Australian Banking Association

Competition into the Australian Financial System

ABA response to the Productivity Commission Draft Report

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Australian Banking Association

Executive Summary

Australia's banking system has performed well over the past decade, helping to grow and support the domestic economy. This was not the experience of other advanced economies, which generally faced contractions in their economies brought on by deep problems within their banking sectors.

A large part of Australia's success in the aftermath of the financial crisis can be attributed to an appropriate calibration of regulation, which for the most part, has balanced stability and competition well. The Australian economy has not only expanded over the past decade, but key products like mortgage lending are among the most competitive they have been, offering Australian households with innovative features at competitive prices.

Australian banks welcome competition and compete fiercely through not only price, but through constant innovations to products which continue to improve customers' experience. Banks are acutely aware of the need to innovate and compete given the well-known changes in business models and technology being experienced across industries.

Australian banks will continue to support evidence-based regulatory change that encourages competition and innovation while ensuring stability through the economic cycle. Consequently, Australian Banking Association (**ABA**) members support many of the draft recommendations in the Productivity Commission's draft report into *Competition in the Australian Financial System*. All members wish to operate in contestable and competitive markets where they can attract new customers.

But the ABA disagrees with characterisations throughout the report around implied behaviour of banks and an apparent lack of competition in banking, which we do not believe have been adequately backed by evidence.

We also do not believe a strong case has been made that a gap exists in our regulatory architecture for a new competition champion to be appointed. The ABA believes that APRA has performed well as a regulator, and we also note the Government's recent announcement of enhanced role for competition in ASIC's decision making.

This submission is not exhaustive. The ABA has focused on commenting on draft findings and recommendations where members hold a strong view. The ABA holds a diverse membership of major banks, smaller and regional banks as well as foreign banks. Members hold diverse views on policy settings so it is worth noting that for the most part, members agree on the ABA's position in this submission. Differences in views among the membership have been called out in this submission.

Finally, the banking industry has in recent years faced substantial regulatory change with many reforms aimed at encouraging new entrants into the system. These reforms must be given sufficient time to embed into the financial system before they are reviewed or expanded.

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1. Competition framework and assessment

1.1 Competitive industry that provides choice

PC draft finding II.1: State of competition in the financial system

"Australia's banking sector is a strong oligopoly with a long tail of smaller providers. The general insurance sector similarly has a small number of very large providers and a long tail of smaller providers.

"Prudential regulation substantially limits the scope for traditional price competition in banking and, to a degree, in insurance. The Reserve Bank of Australia setting of cash rates offers an opportunity for coordinated pricing in banking that is unique to this industry.

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

"Although at less than desirable levels, there is evidence of more competition (albeit on product features rather than price) in the markets for home loans, consumer credit cards, home insurance, wealth management and financial advice.

"There is evidence of less competition in the markets for small business credit, lenders mortgage insurance, add-on insurance and pet insurance."

ABA response

The ABA makes the following comments on draft finding II.1.

Australian banks welcome and encourage a competitive environment which enables firms to compete for consumers. Competition encourages innovation and ensures that resources are used efficiently and costs are minimised for customers, and shareholders receive good returns.

The banking industry is highly regulated, and this regulation constrains competition to some degree through limits on activities, funding and entry. For the most part, the ABA believes that regulatory barriers are well calibrated to protect individual customers and the economy, although there are some areas where competition could be enhanced through reforms.

We do believe that more can be done to level the playing field for smaller banks, including changes prudential policy settings that are outlined later in this report. We also note that innovations underway by the banking industry through opportunities from open data and the New Payments Platform (**NPP**) will make it even easier for customers to shop around for the best deal.

But the ABA rejects the overall characterisation by the Productivity Commission (**PC**) that consumers have no choice and that Australia's market is an oligopoly that limits choice and consumer surplus, that is the benefits derived by customers.

There are currently 140 authorised deposit-taking institutions (**ADIs**) operating in Australia, over half of which are banks, including retail, investment and mutual banks. The other half are predominantly credit unions and building societies. Canstar data, which is narrower in scope, shows there are around 90 institutions offering over 3,500 housing loans, 1,200 deposit accounts, 160 credit cards, and 185 business lending options.

Customers do not look at price alone to choose financial products. The ABA strongly believes that financial products should not be considered commoditised in the same way telecommunications and energy are perceived.

While price will always be an important factor, bank customers also consider:

- Product features that consider their specific financial circumstances such as offset accounts and redraw facilities, loan structure and so forth;

- Trust and brand loyalty;
- Service levels including the digital experience and innovation in new products and services;
- Accessibility including branch locations; and
- Aspects of corporate social responsibility ranging from environmental and social inclusion initiatives through to commitments to local communities.

The ABA believes that customers are best being served by competition when they are able to find a product that is suitable for their circumstances, rather than just at the lowest price. Investments in new technologies by the banking industry will continue to facilitate this decision-making process to the benefit of customers.

Australian customers report high levels of satisfaction with their banking provider. The most recent data from Roy Morgan shows a customer satisfaction rating of 81.2 per cent.

Figure 1.1: Customer satisfaction

Source: Roy Morgan

The ABA disputes the characterisation that "coordinated pricing" can occur in banking due to the Reserve Bank of Australia setting of cash rates that is unique to this industry for two reasons.

Interest rates offered by lenders on different products can at times vary substantially owing to different risk appetites and strategies, as well as wholesale funding cost and a banks' funding mix. We also noted in our first submission that Governor Lowe noted in Parliamentary testimony last year that the spread between the benchmark standard variable rates and the lowest available advertised rates has increased in recent years. The difference reflects both advertised and unadvertised discounts. It is not unusual for the discounts to be up to 1.5 percentage points.

Secondly, electricity and private health insurance are two examples where regulators mandate either selling or input prices in a similar way to the RBA setting the price of one banking input.

Consequently, we do not believe a strong case has been made to support this claim of coordinated pricing by the PC.

A separate point is that the ABA noted in our first submission that the market structure is not unique to Australia. It is worth restating two points:

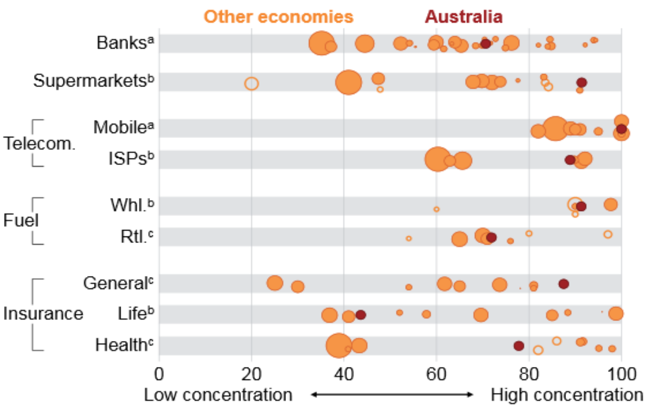
- The RBA found that while Australia has a concentrated financial system, Sweden, Canada and the Netherlands financial systems are more concentrated. The RBA's Governor Phil Lowe, noted in testimony to Parliament in September 2016 that "most banking systems are now very heavily concentrated" following the global financial crisis (**GFC**) which led to a number of mergers around the world. The Governor said, "we are not unusual in having four or five banks that account for the vast bulk of financial intermediation."

- The World Bank notes that bank concentration is often used as an indicator of bank competition "for lack of a better alternative". They note the competitive environment is also influenced by bank regulations, such as restrictions on entry, exit, and bank activities, as well as consumer preferences. In other words, concentration does not necessarily point to a low level of the contestability of the financial markets, or the ability of consumers to shop around for a better deal and the degree of barriers to new banking entrants.

The Grattan Institute's report *Competition in Australia: Too little of a good thing?* found that large firms are not dominant in Australia given the size of our economy.

For banking, Grattan's findings are similar to our original submission, in that Australia sits in the middle of the range for the three-firm market share of high range economies - at around 70 per cent. That share exceeds the 60 per cent in two-thirds of OECD economies. Grattan also noted that on the top-five bank metric, the market share of Australia's five largest banks is "a bit higher than other economies of Australia's size."[1]

Figure 1.2: Concentration ratios by sector, per cent



Notes: Bubbles typically represent OECD economies or large US state economies. Bubble size represents population. a: 3-firm; b: 4-firm; c: 5-firm. Unshaded bubbles mean that fewer firms are represented.

Sources: See Figure 2.2, Figure 2.3, Figure 2.4, Figure A.2, Figure A.3, Figure A.4, and Figure A.5.

Figure 1.3: Three-firm banking concentration, OECD economies

[1] Minifie, Jim; *Competition in Australia: Too little of a good thing?*, Grattan Institute, December 2015, p.15

Australia is a relatively small economy with a dispersed population over a large geography, and a federated system of government that increase regulatory complexity. These factors mean that many industries like telecommunications, energy, aviation and supermarket retailing tend to have several large players with a number of smaller competitors.

1.2 Competition and stability must work together

PC draft finding 2.2: Competition and stability must co-exist

"Competition and stability are both important to the Australian financial system. In order to preserve both, a genuine debate is essential before every material regulatory intervention.

"The stability of Australia's financial system has increased since the global financial crisis and prudentially regulated institutions are unquestionably strong. However, competition has suffered. It is important to ensure that the essential role of competition in economic growth is not eroded further by having stability as the default regulatory position."

ABA response

ABA members agree with draft finding 2.2 in that competition and stability are both important in the financial system, and this provides a unique aspect of regulation in financial services compared to other industries. However, we do not believe that the calibration of the two aims has been tilted too far in favour of stability to the detriment of competition, and we do not believe that the PC report has made this case.

Australia has a strong and well regarded financial system that offers customers with substantial choice. The calibration of Australia's financial regulation has carefully balanced competition and stability and been shown to work through the economic cycle. The Australian economy has continued to grow over the past decade despite substantial shocks, including the financial crisis and volatile commodity price cycles. The role of Australia's financial system in underpinning this growth should not be underestimated, and experience seen in North American and European economies is the strongest evidence of this.

We have internationally well-regarded financial regulators and a regulatory architecture that has been replicated by other countries. These regulators ensure that Australian banks can continue to access a significant single source of funding, that is offshore credit markets, while also ensuring that Australian customers can safely store their money and finance their homes and businesses.

Ensuring these offshore funding markets remain open for all banks but notably for major banks is important for the entire banking system. Both major and non-major banks rely heavily on the domestic deposits for funding. The major banks have a strong reliance on offshore markets for debt funding. If major banks were no longer able to access the offshore markets at a competitive rate, then smaller banks would face even more competition for funds in the domestic market. Consequently, the competitiveness of banks in offshore funding markets is an important factor to consider as a means to ensure competition in the banking system.

