. The four banks can maintain significantly lower levels of capital due to the IRB risk-weighting system.

FIGURE EE

SHAREHOLDERS EQUITY TO TOTAL ASSETS



Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

4 INDIVIDUAL REGIONAL BANK BUSINESS MODEL/S

The history of regional banks goes back beyond the founding of the Australian Federation in 1901. Nearly all domestically-owned banks in Australia either commenced as regional banks, building societies or credit unions.

Regional banks compete in all markets but have the greatest presence in retail banking, servicing household demand for: deposit accounts; credit cards; housing loans; personal loans; and small and medium enterprise products. They are less represented in institutional and large corporate financing, although most regional banks have some large corporate customers. Most regional banks have competitive agribusiness product offerings.

Regional banks have distinguished themselves over a long period of time with customer satisfaction and trust levels that far exceed the major banks. Customer satisfaction surveys from a range of independent research firms regularly rank regional banks ahead of the rest of the market on a range of customer satisfaction metrics. Scores for the broader industry have been trending higher in recent years, demonstrating the value of competitive tension in driving improvements in customer satisfaction.

This achievement is significant when seen in light of the funding and scale advantages of large institutions. The regional banks in Australia have managed to achieve strong customer support through management cultures that understand the importance of customer service to long-term success.

Another closely related feature of regional banks is how they have developed and maintained a corporate structure to embed the philosophy of customer service and develop niche roles in retail banking. Examples include Bendigo Bank's Community Bank® model and BOQ's Owner-Managed Branch model.

4.1 REGIONAL BANKS AND CONNECTION TO CUSTOMER/COMMUNITY/DIVERSITY

As regional banks do not have the scale and funding cost advantages of larger banks, they have needed to develop a corporate structure in order to excel in customer service. The five banks that support this submission have each utilised a different strategy to do this.

4.1.1 Bendigo and Adelaide Bank

The Bendigo Bank is a community-focused retail bank that commenced operations in 1858. In 2007 Bendigo Bank merged with Adelaide Bank to form Bendigo and Adelaide Bank Limited, now the fifth largest domestic retail bank in Australia.

Bendigo and Adelaide Bank's vision is to be Australia's most customer connected bank. We do this by focusing on enabling customer choice; exploring opportunities for growth; partnering for shared success; developing our people; and driving capital and operational efficiency.

Bendigo and Adelaide Bank's well established geographic footprint provides full banking and financial services through 650 service outlets across Australia, including a network of almost 500 company and Community Bank® Branches. There is also a network of mobile relationship managers to ensure the delivery of personalised, immediate and convenient services to support our customers when and where they are in need. This is particularly important to those located in remote areas, and in farming communities.

Customers can access their banking and phone services 24/7, and can apply online for deposit accounts, credit cards, personal and home loans, superannuation and managed funds. Bendigo and Adelaide Bank have a full service business banking division and own Australia's largest locally owned agricultural bank, Rural Bank.

4.1.2 Bank of Queensland

The Bank of Queensland (BOQ) was established in 1874 as the Brisbane Permanent Benefit Building and Investment Society, the first of its kind in Queensland.

In 1887 it converted into a bank but did not become a trading bank until 1942. In 1970 it officially became the Bank of Queensland and was listed on the ASX in 1971. Throughout the 1970s and 1980s the bank continued to grow, and in 1985 it began to open regional branches.

BOQ prides itself on its commitment to customer service, delivered through a range of channels including its unique Owner-Managed branch (OMB) model. It offers a full range of simple, easy to understand banking products and services to individuals and businesses.

In the past 15 years, BOQ has undergone considerable expansion, both organically and also through the acquisition of various businesses including, most recently, Virgin Money Australia.

BOQ is now a large regional bank with assets of \$42.5 billion. Its OMB model, a franchise model which means the branch is owned and managed by people who live locally, know their customers well and are willing to go the extra mile to ensure that they always receive exceptional personal service. This relationship-based distribution approach extends across BOQ's entire business, including Retail and Online Banking, Business Banking, Agribusiness and Financial Markets, Equipment, Debtor & Vendor Finance and Insurance.

Currently BOQ operates 265 branches across Australia, and provides fee-free access for its customers to more than 3000 ATMs nationally.

In 2013 the website Mozo, which focuses on banking and insurance comparison, voted BOQ one of Australia's top five banks based on retail customer feedback. As BOQ has been expanding its Business Banking presence, including a move into agribusiness, it has topped the East & Partners business banking customers' satisfaction survey for the five years straight, up to and including 2013.

4.1.3 ME Bank

ME Bank was founded by Australia's industry super funds in 1994 as Super Member Home Loans with the primary purpose of providing low-cost home loans to Australians belonging to industry superannuation funds. In 2001 ME Bank received its banking license.

Today ME is 100 per cent owned by 29 of Australia's largest industry super funds who collectively have over \$200 billion in funds under management and more than 5.5 million members. ME Bank is headquartered in Melbourne.

Having begun as a home loan originator, ME Bank today offers a full range of personal banking products including home loans, credit cards, personal loans, transaction accounts, online savings accounts and term deposits. ME Bank has over 420,000 customers and \$26 billion in assets.

ME Bank's unique business model centres around its customer-first philosophy and, due to the backing of some of Australia's funds, has the strength and capability of a commercial bank. Our purpose is to help Australians get ahead by giving them ways to get more from their savings, pay less on their loans and cut down on fees – however we can, whenever we can.

We make banking as simple as possible in the belief customers shouldn't have to wade through jargon to find what they need, and opening an account should be easy. And because financial know-how doesn't always come naturally, we give customers tools to spend wiser and save smarter: things like our online school of money 'ed', which is fast, free and simple to use.



4.1.4 Suncorp Bank

Suncorp Bank was founded in 1902 as the Queensland Agricultural Bank and has provided banking services to individuals, SMEs and agribusiness in regional communities of Australia for over 110 years.

