Deloitte Access Economics

The 2014 Financial System Inquiry

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Glossary

ACCC	Australian Competition and Consumer Commission
ADI	Australian Deposit-taking Institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
DAE	Deloitte Access Economics
GFC	Global Financial Crisis
PDS	Product Disclosure Statement
RBA	The Reserve Bank of Australia
SCCI	Specialist Credit Card Institution

Executive Summary

Coles has commissioned Deloitte Access Economics to prepare a report on competition and innovation in the Australian financial system.

Competition

Competition flourished before the Global Financial Crisis (GFC). Competition is good for consumers and the broader economy. More competitive markets deliver lower prices, more choice, better products and improved access to services.

Market concentration in retail banking has increased since the GFC, although it remains below Australian Competition and Consumer Commission (ACCC) thresholds for concern about the level of competition. Increased concentration is not a problem if markets are contested by incumbents and are open to new entrants, i.e. if there is room for innovation.

Regulation

Regulation has costs as well as benefits. Regulators set and monitor barriers to entry. It is important to ensure that **non-financial conglomerates** can continue to provide financial services in Australia, including by entering the retail banking market. Any reassessment of the regulations that apply to potential new entrants (for example, non-financial conglomerates) into financial services need to take account of the importance of competition.

The Reserve Bank of Australia has outlined its position on access arrangements in its March 2014 paper. **Current access arrangements may be more restrictive than necessary; easing them can increase innovation by encouraging new entrants**. Regulatory decisions that take into account economic performance as well as stability are consistent with the terms of reference of this Inquiry.

The Wallis Inquiry clearly defined the responsibilities of the regulators. Since then, this demarcation has blurred and been tested by the GFC. The **regulatory overlap and complexity is inefficient and in some cases counterproductive**; discouraging new entrants by raising the costs of operating in a market. Regulatory overlap and complexity should be minimised.

The future

Regulation needs to **keep abreast of technological advances** so as not to stifle innovation and discourage new entrants. Technology is changing consumer preferences for interacting with financial service providers. Principles-based regulation is more adaptable to change than a rules-based approach.

The challenge for policy makers is to foster a regulatory environment that can accommodate innovation and allow competing business models to flourish without jeopardising the stability of the financial system.

Deloitte Access Economics

1 Background

In November 2013 the Australian Government announced an inquiry into Australia's financial system chaired by Mr David Murray. In the wake of the Global Financial Crisis (GFC), the Murray Inquiry has been tasked with making recommendations that, *"foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users."*

This report focuses on these key aspects of the Inquiry's terms of reference.

The report argues the case for competition and innovation in the Australian financial system to remain strong. Specifically, the report highlights the importance of low barriers to entry to sustain competition and innovation, which in turn promote consumer welfare by widening consumer choice and inducing higher levels of technical efficiency.

The report also examines whether the scope and intensity of financial services regulation is appropriately balanced against the need to foster innovation and competition. In the wake of the GFC, there has been a concerted effort to strengthen regulatory controls on banks in Australia and overseas. The question arises whether this intervention, aimed at shoring up the stability of financial systems, has over-reached.

This report examines developments in the regulatory treatment of non-financial conglomerates.

The challenge for policy makers is to ensure that barriers to entry remain low enough to foster competition and innovation yet not so low as to threaten system stability.

2 Competition in the Australian financial system

The ultimate test of how well a financial system is performing is to match the level of benefits flowing to users and consumers against the cost of operating and accessing the system.

More competition generally leads to better outcomes for consumers by lowering prices, widening the range of choices, improving products and broadening access to services. More competition also can produce instability when key firms enter and exit the marketplace.

Unstable markets potentially undermine consumer welfare. The key is to balance the benefits of competition against the potential costs of market instability.

The surest way to promote competition in a market is to keep barriers to the entry of new participants as low as possible, consistent with the need to ensure market integrity and stability.

2.1 Context

Prior to the GFC, competition in financial services in Australia was strong. Bank lending margins had narrowed substantially and a wider range of borrowers could access credit including those without a long work history such as first home buyers and the self-employed. Participants were actively innovating with new products and delivery channels. New players could easily enter various parts of the financial system given they met the required prudential criteria.

Foreign banks and non-bank lenders jostled with the major domestic banks for market share. Margins were at or near record lows, there was a good deal of product choice, and a wide range of borrowers could access capital easily.

However, the structure and costs of financial services – banking services in particular – have changed in the years since the crisis, making it difficult for players without sizeable balance sheets and/or strong reputations to compete as vigorously as before.