The ABA Financial Accounts highlights the importance of offshore funding. Almost 60 per cent of debt funding is borrowed from offshore ($139.9 billion in short-term funding and $327.1 billion in long-term funding). This is a significant additional source of funding to the $2.1 trillion of deposits held by banks.

Figure 1.4: ABS funding data for Australian banks

Sep-17	$billion	%wholesale
Short-term	$343.9	42%
. Bills of exchange	$13.6	2%
. ONP – domestic	$190.5	23%
. ONP – offshore	$139.9	17%
Long-term	$479.4	58%
. Bonds – domestic	$152.3	18%
. Bonds – offshore	$327.1	40%
Wholesale - total	$823.4	100%

Source: ABS

The ABA's non-major bank members note that in recent years following the financial crisis that regulators have focused more closely on stability and welcome the current discussion on enhancing competition.

All ABA members note that the policy settings must be durable through the economic cycle. The balance between competition and stability ensures that financial excesses don't build in the economy, but also continues to support economic growth through competitive and innovative products and services.

1.3 Empowering customers to make sense of choice and ensuring they benefit from innovation

PC draft finding III.1: Consumers' capacity to put competitive pressure on providers is often limited

"For many financial products, consumers are limited in their responses to variations in price and service and currently cannot be a source of significant competitive pressure on financial institutions. Consumers face information and switching barriers; and they perceive insufficient ongoing difference between providers and product offerings to make the process of switching worthwhile."

ABA response

The ABA disagrees with draft finding III.1.

The ABA provided significant background on factors affecting switching and customers' experiences of switching in our first submission, which do not support the PC's finding. Australians moving banks find it easier than other industries to switch and customers do switch.

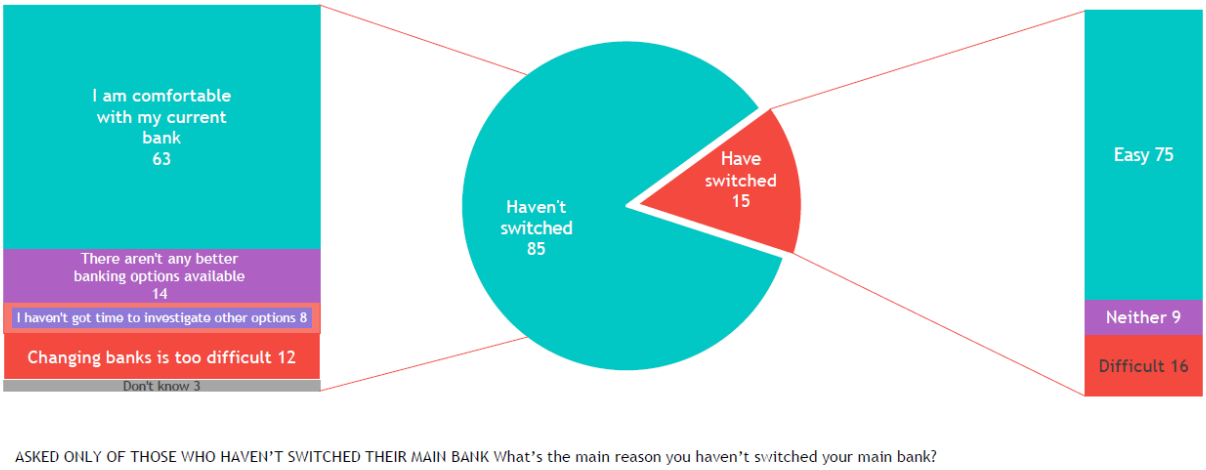
We also note that successive governments have undertaken reforms to make switching easier.

Direct debit authorisations are one remaining area of concern, but banks and new entrants are innovating and issues like this are likely to be resolved through innovations like the NPP.

Finally, customers chose banks based on a range of factors and not just price alone. Brands, digital experiences, local branch access and corporate social responsibility factors are just some of the factors leading a customer to stay with a bank.

New Galaxy research commissioned by the ABA in March questioned 1000 people on their banking relationships (Appendix A). It showed that most Australians were comfortable with their bank which is why they haven't switched their main banking relationship in the past three years (63 per cent of those who hadn't switched). Of those surveyed, 15 per cent had switched banks in the past three years, and of them, 75 per cent said it was easy to do so. The research is attached in Appendix A.

Figure 1.5: Galaxy switching



Source: Galaxy Research, March 2018

PC draft finding 2.1: Key features of workable competition in the financial system

"The key features of workable competition in Australia's financial system must include:

- *an open digital information capacity for consumers to assess how prices or features vary between products and choose (including switching to) preferred products*
- *consumers actively supported by public advice or private advisers to conveniently make informed decisions regarding aspects such as risk (including credit worthiness)*
- *an Open Banking regime that gives consumers perpetual access to their data that is useful to other providers, with the capacity to see it safely moved from one provider to another*
- *minimal limits to entry by new providers, and expansion by existing providers, into regulated product markets (subject to other regulatory objectives such as prudential outcomes)*
- *regulators more open-minded towards innovation and aware of the effects of their actions on weakening competition and creating consumer detriment*
- *effective scrutiny of the adverse use of market power by any participant or set of participants."*

ABA response

The ABA supports finding 2.1 subject to several points.

The ABA supports expansion of markets and encouraging new entrants provided customers are granted the same level of protection regardless of who the provider is, and the new entrant does not pose broader risk to the Australian financial system.

Open Banking will enable customers to access data and make sense of the choice available to them. Open Data in general will facilitate customers being able to assess prices and features and choose preferred products. This is the best way forward to provide customers with that information. We also note that many product comparison sites already exist, which help customers to choose products.

Finally, the ABA supports a whole-of-government approach to innovation policy with strong industry engagement across institution type to ensure sound and innovative policy settings are encouraged.

Greater innovation policy coordination between relevant regulators including APRA, AUSTRAC, and ASIC, together with Treasury, the RBA and the Government's Fintech Advisory Group that would enhance innovation reform within banking.

Australian Banking Association

2. The landscape of retail banking

2.1 The market structure of Australian banking

PC draft finding 3.1: The major banks' oligopoly power

"Australia's four major banks hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is further supported by regulatory settings, which contribute to the major banks' structural advantages.

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

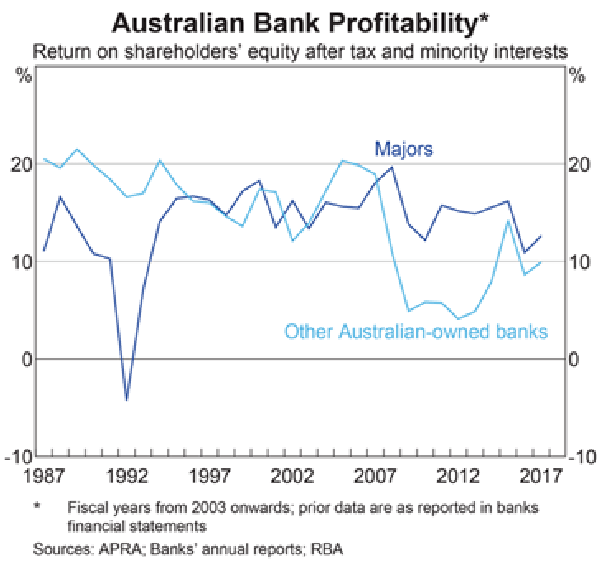
"The smaller banks and non-bank financial institutions follow the pricing trend set by the major banks, where they can. Size and scope, combined with regulatory advantages for the major banks, mean that competition from smaller institutions is not likely to prove sufficiently disruptive to offer consumers a market that is strongly competitive on prices."

ABA response

The ABA members differ in their views on draft finding 3.1.

Both majors and non-majors note that the market for new mortgages is among the most competitive it has been in decades. Strong competition exists in other products markets as well. This evidenced by falling net interest margins and returns on equity across the industry over the past decade.

Figure 2.1: Australian ROEs by bank type



Major banks strongly reject draft finding 3.1 for the following reasons:

- The major banks rely on competition settings being strong in order to compete with each other. The major bank's market share of mortgage lending in both investor and owner-occupier categories rose in the years following the financial crisis. But it peaked in 2013 and has been falling steadily since in both categories, according to analysis of APRA's monthly banking statistics.
- No single major bank has a large enough market share to set prices. Major banks do not act collectively. Rather they compete fiercely against each other and all other banks each month to grow new loans. Major banks pursue different strategies, have different portfolio risk appetites

and have different geographic presences. In some markets, the major bank is competing against a regional bank as the main competitor.

- Australia's regulatory settings enable major banks to compete competitively in offshore markets for funding which benefits all Australian banks. If major banks were unable to tap this source of funding, they would have even greater reliance on domestic deposits as a source of funding. Domestic deposits are the source of funding at around 60 per cent for both majors and non-majors. The regulatory settings benefit the whole market and ensure that all Australian banks can access capital to fund lending.

Smaller banks agree with the PC on part of the finding in that size and scope combined with regulatory advantages for the major banks, mean that competition from smaller institutions is not likely to prove sufficiently disruptive to offer consumers a market that is strongly competitive on prices. Smaller banks attribute this to two factors: differences in prudential policy, and the implicit guarantee.

2.2 Barriers to entry and expansion

PC draft recommendation 4.1: Reducing regulatory barriers to entry and expansion

"The Australian Prudential Regulation Authority (APRA) and the Australian Government should prioritise reforms that reduce regulatory barriers to entry and expansion in banking.

- *"APRA should finalise and implement its phased approach for licensing authorised deposit-taking institutions (ADIs) and revise its policies and guidelines for removing restrictions on the use of the term 'bank'.*
- *"The Australian Government should determine revised ownership rules (including a higher threshold on ownership) under the Financial Sector (Shareholdings) Act 1998 (Cth) to improve access to capital for both new entrants and existing banks. For existing ADIs, share ownership limits should be reviewed, without the presumption of the Four Pillars policy.*

"These reforms and determinations should be completed no later than end 2018."

ABA response

The ABA supports draft recommendation 4.1 in principal but would also like to highlight that APRA is already undertaking a number of reforms to reduce barriers and improve competition.

The ABA supports a review of licensing to streamline new entrants' regulatory processes provided all financial services providers and credit providers be required to maintain adequate financial requirements and compensation arrangements to ensure appropriate consumer protections.

The ABA supports modifying restrictions on the use of the term "bank" provided APRA continues to use its discretionary powers when appropriate.

The ABA does not agree that the reform process should be hastened and "*completed no later than end 2018".*

On 14 February 2018[2], APRA released a discussion paper on revisions to the capital framework and the leverage ratio requirement for ADIs, known as the "unquestionably strong" reforms to prudential regulation. The papers include proposed revisions to the capital framework resulting from the Basel Committee on Banking Supervision (BCBS) finalising the Basel III reforms in December 2017, as well as other changes to better align the framework to risks, including in relation to housing lending.

