



Australian Government
Productivity Commission

PRODUCTIVITY COMMISSION

**INQUIRY INTO COMPETITION IN THE
AUSTRALIAN FINANCIAL SYSTEM**

MR P HARRIS, Presiding Commissioner
DR S KING, Commissioner
MS J ABRAMSON, Commissioner

TRANSCRIPT OF PROCEEDINGS

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MR HARRIS: Welcome to the resumed Productivity Commission inquiry hearings in Sydney into the nature of competition in the finance system. I have Stephen King with me today, who is the Commissioner on the inquiry. I'm Peter Harris. I'm Chair of the Productivity Commission and our other Commissioner, Julie Abramson, is on the - she's in communication with Stephen and will occasionally ask a question via him because she has had to remain in Melbourne.

The way we conduct the hearings is everybody should be aware that you are being recorded and, in fact, we are live streaming as well. This is for us anyway, live streaming is for communications purposes. The Productivity Commission is charged with communicating the nature of its inquiry and discovery processes as a contribution to public information and transparency in Australian public policy making, and you are being recorded as well because we may use some of your comments in our final report. In fact, that's part of the reason we desirably do this the way we do it.

Participants in the inquiry are strongly encouraged to be truthful in their testimony. In fact, if you look at the legislation it goes beyond "strongly encouraged". But here, today, in the nature of the way we conduct things it's just a reminder. I should also note that we meet today on the traditional lands of the Gadigal people of the Eora nation and I pay our respects to elders past and present.

I should finally tell everybody two things in a practical sense. One, try not to be defamatory of any individual. We do worry about this, and from time to time we have actually had, sailed close to the wind, so defamation is not encouraged because we are broadcasting live, amongst other things. And as well, the practical things are if the alarms sound and everybody, as I'm sure you are familiar with from all your buildings, there's green exit signs there. Follow the instructions of fire wardens. I'm told the assembly point is somewhere like Hyde Park, but I'm sure you will make your way with practical advice from the wardens to somewhere else safe.

Our first participants this morning, could you guys introduce yourselves please for the record?

MR WHITEHEAD: Certainly, yes. Chris Whitehead and Caroline Fawshaw from FINSIA, the Financial Services Institute of Australasia.

MR HARRIS: Do you have an opening statement to make or any opening comments?

MR WHITEHEAD: Yes, if I may. FINSIA is Australia's peak professional body for financial services professionals. Its origins date back to the Australasian Institute of Banking and Finance in 1886, with over 8,000 members working across retail and business banking, funds management, superannuation, financial advice and capital markets across a range of institutional types, including the emerging fintech market. FINSIA's mission is to deepen trust in financial services by raising standards of professionalism, and that's been our focus from the very start of the organisation.

With regards to the professionalisation and competition, we believe that professionalisation is fundamental to improving industry standards of competency, conduct and culture, and the competitive principals should be enshrined as part of this. We believe that raising standards of professionalism in banking and finance is best achieved as an industry led initiative to define

and monitor the standards of competence and conduct that should apply to all individuals working in the industry. This will help instil a sense of professional pride for the individuals in the industry, and also improve levels of consumer trust.

Competition is an important part of these standards, and indeed recently FINSIA has been engaged in the definition of global banking education standards, and it is enshrined in the standards of that body also. This is vital to ensure that customer choices are fair and transparent. Many of the recommendations in the draft report will help ensure that the consumers are better informed about financial products and services, and where they can find the most appropriate services for their financial needs. And we believe that is certainly best served by transparent advice from a professional.

The customer's best interests, FINSIA supports recommendation 8.1 that ASIC impose a clear legal duty on mortgage aggregators owned by lenders to act in the consumer's best interests.

With regards to the general advice, FINSIA concurs with draft recommendation 12.1 that the term "general advice" defined in the Corporations Act has the potential to mislead consumers. The term "advice" should only be applied where it is given by a provider that is appropriately qualified and skilled to do so, and is bound by a code of professional conduct. Where fintechs develop global advice tools, consumers should be given clear guidance as to the degree of personalisation that is provided by those tools. FINSIA supports the Commission's proposal to test alternative terms with consumers.

With regards to the financial advisers, in preparing a written submission on the draft report FINSIA will take more detailed feedback from its financial adviser members to respond to information request 12.1, increasing the scope of financial advice to include some credit products. Advisers who offer advice on credit products should have demonstrated professional knowledge of the products that they advise on, and should also be bound by a code of professional conduct. If the scope of financial advice is expanded in any way proposed by the Commission, advisers should have the duty to act in the customer's best interests.