As an Authorised Deposit taking Institution (ADI) regulated by Australian Prudential Regulation Authority (APRA), Suncorp Bank is Australia's leading regional bank and is part of the Suncorp Group.

Suncorp Group Limited is a top 20 ASX-listed company with \$97 billion in assets. The company has evolved from having strong Queensland origins to become a unique, diversified financial services company, delivering highly-valued banking and wealth, and insurance products and services, across Australia and New Zealand. The Group employs around 13,400 employees and serves close to nine million customers through its trusted brands, of which approximately one million are Suncorp Bank customers.

With a network of over 200 branches, agencies, business banking centres, more than 2000 ATMs across Australia, and employing around 2,900 staff, Suncorp Bank offers a strong suite of financial services and simple banking products, which include:

- Personal banking - including home and personal loans, savings and transaction deposit accounts, margin lending, credit cards and foreign currency services;
- Small business banking - including financial solutions for SMEs with borrowing requirements of up to A\$1 million;
- Commercial lending - including financial solutions for SMEs with borrowing requirements of more than A\$1 million; and
- Agribusiness lending - including financial solutions and serviced relationship management for rural producers and associated businesses in rural and regional areas.

Suncorp has begun a major transformation of the organisation including the establishment of the Suncorp Marketplace, with a renewed purpose to create a better today for all of our stakeholders, including customers, shareholders, people and communities. Creating value for the customer is a guiding principle in decision-making.

4.1.5 AMP

AMP is one of Australia's oldest companies, and since the beginning we have been committed to improving the communities in which we operate. We believe that our success is linked to the prosperity of our customers, shareholders, advisers, employees and our communities.

AMP is a financial services company in Australia and New Zealand providing superannuation and investment products, insurance, financial advice and banking products. AMP formed in 1849 as the Australian Mutual Provident Society, a non-profit life insurance company and mutual society. In 1998, it was demutualised into an Australian public company, and listed on the Australian and New Zealand stock exchanges.

Our purpose is to help customers own their tomorrow, helping them take control of their money and achieve their financial goals.

We are Australia and New Zealand's leading specialist wealth management company. For 168 years, we have dedicated ourselves to helping our customers achieve their financial goals with quality products and expert advice. The world has changed immeasurably since our founding days; and while we have evolved and grown to keep pace, our purpose has steadfastly remained to help people own a better tomorrow.

AMP Bank is an Australian retail bank offering residential mortgages, deposits, transactional banking, and SMSF products for around 100,000 customers. AMP Bank distributes through brokers, AMP advisers, and direct to retail customers via phone and internet banking.

As the banking arm of a wealth manager, AMP Bank's role is to leverage and grow the group's customer base and support customer goals through providing banking solutions to both advised and non-advised customers.



4.2 ALIGNMENT TO CUSTOMER INTEREST

Without the subsidy of being a “too big to fail” bank, regional banks have needed to structure their operations or develop a level of trust in the community that enables them to overcome the disadvantages of limited scale and higher costs. While regional banks have profit incentives as do larger banks, they have a stronger need to hardwire customer and community focus into their objectives and operations. Figure FF identifies the core attribute that enables this deep alignment and differentiation.

FIGURE FF

BANK	CORE ATTRIBUTES ALIGNING INTERESTS OF OWNER & CUSTOMERS
AMP	Australian icon, diverse ownership, and focused on helping customers own their tomorrows
Bendigo and Adelaide Bank	Community Bank® model
BOQ	Queensland focus & owner/manager model
ME Bank	Mutual structure of owners
Suncorp Bank	Queensland origin & diversified earnings enabling relationship pricing

4.3 REGIONAL BANKS SET THE “COMPETITIVE FRONTIER” WHILE MAJORS ACHIEVE HIGHER ROE'S

The price of intermediation is the lending margin, the difference between the interest rate paid and the interest rate charged. The available data suggests that the major banks have, at least since the GFC and Basel II was introduced, maintained net interest margins above smaller banks⁴.

In effect, the regulatory and prudential framework has allowed major banks to price consistently with other banks, but then use their cost savings to pay much higher returns to shareholders.

4.4 GROWING BUT CROWDED OUT BY REGULATORY ARBITRAGE

Up until the GFC and when Basel II was introduced, the major banks were losing market share to smaller deposit-taking institutions. Since then, the major banks have been able to increase market share through mergers, and then maintain that market share through their regulatory advantages – lower funding costs and preferential risk weights.

While regional banks are growing in line with the system, the imposition of macroprudential rules, and the increasing layers of regulation are making it very difficult for smaller banks to make inroads in market share. Recent industry issues have precipitated a major regulatory backlash and it is the larger banks that bear a lower relative cost in complying with those fixed regulatory costs.

⁴ See APRA QADIPS

5 KEY POLICY ISSUES/RECOMMENDATIONS

5.1 "TOO BIG TO FAIL" / LEVY

The major banks in Australia are "too big to fail", meaning their failure would lead to a politically unacceptable economic disturbance.

APRA has publicly 'designated' Westpac, NAB, CBA and ANZ as what's called domestic systemically important banks (D-SIBs).

While this may appear an abstract and theoretical issue, it has daily consequences for banking competition.

The rating agency Standard & Poor's (S&P) gives the major banks a three-notch credit rating uplift to reflect their "too big to fail" status, significantly reducing the interest they pay on wholesale funding. Reserve Bank of Australia (RBA) research⁵ released last year indicated that "...the major banks have received an unexplained funding advantage over smaller Australian banks of around 20 to 40 basis points on average since 2000."

In Figure GG, the chart traces the average interest rate paid on deposits and borrowed funds. This is a good proxy for general funding costs. More recent data indicates the major banks have a funding cost advantage of 18 basis points, but that this is at the lower end of a trend established post-GFC. Figure HH shows average spreads on corporate (non-financial) bonds between A-rated and BBB-rated securities.

Even at 20 basis points, the uplift enjoyed by the major banks is significantly larger than the six basis point levy introduced by the Federal Government.