APRA should be allowed to take a holistic approach to implementing all reforms, to finalise the APRA policy for the phased approach for licensing authorised deposit-taking institutions (ADIs) prior to finalising the interdependent Basel III reforms.

All legislation deserves appropriate consultation and consideration.

[2] APRA begins consultation with ADIs on revisions to capital framework, http://www.apra.gov.au/MediaReleases/Pages/18_04.aspx

As previously stated, APRA is already undertaking a number of reforms to reduce barriers and improve competition.

APRA released its final revisions to the capital framework for mutually owned ADIS in relating to changes that provide these ADIs with more flexibility in their capital management in November 2017. Facilitating the ability of mutually owned ADIs to directly issue CET1 instruments was also the first recommendation of the recent Independent Facilitator Review (Hammond Review) into the mutual ADI sector.

In 2014, APRA developed the Mutual Equity Interest (**MEI**) framework for mutually owned ADIs. The advent of MEIs enabled mutuals to issue capital instruments that met the criteria for Additional Tier 1 and Tier 2 capital under APRA's capital adequacy framework. In July 2017, APRA proposed extending the MEI framework to allow mutually owned ADIs to issue CET1-eligible capital instruments directly without jeopardising their mutual status.

APRA released its final Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111). The changes improved the capital management flexibility available to mutually owned ADIs and came into effect from 1 January 2018.

2.3 Australian fintechs

PC draft finding 4.3: Most fintechs are focusing on less regulated services

"Australia's fintech sector has grown substantially in recent years and offers a range of financial services. However, few fintechs consider themselves to be challenger banks. The vast majority are focused on providing services in areas of the financial system with less onerous prudential regulation, such as wealth, small scale lending and payments systems. It remains to be seen if and how global technology companies will compete in banking and the broader financial system."

PC draft finding 4.4: Fintech collaboration and competition

"Many fintechs are attempting to work with and provide services to incumbent banks, rather than compete against them. Incumbent banks are also looking to collaborate with fintechs as a way to innovate and lower the threat of future competitors.

"While this is a legitimate and sensible commercial strategy for many, it means that these fintechs are unlikely to provide the basis for vigorous competition against incumbent banks in the near future.

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

ABA response

ABA members do not accept draft finding 4.3 and 4.4.

KPMG's quarterly *Fintech Pulse* noted that Australia was part of a global trend of increasing focus on digital mortgages. Tic Toc launched digital home loan offerings in 2017, and a new digital home loans broker Uno also raised funds from local investors.[3] Fintech Australia's own map of the fintech ecosystem also highlights the breadth of fintech start-ups activities across lending, personal wealth management, payments, and data analytics. While some of these start-ups collaborate with banks, many are seeking to disrupt or partner with established firms in other industries.

Finally, it is important to note that financial innovation and competition in banking services is also likely to emanate from other industries like technology (where this is already being seen in the United States and China by players like Tencent and Amazon) as well as other industries in Australia (for example, retailers).

[3] https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2018/02/pulse_of_fintech_q4_2017.pdf

Information request 4.1: Should ASIC's regulatory sandbox be extended?

"Should the fintech licensing exemption offered under the Australian Securities and Investments Commission's (ASIC's) regulatory sandbox be extended to prudentially regulated fintechs that want to take retail deposits and issue other eligible financial products? If extended, would:

- *"an extension encourage new fintechs to become banks or providers of financial products*
- *"any additional consumer protections be necessary to prevent poor conduct and retain consumer confidence?"*

ABA response

The ABA recommends that the regulatory sandbox be modified to become more accessible for market participants and ensure that the modifications encourage collaboration between existing institutions and start-ups.

Both Treasury and ASIC have consulted on regulatory sandbox design over the past year. The ABA has made submissions to these processes. One of the greatest change to increase the uptake of regulatory sandbox concession is to follow the lead of vibrant fintech ecosystems like the United Kingdom and Singapore which allow fintechs to partner with incumbent firms within the sandbox environment. Both regimes have resulted in successful launches of new financial products from their regulatory environment so we believe that both Treasury and ASIC should look to these lessons in designing their sandboxes.

The ABA supports ensuring important consumer and financial stability protections apply not just to banks, but other entities that offer banking services. This will ensure the same standards apply to regulated entities, and that consumers are not exposed to different practices and safeguards by institutions and firms offering the same products, particularly where consumers may not be aware of these differences.

2.4 Funding costs

PC draft finding 5.1: Cost of funds for different size banks

"Larger authorised deposit-taking institutions (ADIs) benefit from lower costs of funding, compared with smaller institutions, as they can access funding markets overseas more easily and have higher credit ratings, which in part reflect an expectation of government support.

"In addition, larger institutions gain a cost advantage from being allowed to use risk weights that are lower than the Australian Prudential Regulation Authority's standard requirements.

"These lower costs of funds are not fully passed on to borrowers in the form of lower interest rates.

"Attempts to artificially raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and harm consumers."

ABA response

The ABA questions the analysis behind draft 5.1 The findings reference large and small banks when in fact any analysis should have been conducted with reference to standardised and Internal Ratings Based (**IRB**) approach to credit risk.

The standardised approach uses a common set of risk-weights that seek to reflect general risks of different asset classes. These are not tailored to a specific ADI and are set at a conservative level to ensure adequate capitalisation to cover risk.

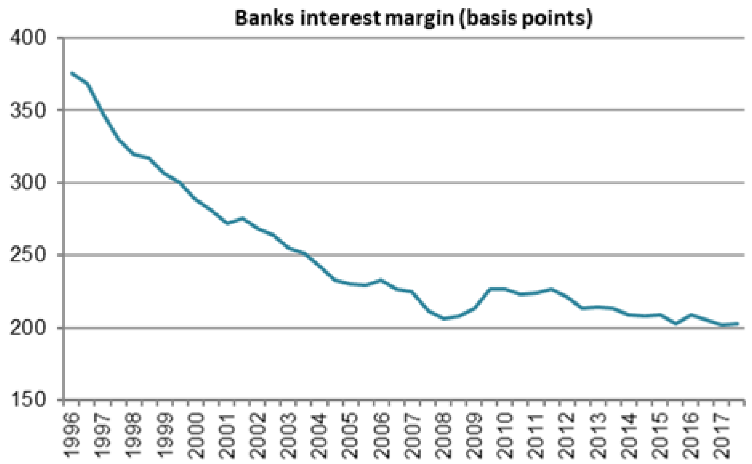
The IRB approach uses an ADI's internal model to assess risk at a granular level for the asset and institution. Achieving accreditation to use the IRB approach requires a strong and sophisticated risk management framework and capacity. It also includes some more stringent specific requirements that are different to the standardised approach. The two approaches are broadly but not directly comparable at a risk-weight level.

An ADI's overall cost of funding, in turn depends on the ADIs' cost of debt, cost of equity, required capital ratio, tax rate, and change in risk-weights and other regulatory reforms which impact the forms of funding for an ADI. Therefore, the ABA disputes the conclusions drawn by the PC from Figure 3 Home Loan interest rate spread on page 8 of the PC's Interim report[4]. The chart details the spread between home loans and the cash rate. The cash rate is not the only factor influencing interest rate for residential mortgages and other loans, thus for the report to draw the conclusion[5] that "the fall in the cash rate does not appear to have been fully passed on in lower prices across the board" is not correct as it does not fully reflect all factors that influence funding costs.

The March 2018 ACCC report *Residential mortgage products price inquiry*[6] details[7] the components of a hypothetical bank's funding costs. The ACCC report also dedicates an entire chapter (Chapter 4) to the significant effect of prudential regulation on funding costs for Australian banks.

The ABA disputes that customers are not benefiting from competition. The ABA would also like to draw the attention of the commission to the fact that over 2017, the major banks' NIM were at the lowest level in decades, ending the 2017 year at 203 basis points. The net interest margin is the most appropriate measure to consider here because it adequately captures both wholesale and deposit funding costs as well as price competition on new products.

Figure 2.1: Major bank NIM



Source: UBS

[4] https://www.pc.gov.au/inquiries/current/financial-system/draft
[5] Page 8
[6] https://www.accc.gov.au/about-us/inquiries/residential-mortgage-products-price-inquiry/interim-report
[7] Box 3.2

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2.5 The costs of APRA interventions in the home loan market

PC draft finding 6.1: Cost of APRA interventions on home loans

"The Australian Prudential Regulation Authority's (APRA's) actions to slow interest-only lending on residential property in early 2017 resulted in higher interest rates on both new and existing residential investment loans, despite the regulatory objective being to slow new lending.

"This led to a windfall gain for the banking sector.

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

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

ABA response

The ABA disagrees with draft finding 6.1 and notes while there has been a disproportionate impact on smaller lenders, APRA's intervention successfully slowed growth in a market that was concerning policymakers.

The ABA challenges the PC's view that a single macro-prudential intervention by APRA in March 2017 to slow interest-only lending on residential property is a sole cause of higher interest rates on both new and existing residential investment loans. The ABA disagrees that the March 2017 macro prudential measure restricted competition. The ABA would hold that the 2014 macro-prudential measure where APRA placed a 10 per cent cap on lending to property investors did restrict competition, not the subsequent macro prudential measures announced in 2017.

We would note that the 10 per cent cap on lending to investors had a greater impact in small and medium ADIs ability to compete; as the smaller size of their investor mortgage book (relative to the 4 major banks), meant that the ceiling of a 10 per cent cap on lending to investors was more easily reached, limiting their ability to compete for new customers or retain existing customers who were seeking an additional investment loan.

The ABA notes that APRA, appearing at Senate Estimates on 28 February 2017 stated that the lending cap introduced in 2014 was reaching "the end of its useful life" and "is potentially becoming redundant".[8]

APRA cited two key reasons for the potential removal of the cap, since the cap was introduced, APRA had been working with all banks to develop stricter underwriting standards for investor loans; and APRA estimated average investor loan growth was currently running at just 5 per cent which indicated to APRA that banks were working hard to comply with the restriction.

The PC's draft finding 6.1 does not consider or include any of the capital impacts (and the subsequent impact on products and prices) of the 2014 Financial System Inquiry (**FSI**) recommendation (subsequently endorsed by the Australian Government) that required APRA to set capital standards such that capital ratios of ADIs are "unquestionably strong".

APRA announced "unquestionably strong" capital benchmarks, its assessment on the additional capital required for the Australian banking sector to have capital ratios that are considered "unquestionably strong" In July 2017.[9] The four major Australian banks now need to have CET1 capital ratios of at least 10.5 per cent to meet the unquestionably strong benchmark. For other ADIs, the effective increase in

[8] http://parlinfo.aph.gov.au/parlInfo/download/committees/estimate/af9a41aa-5001-4587-b5a1-a4a6e26a950f/toc_pdf/Economics%20Legislation%20Committee_2018_02_28_5940.pdf;fileType=application%2Fpdf#search=%22committees/estimate/af9a41aa-5001-4587-b5a1-a4a6e26a950f/0000%22

[9] APRA INFORMATION Paper, (19 July 2017) Strengthening banking system resilience – establishing unquestionably strong capital ratios, http://www.apra.gov.au/adi/Documents/Unquestionably%20Strong%20Information%20Paper.pdf

capital requirements to meet the 'unquestionably strong' benchmark will be around 50 basis points. ADIs are expected to meet the new benchmarks by 1 January 2020.

