AUSTRALIAN BANKERS' ASSOCIATION INC.

Submission

FINANCIAL SYSTEM INQUIRY

March 2014

This page is intentionally blank.

Contents

Contents 3
Appendices 5
Mapping to the Terms of Reference 6
Glossary 7
Figures 9
Executive Summary 11
Overview 13
Submission 23
1. Why this Inquiry is important 25
1.1. The essential purpose of the Inquiry 25
1.2. The outcome needed 25
1.3. This submission 27
2. Context for the Inquiry 29
2.1. How banking has changed for customers since Wallis 29
2.2. The Wallis Inquiry 30
2.3. How the system functioned between Wallis and the GFC 32
2.4. The Global Financial Crisis 33
2.5. Where are we today? 35
2.6. Contribution to Australia's future prosperity 39
3. Funding the economy 43
3.1. The current situation 43
3.2. Likely future situations and the challenges presented 57
3.3. What can be done to manage the challenges 58
4. Ensuring dynamic competition 67
4.1. Why is competition important 67
4.2. Customers 68
4.3. Markets 76
4.4. International Competitiveness 87
5. Getting regulation right 93
5.1. Introduction 93
5.2. The current regulatory framework and the role of Government 93
5.3. When and how much to regulate? 96
5.4. The reasons for regulation and the implications of poor regulation 98
5.5. The consequences of poor regulation 101
5.6. International regulation and extra-territoriality 105

5.7. Solutions 109

6. Technology and innovation 111

6.1. A short and recent history 111
6.2. A technology intensive industry 112
6.3. Mobile banking 113
6.4. Managing risk 114
6.5. Modernising disclosure practices 115
6.6. The transformation of technology infrastructure 115
6.7. Policing cyber space cohesively and collaboratively 116

7. Capitalising on a strong financial sector 119

Appendices

Appendix A: Financial system issues in the context of Wallis

Appendix B: Banking on our Future: Framing a vision for the Australian Banking Industry

Appendix C: Sustainably funding Australia's prosperity

Appendix D: Linking Superannuation to funding and the broader economy

Appendix E: Competition in retail banking

Disclaimer:

These appendices have been commissioned by the Australian Bankers' Association to inform the industry's consideration of issues. The reports reflect the views of their authors only. Each report and points made within each report do not necessarily reflect the views of the ABA or any individual bank.

Mapping to the Terms of Reference

Section 1: Why this Inquiry is important 1; 2
Section 2: Context for the Inquiry 1; 3
Section 3: Funding the economy 1.1; 2.2; 2.4; 3.3; 4.1; 4.2; 4.3; 4.4; 6
Section 4: Ensuring dynamic competition 1.2; 1.3; 2.1; 2.3; 2.4; 3.1; 3.2; 3.4; 4; 6
Section 5: Getting regulation right 1.2; 1.3; 2.2; 2.3; 2.4; 2.5; 3.2; 5
Section 6: Technology and innovation 3.1; 3.6, 4.4
Section 7: Capitalising on a strong financial sector 2; 3

Glossary

ABA	Australian Bankers' Association
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ADI	Authorised Deposit-taking Institutions
AFCF	Australian Financial Centre Forum
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports & Analysis Centre
Banking Act	Banking Act 1959
BCA	Business Council of Australia
BPS	Basis points
CAD	Current account deficit
CFR	Council of Financial Regulators
COSBOA	Council of Small Business of Australia
CPI	Consumer price index
CUBS	Credit Unions and Building Societies
Dodd-Frank	Dodd-Frank Act
FATCA	Foreign Account Tax Compliance Act
FCS	Financial Claims Scheme
FSF	Financial Stability Fund
FSB	Financial Stability Board
GEN Y	Generation Y
GFC	Global financial crisis
HHI	Herfindahl - Hirschman Index
IMF	International Monetary Fund
IWT	Interest withholding tax
LCR	Liquidity Coverage Ratio
NIMs	Net interest margins
NSFR	Net Stable Funding Ratio
PIR	Post Implementation Review Process
RBA	Reserve Bank of Australia
RIS	Regulatory Impact Statement
RMBS	Residential mortgage backed securities

RoE	Return on equity
SRI	Statement of Regulatory Intent
TASA	Tax Agent Services Act

Figures

Figure 2.1: Assets of financial institutions - distribution 36
Figure 2.2: Financial system assets as a multiple of GDP, 2013 37
Figure 2.3: Growth multiple of assets of financial institutions (2008 to 2013) 37
Figure 2.4: Payment systems – number of transactions (million) 38
Figure 2.5: Change in value added since 1996 ($bn) 38
Figure 3.1: GDP growth (annual) 43
Figure 3.2: Industry contribution to economy 44
Figure 3.3: Sources of funding of listed resources companies 44
Figure 3.4: Sources of funding of the finance and insurance industry ($bn) 45
Figure 3.5: Expenditure components of GDP 45
Figure 3.6: Credit growth (annual) 46
Figure 3.7: Business loan outstandings for loan amount under $2m 46
Figure 3.8: Commonwealth Government Securities 47
Figure 3.9: Current account deficit ($bn) 47
Figure 3.10: Financial assets as a share of GDP 48
Figure 3.11: Credit shortfall as a share of GDP 48
Figures 3.12: Financial claims by sector 49
Figure 3.13: Assets of financial system ($trn) 49
Figure 3.14: Australian financial assets outstanding ($trn) 50
Figure 3.15: Bank loan outstandings ($bn) 50
Figure 3.16: OTC debt and currency markets annual turnover ($bn) 51
Figure 3.17: Banks' non-deposit funding ($bn) 52
Figure 3.18: Credit demand and M3 ($bn) 52
Figure 3.19: Bank funding 53
Figure 3.20: Major banks' funding costs* 53
Figure 3.21: Banks' bond issuance maturities, 2012-2013 54
Figure 3.22: Banks – proportion of offshore funding 54
Figure 3.23: Gross bond issuance by Australian Non-Financial Corporations 59
Figure 3.24: Projected growth of superannuation funds 61
Figure 3.25: Assets of Australian superannuation funds 61
Figure 3.26: Investment split (%) by type of superannuation fund (2013) 62
Figure 3.27: Deposits of superannuation funds 63

Figure 3.28: Debt to GDP ratio of AAA rated countries (2012) 64
Figure 3.29: Australian Government Gross Debt ($bn) 64
Figure 4.1: Customer satisfaction - globally... 69
Figure 4.2: Major banks' Net Interest Margins (basis points)..................................... 70
Figure 4.3: Spreads on deposits to cash rate (bps)... 72
Figure 4.4: Spreads selected household loan products to cash rate (bps) 72
Figure 4.5: Business lending – average weighted interest rate.................................. 73
Figure 4.6: Bank service fee revenue from households ($m) 74
Figure 4.7: Products on market.. 75
Figure 4.8: Market share (%) of top three banks by country against population 77
Figure 4.9: ADIs - number of market participants 79
Figure 4.10: Deposits – share by bank.. 81
Figure 4.11: Deposits... 81
Figure 4.12: Housing loan outstandings and providers.. 82
Figure 4.13: Banks - market share of housing loans 82
Figure 4.14: RoE for Top 50 Australian companies (by Market Capitalisation), 2013 ... 84
Figure 4.15: Profitability by bank type 84
Figure 4.16: Main Retail Banks, Return on Equity 85
Figure 4.17: Market Capitalisation and Return on Equity (2013) 86
Figure 5.1: Current regulatory structure 94
Figure 5.2: Regulatory pyramid 96
Figure 6.1: Proportion of working population (15 to 64 years) 112
Figure 6.2: Banking channels used over average four week period (%)................... 112
Figure 6.3: Capital stock of technology by industry, 2013 ($m) 113
Figure 6.4: Proportion of smartphone owners who perform financial activities online (2012) 114
Figure 6.5: Banks - Technology expense ($bn)... 116

Executive Summary

The banking industry welcomes the major inquiry into the financial system, the first since the Wallis Inquiry reported 17 years ago. Much has changed in that time and it is appropriate to assess whether the current policy and regulatory framework is appropriate for today's circumstances and the future opportunities and challenges Australia faces.

The banking industry believes this Inquiry must focus on one overriding objective, and that is to ensure the financial system is allowed to fulfil its central role as a critical enabler of economic activity and growth.

The current and future prosperity of Australians depends on continued economic growth. Economic activity and growth in turn are built on the foundations of a stable, competitive and efficient financial system. The Financial System Inquiry is therefore a key part of an ongoing economic reform agenda.

Since the Wallis Inquiry, the financial system has served its purpose well and this has made a significant contribution to the growth in Australians' incomes and wealth. The system has also stood up well to the greatest Global Financial Crisis it has faced in generations. The first conclusion of the Inquiry therefore should be that the current system works well and that it is imperative that its strengths are preserved. The banking industry will not be seeking dramatic change to the current policy and regulatory framework.

While the system has served Australia well, we cannot afford to be complacent. As a small, open economy on the edge of the fastest growing region of the world, but a world with persistent global uncertainty, Australia must ensure its financial system is delivering all that it can to help build enduring prosperity for the nation.

In this context, the banking industry has identified four areas that warrant close attention by the Inquiry:

Funding the economy: Access to funding is essential for the vitality of an economy; without it, the economy will stagnate. The financial crisis and its lingering impacts show that funding can be vulnerable and, while markets are adaptive and resilient, it would be prudent to put in place a national strategy to ensure all banks and the economy have access to a diverse range of quality funding markets and products, both locally and offshore, to mitigate against any future risks.

Driving competition: Competition is the key to ensuring markets deliver ongoing improvements in products and services for their customers. There is solid evidence that the main markets for consumer and business banking products and services are competitive. There could be opportunities to enhance competition, however, including through broadening the funding options for banks. Where regulatory or tax arrangements can be shown to inhibit competition unnecessarily, these should be reviewed.

Improving regulation: Banking is one of the most regulated industries in Australia and therefore it is vital that the regulatory regime works well. The resilience of Australia's banking system during the Global Financial Crisis is partly due to its strong regulatory and supervisory framework, supported by the prudent and responsible management of banks. Given the strength of our existing regulatory regime, we should be sceptical of the need for ever more regulation. Caution also needs to be exercised when regulating a complex, interconnected system like the financial system. To minimise the risks of undermining the current proven regime and to avoid unintended consequences, we need improved regulation making processes that strike the right balance between stability, competition and efficiency and ensure Australian conditions and needs are recognised when international rules are applied.

Supporting technology: Technology will be a major factor shaping the financial system of the future. It is already transforming the way we do our banking, bringing increased choice, competition and convenience for customers. It is vital that the policy and regulatory framework supports, rather than impedes, the rapid innovation occurring as a result of technology. Rapidly evolving technology can also raise risks, such as security or systemic risks. We need to ensure these are properly managed, so that customers, banks and the broader economy can enjoy the benefits of technology, without risking the core strength of the Australian financial system.

The Inquiry into the financial system is a landmark opportunity to build on the strengths and successes of the financial system to date, and to ensure Australia continues to enjoy the benefits of its world- class system into the future.

Overview

Australia is in a rare position. Unlike most other developed economies, Australia has enjoyed over two decades of uninterrupted annual economic growth, giving Australians one of the highest living standards in the world. Our economy has doubled in size and real incomes have increased by 60%, with wages growing on average by nearly 4% each year.

This growth and prosperity would not have been possible without a strongly performing financial system. The financial system is an essential foundation upon which our vibrant and growing economy is built. Banks are a major part of that system and through their deposit taking, lending, transactional, advisory and financial management products and services, banks in Australia provide households and businesses with the means to contribute to the economy and share in the prosperity economic growth brings.

The Federal Government's Financial System Inquiry is therefore an important opportunity to ensure the Government's policy and regulatory settings allow the financial system to fulfil that central economic role and meet the current and future needs of household and business customers, investors, employees and the broader community.

The last major review, the Wallis Inquiry, reported its findings and recommendations 17 years ago. Those recommendations, and the then Government's response, laid the policy and regulatory foundation for a financial system that went on to perform strongly through good times and through some of the most challenging times in recent history.

Bank customers have been major beneficiaries of the strong performance of the financial system. In the period since the Wallis Inquiry, credit has been readily accessible and deposits have been secure. The range of products and services has grown and, particularly through technological innovation, they have become more accessible and convenient to use. Service quality has improved, branch numbers are close to their peak and customer satisfaction levels are at record highs. At the same time, the cost of many banking services for customers has fallen. Fees paid as a proportion of bank assets have reduced. Competition has driven down bank net interest margins and kept them down.

Today, Australia has a banking system that has proven itself to be stable, resilient and safe, even under extreme pressure. Banking in Australia is competitive, innovative and accessible, with Australia having one of the highest levels of participation in banking in the world. Although concentration has increased since Wallis, the industry remains diverse, with numerous major and regional banks, mutual banks, international banks and credit unions and building societies offering a wide range of products and services. Banks are efficient and profitable, innovative and responsive to their customers, and the market is open to new entrants.

These are all attributes of a well-functioning banking system. The first task of the Inquiry, therefore, is to ensure that any changes to Government policy or regulation do not undermine the existing strengths of a banking system that continues to serve Australia well.

Recommendation 1: The banking industry recommends the Financial System Inquiry reports on the strengths and benefits of the current financial system and ensures any changes to Government policy or regulation build on those strengths and do not undermine a system that currently works well.

Despite the strengths of the current system, we cannot afford to be complacent. As a small, open economy on the edge of the fastest growing region of the world, but a world with persistent global uncertainty, Australia must ensure its financial system is delivering all that it can to help build enduring prosperity for the nation.

There are also lingering challenges resulting from the Global Financial Crisis. While the Australian system performed well, as a result of prudent bank management, effective regulation and supervision and swift action from Government, the crisis has still left its mark. Financial institutions face a changed funding environment. The regulatory response, particularly driven by international rule makers responding to problems in other countries, has also had a significant impact on the system.

We can also anticipate that the Australian economy and financial system will face new opportunities and challenges in future. Major forces will shape the economy and therefore the nature of the financial system we need to serve it. While hard predictions should be avoided, significant trends likely to have a growing impact include:

- the ageing of the Australian population;
- the continuing growth and importance of the Asian region;
- the growing impact of digital technology;
- the increasingly risk averse nature and cost of capital; and
- the increasing scarcity and cost of natural resources.

This Inquiry will have to understand the likely shape and needs of the future economy to ensure the right policy and regulatory settings are put in place to allow the financial system to help Australia meet those future challenges.

The banking industry's assessment is that the Inquiry should therefore focus on four critical areas to ensure the system continues to meet Australia's needs:

- funding the economy;
- driving competition;
- improving regulation; and
- supporting technology.

Funding the economy

Access to funding is essential for the vitality of an economy; without it, the economy will stagnate. Businesses need funding to innovate, grow and create jobs. Households need funding to build and buy homes, acquire goods and to invest. It is particularly important to ensure funding is available to the segments of the economy that can drive future economic growth and the general wellbeing of Australia, such as small business, agriculture and technology.

Most of the funding of the Australian economy is provided through the banking system, so the funding of banks is critical to the funding of the economy. In turn, most of the funding for banks comes from deposits, however, the level of deposits in Australia falls short of the total funding needs of the economy. Currently an additional $600 billion in funding is needed, raised within Australia and from overseas. Over $500 billion of this is raised by banks. With an increase in economic growth and credit demand from businesses and households, the total funding difference between deposits and credit needs could grow.

The financial crisis and its lingering impacts show that funding can be vulnerable. Under extreme pressure, markets can freeze and prices can be highly volatile. In these extreme conditions, it can be necessary for Governments to intervene. For example, when Governments around the world started providing guarantees for the funding of their banks, it became necessary for the Australian Government to follow suit so that our banks were not disadvantaged. Taxpayers have earned $4.4 billion in fees from that low risk support. Government also intervened to support the securitisation market, an important source of funding, particularly for smaller banks, from which taxpayers have earned more than $2.5 billion so far.

As a general rule, however, markets are adaptive and resilient, and banks will be able to raise the funding necessary to support the economy, provided they are allowed to access a full range of quality funding sources and price appropriately when lending to customers.

Given the critical role funding plays in enabling economic development and growth, it would be prudent nevertheless to ensure Australia has a clear plan for mitigating the risks that could arise with funding in the future. In particular, we need to ensure that the economy and banks have access, now and into the future, to as diverse a range of stable funding sources as possible. The role for Government is to work with the industry to identify and remove impediments to achieving this.

Recommendation 2: The Inquiry should support the finance sector and Government developing a clear strategy for ensuring the economy, including banks, have access to as diverse a range of stable funding sources as possible.

The banking industry has been working on this issue with Government over the past few years, in response to the lessons from the Global Financial Crisis. This collaboration resulted in changes in legislation to allow banks to access covered bond markets and saw an extension of the Government's support, through the Australian Office of Financial Management, for the securitisation market. However, it is clear there is no 'silver bullet' to mitigate potential future risks to funding; rather, a suite of policy responses is required.

The funding sources that need further consideration include:

- deposits;
- domestic debt capital markets, including the corporate bond market, securitisation and covered bonds;
- offshore funding;
- superannuation funds; and
- Government debt.

Deposits remain an important source of funding for banks and a source that has grown in importance since the crisis. Regulators and ratings agencies are also applying pressure on banks to increase deposit-based funding, with a number of international rules, such as Basel III liquidity requirements, driving banks to grow their deposit funding. The strategy for securing Australia's future funding needs must therefore identify and remove impediments that work against banks increasing their deposit funding. Two obvious targets are:

- The income tax disadvantages of deposits and other interest earning products relative to other forms of investment, as identified by the Australia's Future Tax System ('Henry') Review; and
- The proposal to tax savings through a deposit levy, which would make deposits even more disadvantaged, more costly to banks and decrease their attractiveness to savers and investors.

Another area where Government can play a vital role is in the development and expansion of the domestic debt capital market. This market in Australia is small compared to other developed economies, but if deepened and made more liquid, could provide an important source of funding for the economy. Government can facilitate this by enacting the improved legislative and disclosure requirements for simple corporate bond issuance contained in the *Corporate Amendment (Simple Corporate Bonds and Other Measures) Bill 2013*. Government should also complete the work started by the Treasury discussion paper, *Development of the Retail Corporate Bond Market: Streamlining disclosure and liability requirements*, issued in late 2011, which examined barriers to issuing bonds to retail investors. Finally, Government can strengthen the market through its own active participation, extending the yield curve through issuing longer dated securities, increasing issuance and facilitating secondary market trading.

Securitisation in Australia, damaged largely through perception rather than actual underlying risk, will remain an important and effective source of funding. The Australian market is limited currently by the low frequency and small size of issuance of many programs, both of which limit investor interest. Coordination to facilitate larger and more frequent issues that can compete with some of the larger programs offshore should be encouraged. This would contribute towards a deeper and more liquid market, and thereby improve pricing. Allowing master trust structures would assist this, while also addressing some specific investor concerns, such as with the term of investment. To facilitate this, Government should finalise regulatory settings for securitisation, including the use of master trust structures, as quickly as possible.

The introduction of covered bonds in Australia has provided a valuable additional source of funding for some market participants. Covered bonds potentially have wider application and could serve as an even greater source of funding. The current legislation sets a cap on the use of covered bonds, in recognition of the primacy of depositor protection. This cap should be reviewed periodically to ensure the right balance between depositor protection and funding source stability and diversity is maintained.

Secondary market trading is essential to creating a deep and liquid capital market. The operation of markets should be examined to identify opportunities to improve market participation, and to increase accessibility to trading infrastructure, facilitating more timely and accurate price discovery and easier settlement. Options include increased trading of bonds on an exchange and more tools to access trading via electronic platforms.

Offshore funding will remain important for banks and the economy. Australia has long relied on overseas savings to help fund the development and growth of the Australian economy and this is expected to continue. The difference between credit demand and money supply within Australia currently sits at over $600 billion. Of this, a total of more than $390 billion is raised by Australian banks in overseas markets, with around $120 billion of that total renewed each year.

Superannuation funds may also provide a potentially greater source of funding for the economy, particularly where the longer term investment needs of superannuation funds can be matched with the longer term growth needs of Australia, such as funding infrastructure. Superannuation funds are the second largest component of the finance and insurance industry in terms of assets, after banks, with current assets of $1.6 trillion, forecast to rise to $3.4 trillion by 2028.

No attempt should be made, however, to compromise the sole purpose of superannuation, which is to provide retirement benefits to fund members. The focus instead should be on ensuring the right investment opportunities exist domestically and that distortions or barriers to appropriate investment decisions are removed. For example, treating superannuation fund deposits, including self-managed superannuation fund deposits, the same as retail deposits for Basel III purposes would increase the availability of superannuation fund deposits to support economic development.

Within a well-run economy like Australia's, the Government will usually have the cheapest access to funding and there will be appropriate circumstances for the Government to use this advantage to support the economy. This funding potential, however, is limited by the Government's willingness to incur debt, which in turn is driven by factors such as the desire to preserve credit quality and, ultimately, Australia's AAA rating. Areas where Government funding has traditionally played an important role include infrastructure development, where direct Government funding or partnerships with the private sector are critical to ensuring the economy has the infrastructure it needs. When examining the funding of the economy as a whole, therefore, appropriate use and levels of Government funding also need to be considered.

There are opportunities in each of these areas to strengthen and diversify the funding sources available to the economy.

An important additional advantage from developing and implementing a strategy to strengthen and diversify funding sources is that this helps drive competition. The less funding is an issue for lenders, including bank and non-bank lenders, the more they are able and willing to compete for customers and market share.

It would therefore be prudent to put in place a comprehensive strategy to ensure banks and the economy have access to a diverse range of funding markets and products, both locally and offshore, to ensure future credit demand is met and to mitigate against any future funding risks.

Driving competition

Competition in banking was freed up by the reforms of the 1980s and 1990s, resulting in the value added by the industry, as a share of GDP, doubling from 1980 to 2013. From 1996 to 2013, the Financial and Insurance Services sector's multi-factor productivity increased by 1.7% per annum a performance in the top half of outcomes for Australian industries. These gains brought considerable benefit to customers and the economy, keeping the cost of banking products and services down.

Price, however, is just one attribute customers consider when choosing their banking provider. Customers also value attributes such as service quality, convenience, innovation in meeting the customer's needs, accessibility and choice from a wide and diverse range of providers.

Customers are the ultimate beneficiaries of competition, and it is therefore important to assess competition levels from the perspective of the customer; what they experience and what is available to them. Competition can also be assessed against a range of market characteristics, such as barriers to entry, concentration or levels of profitability.

All banks agree that markets are currently competitive, but that the Inquiry should consider proposals to drive more competition, on the merit of the case made for those proposals.

Recommendation 3: The Inquiry should assess current competition levels and identify any measures, consistent with a stable and efficient market, which can reasonably be taken to enhance competition further.

There is solid evidence that the main markets for consumer and business banking products and services are competitive, but that measures could be taken to improve competition further. Depending on their commercial strategies and market position, banks have a range of views on the degree of competition and what steps could be taken, which they will address through individual bank submissions.

A major contributor to competition levels is the availability and price of the funding available to banks. Ensuring banks have access to a wide and diverse range of reliable funding sources can help intensify competition.

A number of banks have also identified regulatory or tax arrangements that they consider impede their ability to compete. For example, some banks argue that the interest withholding tax on foreign raised deposits restricts the ability of banks, Australian and international, to use those deposits to improve their liquidity and support their lending in the Australian market. There will be some issues, such as the Advanced Internal Ratings-Based approach to capital and the impact of some banks being seen as 'too big to fail', where individual banks will have different views. These issues are more appropriately left to individual bank submissions.

Improving regulation

Banking is one of the most regulated industries in Australia. It is therefore vitally important that the regulatory regime works well and supports, rather than impedes, the ability of banking to support Australian economic growth. Overall, the system works well, but there are clear areas for improvement.

The resilience of Australia's banking system during the Global Financial Crisis is partly due to its strong regulatory and supervisory framework, supported by the prudent and responsible management of banks. Given the strength of our existing regulatory regime, we should be sceptical of the need for ever more regulation. Instead, what the industry has experienced over the past five years has been a wave of regulatory change, driven by international rule making, the extraterritorial impacts of US legislation and a range of, at times *ad hoc*, regulatory interventions from Government responding to domestic issues. The current Government's commitment to a moratorium on significant new financial regulation is therefore a welcome pause for the industry.

One of the challenges Australia faces is that, increasingly, the rules for financial systems are determined outside of Australia's borders. This trend reflects the growing globalisation of the financial system and was apparent before the Global Financial Crisis. That crisis, however, has rapidly accelerated the trend. As a consequence, large parts of the Australian regulatory regime are determined in international negotiations and are often shaped to deal with problems not experienced in Australia. As a small, open economy, and one that relies on raising money offshore, Australia has little choice but to accede to these international rules. While Australian negotiators have often been able to influence these rules to recognise unique Australian circumstances, Australia is left with a dilemma: the major rules that shape the banking system are not determined with Australia's circumstances in mind. It is critical therefore that Australian regulators use, to the full extent possible, any national discretions within international rule-making to ensure the rules applied within Australia meet our own needs, while satisfying international requirements. There need to be good reasons, for example, for accelerating the adoption of international rules in Australia, especially if these rules are designed to address problems not experienced here.

Regulators also need to exercise considerable caution when regulating a complex, interconnected system like the financial system. It is in the nature of complex systems that, when a change occurs in one part of a system, its impact flows through to other parts, often in unexpected ways. Regulators therefore need to accept that virtually any rule change will have unintended consequences. This should make regulators instinctively cautious and conservative in proposing new or changed regulation.

It also makes it imperative for regulators to allow considerable opportunity and time to discuss proposed changes with those with the best understanding of the system.

Finally, in putting forward regulatory proposals, regulators need to bear in mind the fundamental purpose the banking system serves within the economy. Each regulation development process needs to assess, openly and in detail, the impact further regulation is likely to have on the ability of the banking system to serve its customers and the broader community. Measures, for example, to increase stability even further may achieve that goal, but may not be warranted if they distort bank lending to the degree that it impedes the growth of parts of the economy.

To minimise the risks of undermining the current proven regime and to avoid unintended consequences, we need improved regulation making processes that strike the right balance between stability, competition and efficiency and ensure Australian conditions and needs are recognised when international rules are applied.

Recommendation 4: The Inquiry should recommend Government puts in place new processes for developing or changing regulation that impacts on the complex financial system, to minimise unintended consequences, ensure regulations are appropriate in the Australian context and that the right balance is struck between system stability and economic growth.

As a starting point, Government should commit to spelling out clearly and publicly the problem that it is considering solving and the reason it considers regulation to be the appropriate response. This should be done well ahead of any consideration by Ministers or Cabinet on whether new regulation is required.

Too frequently, proponents of regulation assert a wide-ranging problem exists and back their claims with anecdotal evidence, or claim that a problem will arise unless regulation is put in place first. In neither case is the problem clearly defined, nor objective evidence put forward. As a result, those affected by prospective regulation wear the burden of proof to show that no problem exists, that existing regulation is adequate or that any problem is more narrowly confined. In effect, the burden of proof rests on those that will be regulated, rather than those that argue for regulation.

While these matters should be addressed through regulatory impact statements, many years' experience with that process shows that, even on those occasions when it is used, it typically occurs too late in the process. Instead, Governments should require a short 'statement of intent to regulate' be prepared that sets out clearly the nature and evidence of the problem. This would allow others to contest the case for regulation before any Government decision on the need to regulate has taken place. It would also ensure that, where a problem does actually exist, its nature and scale is clearly defined so that any regulatory response can be tailored to fit the actual problem. It also gives the industry the opportunity to address the problem or self-regulate before a legislative response is imposed.

Given the central role banking plays in enabling economic activity, Government should also have in place mechanisms to ensure the economic impact of proposed regulatory changes has been fully and independently assessed. This should be a critical role for the Treasurer and Treasury, particularly when regulators, such as the Australian Securities and Investments Commission or the Australian Prudential Regulation Authority, are proposing new regulations or requirements. The Council of Financial Regulators could also play a more active and transparent role in assessing the economy-wide impacts of new or changed regulation and coordinating the activities of different regulators.

Australia has a sound and tested regulatory regime, which should not be changed lightly. New and more robust processes are needed to ensure we protect that strength.

Supporting technology

There is little doubt that digital technology will be a major shaper of the financial system of the future. It is already transforming the way we do our banking, bringing increased choice, competition and convenience for customers.

When the Wallis Inquiry reported in 1997, most Australians did their banking in branches and queued up at lunch time, or wrote cheques to pay their bills. It was only in 1997 that Australia saw the first 24-hour internet banking service introduced and BPAY, the world's first single bill payment system accepted across the banking system, launched. Since then, the pace of change has accelerated. It is only four years since the first iPad was released and even less time since the first banking app was offered. Today, Australia has the highest proportion in the world of smartphone owners performing financial activities online. And yet, it is expected that we are only at the beginning of digital technology's transformation of banking.

Technological change brings enormous benefits to customers. Technology makes banking more convenient, with customers able to choose the place and time they want to bank. Transaction times are reduced, whether when paying bills, transferring money or making payments while shopping. Customers are able to compare available banking products and services more easily, increasing accessibility to choice and sharpening competition.

With rapid change driven by technology, it is critical that the regulatory regime adapts to reflect new ways of banking and does not impede the benefits technology can bring. Technology is also expected to make it easier for new players to enter the market, bringing competition and innovation. Although this is not without its potential downside if they also introduce unexpected or unmanaged risks, or build business models based on 'regulatory arbitrage', through avoiding or operating outside of the regulatory framework. Technology can also raise risks, perceived or real, to the security of money and personal information.

The benefits that technology brings are substantial and the risks need to be managed. This requires a systematic approach from Government to ensure the regulatory framework supports, rather than impedes appropriate technological development.

Recommendation 5: The Inquiry should recommend the Government develops, in consultation with the banking industry, a comprehensive strategy to ensure the regulatory regime supports technological innovation, while managing any potential risks.

Given the pace of technology-driven innovation and change in banking, it is not surprising that the regulatory regime already lags the realities of modern banking. Much of the disclosure regime, for example, is premised on face to face interaction between customers and their banks, with information passed over the desk or counter in printed form. While some customers prefer to continue banking this way, more and more customers are doing their banking virtually and the disclosure regime needs to recognise this by ensuring it is 'technology neutral' in terms of how required information is provided to customers.

Regulation also needs to recognise the uncertainties of how technology will shape banking. It therefore needs to be principles-based and flexible. New guidelines being developed by the Australian Prudential Regulation Authority around the use of cloud computing, for example, need to be flexible enough to achieve policy objectives without unnecessarily restricting the use and benefits of this new capability.