In particular, the pricing of risk has changed. For example, residential mortgage-backed securities that typically were priced at around 20-30 basis points (bps) over the bench mark bank bill swap (BBSW) rate are now priced at around 80-100 bps over BBSW. Some participants have exited the market, forced out by higher funding costs in the wake of the GFC. The disappearance of, especially, some innovative players has lowered the intensity of competitive pressure among those that remain.

Market concentration has also increased since the GFC. This reflects the pressure imposed on smaller Australian Deposit-taking Institutions (ADIs) and foreign banks by global market volatility, and the efforts of regulators to strengthen financial stability. Exits, mergers and

acquisitions have also contributed to higher levels of market concentration, especially in retail banking services.

Notwithstanding higher levels of concentration, all of the different markets for retail banking products have concentration ratios that remain below the ACCC's thresholds (ACCC 2008, DAE estimates). Based on this evidence, higher concentration has not 'substantially lessened' competition in any substantial market, to reference the *Competition and Consumer Act 2010* (s.4G).

2.2 Barriers to entry and exit

Concentration can be a poor indicator of the intensity of competition in a market when barriers to the entry of new participants are low. Low barriers to entry (and exit) facilitate market contestability, which keeps incumbent firms on their toes, watchful for the potential entry of new players able to set up shop quickly and bid away customers of incumbent firms.

Regulations imposed on market participants can act as barriers to entry. Of course, some regulations are expected to bar the entry of undesirable participants and/or to restrain unethical or undesirable behaviour by existing players. Even regulations aimed at maintaining the integrity and stability of markets, however, come at the cost of raising the bar on entry and diminishing competitive pressure.

There is a balance to be struck between the benefits of market competition and the entry of innovative players and the potential destabilising impact of such entry on established market participants and their operations.

The Reserve Bank of Australia recently acknowledged precisely this trade-off when it decided in principle to ease restrictions on the entry of new players to Australia's MasterCard credit, Visa credit and Visa Debit systems i.e. the Access Regimes (see Chapter 4 for more discussion).

The Bank has expressed frustration on various occasions at what it perceives to be low levels of innovation in the Australian payments system. Easing entry restrictions is designed to encourage innovation through the (threatened or actual) entry of new players while at the same time ensuring that the integrity of Australia's payments system is maintained.

Duplication and complexity of regulation and overly onerous regulatory requirements can also act as barriers to entry by raising the cost of operating in a market. In the years since the establishment of the Wallis Committee's "twin peaks" regulators, APRA and ASIC, instances of overlap, duplication and 'scope creep' have emerged and, arguably, some regulation has become more onerous than necessary to manage the perceived source of market failure (see Chapter 5 for more discussion).

On the other hand, advances in technology and globalisation have worked to reduce entry barriers in all product markets. New technologies have lowered distribution costs, allowing low-cost players to emerge, while globalisation and policy changes have allowed overseas banks to enter and compete aggressively in Australian markets. Nevertheless, regulation

needs to keep abreast of technological advances so as not to stifle innovation and discourage new entrants (see Chapter 6 for more discussion).

2.3 Consumer benefits

Consumers generally benefit when new players enter the market – including smaller and international participants who typically (at least initially) target a specific market niche by offering innovative products.

Since the 1990s, a range of players have introduced new products and services into the financial services sector. Quick competitive responses by incumbent firms have resulted in innovations being offered widely to consumers in a short period of time. As explained in Section 2.1, credit became relatively cheaper and a wider range of buyers could access it.

Other examples include the introduction of online banking products, the diffusion of mobile banking services, the availability of different distribution channels, and using different sources of funding.

> "Non-bank lenders provided increased competitive tension in the Australian banking system when they commenced operations in the 1990s. Besides competing on price, these lenders also introduced technological innovations for consumers, such as internet banking."
>
> - *Senate Economics References report into the post-GFC banking sector, November 2012*

> "The Australian Bankers' Association (ABA) agreed that foreign banks and the non-banking sector forced the banks to 'accept reduced margins and to roll out new technology and new products, and to otherwise respond to competitive pressures."
>
> - *House of Representatives Standing Committee on Economics report, November 2008*

> "Changes in the modes of distribution for each of these products in particular greater reliance on the internet, telephone and broker channels, has meant that a customer can obtain one of these products, transact and manage their relationship with their financial institution without visiting a branch. This trend has allowed institutions to compete in regions where they do not have a physical presence – for example, ING Direct has attracted a significant share of the Australian savings account market by distributing its products solely through the internet."
>
> - *ACCC on the proposed merger between Westpac and St. George Bank, August 2008*

A competitive and robust Australian financial system contributes to consumer welfare through:

- increased choice, by providing a wider range of financial products and brands;
- reduced search costs for consumers, flowing from bundling complementary products;
- potentially lower prices through competitive tension created by a larger number of market participants; and
- heightened product innovation and adoption of new technologies.