With regards to the mortgage broker commissions, FINSIA cautions that any recommendations on mortgage broker commissions not create incentives for brokers to look to churn customers through alternative products. This would include the careful consideration of trail commissions and the changed incentives that would apply to brokers. Most importantly, mortgage brokers should act in the customer's best interests.

In terms of the regulatory sandbox, FINSIA has supported the development of ASIC's regulatory sandbox and APRA's phased approach to licensing. A condition of being in the sandbox should be a plan to get out of the sandbox. This would include satisfying regulatory requirements, as well as building professional expertise. FINSIA notes that the fintech industry is attempting to define an industry code of conduct. Naturally we support these moves and recommend that the fintech code be developed in collaboration with financial services industry incumbents.

Thank you for the opportunity.

MR HARRIS: Thanks for those opening remarks. I might just ask you first, although I'm not the expert and Julie is, so Stephen should be monitoring any questions that Julie has here. But on general advice, so this is the sort of thing sometimes we encounter what might appear to be tangential issues when you go into inquiry. You have to make a judgment how far you go because you can run down, you know, every rabbit hole that you encounter. But this one seems to be a thorny area where almost everybody seems to agree the current language is wrong. Almost no one knows what to do about it. I'm sort of hoping you might be the first person to say, "I have a solution." We'll probably chance our arm on a solution here because it seems to be a common view that it's not working, the terminology is not working, but (a), do you have a view on is that the common view, and then (b), do you have anything by way of sort of a thought for substitute language?

MR WHITEHEAD: Yes, we do. I would certainly concur that it is the common thought. I think in terms of an alternative language, really as we will state in our submission, we think advice really should be coming from individuals who have a sense, and a real sense, of personal accountability. And we think that that perhaps is one of the problematic areas at the moment that general advice doesn't require, for instance, membership of a professional body. It doesn't require adherence to a code of conduct, other than an institutional code of conduct. And reliance is being placed wholly on institutional compliance rather than professional standards and individual standards. So we think that to use the term "advice", that should be a requirement otherwise we do need to come up with another term which much more reflects that it is information, that it's scripted, rather than being advice based, if the source of that information is someone who doesn't have that level of professional competence, demonstrated professional competence, including ongoing maintenance of the competence through professional development requirements, continuous professional development, and also adhering to a code of conduct.

MR HARRIS: Just another option is to simply delete the category entirely in its nature and only allow the term "advice" to be used in connection with the word "professional", and try and lift the quality and emotability, if you like, of the fact that I'm offering you professional advice and no one else is allowed to use the term. I mean, it might sound a bit weird but then we do that with banks. We use the term "bank" only in selected circumstances. And it is the word "advice" that seems to be causing the problem.

MR WHITEHEAD: Yes. I think if we headed down that direction then I think that may be a positive direction, however I think we need to be careful that the costs of preparing that individual advice are reasonable and competitive, and don't mean that advice ends up beyond the reach of many consumers. And whilst I don't at this point have specific research to point to, I am concerned we've looked at other jurisdictions such as the UK, the levels of complexity, the costs of providing advice, have got to the point that now it's essentially impossible to get advice at a High Street bank in the UK. So I think we need to be just careful that we don't end up in a situation that changing the definition actually moves advice beyond the reach of many Australians.

MR HARRIS: That's a point.

MR WHITEHEAD: There's already very low usage of personal advice and we wouldn't want to make that worse.

MR HARRIS: Yes, and survey work does encourage a view that people really aren't prepared to pay perhaps for as much advice as might appear to be, in an objective sense, wise but that's an uncertainty factor that's quite important here. So that's a worthwhile comment for you to have made. Do you have something, Stephen?

DR KING: Yes. Just from Julie, particular products, are there - so if general advice is kept as a category should it be limited? And you said the limitation, your limitation was across who can provide that? It seems professionals - another way to cut it would be to say well, which products are you able to offer general advice on. If - well, would that be another way of keeping the term and limiting customer confusion and, if so, what sort of products do you think it would be useful to keep that on, to make that advice accessible?

MR WHITEHEAD: Yes. Essentially we have that cut now with ...(indistinct)... 146 tier 1 and tier 2. And so I don't think it's one or the other. I think that also clearly someone needs to be able to, or can only give advice in an area in which they're qualified to give that advice, including appropriate product knowledge and so on. So I think that really comes from that kind of regime.

In terms of general advice, perhaps the area we would be most concerned about is when you're providing advice on credit products to customers. I think that's quite different in terms of the implications and potential impact on customers versus, for instance, a term deposit. So I think you need a very clear idea of your customer responsibilities. And obviously we have the responsible lending regime in place to really try and ensure that credit is not being inappropriately provided, or advised upon, and I think that level of business, it does need to remain. So I think credit products in particular do deserve the higher level of requirements.