The regulatory regime also needs to anticipate potential new risks arising on the back of technology. All participants in financial e-commerce, for example, should be subject to the same degree of regulation and supervision, to maintain the safety and soundness of the payment system and customer confidence. The National Cyber Security Strategy needs to be updated and implemented with a greater level of public/private cooperation, to improve security resilience.

A serious effort will be required to ensure the regulatory regime keeps pace with the rapid changes driven by technology, to ensure customers and the financial system gain the benefits technology can bring, without increasing risks.

Conclusion

Australia has been served well by its financial system since the Wallis Inquiry reported in 1997. The objective for the current Inquiry should be to ensure the system serves Australia as well into the future. For a central part of that system, banking, this means ensuring Government policy and regulatory settings allow the financial system to fulfil its central economic role and meet the current and future needs of household and business customers, investors, employees and the broader community.

The banking industry submission has identified four areas that should be the immediate focus on the Inquiry: funding, competition, regulation and technology.

Beyond that, the banking industry believes Australia should develop and pursue a vision of a world class financial system that encompasses:

- a strong, stable, competitive and diverse set of financial institutions, with an increased presence regionally and globally;

- the delivery of world-class and cost-efficient services to all Australian consumers and businesses;
- continuing growth in financial activity, job creation, exports and tax revenue;
- enhanced capital allocation across the economy; and
- global leadership in innovation and productivity.

The banking industry welcomes the opportunity to make this initial submission to the Financial System Inquiry and looks forward to contributing further throughout the process.

This page is intentionally left blank.

Submission

1. Why this Inquiry is important

1.1. The essential purpose of the Inquiry

The banking industry, through the Australian Bankers' Association (**ABA**), welcomes the opportunity to make this submission to the Financial System Inquiry.

The Federal Government's announcement of a thorough and comprehensive inquiry into Australia's financial system is timely. Seventeen years ago, the Wallis Inquiry and the Government's response laid the policy and regulatory foundation for a system that went on to perform well. We have experienced periods of good economic growth and one of the world's most severe economic downturns with the Global Financial Crisis (**GFC**). We now have sufficient distance on a number of cycles to better understand the implications of Wallis, the impact of regulatory responses and market developments.

But the most important reason for the Inquiry is the central role that the financial system plays in supporting economic activity and growth, which in turn is the key to the current and future prosperity of Australians.

Over the past 23 years, Australia has enjoyed uninterrupted annual economic growth that has delivered us some of the highest living standards in the world. Our economy has doubled in size, with a 60% increase in real incomes per person and wages growing on average by nearly 4% per year.[1] This growth and prosperity would not have been possible without a strongly performing financial system.

Yet, while the system has served Australia well, we cannot be complacent. The critical outcome needed from this Inquiry is to ensure we have a financial system that serves Australia as well in the coming years as it has over the past two decades.

1.2. The outcome needed

A banking system that best meets Australia's future needs is one focussed on meeting the needs of household and business customers, investors, employees and the broader community. Such a banking system is one that is stable, resilient, safe, competitive, innovative, diverse, efficient, inclusive and profitable.

Stable: A stable banking system is one that is able to perform its primary functions regardless of the state of the economy and the performance of its individual parts.

[1] Business Council of Australia, (July 2013) *Action Plan for Enduring Prosperity – Overview*

Resilient: A resilient banking system is one that can withstand external shocks, including from the economy and global financial system, and internal shocks, such as failure or weakness in individual institutions.

Safe: A safe banking system is one where customers' money and personal information is secure and protected from misuse or unauthorised access.

Competitive: A competitive banking system is one where customers have a diverse range of choices, in terms of institutions, products and services, and where institutions have to compete for customers, including on price, service, innovation and reliability.

Innovative: An innovative banking system is one that adapts swiftly to changing customer needs and offers more efficient, convenient and lower cost banking services.

Diverse: A diverse banking system is one that includes a range of different types of institutions, giving customers greater choice and adding resilience to the system through a variety of entities and business models.

Efficient: An efficient banking system is one that meets customer needs effectively, promptly and at the least cost.

Inclusive: An inclusive banking system is one that recognises the central role banking plays in people's lives and provides access to banking products and services so that people have the opportunity to participate fully in social and economic activities.

Profitable: A profitable banking system is one that can invest in its customers' and its own future, can attract equity and debt investors and can generate acceptable returns for its shareholders, including for the nation's retirement incomes and security through superannuation.

The Australian banking system has performed well against these criteria. The stability and resilience of the system has been demonstrated throughout the most disrupted period of global financial and economic activity for 80 years. Our system and customers enjoy high levels of safety, despite ongoing cyber-attacks on banking systems around the world. Banking in Australia remains competitive, with customers enjoying wide ranging choices and markets showing evidence not only of price competition, but competition in service, innovation and access. Technology is driving innovation and increasingly it is customers, rather than banks, that are defining the needs that are to be met through innovation. Technology is also delivering greater efficiency in the system, to the benefit of customers and banks.

While profound changes in the underlying availability and price of funding, brought on by the GFC, have affected many business models, customers can still access their banking products and services from a diverse range of providers, including major and regional banks, international banks, mutual banks, credit unions and building societies.

Australia enjoys one of the highest levels of banking penetration in the world, with the vast majority of Australians having access to readily available and affordable banking. Where particular customers face challenges accessing banking, banks themselves have been active in developing products and programs, such as free banking for low income earners and free ATM access in remote Indigenous communities. Banks have also been active partners with community organisations and Government in promoting higher levels of financial inclusion and literacy.

Finally, on the whole, banks in Australia have remained profitable, through even the most difficult periods of the financial crisis. Over the past five years, the eight largest banks listed in Australia have contributed $88 billion of dividends to their shareholders[2], most of which has gone directly to Australians or into superannuation, providing Australians with the wealth and security they need for retirement. The four major banks are middle-ranked in the largest 50 Australian listed companies in terms of return on equity (**RoE**) which is comparable to returns in other sectors of the economy. This performance has not only allowed banks to be buffered from those external shocks but has ensured they could continue to lend and invest in new products and services. Bank profits continue to grow as the Australian economy grows and as customers seek more and more financial products and services.

These successes should form the basis for continual improvements to the financial system against the above listed criteria. It is these criteria that should shape industry and Government thinking about the banking system into the future and shape the policy and the build of the regulatory framework for the banking industry.

Much has changed in the financial system since the Wallis Committee delivered its report. The robustness of the financial system, and the management and regulation that underpins it has been thoroughly tested and has come through strongly. The task now is to ensure the financial system can continue to play its central role as a critical enabler of economic activity and growth, and the prosperity that brings, into the future.

Recommendation 1: The banking industry recommends the Financial System Inquiry reports on the strengths and benefits of the current financial system and ensures any changes to Government policy or regulation build on those strengths and do not undermine a system that currently works well.

1.3. This submission

This submission is made by the banking industry, through the ABA. While banks are active players in a wide range of aspects of the financial system, this submission focuses primarily on the banking component of the system and how banking serves the needs of household and business customers within the broader economy.

[2] From Annual Reports of eight largest banks.

The ABA represents the following banks operating in Australia:

- AMP Bank Limited
- Arab Bank Australia Limited
- Australia and New Zealand Banking Group Limited
- Bank of America, National Association
- Bank of Queensland Limited
- Bank of Sydney Limited
- Bendigo and Adelaide Bank Limited
- BNP Paribas
- Citigroup Pty Ltd
- Commonwealth Bank of Australia
- Credit Suisse AG
- HSBC Bank Australia Limited
- ING Bank (Australia) Limited
- Investec Bank (Australia) Limited
- Macquarie Bank Limited
- MECU Limited
- Members Equity Bank Pty Limited
- National Australia Bank Limited
- Rabobank Australia Limited
- Rural Bank Limited
- Suncorp-Metway Limited
- United Overseas Bank Limited
- Westpac Banking Corporation

2. Context for the Inquiry

It is critical that this Inquiry delivers a policy framework that will allow the financial system to serve Australia well in the coming years. To achieve that, it is important to understand the context for the Inquiry, particularly how the financial system has evolved since the last major inquiry, how the system functions today and what forces are expected to shape the system into the future.

2.1. How banking has changed for customers since Wallis

The traditional role of banks in the Australian economy is that of an intermediary between lenders, those with savings or money to invest, and borrowers, those households and businesses needing money to grow. The industry bears the associated credit and liquidity risks (risk that borrowers do not repay, and risk that lenders want to access their funds), makes a return by aggregating assets and liabilities and then meets the needs of customers with products that vary by risk, return and tenor. Banks are also the largest participants in the Australian payments system.

The services banks provide include acting as a safe deposit for household and corporate funds, enabling Australians to make payments for goods and services, encouraging savings and investment, and managing financial risk. Banks also facilitate the raising of capital in the financial markets, primarily for companies, governments and other financial institutions, in the local and global debt capital markets, and to a lesser degree in the equity capital markets. The industry is active in currency and commodity markets and derivative markets in order to manage their customers' and their own financial exposures. Increasingly, they are involved in wealth management, utilising their services and skills to help Australians meet their longer term financial needs.

How well banks perform these functions helps determine how well the rest of the Australian economy fares in both the short and longer term.

Banking has changed for customers since the Wallis Inquiry on many measures, as detailed in the proceeding sections of this submission. Since 1996, the cost of banking has fallen for many services; the range of products and services has broadened and developed, service levels have improved and access to banking services for the vast majority of Australians has been transformed by technology.

Since 1996, there have been significant price movements in a broad range of products which signal that the environment has been competitive. Fee revenue as a proportion of resident assets has fallen from around 70 basis points (**bps**) to 44 bps from the late 1990s to now. Net interest margins (**NIMs**)[3] have fallen from 375 bps at the time of the Wallis Inquiry to 213 bps today. The RBA's 2013 survey of bank fees[4] shows that since 2010 total fees paid by households have fallen by $1.12 billion or 22%, taking total fees to the lowest level for seven years.

3 The NIM is calculated by dividing the net interest income of the financial institution by its average interest earning assets
4 Reserve Bank of Australia, (2013), *Banking Fees in Australia*, in June Quarter *The Bulletin,* www.rba.gov.au/publications/bulletin/2013/jun/index.html

The industry believes that competition has been a strong contributor to the reduction in NIMs, with falling Returns on Equity (**RoE**) suggesting rising costs have, to an extent, been absorbed by banks and their shareholders.

Australian consumers have access to a wide and continually evolving range of products and services. New products to the market include no-fee transaction accounts, low-doc loans and foreign currency debit cards. Service channels have expanded rapidly, and customers can now do most of their banking from their laptops or phones. Customers still have ready access to bank branches, with branch numbers having increased steadily to peak at a record number in 2012 of 5,632 branches, before dropping slightly to 5,582 in 2013.

The most significant change since Wallis has been exponential developments in information technology and the transformation it has brought to accessing bank products and services. In 1996, the year the Wallis Inquiry was established; the Internet was only just making its presence felt. One year later, the industry-owned BPAY was launched and the first online service was offered by one of the major banks. Functionality on internet banking continued to develop steadily until 2012, by which time mobile banking had become ubiquitous. Today, customers have more convenient and faster banking services available on smartphones and tablets. In Section 6 of this submission we provide a short and recent history on technology as well as a recommendation on the management of its opportunities and risks, real and perceived.

At the end of 2013, Australia had the fourth highest level of bank satisfaction in the world as measured by Capgemini and Efma[5]. According to Roy Morgan, bank satisfaction has risen from 60% to 80% in the decade to 2012. It continues to reach record high levels and is now 81.6% in January 2014.[6] The 17 years since the Wallis Report have been truly transformative.

Although the number of licenced banks is largely the same now as in 1996, market structure has changed significantly. Major banks now hold a more significant share of the core retail markets, a number of European banks have left or reduced their presence in the market, as have non-bank financial service providers, and a number of non-banks have sought to partner with banks to provide banking services. These developments are in part an outcome of the GFC and its aftermath, and in part, of competition.

In anticipation of the Financial System Inquiry, the industry commissioned Professor Rodney Maddock of Monash University to complete a paper on the developments in the financial system since the Wallis Inquiry. This forms the basis of much of the following history. The full paper can be found in Appendix A of this submission.

2.2. The Wallis Inquiry

The Wallis Inquiry was set up in May 1996 to examine three issues: the experience of financial deregulation in Australia, the main forces for change in the system and the changes to the regulatory arrangements needed in the light of the continuing evolution of the Australian financial system. While its formal terms of reference were extensive, the central focus was on regulation.

[5] Capgemini and Efma, Deloitte Access Economics, (2014), *Competition in retail banking*, Appendix E

[6] Roy Morgan Research available at: http://www.roymorgan.com/findings/5451-satisfaction-with-banks-reaches-record-high-201402260024

One of its major objectives was to examine the 'twin peaks' approach recommended by Treasury, of a single prudential regulator and a single disclosure regulator responsible for consumer protection.

The Wallis Inquiry ultimately supported the 'twin peaks' approach, recommending the reallocation of prudential responsibilities to the Australian Prudential Regulation Authority (**APRA**) from the Reserve Bank of Australia (**RBA**), which was to retain systemic supervision, and the allocation of market integrity and consumer protection responsibilities to the Australian Securities and Investments Commission (**ASIC**). The Inquiry, with its emphasis on efficiency, was not focussed on deregulation, but rather highlighted the need to make regulation more streamlined and conducive to competition. In doing so, the Inquiry aimed as far as possible to promote efficiency and cost savings through enhanced competition and contestability, while preserving the financial system's safety and stability.

How Wallis anticipated the future

In hindsight, the Wallis Inquiry correctly foresaw three fundamental transformations that lay ahead for the Australian financial services industry: changes in customer needs, changes in skills and technologies, and changes in regulation.

The Inquiry recognised that changing customer needs would be driven by an ageing population, a better educated population, changes in workforce participation, a population increasingly exposed to the financial system and hence to financial risk, and one more sensitive to value in its purchases. For consumers, the Inquiry saw technological developments enhancing electronic forms of delivery of financial services, making it the dominant form of service delivery. The rise of ATMs, EFTPOS, internet banking, smart cards, electronic cash and data mining were all foreseen. These new technologies were expected to change the underlying cost structures of financial organisations, leading consumers to adopt more sophisticated and market-oriented strategies at the expense of traditional organisational models.

The Inquiry also foresaw an increasing focus on efficiency and further globalisation of markets, both leading to greater competition, further conglomeration and market widening, and a continuing shift away from bank intermediaries towards markets. In hindsight, the extent to which these effects have played out in the markets is unclear.

While there is evidence in the financial sector of ongoing improvements in efficiency and productivity, the extent to which this has resulted in increasing contestability of the system is an open question. Foreign competitors have existed in the market for many years, but as they have captured limited market share, it is more likely that the potential competition has been an important disciplining force. Instead, direct competition took the form of new business models and brokers, such as Aussie Home Loans, Resimac and Macquarie Bank, who in some cases used the securitisation market to fund attacks on bank product markets. ING took on the banks on deposit pricing, online brokers cut deeply into the margins of traditional broking companies, and banks took market share from insurers.

While world markets have become more closely integrated since Wallis, there have been fewer foreign competitors entering the market or Australian banks pursuing offshore opportunities than was expected. Macquarie has been able to establish an offshore business, albeit a non-bank business, while ANZ is advancing an offshore strategy. The exception to this trend is the growth of the larger Australian banks in New Zealand, where all have significant positions. The globalisation which has had the largest impact on banks in Australia is a growing reliance on international funding. Today, foreign currency denominated liabilities account for 50% of GDP.[7]

The Wallis Inquiry expected increased conglomeration would challenge traditional institutional and regulatory boundaries, with new competitors emerging from outside the industry. This has been most clearly evidenced by the banks' movement into wealth management with CBA and Colonial, Westpac and BT, and NAB and MLC illustrating the point. AMP has gone the other way, adding banking to its insurance and wealth businesses. There may have been fewer entrants from outside the finance industry than anticipated by the Wallis Committee and the prediction that financial businesses would tend to disaggregate their businesses vertically has only been partially correct. Indeed since the GFC, there has been some movement towards vertical integration with major banks acquiring a number of the previously independent mortgage brokers and aggregators.

The Wallis Report also suggested markets would increasingly challenge intermediaries for the provision of finance and the management of risk. In Australia, banks continue to play a major role in funding and risk management compared with, for example, the US. Financial markets have clearly become more important, particularly as vehicles for reallocating risks within the financial sector, but have not diminished the central role played by the banks. Indeed, this has served to highlight that one of the notable features of the Australian financial system is how little of it currently sits outside the prudentially regulated sector.

Having the benefit of hindsight, these unforeseen transformations along with the predicted changes had a significant effect on the industry, as shown by how the system functioned between the Wallis Inquiry and the onset of the GFC.

2.3. How the system functioned between Wallis and the GFC

In the decade between the Wallis Report in 1997 and the onset of the GFC, beginning in 2007, the industry effectively facilitated a realignment of asset prices and ownership after a long spell of regulatory induced distortion between 1945 and 1980. The growth in the financial sector during this time was considerable, with value added as a share of GDP almost doubling. A key underlying driver of this was the considerable rise in household assets, both financial and in dwellings, which appears to have been driven by the choices of the individual households.

These choices reflected the greater freedom available to retail customers to manage their personal balance sheets with the end of credit rationing; the decline in global and Australian inflation rates allowing households to service larger loans; and a broadening of the products available for managing risk.

[7] RBA Bulletin (2012), *International activities of Australian banks.*

Households borrowed, increasing their interest payments but also boosting assets considerably. The consequent increase in the price of housing was not confined to Australia: households globally made similar choices, suggesting that local house price rises were not exceptional. Rather, Australian households appear to have a strong preference for better housing, and the supply of such housing was slow to meet the increased demand, putting upward pressure on prices. There is also evidence that the quality of local housing has changed, so that part of the price rise reflects an improvement in housing quality.

A further consequence of growth in the sector, along with the value of the Australian dollar and the high price earnings ratios, was that the major Australian banks became amongst the most valuable banks in the world, as measured by price to book value. While the superannuation funds were not large on a global scale during this time, they continued to consolidate and grow quickly, attracting attention from offshore managers.

The very rapid growth of the system was accompanied by some structural changes, but perhaps less than might have been anticipated. The biggest change was the decline in the importance of registered financial corporations (**RFC**) and the ongoing decline of building societies. The growth of securitisation also facilitated significant entry and growth of smaller financial institutions during the period.

In 1998, as per the Wallis recommendations, the 'six pillar' policy that prohibited the merger of the big four banks and the big two insurance companies was replaced by a 'four pillar' policy which prohibited mergers amongst the major banks. The period between 1996 and 2007 also saw a number of mergers: Metway Bank merged with the Suncorp Insurance and finance group, St George Bank merged with Advance Bank, and Bank of Melbourne merged with Westpac. ASIC and APRA commenced operations in 1998 as part of the overhaul of the financial sector's regulatory framework.

The collapse of insurance giant HIH was the biggest financial industry crisis in the post-Wallis phase ahead of the GFC. It provided a valuable opportunity prior to the GFC to review the role of the regulators as well as Australian corporate governance and risk management.

2.4. The Global Financial Crisis

The impact of the GFC can be split into three distinct phases – the 'sub-prime crisis' period; the 'financial crisis' period after Lehman Brothers collapsed, and the 'after period' immediately following the crisis.

The initial phase, timed locally from the collapse of two hedge funds, Absolute Capital and Basis Capital in July 2007, was mainly characterised by a sharp rise in the wholesale cost of funds from the pre-existing low levels. Rising sensitivity to risk fuelled by growing global uncertainty saw a sharp decline in global money market volumes as participants began to question each other's credit quality and to shore up their liquid assets.

The major banks had few problems in this first phase. They did face some losses on loans to failed firms, and had difficulties restructuring some of these given the widespread use of syndication of corporate debt, but had very limited exposures to toxic securities, such as collateralised debt obligations. However, some of the smaller banks and non-banks with lower credit ratings, which relied more on securitisation as a source of funding, suffered relatively more as securitisation markets stalled and credit spreads widened.

The RBA acted quickly, expanding the range of repo-eligible securities to private and then own-name securities and increasing the term of such repos. To offset the additional risk, the RBA increased the haircuts it required through excess collateralisation and APRA increased the intensity of its stress testing of the banks.

Following the collapse of Lehman Brothers in September 2008, the crisis of confidence moved into a second, more severe phase with escalating global interest rates, the closure of some wholesale markets, large falls in asset prices, a collapse in trade credit and fears of global recession.

Policy makers in Australia reacted swiftly to address the collapse of confidence. Short selling of stock was banned on 21 September, 2008. The Government's residential mortgage backed securities (**RMBS)** investment program was announced on 30 October, 2008. With growing nervousness among depositors, the Australian Government announced, on 12 October, 2008 extended guarantee arrangements for deposits. On the same day, the Government announced it would guarantee, for a fee, the wholesale funding of banks.[8] This followed moves by governments overseas to guarantee the funding of their banks, placing Australia's banks at a comparative disadvantage and risking the ability of our banks to continue funding the Australian economy.

These decisions were followed by the announcement of a fiscal stimulus program, on 14 October, 2008 while the RBA cut the cash rate by 300 bps in the final three months of the year.

During this period, the Australian banking system operated well especially compared to systems in most other developed economies. There were no retail runs on deposits as seen in the UK and domestic banks continued to lend and borrow, albeit at higher costs. None of the banks were downgraded by credit rating agencies and all retained access to global markets, based on their own strength and with the backing of the Government guarantee during the most difficult period of the crisis. The RBA proved adept at keeping markets operating and facilitating adjustment during the crisis.

In the midst of the crisis, CBA was able to absorb Bankwest from its failing UK parent. The Australian Competition and Consumer Commission (**ACCC**) examined the consequences to competition from the acquisition, but ultimately decided that Bankwest would either substantially contract or fail and therefore the acquisition by CBA would not substantially lessen competition.[9] Banks were also able to access additional equity at small discounts to their reduced share prices from retail and institutional investors, including Australia's superannuation funds.

[8] To date, the fee paid by banks for the wholesale guarantee has raised over $4.4 billion for the Government and taxpayers

[9] From an interview with the retiring chairman of the ACCC, Graeme Samuel, on the ABC, June 8, 2011, published at http://www.abc.net.au/sundayprofile/stories/3238828.htm, accessed 5 March 2014

The third phase arrived once the immediate threat of collapse had passed and arguably continues today, with a focus that has shifted from dealing with a current crisis to preventing future crises. It is characterised by an understandably more risk-averse response from consumers, banks and regulators, both in Australia and offshore, based on the lessons and consequences of the GFC.

2.5. Where are we today?

Following the GFC, banks, governments, businesses and retail customers globally have a renewed appreciation of, and sensitivity to, risk. The most fundamental adjustment post-crisis has therefore been the insertion of larger risk premia into a wide variety of prices, even with spreads on government bonds blowing out in many jurisdictions. Lenders too have analysed more clearly the risk characteristics of borrowers and differentiated prices more sharply.

Household behaviour also changed to lessen its risk exposure. Notably this has involved a switch out of equities and into deposits. While this is consistent with an ageing population, an underlying shift in household preferences against riskier assets is apparent. Modified behaviour has seen households systematically reduce their risk exposures: they have borrowed less, increased their savings, and shifted their savings into safer products.

Regulators have responded strongly to the heightened perception of risk in the financial system by introducing reforms designed to make the system safer. These have mainly occurred in the context of global conditions, although the recent decision to impose capital surcharges on the major domestic banks – deemed to be of systemic importance locally – has important implications for the operation of the domestic financial system.

The GFC also served to highlight concerns about the continuing ability of banks in Australia to rollover their short-term offshore borrowings during a crisis. Bank management has recognised this issue and has worked quickly in advance of any regulatory decisions, to diversify funding sources, lengthen tenors, raise more deposits domestically, and shift the weight of deposit funding towards term deposits. In late 2011, the Government assisted the process by allowing banks to issue covered bonds, which allowed some to widen their funding sources and increase the average tenor of their borrowings.

Some smaller banks and non-banks were also affected significantly by the lack of market liquidity. The Government supported some of these players through the Australian Office for Financial Management's investment in residential-mortgage backed securities, which gave support to the securitisation market.

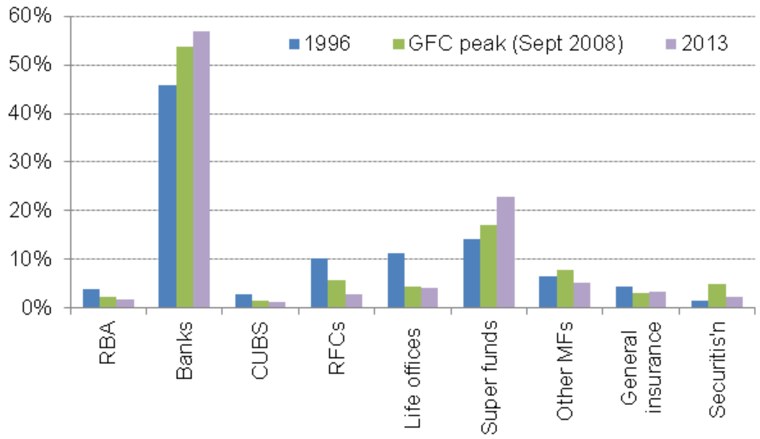
In terms of the impact of global regulation, the broad thrust of the emerging regulatory actions under Basel III operates in the same direction that management and boards of directors of banks in Australia have required: more capital, safer capital, and more liquidity. This is not to say that all of the new international requirements suit Australian circumstances. The most important consequence for Australia is that the regulators around the world have moved towards 'rule-based' regulation, compared to an earlier dependence on 'principles-based' regulation and intense supervision. This has left Australia in a situation where we continue to have intense prudential supervision under the pre-existing approach that worked well through the GFC, on to which has been added a substantial new suite of detailed regulatory requirements.

Australia also faces a situation where the trend towards increased globalisation of rule setting has accelerated as a result of the GFC. This is possibly inevitable, with an increasingly globalised financial system, and beneficial, including to Australian banks dealing with overseas counterparts, but raises the question of how Australia ensures these internationally set rules, and the way they are adopted domestically, suit Australia's particular circumstances.

Size

Today, the banking industry in Australia is large in absolute terms as measured by total assets, albeit not large relative to other developed economies. At September 2013, total bank assets were $3.1 trillion, which accounted for 56.8% of all financial institution assets in Australia (see Figure 2.1). Ownership of resident assets is concentrated with the four major banks, which hold 80%.

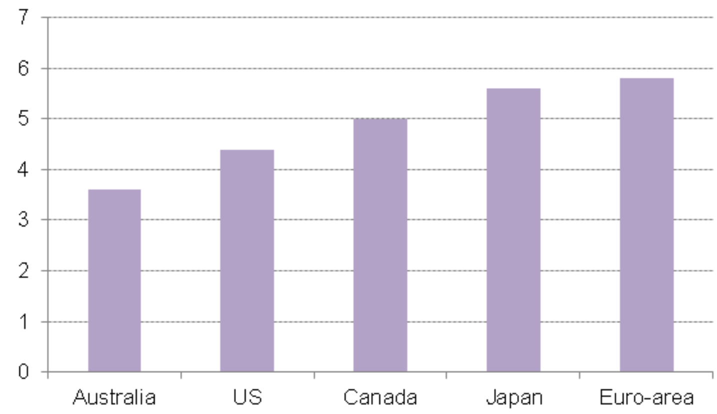
Figure 2.1: Assets of financial institutions - distribution



Source: RBA

In 2013, Australia's financial system was 3.6 times the size of the Australian economy as measured by GDP. By comparison, the Euro-area has the largest financial system relative to its GDP, at 5.8 times. Canada, which given its banking system and population provides a good comparison with Australia, has a financial system which is 5.0 times its economy (see Figure 2.2).

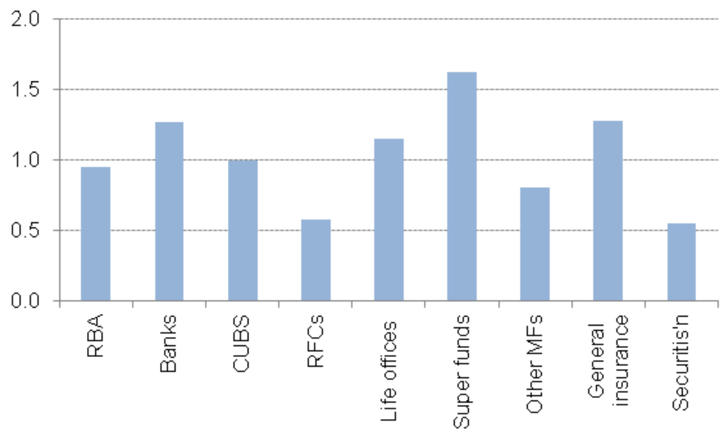
Figure 2.2: Financial system assets as a multiple of GDP, 2013



Sources: RBA, Bank of Japan research

While banks are the largest contributor to the assets of the Australian financial system, they are not the fastest growing (see Figure 2.3). Since 1996, bank assets have grown 6.2 times, while assets of superannuation funds have grown by 8 times. Over the last five years, this trend has become more pronounced, with banks' assets growing to 1.3 times their level in 2008, compared with superannuation, which has grown 1.6 times.

Figure 2.3: Growth multiple of assets of financial institutions (2008 to 2013)

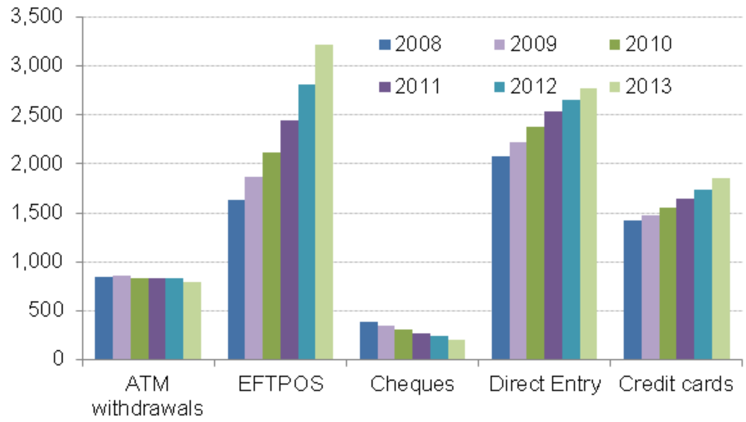


Source: RBA

The payment systems, in which banks are the major participants, is large (see Figure 2.4). Over the year ending June 2013, a total of 8.9 billion transactions were made using ATMs, EFTPOS, cheque, direct entry, debit and credit cards, with a value of $15.1 trillion. This is an average of 170 million transactions with a value of $290 billion every week.

EFTPOS is the largest of the payment systems channels in terms of the number of transactions, with 3.2 billion transactions over the year ending June 2013, at a value of $197.6 billion. The use of EFTPOS has been growing at a fast pace. The number of EFTPOS transactions has increased by 14.6% on average each year over the past five years, while the value of EFTPOS transactions has increased by 12.0%.