Since the Government accepted the FSI's unquestionably strong recommendation APRA has repeatedly and publicly flagged that changes to capital ratios were coming and all impacted ADIs needed to start to prepare for these higher capital ratios.

On 14 February 2018, APRA released a Discussion Paper on, *Revisions to the capital framework and the leverage ratio requirement for ADIs*, known as the 'unquestionably strong'" reforms to prudential regulation. The paper includes proposed revisions to the capital framework resulting from the BCBS finalising the Basel III reforms in December 2017, as well as other changes to better align the framework to risks, including in relation to housing lending.

In July 2015, APRA announced changes to the treatment of residential mortgages for banks able to use internal models for capital adequacy purposes.[10] In particular, APRA adjusted the risk-weight calculation used by ADIs accredited to use the internal ratings-based (**IRB**) approach to credit risk. The adjustment was intended to increase the average risk-weight on Australian residential mortgage exposures, measured across all IRB ADIs, from approximately 16 per cent to an average of at least 25 per cent. The increase in IRB risk-weights came into effect from 1 July 2016. These reforms would also have an impact onthe mortgage books of the IRB banks.

The draft recommendation also does not consider the substantial revisions to the capital framework resulting from the BCBS finalising the Basel III reforms in December 2017 after several years of consultation and debate.

All of the above interlinked prudential reforms were years in the making and each were destined to impact the capital, funding and liquidity profiles of all Australian ADIs. APRA, in numerous speeches from 2015 onwards (as the Basel III revisions were being debated) flagged these changes and rightly urged Australian banks to prepare or be a 'boiled frog'.[11]

The ABA holds that it is impossible to draw a conclusion from a single macroprudential intervention by APRA without any reference, or consideration of the impacts that recent and ongoing reforms to all Australian ADIs, and the flow-on impact that would have on an ADIs pricing and product offerings.

[10] APRA increases capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach, http://www.apra.gov.au/MediaReleases/Pages/15_19.aspx

[11] Key issues for the year ahead: bank capital and boiling frogs http://www.apra.gov.au/Speeches/Pages/Key-issues-for-the-year-ahead-bank-capital-and-boiling-frogs.aspx

3. The residential home loan market

3.1 The broker mortgage market

PC draft finding 8.1: Interest rates from brokers versus other channels

"Home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels. Further analysis is needed to inform the Commission's view of the sources of such differences and whether they are significant."

ABA response

The ABA accepts the PC's finding that home loans originated by mortgage brokers have only slightly lower interest rates than those originated through direct channels and that further analysis is needed.

The PC's finding aligns with Finding 6 of ASIC's *Report 516, Review of Mortgage Broker Remuneration* with the data ASIC obtained not showing a "consistent trend that brokers obtained either cheaper loans or more expensive loans".

The feedback from our member banks is also consistent with this finding. The Australian home lending market has been fundamentally reshaped by the emergence of mortgage brokers. There are over 16,000 residential mortgage brokers operating in our market[12] and they are involved in brokering over 50 per cent of all loans.[13]

Australian banks have responded to the competitive pressure brought by brokers by focusing on providing the most competitive interest rates for customers, irrespective of the originating channel. This competition has not only benefited the customer in terms of price as the role of brokers extends to other aspects of taking out a loan, such as identifying the right product features (i.e., offset accounts), to meet a customer's individual needs.

We believe it should be easier for Australians to understand the pricing between channels. We are actively involved in the work of the Combined Industry Forum (**CIF**) to establish a new public reporting regime of customer outcomes and competition in the home loan market, which is in line with proposal 5 of ASIC's Report 516, Review of Mortgage Broker Remuneration.[14] This will involve additional reporting by lenders (for example, weighted average pricing of home loans across different distribution channels) and aggregators (for example, spread of lenders being used by brokers) to ASIC.[15] It will also involve brokers publishing information for customers covering their relationship with lenders to assist customers determine the right home loan.[16]

[13] MFAA, 2017, About our industry, available online at: https://www.mfaa.com.au/our-industry/about
[14] ASIC report 516, http://download.asic.gov.au/media/4213629/rep516-published-16-3-2017-1.pdf
[15] Combined Industry Forum, *Improved Customer Outcomes: The Combined Industry Forum response to ASIC Report 516: Review of mortgage broker remuneration*, available at: https://www.mfaa.com.au/sites/default/files/users/user130/CIF_Report_Submitted_281117_0.pdf
[16] Ibid.

Australian Banking Association

PC draft finding 8.2: Cost of home loans through brokers versus branches

"Mortgage brokers enable smaller lenders to gain wider reach, increasing product variety in the home loan market. Whether brokers are an efficient, lower-cost distribution channel for lenders depends in large part on the way lender branch costs are apportioned between different activities.

That the providers of half of Australia's home loans were unable to give evidence on how they assess the costs and benefits of using brokers rather than branches to source home loans is surprising."

ABA response

Mortgage brokers provide a specific service in the market and customers often have different expectations to what they expect from a bank. For example, brokers will often visit a customer's home and work closely with them to deal with paperwork and negotiate with lenders.

Brokers also play an important role in facilitating competition by offering distribution channels for lenders, such as smaller banks, with limited or no branch network. Brokers also enable banks to scale distribution and act as an important variable cost channel.

ABA draft recommendation 8.1: Duty of care obligations for lender owner aggregators

"The Australian Securities and Investments Commission should impose a clear legal duty on mortgage aggregators owned by lenders to act in the consumer's best interests. Such a duty should be imposed even if these aggregators operate as independent subsidiaries of their parent lender institution, and should also apply to the mortgage brokers operating under them."

ABA response

The ABA is committed to working towards enhancing consumer protections in home lending, including in the mortgage broker market.

Through involvement with the CIF, the banking industry is already taking action to better protect consumer interests, such as for the first time, defining what constitutes 'good customer outcomes' and setting new standards to assess whether loans are appropriate and meets a customer's requirements and objectives. However, the banking industry is also committed to considering further reforms to protect consumers and drive higher standards of conduct.

Good customer outcomes

The ABA is actively involved in the work of the CIF work to provide enhanced protections for customers applying for home loans. An important milestone has been the commitment of CIF participants to establish a new definition of "good customer outcome" in mortgage broker dealings with clients, which is set above current legal obligations. This new definition builds on existing legislative requirements and will establish a new industry standard for brokers.

The definition of "good customer outcome":

> *"The customer has obtained a loan which is appropriate (in terms of size and structure), is affordable, applied for in a compliant manner and meets the customer's set of objectives at the time of seeking the loan."*

This is a standard above existing compliance with responsible lending obligations and requires consideration of four key measures that need to be satisfied to determine a 'good customer outcome':

- Appropriate size and structure of the loan;
- Meeting the customer's stated requirements and objectives;
- Affordability for the customer; and
- Applied for in a compliant manner (meeting all responsible lending requirements).

The implementation of this new standard by the industry is an important step in improving consumer outcomes in the home lending market.

Giving the client's interests' priority

The ABA supports further exploration of a duty on both aggregators and mortgage brokers to prioritise the interests of a customer ahead of their own. This duty would be a means of addressing concerns that aggregators and brokers make business decisions and/or recommendations to customers that are conflicted, or motivated by, their own interests.

Such a duty, known as the "conflicts priority rule", could be similar the duty imposed on financial advice providers under section 961J of the Corporations Act 2001 (Cth) which was introduced as part of the Future of Financial Advice reforms in 2013. However, the duty would need to be designed and fit for purpose for the mortgage broking industry, which is fundamentally different to the financial advice industry.

If a similar model was adopted for the home lending market, aggregators and brokers would not be permitted to act to further their own interests or those of a related party over those of the customer when providing the service. In complying with the duty, mortgage brokers would potentially need to consider what a reasonable mortgage broker without a conflict of interest would do.

The ABA believes that exploring the "conflicts priority rule" has considerable merit as it can be clearly articulated and compliance documented.

The banking industry is currently considering the potential formulation of this obligation and how it could be codified. We support consideration of this obligation being implemented through a robust industry code, such as the mortgage industry code that will be developed by the CIF.

Perceived ownership conflicts

We note the proposal for any new duty to apply to aggregators owned by lenders, and the mortgage brokers operating under them. We accept the perceived conflict of interest for bank owned aggregators, and through the CIF, the industry has committed to prominently disclosing these ownership structures where "significant influence" is exerted, for example, where a board seat is held or ownership is greater than 20 per cent.

PC information request 8.1: How should new duty of care obligations for lender owned aggregators be implemented?

"How should obligations on lender-owned aggregators to act in clients' best interests be imposed? Can such obligations be imposed under the current regulatory and licensing regime (the National Consumer Credit Protection Act 2009 (Cth)), or is there a need for a separate regime for mortgage aggregators and brokers?"

ABA response

The industry should take the opportunity to develop and implement the new obligation through a robust and enforceable industry code. The code to be developed through the CIF would apply to mortgage brokers, lenders, aggregators and, where appropriate, referral businesses and would be subject to all applicable regulatory and competition law approvals. If legislation is required, we support utilising the existing NCCP regime, rather than implementing a new legislative framework.

Information request 8.2: Should consumers pay broker fees for service?

"Should consumers pay mortgage brokers directly through fees for service (rather than brokers receiving commissions from lenders)? What is the likely effect on consumers' use of brokers and on home loan providers' ability to source home loans through brokers? What is the likely effect on brokers' incentives to recommend loans to consumers?"

ABA response

A consumer paid fee for service models should be approached with caution. We are concerned that such a model may:

- result in additional direct costs to consumers to access the broker channel;
- put brokers at a significant disadvantage to the lender branch channel (who do not charge direct fees);
- result in rationalisation of broker numbers, increasing barriers to entry for new lenders, whilst disadvantaging smaller lenders and those without a branch footprint
- not correlate to economic value produced by the broker; and
- result in brokers servicing a much narrower band of customers.

Through the CIF, the industry has committed to remove incentives for a broker to recommend the customer borrow more than they need or will use, by calculating commissions on drawn down amounts net of offset.

