Australian Banking Association

20 April 2023

Committee Secretary
The House of Representatives
Standing Committee on Economics
By email: economics.reps@aph.gov.au

Dear Committee,

Inquiry into promoting economic dynamism, competition and business formation

The Australian Banking Association ('**ABA**') is pleased to make this submission to the *Inquiry into promoting economic dynamism, competition and business formation*.

Australian banks operate in a competitive and dynamic environment. They compete with each other and with other financial service providers, including tech companies, to provide products and services to consumers. Given the pace of technological change and transformation, banks are constantly innovating their customer offerings and processes to remain competitive.

To compete effectively, banks continually adapt to respond to customer needs and preferences. As such, banks have, over the past several decades, become increasingly digital.

Banks have also played a key role in facilitating innovation across the broader economy by providing financing solutions for business. Some banks have also adopted other measures to help support business innovation, including advisory services and establishing dedicated workspaces for innovation. The banking industry has invested heavily in payments systems architecture, which has enabled businesses, including fintechs, to launch new ways for consumers to make payments.

Banking sector regulation helps ensure the stability and safety of the financial system. However, the costs of complying with regulation are significant and can have negative effects on competition and innovation because they create barriers to entry into the sector and divert funds from the development of new products and services. At the same time, uneven regulation can enable large non-bank players to innovate while limiting innovation by banks. Innovation is best encouraged through scalable and appropriate regulatory regimes where activities rather than institutions are the target of regulation.

Additionally, to manage regulatory burden, attention could be paid to the coordination of regulatory reform implementation. The ABA recommends that Government and the financial system regulators publish a combined regulatory plan on a 24-month basis. Additionally, some regulatory requirements could be reviewed to help reduce barriers to entry and free up capital for innovation while not undermining the purpose and function of the requirements.

I thank the committee for its time in considering this submission. Should you have further queries please contact

Yours sincerely

Chief Executive Officer, Australian Banking Association

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Annexure: ABA Submission to the Inquiry into promoting economic dynamism, competition and business formation

1. Competition and innovation in banking

Australian banks operate in a competitive and dynamic environment.

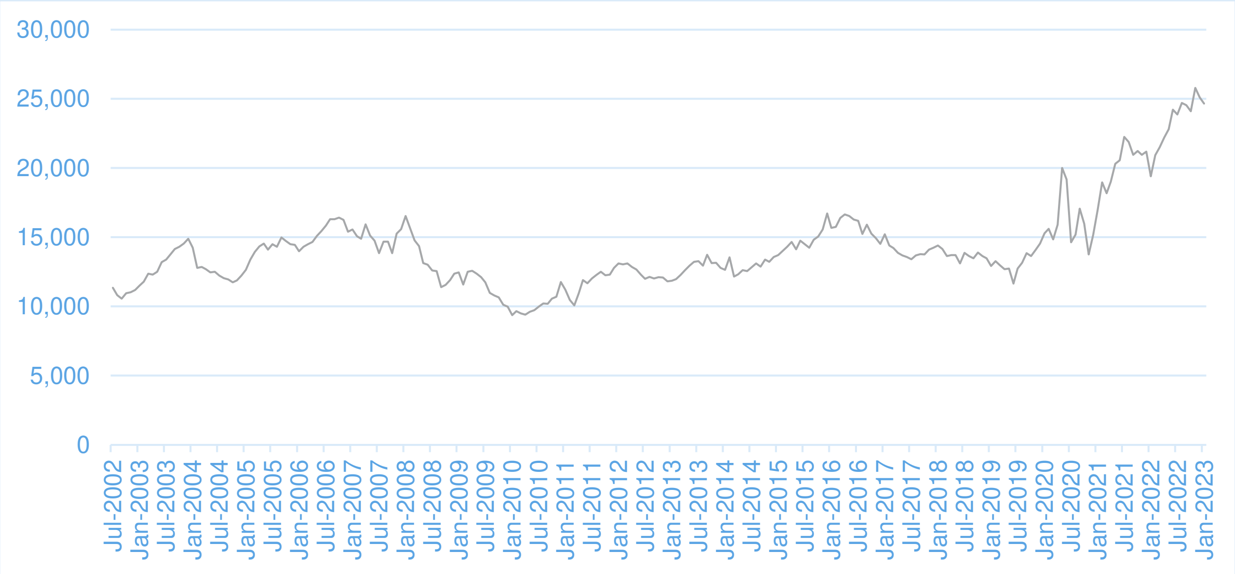
They compete with each other and with other financial service providers, including tech companies, to provide products and services to consumers. Given the pace of technological change and transformation, banks are constantly innovating their customer offerings and processes to remain competitive.