Figure 2.4: Payment systems – number of transactions (million)

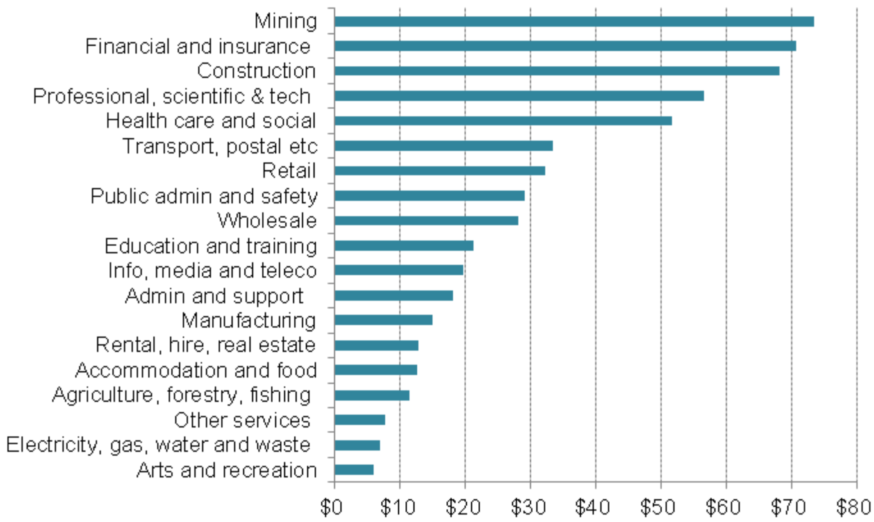


Source: RBA

Contribution to the Australian economy

The finance and insurance industry is one of the largest contributors to the economy in Australia. In dollar terms, the industry contributed $123 billion to economic activity over the 12 months ending September 2013, which was second only to the mining industry at $151 billion. This equates to 8.6% of Australia's $1.5 trillion economy. In terms of growth, the construction industry has grown the most at 143.3% over the 17 years since the Wallis Report. The finance and insurance industry ranked second at 134.9% or just over $70 billion (see Figure 2.5).

Figure 2.5: Change in value added since 1996 ($bn)



Source: ABS

Other contributions to the economy from the eight largest Australian listed banks[10] include:

Employment: At the end of 2013, the banks employed around 140,000 domestic employees, which accounted for one-third of the finance and insurance industry and 1.2% of the Australian labour force. They paid $22.8 billion in wages.

Tax: Banks provide the government with considerable tax revenue. Over the past five years, banks paid $47 billion in tax, with $12.1 billion paid in 2013.

Dividends: Banks have continued to return wealth to shareholders. Over the past five years, banks have paid out a total of $88 billion in dividends, with $21.2 billion paid out in 2013. Most of these payments have gone directly to Australians or into superannuation funds which support the needs of current retirees and provide a growth retirement savings pool for future retirees.

Technology: Banks contribute to Australia's economic development by making large investments in technology, which is a key driver of productivity in Australia. Over the past five years, banks have invested $19.4 billion in IT, with $4.6 billion invested in 2013.

Business: Banks are a major user of goods and services from other Australian businesses, including many small businesses. According to the Business Council of Australia (**BCA**), large businesses contribute $247 billion each year to small businesses in Australia, through the purchase of goods and services. Banks are a significant contributor to this.[11]

Community: Banks are a major contributor to community services and programs around Australia, donating funds, time and effort. In 2013, the banking industry donated over $500 million in funds and in-kind donations although this is likely to understate the true level of community investment.[12]

2.6. Contribution to Australia's future prosperity

To put in place the policy framework for the financial system, we need to understand the future opportunities and challenges the Australian economy and the financial system will face.

Predictions can be difficult to make, and while the Wallis Inquiry did a commendable job in anticipating many of the changes in the evolving financial system, the banking industry has elected to identify the major forces that are expected to shape the future. To do this, the industry has utilised global consulting firm A.T. Kearney's report "Banking on Our Future: Framing a Vision for the Australian Banking Industry" included as Appendix B to this submission.

A.T. Kearney has identified five 'megatrends' which are expected to impact the country's future. They are:

1. the ageing of the Australian population;

2. the growth of Asia;

[10] Focus on eight largest Australia-listed banks is for ease of reference
[11] Business Council of Australia, (2010), *Working in Parallel*, page 9
[12] Estimated by the Australian Bankers' Association

3. the growing impact of digital technology;

4. the increasing risk averse nature and cost of capital; and

5. the increasing scarcity and cost of natural resources.

At the extremes, depending on how we respond to these trends, they could deliver one of two opposing scenarios for Australia:

- Australia as a rich, diversified, integrated and digital economy; or
- Australia at risk of becoming an isolated, old economy with capital locked up in property and low risk investments.

The first, positive scenario has a number of features. A maturing society would be increasingly affluent from the accumulation of capital. Further, Asian integration, combined with demand for resources, would see Australia export more, and export a broader range of goods and services. Asian capital would be invested in Australia, while excess domestic capital would command higher global returns. The digital age would improve efficiency, create more value for the customer and develop new markets.

A second, negative scenario would see a maturing society weigh heavily on the economy, with more support required from the Government to provide pensions and health care. Without integration with Asia, there would be increasing competition for goods, services and capital, with a flood of low cost imports affecting Australian businesses. Digital capabilities could erode our economic surplus and add to misinformation, security and privacy risk. Local enterprises could find capital hard to get and there would be intense competition for limited natural resources.

Neither scenario is a prediction, and the likely outcome will be somewhere between the two. Nevertheless, a sense of the range of possibilities facing Australia highlights the need to ensure our financial system can continue to serve Australia's developing economic needs.

There are a number of means by which the banking industry can contribute to a positive economic outcome. Broadly speaking, the banking industry in Australia can:

1. Continue to provide capital to fund growth and innovation and to meet the needs of an ageing population.

2. Continue to compete on product, price and service to meet the needs of customers.

3. Facilitate Asian integration by using banking's superior risk insights to assist Australian businesses expand into the region.

4. Act as a technology catalyst to create unprecedented value and to shift the economy towards sophisticated, knowledge-based industries.

Section 3 of this submission explores specific challenges and opportunities to develop funding markets to serve Australia's growing economy. Section 4 examines competition in the industry, recognising the importance of a diverse range of choices, with banks competing for customers on price, service, innovation and quality.

As one of the most highly regulated industries in Australia, the efficient and effective regulation of the industry is at the core of whether the system is able to meet the needs of the economy. Section 5 examines the roles and responsibilities of the regulators from an industry point of view, and looks at how they can support the growth of Australia, while meeting the country's need to maintain a financial system which is safe and stable.

Section 6 looks at the opportunities arising from digital developments to enhance customer value and improve productivity.

Banking, and the flows of capital, trade and information it facilitates, will help Australia continue to integrate with Asia, and indeed all regions of the world. This is discussed in more detail in Section 4. China, in particular, is opening its capital account and this will lead to further substantial capital flows. While the banking industry's offshore reach is not sizeable, relative to banks in other countries, it is growing and is an important component in the ongoing integration of the whole economy with the region.

This page is intentionally blank.

3. Funding the economy

Funding is the key to growth, and when risks are well managed funding can enable individuals and entities to seize opportunities for growth. Likewise, lack of funding can render the economy stagnant. Australia has fared relatively well, through even the most turbulent times such as the GFC, in sourcing funding to support growth. However, in the future, it is vitally important that Australia has the most stable and diverse sources of funding available to access as and when required, and to that end, there are a number of points that the banking industry makes in this submission to improve the existing platform, based on the following recommendation:

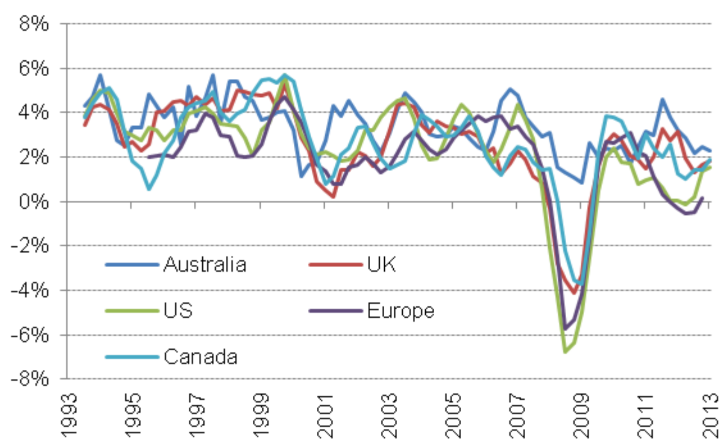
Recommendation 2: The Inquiry should support the finance sector and Government developing a clear strategy for ensuring the economy, including banks, have access to as diverse a range of stable funding sources as possible.

3.1. The current situation

Growth to date

Much to the envy of many worldwide, Australia has experienced continual annual growth since the Wallis Inquiry. Not only did Australia fare well through the boom period at the turn of the century, Australia also avoided the negative growth seen in most developed economies since 2008. The following graph details economic growth to date for some key economies, and shows that Australia averaged 3.4% growth per annum since 1993 while the comparison economies in Figure 3.1 averaged 1.9-2.6%.

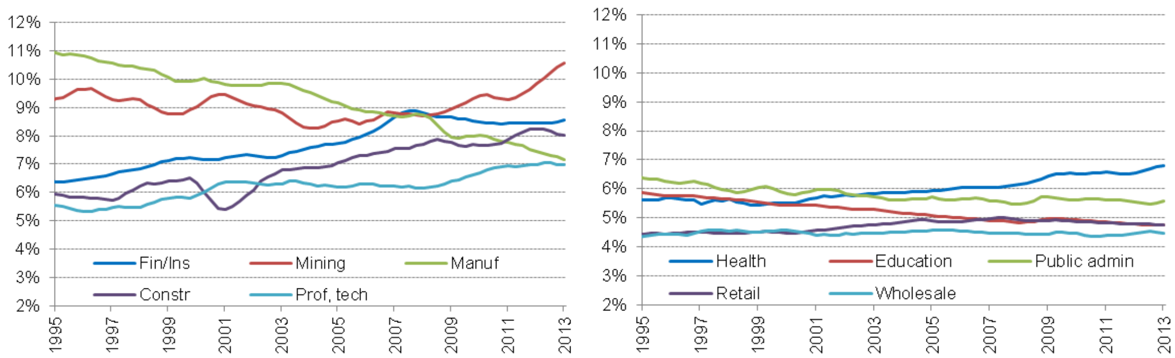
Figure 3.1: GDP growth (annual)



Source: Thomson-Reuters

The growth in Australia came from a number of industries as detailed in the following figures.

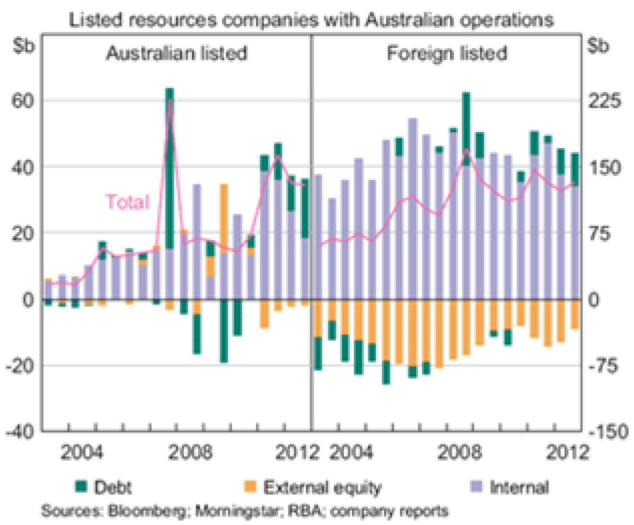
Figure 3.2: Industry contribution to economy



Source: ABS

Representing Australia's largest industry, growth in the mining industry since 2003 has been funded by domestic and offshore sources, and predominantly through internal profit of the companies (see Figure 3.3). The little demand for external funding has been met through the issuance of foreign currency bonds offshore.[13]

Figure 3.3: Sources of funding of listed resources companies

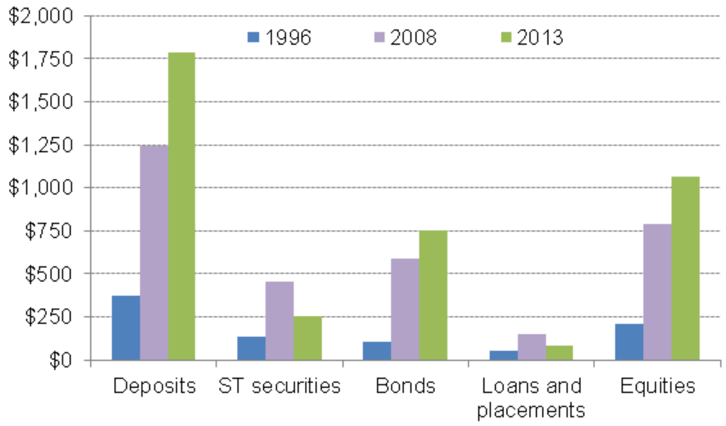


Source: RBA

On the other hand, the financial and insurance services industry, representing the economy's second largest industry, with a central role within the financial system as both a user and provider of funding, consequently has had a substantially greater need for external funding. The amount and types of external funding used by the industry are summarised in Figure 3.4.

[13] RBA Bulletin, (March Quarter 2013) – *Funding the Australian Resources Investment Boom*

Figure 3.4: Sources of funding of the finance and insurance industry ($bn)

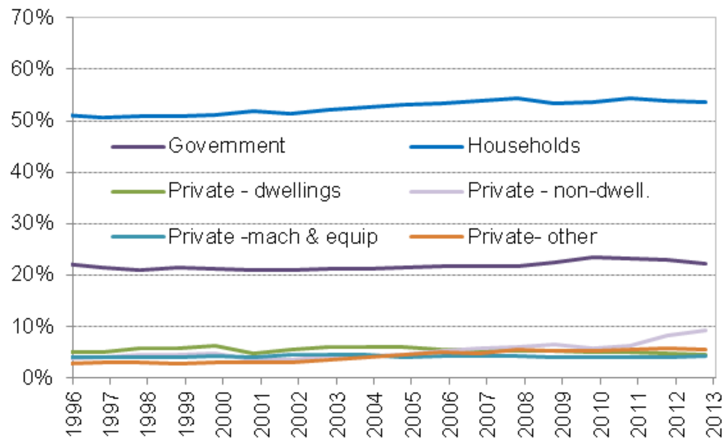


Source: ABS

More generally, demand for external debt is relatively limited for most Australian companies given they are typically modestly geared with dividend imputation reducing tax incentives to use debt relative to equity.

If we then turn to activity by sector, the following figure provides a breakdown of GDP by sector.

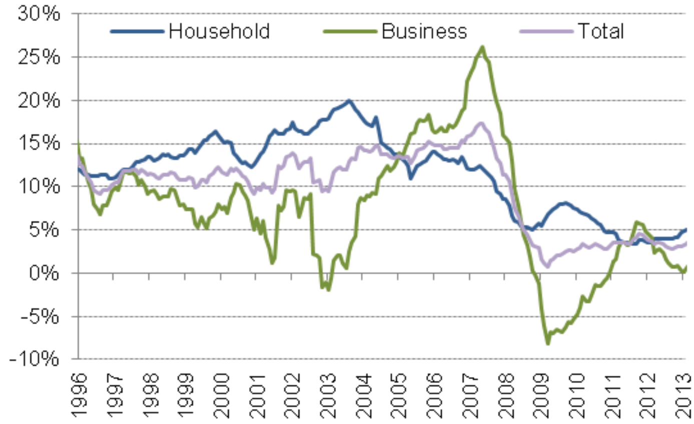
Figure 3.5: Expenditure components of GDP



Source: ABS

Households, which constitute more than 50% of expenditure in the economy, have continued to need funding, albeit at a slower growth rate since the GFC, with the bulk of that funding provided domestically and by banks. Credit growth for businesses has also been modest overall since the GFC (see Figure 3.6).

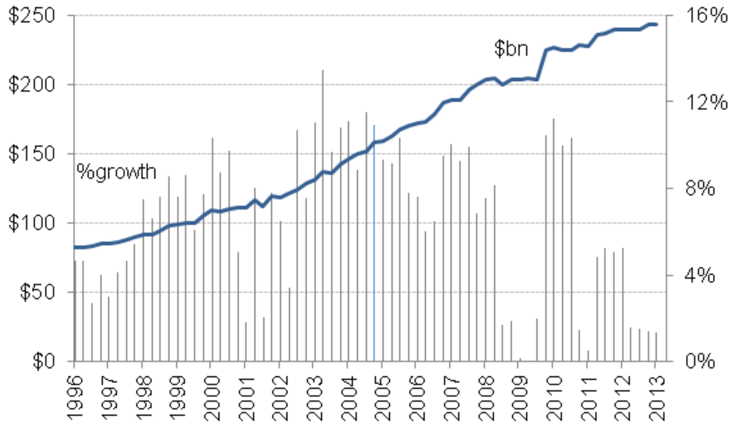
Figure 3.6: Credit growth (annual)



Source: RBA

Banks play a significant role in financing small business with banks accounting for more than three quarters of lending.[14] Business loans under $2 million have grown steadily over the longer term, although growth was disrupted during the GFC, with demand for credit falling significantly. While there was no significant fall in the total level of bank lending, there was little growth over the 18 months from the height of the financial crisis to March 2010. Currently, business loans under $2 million with banks total $243.1 billion, an increase of $39.5 billion or 19.4% since March 2010.

Figure 3.7: Business loan outstandings for loan amount under $2m

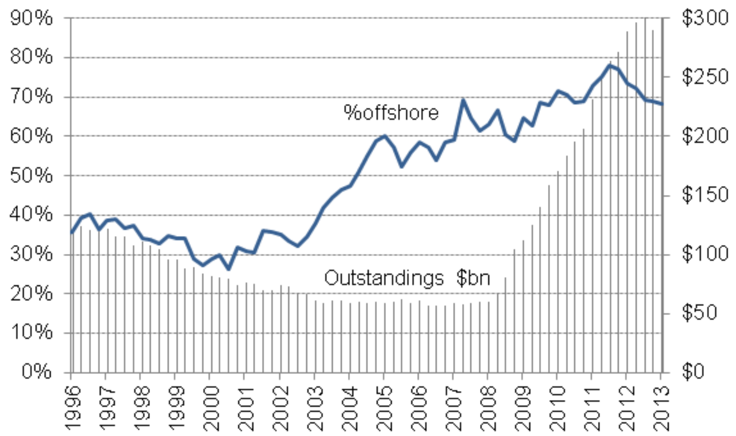


Source: RBA

Government increased its debt issuance over the past five years with the bulk of that funding sourced from offshore investors (see Figure 3.8).

[14] Matić, M., Gorajek, A., Stewart, C., (May 2012) *Small Business Funding in Australia,* Small Business Finance Roundtable

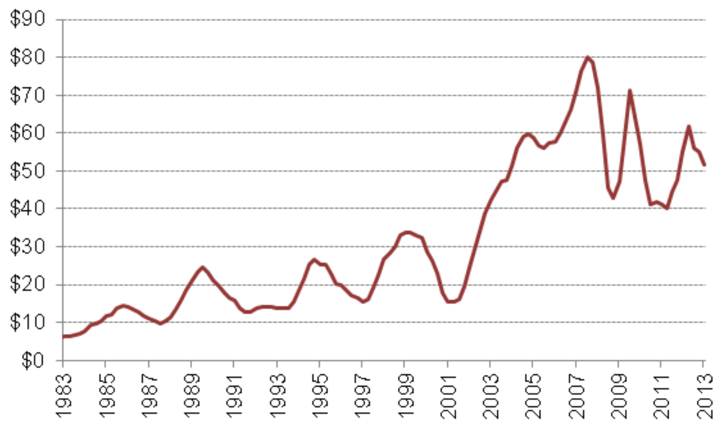
Figure 3.8: Commonwealth Government Securities



Source: ABS

Considering the flow of funds broadly, Australia has consistently had more investment opportunities than can be funded domestically and accordingly has recorded a current account deficit (**CAD**) for most of the last century (see Figure 3.9). This has meant growth has been funded through both domestic and offshore sources for a considerable part of our history.

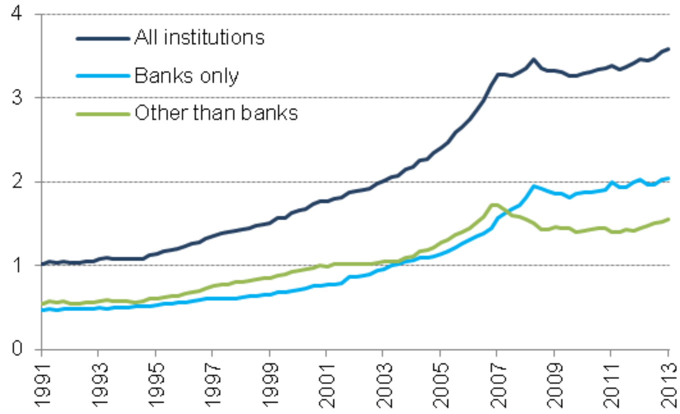
Figure 3.9: Current account deficit ($bn)



Source: ABS

Although funding will always be dynamic, there have been some significant changes in the way Australia sources and distributes funding since the Wallis Inquiry. Foremost, the burden of funding the CAD has shifted from Government to the private sector and most notably to banks. More recently, through the GFC, we saw disruption in funding markets, with growth in savings including superannuation and a reduction in borrowings. Overall, the financial system barely grew relative to GDP, with the economy increasingly reliant on banks (see Figure 3.10).

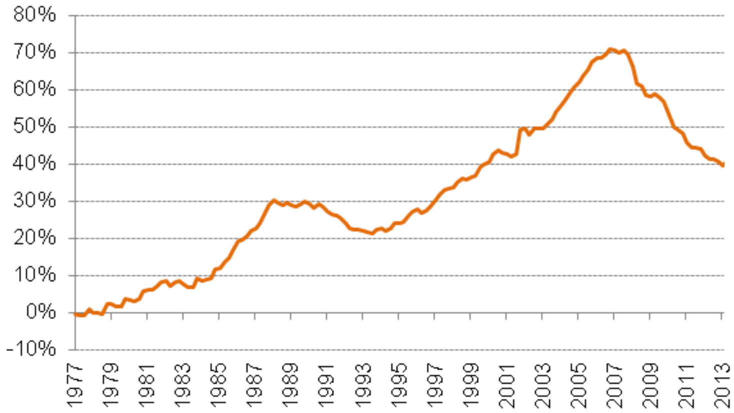
Figure 3.10: Financial assets as a share of GDP



Source: RBA

This is further demonstrated in Figure 3.11 where the credit shortfall has decreased as a share of GDP.

Figure 3.11: Credit shortfall as a share of GDP



Source: PWC

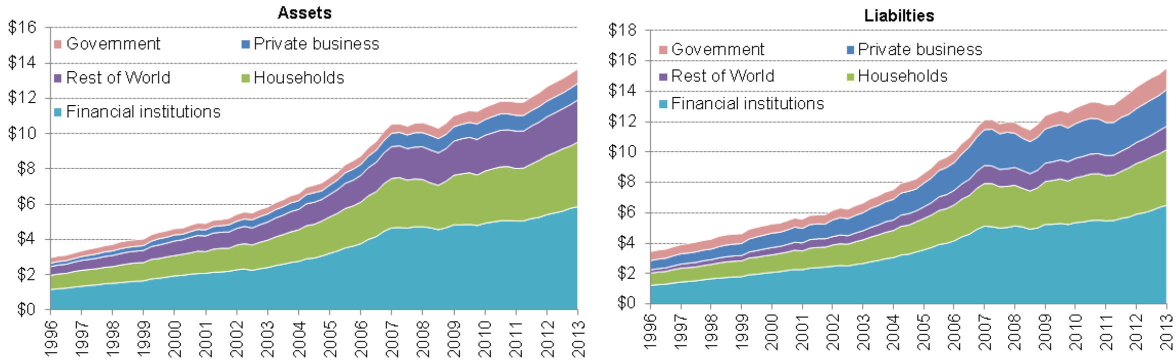
It is important to acknowledge the domestic banks' contribution to the stability of the financial system through the GFC when the market experienced significant consolidation, in particular by filling the void left by the exit of market participants.

The financial system

Beyond simply looking at who needs funding and where the funding comes from, it is also worth revisiting the overall financial system. The funding process consists of complex interactions between various providers and users of funding in which financial markets play a significant central role. Financial markets and banks not only provide a significant amount of the actual funding, but also facilitate many of the transactions between third parties. For example, a bank can be the arranger, lead manager or dealer of a debt or equity capital market raising (such as the issuance of bonds offshore for the mining industry or issuance of Commonwealth Government Bonds), or as the provider of ancillary products, such as derivatives, that support such raisings.

The financial claims graphs below omits intra-sectoral claims, and on that basis show that financial assets and liabilities are now around $14-$15 trillion of which domestic financial institutions account for 42-43% of the direct funding alone.

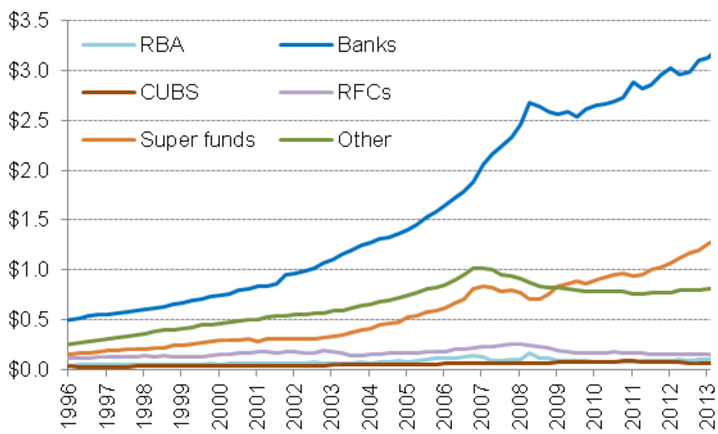
Figures 3.12: Financial claims by sector



Source: ABS

Within the financial institutions sector, APRA regulated institutions hold $5 trillion in assets or 88% of financial institutions' assets. Breakdowns of the assets within that sector are provided in Figure 3.13.

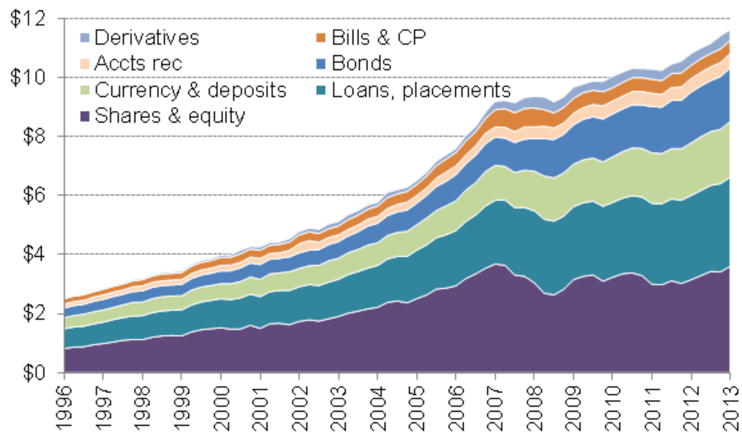
Figure 3.13: Assets of financial system ($trn)



Source: RBA

The products used to fund economic growth at any point in time reflect investor and borrower preferences. These are influenced by a number of factors including risk appetite, product availability, price and the regulatory environment. Accordingly, growth to date has been funded through a range of products (see Figure 3.14).

Figure 3.14: Financial assets outstanding ($trn)



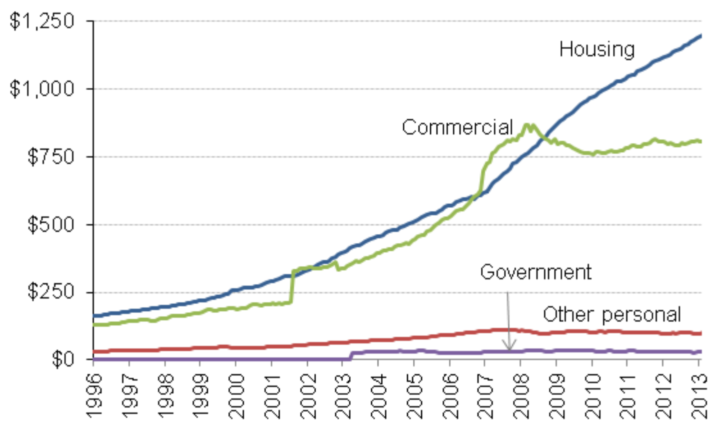
Source: ABS

Shares and equity, widely acknowledged as more risky asset classes, continue to account for the greatest proportion of financial assets.

Central role of banks

As noted previously, banks play the most critical role within financial markets. They are the largest and most efficient intermediary in the economy. They directly fund the national economy by using deposits, debt and equity to provide loans and other products as well as making investments in debt and equity themselves. In addition, it is predominantly the banks that develop, originate and roll out the capital markets transactions that more directly match investor and borrower needs. Figures 3.15 and 3.16 provide some insight into the range of these activities.

Figure 3.15: Bank loan outstandings ($bn)



Source: RBA

Figure 3.16: OTC debt and currency markets annual turnover ($bn)[15]

	2010-11	2011-12	2012-13	%change since 2010-11
Debt markets total	32,101	39,201	44,729	39%
. Physical turnover	13,431	13,550	13,629	1%
* Govt debt securities	1483	1,758	1,706	15%
* Non-govt debt securities	908	592	788	-13%
* Negotiable & transferable instruments	3,676	3,675	3,271	-11%
* Repurchase agreements	7,364	7,525	7,864	7%
. Derivative turnover	18,670	25,651	31,100	67%
Currency markets total	45,248	40,850	43,677	-3%
. Physical turnover	11,853	10,843	11,071	-7%
. Derivative turnover	33,395	30,007	32,606	-2%

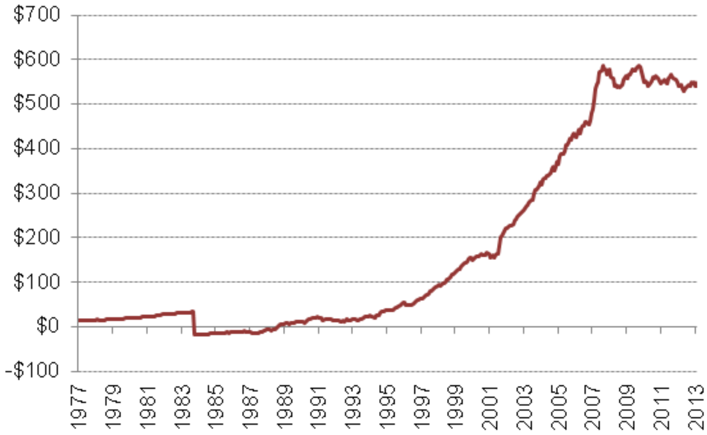
Source: AFMA

Bank loans and similar products have always been a significant component of funding Australia's growth. Banks' ability to efficiently, consistently and competitively provide such products heavily relies in turn on banks' ability to access funding and convert it into lending. Capital and liquidity requirements have an impact on this efficiency as the amount of assets held for capital and liquidity purposes reduces the amount available for lending. Furthermore, these requirements can also have an impact on pricing and meeting return targets.