PC draft recommendation 8.2: Mortgage broker disclosure requirements

"The Australian Securities and Investments Commission should require that before mortgage brokers recommend loans to consumers, they must have a discussion with consumers about, and provide plain-English documents to consumers on:

- *"the types of products offered by different lenders (including white-label loans and which lender provides the funding for them) and associated loan features;*
- *"the role of mortgage brokers in matching borrowers with home loan providers, including how brokers are limited in their ability to help consumers apply for loans from all lenders because not all lenders are on the aggregator's panel or the broker is not accredited with a particular lender;*
- *"how mortgage brokers are paid (including specific information about their payment arrangements);*
- *"any ownership relationships between lenders and the aggregator, and the requirement for brokers to act in consumers' interest where an ownership relationship exists (draft recommendation 8.1).*

"Specific details regarding the information provided and the way it is presented should be developed through consumer testing to ensure that consumers understand the information, and the effect of these measures should be reviewed after they have been implemented."

ABA response

The ABA fully supports clearer disclosure requirements in the mortgage broking industry, which will better inform customers and improve competition in the home lending market.

The banking industry supports the work of the CIF in moving to establish a new public reporting regime across aggregators, lenders and broker and will involve improved disclosure to ASIC and customers. The CIF has proposed the following disclosures:

Aggregators will disclose:

- List of all lenders available on panel and percentage share of business written with each over the previous financial year
- Spread of number of lenders being used by brokers in the group/aggregator (in the last 12 months):
    - Percentage of brokers using fewer than three lenders;

  - Percentage of brokers using four to seven lenders;
  - Percentage of brokers using eight plus lenders; and
- Weighted average commission rate percentage earned in the previous financial year for mortgages.

Lenders will disclose to ASIC:

- Weighted average pricing of home loans in the previous financial year across their different distribution channels using various standard scenarios (to be defined).

Brokers to publish to customers:

- List of lenders available to the customer via the broker's aggregator;
- Number of lenders used in the previous financial year;
- Top six lenders and the percentage of business written in the previous financial year.

These commitments align with ASIC's proposals and will be implementeds by end 2018.

The ABA notes that these new obligations will strengthen the existing NCCP provisions requiring mortgage broker commissions to be disclosed to customers.

Ownership structure disclosure

The ABA supports initiatives to support clear and effective disclosure of ownership structures in order to address perceived conflict of interest for bank owned aggregators home lending and help to build consumer confidence through increased transparency.

Through the CIF, the industry has committed to prominently disclosing these ownership structures where 'significant influence' is exerted, for example, where a board seat is held, or ownership is greater than 20 per cent. The industry has also committed to ensuring that this disclosure obligation applies to all players in the home loan distribution chain and be included in relevant marketing material.

3.2 Home loan data

PC draft recommendation 8.3: Collection of home loan interest rate data

"As part of the modernised Economic and Financial Statistics collection, the Australian Prudential Regulation Authority should, on behalf of the Australian Securities and Investments Commission, collect monthly data from mortgage lenders (ADIs and non-ADIs) on median interest rates for different categories of new residential home loans.

"The categories of loans should be developed through consultation, but the data to be collected may include that relating to features of the loan or borrower, such as:

- *the size and length of the loan*
- *the loan-to-value ratio*
- *loan fees*
- *the type of borrower (owner-occupier or investor)*
- *the type of repayments (principal-and-interest or interest-only)*
- *the type of interest rate (fixed or variable), and, for fixed rates, the length of the fixed period*
- *the credit rating(s) of the borrower(s)*
- *the nature of employment of the borrower(s) (for example, permanent full time, permanent part time, self-employed)*

- *the industry of employment of the borrower(s)."*

ABA response

The ABA understand the importance of providing data to regulators but we do not believe the data outlined in draft recommendation 8.3 will be useful in meeting its intentions in draft recommendation 8.4.

It is worth highlighting, however, that ABA members provide significant data to regulators including the ABA, APRA, ASIC, ATO, Austrac and the RBA. ABA members also meet many ad hoc data requests including from agencies like the PC.

The Economic and Financial Statistics collection undertaken by the three agencies (APRA, ABS and RBA) has recently been revised and the rollout of this project will occur through to the end of 2019 with significant implementation costs and time being invested by the banks in this process. Costs involve IT expenditure to make necessary changes to IT systems both internally as well as ensuring secure transfer system, along with significant costs associated with data quality. Given this, the industry asks that any process to further expansion to data collection is not considered until after the current project ends.

Furthermore, as the ABA noted in its submission to APRA on the previous data collection process, future data collection processes run by the three agencies must have appropriate project governance to ensure that the data collection is well managed and does not impose any unnecessary costs on the industry. Finally, the process could be enhanced by better industry engagement by the agencies, especially with smaller banks.

3.3 Home loan comparison site

Draft recommendation 8.4: Interest rate transparency rate for home loans

"The Australian Securities and Investments Commission should, using data collected on its behalf by the Australian Prudential Regulation Authority (draft recommendation 8.3), develop an online tool that:

- *allows consumers to select different combinations of loan and borrower characteristics;*
- *reports median interest rates for loans issued in the previous month with those characteristics by lender;*
- *details the specific fees and charges that would affect the total cost of a loan.*

"The Australian Prudential Regulation Authority should also publish the underlying data in a way that is accessible to third parties such as web application developers, so that these parties are able to develop comparator websites if there is a commercial benefit in doing so. Making data accessible would, at a minimum, require it to be published in a machine-readable format."

ABA response

The ABA does not support recommendation 8.4 as we do not believe that this portal will be effective in providing customers with useful information to assess mortgage choice.

The ABA acknowledges that at times customers face difficulties comprehending the range of choice available to them. However, we do not believe that a regulator-run comparison website will provide customers with meaningful information to help them choose the best home loan specific to their needs and features they desire. This follows from an earlier point that customers look beyond price when choosing a home loan, considering aspects like loan features as well as the services offered by the issuing bank.

Median interest rate comparisons are likely to confuse and mislead customers and may lead to perverse consequences for lenders. Banks determine mortgage interest rates based on factors such as a bank's wholesale funding mix and cost, its portfolio risk appetite and business strategy, as well as its own analysis of a borrower's circumstances. The borrower's circumstances include their financial position, the size of the loan and the location of the property.

These factors mean median loan comparisons are meaningless for all but the small number of Australians who fall at the median across a range of indicators.

On the lender side, such a website may lead to unintended alignment of loan prices across the industry, and may lead lenders to consider if they lend to those borrowers who deviate dramatically from the median.

The history of similar initiatives in other industries like FuelWatch and Grocery Choice suggest such a website is unlikely to provide customers with the information they seek in assessing home loans. These websites were criticised for providing information that was non-comparable, dated and did not provide a coherent picture of the range or availability of products for customers relevant for their circumstances.

The ABA also notes that many product comparison websites already exist for home loan products including finder.com.au, Loans.com.au, ratecity.com.au and so on. The PC should explain why these comparison websites do not provide customers with the information outlined in its recommendation. Brokers also provide a source of home loan comparison which enables customers to see the full breadth of a home loan products features beyond the price.

Finally, the open data reforms underway by the Treasury will allow home loan comparisons to become easier and specified to customers' circumstances.

3.4 Lenders Mortgage Insurance

PC draft recommendation 8.5: Lenders Mortgage Insurance refund

"The Australian Government should require all lenders to offer home loan customers refunds for the cost of lenders mortgage insurance when customers choose to refinance or pay out their loan. The refund schedule for the remaining life of the loan should be set and made available to the borrower at the time the policy is started."

ABA response

The ABA believes that this recommendation is worthy of further consideration and industry feedback.

Lenders' Mortgage Insurance (**LMI**) is insurance which protects a lender from losses if a borrower defaults on their loan. Lenders generally purchase mortgage insurance for loans with a Loan to Value Ratio (**LVR**) higher than 80 per cent. The insurance is paid by the lender as a once-off premium and the cost is usually passed on to the borrower who can choose to pay upfront or capitalise it into the value of their loan.

LMI allows people, typically first home buyers, who don't have a 20 per cent deposit to access home ownership. For banks this allows them to transfer the risk of default to the insurer and offer loans they might otherwise not be able to, particularly in an environment of increasingly stringent prudential and capital adequacy regulations.

The banking industry supports further investigation of this recommendation. We recommend that the PC consult closely with industry to work through the complexities associated with this recommendation, some of which are noted in the PC's report.

In particular:

- Any changes should be prospective and not require changes to existing insurance policies or loans.
- As identified in the PC's draft report there are complexities that would need to be worked through in how refunds would be calculated and passed on to consumers.

- Note that it's possible that this measure could change the way LMI is priced, increase compliance costs and therefore increase the cost to consumers. Consideration should be given to the likely quantum of this impact to ensure it does not render some borrowers significantly less able to access the housing market. LMI is insurance which protects a lender from losses if a borrower defaults on their loan. Lenders generally purchase mortgage insurance for loans with a LVR higher than 80 per cent. The insurance is paid by the lender as a once-off premium and the cost is usually passed on to the borrower who can choose to pay upfront or capitalise it into the value of their loan.

PC draft finding 8.3: If you have a high loan to value ratio, you are probably paying for it twice over

"Home loan consumers with a loan to value ratio in excess of 80% are often required to compensate lenders twice for this risk: by bearing the cost of lenders mortgage insurance, and also by paying a higher interest rate on their home loan, even after other loan and borrower characteristics have been accounted for."

ABA response

The ABA does not agree with draft finding 8.3.

We agree with the PC's implication that lenders should not require consumers to compensate them twice for the same risk (by paying LMI and also a higher interest rate). However, as the PC has noted in its draft report, the difference between the average interest rate paid by a borrower with LMI and a borrower without LMI is very small. The PC estimates the difference to be 0.00066%. For a loan size of $400,000 (the current average amount for new home loans) at the suggested rates given by the PC in its report (5% and 5.003%) a borrower with LMI would pay $12 more a year, just $1 per month (or 23c a week).

It is not obvious to us that the difference identified by the PC is statistically significant, or that it can be causally linked to whether a customer has LMI. In any case the difference is so small and has such a limited financial impact on borrowers we believe any policy response to address this would be wholly inappropriate and likely cost more to implement than any potential benefits.

Information request 8.3: Are changes needed to lenders mortgage insurance?

"Are there any circumstances in which it is reasonable for a home loan consumer to be paying both lenders mortgage insurance and a higher interest rate? If not, what changes could feasibly be implemented?"

ABA response

The interest rate paid by a borrower is affected by a multitude of factors including, but not limited to: choice of lender (and the funding costs of that lender), additional features of the loan (including discretionary benefits like frequent flyer points or associated credit cards), term of the loan, fixed or variable rate loan, interest only or principal and interest loan, the size of the loan, and the borrower's credit history.

As noted above, we agree that lenders should not require consumers to compensate them twice for the same risk however, it is not clear that this is occurring and if it is, the impact is so minor that any changes to attempt to prevent this would be disproportionate and inappropriate.

