



“Competition and competitive markets are at the heart of the Inquiry’s philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system’s efficiency. (*Financial System Inquiry Final Report, page xvi*)

“Although the Inquiry considers competition is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time.

“The Inquiry’s approach to encouraging competition is to seek to remove impediments to its development.” (*Financial System Inquiry Final Report, page xvi*)

**Table 1: Competition recommendations**

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Source: Derived from *Financial System Inquiry Final Report, page xvii*

**Competition in banking**

“Australia’s current capital framework for authorised deposit-taking institutions (ADIs) includes two approaches to determining risk weights for the purpose of calculating capital ratios:

- Standardised approach: This is the default approach... a common set of risk weights that seek to reflect general risks of different broad asset classes...
- Internal ratings-based (IRB) approach: Accredited ADIs (IRB banks) use their own internal models to determine risk weights for credit exposures... To date, APRA has only accredited the four major banks and Macquarie Bank to use IRB models.” (*Financial System Inquiry Final Report, page 60*)

“Since the IRB approach was introduced, the divergence in mortgage risk weights between the two approaches has widened... The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks... this translates into a funding cost advantage” (*Financial System Inquiry Final Report, page 61*)

“In the Inquiry’s view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another.” (*Financial System Inquiry Final Report, page 61*)

The Inquiry has made the following recommendation:

**“Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk weight models and those using standardised risk weights.”**

*(Recommendation 2) (Financial System Inquiry Final Report, page 60)*

This recommendation seeks to: “improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of authorised deposit-taking institutions”. (*Financial System Inquiry Final Report, page 60*)

### **Competition in superannuation**

“Fees have not fallen by as much as would be expected given the substantial increase in the scale of the superannuation system. As noted by the Super System Review, a major reason for this is the absence of strong consumer-driven competition, particularly in the default fund market. This reflects members’ lack of engagement and reliance on employers to choose default funds for their employees.” (*Financial System Inquiry Final Report, page 101-102*)

“Government intervention in the superannuation system is warranted to improve the system’s efficiency in the accumulation phase... A more efficient system would ensure that all default fund employees, including the disengaged, receive the benefits of wholesale competition” (*Financial System Inquiry Final Report, page 108*)

“The Productivity Commission should hold an inquiry by 2020, following the full implementation of MySuper... to determine whether further reform would be beneficial.” (*Financial System Inquiry Final Report, page 101*)

The Inquiry has made the following recommendation:

**“Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.”**

*(Recommendation 10) (Financial System Inquiry Final Report, page 101)*

This recommendation seeks to:

“Enhance efficiency in the superannuation system to improve long-term net returns to members and build trust and confidence in funds regulated by Australian Prudential Regulation Authority.” (*Financial System Inquiry Final Report, page 101*)

“This option would remove the role of the industrial relations system in selecting default funds. This would reduce employers’ compliance costs and address concerns... about superannuation funds offering employers inducements to choose the fund. It would also better align incentives between employers and employees.” (*Financial System Inquiry Final Report, page 110*)

### **Facilitating competition and innovation**

“For the financial system, technology-driven innovation is transformative. New business models, products and services are emerging, driving competition and changing the way users interact with the system.” (*Financial System Inquiry Final Report, page 143*)

“The Inquiry believes the innovative potential of Australia’s financial system and broader economy can be galvanised by taking action to ensure policy settings facilitate future innovation that benefits consumers, businesses and government.” (*Financial System Inquiry Final Report, page 144*)

The Inquiry has made the following recommendation:

**“Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protection.”**

(*Recommendation 19*) (*Financial System Inquiry Final Report, page 181*)

This recommendation seeks to: “Improve the quality of business and consumer decision making, public policy development and implementation, and research into how the financial system and broader economy function.

“Better enable innovative business models that rely on data, where they improve user outcomes and overall system efficiency.” (*Financial System Inquiry Final Report, page 181-182*)

The Inquiry has made the following recommendation:

**“Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives... and include consideration of competition in the Australian Securities and Investments Commission’s mandate.”**

(*Recommendation 30*) (*Financial System Inquiry Final Report, page 254*)

This recommendation seeks to:

- “Increase the focus on competition in the financial sector.