Deposits are considered to be the highest quality source of funding for banks and have always constituted the greatest source of funding. However, particularly since the mid-1990s, deposits have been insufficient to meet banks' funding requirements. As a result, banks have increasingly needed to access alternative sources of funding, primarily through debt capital markets to make up the difference. This difference is currently in excess of $500 billion in total for banks alone and $606 billion in total across the financial system. Note, this is the amount of outstanding issuance and does not reflect new issuance. As Figure 3.17 highlights, the stock of debt market funding required by banks has stabilised since the GFC with little additional debt capital market funding required.

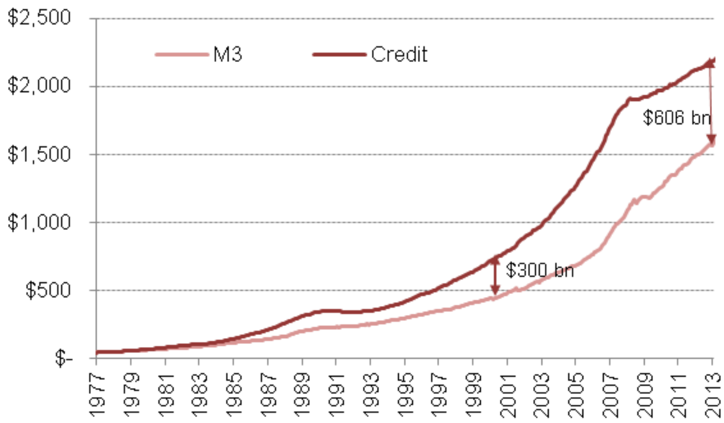
[15] Data in this table includes participants such as investment banks, investment activities of retail banks and others

Figure 3.17: Banks' non-deposit funding ($bn)



Source: PWC

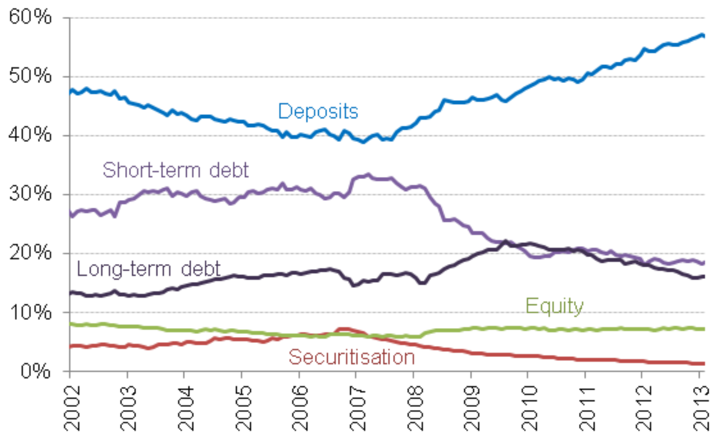
Figure 3.18: Credit demand and M3 ($bn)



Source: PWC

Contemporaneously, as the gap between supply and demand for money widened, domestic funding sources proved limited and, until the GFC, banks increasingly ventured offshore to meet demand for lending (see Figure 3.22).

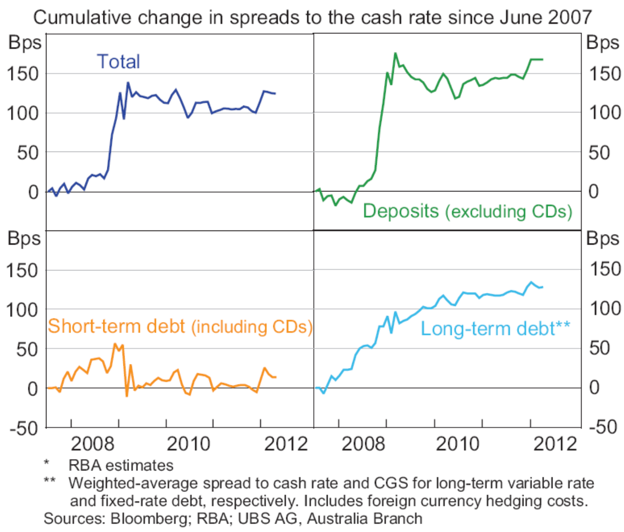
Figure 3.19: Bank funding



Source: RBA

The cost of funding varies by product. The overall cost for banks depends on the mix of funding sources used which in turn depends on a number of factors including supply of product, regulatory and credit rating requirements, the cash rate, relevant money market rates and derivative rates, market access, economic conditions, competition and the credit rating of the bank. Figure 3.20 provides some insight into the relative cost of the key funding sources for the major banks.

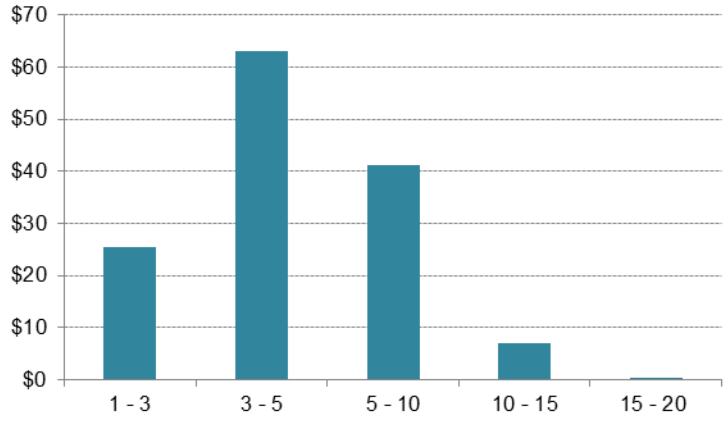
Figure 3.20: Major banks' funding costs*



Source: RBA

Term of funding also varies by product. While banks have always, to some extent, borrowed short term to lend longer term, the GFC tested the limits to this model and resulted in the participants in the financial industry taking a more conservative approach since. Extending the term of funding for banks ultimately means a higher cost of borrowing for consumers especially under a positive yield curve (where pricing goes up as term extends). Figure 3.21 provides an insight into the term of funding through the issuance of unsecured bonds for Australian banks.

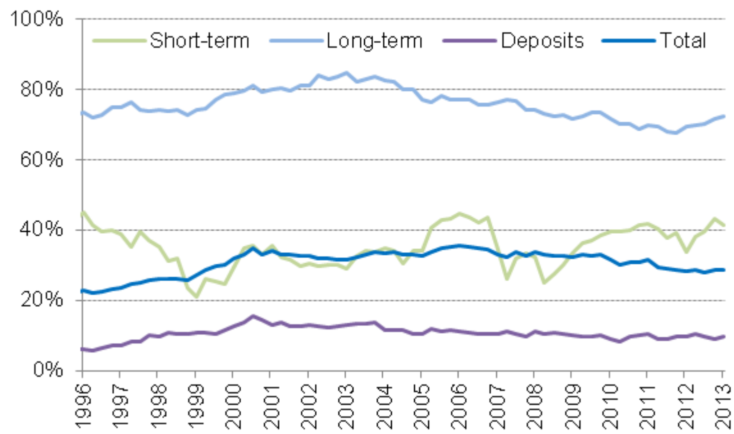
Figure 3.21: Banks' bond issuance maturities, 2012-2013



Source: RBA

As noted above, banks source funding both domestically and from offshore with 30% currently from offshore (see Figure 3.22).

Figure 3.22: Banks – proportion of offshore funding



Source: ABS

A significant factor contributing to the increasing demand for funding by banks was government policy to reduce public debt, which pushed the task of funding the economy into the private sector.

Full details of the funding crisis during the GFC are provided in Appendix A.[16] In summary, experience through the GFC has seen the finance industry subsequently reduce its reliance on debt capital markets and in particular, highlighted the vulnerability of mismatched funding (borrowing short term while lending longer term) even though this had always been a fundamental part of banking.

[16] Section 6.3 in particular

Notwithstanding this recent experience, history has repeatedly proven the value of diversification of funding sources. For example, following the US savings and loan crisis around 1990 where commercial mortgage lending from banks dried up and alternative forms of financing such as securitisation flourished, having the infrastructure in place to tap funding from alternative sources as and when available became essential.

It is imperative for stability, efficiency and competition that banks have access to as wide a funding base as possible, by both product and jurisdiction. Access to covered bonds, both domestically and offshore, and Government support for the securitisation market, are recent welcome developments highlighting this point. Likewise, allowing master trust structures[17] would continue to aid in this effort by providing financial institutions with yet another tool that will enable the supply of more alternative investment options out of Australia.

Diversification in terms of investor type, region, market, product and instrument is an important part of a bank's liquidity, risk and capital management framework. External limitations on funding, such as the current push for greater reliance on deposits by rating agencies in particular, will place limits on efficiency and to that end the Inquiry should reconsider any requirement that narrows the range of funding options available to banks.

In particular, Government should work with industry to consider removing limitations to funding by product and jurisdiction, fully cognisant of all the limitations including those imposed by rating agencies. Furthermore, Government should work with all levels of the financial system to optimise ready access to funding to support economic growth and consider more alternative funding options including master trust structures.

Risk allocation and risk management

While access to funding is paramount, understanding the associated risks and competency in managing those risks is also important.

Risk is the raison d'être and function of the system. It is inherent in all facets of the financial system and must be embraced – without risk there is simply no opportunity.

Immense effort is taken to mitigate risk, through infrastructure build, application of risk management products and organisational measures. Strong regulatory frameworks are in place. APRA-regulated institutions must have in place risk management frameworks to address risks related to credit, markets and investments, liquidity, insurance, operations, strategic and business plans and any matters that may impact on the institution. Boards are required by APRA to approve "risk appetite", and planned operational implementation of risk management and resourcing.

Risk management has continued to evolve as new challenges have been faced by the industry. This evolution is both within institutions through development of proprietary frameworks of various levels of sophistication, and across institutions as minimum standards are set through regulation and best practice. While frameworks vary, risk is actively managed and key risks addressed remain credit, market, liquidity and operational risks.

[17] An alternative structure used in securitisation

Risk lies with all financial system participants including individuals, households, businesses, financial institutions and Government, with the level of risk dependant on product and product provider, mitigated to some degree by regulation. Given 99% of Australians are customers of financial institutions and 70.9%[18] invest through a superannuation fund, financial risk has a wide reach.

Hence each participant's comprehension of the risks involved is also important to market stability. To highlight this point, in an over-regulated environment there could be a build-up in expectations that risk is eliminated and therefore consumer focus could be more on maximising return with less consideration of risk.

Households are predominantly concerned with financial risk with respect to their mortgage, retirement income and investments. Businesses are predominantly concerned with financial risk with respect to access to debt and equity. Financial institutions not only carry the same concerns as other businesses, but being central to most financial claims, are also concerned with all elements of financial risk and foremost with respect to lending.

There have also been some fundamental shifts of risk allocation worth noting. For example, market risk has moved from Government to the private sector, and largely banks, as the burden of funding the current account deficit has shifted. Investment risk and market risk have also moved, from corporations to individuals, as superannuation funds have shifted from defined benefit to defined contribution.

Systemic risk has become a focus of governments, central banks and financial regulators across the globe. Balancing local needs with international consistency has meant that countries like Australia have had to wear the cost of regulation designed to address failings in other jurisdictions. It has also meant the implementation of measures that weren't necessarily required locally. This pursuit of further regulation and stability comes at the cost of opportunity and growth, and highlights the significance of political and regulatory risk to the financial system, which should be considered as important as financial risks.

The GFC understandably led to significant changes to regulatory frameworks across the globe and ultimately to how systemic risk is now managed. To some extent, the coordination amongst the scrutinising entities and the fall-out as to how systemic risk is managed remains contentious and is a work in progress. Nevertheless, systemic risk locally, predominantly managed by APRA, the RBA, and increasingly so by ASIC, has been well managed. This is shown by Australia's performance through the GFC. However, there is a cost and benefit to regulation. Sectors that are most heavily regulated, such as banks, bear less risk due to both reduced risk appetite constrained by regulatory boundaries and resources allocated to their implementation at the cost of pursuing business. On the other hand, sectors that are less regulated such as non-ADI financial companies are able to bear more risk and pursue wider opportunities.

---

[18] ASFA, (February 2014), reflects all persons aged 15 and over, http://www.superannuation.asn.au/resources/superannuation-statistics/

3.2. Likely future situations and the challenges presented

The potential for further growth abounds for Australia. The most likely future situation facing Australia is that economic growth will continue and pick up as global sentiment and economic conditions improve. The key challenge in this situation will be to ensure there is sufficient funding to optimise Australia's opportunities along that journey. Australia, already significantly reliant on offshore funding, could then be challenged with an increased reliance on that funding and the limitations of domestic funding.

Having said that, and despite having fared well to date, the danger of negative growth is not yet over for Australia and hangs delicately on the appropriate management of the risks that prevail; risks that are both within Australia's control and risks that remain out of our control, including the economic health of our trading partners.

Australia may continue to feel the pressure to further regulate should economic instability continue, even when such measures are neither warranted locally nor offer any tangible benefits to consumers. This would continue to divert effort away from generating business and limit economic growth.

Australia is highly likely to continue to have a CAD as it has for over a century; however there is also the possibility of a reversal (current account surplus) under certain events, including growth of offshore investments by superannuants or with the movement of the resources sector from investment to production. Such a reversal could ultimately mean a lower economic growth rate than otherwise anticipated.

Viewed as a relatively safe haven during the global chaos with the added bonus of relatively high interest rates, Australia received, and continues to receive, a high share of the cross-border capital flows. However, this may ease off as global sentiment improves and risk appetites change, especially with the tapering of the Quantitative Easing by the US Federal Reserve. Furthermore, any efforts by foreign countries to reduce external capital flows would compound any concerns about Australia's reliance on offshore funding.

Australia cannot be insulated from the competitive pressures from offshore, including competing demands to fund offshore growth. For instance, the relative emergence and popularity of Kanga issues (which has accounted for 45% of vanilla bonds issued in Australia for the year to date)[19] provides wider investment opportunities domestically and also channels funds away from funding Australia's growth to funding the growth of businesses offshore. Likewise, superannuation and other funds channel a significant portion of their investments offshore and as noted above, this may increase.

Deposits are expected to continue to fund the bulk of credit demand. The gap between lending and deposits has remained relatively steady since 2008, but may widen further as market sentiment improves and risk appetite returns.

---

19 KangaNews League Tables, http://www.kanganews.com/league-tables/au-domestic1/all-aud-domestic-deals

If there is an expectation from regulators or rating agencies that deposits need to constitute a certain percentage of funding, then all other things being equal, credit from financial institutions, and banks in particular, may be limited by the uptake of deposits by consumers. Likewise, any other externally prescribed funding mix may limit the availability of credit.

Financial institutions are encouraged, both internally and externally, to continue to lengthen the duration of their funding which, all things being equal, will mean a higher cost of funds that will ultimately impact the supply and price of products and services to consumers.

As economic growth strengthens, the difference between money supply and the funding needs of the economy is likely to grow from its current total of $600 billion.

3.3. What can be done to manage the challenges

There is a range of opportunities for potential funding and measures that can be put in place to improve funding from those sources, in order to support economic growth.

Deposits

Deposits are expected to continue to fund much of the demand for credit and therefore growth. Financial institutions are highly incentivised both internally and externally, most notably by rating agencies, to maximise deposit taking and accordingly every effort will continue to be taken to ensure pricing and product development continues to attract consumers. The one issue that stands out as an impediment to this is the tax treatment of deposits and other interest earning products. While there are a number of tax inequities across products, deposits fare the worst and as summarised in the Henry Review[20], the real effective tax rates on bank deposits are already nearly double the marginal rate and significantly higher than the rates for other asset classes.

It is counter-intuitive, from a stability perspective, to have the tax system incentivise consumers away from relatively less risky products, like bank deposits, in favour of relatively more risky products like equities. This situation would be made significantly worse by a levy on deposits, as proposed to establish an unnecessary Financial Stability Fund. Accordingly, and in line with the Henry Review Recommendation 14, the Inquiry should consider the benefits of a tax concession for interest income for all taxpayers to remove the tax bias against interest income in the tax system.

Debt capital markets

Another source of funding that has great potential to support growth is the domestic debt capital market.

The domestic debt capital market continues to be limited for a number of reasons, including lack of participation from Australian corporates in particular. Australian corporates have increased their activity relatively recently with greater issuance offshore as detailed in the graph below.

[20] The Treasury (December 2009), *Australia's Future Tax System, Report to the Treasurer* http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm

Figure 3.23: Gross bond issuance by Australian Non-Financial Corporations

Source: RBA

Nevertheless, the size of our corporate bond market remains small and the Inquiry must fully explore the creation of a deeper and more liquid bond market, addressing any hindrance to issuance as well as investor demand, both domestically and from offshore. To that end, there are a number of measures that can be taken by the Government and regulators as well as market participants. For example, adopting the extension of the domestic bond market as Commonwealth Government policy to improve economic growth would recognise that active Government participation is inherent in all mature bond markets.

Specifically, Government could:

- extend the yield curve[21], step up issuance and facilitate secondary market trading;
- complete the work started by the Treasury discussion paper issued in late 2011 that looked at barriers to issuing bonds to retail investors, *"Development of the Retail Corporate Bond Market: Streamlining disclosure and liability requirements*"; and
- enact the proposed legislation: *Corporation Amendment (Simple Corporate Bonds and Other Measures) Bill 2013*.[22]

Within debt capital markets, securitisation and covered bonds are worthy of additional attention.

Securitisation

Securitisation, largely damaged through perception rather than actual underlying risk, proved to be an effective source of funding facilitating growth not just in Australia but across the globe. This is appreciated by the regulatory authorities worldwide and hence there have been unprecedented measures taken to support the securitisation market internationally. Albeit slower than desired and with still a long way to go, this has led to some recovery and, as this continues, so will this product's potential as a source of funding to support growth across businesses.

[21] i.e. issue longer dated securities
[22] More information is available at: http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5007

One limitation of securitisation in Australia is the frequency and size of issuance of many programs, both of which are small and therefore limit investor interest. Coordination to facilitate larger and more frequent issues that will truly compete with some of the larger programs offshore should be explored. This could improve pricing, and also contribute towards the creation of a deeper and more liquid market. Allowing master trust structures will aid in this effort, and it will also help address some specific investor concerns, such as term of investment.

To that end, finalising the regulatory settings for securitisation, including the use of master trust structures, as quickly as possible and recognising the benefits of a liquid and transparent securitisation market, including for smaller institutions, are paramount.

Covered bonds

The introduction of covered bonds in Australia has proven to be a valuable additional source of funding for some market participants, facilitating incremental funding for Australia. As market sentiment continues to improve, the product could have wider application and therefore serve as an even greater source of funding. Opportunities are limited however, by the cap set by the regulators.

Accordingly, a periodical review of the cap on the covered bond pool in light of the operation of the covered bond market and other developing trends in bank funding is important.

Secondary market

Secondary market trading is the key for vitality and therefore the existence of a deep and liquid capital market. The GFC tested the secondary market trading capability of participants across the globe such that financial institutions are no longer able to provide the support they once did. The Inquiry must take this into consideration in their review.

A review of the markets in which eligible securities are traded to improve market participation is warranted, so that they become more liquid, and accessibility to trading infrastructure is increased to facilitate timely and accurate price discovery and easier settlement. This could include trading more bonds on an exchange and more tools to access trading via electronic platforms.

Offshore funding

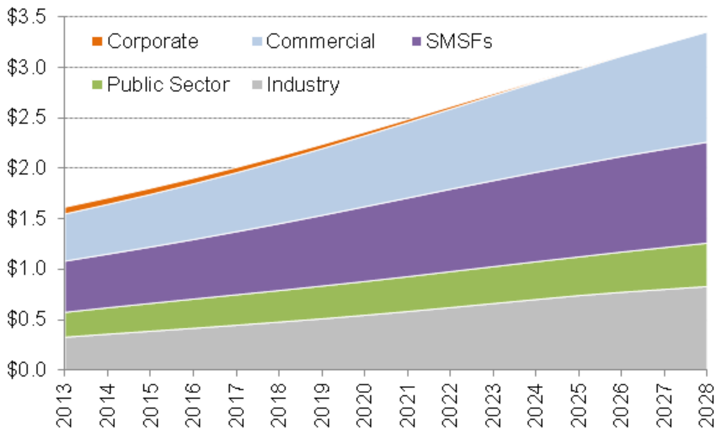
In the context of the global financial system, Australia is a small participant albeit often punching above its weight. Accordingly, funding from offshore will always provide significant opportunities for diversification at the very least. Furthermore, as we have seen to date, Australia will look offshore when domestic funding is insufficient or pricing efficiencies can be explored. Both have positive implications for consumers albeit at the cost of rendering the financial system vulnerable to external factors.

The risk associated with reliance on offshore funding will be mitigated to some degree as the domestic capital markets become deeper and more liquid.

Superannuation funds

Superannuation funds form the second largest part of the finance and insurance industry in Australia, with $1.6 trillion in assets projected to reach $3.4 trillion by 2028.[23] With such strong growth expected in this area, it is worth exploring whether superannuation can be a greater source of funding for the economy.

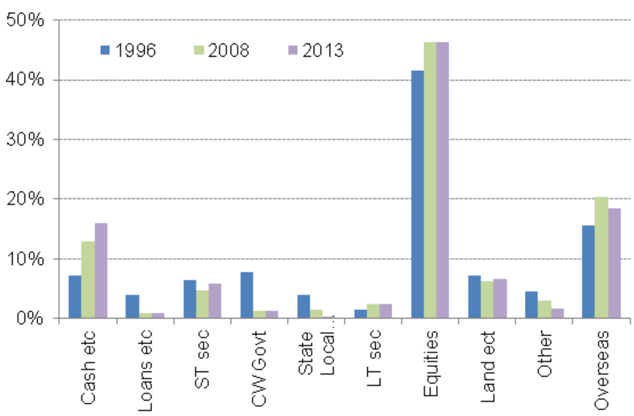
Figure 3.24: Projected growth of superannuation funds



Source: Rice Warner

Superannuation funds are heavily weighted towards equities, both on a stand-alone basis as well as in comparison to many offshore jurisdictions, and increasingly invest (and therefore fund growth) offshore. The Inquiry must explore whether there are any barriers to diversification for superannuation funds, and in particular, what is stopping them from a greater allocation to domestic fixed income products. Of particular interest is the opportunity to match funding between the longer term investment needs of superannuation funds and the longer term growth needs of Australia, including the funding of infrastructure projects.

Figure 3.25: Assets of Australian superannuation funds



Source: RBA

[23] See Appendix D, page 6

Figure 3.26: Investment split (%) by type of superannuation fund (2013)

Fund type	Equities	Property	Australian Fixed Interest	International Fixed Interest	Cash and Term deposits	Other	Total
Corporate	58	9	12	5	8	8	100
Industry	52	11	7	5	5	19	100
Public Sector	48	10	7	6	12	17	100
Commercial	47	7	15	6	15	10	100
SMSF	50	15	1	0	31	3	100
Total	**50**	**11**	**8**	**4**	**17**	**11**	100

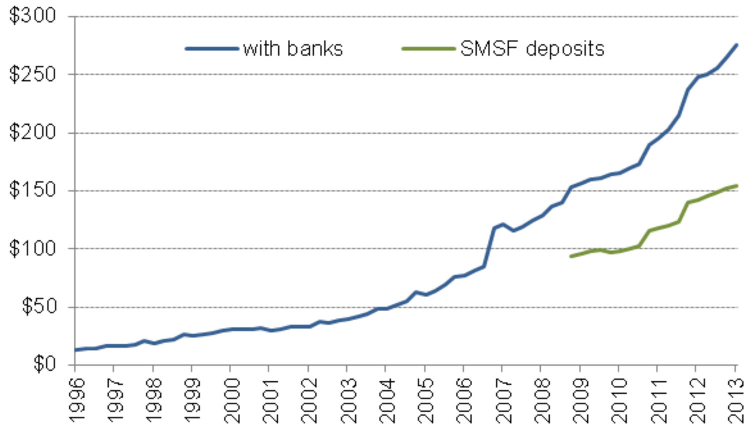
Source: Rice Warner

The investment needs of the various types of superannuation funds vary greatly and depend on a number of factors including the extent to which a fund is in pension phase, whether contributions meet liquidity needs, the need for annuity and lump sum withdrawals, the need to match assets and liabilities as well as meeting return targets. Each factor then has different implications for investment demand. For instance, the appeal of equities in a low interest rate environment is even higher. Demand for fixed income products may increase as the need for matching assets and liabilities grows, demand for annuity grows, and most importantly, supply of fixed income products that meet the cash flow needs of superannuation funds grows.

Predicting the future needs of each type of fund is challenging. Demand for fixed income products may remain low overall (see Appendix D). However, particularly with an aging population, there may be a pickup in demand from some segments including Commercial Funds.

Relatively recently, super funds, particularly self-managed super funds, have been attracted to bank deposits. While this significantly contributes to deposits becoming an even greater source of funding for Australia, the liquidity treatment of superannuation deposits under Basel III means that there is greater dilution in circulating superannuation deposits within the financial system (i.e. more liquid assets need to be held against these deposits in comparison to retail deposits). In the interests of efficiency, the industry believes this liquidity treatment warrants review.

Figure 3.27: Deposits of superannuation funds



Source: ABS

Accordingly, the regulatory run-off assumptions applied to superannuation deposits should be periodically reviewed, to ensure that the liquidity value of those deposits, including intermediary deposits, accurately reflects their underlying liquidity risk.

The banking industry fully appreciates that the superannuation funds' priority is to provide retirement benefits to members. The industry supports providing investment opportunities that improve funding, consistent with this goal. Accordingly, a review of the market to determine if there are changes to both superannuation funds and the types of bonds on offer that would result in superannuation funds holding more bonds may be of great benefit. The potential benefits from creating investment opportunities for superannuation funds in terms of facilitating growth for Australia is worthy of the Inquiry's full attention.

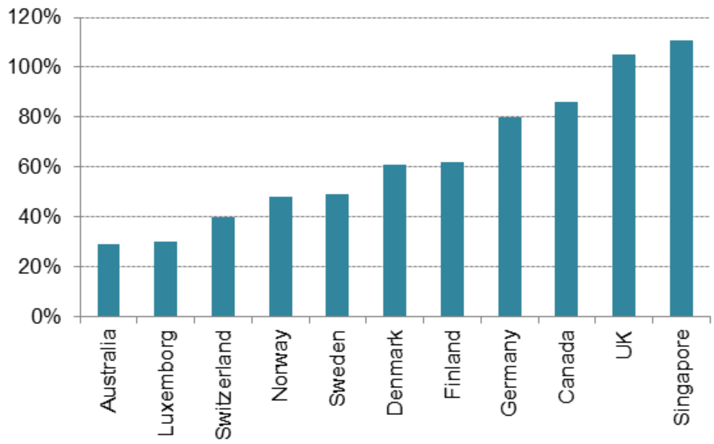
Other funds

Funds under management, excluding superannuation funds but including the Future Fund, total approximately another $216 billion. Hence, following a similar approach to superannuation funds, it is also worth exploring how the investment needs of other funds can be met domestically in order to support Australia's economic growth.

Government debt

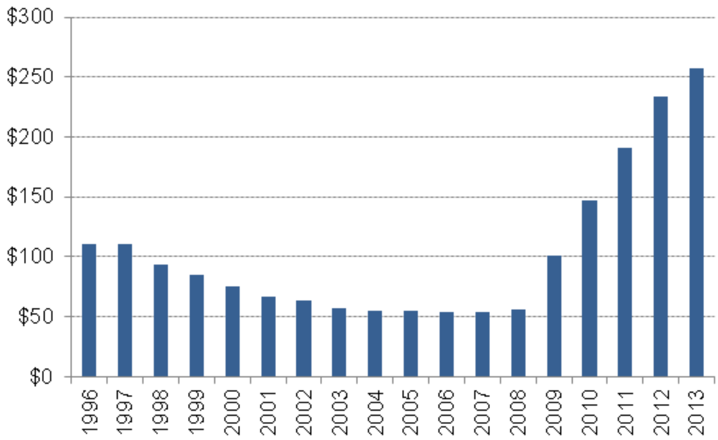
Within a well-run economy like Australia, Government will always have the cheapest access to funding with the pricing for all other market participants at a spread above Government rates. This funding potential is limited by the Government's willingness to incur debt, which in turn is driven by a number of factors including the desire to preserve credit quality (and ultimately AAA rating). Having said that, while debt has recently increased (see Figure 3.29), it would appear there remains significant capacity for further issuance in comparison to peers (see Figure 3.28).

Figure 3.28: Debt to GDP ratio of AAA rated countries (2012)



Source: S&P/OECD

Figure 3.29: Australian Government Gross Debt ($bn)



Source: ABS

A more palatable alternative could be for the Government to consider working with the private sector, either through Public Private Partnerships or other arrangements, to facilitate funding for a variety of areas, including infrastructure and housing. While the private sector has social responsibilities, it also wears a responsibility with respect to generating profits for shareholders and thereby supporting financial stability for the benefit of consumers.

The Government is better placed to consider the wellbeing of the Australian people more holistically.[24]

In conclusion, it is vital for Australia to have access to as many funding sources as possible so that funding is no hindrance to growth, and there are a number of steps that could be taken to improve current access.

[24] The issue of financing and funding major infrastructure projects is currently subject to an inquiry by the Productivity Commission (www.pc.gov.au). The draft report (March 2013) finds that governments can act to attract higher levels of private infrastructure investment and improve their own capacity to fund infrastructure, even in the presence of apparent borrowing constraints. This can be done through pricing mechanisms and by establishing stronger transparent processes for project identification, selection, design and implementation.

This page is intentionally blank.

4. Ensuring dynamic competition

4.1. Why is competition important

"Competition provides the spur for businesses to improve their performance, develop new products and respond to changing circumstances. Competition offers the promise of lower prices and improved choice for consumers and greater efficiency, higher economic growth and increased employment opportunities for the economy as a whole." Hilmer Report[25]

The Hilmer Report was right to emphasise the broad economic benefits on enhanced competition. The Productivity Commission, reviewing the impact of the Hilmer reforms, has estimated that those reforms contributed up to $20 billion or 2.5% of GDP to the economy.[26]

A core principle underlying the Hilmer reforms was that competitive markets, rather than regulation, drive an efficient economy and the best outcomes for consumers. This principle is highly relevant to the financial system today and should form the basis for the Inquiry's examination of competition.