Australian Banking Association

4. Competition in credit provision to small and medium businesses

4.1 SME lending

PC draft recommendation 9.1: Standardised risk weightings for SME lending

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

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

"In light of apparent major improvements in the use of Artificial Intelligence algorithms and data collection via the new payments platform, APRA should consider proposals by ADIs for variations to the standardised risk assessment for business lending, based on their data and risk management systems."

ABA response

The ABA supports APRA exploring the proposal to introduced a schedule of risk weights for SME lending outlined in draft recommendation 9.1.

The ABA believes that APRA should take these considerations into account through its ongoing work to implement the 2014 FSI recommendation for Australia to have unquestionably strong banks.

On 14 February 2018 APRA released a discussion paper[17] for consultation with authorised deposit-taking institutions (**ADIs**) on proposed revisions to the capital framework. The paper includes proposed revisions to the capital framework resulting from the Basel Committee on Banking Supervision finalising the Basel III reforms in December 2017, as well as other changes to better align the framework to risks, including in relation to housing lending.

During the process of consultation, APRA will undertake further analysis of the impact of the proposed changes on ADIs. This analysis will include a quantitative impact study, which will be used to, where necessary, calibrate and adjust the proposals.

The key proposed changes to the capital framework include:

- lower risk weights for low LVR mortgage loans, and higher risk weights for interest-only loans and loans for investment purposes, than apply under APRA's current framework;
- amendments to the treatment of exposures to small- to medium-sized enterprises (SME), including those secured by residential property under the standardised and internal ratings-based (IRB) approaches;
- constraints on IRB ADIs' use of their own parameter estimates for particular exposures, and an overall floor on risk weighted assets relative to the standardised approach; and
- a single replacement methodology for the current advanced and standardised approaches to operational risk.

The paper also outlines a proposal to simplify the capital framework for small ADIs, which is intended to reduce regulatory burden without compromising prudential soundness.

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[17] APRA begins consultation with ADIs on revisions to capital framework, http://www.apra.gov.au/MediaReleases/Pages/18_04.aspx

5. Integrated services and the provision of warehouse funds

5.1 Warehouse funding

PC draft recommendation 7.1: A proportionate approach to risks non-ADIs pose

“The implementation of the revised Prudential Standard APS 120 that came into effect on 1 January 2018 should be revised and limited in its effect, in the first instance, to warehouse funds provided to authorised deposit-taking institutions (ADIs). Prior to any later extension of the standard funds provided to non-ADIs, the costs to non ADIs of changes to regulatory capital requirements for the provision of warehouse facilities should be subject to a public cost-benefit analysis that includes calculation of regulatory capital costs and any pass-through.”

ABA response

The ABA is generally supportive of draft recommendation 7.1

The ABA views the new treatment of warehouse facilities under APS 120 is overly conservative with respect to the regulatory capital requirements for ADI providers of those facilities. The impact is borne by smaller ADI and non-bank lenders and thus restricts the competitive influence of those small ADIs and non-banks.

As per the PC’s draft recommendation 7.1, the ABA would support APRA undertaking a cost/benefit analysis that includes calculation of regulatory capital costs and any pass-through. Ensuring that any potential revisions to Prudential Standard APS 120 aligns with the Basel standards would be an important factor to support and facilitate growth and competition in the market. APRA should also consider the implications of any changes on competitive neutrality between smaller banks and non-ADI lenders.

5.2 Integration

PC draft recommendation 7.2: Building an evidence base on integration

“Firms that are undertaking mergers or acquisitions within the financial system — including banks, insurers and other financial services firms — should notify the Australian Competition and Consumer Commission and the Australian Securities and Investments Commission (ASIC) on the nature and size of these acquisitions as they undertake them.

“ASIC should maintain a publicly accessible database of the relationships between parent and subsidiary companies, and report annually on all notifications received.”

ABA response

ABA members are unopposed to draft recommendation 7.2 understanding the intent of ASIC’s register to enhance transparency for customers to understand which banking parent a lender may belong to.

The ABA cautions that implementing this recommendation is likely to be costly for ASIC, the ACCC and all financial market participants.

Most large ADI groups will have hundreds of subsidiaries. Many of these subsidiaries will be holding companies, trustee companies, investment vehicles, special purpose vehicles or companies that exist for historical reasons, the majority of which do not materially or significantly impact the ADI group’s business or operation as a whole.

The ABA questions the benefit to competition of ASIC collating, reporting and publishing all of these data. High level reporting of those customer-facing entities meets the intent of the recommendation without introducing costly complexity that will confuse customers if all trustees, SPVs and so on are reported.

6. Competition in the payments system

6.1 Review of pre-purchased payment facilities

Drafted recommendation 10.1: Review regulation of purchased payment facilities

"The Australian Prudential Regulation Authority should, either itself or outsourced elsewhere, design a tiered prudential regime for Purchased Payment Facilities to reduce barriers to growth.

- *Purchased Payment Facilities with total stored value below $50 million and individual holdings of no more than $500 would not face prudential regulation.*
- *The lower prudential tier would maintain the current 100% liquidity ratio requirement but reduce other prudential requirements to lower compliance costs.*
- *The higher prudential tier would reduce liquidity requirements but strengthen other prudential requirements.*

"These reforms should be implemented no later than mid 2019."

ABA response

The ABA supports a review into regulation of purchased payment facilities by APRA to explore how competition could be encouraged in this market.

We note that consumer protections should remain paramount if APRA believes any changes to Pre-purchased Payment Facilities are warranted. While the ABA is yet to consider the issue widely, $500 in electronic cash represents a significant amount of money to a vulnerable customer so we do not believe that no regulation is appropriate. Customers should have equal protection regardless of the institution offering the product and we do not believe removing consumer protections is a good approach.

6.2 ePayments Code

Draft recommendation 10.2: Making the ePayments Code mandatory

"The Australian Securities and Investments Commission should amend the ePayments Code to make subscription to the code mandatory for any entity that intends to send or receive electronic payments."

ABA response

The ABA supports draft recommendation 10.2 in principal.

The ePayments Code should be reviewed to reflect changes in the market since it was last reviewed five years ago including open data and NPP.

As part of this review, there should be consideration given to the costs and benefits of making the code mandatory alongside setting up a mechanism to ensure the code it kept up to date in an orderly fashion and does not hinder innovation in a rapidly evolving payments ecosystem.

Information request 10.1: How should liability for unauthorised transactions be shared?

"What would be the costs and benefits of different ways that liability for unauthorised transactions under the ePayments Code may be shared between financial institutions and third parties, including participation in financial dispute resolution schemes? This includes the feasibility of having Code subscribers provide unique access details to third parties approved by customers.

"We are also interested in stakeholder views about whether the new Open Banking policy (once implemented) could be relied upon as a better alternative for secure, shared access."

ABA Response

The ABA believes that the Open Data and Open Banking review now being led by Treasury is the best place to consider these issues. We strongly support Farrell's principle on liability that each party must be responsible fully for their actions. The ABA would not support liability for unauthorised transactions being shared when a third party is responsible for a data breach.

6.3 Interchange fees

Draft recommendation 10.3: Ban card interchange fees

"The Payments System Board should introduce a ban on card payment interchange fees by mid 2019.

"Any remaining fees should be directly related to the costs of operating the system. Such fees should be made transparent and published."

ABA response

The ABA does not support draft recommendation 10.3.

The RBA recently completed[18] a two-year root and branch review of interchange fees and examined all options. The Payments System Board (**PSB**) after examining all options made a series of recommendations which came into effect in July 2017, including introducing an upper limit on the highest levels of interchange for both debit and credit, thus the new market structure is only months old and it is illogical to commence another review of interchange fees. The PSB has already committed to reviewing the impact of changes to interchange fees in Australia five years after these substantial market reforms take effect. The current settings are designed to achieve that an appropriate balance between competition and innovation and must be given time to work. The payments ecosystem is very complex and the PC's standalone recommendation is likely to create unintended market distortions within the payment system which could impact systemic stability,

Moreover, the ABA has concerns about the PC's proposed ban on card payment interchange fees. The Interchange mechanism is an efficient (and globally used) way of managing the costs in the payments system, having a whole range of other charges to cover the cost of payment systems and services is unnecessarily complex for consumers and merchants.

For consumers, interchange covers the cost of fraud protection, allowing cardholders to be automatically repaid in the event of fraud (often referred to as zero liability for consumers). Interest free days on credit cards are also paid for by interchange, which gives Australian consumers added flexibility in managing their finances. Interchange on debit cards also facilitates flexibility for consumers, allowing them to safely spend their own money instore, but also on line, overseas and over the phone.

Consumers also benefit from innovations in payments technology, which are supported by interchange. Advancements like tap-and-go and mobile payments give consumers new ways to access their money as well as increasing convenience and efficiency when shopping.

Interchange also delivers value to retailers. Interchange provides convenience; security and fraud protection; increased sales and guarantees that retailers are paid even when the cardholder does not repay their bank.

Draft recommendation 10.4: Merchant choice of default network routing

"Merchants should be given the ability to choose the default network to route contactless transactions for dual network cards. As the technology is readily available, this option should be offered from 1 January 2019 at the latest.

"The Payments System Board should require that neither a scheme, nor any of its participants (including issuers and/or acquirers), can prevent merchants from setting (or asking their acquirers to set) the default route."

[18] http://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/

ABA Response

The ABA does not wish to pre-empt the work underway by the RBA so we do not support draft recommendation 10.4

The ABA believes the RBA are best placed to continue work on merchant routing and that any recommendations should flow from that evidence-based work and after industry consultation.

Given the RBA has prioritised this work and the power and authority of the PSB covers the field alongside the fact that competition has already resulted in such functionality being offered to Australian markets today like Tyro. The ABA notes the recent PSB media release which stated members were encouraged that some financial institutions have made progress towards providing least-cost routing functionality to their merchant customers. The PSB expects to make a decision at its May meeting if the market is providing this functionality or if the Bank should issue a draft standard for consultation.

6.4 New Payments Platform

Draft recommendation 10.5: Access regime for the New Payments Platform

"The New Payments Platform (NPP) is a significant piece of national infrastructure that can benefit competition in retail banking and payments. But more transparency is needed to facilitate third party access. The NPP should be subject to an access regime imposed by the Payments System Board.

"As part of an access regime, the Payments System Board should:

- *review the fees set by participant entities of the NPP and transaction fees set by New Payments Platform Australia*
- *require all transacting participant entities that use an overlay service to share de identified transaction level data with the overlay service provider*
- *consult the Australian Competition and Consumer Commission on the final design of the data sharing obligations."*

ABA response

The ABA does not support draft recommendation 10.5. The NPP, while a private company that is owned by banks and other payment service providers, has key administrative arrangements in place to ensure that its open access and access decisions are not constrained by serious conflicts of interest. As the NPPA's submission notes, NPPA management, rather than the Board, are to determine new access applications.