1.1 The competitive environment

In December 2022, there were 95 banks operating in Australia, along with 35 credit unions and building societies.[1] As at March 2023, there were 150 credit cards, 750 transaction deposit products and 6,000 home loans available to retail banking customers.[2]

Each of these banks is in constant competition with other banks and non-bank lenders to retain or grow their share of the market for its product offerings. Competition amongst banks and non-bank lenders (including consumer finance companies specialising in residential mortgages and credit unions)[3] for home loans is currently 'fiercer than ever', with several banks writing new loans with internal rates of returns below the cost of capital to win customers.[4] Analysis by the ABA of data from ABS Lending Indicators show that since 2019, the monthly number of home loans being refinanced with a different bank has increased by around two-thirds (see Figure 1).

Figure 1: Externally refinanced housing loans, July 2002 – January 2023, N

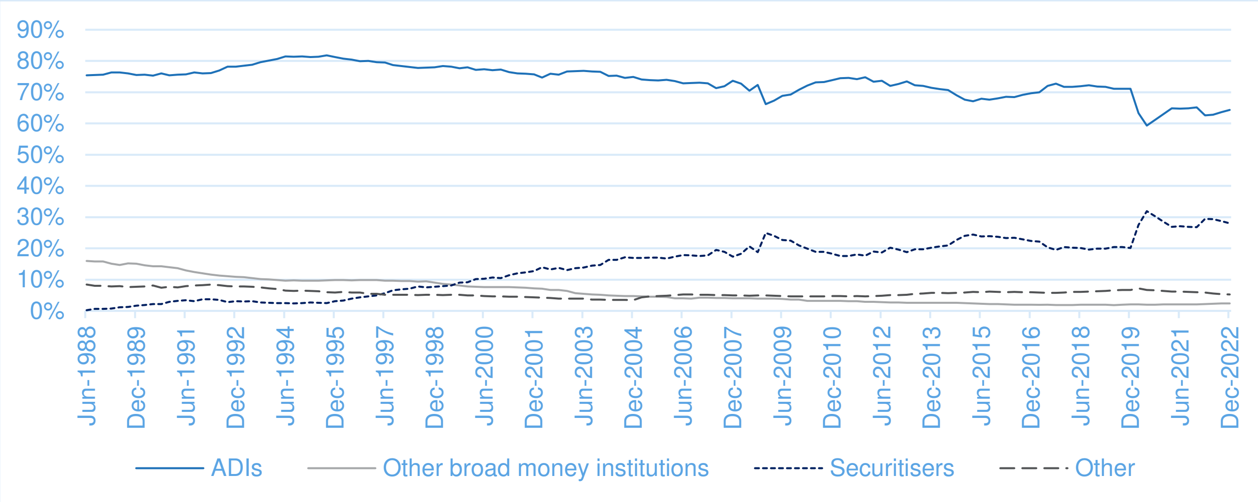


Source: ABS Lending indicators; ABA

[1] APRA, Quarterly ADI statistics, December 2022
[2] Canstar, https://www.canstarview.com.au/, Accessed 23 March, 2023
[3] For a current list of lenders in the mortgage see Canstar https://www.canstar.com.au/providers/home-loans/
[4] Australian Financial Review, 'Why 'uneconomic' mortgages are forcing a rethink at the big banks', 31 March 2023 https://www.afr.com/chanticleer/why-uneconomic-mortgages-are-forcing-a-rethink-at-the-big-banks-20230331-p5cwzy

In some product categories, banks also face competition from other financial service providers, including non-bank lenders, buy now pay later (BNPL) providers, and fintechs. For example, over the past several decades, the proportion of long-term liabilities held by ADIs has reduced, while that held by securitisers has increased (see Figure 2 below). The change in market share shows the capacity of the market, over the long term, to allow new players to enter.