In banking, competition means banks constantly have to improve and adapt the products and services they offer, so they can retain their existing customers and attract new ones from their competitors. Competition drives banks to be more efficient, innovative and customer focussed. They have to develop better business distribution mechanisms and service models, resulting in a wider range of products, services and providers. Competition also allows customers to put downward pressure on prices.

As with the Hilmer reforms for the wider economy, competition in the finance sector has played a major part in both productivity gains and growth in the sector. Competition was freed up by the reforms of the 1980s and 1990s, resulting in the value added by the industry, as a share of GDP, doubling from 1980 to 2013.[27] From 1996 to 2013, multi-factor productivity for the financial and insurance services industry[28] increased on average by 1.7% per annum (see Appendix A page 11 for further discussion of productivity), the third highest result for the 16 industries for which data are presented. These gains brought considerable benefit to customers and the economy, keeping the cost of banking products and services down.

Price, however, is just one attribute customers consider when choosing their banking provider. Customers also value attributes such as service quality, convenience, innovation in meeting the customers' needs, accessibility and choice from a wide and diverse range of providers.

---

[25] *National Competition Policy Review*, (1993), Committee chaired by Professor Fred Hilmer, also known as the Hilmer Report, p 2, available online at http://ncp.ncc.gov.au/docs/National%20Competition%20Policy%20Review%20report,%20The%20Hilmer%20Report,%20August%201993.pdf

[26] Productivity Commission, (2005), *Review of National Competition Policy Reforms* P 51, available online at http://www.pc.gov.au/projects/inquiry/national-competition-policy/docs/finalreport

[27] ABS, (Sept 2013), *Australian National Accounts: National Income, Expenditure and Product,* 5206.0,

[28] Multifactor productivity is defined as the ratio of output to two or more inputs (often capital and labour).

`

Customers are the ultimate beneficiaries of competition, and it is therefore important to assess competition levels from the perspective of the customer; what they experience and what is available to them. Competition can also be assessed against a range of market characteristics, such as barriers to entry, concentration or levels of profitability.

All banks agree that markets are currently competitive, but that the Inquiry should consider proposals to drive more competition, on the merit of the case made for those proposals.

Recommendation 3: The Inquiry should assess current competition levels and identify any measures, consistent with a stable and efficient market, which can reasonably be taken to enhance competition further.

There is solid evidence that the main markets for consumer and business banking products and services are competitive, but that measures could be taken to improve competition further. Depending on their commercial strategies and market position, banks have a range of views on the degree of competition and what steps could be taken, which they will address through individual bank submissions.

This section describes a range of banking competition indicators, from both a customer and a market perspective.

4.2. Customers

Customers, as the ultimate beneficiaries of competition, play an important role in defining the necessary characteristics of a competitive market through the attributes they demand from that market. Price is important, but customers also demand other attributes, such as product features, service, accessibility, innovation and quality. For competition to operate effectively, it is also important customers are well informed and able to make rational choices.

Customer service

Given that competition is ultimately for the benefit of customers, measures of customer satisfaction can be an indicator of the overall healthiness of competitive markets.

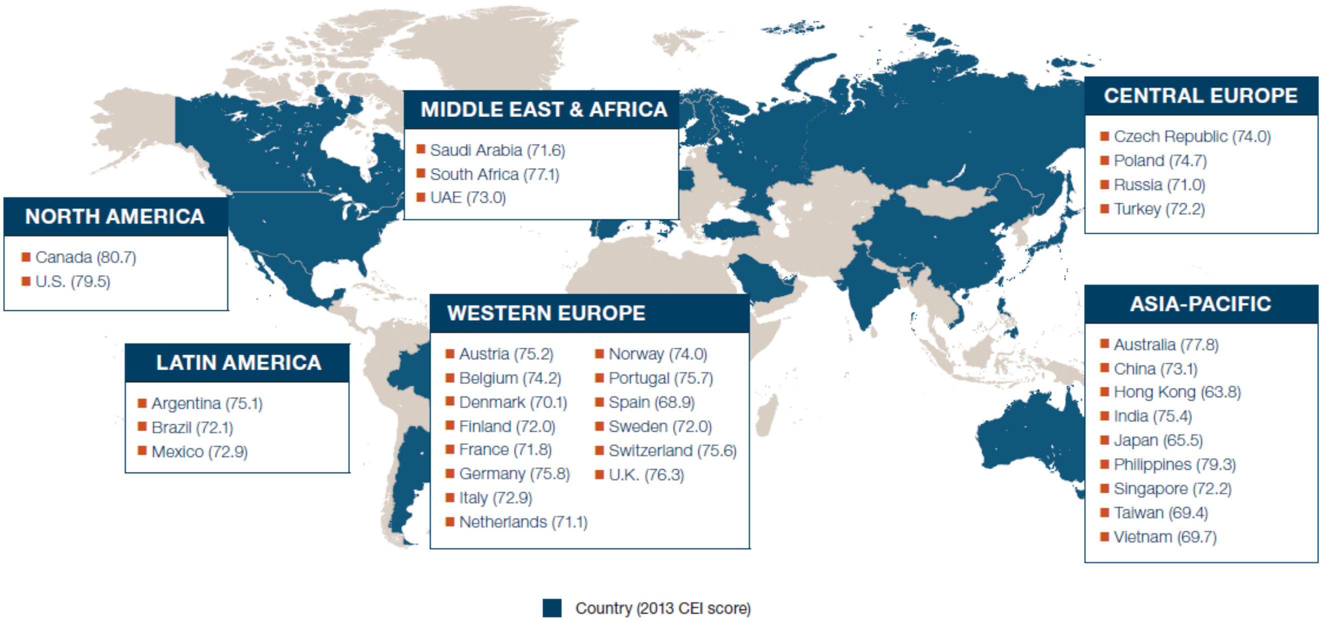
Customer satisfaction has improved considerably since the time of the Wallis Inquiry, on the back of falling prices across many products, growing product ranges and innovation, significant improvements in service levels and a transformation in accessibility through technology. Satisfaction levels for all with banks are at an all-time high and are improving.

Capgemini research has found that Australians have one of the best customer experiences in banking in the world, ranking second in the Asia Pacific Region, and fourth in the world after Canada, the US and the Philippines (see Figure 4.1). Australian consumers also recorded the fourth highest increase globally in positive customer experiences in 2013, following Canada, the US, and the Philippines.[29]

[29] Capgemini and Efma, (2013), *World Retail Banking Report*, as referred to in Appendix E, p 40

Within Australia, banks show steady progress in improving customer satisfaction. Roy Morgan data (2014) showed customer satisfaction grew from 2001, reaching a high of 81.6% in January 2014, with the smaller banks scoring slightly higher than the major banks.[30] Better customer service has been a major feature of competition between banks, and with other providers, over the past decade as they fight to attract and retain customers.

Figure 4.1: Customer satisfaction - globally



Source: Capgemini, 2013

In addition to competition between banks, customer service has improved through a high level of industry commitment to codes and other initiatives designed to protect and support customers. The bulk of banks offering retail services have signed up to the industry's Code of Banking Practice,[31] and nearly all ADIs[32] to the ePayments Code.[33] There is also a range of other guidelines and principles designed by the banking industry to support customers, and guide banks in their engagement with Australian communities.[34] Banks have internal dispute resolution schemes, and support external dispute resolution. Banks help fund the independent Financial Ombudsman Service as the main resolution body for customers, small business and the financial services industry. Both at an individual bank level and across the industry, banks have improved their support for customers in financial hardship, have improved the features and availability of no cost or low cost transaction accounts and have supported improved financial literacy in the community.

---

30 Roy Morgan data, February 2014 available online at http://www.roymorgan.com/findings/5451-satisfaction-with-banks-reaches-record-high-201402260024

31 See the ABA's website at www.bankers.asn.au/Industry-Standards/ABAs-Code-of-Banking-Practice/Banks-that-have-adopted-versions-of-the-Code-of-Banking-Practice for a full list of signatories.

32 An ADI is an Authorised Deposit-taking Institution, authorised by APRA under the Banking Act 1959. ADIs are authorised to take deposits, and provide other banking services and these organisations include banks, building societies and credit unions.

33 See ASIC's website at http://www.asic.gov.au/asic/asic.nsf/byheadline/ePayments-Code--List-of-members?openDocument for a full list of signatories.

34 See the ABA's website at http://www.bankers.asn.au/Industry-Standards for a full list of industry standards.

Price

There have been significant price movements across a broad range of banking products since 1996. Today, term deposits attract interest well above the cash rate, interest rates for home loans have dropped from their 1996 levels, interest rates for small business borrowers are at their lowest absolute level since 1993, and bank account service fees have dropped significantly since 2008.

Impact of GFC on risk and price

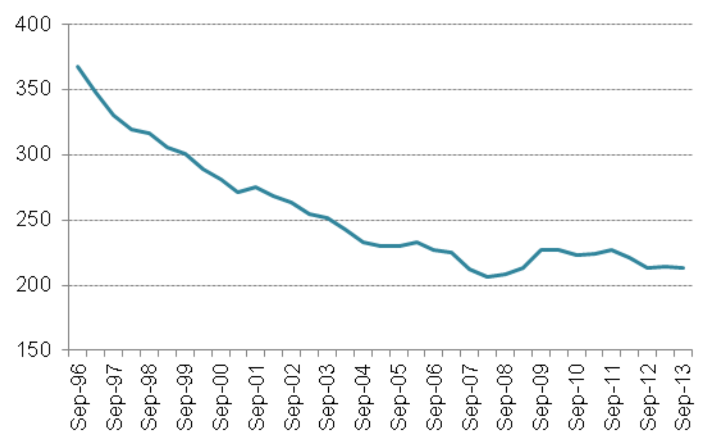
Pricing, however, has and continues to be affected by the GFC and its consequences. At a global level, banks have repriced in response to changed assessments of risk. This has been driven by banks' own risk management strategies, the demands of investors, expectations of credit rating agencies and tougher regulatory requirements. The markets from which banks fund themselves have also repriced for risk. This has led to a substantial increase in the cost of both deposit and wholesale funding. Another impact of this has been to weaken the link between the RBA's cash rate and the true cost of funding to banks.

In response, banks have changed their funding mixes by reducing their reliance on short term wholesale funding and increasing their use of long term wholesale funding and deposits. The cost of bank lending products, such as secured and unsecured credit, has risen as a result. This can be observed in Figures 4.4 and 4.5, with an increase in spreads seen in 2008. Further detail on these developments can be found in Appendix A.

Net Interest Margins

Movement in Net Interest Margins (**NIMs**) is frequently used as a measure of competition between the banks. NIMs are, in effect, the price of banking. At the commencement of the Wallis Inquiry, the major banks' average NIM was around 375 bps. It declined from the late 1990s to 213 bps as at September 2013 (see Figure 4.2). NIMs are lower again for some regional banks, due to their higher use of deposit funding, higher cost of wholesale debt funding compared with the major banks, and their larger share of lower-margin housing lending.

Figure 4.2: Major banks' Net Interest Margins (basis points)



Source: UBS

In 2009, the then Deputy Governor of the RBA, Ric Battelino, noted that "between 2000 and 2007, the NIM on the major banks' Australian operations had narrowed by about 100 bps. This was driven by competition, and was made possible by sizeable reductions in banks' operating costs over that period, which allowed banks to continue operating profitably despite falling margins".[35]

The NIM for the major banks was at its lowest in early 2008 when it fell to 206 bps, as the GFC began and as banks competed more actively for deposits. Since 2008, NIM has remained in a narrow range, as competitive pressures on both the deposit and lending side have continued.

An examination of NIMs, which have narrowed for the whole of the banking sector, and Returns on Equity (**RoE**)[36], which have decreased (reflecting a lower return to shareholders), points to banks absorbing a portion of the increase in their funding costs at the time, rather than passing these on to customers in full.

Deposits

While much public attention is given to competition on the lending side, a major shift arising from the GFC has been the surge in competition for deposits, as banks look to secure their funding base. This competition has been to the huge advantage of those Australians with savings, such as retirees.

Using the cash rate as a benchmark for comparison purposes only shows that, in 2000, only special term deposits paid more than the cash rate in interest, with other deposits earning less than the cash rate. Today, most types of deposit accounts have interest rates on average of at least the cash rate. Transaction accounts are the exception. These traditionally pay less interest, as these accounts are driven more by customer transactional needs than price and support a larger number of customer services. Even with transaction accounts, however, the margin has changed in favour of customers.

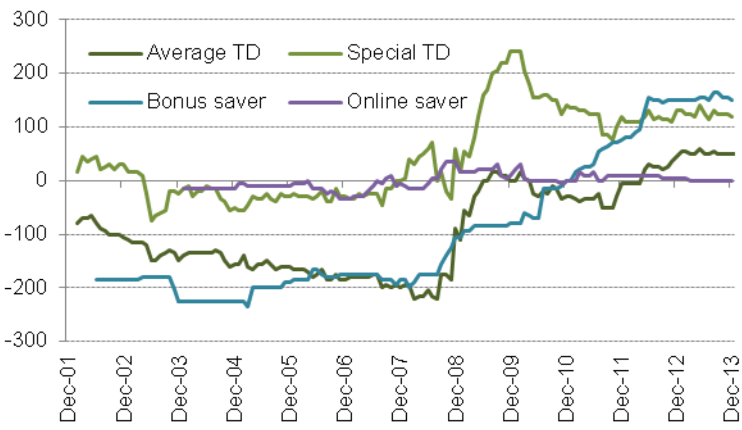
The spread[37] on interest rates paid for deposits rose across deposit categories from December 2006. For term deposits and savings accounts, it markedly increased in 2008, declined in 2009 and held a steady rate from 2011 to 2013, well above the cash rate (see Figure 4.3). Illustrating the degree of change, the spread on interest rates paid for term deposits has increased 220 bps from 2005 to 2013, starting at 168 bps below the cash rate, and moving to 52 bps above it.

[35] Ric Battellino, Deputy Governor, RBA, (16 December 2009) speech available online at: http://www.rba.gov.au/speeches/2009/sp-dg-161209.html

[36] Return on Equity is a ratio used to measure profitability. It is derived by dividing net income returned by shareholders equity. It shows how much profit a company generates with the money shareholders have invested.

[37] Spread is used in financial discussions as a measure of the difference between two interest bearing items. In this case it is used as a measure of the difference between the RBA's central cash rate, and the interest rate offered by banks to depositors.

Figure 4.3: Spreads on deposits to cash rate (bps)



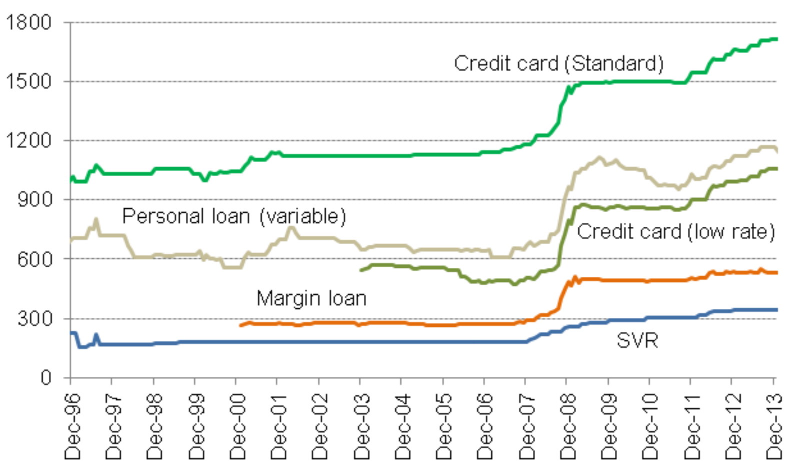
Source: RBA

Household interest rates

The cost of a home loan to the customer is less than it was in 1996. In December 1996, the standard variable rate for a home loan was 8.25%, and in January 2014 it was 5.95%. This drop can largely be attributed to reductions in the cash rate. Of course, the standard variable rate is only an indicative rate and the vast majority of customers pay less than this rate.

In relative terms, pricing on lending products for households, measured by the spread to the official cash rate, has increased since 1996 (see Figure 4.4), with the most marked increase occurring following the peak impact of the GFC in 2008. This reflects the impact of the GFC described above.

Figure 4.4: Spreads selected household loan products to cash rate (bps)



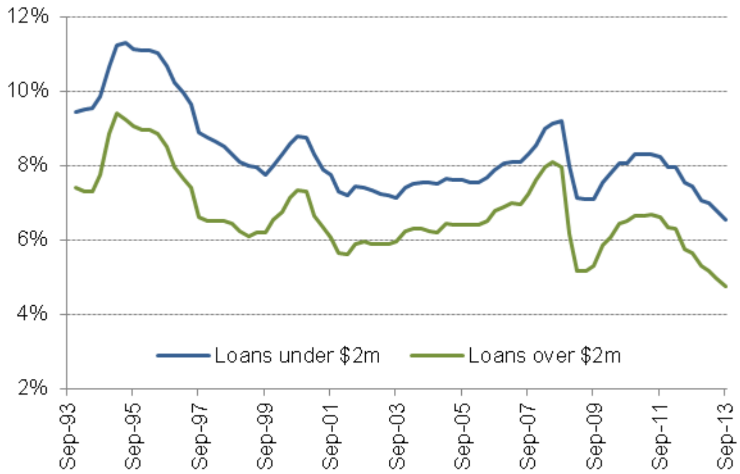
Source: RBA
(SVR: average standard variable rate on a mortgage)

Business interest rates

In absolute terms, at an average 6.55%, business loan interest rates are at their lowest point since 1993 (see Figure 4.5). However, spreads for business credit against the cash rate have risen since the onset of the GFC, with the spread for mortgage secured loans to business rising from 230 bps in January 2008 to 460 bps in November 2013.

Small businesses have expressed concern that they pay more for credit than housing loan customers and larger businesses. These higher prices are largely due to the higher cost to the banks of lending to small business. There is more risk attached to these loans, as small business income is more volatile, the arrangements to secure the loans vary considerably, and smaller businesses tend to have a shorter financial history and less information to offer banks to make an assessment of risk. The GFC made two further contributions to increased prices of credit for SMEs: the increased cost of funding to the banks; and the need to reprice risk along with the associated increased capital costs incurred through tougher risk management standards (sought by the banks, regulators and credit rating agencies). It is worth noting that for some time now, regulators have required banks to hold more capital against small business loans than mortgages, given the higher repayment risks, which increases the cost of these loans to the banks.

Figure 4.5: Business lending – average weighted interest rate

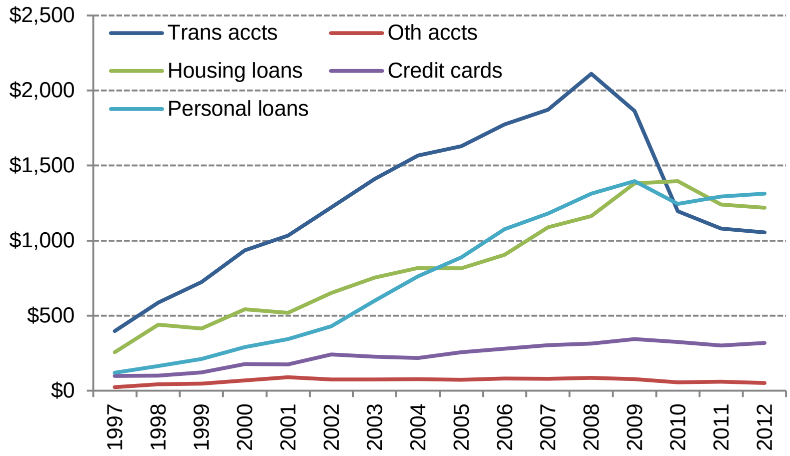


Source: RBA

Fees

Overall, customers are paying less in fees than they have in the past, with householders as the principal beneficiaries (see Figure 4.6). Fee revenue has grown more slowly than the growth rate of the banking sector, which was 7.5% as measured by resident assets (mainly loans).

Figure 4.6: Bank service fee revenue from households ($m)



Sources: RBA/ABA

The RBA's 2013 survey of bank fees[38] shows that since 2010 total fees paid by households have fallen by $1.12 billion or 22%, taking fees paid by households to their lowest level for seven years. This is despite increasing numbers of transactions by customers. For competitive or regulatory reasons, banks have reduced and abolished many fees, and customers are choosing free or lower-cost banking products.

In the three years after the onset of the GFC, fee revenue from businesses was growing at an average of 9.8% per annum. During this time, businesses increasingly turned to banks to support their financing needs as other markets tightened or closed entirely. This saw aggregate fees on business lending increase by over 20% in 2009 and 2010. Growth since that point has slowed, but the remaining growth is still largely attributable to an increase in volume of borrowing activity, particularly on the part of larger businesses.

Overall, all businesses have benefitted from large falls in fees on deposit accounts, which are now at their lowest level since 1999. For the fifth consecutive year, there have been reductions in fees on business deposit accounts, falling by $212 million or 25%.

Customer choice

Customers have access to a considerable number of products through the banking sector, and even more when the pool is broadened to include credit unions, building societies and other providers (see Figure 4.7). According to APRA, there are 164 banks, building societies and credit unions which provide the main retail banking services in Australia.[39]

---

[38] Reserve Bank of Australia, (2013) "*Banking Fees in Australia*", in June Quarter *The Bulletin,* www.rba.gov.au/publications/bulletin/2013/jun/index.html

[39] List of APRA licensed Authorised Deposit-taking Institutions available online at: http://www.apra.gov.au/adi/Pages/adilist/aspx

Figure 4.7: Products on market[40]

January 2014	Total products listed	Total institutions	% Banks	%CUBS	% non-ADIs
Deposit accounts	681	97	31	67	2
Housing lending	2000	103	49	24	20
Credit cards	202	68	48	28	23
Business Lending	226	24	77	22	1
			Banks	**CUBS**	**non-ADIs**
Number of providers			70	94	23

Source: Canstar

Not only do customers have a wide ranging choice of products and providers, these choices are now more easily found and compared than ever before, with the rise of comparison websites.

Accessibility

Access to financial services is central to an individual's ability to engage fully with the economy. Engagement through the financial system helps them, for example, to get paid, make purchases and save for their retirement.

Over 98%[41] of individuals aged over 15 having an account with a financial institution, one of the highest rates in the world.[42]

Innovation in banking products has seen accessibility increase. Examples include:

- low and no fee basic accounts for customers needing or seeking low price banking options;
- reverse mortgages, releasing equity tied up in homes;
- mobile banking, with customers able to meet with their bankers at a location of their choice; and
- brokers and aggregator websites giving customers better information with which to compare products.

Technological advances have made banking services, particularly payments, far more accessible to customers. Prime examples are BPAY, online direct debits and chip technology enabling safe use of credit cards. Customers have embraced this technology, with the electronic payments system recording over 24 million transactions a day (the impact of technology on the banking industry is discussed further in Section 6).

40 Canstar (January 2014), data generated for ABA. These figures should be regarded as indicative. Listing a product with Canstar is not compulsory, and generally, credit unions and building societies are more likely to list their products than banks. Canstar can be contacted through its website at www.canstar.com.au/

41 Roy Morgan (2012) data as referenced in The Centre for Social Impact for National Australia Bank's June 2013 report "*Measuring Financial Exclusion In Australia*', available online at http://www.financialliteracy.gov.au/media/465159/nab_csi_measuring_financial_exclusion_in_australia_2013.pdf

42 The Government's policy of directing benefit payments through bank accounts has contributed significantly to this level of participation.

This change has reduced the advantages to market participants of a physical branch network. Nevertheless, traditional channels have been maintained, with steady growth from 4,789 branches in 2001 to 5,582 branches in 2013[43]. Branches remain important for many customers, with small businesses and those without internet access often preferring a face-to-face relationship with their bankers.

Small business has ready access to credit from the banking sector. The RBA notes that only a small portion of small businesses that are not accessing finance attribute this to difficulty in obtaining it.[44] This finding was supported by a joint report between the Council of Small Business of Australia (**COSBOA**) and the ABA released in October 2013[45]. It is important, however, to ensure that those businesses that do need funding to grow can get ready and appropriate access to finance. Given ongoing concerns among small businesses, the ABA and its member banks have continued to work with COSBOA, CPA Australia and other small business representatives to develop means of addressing these concerns. Section 3 also discusses the role banks play in funding small business.

Even though Australia has one of the highest 'banked' populations in the world, the banking industry and individual banks have put in place a number of initiatives to help address community concerns about financial inclusion. These include providing basic fee-free bank accounts for eligible disadvantaged customers[46], fee free ATMs in very remote Indigenous communities, financial hardship support to assist customers in financial difficulty[47], relief for customers affected by natural disasters and financial literacy programs.[48]

The banking industry is also contributing to the ASIC 2013-2017 National Financial Literacy Strategy, to improve financial literacy among consumers and businesses through targeted guidance and support. This helps customers to make informed decisions about banking and financial products and services, find the best priced products and services to suit their needs and switch product providers if they so desire.

4.3. Markets

In addition to customer outcomes, there are a range of indicators that are relevant in assessing the likely levels of competition in a market, including market structure, entry to and exit from the market, profit levels, whether any competitor has the market power to control prices, the continuing growth of the market and the pace of innovation in products and delivery channels. This range of indicators is examined in the Hilmer Report, in the ACCC's Merger Guidelines and

43 APRA, (2013), *Points of presence data collection*, available online at www.apra.gov.au/adi/Publications/Pages/points-of-presence.aspx.The collection shows a steady increase in the number of branches from 2001 when the collection started to 2012. There was a minor reduction from 2012 – 2013 from 5632 to 5582.

44 RBA, (2012), "Small Business Finance Roundtable: Summary of Discussion". *The Bulletin*, Jun, available online at http://www.rba.gov.au/publications/workshops/other/small-bus-fin-roundtable-2012/pdf/02-small-bus-funding-aus.pdf

45 ABA (20 October 2013), *Media Release: New report - small business access to finance,* available online at http://www.bankers.asn.au/Media/Media-Releases/Media-Release-2013/Small-Business-Access-To-Finance.

46 These are listed on the banking industry website, www.affordablebanking.info

47 See banking industry initiative www.doingittough.info which provides advice for banking customers in financial difficulty.

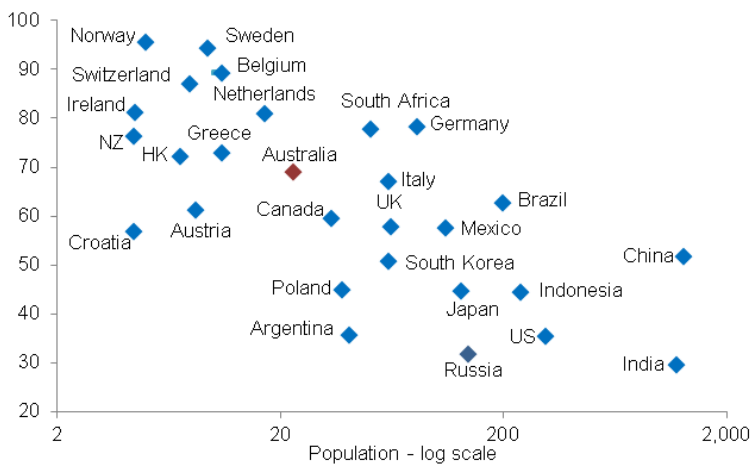
48 See www.bankers.asn.au/Consumers/Financial-Literacy/Financial-Literacy-Home for information on bank initiatives to improve financial literacy.

in the OECD Competition Committee's 2011 publication, *Competition Issues in the Financial Sector*[49].

Market structure

An international comparison, based on World Bank data, shows Australia's banking sector concentration relative to other countries (see Figure 4.8). Where the percentage of assets within the market held by the three largest banks are charted against population size, twelve countries exhibit higher levels of concentration than Australia, while sixteen have lower levels (the three largest banks are used to allow comparisons across countries with different sized populations and banking systems).

Figure 4.8: Market share (%) of top three banks by country against population[50]



Market participants

As noted above, customers have access to a considerable number of products through the banking sector, credit unions, building societies and other providers. These products cover deposit accounts, personal lending, housing loans, small business banking, corporate banking and wealth management. To attract and retain customers in these areas, banks compete with each other, credit unions and building societies, and non-ADIs.

A substantial competition challenge is made to the banks by non-ADIs. It is substantial because the fast evolution of technology supports quickly evolving business models, and because these business models have the potential for growth and the disruption of existing markets. Prior to the GFC, mortgage originators and finance companies won substantial market share in credit markets, due to the rapid rise of the securitisation business model. Many of these businesses became unsustainable, however, through the GFC, as funding became more expensive.

---

49 OECD Competition Committee, (2011), *Competition Issues in the Financial Sector,* available online at www.oecd.org/regreform/sectors/47836843.pdf

50 From World Bank data available online at: http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALFINREPORT/0,,contentMDK:23269602~pagePK:64168182~piPK:64168060~theSitePK:8816097,00.html

More recently, there have been a number of non-ADIs partnering with ADIs to provide banking services. Examples include Yellow Brick Road and merchant branded credit cards, such as the Woolworths Everyday Rewards (Qantas) card, offered by a partnership between a retailer and an ADI.

Some smaller organisations have also entered the market using internet technologies to enable "crowd funding", where those seeking credit or equity can put their request through a website and many small contributors combine to meet that funding request. Peer-to-peer lending is another non-ADI credit innovation. Virtual currencies, such as Bitcoin, have entered the market offering products designed to avoid the need for banking transaction accounts and associated transfer fees.

Barriers to entry

The level of barriers to entry into a market will shape the dynamics of that market and, in particular, whether competitive pressure exists from the entry, or threat of entry, of new participants. In banking, barriers to entry vary considerably depending on the market segment, whether for deposits, lending or payment services, for example.

In terms of entry by new banks, there are barriers to entry, posed largely by regulation. Australia has strict requirements that organisations must meet if they wish to describe themselves as a 'bank' and accept deposits. These aim to ensure market participants are prudentially sound and have the skills, expertise and incentives to manage their institutions appropriately, to ensure stability and confidence in the financial system and to protect depositors.

These requirements were relaxed in the 1980s and 1990s, with the most notable change of allowing foreign banks to enter the market. The continuing requirements largely relate to:

- company and ownership structure;
- capital;
- governance, risk management and internal control, compliance, information and accounting systems, external and internal audit;
- supervision by APRA; and
- ongoing prudential and data reporting requirements.