- “Deliver more explicit reporting about the competition implications of regulatory decisions.
- “Highlight areas where there may be opportunities to strengthen competition.” (*Financial System Inquiry Final Report, page 255*)

“In the absence of change, there is a risk that regulators and policy makers will not place sufficient emphasis on competition when making decisions.” (*Financial System Inquiry Final Report, page 256*)

The Inquiry has made the following recommendation:

**“Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral. Embed consideration of the principle of technology neutrality into development processes for future regulation.”**

(*Recommendation 39*) (*Financial System Inquiry Final Report, page 269*)

“A technology-neutral approach to regulation enables regulators and government to adapt to innovative developments and manage risks. It can also reduce compliance costs by removing unnecessary regulatory impediments and improving the stability and longevity of regulation.” (*Financial System Inquiry Final Report, page 270*)

## Payments

“Currently, Australia’s payments industry is undergoing rapid innovation, giving consumers access to an increasing array of online and mobile payment options... Payments system regulation needs to be able to accommodate future changes in structure and technology.” (*Financial System Inquiry Final Report, page 163*)

“Ensuring current regulation can accommodate services using alternative mediums of exchange would support innovation and confidence in the payments system.” (*Financial System Inquiry Final Report, page 167*)

The Inquiry has made the following recommendation:

**“Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority. Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.”**

This recommendation seeks to:

“Ensure retail payments system regulation:

- Maintains confidence and trust in the payments system.
- Is better understood by industry, particularly new entrants, and accommodates rapid market development.” (*Financial System Inquiry Final Report, page 163*)

“The Inquiry considers that surcharging regulation should ensure merchants can surcharge to reflect their relative costs of accepting different payment methods.” (*Financial System Inquiry Final Report, page 169*)

The Inquiry has made the following recommendation:

**“Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.**

**Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.”**

*(Recommendation 17) (Financial System Inquiry Final Report, page 168)*

This recommendation seeks to:

- “Clarify regulation and enhance competitive neutrality between system providers.
- “Improve the efficiency and effectiveness of price signals, and reduce the potential for cross-subsidisation between customer groups and merchant groups.” (*Financial System Inquiry Final Report, page 169*)

**Figure 1: Cameos on how the proposed reforms would improve outcomes**

### Effects of proposals for interchange fee caps

Wei Ling and Brian often purchase tacos from their favourite Mexican food truck, which is operated by small business owner, Sarinda. When Wei Ling and Brian make card payments, their banks charge an interchange fee to Sarinda's bank. Sarinda's bank charges Sarinda a merchant service fee, in part to reflect the cost of the interchange fee. Interchange fees are capped by regulation.

**Current situation:** Brian chooses to pay with his premium credit card because it provides frequent flyer points. His bank is able to offer these rewards because it charges high interchange fees, particularly for transactions involving small businesses like Sarinda's. These high interchange fees result in high merchant service fees for Sarinda.

Sarinda would like to charge Brian for this cost with a surcharge. However, he is reluctant as Brian may switch to one of Sarinda's competitors who does not surcharge. Instead, like his competitors, Sarinda recovers the cost through higher prices for all his customers. This penalises Wei Ling, who pays with a low-cost debit card with no rewards points.

Sarinda also sets a minimum spend of \$10 for card purchases because his fees are proportionally higher for lower-value transactions, due to the way interchange fees are set. Wei Ling only wishes to purchase a snack, but must now also purchase a drink to meet the minimum spend.

**After proposed reforms:** Sarinda benefits from lower interchange fee caps, which have led to lower merchant service fees. Sarinda also benefits from hard interchange fee caps, which have narrowed the difference in fees paid by small and large businesses. Like his competitors, Sarinda passes these savings onto his customers by lowering his prices to remain competitive.

Both Wei Ling and Brian benefit from the lower prices. Wei Ling particularly benefits from no longer subsidising the reward points and other benefits for customers like Brian. However, Brian now receives fewer frequent flyer points for his purchase because the interchange fees for his credit card are lower.

Wei Ling also benefits from Sarinda removing his \$10 minimum spend for card purchases, which he is able to do because fees for low-value purchases have been reduced. Wei Ling is now able to purchase a snack with her debit card, without having to buy additional items.

### Effects of proposals for surcharging standards

Wei Ling wishes to purchase a plane ticket online at short notice.

**Current situation:** The airline imposes a \$9 surcharge for all debit and credit card purchases. For most transactions, this exceeds the airline's cost of accepting debit and credit card payments. Wei Ling cannot avoid the excessive surcharge.

**After proposed reforms:** Like all businesses, the airline benefits from lower interchange fees. However, it can no longer surcharge low-cost debit cards and must comply with set limits for medium-cost credit cards. Wei Ling chooses to pay with her debit card to avoid a surcharge.

Source: *Financial System Inquiry Final Report*, page 170