Figure 2: Long-term liabilities for Australian households, By issuer, June 1998 – December 2022, %



Source: ABS, Australian National Accounts, Finance and wealth; ABA

A further example is the relationship between BNPL and credit cards. The number of BNPL accounts has increased roughly 40% from around 5 million in June 2021 to around 7 million in June 2022.[5] In the same period the number of credit card accounts decreased from 13.31 million to 13.16 million, or roughly 1.1 per cent.

1.2 Innovation in banking

To compete effectively, banks must continually adapt to respond to customer needs and preferences.

As such, banks have, over the past several decades, become increasingly digital. Banks are continuing to develop new functionality in their digital banking offerings and the digital payments infrastructure.

Banks have also adopted technology to improve the accuracy and efficiency of their processes, including by using artificial intelligence methods to support decision-making and fraud detection.

According to the IMF, the 'digital disruption' of banking promises significant benefits:

> *The digital disruption of banking promises to lead to a general increase in efficiency and service by helping to overcome information asymmetries (using big data and AI/ML techniques and blockchain technology), providing a user-friendly consumer interface and a higher standard of service, and ultimately replacing obsolete technology. Banking will thus move to a customer-centric platform-based model.*[6]

The move to digital has, in large part, been driven by customer demand. As customers have become more familiar with digital services, they have demanded more digital banking options.

[5] RBA Payments System Board Annual Report 2022 (link)
[6] IMF, 2020 Digital Disruption in Banking and Its Impact on Competition, p39 (link)

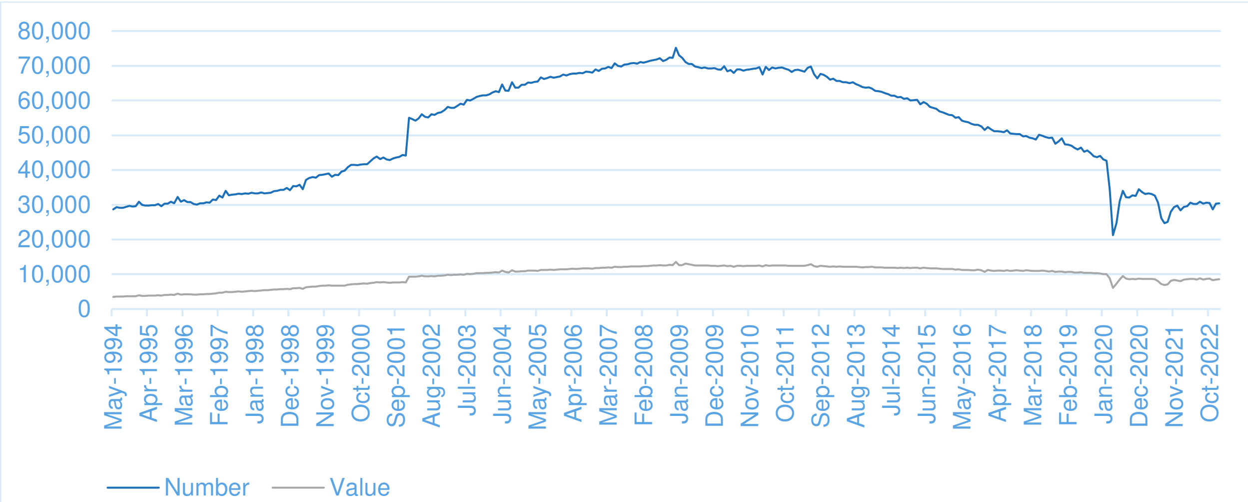
According to data from RFi Global in December 2022: [7]

- The number of Australians who reported leaving their wallet behind and relying on their phone or wearable to make a payment doubled in just three years, from 19 per cent in 2019 to 38 per cent in 2022
- More than 80 per cent of Australians report preferring to do their daily banking activities online or over the phone
- Around two-thirds of Australians have downloaded the banking app of their main financial institution.

Research by the Reserve Bank of Australia also found that in 2022 more than one third of Australians had made a payment by tapping a mobile device at least once over the course of a week. This was up from around ten per cent in 2019.[8]

The increase in customer usage of digital banking has correlated with a decline in the usage of branches and cash. For example, the number of ATM withdrawals has steadily declined since 2009 (see Figure 3).