In light of this advantage, regional banks support⁶ the Federal Government's imposition of a 0.06% tax on banks with specified liabilities exceeding \$100 billion.

While the levy only compensates taxpayers for a proportion (even at the lower end of benefit estimates) of the "too big to fail" subsidy, it is a positive step for competitive neutrality.

A summary of the advantage was included in Suncorp Bank's submission to the recent Senate Inquiry into the Major Bank Levy Bill:

⁵ Research released under Freedom of Information (FOI). See link: <http://www.rba.gov.au/information/foi/disclosure-log/rbafoi-151609.html>

⁶ The Government's levy on five banks is an awkward issue for regional banks. As part of the business community, we typically argue against tax impositions on business activity. However, there is a legitimate role for tax in addressing market failures or compensating taxpayers for contingent risks. On balance, we support the levy due to its role in partly addressing the "too big to fail" funding subsidy.

"...the major banks currently enjoy an artificial funding cost advantage over the rest of the sector by virtue of their status as being "too big to fail."

Since these banks are considered "too big to fail", it is commonly accepted that they would receive Government support if they ever found themselves in financial difficulty. In effect, it is assumed the Government implicitly guarantees these institutions, which leads to them enjoying higher credit ratings than they otherwise would. S&P has consistently stated that it values the Australian Government's implicit support as being worth a two-notch uplift, and that the credit ratings of these institutions are therefore two notches higher than they would be in the absence of this support.

This uplift has a direct impact on major bank funding costs, making them lower than they would otherwise be, and providing them with an artificial advantage not available to the rest of the sector.

While difficult to quantify the value of the uplift, it is clearly significant. Credible and independent commentators assert the advantage sits well above six basis points.

More recently, the scale of this advantage has become even greater. Late last month, S&P announced that it had lowered the credit ratings of 23 Australian financial institutions, but left the credit ratings of the major banks Credit Profile (SACP) of the majors by one notch, their overall issuer ratings remained unchanged, "...reflecting our expectation of likely timely financial support from the Australian Government, if needed..." In effect, this means the two notch upgrade that was previously enjoyed by the majors banks has now been increased to three notches."



5.2 POSSIBLE LEVY DESIGN CHANGES

Regional banks support the Government's imposition of a levy on the major banks for the reasons outlined previously, albeit as members of the business community our general disposition is to oppose tax on business activity. Like all areas of public policy, design changes that reduce unintended consequences or improve outcomes should be considered.

Regional banks see a case for more strongly tying the levy to estimates of the actual funding cost advantage enjoyed by the D-SIB banks. This estimate could be undertaken annually by the Council of Financial Regulators (COFR). Federal Cabinet could decide what proportion of the advantage would be taxed.

By more strongly tying the levy to the funding cost advantage, the levy is indisputably rational and a worthwhile microeconomic reform, in addition to compensating taxpayers for the risk associated with systemically large banks. Of course, regional banks also acknowledge that there are other policies that could mitigate this subsidy, such as higher capital levels imposed through the D-SIB levy.

FIGURE GG

INTEREST RATE PAID

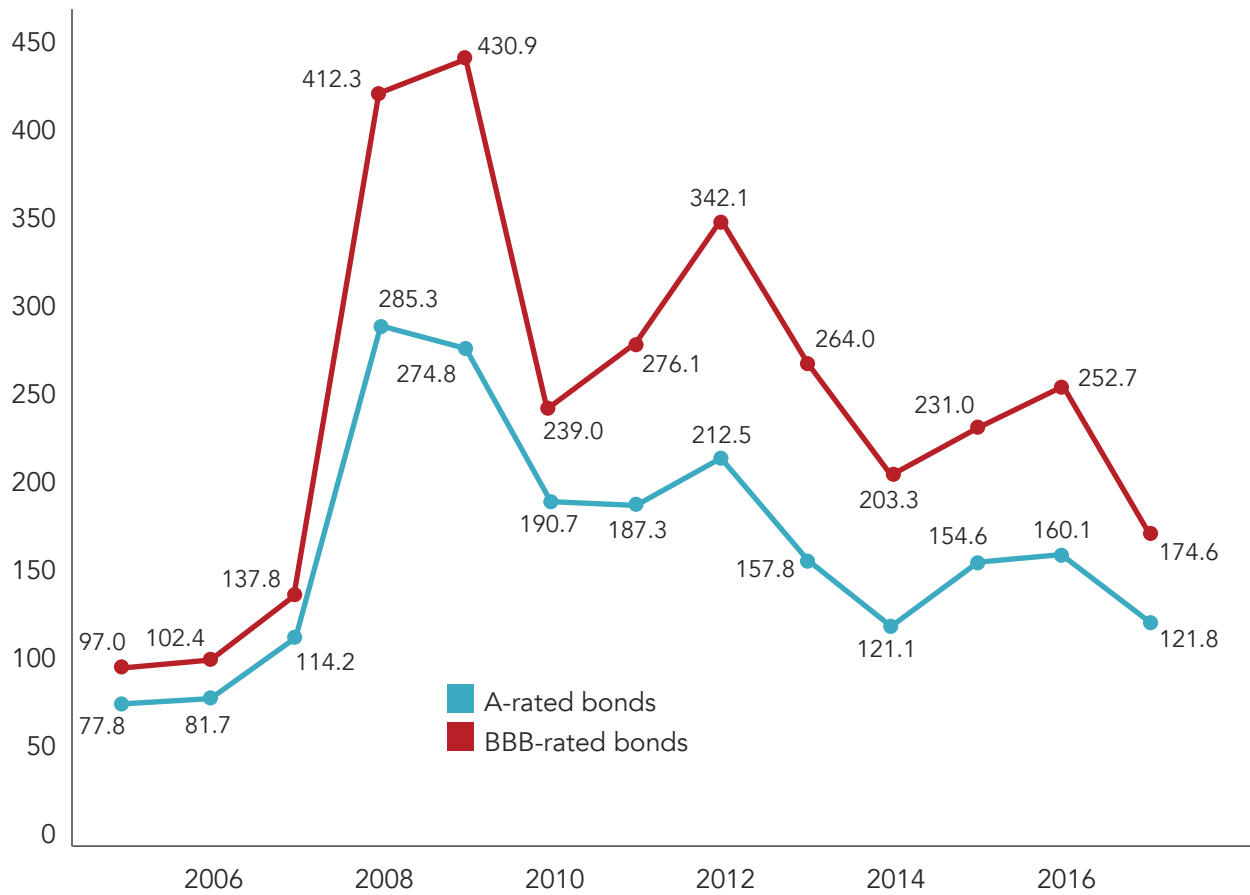


Source: Underlying data from APRA QADIPS. Calculations and visualisation by Benchmark Analytics.