The fees set by the NPPA reflect the economic cost of using the infrastructure which was built by the shareholders at a cost of around $1 billion. Such arrangements exist to ensure that economic incentives to invest in technology platforms remain and cannot be altered after the investment has been made.

Draft finding 10.1: The New Payments Platform could do more to ease customer switching

"The New Payments Platform's addressing service, PayID, has the potential to improve competition by making it easier for customers to switch financial institutions or products.

"However, at launch, PayID will have very limited functionality.

"New Payments Platform Australia Limited and its participating financial institutions have the capacity to improve the capability of PayID to give customers the ability to both send and receive recurring bank transfers, direct debits and card payments.

"Changing bank accounts with many direct debits, or credit cards with recurring charges, would then require only a single update, removing one of the apparent reasons why there is limited switching of accounts."

ABA response

The ABA agrees with the substantive point in draft finding 10.1 that the NPP will provide the platform for further innovations such as addressing direct debits and enable greater switching. We understand that the NPPA is exploring these opportunities.

We do note NPPA's point that while PayID technology may resolve these issues in new ways, there are technical and contractual challenges with linking existing direct debit arrangements to payer PayIDs. Direct debits are processed via the legacy, batched, overnight direct entry system, while PayID is designed only to be used with the new NPP platform and 24/7/365 messages.

7. Improving outcomes for consumers

7.1 Financial advice

PC information request 12.1: Potential to increase the scope of financial advice to include some credit products

"The Commission is considering recommending that ASIC-licensed financial advisers be able to provide advice on some credit products, in particular home loans, personal loans and credit cards. We seek views on:

- *the merits of such a proposal*
- *which credit products should be included in this increased scope to provide advice*
- *the nature of any duty advisers would have to their clients*
- *different licensing approaches including the form of the licence*
- *the regulatory costs and impact on the industry."*

PC draft recommendation 12.1: Rename general advice to improve consumer understand

"General advice, as defined in the Corporations Act 2001 (Cth), is misleading and should be renamed. The Commission supports consumer testing of alternative terminology to ensure that misinterpretation and excessive reliance on this type of promotional information is minimised.

The term 'advice' should only be used in association with 'personal advice' that takes into consideration personal circumstances."

ABA response

The ABA strongly supports a full review of the definition of financial product advice under the Corporations Act. The review should seek to redefine advice, as advice that takes into consideration personal circumstances, and should remove the link to product recommendations and focus on wealth advice, investments, insurance and other financial planning topics including aged care, estate planning and budget management.

The term "general advice" should be withdrawn and replaced with a new term covering factual information and marketing.

7.2 Mortgage brokers and switching

ABA response

The banking industry recognises that changes are needed to remuneration, including commissions and bonuses, to improve behaviour and ensure it aligned with the interests of customers.

That is why in 2016 the ABA commissioned former Public Service Commissioner Stephen Sedgwick AO to conduct an independent review of how employees and third parties are paid by banks. The final review report made 21 recommendations that were endorsed in full by the ABA Council.

All ABA member banks have committed to implementing the recommendations and a number of these applied to the remuneration of third parties:

> **Recommendation 16**
>
> In respect of remuneration of Mortgage Brokers:
>
> a. Banks cease the practice of providing volume based incentives that are additional to upfront and trail commissions;

b. Banks cease non-transparent soft dollar payments in favour of more transparent methods to support training etc.; and

c. Banks cease the practice of increasing the incentives payable to brokers when engaging in sales campaigns

Recommendation 17

Banks adopt, through negotiation with their commercial partners, an 'end to end' approach to the governance of Mortgage Brokers that approximates as closely as possible a holistic approach broadly equivalent to that proposed for the performance management of equivalent retail bank staff.

Recommendation 18

Banks adopt approaches to the remuneration of Aggregators and Mortgage Brokers that do not directly link payments to loan size and reflects a holistic approach to performance management **(see Recommendation 17):**

a. To establish in a timely fashion how best to address Recommendations 17 and 18, banks with a significant recourse to the Mortgage Broker channel, but at least the four major banks, each report regularly to ASIC on their progress; and

b. With enhanced oversight by ASIC (and other regulators as necessary) to monitor market responses.

Through the CIF, the banking industry has developed its response to Recommendation 16 and most banks are well progressed on their implementation. The banking industry through CIF, continues to work on implementation of Recommendations 17 and 18 of the Sedgwick Review.

As part of the response to Recommendation 18, the industry is examining how to remove the link between loan size and broker remuneration and we are operating in recognition that the current standard commission model needs to change.

Banks have also committed to paying commissions based on the funds utilised by the customer net of offset, and not on facility limits to discourage large initial offset balances. We will continue to consider what further reforms are required to implement the Sedgwick Review and ensure good customer outcomes.

Trail and clawback commissions

In terms of the PC's request 13.2, the ABA makes the following comments in relation to trail commissions and clawback commissions.

Trail commissions are designed to align the interests of brokers and consumers to provide ongoing service (at appropriate intervals) over the term of the loan. It also serves to promote good customer outcomes, as it is standard industry practice to "switch off" trail commissions if the loan goes into arrears. The industry is actively considering opportunities to use trail better as a lever to drive the right behaviours for brokers and align to the performance of the loan.

Clawbacks enable cost recovery and discourage writing of loans that are unaffordable or unsuitable for customers.

The banking industry is actively improving the standard commission model and has committed to implementing the recommendations of the Sedgwick Review by 2020.

7.3 Open data

PC draft recommendation 13.1 Data access to enable switching

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

ABA response

The ABA supports draft recommendation 13.1 and commends the PC for its Data Availability and Use report which laid out a sensible path forward for an open data economy.

ABA members are committed to the success of Australia's Open Banking regime and open data more broadly. Open data is a ground-breaking reform that will take place across the economy with banking, followed by energy and telecommunications as the first movers. It will boost choice, increase competition and simplify the application process for a financial product, mobile phone or power provider.

A reform as large as Open Banking must be carefully considered and properly implemented. Australian banks' priority is to ensure customers' security, privacy and liability are adequately safeguarded so they can get full benefits of data sharing safely. These are the issues we are working through as we respond to the Farrell Report.

Research shows that Australians trust their banks with personal information, more than online retailers, social media companies and even governments. It's important that banks maintain this trust and ensure that the open data reforms don't place personal information at risk. Polling by Galaxy found that two-thirds of Australians trust their banks as custodians of their data, which was more than government agencies, technology companies, and only just behind their GP and hospital.

8. The financial system regulators

8.1 Considering a competition regulator

8.1.1 APRA's role in encouraging competition

PC draft finding 15.1: APRA not well placed to consider competition in the financial system

"The Australian Prudential Regulation Authority (APRA) is not well placed to balance the cost to competitive behaviour in its regulatory actions. The preponderance in its remit favours system stability, even at a significant cost to competition.

"The Commission does not propose to alter APRA's ability to consider competition in making its risk assessments and actions, but it is evident that a debate on the question of whether the public interest is served by restricting competition could be better authorised. The Council of Financial Regulators is a valuable forum for a rigorous and informed competition debate."

ABA response

The ABA does not agree with draft finding 15.1. The ABA believes that APRA is well placed to consider competition, and we do not agree that with the implication that its decisions have unduly favoured stability in the past. The finding is too broad and not backed by evidence. The ABA would strongly dispute the finding that there is a failure of APRA to consider competition in their regulatory actions. APRA's statutory mission, as defined in the APRA Act states:

> *APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.*

As proven by the stability of Australia banking system during the GFC the ABA would hold that APRA's statutory mission is well defined and appropriate. APRA's mission is effectively focussed on balancing safety with a number of desirable attributes, and promoting financial stability

8.1.2 Appointing a standalone regulator

PC draft recommendation 17.1: New Competition Functions for a Regulator

"To address gaps in the regulatory architecture related to lack of effective consideration of competitive outcomes in financial markets, an existing regulator must be given a mandate to take the lead on matters related to competition in the financial system.

"To minimise cost and disruption, this role should be implemented in substantial part through the Council of Financial Regulators (CFR).

"There would be no change under this recommendation to the current legislated responsibilities of the regulators. Rather, the Australian Government should include in its Statement of Expectations for all members of the CFR the practice of reviewing, before they are implemented, regulator actions that may have material effects on competition.

"The competition-related functions of the designated Council member would include:

- *transparent analysis of competition impacts tabled in advance of measures proposed by regulators*
- *testing of the impacts of competition and community outcomes of additional provider integration."*

Australian Banking Association

Information Request 17.1: Which regulator should advance competition in the financial system

"The Commission has presented two possible options for a regulator to advance competition in Australian financial system and ensure robust consideration of competition in the regulatory decision making processes of the Council of Financial Regulators:

"Option 1: that ACCC be afforded new proactive functions to supplement its current reactive role in the financial system

"Option 2: that ASIC's existing financial system focus be expanded beyond participant conduct and consumer outcomes to include the advancement of competition.

"We welcome feedback on the merits of each option or alternative possibilities."

ABA response

ABA membership does not hold a universal view on this recommendation. However, the ABA does not believe that Australia needs a new competition champion appointed for the financial system outlined in draft recommendation 17.1 or the proposed path in Information request 17.1. We do support a stronger articulation of competition in existing regulators' mandates and more transparency around proposed regulations' impacts in competition, but we do not believe that the PC's report has made a strong case to introduce a new champion or regulator in to the financial services space.

We note that the ABA's regional members have advocated for stronger competition powers for either ASIC or the ACCC in their submission. We also note that the Minister for Revenue and Financial Services Kelly O'Dwyer recently announced changes to ASIC so that competition has a greater focus in its decision making.[19]

Australia's "twin peaks" system of financial regulation is world leading, as evidenced by its adoption overseas.[20] Both APRA and ASIC have served Australians well, and have been backed by the RBA and Treasury.

The ABA does not believe the draft report has established that there are gaps in the regulatory architecture that lead to lack of effective consideration of competitive outcomes in financial markets.

The ABA also rejects the view that there is an absence of rigorous and informed competition debate within the Council of Financial Regulators. While the ABA agrees that the deliberations of CFR need greater transparency and accountability, the ABA does not see the current functioning or membership of the CFR as an impediment to further promoting competition. This is consistent with our responses to the Financial System Inquiry.

The ABA most strongly rejects the finding that there should be a 'party' to be specifically authorised to take on responsibility for representing competition, to do so would add cost and complexity in the financial system with no analysis that any such reforms have would work or is necessary in Australia financial system. All regulators should work to increase competition, with Treasury taking the overall lead cross-agency reforms.

While the ABA agrees that the deliberations of CFR need greater transparency and accountability, the ABA does not see the current functioning or membership of the CFR as an impediment to further promoting competition within the financial sector.

We believe that effective and immediate solution would be for Governments to supplement a regulators statutory mission via the Statement of Expectations given to each regulator.