These benefits must be weighed against the benefits of greater market stability which can arise through more intensive regulation. Financial market integrity and stability are also beneficial to consumers of financial services.

But these benefits should not outweigh the sacrifice of consumer choice and product innovation that can arise when regulation becomes onerous, inappropriately targeted and/or poorly administered.

3 Regulation

Regulation has costs as well as benefits. The financial sector is among the most highly regulated industries in the economy, and the impact of regulation on the cost of doing business is therefore an ongoing topic of concern for financial services providers. The challenge for policy makers is to improve competition without undermining stability.

3.1 Shifting regulatory landscape

A series of new banking regulations has been introduced since the GFC, including the Basel III minimum standards for bank capital reserves and liquidity. While these reforms are intended to increase the resilience of the financial sector to future shocks, they also raise banks' cost base and create barriers to new market participants (for example, more onerous capital requirements create an additional hurdle for potential market entrants).

Other reforms originating from abroad, e.g. from the G20/FSB and the US Congress in the Dodd-Frank reforms, as well as domestic regulatory changes, may also raise the cost of providing banking services. The insurance and superannuation sectors too have experienced a tightening of prudential regulations.

As argued above, there has been a shift in Australia's regulatory landscape since the GFC towards a greater emphasis on financial stability and regulatory conservatism. Obviously a sufficiently robust financial system is needed to provide market certainty and ensure consumer protection.

However, in the wake of the GFC, the question needs to be asked whether Australia's prudential regulatory environment has become onerous and is acting as an impediment to competition, innovation and technical efficiency in financial markets.

3.2 Clarifying the rules and APRA's reach

One important source of competition to established players in financial markets is non-financial conglomerates (such as supermarkets) seeking to offer financial services through subsidiaries.

Any reassessment of the regulations that apply to potential new entrants (for example, non-financial conglomerates) into financial services need to take account of the importance of competition.

It would be beneficial for the Inquiry to define the scope of prudential regulation applying to the banking operations of predominantly non-financial conglomerates. That is, whether the banking operations are quarantined from the rest of the conglomerate.

APRA's 2013 discussion paper, *Supervision of Conglomerate Groups,* notes that:

> *"In relation to capital adequacy, APRA proposed that a Level 3 group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions in the group."*

So long as the capital position of the financial subsidiary meets APRA's minimum requirements, the group's decisions on capital allocation elsewhere in the conglomerate need not be a matter over which APRA could exercise any discretion.

APRA may be reluctant to move into this sector of the market, given this has traditionally been beyond its regulatory scope.

It would be helpful if the Inquiry addressed these issues given that APRA intended (in September 2013) to release the final reporting standards, reports and instructions in the first quarter of 2014. Level 3 conglomerates will be required to comply with the standards from 1 January 2015.

3.3 Non-financial conglomerates active in financial services

Non-financial conglomerates have been active in overseas banking sectors for years. For example, Tesco, a supermarket chain, has been active in the UK banking market since 1997.

Tesco, regulated in the UK by the Prudential Regulation Authority (formerly the Financial Services Authority) commenced banking operations as part of a joint venture with the Royal Bank of Scotland (RBS). Tesco acquired RBS's shareholdings in 2008, which resulted in the bank becoming a wholly-owned subsidiary. From this point, Tesco Bank operated under its own banking licence.

Since the commencement of Tesco's banking operations, savings deposits have grown to over £5.2 billion, lending balances have grown to over £6.4 billion, and Tesco Bank credit cards comprise 12% of all MasterCard and Visa credit card transactions in the UK. It is noteworthy that Tesco Bank has embraced technology, with 86% of Tesco Bank's product sales conducted online.

Domestically, non-financial conglomerates have been active in the Australian financial services sector – specifically the insurance market – since at least 2010. These entrants to Australia's financial markets have placed competitive pressure on incumbents and widened product choice for consumers.

The unique experience of predominantly non-financial conglomerates, such as Wesfarmers group, could offer valuable insight to the Inquiry as it considers the appropriate financial regulation of non-financial conglomerates.

4 Access Regimes

The Payments System Board has decided in principle to change the access arrangements for the MasterCard credit, Visa credit and Visa Debit systems, including varying the RBA's Access Regimes for those systems. The RBA has announced its intention to ease restrictions on the entry of new players to Australia's MasterCard and Visa systems.