FIGURE HH

CORPORATE BOND PRICING

Spread to Australian Government Securities, 3-10 year target tenors



Source: Underlying data from RBA. Calculations and visualisation by Benchmark Analytics.

Recommendation: A. Regional Banks support the Government’s levy on the major banks and Macquarie as a means of partly addressing the “too big to fail” funding advantage. As the levy only recoups a proportion of the “too big to fail” funding benefit, further policy interventions to reduce the benefit should be considered.



5.3 CAPITAL/RWA

Another significant subsidy to the major banks is implicit in the dual system of estimating risk-weighted assets.

As minimum capital requirements are set by reference to risk-weighted assets (not the full value of assets), these estimates are critical for determining capital levels and, therefore, overall leverage and profitability.

Smaller banks use an APRA-prescribed approach called 'standardised,' whereas the major banks and Macquarie use an APRA-accredited approach called internal ratings based (IRB). This system was introduced in 2008 (Basel II) and continued under Basel III.



This dual system has resulted in two problematic outcomes:

(a) Wide variations in risk-weight estimates between smaller 'standardised' banks and IRB banks, especially on residential mortgage loans.

Since the introduction of the dual system in 2008, the major banks' mortgage risk-weighted assets fell to an average of 16%, compared to the regional banks' average of around 39%.

(b) Mortgage loans by 'standardised' banks are subject to a 35% risk weight floor, whereas IRB banks do not face a per-loan floor.

For safe loans, such as those with a loan-to-value ratios (LVRs) below 70%, an IRB bank can assign very low-risk weights, and hold negligible capital against those loans. This gives the IRB bank a huge pricing advantage as only small interest margins are needed to cover capital costs.

One IRB bank has published data showing around one-quarter of its residential mortgages have risk-weights between 0.0% and 5%⁷. Whereas the lowest risk-weight of any smaller, standardised bank is 35% - a material differential. The differential has material implications for return-on-equity outcomes (per loan basis) and, as such, the ability of IRB banks to achieve return targets with lower interest margins.

Faced with this risk-weight differential since 2008, some smaller banks have invested heavily in risk management capability to achieve IRB accreditation⁸.

With very low relative risk-weights for housing mortgages, the big four banks all have strategic objectives to grow their mortgage portfolios⁹, although these strategies are pushing against an already heavily indebted household sector. The concern is that mortgage lending has come at the cost of credit to the real economy, that of non-financial corporations and small businesses.

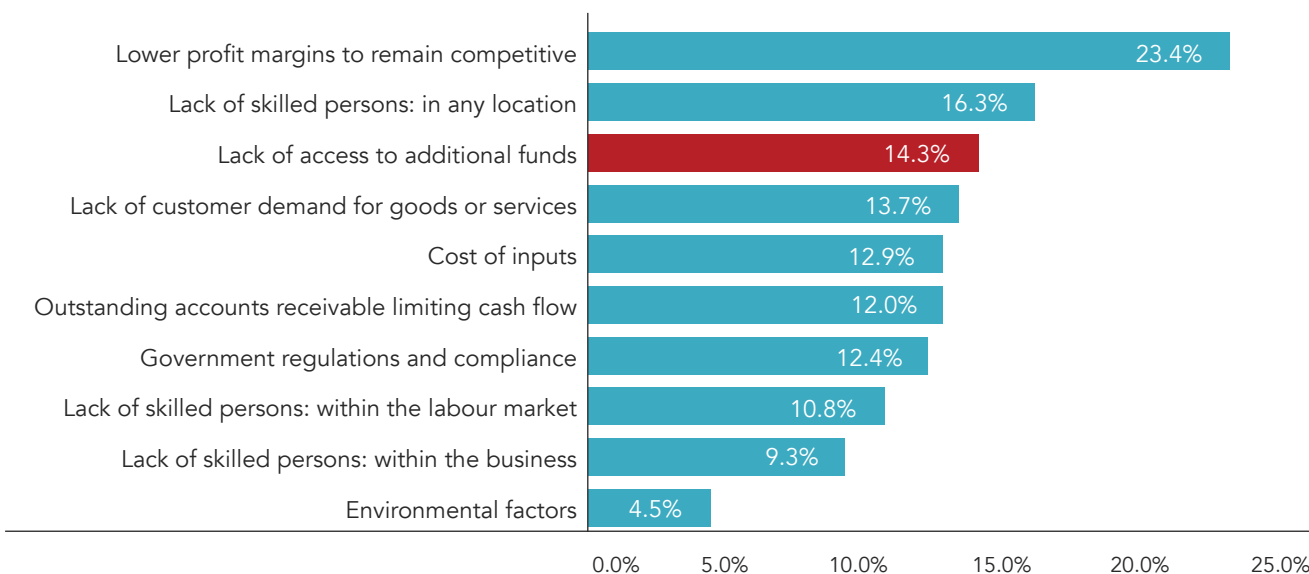
In August 1991, mortgages accounted for just 17% of major banks' assets. Today, mortgages account for 45% of total assets¹⁰.