Figure 3: ATM cash withdrawals, May 1994 – January 2023, Number ('000) & Value ($m)



Source: RBA, ATMs – Seasonally adjusted series, C4; ABA

Increased digital banking use is a precursor for innovation in the real economy. We refer to the ABA submission to the Inquiry into bank closures in regional Australia,

> '[T]he Productivity Commission's (**Commission**) recent *'5-year Productivity inquiry: Advancing Prosperity'* report – a follow up to the 2017 *'Shifting the Dial'* report – considered these digital trends and their impact on productivity in significant detail.

[7] RFi Global, Australian Digital Banking Program, Quarterly tracking. Data collected in December 2022 based a representative sample of Australian adults, N = 2,036
[8] Connolly, E., *The Shift to Electronic Payments – Some Policy Issues,* Speech to the AFR Banking Summit, Sydney, March 28 2023, https://www.rba.gov.au/speeches/2023/sp-so-2023-03-28.html

The Commission notes that productivity gains in the services sector are *"harder won"* than in industries that produce goods such as agriculture and resources. In relation to the former, it notes that the:

"[g]reater use of digital technology and data can improve product quality and consumer choice, particularly in the services sector. Millions of phone apps, online banking, telehealth consultations, computer-assisted services such as counselling, and entertainment streaming services are examples of improved and/or new products enabled by technology and data." (emphasis added)

Further, that the pandemic-induced:

"…adoption of digital technologies constituted a massive productivity boost, relative to a counterfactual scenario in which such technologies did not exist or were not adopted en masse. …the uplift in online capacity (among both businesses and households) combined with a broader embrace of the innovative potential of digital technology, can transform the way the economy operates – services in particular – with significant productivity benefits."

The shift to digital and the corresponding decline in branch/ATM usage should be seen in this context. It has given rise to a situation where there have never been more ways for customers to access banking services. Customers can access online banking services 24/7 and phone banking is typically available from around 8am to 8pm – much longer than the opening hours of most branches.'[9]

2. Innovation facilitated by banking

Banks have also played a key role in facilitating innovation outside of the banking sector. For example, banks have:

- Invested heavily in payments systems architecture, which has enabled other companies, including fintechs, to develop and implement new ways for consumers to make payments

  Many of these new entities offer products or services that have 'relied on existing payment rails for clearing and settlement of transactions – i.e., supplementing existing card payment methods with new features, channels or business models'.[10]

- Provided credit to Australian businesses that has enabled them to innovate. This includes funding companies with innovative product and service offerings.

Some banks have also adopted other measures to help support the development of innovative companies. These include:

- Establishing dedicated workspaces for innovation[11]
- Establishing sponsorship and graduate programs focused on areas of innovation and growth[12]

[9] ABA, 2023, 'Submission to the Inquiry into bank closures in regional Australia' p4
[10] RBA, Review of Retail Payments Regulation – Issues Paper, November 2019, at pg 2, available at: https://www.rba.gov.au/payments-andinfrastructure/review-of-retail-payments-regulation/pdf/review-of-retail-payments-regulation-issues-paper-nov-2019.pdf
[11] Examples include NAB, Commonwealth Bank, Suncorp, Citi Bank, ING and BOQ.
[12] For example, Westpac's Scholars program, Commonwealth Bank's x15ventures program and NAB Ventures.

- Partnering with other organisations, including global businesses and start-ups, to deliver support services to relevant companies. [13]

3. How competition and innovation could be further promoted

Banking sector regulation helps ensure the stability and safety of the financial system. However, the costs of complying with regulation are significant.

These costs can have negative effects on competition and innovation as they:

- Create barriers to entry into the sector
- Divert funds and resources from the development and delivery of new products and services.

To best facilitate competition and innovation, regulatory compliance costs should be calibrated so that the expenditure achieves government regulatory obligations while keeping barriers to entry and innovation opportunity costs as low as possible.

The ABA has two key suggestions for the Committee on how this could occur.

First, there could be additional consideration paid to the coordination of regulatory reform implementation. By purposefully considering the sequencing and interaction of the various reform initiatives affecting banks, the burden of the reforms can be materially reduced.[14] Such sequencing would also provide support for other sectors such as technology.

To help this, the ABA would recommend that Government and the financial system regulators, such as the Council of Financial Regulators, publish a combined regulatory plan on a 24-month basis like the UK's Regulatory Grids Initiative[15]. This would help align regulatory initiatives in a way that allows the Government to implement its policy objectives while giving clarity to how the banking industry deploys its expenditure on regulatory compliance.