But otherwise there are products where the consequences, if you like, of the advice being more general than personal, ultimately are not that significant. A term deposit with an ADI, there may be some basis points of variance, but it's fundamentally a relatively simple product and the consequences, if you like, of not getting good advice are nowhere near as severe as they may be with other products.

DR KING: Can it be connected to - I'm just thinking, you mentioned codes of conduct for the professionals. So we've suggested for brokers acting for integrated aggregators that there be a duty of care, a best duty of care obligation, with regards to their clients. I mean, is that also something that we should be thinking of in terms of the sort of advice that is being given? Does that cover off?

MR WHITEHEAD: Yes. It would be FINSIA's contention that anyone providing advice should be subject to a professional code of conduct, and much of FINSIA's work currently is working on the professionalisation of important roles within financial services which today are not seen as professional roles, and we believe should be. So advice is really the key, I guess, determinant of those who we believe should be required to operate in a professional manner. That means that they have defined levels of competency which can be tested, that they have requirements to maintain their competency with regards to ongoing professional development, that they're subject to a code of conduct and obviously disciplinary process attached to that code of conduct.

MR HARRIS: The problem with doing this in the case of broking though, it seems to me, is there isn't a professional requirement in the same way there is for what I might call wealth advising, and so the sanction of a code of conduct in a wealth advising sphere where professionalism is increasingly being valued and represented by, as you say, maintaining competencies and things like that, doesn't apply here, if I understand it correctly.

MR WHITEHEAD: And we believe it should apply. There is, I think, a real danger of a conflict of interest between the principals and owners of firms versus their responsibility as advisers or the responsibility of their staff to advise. And I think if you look at any professionalised industry then there is a professional body that is independent, if you like, of the owners of the businesses that work certainly with the industry. But we do need to manage the conflict of interest between owners and advisers.

MR HARRIS: Yes. So we're on common ground there for sure. And the value in a code of conduct that emphasises professionalism and maintaining competency in a measurable sort of form is that then it's more enforceable, isn't it? You haven't maintained your competencies and therefore you can't claim the professionalism. So the two have to go together don't they otherwise you don't have the sanction inside the code? You've lost your professional status.

MR WHITEHEAD: Absolutely, and I think what's important by that being imposed beyond the firm's own code of conduct is it's also visible across the industry, that where you have a professional institute in place then that membership is, if you like, stays with the person. The record stays with the person. And having them subject to the discipline of their peers I think is a well proven effective method over centuries in order to drive better levels of conduct.

MR HARRIS: Yes, yes. I interrupted your turn so keep going.

DR KING: That's fine, I'm right.

MR HARRIS: So I think you said you also were supporters of the regulatory sandbox kind of concept that's being used by ASIC in particular to, I guess, experiment a little with innovation in this sector. Can you just link in though - I mean, it's something that - I did read this in the notes for your presentation and it's the one thing that struck me as a query. I thought that's interesting, a professional standards body is actually supporting technology shifts. I'm not saying there's anything inconsistent in that, it's just that in my own experience from inquiries like this often professional standards bodies just eschew anything at all but the educative concept, and you're prepared to go further on a quite important issue, I think.

MR WHITEHEAD: Yes. I mean, it would be - I mean, we believe this industry, financial services, will be transformed and is being transformed by technology, and I think our challenge as a professional organisation is actually to support that and to help enable individuals who'd like to change, as well as organisations to change. So we're conscious of the disruptive effect on people's careers, how do we best position people for new careers, and to maintain their skills. So we're looking at our qualifications which FINSIA is introducing, and certainly considering within those qualifications how do they pick up concepts such as agile working and the adaptation of technology.

Having said that we think competitive principles should be enshrined in a professional code, then obviously I think recognising that the - and supporting the growth of innovative small organisations does require perhaps the kinds of concessions or staged regulatory approach that's being proposed. FINSIA is considering how it could support those organisations, and indeed has been approached by a number of fintechs in that regard in terms of how do we help them build their competency, demonstrate to regulators the competency and conduct to which they wish to be held. And so we think we have a role to play both within incumbent organisations, but also to support other organisations to raise them to the standards of the industry. And we have concern with regards to fintechs. It is of course - there should be no regulatory arbitrage. It should be seen as a staged approach to full regulatory surveillance.

MR HARRIS: Yes. You get relief for a period in order to test your idea, but you don't maintain that permanently as an advantage - - -

MR WHITEHEAD: Absolutely.

MR HARRIS: - - - as you become more significant in the system.