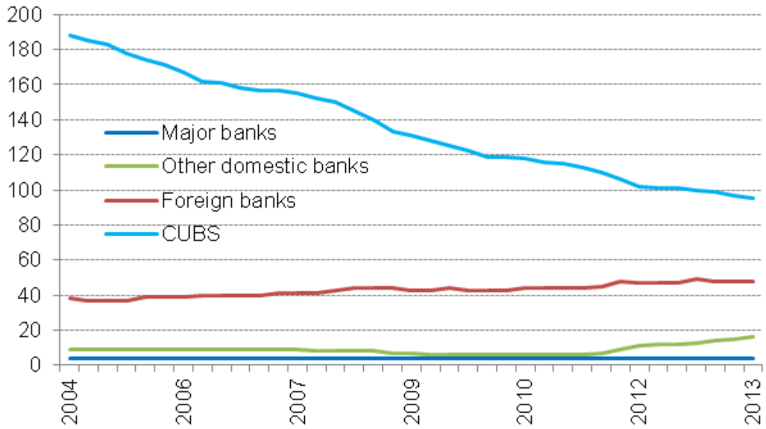
These are discussed further in Appendix E (page 31).

Barriers to entry in lending services are lower and, as noted above, did not prevent significant competition from non-bank lenders prior to the GFC, nor the gradual return of non-bank lenders as funding markets have stabilised. Measures to improve funding further, discussed in Section 3, will not only support greater competition from existing participants, but will aid new players to enter lending markets.

Barriers to entry in payments are even lower and falling, particularly as a result of technological innovation. This is discussed in Section 6.

This steady flow of entries and exits to the banking sector not only supports competition, but has helped maintain diversity in banking markets. Diversity in turn creates a range of different business structures, models and behaviours that improve the overall resilience of financial systems.[51] For this reason, and to ensure wide choice for customers, it is important that the banking sector continues to consist of a broad range of major and regional banks, mutual banks, international banks, credit unions and building societies (see Figure 4.9, noting that these figures are influenced by a number of credit unions and building societies recently become mutual banks and hence changing categories).

Figure 4.9: ADIs - number of market participants



Source: APRA

Switching costs can also be considered a barrier to entry. Bernie Fraser, former Governor of the Reserve Bank, was commissioned by the Gillard Government to examine barriers to switching[52]. He concluded that:

> *…customers who are sufficiently motivated to switch find it reasonably easy to do so, and that the problems encountered by others may have more to do with motivation and perceptions, rather than real barriers.*

While customers frequently switch mortgage accounts and interest bearing deposit accounts, they tend to switch transaction accounts less frequently. Mr Fraser attributed this to the lower gains to be had from switching these accounts, as they attract little or no interest, and have few fees attached. He did, however, note that reluctance to switch transaction accounts could flow on to other accounts, given the bundled nature of many banking retail products. Reviewing current switching behaviours, and international responses to the same issue, Mr Fraser proposed an enhanced switching system, built on that implemented by the industry in 2008, although he anticipated its impact on competition would be "in the margins", as he considered that current impediments to switching were not high.

---

[51] Michie J., Oughton C., (2013), "*Measuring Diversity in Financial Services Markets: a Diversity Index*", Centre for Financial and Management Studies, Discussion Paper Series, Discussion Paper No. 113.

[52] Fraser B., (2011), *Banking Services, Cost-Effective Switching Arrangements*, available online at banking.treasury.gov.au/banking/content/reports/switching/downloads/switchingarrangements_aug2011.pdf

In doing so, he also explored proposals around establishing account portability and determined that the proposal's costs far exceeded its benefits. In 2012, ABA members, working with the Australian Payments Clearing Association, implemented the new switching arrangements recommended by Mr Fraser.

More recently, changes to credit reporting, which will see credit providers able to view fuller information on credit applicants, regardless of whether the applicant has a history with them, should assist new entrants undertake credit assessments and therefore can be expected to increase the range of providers where customers can access credit.

Market share

The distribution of market share is one feature of markets typically analysed to assess the competitiveness of those markets.

The methodology used by the ACCC and other competition regulators for assessing the significance of market share is the Herfindahl-Hirschman Index (**HHI**). Where that index is below 2000, competition regulators typically do not see market concentration as raising significant competition issues. According to the report by Deloitte Access Economics, each of the key retail banking product markets delivers HHI scores of less than 2000, although these have increased since 2007 and some are getting close to that benchmark (see Appendix E page 25).

The GFC played a large part in changing the relative market share of large and small banks and other providers. Up until the GFC, the trend in Australia was towards reduced market share for the major banks.[53] Reduced access to funding, particularly for smaller institutions, withdrawal of some foreign banks in part or in full and increased regulatory burden has seen the market share of the major banks grow since the GFC. But market share is not static and is likely to change again; foreign banks, albeit different ones, have re-entered the market and the securitisation market is showing signs of recovery.

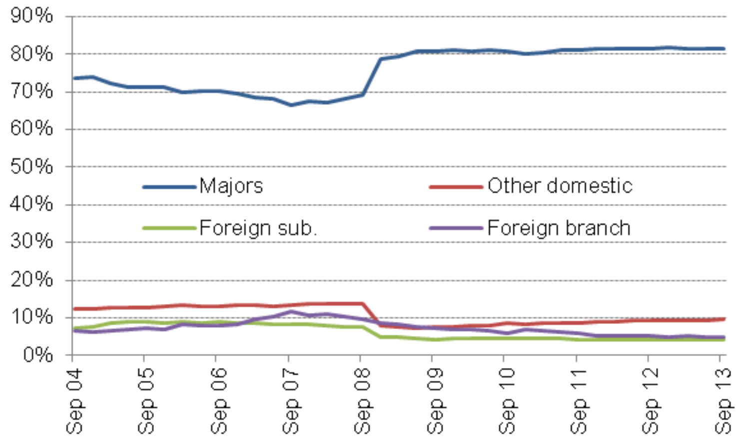
Market structure in deposits

Up until 2007, the market share of deposits of the major banks was declining in favour of the foreign banks and other Australian banks, reaching a low of 66.5% in September 2007 (see Figure 4.10). Their share rose significantly in 2008, driven by the merger between Westpac and St George, CBA's takeover of the troubled Bankwest, and the post GFC withdrawal of some foreign banks. In December 2008, the major banks held 78.8% of the market, after which growth steadied, with major banks now holding 81.4% (September 2013).

Supply side factors have also had an impact with strong growth in deposits, particularly since the onset of the GFC (see Figure 4.11), with customers deleveraging, moving funds from other investments to cash and seeking the safety of banks for their funds.

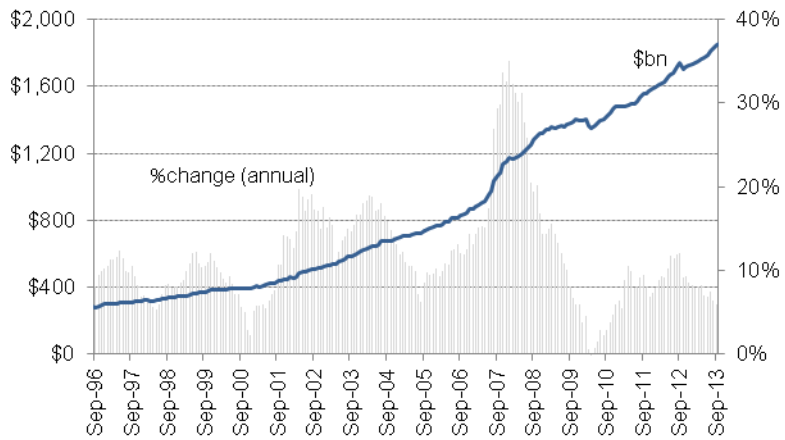
[53] Davis, K., 2007, "Banking Concentration, Financial Stability and Public Policy", RBA conference paper, available online at: http://www.rba.gov.au/publications/confs/2007/davis.html

Figure 4.10: Deposits – share by bank



Source: APRA

Figure 4.11: Deposits



Source: RBA

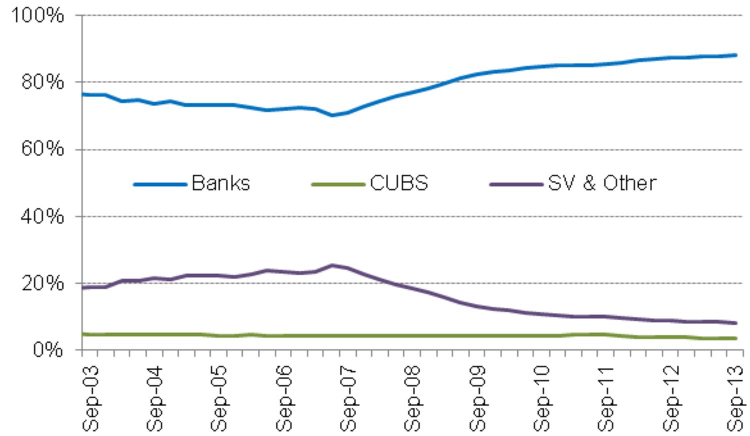
Since 2008, banks have also moved away from short-term wholesale funding and RMBS funding towards deposits and long-term wholesale funding as funding sources. This need for more stable funding was identified by banks, regulators and credit rating agencies. The impact of these drivers is observable for the major and regional banks, with regional and other smaller Australian-owned banks doubling the proportion of their funding met by deposits since 2007. Basel III liquidity requirements are likely to continue to press banks to compete for deposits in order to continue to increase the proportion of their assets funded by retail deposits. These requirements are also likely to impact on pricing strategies, in order to deal with liquidity costs associated with those deposits that are considered to be less stable than others.

Market structure in lending

Major banks, regional and foreign banks, credit unions, building societies and non-ADIs all compete to provide credit to households and businesses. Banks hold the bulk of those markets (housing lending: 94%; personal lending: 85%; and commercial lending: 94%).

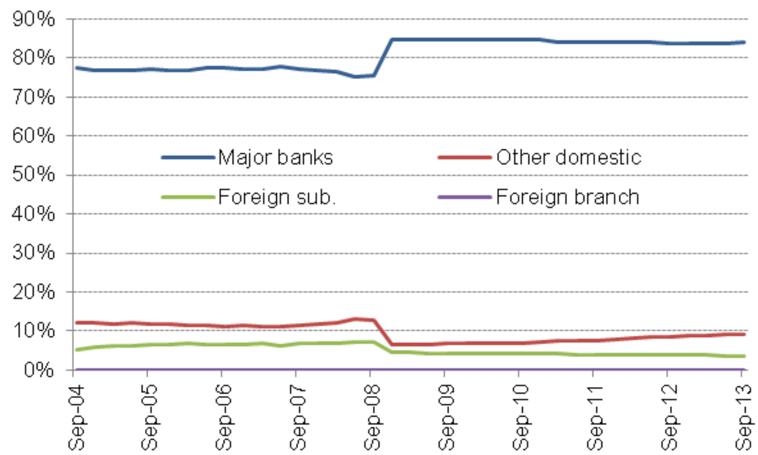
For housing loans, the major banks were losing market share to regional banks, foreign banks and non-ADIs up until 2007 (Figure 4.12). In June 2007, non-ADIs held 25.4% of outstanding housing loans, presenting a significant market challenge. Of the 70.2% held by banks, the major banks held 81.6%, the regional banks 11.7% and foreign banks 6.8%. Today, within banks, the major banks hold 86.6%, the regional banks 9.5% and the foreign banks 3.8% (see Figure 4.13).

Figure 4.12: Housing loan outstandings and providers



Source: ABS

Figure 4.13: Banks - market share of housing loans



Source: APRA

The increase in market share held by the major banks was driven by the merger between Westpac and St George and CBA's takeover of Bankwest in 2008, which saw these banks' lending books come to be counted within the major banks' market share. It was also driven by changes in funding following the GFC, including the pricing of the wholesale government guarantee.

The major change in market share in relation to business credit has been an increase in activity (lending and leases) for the banks, as businesses moved away from the non-ADI sector. In 1997, finance companies held approximately 33% of the market, and banks 67%. By 2013, banks' share of the market had grown to 94%.[54] While the decline in market share of non-ADIs has been occurring since 1997, there was a sudden drop in share in the early 2000s, and again from 2006, continuing on as the GFC impacted on funds available to the non-ADIs.

Profits

Australia's banks are profitable, and this, combined with prudent behaviour and sound regulation, has seen them remain sound throughout the GFC, in contrast to the experiences of many US, UK and European banks.

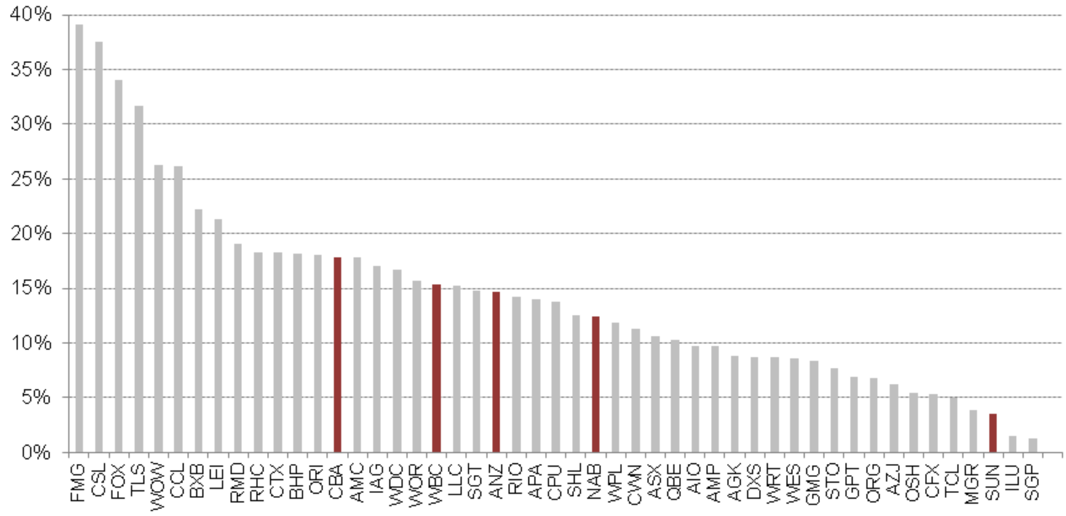
Comparing banks' returns to those of S&P/ASX 200 companies operating in Australia shows that, in 2013, no Australian bank featured in the top 50 most profitable companies when ranked by RoE, with CBA ranked 52nd, Westpac 61st, ANZ 69th and NAB 77th.

Of Australia's 50 largest listed companies, by market capitalisation, five are banks: the four major banks and Suncorp (see Figure 4.14). Comparing the RoE of the 50 largest companies sees the four major banks come in the middle of the pack: CBA at 14th, Westpac 19th, ANZ 22nd and NAB 27th, with Suncorp coming in 48th.

Profit levels have been rising for the major banks for the last couple of years and are expected to continue growing, according to RBA analysis (see Figure 4.15). Regional banks profitability has been more challenged, but they are expected to rebound strongly. Increasing profits are to be expected as the economy continues to grow and as Australians use more financial products and services.

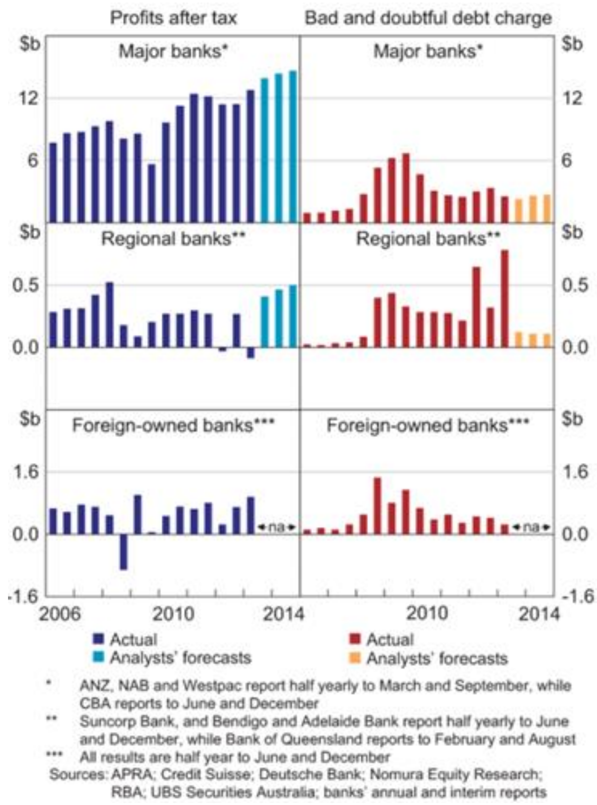
54 ABS, (2013), *Lending Finance, Australia, Dec 2013* , 5671.0 available online at www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5671.0Dec%202013?OpenDocument

Figure 4.14: RoE for Top 50 Australian companies (by Market Capitalisation), 2013



Source: Thomson-Reuters

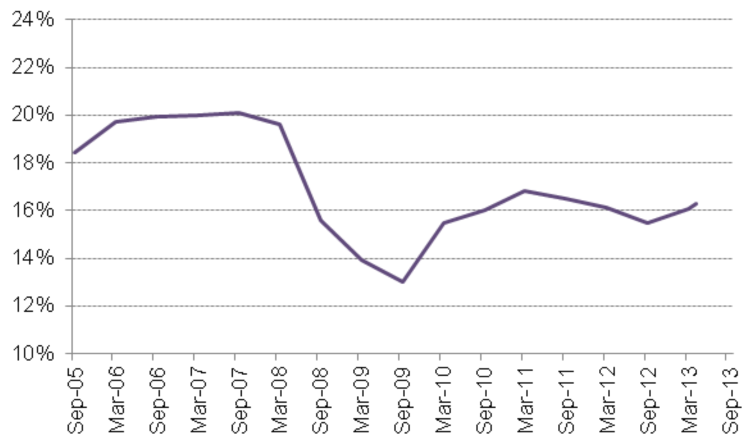
Figure 4.15: Profitability by bank type



Source: RBA Chart Pack

While profits in absolute or dollar terms have continued to grow, RoE fell following the GFC and remains lower than before the crisis (see Figure 4.16). This reflects increased funding costs, increased capital raising from shareholders and the cost of dealing with impaired assets following the GFC.

Figure 4.16: Main Retail Banks, Return on Equity[55]



Source: Annual reports

When Australian banks are compared with banks of other countries that survived the GFC relatively well, such as Canada and China, the profitability of the four majors does not stand out (see Figure 4.17). Australian major banks delivered RoEs of between 13-19% in 2013, China's banks 18-23%, and Canada's banks 14-23%. Banks in countries that bore a higher impact from the GFC, such as the US, UK, France, Spain and Italy, currently show much lower RoEs, signalling that these systems are still in recovery. Prior to the GFC, average RoE for the major UK banks was 22-23%.[56] This compares with RoE close to 20% for Australian major banks over that same period.

[55] Figures for ANZ, Bank of Queensland, Bendigo Adelaide, CBA, NAB, Westpac
[56] Annual Reports of Lloyds Banking Group, Royal Bank of Scotland Group, Barclays and Standard Chartered

Figure 4.17: Market Capitalisation and Return on Equity (2013)

	Mkt Cap (AUD)	RoE
China		
ICBC	212,395	22.4%
China Construction Bank	180,299	21.7%
Agri Bank of China	138,388	21.0%
BOC - HK Holdings	124,703	18.5%
Canada		
Royal Bank of Canada	102,075	18.9%
Toronto-Dominion Bank	93,110	14.0%
Bank of Nova Scotia	77,284	15.9%
Bank of Montreal	46,185	14.7%
Canadian Imperial Bank of Commerce	37,442	22.8%
Australia		
CBA	121,555	18.3%
Westpac	104,028	15.0%
ANZ	88,250	14.7%
National Australia Bank	81,498	13.0%
US		
Wells Fargo	284,193	14.0%
J P Morgan Chase	251,023	8.4%
Bank of America	204,447	4.6%
US Bankcorp	86,261	15.8%
France		
BNP Paribas	107,866	6.1%
Societe Generale	54,285	4.2%
Spain		
Santander	114,512	6.1%
BBVA	76,697	5.3%
Italy		
Intesa	57,102	1.1%
UK		
HSBC	207,745	8.9%
Lloyds Banking Group	100,581	-2.1%
Barclays	70,060	1.0%
RBS	61,415	-14.2%
Standard Chartered	52,962	8.9%

Source: Bloomberg

4.4. International competitiveness

The Australian financial sector has a considerable international presence. In 2009-10, Australia had 1,245 finance and insurance foreign affiliates operating in 70 countries around the world. Australia's investment in these affiliates was worth $71.1 billion. Total economic value of financial, insurance and pension services provided by these affiliates was valued at $38.9 billion. These affiliates earned $6.5 billion profit during the year.[57]

Focussing just on exports, the Australian Bureau of Statistics (**ABS)** records the value of exports from Australia's financial sector over the past two years as more than doubling, from $1 billion to $2.2 billion.

There is considerable benefit in growing this base, both for income from direct trades, and for the additional benefits that will accrue to Australia in having access to banks with strong links to the economies of our major trading partners. In its submissions to the Australian Financial Centre Forum (**AFCF**) in 2008 and 2009, the Finance Industry Council of Australia, of which the ABA is a member, set out general objectives for enhancing Australia's position as a financial centre:

> ***Increased capital flows:*** Attract increased capital flows into Australia.
>
> ***Competitive and transparent tax system:*** Achieve a regionally competitive and transparent taxation system for the financial services industry.
>
> ***Offshore expansion:*** Lower the offshore barriers and obstacles facing the Australian financial services industry.
>
> ***Integration with region:*** Further integrate the Australian financial services industry with the Asia Pacific Region.
>
> ***Industry regulation and structure:*** Further enhance the regulatory framework and operation for all financial services participants in Australia.
>
> ***Enhanced foreign presence***: Continue to attract new entrants into the Australian financial services industry.
>
> ***Branding and positioning:*** Enhance regional awareness of Australia's financial services sector, and its strengths and capabilities.
>
> ***Quality workforce:*** Attract and retain a high-quality workforce.

The banking industry believes these objectives remain current.

57 ABS, 2010, "Australia's Outward Finance and Insurance Foreign Affiliates Trade in Services, 2009-10 ", available online at: http://www.dfat.gov.au/publications/stats-pubs/australias-outward-finance-and-insurance-foreign-affiliates.pdf

The AFCF's report to Government (the "Johnson Report") concluded:

- *Countries with high quality financial sectors like Australia should be reaping the full benefits by exporting their financial services skills and experience to other countries.*

- *… Our financial sector ranks highly in international surveys on many of the key requirements for a successful financial centre. These include a highly skilled workforce and a first class regulatory framework that has served us well through the global financial crisis. Yet our exports and imports of financial services are low by international standards…*

- *There are many reasons for this 'inward focus' of our financial sector. Central amongst them are some policy settings which inhibit a greater volume of cross-border financial transactions occurring through Australia — a distinguishing feature of successful financial centres.*[58]

While progress has been made since the Johnson Report, there are still policy settings impeding cross-border transaction flows. To assist Australian banks as they look to be competitive internationally, attention needs to be given by Government and industry to:

Withholding tax on foreign-raised deposits: Banks are currently penalised for deposits raised overseas used for lending within Australia, limiting their access to liquidity and adding to funding costs[59]. This is discussed in more detail below.

Access to new markets: Bi-lateral and multi-lateral trade negotiations are an important component of success for many Australian industries. The banking industry and its customers would benefit from further access to offshore markets, a reduction in ownership caps, liberalisation of branch and footprint restrictions, and greater access to different licence classes. Financial services should have a higher priority in Australia's trade negotiations.

Capital costs: The Australian banking industry recognises the need to ensure there is adequate capital and liquidity for the operation of a safe and sound banking system. There is a view that the level of capital Australian banks are required to hold is greater than similar banks in the UK, EU, US and Canada. This puts banks in Australia at a competitive disadvantage in international markets. Further, Australia's classification of additional tier 1 (AT1) instruments (contingent convertible capital instruments) as equity rather than debt carries a tax disadvantage, as were they to be classified as debt, interest expenses would be tax deductable. The Bank of International Settlements notes that categorisation varies from country to country and that approximately 64% of these instruments have tax-deductable coupons[60]. Thus Australian banks are at a further disadvantage internationally,

58 Australian Financial Centre Forum, (2009), *Australia as a Financial Centre: Building on our Strengths*, available online at: http://cache.treasury.gov.au/treasury/afcf/content/final_report/downloads/AFCF_Building_on_Our_Strengths_Report.pdf
59 This can also reduce the ability of international banks operating in Australia to compete in lending markets.
60 Bank of International Settlements, September 2013, "CoCos: a primer" in BIS Quarterly Review, available online at: http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf

Double Taxation: Profits earned offshore are typically taxed in the location where they are derived. When an Australian-based company pays post-tax profits earned offshore to its Australian shareholders, the dividends are subject to the full rate of Australian tax. In other words, offshore profits are subject to full rates of tax in the location where they are derived and also in Australia. In the absence of offsets from domestic franking credits, this results in an uncompetitive, high rate of tax on offshore profits derived by an Australian-based company. Other than New Zealand, no other OECD country taxes offshore profits earned by their multinational companies without partial or full recognition that the offshore profits have already been subject to tax.

At present, companies, including banks, are required to co-mingle Australian-sourced and non-Australian sourced income, which has the effect of channelling franking credits away from domestic shareholders to foreign shareholders who have no use for them. As a result, Australian banks with significant offshore operations are less attractive to domestic tax-paying shareholders.

New products: Australia needs to look to the development of products attractive to offshore markets, including Islamic finance products.

The banking industry must act to capture opportunities and achieve financial centre objectives, but also sees a role for the Government in revising regulatory and taxation settings, and taking a bigger role in opening up international markets.

Interest withholding tax

Australia already makes several exemptions from interest withholding tax (**IWT**). Outside these exemptions, the tax applies (broadly speaking) at the rate of 10% on the gross amount of interest paid by Australian borrowers to non-resident lenders.

Because the existing exemptions are both incomplete and subject to serious constraints, they effectively deny Australian banks and other borrowers access to cost effective funding from a variety of foreign sources. Unlike in other countries, the current legislated interest withholding tax exemption is limited to wholesale funding raised in a prescribed manner. Extending the exemption from interest withholding tax to all funding raised from non-residents by Australian financial institutions, including via their offshore branches would have the additional benefit of diversifying the sources of funds available to Australian banks.

Since the market convention is that foreign lenders will not “absorb” Australian IWT, the existence of withholding taxes distorts the flow of funds in global capital markets and, in practical terms, increases the cost of funds to Australian borrowers.

IWT also adds to the costs Australian foreign branches and Australian subsidiaries incur in borrowing from their overseas parent. This not only impacts on the funding available to foreign bank branches, it also reduces the ease with which funds can be moved in and out of Australia, reducing Australia’s attractiveness as a destination for international funds. The Johnson Report and Henry Review both recommended the phasing down of IWT on offshore borrowing by banks.

In the 2010/11 Federal Budget, commitments were made by the Labor Government to undertake a phase-down of the rate of IWT for financial institutions from 2013-14. In November 2011, the Government announced the deferral and extension of the proposed phase-down of IWT, with the announced changes fully taking effect from 2015-16.

The current Government has indicated that the phase-down of IWT is to be discontinued.

The banking industry believes this decision should be reviewed, and that the IWT on foreign-raised funding by banks in Australia should be eliminated. A phase-down of IWT would:

- significantly increase market liquidity;
- diversify the sources of funds available to Australian banks and other borrowers;
- enable greater access to lower cost funding by Australian borrowers (especially banks) to flow on to their dealings with their customers, for example, through lower domestic interest rates; and
- enhance Australia's credentials as a financial services centre.

Further consideration of double taxation and options to address shall be included in the pending tax review.

Further policy options for enhanced competitiveness

Overall, the banking industry considers that all of the Johnson Report recommendations should be implemented.

In addition to the work of the Johnson Report, the Board of Taxation has conducted a number of reviews in recent years in areas related to international competitiveness, including:

- Arrangements Applying to Permanent Establishments;
- Taxation Treatment of Islamic Finance Products;
- Application of GST to Cross-Border Transactions, and
- Tax Arrangements Applying to Managed Investment Trusts.

The banking industry believes that with suitable resourcing, the Board would be well positioned to take on a broader review, one that started with consideration of agreed national objectives in relation to international competitiveness in financial services, and then look back at the tax system to develop policy recommendations. It is likely that not all priorities would be actionable in the short term, but it is important that a coherent set of recommendations for changes to the Australian taxation system to improve the international competitiveness of the financial system be developed.

The review could inform the Government's tax white paper process, and would find fertile ground in the work of the Henry Review and Johnson Report.

Market access

The industry believes that the Australian Government can play a bigger role in encouraging governments to open up their markets, reciprocating the openness of Australian markets. Industry should support the Government in assembling the intellectual case for engagement with foreign governments.

Specific areas to be addressed include ownership restrictions, branch and footprint restrictions, degrees of freedom within different licence classes, the difficulty of licence acquisition, access provided for workers, prudential requirements, intellectual property issues and the different degrees of freedom for foreign and domestic banks.

The banking industry would welcome the opportunity to work more closely with Government to improve market access for Australian financial institutions seeking offshore expansion opportunities.

This page is intentionally blank.

5. Getting regulation right

5.1. Introduction

The resilience of the Australian banking system, through the GFC and other crises, can in part be attributed to its strong regulatory framework. This framework, with its emphasis on safety, stability and consumer protection, has complemented the prudent and conservative management of banks.

While a strong regulatory framework brings benefits, regulation of the Australian banking system also comes at a cost. These costs are both direct, such as compliance and reporting costs, and indirect, such as the opportunity cost to the economy from impeding new entrants. With the launch of the Financial System Inquiry, and the global economy showing increasingly strong signs of recovering from the GFC, it is a good time to consider the stock of regulation already in place, how new regulations are developed, the impact of regulations on the broader economy and the impact of extra-territorial legislation. Now is the right time to consider the balance being struck between stability, growth and innovation, for the prosperity of the wider economy and the benefit of customers.

As banking is one of the most regulated industries in Australia, it is particularly important that the regulatory regime works well and supports, rather than impedes, the ability of banking to support Australian economic growth. Given the strength of our existing regulatory regime, we should be sceptical of the need for ever more regulation. Regulators also need to exercise considerable caution when regulating a complex, interconnected system like the financial system. It is in the nature of complex systems that, when a change occurs in one part of a system, its impact flows through to other parts, often in unexpected ways. Regulators therefore need to accept that virtually any rule change will have unintended consequences. This should make regulators instinctively cautious and conservative in proposing new or changed regulation.