Easing entry restrictions is deliberately designed to encourage innovation through the (threatened or actual) entry of new players while at the same time ensuring that the integrity of Australia's payments system is maintained.

This is consistent with the RBA's role in promoting economic growth while also securing financial stability.

4.1 Context

When establishing the existing access framework (implemented in 2004 and 2005), the RBA worked with APRA to create a new class of ADI known as specialist credit card institutions (SCCIs). This allowed new entrants that would otherwise have been ineligible for membership (non-ADIs) to apply to APRA to join the MasterCard and Visa systems. However, the impact has been that SCCIs have fallen within APRA's prudential supervision regime for ADIs. While SCCIs do not take deposits like other ADIs (at least not to any material extent), they must by and large meet the same standards as other ADIs.

The RBA website notes that:

> *"…recent developments suggest that the Access Regimes in their current form may no longer be fulfilling their original objective and could unnecessarily be preventing some prospective participants from entry."*

The RBA sought feedback over the past year on draft variations to the Access Regimes that would allow MasterCard and Visa to widen eligibility for membership of their respective systems.

This is an example where a regulator has self-identified that the scope of its regulatory oversight may have over-reached its original intentions and is therefore impeding innovation.

4.2 The RBA's position

The RBA's position, outlined in its December 2013 consultation paper, *Proposed Variation to the MasterCard and Visa Access Regimes: Consultation Document*, notes that there is evidence that the current access arrangements may be more restrictive than necessary:

1. Entities other than ADIs/SCCIs are prevented from joining the schemes, even if the schemes would have otherwise been willing to admit them.
2. Only two entities have gained SCCI status since the existing framework was implemented nearly 10 years ago.

3. APRA's authorisation process and ongoing fee requirements may be excessive. This point is highlighted in the RBA consultation paper which notes:

> *"Taken as a whole, the prudential framework establishes a relatively high hurdle to entry and results in costs for potential entrants, some existing members and for APRA itself."*

Although the fact that only two entities have gained SCCI status may simply indicate that relatively few non-traditional parties have seen a business case for joining the schemes, the RBA has noted it is aware that parties have considered pursing the SCCI path, but have since decided against it.

The RBA is aware of at least five entities interested in issuing or acquiring credit card transactions in Australia; however, most indicated they consider the requirements to become an SCCI to be 'significantly more onerous than warranted'.

Further to the RBA, APRA has also argued that the current regime may be too onerous. It has communicated to the RBA that supervising credit card participants is no longer an appropriate use of APRA's resources and is not consistent with its core mandate. In APRA's view, responsibility for determining access to the card schemes rests with the schemes themselves. APRA is a prudential regulator responsible for protecting depositors, not receivers of credit.

4.3 Options to improve competition

The RBA has outlined that competition and efficiency could be fostered by:

- providing greater scope for the entry of new participants into the MasterCard and Visa systems, including from entities that are not ADIs;
- providing a sustainable mechanism for the risk to the MasterCard and Visa systems from new entrants to be assessed and managed; and
- ensuring that regulatory imposts on participants are not higher than warranted.

The RBA notes that the current regime might be preventing users of the system from gaining the benefits that new entrants might bring to the market. For instance, the virtual card products proposed by several prospective entrants have the potential to improve the efficiency of payments and reconciliation for businesses operating in the travel industry.

The aim of the revised access arrangements is to encourage competition and innovation in the payments system by striking an appropriate balance between new entry and controlling risk. The RBA recently acknowledged that the correct balance is not currently being achieved.

On 7 March 2014, the RBA announced its in principle decision to vary the Access Regimes applying to the MasterCard and Visa systems and to seek removal of the current SCCI framework.

5 Reviewing regulators' roles

Overlap of regulators' responsibilities and duplication of regulation can act as barriers to entry by raising the cost of operating in a market.

In the years since the Wallis Inquiry, some regulation has arguably become more onerous than necessary to manage the perceived risk of market failure.

5.1 Mission creep

The 'twin peaks' regulatory structure was born of the Wallis Inquiry, with APRA created as the prudential regulator for institutions and ASIC as the markets regulator.

However, since the GFC the demarcation of responsibilities between the two has become less clear. Instances of overlap, duplication and 'mission creep' have emerged and, arguably, some regulation has over-reached what it necessary to mitigate the risk of market failure.

For example, ASIC is now prudentially supervising some non-deposit taking institutions while APRA is monitoring executive remuneration and imposing its own 'fit and proper person' test on listed ADIs. As previously mentioned, APRA has also expressed its concerns to the RBA that the supervision of credit cards is not within its core mandate. APRA's concern rests with people who are providing deposits, not those who are receiving credit.