ABS data suggests that lack of access to additional funds is a barrier to business performance and, critically, to innovation. Figure II shows that in the latest ABS survey of business characteristics, 14.3% of businesses responded that lack of access to additional funds was a barrier to their business performance. The leading barrier was the need to lower profit margins to remain competitive, followed by an absence of skilled labour.

FIGURE II

BARRIERS TO GENERAL BUSINESS ACTIVITIES OR PERFORMANCE

% of respondents, All business



Source: Underlying data from ABS. Calculations and visualisation by Benchmark Analytics.

⁷ See CBA Pillar 3 report, December 2016.

⁸ Publicly available media reports have identified some of the smaller banks that have lodged IRB applications with APRA.

⁹ PWC notes: "Our review undertaken in May found that Australia's major banks had to work hard in the first half of 2017 to maintain momentum, with two key factors supporting their results: continued growth in Australian housing lending and reductions in credit losses. In the quarter just passed, the story has remained largely unchanged as major bank executives executed the strategic and portfolio changes made to date". (PWC, 2017)

¹⁰ Balance sheet data for the major banks in 1991 is found on the RBA website <http://www.rba.gov.au/statistics/historical-data.html>. Recent data is taken from APRA's monthly banking statistics.

In terms of businesses that are actively innovative, around 24.5% of survey respondents cited lack of funds as a barrier to innovation, the second highest barrier cited, see Figure JJ.

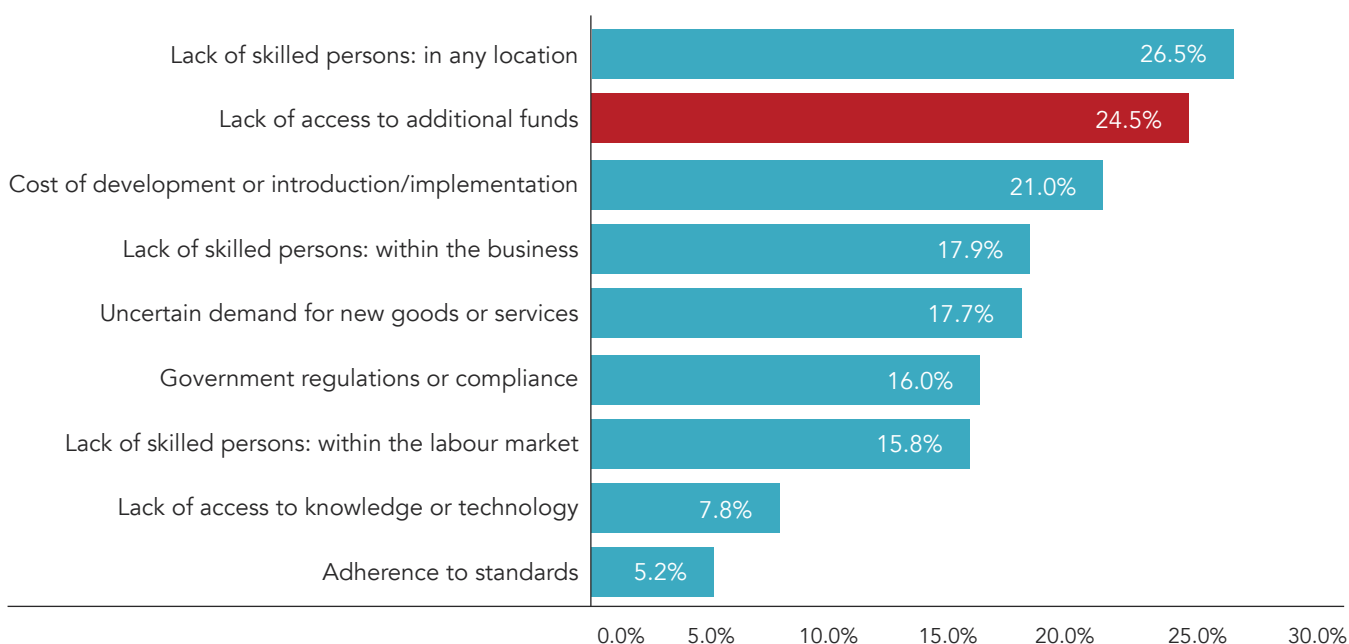
By adjusting the relative risk-weight between IRB and standardised, and mortgages and non-retail loans, there will be a higher incentive at the margin to increase business lending relative to housing lending.

Most effective is likely to be an increase in the mortgage risk-weight at the very safe end of the lending market, i.e. the minimum risk-weight on loans where the borrower is PAYE and the loan to value (LVR) is below 70%. The low risk weights in this segment make it a highly attractive asset for major banks, and acts as a disincentive to allocate capital to business.

FIGURE JJ

BARRIERS TO INNOVATION

% of respondents, Innovation active businesses



Source: Underlying data from ABS. Calculations and visualisation by Benchmark Analytics.

In the interests of contributing positively to further reform of risk-weights, the regional banks have designed a set of reform principles. These are:

1. *That the gap between IRB and standardised approaches remains too wide and that it should be further narrowed.*
2. *That the gap is most pronounced for loans with the lowest risk, and that this is where efforts to narrow the gap should be focussed.*
3. *That the gap is too wide in aggregate terms as reflected in the different leverage across bank balance sheets. There should be a narrowing in the difference in aggregate capital levels required under IRB and standardised approaches.*

That narrowing can be achieved by either lowering standardised risk-weights or raising IRB risk weights. For standardised loans, the risk-weight floor (currently 35%) should be reduced for low risk loans. Basel is currently considering a risk weight of 25% for low risk mortgages held by standardised ADIs.