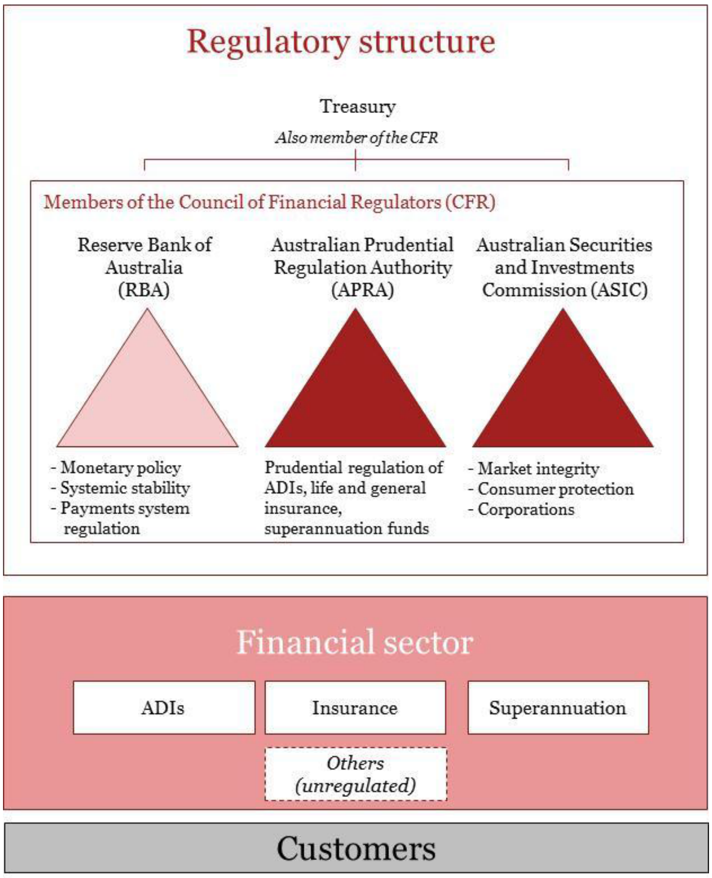
5.2. The current regulatory framework and the role of Government

The current regulatory framework

Australia adopted a 'twin peaks' regulatory model following the recommendations of the Wallis Inquiry. Under this model, APRA is responsible for, *inter alia*, prudential regulation of financial institutions and ASIC is responsible for, *inter alia*, business conduct and consumer protection (see Figure 5.1). The RBA also plays a role in managing the financial system with responsibility for developing and implementing monetary policy and the systemic stability and payments systems. This includes acting as a clearing house for ADIs that operate Exchange Settlement Accounts.

Financial risks are overseen by both APRA and ASIC, primarily driven by the way regulated entities are licensed or otherwise authorised to carry out restricted business, including banking and insurance (see Figure 5.1).

Figure 5.1: Current regulatory structure



Source: PricewaterhouseCoopers[61]

The manner in which supervision is conducted by both agencies stems from Federal legislation, including the *Banking Act 1959* (**Banking Act**) and the *Insurance Act 1973* in the case of APRA and the *Corporations Act 2001* (**Corporations Act**) in the case of ASIC.

This model offers a number of advantages compared to those seen in some other jurisdictions. For example, it reduces the risk of regulatory arbitrage, which has been identified as one of the weaknesses of the complex, segmented US model. It also avoids possible conflicts of interest that may arise when prudential oversight and business conduct regulatory functions are concentrated in a single regulator, such as with the UK's Financial Services Authority (FSA).[62]

The 'twin peaks' model has served Australia well, and although there is scope to improve the way regulation is developed and implemented, as discussed below, the banking industry supports the continuation of this model.

61 PwC discussion paper, *Financial and Systemic Risk in Australia: From Framework to Institutions*, commissioned by the Australian Bankers' Association, February 2014.

62 In April 2013, the FSA was abolished due to perceived failures during the GFC. The responsibilities of the FSA were divided between the Prudential Regulation Authority, the Financial Conduct Authority and the Bank of England.

The role of Government

The role of the Commonwealth Government in allocating and managing financial and systemic risk is delegated through various Acts of Parliament to financial regulators in Australia. In extraordinary circumstances (such as those presented by the GFC), the government of the day may seek particular input and responses from regulators or provide additional support beyond the remit of legislation and regulations.

The Treasury does not, strictly speaking, directly supervise or regulate financial institutions in Australia. However, it is a member of the Council of Financial Regulators (**CFR**), which is the coordinating body for Australia's main financial regulatory agencies. Members of the CFR are APRA, ASIC, the RBA (as chair) and Treasury.

The role of CFR is to promote efficiency and effectiveness within the financial services industry, as well as financial stability in Australia. This role also extends to sharing information, discussing regulatory issues and coordinating responses to crises or other potential threats to financial stability. Generally, the CFR has operated well, for example, during the early stages of the GFC when the CFR was a coordination point for Australia's response to the crisis. However, there is scope for the CFR to be more effective (as discussed below).

The current regulatory environment

Regulation is far reaching and has an impact on every aspect of banking, from limiting the products that can be sold, to the price of those products and even to the colour used on information sheets banks are required to issue to customers. Wayne Byres, current Secretary-General of the Basel Committee on Banking Supervision, has defined regulation as:

> *'…the sum of the legislation, prudential standards, and guidance material available to and produced by agencies like APRA.'*[63]

This highlights that regulation includes not only primary and delegated legislation, but also quasi-regulation, such as codes of conduct and advisory instruments.

Regulations for the banking industry are provided by many government agencies. In addition to those bodies discussed above, at a Federal level, other sources of regulation include the ACCC, the Australian Taxation Office, the Australian Transactions Reports and Analysis Centre (**AUSTRAC**) and the Office of the Australian Information Commissioner. In addition to external regulation, banks self-regulate through industry codes of conduct, such as the Code of Banking Practice.[64]

In summary, regulation includes all legislation, codes, rules, (prudential) standards and guidance material produced by any government department or agency that imposes limitations on, or otherwise seeks to modify the behaviour of, individuals or companies.

---

[63] Speech by Mr Byres (2011), *The Role of Supervision in Seeking a Balance between Safety and Efficiency,* at: http://www.apra.gov.au/Speeches/Documents/UNSW-SpeechWayne-Byres.pdf

[64] For more information on the Code of Banking Practice see: http://www.bankers.asn.au/Industry-Standards/ABAs-Code-of-Banking-Practice

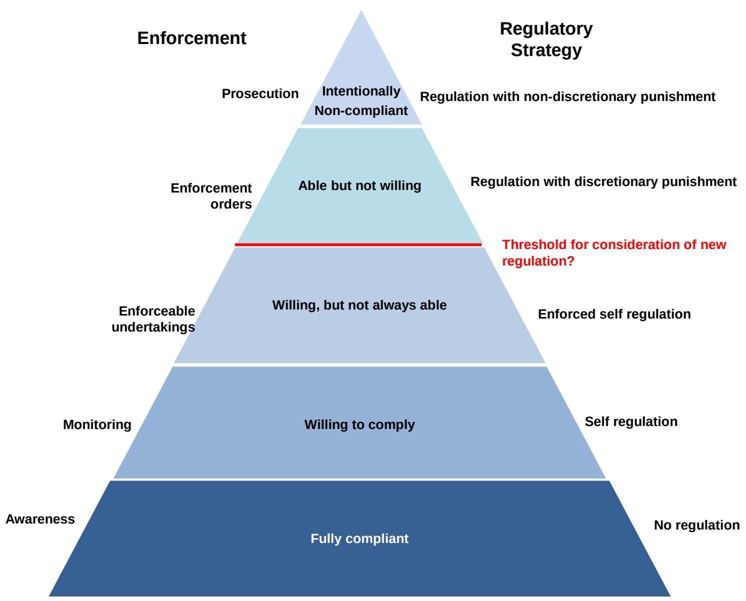
5.3. When and how much to regulate?

Regulation done well can provide real benefits to individuals, regulated entities and society. However, there is a cost to regulation which is borne by all participants in society, including customers, shareholders, businesses, the Government, the wider community and the economy. Given the costs of regulation, it is vital that before implementing new regulation, regulators have thought through the consequences. Each piece of new regulation is enhanced when there is full consultation with those affected; testing the broader implications of proposed regulation and when consideration is given to ensuring the best level of regulation is reached.

While some regulators have a particular focus, regulation should seek to achieve the greatest good for the wider economy, rather than targeting one particular policy goal over all others.

Some may argue that regulation is required whenever a real or potential market failure occurs or a vulnerable party appears at risk. An alternative approach is to consider the other avenues available and the real costs and inefficiencies of regulation. A useful framework for determining the appropriate response to a range of circumstances is an amalgam of various versions of the Braithwaite 'regulatory pyramid' (see Figure 5.2).[65] The pyramid itself is segmented into classes of entities covered by a particular class of regulation or regulation in general. The labels on the left of the pyramid describe enforcement strategies for each entity segment and the labels on the right describe regulatory strategies.

Figure 5.2: Regulatory pyramid



Source: ABA

[65] For more on the concepts behind the 'Braithwaite pyramid' concept, see Ayres, Ian and John Braithwaite (1992), *Responsive Regulation: Transcending the deregulation debate*. New York: Oxford University Press - page 35. It was earlier described by John Braithwaite in "To punish or persuade", State University of New York, 1985, at page 142. The model's evolution over time is tracked in a paper by John and Valerie Braithwaite in "An Evolving Compliance Model for Tax Enforcement"

Some very simple principles arise from the pyramid:

- regulation should be targeted to non-compliance.
- the cost of regulation and enforcement should be proportionally higher for the non-complying.
- the cost of enforcement (to Government) should also be higher for the non-complying.

These principles should guide the decision on whether new regulation is needed, and if so, what type of regulation. It need not follow that because a problem is identified or suspected, new regulation is required.

If after consultation, it is thought that a new piece of regulation is required, it is worth identifying why existing regulation is considered insufficient, and whether an identified problem is due to non-compliance or non-enforcement of existing laws, rather than to a flaw in the regulatory regime. It is also important to assess the impact any new regulation has on the stock of regulations already in place.

The cumulative effect of regulation also needs to be considered. Generally speaking, a law of diminishing returns applies to regulation. That is, the benefits of further regulation progressively reduce, although the costs may remain high. At some point, a regulated entity or market finds that the addition of further regulation has effects that work against those that the regulation is seeking to benefit, typically consumers.

For example, with the regulation of financial products, additional regulation may increase the compliance costs for product developers and providers to a point where fewer participants are able to enter or participate in the market. High compliance costs, for example, will amplify the importance of economies of scale, meaning only larger institutions may be able to develop and provide new products profitably. Overall, this can lead to a reduction in the variety and personalisation of products offered to consumers.

Another example is regulation to increase stability in the financial system. Additional regulation may add further stability to an already robust system, but at a cost which might far outweigh the marginal gain. As seen from the GFC, systemic stability is critical and the costs of instability can be enormous. Equally, the benefits of a stable system, as demonstrated by the performance of the Australian financial system and economy during the GFC, are of great value.

It does not follow, however, that every measure designed to improve stability should be implemented. One example is the protection of depositors in Australia. Prior to the GFC, Australia had a robust and stable banking system, backed by close and effective supervision from APRA and depositor preference legislation. Australia also had no history of depositors' funds in banks being lost since Federation, with the last significant losses experienced in the 1890s. The GFC and responses to it have seen additional layers of protection put in place, ranging from deposit guarantees through the Financial Claims Scheme (**FCS**), to higher capital and liquidity requirements to strengthen banks even further. Nevertheless, the Government announced a levy on deposits to create a fund to be available to cover deposits should all the previous protections fail. Such a levy would have the effect of making deposits less attractive, for banks and savers, at a time when regulators and rating agencies want banks to increase their deposit base.

It is difficult to sustain an argument that the marginal benefit to depositors of having the fund outweighs the real and immediate impact on the deposit market (a full case study of the fund as an example of poor regulation is provided below).

5.4. The reasons for regulation and the implications of poor regulation

There are many reasons why regulation may be necessary. When regulation is written and enforced effectively, it provides a set of clear rules within which individuals, businesses and others can operate. Good regulation clarifies the rules all market participants must follow, giving everyone certainty and clarifying expectations. Good regulation can also reduce barriers to investment, and make it easier for businesses to grow.[66]

However, when regulation is poorly implemented, it can clearly translate into higher costs for banks, which may be passed on to depositors, investors and customers.

Because of the banks' role as economic enablers, there can be indirect consequences right through the economy, with higher costs resulting in reduced incentives to innovate, invest and create new jobs.

The following case study is an example of poor regulation.

Case Study: Depositor protection and the Financial Stability Fund

Specifically for the banking industry, a goal of legislation and regulation is to protect depositors. This is a commonly held goal of regulators around the world and has been a particular focus of APRA.

In Australia there are multiple layers of protection for depositors. Before depositors' funds become at risk the following layers would need to be depleted[67]:

- a very safe and stable financial sector;
- strong risk management at individual institutions;
- sound prudential oversight by APRA;
- bank equity holders (who would suffer losses before depositors); and
- holders of bank debt (who would also suffer losses before depositors).

A relatively new aspect of the protection of depositors is the FCS, introduced by the Government during the GFC[68] as a temporary stability measure, and which became permanent in February 2012.

[66] Business Council of Australia, (2007), *Improving Australia's Regulatory System* at: http://www.bca.com.au/publications/improving-australias-regulatory-system
[67] For more information on depositor protection in Australia, see Turner. G., (2011) *Depositor Protection in Australia*, RBA at http://www.rba.gov.au/publications/bulletin/2011/dec/pdf/bu-1211-5.pdf
[68] In October 2008

The purpose of the FCS is to protect depositors of ADIs and policyholders of general insurance companies from potential loss due to the failure of these institutions. APRA is responsible for the administration of the FCS. For ADIs, the scheme provides protection to all depositors up to the limit of $250,000 per account holder per ADI, and seeks to provide depositors with timely access to their deposits in the event of the failure of their ADI. The Government initially provides the funds to make payments under the FCS. Moneys paid under the FCS are then recovered from the assets of the ADI in the winding up process. There is also a provision to make up any shortfall by applying a levy on the ADI sector.[69]

Related to the FCS is the proposal in late 2013 for a 'Financial Stability Fund' (**FSF**), the purpose of which would be to reduce the size of the initial claim on the public purse in relation to an event where the FCS was activated. Industry would be levied to build the fund over time.

Arguments in relation to depositor protection frameworks are complex, but the industry believes there are three underlying principles to be considered for any change to the current arrangements:

- Is there a sound underlying policy rationale?
- Is it necessary and will it increase depositor protection?
- Do the benefits of the proposal outweigh the costs?

Is there a sound underlying policy rationale?

Australian banks are well managed and well supervised. Depositors are well protected due to a wide range of mechanisms already in place to manage risk, for example, APRA's extensive supervisory powers and, unlike most countries, a legislated depositor preference.

In the existing policy framework, the Banking Act provides depositors with a priority claim on the assets of a failed ADI ahead of other unsecured creditors. Australia is one of a minority of countries that has depositor preference, with most countries instead relying solely on deposit insurance. As listed above, there are a number of layers of protection that would need to be depleted before depositors' funds become at risk.

The FCS also allows for a levy to be charged on industry participants to cover any shortfall in funds available to pay out depositors (following resolution of the failed entity). This ensures the industry bears the cost of bank failures and taxpayers are protected.

The banking industry believes that the current policy framework for depositor protection is suitable for Australia and considers that no sound policy rationale for introducing a change such as the FSF has been presented.

Is it necessary and will it increase depositor protection?

The banking industry sees no risk-based justification for additional measures. Depositors are well served by the current layers of depositor protection, including the FCS, and no depositor has suffered a significant loss from a commercial bank in Australia since the 1890s.

[69] More information on the FCS can be found at: http://www.apra.gov.au/crossindustry/fcs/pages/default.aspx

Regulators globally have implemented a vast array of measures to increase the safety and stability of the world's financial systems. These changes include requiring banks and other ADIs to hold a larger amount of high quality assets, improve systems and reduce incentives for risk taking. The implementation of an FSF would not reduce the risks in the system. The proposal would not require banks to hold more capital or liquidity, it would not change the incentive structure within banks nor would it require banks to enhance systems. It would create a pool of money on the Government's balance sheet that was highly unlikely ever to be needed for its stated purpose.

Pre-funding does not necessarily avoid stress being placed on the system after a bank failure. Accumulating a fund sufficiently large, such that it would allow the FCS to be used for a large or mid-sized bank without requiring additional funds would require a considerable amount of time and a significant levy on bank deposits. As such, the fund would need to be topped up through extra contributions from surviving banks in a stressed environment. In summary, an ex-ante fund is likely to generate sizable administration costs while being insufficient to ensure an ex-post levy is not required in the case of a large or mid-sized bank's failure.

Do the benefits of the proposal outweigh the costs?

Pre-funded schemes come at a cost. There is a need to create a vehicle to manage the scheme and the fund (with supporting legislation), and they add complexity to depositor protection arrangements. Some have argued that the levies involved constitute a tax on the economy:

> *Any tax you put on the banking system, because the banking system is the financial intermediary to the whole economy, it's the same as putting a tax on the whole economy."*[70]

Others have pointed to a possible intergenerational inequity, where deposit holders in the future benefit from present contributions, and to the opportunity cost to the economy of having a sizeable amount of capital sequestered in a depositor protection fund.

It is the view of the banking industry that the costs of such a scheme would outweigh the benefits. The probability of the scheme being used is very low (low ADI failure rate), there would be an additional management overload and added complexity, and Australia's borrowing position (to support the FCS) is strong.

In summary

The industry believes the current arrangements for depositor protection in Australia, including the FCS, are adequate. Additionally, the banking industry opposes the introduction of a pre-funded scheme, such as the FSF, as it is unnecessary in Australia, and no sound policy rationale for such a measure has been presented. From a practical implementation point of view, the industry considers that the benefits of an FSF do not outweigh the costs.

[70] David Murray, (2013), quoted in, *Bank levy 'tax on whole economy', says David Murray,* Australian Financial Review, 2 August, available at: http://www.afr.com/p/business/financial_services/bank_levy_tax_on_whole_economy_says_Arbu3M9kVMRER0RnGKrl7K

5.5. The consequences of poor regulation

The main consequences of poor regulation are:

- creating a workload for a financial institution that redirects internal resources away from a focus on the customers, depositors and investors;
- creating higher costs for consumers and depositors, as banks pass on the costs of regulation; and
- deterring investment in Australia, both from home and abroad, if rule-making is too prescriptive and exacting.

Poorly thought out and executed regulation is a risk to a well-functioning financial system and should therefore be a critical area for review in this Inquiry. While overall the regulatory framework has served Australia well, it is not without its opportunities for improvement. Broadly speaking, these fall into two main categories:

- problems with the cost and volume of regulation; and
- problems with a lack of coordination between government agencies and regulators.

The cost and volume of regulation

The wide array of regulation faced by the financial system increases the cost of doing business. This in turn, impacts on banks' ability to provide cost-effective products and services to consumers.

The costs of regulation are keenly felt. One major bank stated in its most recent annual report that it was spending $236 million on technology related to managing compliance and operational risk. This was only the cost of technology, and excludes other compliance costs for the business. As a further illustration, it is estimated that the total cost for the Australian banking industry of Basel III implementation in 2013 approached $1 billion.[71]

In addition to these sorts of costs are the challenging reporting requirements met by banks.[72] These requirements mean that some banks report over 200,000 cells of data each year, to various agencies, such as the ABS, APRA and the RBA.[73] Generating this data requires the use of expensive IT systems and the employment of highly skilled staff, the cost of which is ultimately borne by banks' shareholders and customers.

[71] Source: National Australia Bank. Sourced from the CEDA 2014 Political and Economic Overview, available online at: http://www.ceda.com.au/media/356309/epo4thfeb2014.pdf

[72] This is not to suggest that these reports are not of value. The data contained in these reports provides information to regulators, investors and the public. However, it is at times unclear for what purpose, if any; some of the reports that regulators require banks to generate are actually used.

[73] In its 2006 report titled 'Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business', the Regulation Taskforce found excessive reporting or recording requirements to be one of the five key features of regulation that contributed to compliance burdens on business not justified by the intent of the regulation. More can be found here: http://www.pc.gov.au/research/regulation-taskforce

Improving regulation

Governments frequently recognise the costs to individuals, businesses and the economy at large of poor, unnecessary or excessive regulation, but find it difficult to put in place effective measures to contain the flow of such regulation. There are two competing reasons for this:

- governments typically focus on cutting back existing regulation or 'red tape', and
- governments, and regulators, face powerful incentives to increase regulation.

Cutting existing regulation

Governments are encouraged to identify existing regulation that can be removed where its costs outweigh its benefits. By addressing the 'stock' of regulation, governments can reduce compliance burdens on consumers and businesses, remove distortions or address other problems with poor regulation.

This is of limited benefit however, if the ongoing 'flow' of new regulation is not also addressed. For example, in 1996, the Government established a Small Business Deregulation Task Force to report on ways to reduce drastically the paperwork and compliance burden faced by small business. Yet, by 2005, the BCA was able to show that half of all legislation passed by the Commonwealth Parliament since Federation had been passed in just the previous 14 years, including the 9 years of the Howard Government[74]. Of the 350 pages of new laws passed every week by Parliament, two-thirds were found by the BCA to affect business.[75]

The 'flow' of regulation is particularly important to banks, as the major costs associated with regulation are borne as a result of new or changing regulation. New regulation typically involves major investments to change bank systems, training and compliance regimes, major distractions for management and uncertainty for customers. Once a regulatory change has been embedded within the bank, the ongoing costs can be significantly less than the cost of further change.

Incentives to regulate

The people of Australia in general expect their governments to intervene to address perceived problems, and can punish governments electorally if they are seen to be ineffective. To take action on a community concern, governments are largely limited to two tools:

- allocating money to a program; or
- developing new rules to address directly the concern.

Governments have developed robust systems to manage the allocation of funds and to ensure those funds are appropriately and effectively spent. While governments can, for political or urgency reasons, override these checks and balances, processes such as the Expenditure Review Committee and reviews by the Australian National Audit Office mean the allocation and expenditure of money by the Government and its agencies is subject to strict accountability

[74] Business Council of Australia (2005), *Business Action Plan for Future Prosperity*.
[75] Business Council of Australia (2005), *Regulation Blow-Out Risks Economic Growth and Prosperity*, http://www.bca.com.au/newsroom/regulation-blow-out-risks-economic-growth-and-prosperity accessed 20 February 2014

measures. No such measures exist for the development of regulation and this creates a distortion for governments towards adding to the regulation stock and flow.

It is the case that proposals for new regulation within government face some checks and balances, including approval by Cabinet. These processes, however, are opaque. It is also the case that new legislation needs to be passed through Parliament, however, given the volume of legislation on the Parliamentary calendar and even with scrutiny by parliamentary committees, it is debatable whether Parliament is able to comprehend fully the impact of new regulation on business before it is passed. This is compounded by a growing trend to pass legislation that leaves the detail to subsequent regulation, developed by government agencies and subject to less Parliamentary scrutiny.

Improving the regulation-making process

Previous attempts to improve regulation making have focussed on the Regulatory Impact Statement (**RIS**) process. Despite repeated criticism of poor compliance with RIS requirements[76], and commitments by governments to improve that performance, major pieces of legislation continue to be passed without a RIS being completed.[77]

The RIS process also faces the challenge that it relies on government agencies being able to quantify the costs imposed by regulation. Understandably, those agencies are not well placed to do this and seek input from the affected businesses. Those businesses, however, often cannot quantify the cost of the regulation until the detail of that regulation is known, by which time decisions to regulate are usually irreversible.

A major step forward would be to make the proponents of new regulation more accountable and their proposals more contestable, before a decision to regulate is made. At present, new regulatory proposals are often based on ill-defined problems identified through anecdotal evidence or assertions from their proponents. It is then down to those affected by the regulation, such as business, to demonstrate that the regulation is not needed, or that the costs outweigh the benefits. In effect, the onus of proof lies on those resisting new regulation, rather than on those proposing it.

To improve the quality of regulation, governments should require the proponents of regulation, whether their own agencies or outside interests, to prepare a Statement of Regulatory Intent (**SRI**). The SRI should:

- identify clearly the problem that is seen as requiring new regulation;
- provide factual evidence of the existence of that problem, including quantifying the size and nature of the problem;
- provide evidence that existing regulation is incapable of addressing that problem; and
- demonstrate that regulation, rather than other measures such as awareness raising or self-regulation, is the least cost and most effective way of addressing the identified problem.

[76] Most recently in the Independent Review of the Australian Government's Regulatory Impact Analysis Process in 2012
[77] Such as the previous Government's Future of Financial Advice (FOFA) reforms

Putting this requirement in place would have a number of benefits:

- it would ensure the burden of proof for new regulation rested with those proposing the regulation, rather than those affected by it;
- it would ensure precision in scoping out the problem being addressed, giving others the opportunity to challenge the basis for the regulatory proposal and ensuring any subsequent regulation was narrowly targeted at the actual identified problem; and
- it would give those responsible for the problem the opportunity to address it through changed practices or self-regulation, before regulation was imposed by Government.

Poor regulation results in more cost, less innovation, less growth and fewer choices for the consumer. As governments and regulators are employed and empowered to produce beneficial outcomes for society they should genuinely attempt to implement a process to assess fairly their proposals and to ensure society's interests are upheld.[78]

To achieve this, the Government should put in place a SRI process to ensure those proposing new regulation carry the onus of proving its necessity and accurately defining the problem they want addressed.

Another area that needs to be addressed is coordination between regulatory authorities.

Case Study: Better coordination between regulatory bodies

An example of demonstrating how better coordination between Australia's financial regulators can remove unnecessary regulation is the implementation of the Tax Agent Services Act (**TASA**). This legislation regulates how tax advice is given and who gives it, and brings financial services licensees under the umbrella of the Tax Practitioners Board.

Problems with TASA arise from the duplication of requirements to register with the Board and the licensing and regulatory guidance framework overseen by ASIC. There does not appear to be any rationale for adopting a different approach between the two. The blurring of boundaries between regulators shows how businesses can be adversely affected when there is insufficient coordination between regulators. There is also the cost of two separate agencies seeking to undertake the same work at the same time.

This is an example of where regulators, when working more closely together for surveillance or enforcement activity, can actively reduce the burden of duplicative requests on industry.

Shadow banking

One of the impacts of poor or excessive regulation can be to move financial activities out of the regulated space and into 'shadow banking'.

---

[78] Maddock, R., (2014) 'Red tape and its discontents' *Economic and Political Overview 2014,* Committee for the Economic Development of Australia found at: http://www.ceda.com.au/media/356309/epo4thfeb2014.pdf

The Financial Stability Board (**FSB**) defines shadow banking as 'credit intermediation involving entities and activities outside the regular banking system'.[79] The term is taken to mean a range of companies, from Registered Financial Corporations (**RFCs**), securitisation vehicles, money market funds and other investment funds. In Australia, RFCs are not ordinarily regulated by APRA as they are not considered ADIs,[80] but are expected to meet ASIC's requirements on disclosure, licensing and conduct that apply to all financial companies. The lack of prudential regulation, though, is critical.

During the GFC, it was not uncommon for large funds in the US and Europe to be affected by investor 'runs' when confidence fell. These 'runs' created problems for liquidity and led to calls for assistance from governments to intervene. Without this intervention there would have been even more pressure on the global financial system than there was when the GFC was at its peak.

As of September 2011, around 15% of the Australian financial system's assets were held by shadow banking entities, a smaller percentage than found in Canada and the United States.[81] Given the smaller size of the proportion of the financial system involved in shadow banking, Australian regulators have paid less attention to these companies than their counterparts overseas.

Shadow banking plays a useful role in the Australian financial system as it provides a valuable alternative to banks in providing credit to support economic activity. However, if there is too much regulation applied to the prudentially regulated section of the banking industry, rising costs and reducing innovation may lead to more activity moving to shadow banking – which would put the stability and resilience of the financial system at greater risk, and expose the users of that system to greater risk as well.

5.6. International regulation and extra-territoriality

In addition to the large volume of domestically generated regulation and legislation, banks are required to adhere to domestically implemented international rules and the extra-territorial reach of offshore legislation. These requirements add a considerable additional burden and cost to Australian banks and often, especially for extra-territorial legislation, they have very limited or no benefit to the Australian consumer. Some examples are provided below.

Basel III

Basel III was an understandable reaction to the GFC, and has resulted in a stronger system here and overseas. That does not mean, however, that all the new rules are necessary or appropriate for Australia, given the demonstrated robustness of our system. It is also unclear why, for example, Basel III needs to be implemented more conservatively and ahead of the internationally agreed schedules, when it is largely designed to address weaknesses in systems overseas that were not apparent in Australia.

---

[79] This definition is found at: http://www.financialstabilityboard.org/publications/r_131114.pdf

[80] If RFCs exceed assets of $50 million they are subject to certain APRA reporting requirements

[81] RBA comments on shadow banking can be found on a fact sheet on their website at: http://www.rba.gov.au/publications/fsr/boxes/2012/mar/d.pdf

The Liquidity Coverage Ratio (**LCR**), for example, will come into force in Australia from 1 January, 2015. This is despite a number of large jurisdictions overseas delaying implementation and the Basel Committee permitting the LCR to be phased in over a four-year period, starting from 1 January, 2015. The US Federal Reserve has previously proposed a two-year phase-in period for the LCR.

Australia's more conservative implementation of Basel III capital standards means that, although our banks are subject to stricter requirements, they *appear* less capitalised than their peers. This is due to the approach taken for the calculation of the capital ratios of Australia. It has been argued that (offshore) banking analysts will take into account the differences between APRA's approach and that undertaken by overseas jurisdictions and adjust their view on the capital adequacy of Australian banks accordingly. However, there are a number of banking analyst reports that have explicitly not taken APRA's adjustments into account (though being aware of them) and make the conclusion that Australian banks *appear* less capitalised than their peers.

In addition, when new international rules are introduced, regulators need to assess the impact on existing domestic rules. For example, risk weightings as applied by regulators to different assets have an impact on the composition of the bank's balance sheet, the pricing of products and services and the ability to compete. There are different views on implications and solutions and these will be addressed in individual bank submissions.

Over-the-Counter reforms

Another concern is the introduction of regulation without appropriate scrutiny. For example, regulation of Over-the-Counter (**OTC**) markets, driven by the FSB, is being introduced without scrutiny by Parliament. These reforms have been pursued through the Corporations Act and have been implemented by using ministerial determination on advice from regulators and are followed up by assessments on the effectiveness of the reforms, but do not get considered by Parliament.

Dodd-Frank

The Dodd-Frank Act (**Dodd-Frank**) is an example of foreign legislation that has had a marked impact across the globe.[82] Dodd-Frank is the largest legislative change to financial supervision in the US since the 1930s. This legislation will affect every financial institution that operates in the US, many that operate from outside the country and will also have a significant effect on non-financial commercial companies. As a result, both financial institutions and commercial companies must deal with the historic shift in US banking, securities, derivatives, executive compensation, consumer protection and corporate governance that will grow out of the general framework established by Dodd-Frank. While the full weight of Dodd-Frank falls more heavily on large, complex financial institutions, smaller institutions will also face a more complicated and expensive regulatory framework.