[19] http://kmo.ministers.treasury.gov.au/media-release/030-2018/
[20] https://www.lowyinstitute.org/the-interpreter/financial-regulation-australias-twin-peaks-model-successful-export

8.2 Increasing regulatory transparency

PC draft recommendation 15.1: Statements of Expectations for Regulators

"*Regulator Statements of Expectations and Statements of Intent, as agreed in the response by the Australian Government to the Murray Financial System Inquiry, should be urgently implemented. They should be written in clear language and updated at regular intervals thereafter.*

"Statements of Intent should be published by regulators within three months of receiving the Statements of Expectations.

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

ABA Response

The ABA supports draft recommendation 15.1 and believes it meets the intent of the draft recommendation 17.1, the PC could revise the recommendation that the financial regulators who comprise CFR revise the MOUs to explicitly include competitive considerations when deliberating actions which contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system.

PC draft recommendation 17.2: Transparency of Regulatory Decision Making

"The Council of Financial Regulators (CFR) should implement a process of review before its members put in place regulatory interventions that may have a material impact on competition in a product market.

"There must be a member of the CFR designated to take up the role of assessing planned interventions, to establish possible consequences for competition in financial markets.

"The assessment of competition impacts should be discussed at the CFR meeting, and the regulator planning the intervention should consider amending its policies to reduce the effects on competition.

"Competition analyses, as well as the minutes of the CFR meetings, should be made public in a timely manner."

ABA response

The ABA supports draft recommendation 17.2 in principle.

While the ABA agrees that the deliberations of CFR need greater transparency and accountability, the ABA does not see the current functioning or membership of the CFR as an impediment to further promoting competition within the financial sector.

The ABA also disagrees with the assertion that competition has hitherto been ignored CFR's deliberations. We await the CFR members' clarification on this point.

We do believe that there could be benefit to all financial market participants through greater disclosure and transparency of CFR decision making, provide that the CFR continues to provide a full and frank source of discussion for its members. Consequently, we are not prescriptive on how CFR lifts transparency.

PC draft recommendation 17.3: Robust and transparent analysis of macroprudential policies

"The Australian Prudential Regulation Authority should conduct and publish annually quantitative post-implementation evaluations of its macroprudential policies, including costs and benefits to market participants and the effects on competition."

Australian Banking Association

ABA response

The ABA supports draft recommendation 17.3 in principle. However we note that the RBA provides semi-annual assessments of macroprudential policy in its Financial Stability Review.

APRA Chairman Wayne Bryes also appears regulary at Senate Estimates. At the recent Senate Estimates appearance on 1 March 2018, the APRA chair indicated that the 10 per cent investor growth benchmark announced in 2014 is probably reaching the end of its useful life.

The APRA chair also indicated the more recent 30 per cent interest-only benchmark put in place in 2017 is an agenda topic each quarter at the Council of Financial Regulators. APRA indicated they would like to see how the industry adapts before they consider removing that 30 per cent benchmark, but both are under review and APRA indicated that as circumstances change, that APRA would modify the benchmarks as needed.[21]

8.3 Risk weights on standardised mortgages

Draft recommendation 16.1: Review standardised risk weights for residential mortgages

"The Australian Prudential Regulation Authority should commence and complete a review of the standardised risk weights for residential mortgages set out in Prudential Standard APS 112 by June 2020.

"The review should be focused on more finely calibrating the risk weights to better reflect the risk inherent in individual mortgages.

"In particular, consideration should be given to replacing the single risk weight that applies to standard eligible residential mortgages with a loan-to-valuation ratio below 80% with risk weights defined in more narrow bands."

ABA response

The ABA supports draft recommendation 16.1 in principle.

The ABA believes that the appropriate place for APRA to consider standardised risk weights of mortgages is through its current "unquestionably strong" process. We do not believe a further review of risk weights is necessary in light of this process.

On 14 February 2018[22], APRA released a discussion paper on revisions to the capital framework and the leverage ratio requirement for ADIs, known as the "unquestionably strong" reforms to prudential regulation. The papers include proposed revisions to the capital framework resulting from the Basel Committee on Banking Supervision finalising the Basel III reforms in December 2017, as well as other changes to better align the framework to risks, including in relation to housing lending.

The ABA believes that any proposed changes to the standardised approach in Australia will need to take consideration of international financial standards. In a 2017 speech, APRA chair, Wayne Byres explained the importance and benefits to competition in Australia adopting international standards[23].

The APRA chair said:

> "The past decade has seen substantially increased activity by a range of international standard-setting bodies: the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), and

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[2121] http://parlinfo.aph.gov.au/parlInfo/download/committees/estimate/f6895598-e300-42ab-9ed8-5174ed8ed7d9/toc_pdf/Economics%20Legislation%20Committee_2018_03_01_5947.pdf;fileType=application%2Fpdf#search=%22committees/estimate/f6895598-e300-42ab-9ed8-5174ed8ed7d9/0000%22

[22] APRA begins consultation with ADIs on revisions to capital framework, http://www.apra.gov.au/MediaReleases/Pages/18_04.aspx

[23] International standards and national interests, http://www.apra.gov.au/Speeches/Pages/International-standards-and-national-interests.aspx

the International Association of Insurance Supervisors (IAIS). As a result, the international 'rulebook' has grown significantly.

"From an Australian perspective, we have long seen international financial standards as being a public good from which we derive great benefit, in two main ways.

"We see adhering to international standards as strongly in our interests. As a small-ish but open economy that relies to a large extent on accessing the savings of foreigners, the credibility that comes from being seen to adhere, and in many cases, clearly exceed international minimum standards is important. It allows our financial institutions to access international markets to an extent, and at a price, not possible if we sought to operate a system that was purely 'made in Australia' and, therefore, foreign to foreigners.

"We also see others' adherence to standards as being of benefit to us. Over the past couple of decades, Australia has sought to have a financial system that is open to foreign competitors – many of whom have brought a strong competitive impetus, not to mention a healthy degree of innovation, to the benefit of the Australian community. Adherence to well-established international standards by those foreign-owned participants allows us to place a much greater degree of (although not total) reliance on home country prudential requirements, and correspondingly less need for duplicative or restrictive domestic regulation, than might otherwise be the case."

Given APRA's ongoing work to make Australia's banking system unquestionably strong, recommendation 16.1 is no longer necessary.

8.4 Improving accreditation process to become an Internal-Risk Based approach bank

PC Information request 16.1: Where can IRB accreditation processes be improved?

"We are interested in any suggestions for improvements to the internal risk-based (IRB) accreditation process to make IRB modelling more accessible to non-major banks. Of particular interest is:

- Information on existing international programs or proposals for alleviating data requirement burdens (such as use of external/shared loan data)
- Availability of expertise to develop IRB models outside of major banks and potential to outsource IRB model development (or for external parties to develop 'off the shelf' solutions)
- Any other recommendations for APRA's accreditation processes (such as process transparency)."

ABA response

The ABA supports reforms which would make it easier for ADIs to achieve IRB accreditation, subject to these changes not undermining the integrity of the accreditation outcome.

We also note that ING recently became the first ADI to be accredited since APRA revised the accreditation process in 2015 following the FSI.

APRA continues to engage with other ADIs seeking accreditation to use internal models for calculating regulatory capital requirements.

We note the PC's suggestion around potential outsourcing of IRB model development. Certainly, it is true that smaller banks find it extremely difficult to compete for the hiring of experienced model developers for a number of reasons. In particular:

- Most staff with experience in this field are based in either Sydney or Melbourne, and many smaller banks have their principal operations in locations other than these;

- Salary expectations can be challenging for smaller banks to meet, given that major banks have historically been able to pay these experts more than smaller banks are able to offer; and
- Major banks tend to have teams with individual experts dedicated to very specific customer portfolios, whereas smaller banks will generally seek staff with exposure to a broader range of IRB models and customer portfolios. It can be difficult for smaller banks to find potential employees with this broader exposure and experience.

Notwithstanding the above, outsourcing IRB model development could also pose its own challenges. One approach would be for IRB banks to sell model development services to smaller institutions that require this, or alternatively external parties may be able to develop 'off the shelf' solutions. However, for banks running IRB models, there is an advantage in having in-house expertise to manage ongoing operations, and there may be concerns around whether a bank had sufficient internal expertise to support an externally produced model. It should also be noted that 'off the shelf' may imply a 'one size fits all' approach, which would appear to be inconsistent with the underlying objectives of advanced accreditation.

More generally, we believe that the accreditation process would benefit from greater clarity from APRA, particularly around process and timeline expectations. Smaller banks seeking IRB accreditation have previously noted that the process can be protracted and inefficient. There are a number of factors that have led to these difficulties. For example, new or amended prudential requirements can have flow on impacts on how IRB models need to be built, which may necessitate further rounds of amendments to an IRB model before it can be finalised. Revised industry requirements can have similar impacts. In addition, under the current arrangements, IRB models effectively need to be pre-approved before an application can be submitted, and it is unclear how long these pre-approvals will take.

We would like to reiterate that the regulator has been extremely consultative in its approach to the accreditation process. However, this could be complemented further by clear expectations around key milestones that ADIs would need to meet along the way. There may also be capacity for APRA to be more flexible in accommodating the specific circumstances and needs of an individual ADI. We note that APRA currently adopts many of these elements in their approach to ADI licensing, and we believe there would be merit in the regulator considering IRB accreditation in a similar fashion.

Finally, smaller banks would also benefit from further clarity from APRA around the likely capital outcomes for standardised banks moving to the IRB approach, given the unquestionably strong capital benchmarks currently being introduced by APRA.

8.5 Too big to fail perception

PC draft finding 16.1: Ratings agencies exacerbate the perception of "too big to fail"

"By incorporating perceived government support in their relative ratings of Australia's banks, ratings agencies further embed the major banks' 'too big to fail' status, with consequent advantages to these banks in the costs of funds."

ABA response

Views within the ABA's membership differ on the significance of the Australian Government's implicit guarantee of taxpayer assistance in the event of a crisis. Larger banks do not support draft finding 16.1 while smaller banks agree.

As the ABA noted in our original submission, the too big to fail perception incorporated into bank ratings by the ratings agencies could be mitigated if the Government clarified its support for all ADIs in times of crisis.

Articulation of the Government's commitment to all ADIs is needed in light of the credit ratings agencies' perception of differing levels of government support between Australian ADIs and the consequent impact on their credit ratings, and therefore cost of raising funds.

We would also ask that the PC do further work to acknowledge key prudential reforms undertaken across the banking industry since the financial crisis that have strengthened the sector's ability to withstand shocks and therefore reduce the likelihood that Government assistance would be required. These reforms include total loss-absorbing capacity (TLAC), crisis resolution, unquestionably strong reforms, as well as the RBA's committed liquidity facility (CLF).

Australian Banking Association

About the ABA

With the active participation of 24 member banks in Australia, the Australian Bankers' Association provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services.

The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.