MR WHITEHEAD: And you require similar levels of competence. Ultimately you need to demonstrate similar levels of competence. One of the things that FINSIA can do, given its very senior membership across the industry, is actually connect fintechs up with experienced senior industry individuals, and that certainly can help as well. So beyond education we think there's a, like an industry networking opportunity, a connectivity opportunity.

DR KING: Are you thinking of it being almost a mentoring type of role?

MR WHITEHEAD: Yes mentoring, absolutely. And indeed fintechs may provide good opportunities for, new employment opportunities for senior members of the industry.

DR KING: I want to just switch track slightly. Just on the difference - I understand you're talking with your members on this, but our look at whether advisers who provide credit information, or who have wealth licences should also be able to provide credit information and we would be interested to get just your views on if you see any problem with that. I guess a starting point is to your knowledge do many of the wealth advisers currently also have credit licences or are they really very, very separate at the moment? Do you see any problems with allowing wealth advisers to move into that area?

MR WHITEHEAD: It's, as I say, something we would really like to consult with our members on. I think at first look we don't see enormous problems with that at the moment. Many would have referral type arrangements if they don't have their own, within their own organisations for instance, credit advice. Provision that they will have some kind of referral arrangements very atypically. So they are already involved, I think. To extend that, given appropriate safeguards around ensuring they have appropriate qualifications and going back to a code of conduct, then I can't see any reason why that would be a great issue.

MR HARRIS: And they have a different methodology. You mentioned commissions and the need to be, and to take care around the issue of churn, and I think we are conscious of churn. On the other hand, one person's churn is another person's competitive opportunity so there is

a, as ever, a balance to be struck here. But in the case of financial advisers, they have transited substantially to a different kind of model than a commission based structure. I'm not saying completely, and not saying in any sense it's absolute for either of the parties, but introducing them does introduce a different kind of potential for a charging structure, doesn't it?

MR WHITEHEAD: It does, and for instance I think one could consider to what extent does the effort and reward in terms of providing mortgage advice vary, depending on the size of the loan. Is there a substantial difference between the effort of a \$200,000 mortgage and a \$1 million mortgage? And should they have substantially different commission arrangements and so on? So I think there are opportunities to look at the impact on changing the approach that perhaps might better reflect the association of cost with effort.

DR KING: Do you think that - let's assume that the approach moved forward so that there was wealth advisers that could provide credit product advice, appropriately trained and appropriate professional code of conduct, but just to follow up on that point that currently their award structures are quite different, do you see that creating problems? In a sense, do we have to think about two things at the same time? You can't just say well, go into more credit as well as wealth without changing the current remuneration structure from mortgage brokers.

MR WHITEHEAD: Yes. I think you absolutely would have to look at remuneration structures. Of that I have no doubt because I mean you wouldn't want to take the advice industry back. It's been on this journey towards professionalisation to a large extent. It's the same journey that we're advocating more broadly across financial services, and therefore I think inevitably you have to look at remuneration, in the same way as the banking industry has looked at remuneration through the Sedgwick report, in the same way as remuneration has been reviewed under the financial advice changes over recent years. The two absolutely go together, and so remuneration is an important driver of outcomes in the mortgage broking industry.

DR KING: You notice the issue of potential churn, you notice the issue of is payments aligning with costs and time. Do you see any problems with moving the current reward structure for wealth advisers into the mortgage broking space?

MR WHITEHEAD: This is not something that FINSIA has done a lot of work on so perhaps it may be more of a personal comment based on my experience working in another jurisdiction and working closely within the UK banking and mortgage industry where there are no trail commissions. I think there is the potential for a significant shift in terms of product recommendations and so on that would - I understand your comment that one person's churn is another person's opportunity, but if you like you can generate more opportunities by putting customers into shorter term products which need more regular review and so on. So I think you can't just look at the point in time of a customer who is on this product, is there a better product. I think you have to say well, are we changing the product dynamics of the industry potentially? And that's why I think it would be worthwhile looking at other jurisdictions, and where there's a significant broker market which does not have an ongoing, for instance, trail commission what other mechanisms are there to ensure that we don't create some kind of distortion, not just in point of time advice but, if you like, in the industry structure and product structure.