Not only should regulatory overlap be minimised to eliminate misalignment and duplication of regulation – which can create confusion and additional compliance costs for market participants – but it should also be minimised to refocus regulators' time and resources on their core responsibilities.

> *"We believe that the current twin peaks model is robust and appropriate. However, the scope and role of the two regulators needs to be examined…. The exact boundaries of the regulators need to be set and adhered to."*
>
> *John Brogden, CEO, Financial Services Council*

5.2 Non-cash payment facilities

Non-cash payment facilities such as pre-paid purchase products (e.g. supermarket gift cards) and 'rebatable' (i.e. rechargeable) cards are examples of financial products subject to duplicated regulatory requirements.

The RBA limits supermarket gift cards to a maximum balance of $500. There are concerns that ASIC may also regulate gift cards, given the view that the ASIC-enforced prohibition on sending an unsolicited debit or credit card (s.12DL of the *ASIC Act 2001*) may extend to pre-paid cards. The application of the law is unclear as pre-paid cards did not exist when the legislation was drafted.

As an example, a major airline recently received a no-action letter from ASIC, effectively permitting it to distribute stored-value-enabled cards to customers without their consent. As these cards could arguably be classified as unsolicited debit cards, the Inquiry should clarify the position of pre-paid and rebatable cards.

Given ASIC already provides various regulatory exemptions and relief to non-cash payment facilities (for example, to certain loyalty programs), the necessity and scope of the current regulatory regime should be reviewed. The current regulatory requirements and restrictions are arguably overly restrictive given the low risks associated with these products.

6 Looking to the future

Technology is changing rapidly and regulators need to stay abreast of the latest developments so as not to stifle innovation and discourage new entrants.

Advances in technology and globalisation have worked to reduce entry barriers in all product markets. New technologies have lowered distribution costs, allowing low-cost players to emerge, while globalisation and policy changes have allowed overseas banks to enter and compete aggressively in Australian markets.

It is important that Australia's regulatory landscape accommodate innovation, including through technological developments.

6.1 New technologies

New technologies are changing consumer preferences for interacting with financial service providers.

For example, it is becoming increasingly common for consumers to research and purchase financial products online. Consumer confidence in the online financial product space is growing and this is not limited to younger users.

In fact, Firstmac indicated in *The Australian Financial Review* on 20 February 2014 that, not only are 50% of its loans (including mortgages) sourced from its website, but the average age of a customer visiting the site is 40-50 years.

This trend is driven by consumers who are time-poor and who are becoming increasingly confident to purchase financial products online using technological innovations such as tablets and smart phones.

Given this shift in consumer preferences, financial service providers are adapting their product platforms and investing significantly in technology development. For example, the Commonwealth Bank of Australia has spent close to a billion dollars annually since the GFC on 'core banking' technology upgrades (as referenced in the above AFR article). Many financial service providers are placing a large emphasis on 'digitising'.

> *"Product innovation is critical to staying ahead of the curve and meeting the changing needs of our customers.'"*
>
> *Cameron Clyne, CEO, National Australia Bank*

Given shifting consumer preferences and financial service providers' increased emphasis on digital services, it is vital that regulators also adapt to this changing environment.

6.2 Disclosure requirements

There are instances where regulatory requirements may be out of step with new technology, including, for example, product disclosure statement (PDS) requirements for digital advertising being out of kilter with the format of social media platforms.

Specifically, various advertising and social media platforms (e.g. Twitter) have a maximum character limit per post. Rather, they are only able to provide a link where the shopper can 'click through' to the PDS information housed on a separate landing page.

The new technology requires the PDS to be scalable, i.e., providing the customer with the right amount of information at each point in the process. For example, a full PDS is not necessary for a click-through banner ad, but is appropriate when the consumer reaches the point at which a decision to purchase is made.

Furthermore, regulations governing how a credit provider communicates with its customers may be overly restrictive. The National Credit Code and the *National Consumer Credit Protections Act 2009*, for example, outline how credit providers can send statements and other required notices to customers electronically. They limit the method of delivery to a particular technology (for example, the Code references fax machines and electronic communication more broadly). These limitations may be out of date and it is important that permissible methods of communicating with customers evolve in line with technology.

6.3 Technology will continue to change

It is in consumers' best interests that regulators adapt to new technologies. Technological innovation in banking will continue and consumer preferences will evolve in response to innovation.

Appropriate principles-based regulation may be the best approach to keeping pace with technological developments. Such an approach would be more flexible and less prone to obsolescence than a rigid, rules-based approach.

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