[82] A summary of Dodd-Frank, from the US Senate Banking Committee, can be found at: http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf

Despite its breadth, Dodd-Frank is focused on just three key outcomes: limiting risk in the financial system, increasing consumer protection and regulating the unregulated:

> *The Dodd-Frank Act potentially subjects foreign non-bank financial companies, including Australian companies, to prudential supervision in the US. This will occur if, amongst other things, the foreign company is considered by the US regulator to be systemically significant or interconnected to the US economy.*
>
> *The US reforms also allow US regulators to invoke an involuntary, orderly liquidation process which potentially applies to Australian financial companies doing business in the US. This power is available where, amongst other things, the failure of the financial company would have serious adverse effects on US financial stability.*
>
> *Some investment advisors in Australia (and other foreign countries) will now be required to register with the SEC to carry on business as investment advisors (formerly they were exempt). This may ultimately affect Australian advisors for private equity and other investments, as they will now be subject to a registration requirement where formerly there was none.*
>
> *The new US regulation of derivatives activities is drafted to apply to non-US entities. This means, for example, that non-financial Australian entities which engage in swaps-related activities in the US will potentially have to put up margin (which they currently don't have to do).*
>
> *"Foreign banking organisations" carrying on business in the US (through branches or subsidiaries) will be subject to restrictions on proprietary trading and hedge and private equity fund sponsorship.*[83]

Extra-territoriality

As noted above, Australian banks must comply with regulation emanating from other countries, in addition to international rule-setting bodies. These regulations often appear to be developed without apparent regard by the foreign regulators for the scope of the extra-territorial impact of the new rules. Key examples, all from the US, include the Patriot Act, Sarbanes-Oxley Act, the Foreign Account Tax Compliance Act (**FATCA**), and Dodd-Frank. Dodd-Frank is described briefly above. In this section, one part of Dodd-Frank, the Volcker Rule, is considered in more detail.

The Volcker Rule is aimed at prohibiting 'banking entities', a term which includes 'Foreign Banking Organisations' and their affiliates, operating in the US or providing services in the US, from engaging in a range of activities including proprietary trading, hedge funds and private equity. President Obama, in his original announcement, described this as:

> *Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. If financial firms want to trade for profit, that's something they're free to do.*

83 Rice, S. (2010). *Australia in danger of financial regulation overload*, 20 December 2010, Herbert Smith Freehills LLP, Australia

> *Indeed, doing so – responsibly – is a good thing for the markets and the economy. But these firms should not be allowed to run these hedge funds and private equities funds* ***while running a bank backed by the American people****.[84] (emphasis added)*

The extra-territorial reach and range of the Volcker Rule is now much greater than had been anticipated in the original legislation and earlier statements of the policy intent, and the time to achieve compliance remains very short. While the final rule, issued on 11 December, 2013 and effective from 1 April, 2014,[85] does limit the rule's reach, there remain considerable compliance costs and burdens to Australian banks.

Concerns regarding the extra-territorial nature of the rule are widespread. More than 16,000 public submissions were lodged with the joint agencies on the proposed rule, many of which raise serious concerns over the extra-territorial aspects of Volcker. For example:

> *I am particularly concerned that the proposed rule could severely impact the liquidity of Canadian government debt markets and interfere with the risk management practices of banks in Canada. The draft rule could also have serious unintended consequences for Canadian bank-sponsored mutual funds, hampering their ability to provide services to their Canadian clients.[86] (Canadian Finance Minister, James Flaherty).*

> *Two specific areas of concern that I would like to raise for further discussion…On the first, I am concerned that the regulations could have a significant adverse impact on sovereign debt markets, including here in the UK… On the second, there may be a risk that the proprietary trading restrictions continue to have implications for firms foreign to the US which use US exchanges or other market infrastructure to carry out their business.[87] (UK Chancellor, George Osborne).*

The ABA submission on the proposed rule focused on extra-territoriality and the exemptions available under the Volcker Rule. It contained recommendations on the extra-territorial application of the Rule, proprietary trading, government securities, covered funds and compliance.[88] Another issue was that a number of matters need to be clarified to avoid Volcker Rule provisions applying in unintended ways, with potentially significant adverse impacts on the wealth management operations of Australian banks.

Other international regulation

There are many other examples of new international regulatory developments impacting on the Australian banking sector, including the US FATCA, the objective of which is to recover lost US tax revenue, but which places customer identification and reporting obligations on Australian and other foreign financial institutions globally.

84 President Obama, (2010), *Remarks by the President on Financial Reform*, The White House, 21 January
85 Jointly by the OCC Board, FDIC and the SEC
86 Canadian Government submission http://www.fin.gc.ca/n12/data/12-016_1-eng.asp
87 British Government submission http://www.sec.gov/comments/s7-41-11/s74111-92.pdf
88 ABA submission on Dodd-Frank http://www.sec.gov/comments/s7-41-11/s74111-329.pdf

Several large global financial institutions have estimated the cost of compliance for FATCA could exceed $100 million each.[89] Based on US Treasury estimates of annual revenue to be collected under FATCA, the Australian share of this has been estimated to be in the range of $20 million.[90] However, the cost will be much greater if an Inter-governmental Agreement is not achieved.

As the burden of FATCA has been realised, moves are underway to develop a global equivalent to reduce tax avoidance, a Standard for Automatic Exchange of Financial Account Information,[91] which would result in further regulatory burdens.

5.7. Solutions

Government and regulators should give a higher priority to economic growth in the development and implementation of regulation, including of internationally agreed rules that are to be applied in Australia. This is a critical step towards taking a more considered approach to adoption of international standards and regulatory trends. Australia does not have to be the first or the fastest to implement these standards. Instead, regulation should support the ongoing growth of the economy and wealth of Australians, and preserve system stability.

Treasury, as the Government's key economic adviser, has an essential part to play in bringing the importance of economic growth to the fore. Its influence could be enhanced through a stronger role in the CFR, doing more to drive the policy agenda in consultation with other members, and possibly chairing it as well.

The CFR itself could be strengthened through legislating its functions and membership. Its functions would be similar to those it has now, but greater emphasis could be placed on its role in ensuring growth of the economy is considered in regulatory decisions, and in ensuring coordination and consistency across the regulatory agendas of the member agencies.

Coordination and consistency is particularly important given a considerable part of domestic regulation for the banking industry is driven by international standard setting bodies, most topically the BCBS, FSB and G20. Currently, there has been no formal decision made by Government to implement standards set by these bodies. The independence of the regulators should certainly be maintained, but where there are regulatory initiatives that have the potential to impact on the whole economy, such as Basel III and its flow-on effects of higher costs for customers, and a more risk averse banking sector, there is a strong argument that the Government and Parliament (not just the regulators) should have a voice in these matters.

---

89 Deloitte Regulatory Review, FATCA: Determined to Pierce the Corporate Veil (Apr. 2011), p. 3, available at http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Regulatory%20Review%20April%202011/Deloitte_Regulatory_Review_April_2011_FATCA.pdf

90 Deloitte Regulatory Review, FATCA: Determined to Pierce the Corporate Veil (Apr. 2011), p. 3, available at http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Regulatory%20Review%20April%202011/Deloitte_Regulatory_Review_April_2011_FATCA.pdf

91 For more information see the OECD's Common Reporting Standards report, *Standard for Automatic Exchange of Financial Account Information*, released in February 2014.

Regulators should also be required to work together more closely in the formulation of policy and surveillance or enforcement activity to reduce the burden of duplicative requests on industry**.** A strengthened CFR could be the mechanism to more thoroughly review the wider impacts of the domestic implementation of international rules and ensure their relevance to Australian circumstances.

As noted above, standards agreed internationally by regulators, such as APRA and ASIC, are often implemented in Australia without an open assessment of their relevance to Australian conditions or their implications for the Australian economy. Through CFR, these regulatory proposals should be subject to an independent and open assessment against these two criteria. The assessment and consultation process should not be left to those regulators that negotiate the international commitments.

A review of existing regulation is also important, and the industry places a priority on reviewing the impact of recent international standards, and legislative actions on the part of our trading partners. The CFR would be well placed to conduct such a review. On an ongoing basis, industry welcomes the Government's commitment that all regulation with a major impact should be reviewed under the Post Implementation Review Process (**PIR**). The Basel III regulations should be considered for possible review under the PIR process, following the commencement of the LCR in 2015, given their potential impact across the economy.

Finally, the Government and its agencies should be more proactive in anticipating and negating the deleterious effects of international standards, and legislative initiatives of its trading partners on Australian banks, Australian consumers and the Australian economy.

Recommendation 4: The Inquiry should recommend Government puts in place new processes for developing or changing regulation that impacts on the complex financial system, to minimise unintended consequences, ensures regulations are appropriate in the Australian context and that the right balance is struck between system stability and economic growth.

6. Technology and innovation

Technology will have a major impact on the shape of the financial system of the future. It is already transforming the way we do our banking, bringing increased choice, competition and convenience for customers. Rapidly evolving technology can also raise some risks, such as security or systemic risks. The role of Government will be to ensure the regulatory framework does not impede the ability of technology to meet changing customer needs, while ensuring any risks that arise are appropriately managed.

6.1. A short and recent history

Technology has been an area of fundamental change in the financial system, with many developments launched soon after the Wallis Inquiry. While the Internet existed before the Inquiry, it was only in 1996 that it began to take hold in the commercial world. In 1997, the first 24-hour internet banking service was introduced in Australia. The same year, the industry-owned BPAY was launched and became the world's first single bill payment system accepted across the banking system.[92] It was initially introduced as a phone and paper-based service, but quickly migrated to the Internet and today processes over 1 million payments each day.

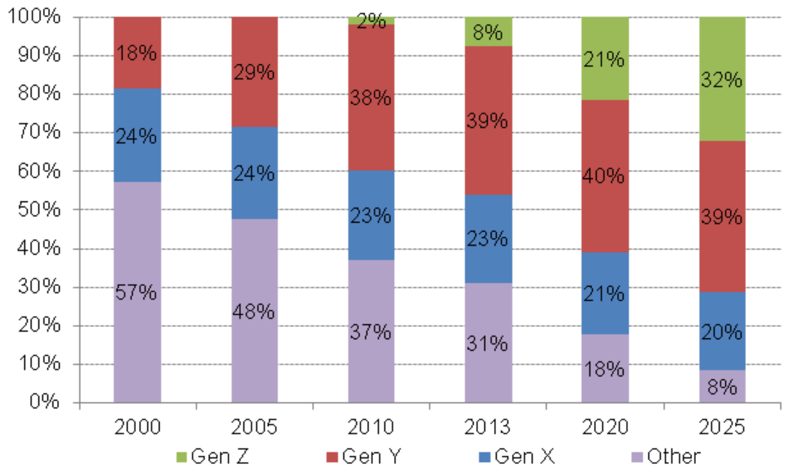
As has been seen in many industries, the Internet has disrupted established business models, providing new entrants with faster and cheaper means of selling goods and services. This has been true for the banking industry, where new entrants have taken business away from incumbents, providing an important source of competition and value for bank customers. An example was the launch of online deposit accounts in the 1990s by a relatively smaller bank with a new business model, enabling it to provide strong competition on rates and fees.

Other benefits of online technology for customers have been faster and more convenient services, as well as the ability to compare banking offers. Today, customers can more easily and in real time monitor their accounts, send and receive payments to and from each other, pay bills and make investments. Applications for both home loans and credit cards have long been possible online, and recent services, such as budgeting tools, are now also available online. A number of internet sites aggregate product information from many providers, making it easier for consumers to compare offers of banking services.

Demand for these faster, cheaper and easier services is expected to grow. While in the past, banks often drove the adoption of technology, today it is driven more by customer demand. Demographic changes are likely to accelerate this trend. The Generation Y (**Gen Y**) population, those born between 1977 and 1994, have been called 'digital natives' and came of age during the Internet era. They have a familiarity and comfort with technology that makes them early adopters of new digital banking services. In 2013, they were the largest segment of the working population, at 39% (see Figure 6.1). In 2020, Gen Y combined with the next generation, Generation Z, will comprise an estimated 61% of Australia's working population.

[92] BPAY, Overview, available online at: http://www.bpay.com.au/About-BPAY/Overview.aspx

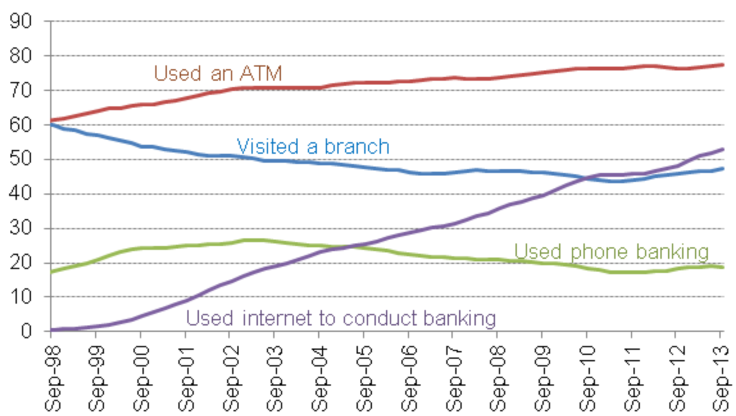
Figure 6.1: Proportion of working population (15 to 64 years)



Source: ABS

The popularity of technology for banking services is apparent from the data on the use of different banking channels. Roy Morgan's study of banking channels saw internet banking overtake branch visits as the most popular banking channel behind ATMs at the end of 2010 (see Figure 6.2).

Figure 6.2: Banking channels used over average four week period (%)



Source: Roy Morgan

6.2. A technology intensive industry

The finance and insurance industry has the highest level of capital stock of technology across all industries. In 2013, the finance and insurance industry had $19.6 billion of computer hardware and software, 58% more than the next industry (see Figure 6.3). In fact, the stock of technology resources held by the finance and insurance industry is 3.2 times the average across all industries.

Figure 6.3: Capital stock of technology by industry, 2013 ($m)

Capital stock ($ million)	Computer hardware	Computer software	Total
Financial and Insurance Services	$4,817	$14,795	$19,612
Professional, Scientific, Technical Services	$3,726	$8,666	$12,393
Transport, Postal and Warehousing	$1,480	$7,104	$8,584
Manufacturing	$2,399	$5,266	$7,665
Information Media and Telecommunications	$2,421	$5,057	$7,479
Rental, Hiring and Real Estate Services	$5,676	$1,658	$7,334
Electricity, Gas, Water and Waste Services	$3,059	$4,005	$7,064
Retail Trade	$2,239	$4,379	$6,618
Wholesale Trade	$2,225	$4,377	$6,601
Administrative and Support Services	$1,209	$2,562	$3,771
Construction	$1,693	$1,830	$3,523
Mining	$617	$2,628	$3,246
Arts and Recreation Services	$670	$1,401	$2,071
Accommodation and Food Services	$766	$482	$1,248
Other Services	$409	$822	$1,231
Agriculture, Forestry and Fishing	$313	$574	$887

Source: ABS

With an average of $46,748 of computer technology stock for each employee, the finance and insurance industry is a highly intensive user. This is 2.8 times the average across all industries and second only to the utilities industry at $48,233 of computer technology per employee.

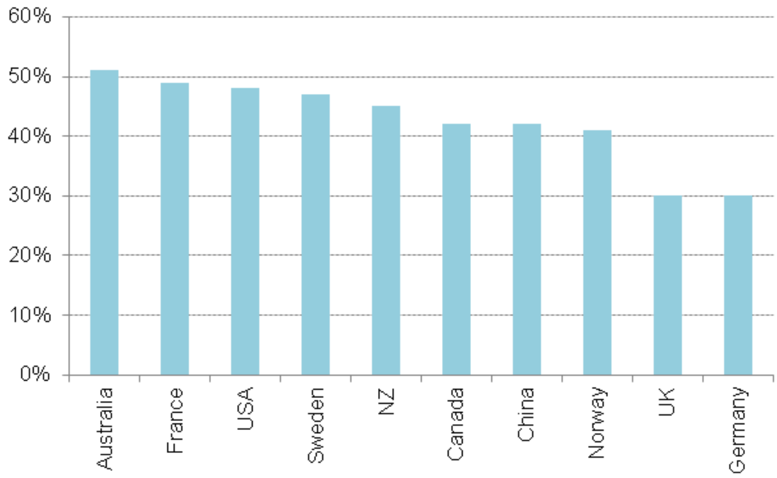
6.3. Mobile banking

One of the fastest growing and changing bank services is mobile banking, with applications created for smartphones and tablets to enable banking anytime and anywhere. The size and scope of the opportunity to provide services in mobile payments has been well recognised by the banking industry in Australia and by new entrants such as Google Wallet and Square. New entrants can bring competitive pressure to bear in established or evolving markets and introduce innovations into those markets.

Australians are eager adopters of mobile banking, in part due to the high penetration of smartphones. In 2013, Australia had one of the deepest smartphone market penetrations in the world, at 64.6% - more than both the US and the UK.[93] Australia also had the highest proportion of smartphone owners performing financial activities online: 51% compared to 48% in the US and 30% in the UK (see Figure 6.4).

[93] Google: *Our Mobile Planet: Australia*

Figure 6.4: Proportion of smartphone owners who perform financial activities online (2012)



Source: Our Mobile Planet, Google

Customers continue to use a wide range of channels for banking and making payments. Over the year ending June 2013, a total of 8.9 billion transactions were completed using ATMs, EFTPOS, cheque, direct entry and credit cards, with a total value of $15.1 trillion. Mobile payments are a subset of these transactions, but are growing quickly. From 2011 to 2016, mobile payments globally are expected to increase sixfold - from US$105 billion to US$617 billion.

6.4. Managing risk

While technology is going to deliver even more benefits to consumers, it is not without its risks. The arrival of new entrants brings not only increased competition but also potential risks into the financial system. The banking industry supports the entrance of competitors, but not at the expense of security and customer confidence. Poor or uneven regulation can allow some participants to build businesses on the back of 'regulatory arbitrage', where a lack of regulation and oversight provide the basis for their business models. Other potential risks posed by new non-bank entrants include operational risks and breaches of consumer rights, such as privacy. Any disruption to a service resulting from inappropriately regulated participants could lead to a major loss of confidence in the banking system and commerce more broadly.

One area where risk may arise is in the payment system. At present, the payment system is well regulated and supervised by the RBA. There are other important government agencies involved, including APRA, ASIC and AUSTRAC, an authority charged with countering money laundering and the financing of terrorism. It will be important to balance the need to promote competition by fostering innovation and keeping compliance costs down with the need to maintain the safety and soundness of the payment system as new participants enter the market. Virtual currencies, such as Bitcoin, are a potential hazard within the payment system primarily due to the anonymity they support, although the banking industry does not believe they pose a threat at this time.

6.5. Modernising disclosure practices

While bank customers have embraced new online banking services, disclosure obligations have failed to keep pace across all financial products. Many of the current disclosure rules were originally designed on a paper-based, face-to-face transaction model and not all have been updated. They are rapidly becoming out of step with the realities of how customers want to do their banking.

There have been a number of changes made to the legislative framework to facilitate better disclosure through the electronic delivery of disclosure materials and other documentation (typically subject to the prior express consent of the consumer), but there is no uniform approach across all financial products and services. Applications for new products and services on mobile banking platforms increase the challenge of meeting pre-contractual disclosure online.

The legislative and voluntary code framework does acknowledge that material may be sent electronically, however the language used does not recognise that most regulated disclosures and other related documentation are available to customers electronically at any given time.

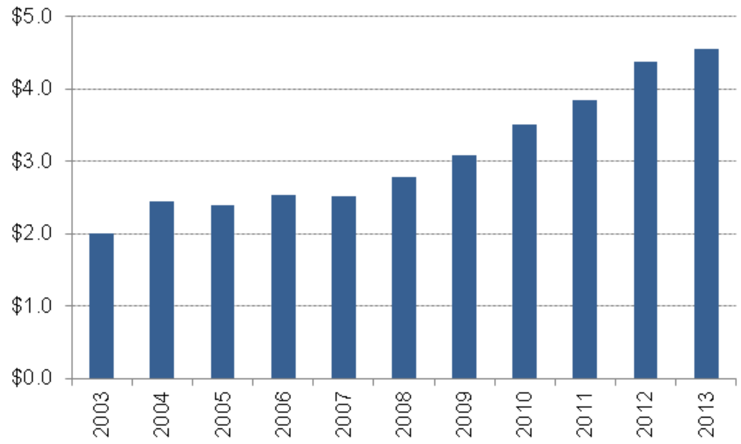
To ensure consumers can enjoy the full benefit of technological change, while continuing to be covered by consumer protection legislation, the banking industry would like to see a review of the disclosure obligations and the associated provisions, with regulations adopting a technology-neutral approach. This will assist in addressing existing differences, such as those in content, presentation, timing and form of delivery for regulated disclosures. Additionally, the review should re-examine certain disclosure obligations that have been changed or adjusted through regulatory amendments, class order relief and regulatory guidance.

The industry recognises not all customers have access to or the desire to use technology and an ongoing process of disclosure is important. It will continue to meet the needs of customers who have a preference for paper-based communication.

6.6. The transformation of technology infrastructure

The development of technology infrastructure since the Wallis Inquiry has been transformative, on the back of substantial investments by the banking industry. Over the past five years alone, banks in Australia have spent an estimated $19.4 billion in technology; with an expenditure growth rate of 10.3% each year (see Figure 6.5). Banks maintain large and complex technology platforms, providing services anywhere in Australia and internationally, 24 hours a day, while, in the process, monitoring the safety and security of billions of dollars' worth of transactions each year. Many banks have been updating their core systems to provide better customer services and enhanced risk management.

Figure 6.5: Banks - Technology expense ($bn)



Source: Banks' annual reports[94]

The banking industry believes a critical issue at this time is the appropriate implementation and regulation of cloud computing. Cloud computing is defined as "*a model for enabling convenient, on-demand network access to a shared pool of configurable computing resources (for example: networks, servers, storage applications and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction*."[95] In short, it is a shared and centralised service, typically run by a third party.

Because of its scale, cloud computing infrastructure is cheaper to run, more flexible to use, and can provide greater security, with the ability to update services rapidly with enhanced safeguards. One major bank estimates cloud computing has contributed to a reduction in its infrastructure costs from 50% of total information technology costs in 2007 to 26% as of 2013, enabling it to free up capital. Another bank has moved its entire technology infrastructure to the cloud.

It is clear that the security of the financial system cannot be taken for granted when new technologies are introduced and, as such, the banking industry recognises the important role regulators need to play in understanding and monitoring cloud computing's application. APRA is currently creating guidelines for the use of cloud computing by financial services companies. Given the dynamic nature of technology and the opportunity for innovation, the banking industry would support the maintenance of a principles-based approach rather than prescribed guidelines that will unnecessarily restrict the use of cloud computing.

6.7. Policing cyber space cohesively and collaboratively

Security is central to maintaining the integrity of the payments system and banking more broadly. Unavoidably, however, the capability of cyber attackers continues to grow, necessitating continued investment by banks in Australia in technology and staff to maintain the integrity of banking products and services.

[94] Based on the Annual Reports of the eight largest banks listed on the ASX200
[95] National Institute of Standards and Technology, US Department of Commerce, (2011), *The NIST Definition of Cloud Computing,* (available online at http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf

This is a matter of national security, well recognised by the Government. According to the Attorney-General's Department, "*The risk to the Australian economy from computer intrusion and the spread of malicious code by organised crime has been assessed as high. An increase in the scale, sophistication and perpetration of cybercrime has made it increasingly difficult to identify and defeat.*"[96] Reflecting the importance of the issue, the Department of Defence is currently establishing an Australian Cyber Security Centre.

Recognising the importance of cyber issues, many countries, including the US and UK, have prioritised a national-level policy focus on cyber security. Australia needs to comprehensively review and update its National Cyber Security Strategy. The opportunity exists for greater intelligence sharing and collaboration between Government, banks and other market participants, while also exploring appropriate baseline standards for security. In addition, the strategy for cyber security should consider ensuring compliance with anti-money laundering and "Know Your Customer" regulations, in particular for new players that may not be subject to those regulations otherwise.

Recommendation 5: The Inquiry should recommend the Government develops, in consultation with the banking industry, a comprehensive strategy to ensure the regulatory regime supports technological innovation, while managing any potential risks.

A technology strategy should consider the following opportunities.

- Reviewing the disclosure requirements for customers of all banking products and services to ensure disclosure can be conducted electronically where appropriate.
- Extending the RBA's remit to regulate and supervise market participants to ensure all providers of financial e-commerce services are covered, to maintain the safety and soundness of the payment system and customer confidence.
- Ensuring APRA's guidelines for new technologies, particularly cloud computing, remain principles-based rather than rules-based to allow flexibility as the infrastructure develops.
- Updating and implementing the National Cyber Security Strategy to help improve security resilience for all industries, with greater public-private sector cooperation.

Technology will continue to impact banking services in Australia in ways that are difficult to forecast. Peer-to-peer lending may provide investors with higher, albeit riskier returns. Social media platforms may migrate from being sources of information, to payment platforms. The banking industry recommends regulators continue to monitor developments in these areas.

[96] The Attorney-General's Department, Cyber security, available online at: http://www.ag.gov.au/RightsAndProtections/CyberSecurity

This page is intentionally blank.

7. Capitalising on a strong financial sector

Australia is a leader in the provision of financial services. This submission provides considerable evidence on this point: the continuing stability and profitability of Australian banks, the high levels of customer satisfaction, continuous product and service delivery innovation building on opportunities provided by new technology, a high level of international integration, backed by a sound and respected regulatory structure. These factors make the financial sector one that Australia should capitalise on, using our competitive advantage for the benefit of the Australian economy.

Beyond its role in intermediation and risk management, the banking sector makes a considerable contribution to the Australian economy as an employer, a corporate citizen, a purchaser of goods and services, a source of productivity gains, and a leader in development of technological innovation. It is also an exporter, a facilitator of Australian international trade, and a source of stability contributing to Australia's reputation as a stable and open economy with which to do business.

The banking industry's submission sets out a range of measures that will enable the financial system to continue to play its central role in supporting economic activity and growth, and the future prosperity of Australians, through its core functions of intermediation and risk management. Given the high level of value-add provided by the industry, and Australia's expertise in providing financial services, the banking industry believes there should also be a shared vision for building the financial industry itself as a source of current and future wealth for Australia.

The financial sector is now the second largest contributor to national output, and is the largest contributor to services, with the potential to increase this contribution. Over the five years since the height of the GFC, average annual growth for the finance and insurance industry was 1.8%, compared with 2.5% for the overall economy. If the finance industry had grown at 2.5% over those five years, the additional gross value added to the economy would have been $2.7 billion. Within that additional contribution to the economy would have been additional contributions to employment and government revenue, given the existing base employment of 140,000 employees, and a $12.1 billion contribution to government revenue. Dividend payments to shareholders (largely Australian citizens either directly or through their superannuation funds) would also stand to increase from the $21.2 billion paid out in 2013.

Growth in the financial sector would support growth in bank investments in technology, already substantial with $4.6 billion invested in IT in 2013. It would also see an expansion in goods and services purchased from other Australian businesses. Banks' contributions to community services and programs around Australia could also be expected to grow.

Productivity is a crucial challenge for the Australian economy, and increasing productivity in the financial sector by removing barriers to competition and innovation, and increasing capacity for success in international competition would yield substantial benefits.

The global management consulting firm McKinsey & Company has estimated that if market productivity was restored to the long term average growth rate (approximately 3% per annum), an additional $90 billion could be added to GDP by 2017.[97] On current contributions, it could be assumed that at least 10% of this $90 billion would come from financial services (as a direct contribution). The banking industry's ready contribution to both developing and adopting innovation in technological, product, service, and business models places it well to support improved productivity for Australia.

Internationally, the Australian financial sector already has a strong presence. Exports of financial services as a proportion of services exports were 4.1% (by value) for the year ending September 2013, and 0.7% of total exports. In 2009-10, Australia had 1,245 finance and insurance foreign affiliates operating in 70 countries around the world. Australia's investment in these affiliates was worth $71.1 billion, and these affiliates earned $6.5 billion profit during the year. There is a very significant opportunity to lift this international performance, directly and in support of high growth export industries, such as those identified by Deloitte: agribusiness, gas, tourism, international education and wealth management.[98]

In building this vision for the future financial system consideration will need to be given to drivers in the banking business:

- increasing demand for customer-centricity, for example, customers "taking control" of relationships with their financial institutions;
- an increasing focus on risk management across all business functions and geographies;
- financing needs of major infrastructure developments, including shared services facilities; and
- further enhancements and growth in delivery channels and payment systems.

It will also need to respond to key trends in the external environment that impact on the whole of the economy, as listed in Section 2 of this submission, particularly:

- an ageing population - the ageing population will create opportunities and threats for the Australian economy;
- the continuing emergence of Asia - growth in the region is forecast to be higher than in any other part of the world;
- the increasing impact of digital developments - a digital "tsunami" is driving structural changes in industries across the globe; and
- uncertainties in relation to global capital access and cost.

These forces will shape both the Australian economy and its financial system into the future. While it is difficult to predict exactly what shape the financial system might take in the longer term, the banking industry believes Australia should pursue a vision that encompasses:

---

[97] Taylor, C., Bradley, C., Dobbs, R., Thompson, F., Clifton, D., 2012, *Beyond the boom: Australia's productivity imperative*, published by McKinsey and Company, available online at: http://www.mckinsey.com/insights/asia-pacific/australia_productivity_imperative

[98] Deloitte, 2013, *Super-growth sectors worth $250b to build Australia's 'lucky country'*, available online at: http://www.deloitte.com/view/en_au/au/514b317cfb181410VgnVCM3000003456f70aRCRD.htm

- a strong, stable, diverse and competitive set of financial institutions, with an increased presence regionally and globally, keeping the goal of establishing Australia as a global financial centre;
- delivery of world-class and cost-efficient service to all Australian consumers and businesses;
- continuing growth in economic activity, exports and tax revenue;
- enhanced capital allocation; and
- global leadership in innovation and productivity.

Achieving this vision will also deliver a financial system that is stable, resilient and safe, more competitive and diverse, and recognised as world class in innovation, efficiency and inclusiveness.

Industry and Government need to work together to consider the factors shaping the future of the financial services industry and define ambitious policy objectives if the potential gains to employment, innovation, and trade are to be captured. The banking industry welcomes an opportunity to work with the Government on building a national strategy for the financial sector, based on an agreement on long-term objectives for the sector.