Second, some regulatory requirements could be reviewed to help reduce barriers to entry and free up capital for innovation while not undermining the purpose and function of the requirements. For example, we suggest:

- The issuance limit for covered bonds should be increased from 8% to 12% of total assets

  Covered bonds are a form of bank financing that sees specific assets allocated to back up a specific debt obligation. Currently, the assets securing covered bonds can be no more than 8% of the value of a bank's Australian assets.[16] If this ceiling were raised, it would allow banks to access a greater proportion of their funding through covered bonds. This would help allow banks to lower funding costs, with covered bonds typically priced below that of other forms of wholesale funding.[17] Everything else being equal, lowered cost of funding could help banks allocate more funds to price competition and/or capital expenditure on innovation.

[13] For example, BOQ's strategic partnership with Microsoft.
[14] The ABA has previously recommended this to the Department of Prime Minister and Cabinet in its submission on the Regulatory Performance Guide: https://www.ausbanking.org.au/wp-content/uploads/2021/07/210602-Submission-to-PMC-Regulator-performance-guide.pdf. The ABA also suggested the Government should publish a combined financial regulator plan on a 24-month basis.
[15] To manage regulatory impact, the UK Government established a Regulatory Initiatives Forum, comprising government bodies and England's Central Bank (akin to the Australian Council of Financial Regulators), that prepares and publishes a Regulatory Initiatives Grid twice a year, setting out a 24-month outlook of regulatory reforms proposed by the prime financial regulators.
[16] Prudential Standard APS 121 Covered Bonds, paragraph 39.
[17] Lonsdale, J. (2011) *Understanding the key elements of covered bonds legislation*, Speech

- Further, covered bonds should be eligible for inclusion in banks' High Quality Liquid Asset (HQLA) holdings

  As a supporting measure to our prior point, we note that APRA requires banks to hold HQLA as part of their regulatory requirements. If covered bonds were eligible for inclusion as HQLA, this would likely deepen the domestic market for covered bonds by providing an additional market for these assets, and, in doing so, potentially put downward pressure on covered bonds pricing. Additionally, for smaller banks, this would provide additional funding opportunities in the domestic market, reducing their reliance on offshore markets.

- APRA could provide more support for banks to move to an internal ratings-based (IRB) approach

  Under the IRB approach, banks are permitted to utilise their 'internal models' to generate risk-weightings for their assets.[18] These risk-weightings determine the 'risk-weighted assets' against which banks must hold capital. There are, however, significant requirements (and costs) to banks associated with obtaining IRB accreditation. As such, only the largest Australian banks have been able to obtain IRB accreditation. Non-IRB banks, use the 'standardised' approach to calculate capital risk-weights and hold more capital[19].

  Greater assistance could be provided by APRA to banks wanting to obtain IRB accreditation. This could include more detailed engagement and adjusted expectations.

- Consideration by CFR agencies when designing support programmes for impact on competition.

  In 2020, the Reserve Bank of Australia established the Term Funding Facility (TFF)[20] as a temporary measure to reinforce the benefits to the economy of a low cash rate and to encourage ADIs to increase their lending to businesses during the Covid pandemic. Under the facility $188 billion of funding was outstanding[21]. Under the terms of the TFF, funding was for three years from funds access. This created a maturity concentration when combined with the need to refinance another temporary measure, the Committed Liquidity Facility, putting material pressure on near-term refinancing requirements. As the first repayments across the industry became payable in April 2023, banks needed to find alternative funding sources, leading to heightened competition for funding including deposits.

  The ABA encourages the CFR to give greater consideration to the impact on competition within capital markets and between regulated entities when designing measures (including their wind down) like the TFF.

[18] Put simply risk-weights are the product of the probability of default, the exposure at default and the loss given default and the effective maturity of a specific exposure within a specific risk category.
[19] Risk weights for Standardised banks are set predominantly by APRA's *APS 112 Capital adequacy: Standardised Approach to Credit Risk*.
[20] The ABA supports the measures taken during the COVID pandemic such as the TFF and the Committed Liquidity Facility. The availability of the TFF and the speed at which this was made available played a key role to settle the markets.
[21] https://www.rba.gov.au/mkt-operations/term-funding-facility/overview.html