4. *Should APRA form a view that IRB capital levels need to increase, this should be achieved through the introduction of a risk-weight floor on individual IRB mortgages, rather than via increases in the correlation factor.*
5. *That any narrowing does not eliminate the incentive for smaller ADIs to seek advanced accreditation.*

Recommendation: B. *Regional banks advocate further reform of risk-weight setting as per the set of key principles.*



5.4 MACROPRUDENTIAL COMPLEXITY

In 2015, APRA and the RBA imposed a macroprudential rule on mortgage investment lending, a 10% annual growth limit. In March 2017, APRA announced a 30% cap on the proportion of mortgage loans that are interest-only. The countercyclical buffer in Australia is currently set at zero. The 10% investor portfolio growth restriction has the effect of locking-in market share status quo. It is in effect similar to the 'yellow flag' being waved at the Grand Prix, where all drivers are then prohibited from overtaking one another.

Macroprudential rules (yellow flags) can have implications for consumer choice and pricing. This consumer cost needs to be fully considered in policy decisions, in addition to implications for competitive neutrality.

The largest four banks account for more than 80% of mortgage investor loans. By restricting all banks to a maximum of 10% growth, it is impossible for a smaller bank to make any headway in increasing market share, particularly when system demand is greater than the cap.

Regional banks are keen to explore mechanisms that better balance the need for macroprudential targets to be met, but do not undermine competition in the process.

As outlined in section 1.9, when S&P downgraded Australian banks due to housing price concerns, the major banks were exempted on the basis they have government support.

The effect of this exemption is to put more policy weight on macroprudential mortgage loan limits to cool the housing market. This disadvantages smaller banks by locking in major bank market share.

A good explanation of the issue and its implications generally was provided by David Carter, Suncorp's CEO Banking and Wealth, to the PC roundtable:

"Policy changes that fail to consider competition can also lead to poor customer outcomes. For example, while we understand the need for APRA to announce macroprudential interventions, the blunt nature of the tools selected has effectively frozen investor and interest only market shares at current levels, with detrimental consequences for competition.

The caps mean that smaller banks are limited to competing for owner occupied loans, as they cannot freely compete for investor and interest only loans without breaching APRA's cap. Customers with investor and interest only loans find it harder to switch banks, and the major banks, with the largest exposures to lending of this kind, can take advantage of the situation.

It is unsurprising that the major banks have significantly increased interest rates where competition is restricted (investor and interest only lending) and reduced interest rates where competition is strong (owner occupier loans). In aggregate, these changes have significantly improved the financial position of the major banks. For example, since December last year, one major bank has increased investor interest rates by 23 basis points, and interest only interest rates by 50-70 basis points, while reducing owner occupier interest rates by 5 basis points. This has resulted in an average interest rate increase of around 23 basis points across their residential mortgage portfolio, delivering an annualised benefit of almost \$900 million." (Carter, Evidence, Transcript of Proceedings, 2017)

An alternative competitively neutral approach is for APRA to implement its macroprudential investor lending disincentives by using minimum capital requirements to help restrain those banks which avoided the S&P rating downgrade (due to government support).

Recommendation: C. *APRA should engage with regional banks to design macroprudential rules that better balance macro outcomes and banking competition, and consider greater policy weight being given to minimum capital requirements.*

5.5 BROKER (VERTICAL INTEGRATION)

Around 53%¹¹ of mortgage loans are arranged through brokers. It is an important component of the mortgage loan distribution business.

A recent ASIC review (ASIC, March 2017) found evidence that major banks' ownership of broker platforms influences the proportion of loans the owner receives from the broker. This is a regulatory concern because mortgage brokers are obligated to ensure consumers get the most suitable loan product.

ASIC noted:

"Our review identified that competition in the home loan market is affected by ownership relationships between lenders and aggregators and the inability of smaller lenders to access or remunerate brokers in the same way as larger lenders.

Within consumer markets, better outcomes are usually seen where businesses compete with each other by offering the best product or service at the best possible price to the consumers, rather than competing with each other to offer better incentives to the distributors of their products. In the home loan market, this means that lenders should be primarily competing on the best home loan and customer service, rather than competing by offering higher commissions to aggregators and brokers.

...While the findings for Macquarie were mixed, overall there is evidence from the data for 2012–15 that ownership structures—particularly when combined with white label arrangements—have an impact on loan flows in the home loan market." (ASIC, March 2017)

Smaller banks are typically dependent on unbiased distribution networks to overcome the disadvantage of smaller physical branch networks and marketing budgets.

Regional banks support strong regulation in this area, including effective ownership disclosure obligations.

In its submission to the FSI, the regional banks recommended that mortgage brokers and aggregators owned by the major banks report publicly¹² and regularly on the proportion of their loan business directed to their owners.

Recommendation: D. Mortgage aggregators and brokers owned by major banks should publicly (and regularly) report on the proportion of loans they direct to their owners.

¹¹ See Australian Broker article: <http://www.brokernews.com.au/news/breaking-news/nonmajor-to-make-broker-channel-comeback-227860.aspx>. Note that ASIC's review of mortgage broking (published in 2017) found that brokers arranged 54.3% of loans for those banks included in the ASIC survey (ASIC, March 2017, p. 8).

¹² Regional banks support having customer outcomes at the centre of the industry's approach to changes to the remuneration and governance practices in the mortgage industry. We support an industry self-regulatory approach which promotes competition at all levels of the industry and ensures appropriate transparency of process for industry participants, government and consumers.



5.6 REGULATORY BURDEN

Regulatory change in the banking system is proceeding at an unprecedented pace. Many of the Government's recent changes have been announced as responses to bank scandals.

While well-intentioned, these regulations impose additional compliance burdens on all banking institutions.

However, the burden of implementing and complying with these new and changed regulations falls most heavily on smaller banks, given that the costs of compliance are typically fixed and independent of a bank's size.

Even where large banks incur higher absolute costs of regulation and other obligations, it is typically the case that smaller banks incur higher costs relative to their total revenue or assets. Major banks have a greater capacity to absorb these regulatory costs.

Indeed, economists argue that regulation is one of the most effective barriers to entry, and also can be used to increase the relative operating costs of a rival firm.

Exempting smaller banks from regulation is rarely a solution. Smaller banks do not want to sit outside mainstream regulatory rules. This has implications for customer confidence and fund-raising. Dual licensing regimes are typically non-competitively neutral.

Ensuring competitive neutrality is the right policy solution to minimise regulation.

Recommendation: E. That before any new regulations are introduced, greater consideration should be given to the impacts on smaller banks.

CONCLUSION

The banking system has generally served the market well over time. While other sectors of the financial system, such as superannuation funds, may play an increased role in the provision of capital to the economy in the future, the banking system will continue to play a significant and critical role in the intermediation of capital and provision of efficient payment systems. Regional banks will also continue to contribute to this process by providing competitive tension in the delivery of quality products and services to consumers, small business, and regional communities.

The GFC and increasing prevalence of industry issues (poor customer outcomes) provide the main backdrop to the PC's Competition Inquiry.

The big four banks have emerged from the GFC with larger balance sheets and even greater market dominance. The increase in industry issues has not transpired into a loss of market share for the big four banks. The big four are now so dominant, the vital connection between customer satisfaction and market share performance has broken.

The view of the regional banks is that the restoration of this link is critical for Australian consumers and the long-term contribution of the banking system. Ensuring genuine competitive neutrality is the key strategy in this task. By adopting the recommendations in this report, regional banks believe further headway can be made in improving the banking system, restoring competitive neutrality, and securing outcomes for consumers.



REFERENCES

- Areeda, P. E., Solow, J. L., & Hovenkamp, H. (2002). *Antitrust Law: An Analysis of Antitrust Principles and Their Application, Volume IIA Second Edition*. New York: Aspen Law & Business.
- ASIC. (March 2017). *Review of mortgage broker remuneration*. Sydney: ASIC. Retrieved from <http://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf>
- Australia and New Zealand Bank. (1992). *Report to Shareholders*. Melbourne. Retrieved from <https://www.shareholder.anz.com/sites/default/files/1992AnnualReport.pdf>
- Australian Bankers Association. (2016, April 21). *Banks act to strengthen community trust*. Sydney. Retrieved from <http://www.bankers.asn.au/media/media-releases/media-release-2016/banks-act-to-strengthen-community-trust>
- Australian Bureau of Statistics. (June 2017). *Australian National Accounts: National Income, Expenditure and Product*. Canberra: ABS.
- Australian Competition and Consumer Commission. (2008). *Merger guidelines*. Canberra.
- Bain, J. S. (1956). *Barriers to New Competition*. Cambridge: Harvard University Press.
- Baumol, W. J., & Willig, R. D. (1981). Fixed Costs, Sunk Costs, Entry Barriers, and Sustainability of Monopoly. *The Quarterly Journal of Economics*, 405-431.
- Bork, R. H., & Sidak, J. G. (2013). The Misuse of Profit Margins to Infer Market Power. *Journal of Competition Law & Economics*, 9, 511–530.
- Byres, W. (2017, April 28). *Prudential perspective on the property market*. Sydney. Retrieved from <http://www.apra.gov.au/Speeches/Pages/Prudential-perspectives-on-the-property-market.aspx>
- Byres, W. (2017, April 5). *Speech: Fortis Fortuna Ajiuvat: Fortune Favours The Strong*. Sydney.
- Campbell, J. K., McCrossin, R. G., Coates, A. W., Mallyon, J. S., Helkerston, K. W., & Argy, F. (1981). *Australian Financial System - Final Report of the Committee of Inquiry*. Canberra: AGPS.
- Carter, D. (2017, June 29). *Evidence, Transcript of Proceedings*. Melbourne. Retrieved from <https://www.pc.gov.au/inquiries/current/financial-system/roundtable-hearing/financial-system-roundtable-transcript.pdf>
- Carter, D. (2017). *Suncorp Submission to Productivity Commission*. Sydney.
- Diamond, D. W., & Dybvig, P. H. (1983). Bank runs, deposit insurance, and liquidity. *Journal of Political Economy*, 91(3): 401-419.
- Financial Conduct Authority. (2017, April 7). *Ring-fencing*. Retrieved from <https://www.fca.org.uk/consumers/ring-fencing>
- Haldane, A. G. (2012). *On being the right size. Institute of Economic Affairs' 22nd Annual Series, The 2012 Beesley Lectures*. London: Bank of England.
- Harper, I., Anderson, P., McCluskey, S., & O'Bryan, M. (March 2015). *Competition Policy Review - Final Report*. Canberra: Commonwealth Government.
- Hilmer, F. G., Rayner, M. R., & Taperell, G. Q. (1993). *Hilmer, F. G., Rayner, M. National Competition Policy: Report by the Independent Committee of Inquiry*. Canberra: AGPS.
- House of Representatives Standing Committee. (April 2017). *Review of the Four Major Banks (Second Report)*. Canberra: Commonwealth of Australia.
- House of Representatives Standing Committee on Economics. (2016). *Review of the Four Major Banks (First Report)*. Canberra: Commonwealth Government. Retrieved from http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Four_Major_Banks_Review/Report

- HSBC. (2017, May 5). UK Ring-fencing - Why are we changing our structure? London. Retrieved from <https://www.hsbc.co.uk/1/2/ringfencedbank>
- IMF. (April 2014). *How Big is the Implicit Subsidy for Banks Considered Too Important to Fail?* Retrieved from <http://www.imf.org/external/pubs/FT/GFSR/2014/01/index.htm>
- Industry Super Australia. (2014). *Submission to the Financial System Inquiry*. Melbourne: ISA. Retrieved from http://fsi.gov.au/files/2014/04/Industry_Super_Australia_2014.pdf
- Joye, C. (2017, May 12). Bank levy is cheap. *Australian Financial Review*.
- Kaysen, C., & Turner, D. F. (1959). *Antitrust Policy: An Economic and Legal Analysis*. Cambridge: Harvard University Press.
- Kolasky, W. J., & Dick, A. R. (2003). The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers. *Antitrust Law Journal*, 71, 207-251.
- Landes, W. M., & Posner, R. (1981). Market Power in Antitrust Cases. *Harvard Law Review*, 94, 937-996.
- Massola, J., Danckert, S., & Yeates, C. (2016, April 6). Malcolm Turnbull lashes banks over trust and standards following ASIC allegations. *The Sydney Morning Herald*. Retrieved from <http://www.smh.com.au/federal-politics/political-news/malcolm-turnbull-lashes-banks-over-trust-and-standards-following-asic-allegations-20160406-gnzjyh.html>
- Morrison, S. (2017, May 30). Major Bank Levy Bill 2017, Second Reading speech, Parliament House. Canberra, Australia. Retrieved from <http://sjm.ministers.treasury.gov.au/speech/012-2017/>
- Morrisson, S. (2017, May 14). Interview ABC Insiders. Retrieved from <http://www.abc.net.au/insiders/content/2016/s4668839.htm>
- Murray, D., & Davis, K. (2014). *Financial System Inquiry Interim Report*. Canberra: Australian Government.
- Noss, J., & Sowerbutts, R. (2012). *The implicit subsidy of banks*. London: Bank of England.
- PWC. (2017). Major Banks Analysis: June Quarter Snapshot. *Banking Matters*. Retrieved from <https://www.pwc.com.au/publications/major-banks-analysis-jun-quarter-17.html>
- Restoy, F. (2017, April 26). Financial soundness indicators - looking beyond the lessons learned from the crisis. Washington DC. Retrieved from <http://www.bis.org/speeches/sp170427.htm>
- Santos, J. A. (December 2014). Evidence from the Bond Market on Banks' "too big to fail" Subsidy. *FRBNY Economic Policy Review*.
- Sedgwick, S. (2017). *Retail Banking Remuneration Review*. Sydney: ABA. Retrieved from http://retailbankingremreview.com.au/wp-content/uploads/2017/04/FINAL_Rem-Review-Report.pdf
- Shorten, B., Bowen, C., Dreyfus, M., & Chalmers, J. (2016, April 8). Royal Commission into the Banking and Financial Services Sector. Retrieved from http://www.billshorten.com.au/royal_commission_into_the_banking_and_financial_services_sector
- Wallis, S., Beerworth, B., Carmichael, J., Harper, I., & Nicholls, L. (1997). *Financial System Inquiry Final Report*. Canberra: Australian Government Publishing Service.
- Westpac Banking Corporation. (1993, November 18). Westpac Reports Profit for 1993 Year. Sydney. Retrieved from <https://www.westpac.com.au/docs/pdf/aw/ic/res0993.pdf>
- Wikipedia. (2017, September 5). *AMP Limited*. Retrieved from Wikipedia: https://en.wikipedia.org/wiki/AMP_Limited
- Yeates, C. (2016, May 25). Taxpayer subsidy worth up to \$3.7 billion for the four big banks. *The Sydney Morning Herald*. Retrieved from <http://www.smh.com.au/business/banking-and-finance/taxpayer-subsidy-worth-up-to-37-billion-for-big-four-banks-20160525-gp3obl.html>

APPENDIX 1: TERMS OF REFERENCE

Competition in the Australian Financial System

Terms of reference

I, Scott Morrison, Treasurer, pursuant to Parts 2 and 3 of the Productivity Commission Act 1998, hereby request that the Productivity Commission (the Commission) undertake an inquiry into competition in Australia's financial system.

Background

The financial system undertakes a number of key functions both directly for households and in support of the operation of the whole economy. These include allocating capital, aiding the smoothing of consumption, helping manage risks, and providing payment services. The financial sector itself is the largest sector in Australia - accounting for around 10 per cent of our economy.

The 2014 Financial System Inquiry (the Murray Inquiry) considered that although competition generally appears adequate, the high concentration and degree of vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time.

The Murray Inquiry recommended that the Government strengthen the focus on competition in the financial system, including by reviewing the state of competition in the sector every three years. In response, the Government agreed to implement periodic reviews of competition in the financial system, and to tasking the Productivity Commission in 2017.

Following other recommendations of the Murray Inquiry, the Government has already commissioned other Productivity Commission work of direct relevance to furthering competition in the financial system, which this inquiry is intended to build on and complement. That work concerns data availability and use, and the efficiency and competitiveness of the superannuation system.

Scope of the Inquiry

The Commission is to review competition in Australia's financial system with a view to improving consumer outcomes, the productivity and international competitiveness of the financial system and economy more broadly, and supporting ongoing financial system innovation, while balancing financial stability objectives.

Without limiting related matters on which the Commission may report, its report to the Government should:

1. consider the level of contestability and concentration in key segments of the financial system (including the degree of vertical and horizontal integration, and the related business models of major firms), and its implications for competition and consumer outcomes
2. examine the degree and nature of competition in the provision of personal deposit accounts and mortgages for households and of credit and financial services for small and medium sized enterprises
3. compare the competitiveness and productivity of Australia's financial system, and consequent consumer outcomes, with that of comparable countries
4. examine barriers to and enablers of innovation and competition in the system, including policy and regulation
5. prioritise any potential policy changes with reference to existing pro-competition policies to which the Government is already committed or considering in light of other inquiries.

The Commission should have regard to the Government's existing wide-ranging financial system reform agenda and its aims to:

- strengthen the resilience of the financial system
- improve the efficiency of the superannuation system
- stimulate innovation in the financial system
- support consumers of financial products being treated fairly
- strengthen regulator capabilities and accountability.

Process

The Commission will commence the inquiry on 1 July 2017.

The Commission should undertake appropriate public consultation processes, including holding hearings and inviting public submissions.

It should consult widely, including with consumers, financial institutions and the agencies that regulate the financial system, in particular the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Reserve Bank of Australia. The Government has asked the regulators to consider making submissions on matters that relate to their areas of expertise.

The final report should be provided to the Government within 12 months of commencement.

Scott Morrison, Treasurer

[Received 8 May 2017]