MR HARRIS: What seems to be though exceptionally obvious in those kind of comments is that other markets don't necessarily need to use trail, and that's not just the UK as you mentioned but it's other finance markets in Australia have managed to shift themselves substantially away from trailing commissions and moreover that fee, that ongoing fee which implies, and brokers have stated this publicly, that it's their apparent intent to continue to service the customer as a consequence of that fee. Nevertheless they're not obliged to do so in the customer's interests. So this whole question of serving a party in the customer's interests seems to be the pivotal element of all this. It's like the claim appears to be you can have a payment and not create the conflict simply because we assert it as so, but the absence of some kind of enforceable standard which says you're receiving this payment and continuing to service the customer, fine, are you doing so in the customer's interests or in the interests of the party from whom you are receiving the money? It's quite an arguable proposition, isn't it?

MR WHITEHEAD: And behind my comment is really that those are jurisdictions that don't have a prevalence of trail commissions but do have other mechanisms for remuneration.

MR HARRIS: That's right. These do exist.

MR WHITEHEAD: And hence going back to yes, they have to be looked at in conjunction. If you change the advice model you have to look at how that advice is paid for.

MR HARRIS: Right. I don't have anything more for you. Do you have anything more?

DR KING: No, that's me done.

MR HARRIS: Okay. Do you want to check the remote monitor?

DR KING: And I think we've covered off on what Julie was after.

MR HARRIS: Excellent. Have we failed to ask you something that you otherwise would have liked to bring out and didn't make in your opening statement?

MR WHITEHEAD: No. I would like to thank you for the opportunity and commend you on the draft report and look forward to further progress.

MR HARRIS: We appreciate you making the time to come along and talk today, and for the submission that you are going to put in. Thank you.

MR WHITEHEAD: Thank you very much.

MR HARRIS: Okay. We are almost exactly on time and I think I have Mastercard down as the next group. Could you identify yourself for the record please?

MR SIOROKOS: Sure. Good morning, my name is Chris Siorokos. I am the Director of Public Policy for Australia for Mastercard.

MR HARRIS: Chris, do you have any opening comments that you would like to make?

MR SIOROKOS: Yes, I do. Thank you very much for allowing me to appear today on behalf of Mastercard. My comments are mainly going to focus on the recommendation regarding interchange. That's draft recommendation 10.3. And I will also touch on the recommendation relating to merchant routing. That's draft recommendation 10.4. But before I do that I just want to make a quick comment about Mastercard. I just want to, for the benefit of the room, Mastercard doesn't issue cards or provide credit. It's the issuing banks and financial institutions that do that. To put it really simply, we're not a bank. The banks are our customers. We're a payments network.

Getting on to interchange, as most people know interchange is a small fee. In Australia it's an average of 0.5% for credit and \$0.08 for debit and it's paid between banks to support the card payment system. And interchange helps issuers cover reasonable costs they incur. That's things like processing and authorisation, fraud and fraud protection and funding interest free days on transactions. I want to be clear, Mastercard doesn't earn revenue from interchange. In Australia we set interchange rates within the regulatory limits set by the Reserve Bank, and our interchange rates and categories are completely transparent and they're published on our website.

In terms of interchange it's important to set the balance, the level right and to get a balance, because if interchange rates are too high merchants may choose not to accept cards or deter card payments, and if interchange is too low issuing banks don't have an incentive to cover the risks of issuing cards. And we think flexible interchange rates make it possible for electronic card payments to deliver maximum value at the lowest cost for both merchants and consumers.

On debit, interchange supports the ability for consumers to safely spend their own money, not only in store but online overseas and over the phone. And in relation to credit, we know interchange supports the use of credit cards which increase sales. And according to the RBA, credit card sales at large merchants are on average about three times as large as cash transactions. And we know for retailers interchange delivers enormous value. It provides convenience, security and fraud protection, increased sales and guarantees that retailers are paid even when a cardholder doesn't repay a bank.

Retailers get guaranteed payment when they accept credit cards, freeing them from the worry of credit risk. And so every year banks write off two to four per cent of credit card balances as losses, a cost which would almost unavoidably sit with retailers without interchange, and the fact that interchange supports card payments.

Australian businesses benefit from overseas visitors using their cards and average transaction sizes for tourist transactions are significantly higher than domestic transactions. And we know that the value retailers receive in card payments is greater than the small cost they pay to accept cards. Some 2015 Mastercard data shows that the value provided to a merchant by electronic card payments products - credit payment products, I'm sorry - is at least two times greater than the total cost of acceptance to the merchant.

The RBA has been regulating interchange since 2003, and in 2017 the bank introduced an upper limit on the highest level of interchange for both debit and credit. The RBA's payment system board's decisions on interchange regulation followed extensive reviews that took into account the public interest, impacts on the economy and were based on a thorough understanding and

knowledge of the payment system. And while we didn't agree with all of their outcomes, we did acknowledge the thoroughness of their processes and their analyses.

We believe interchange is an incredibly efficient way of managing costs in the system. Having a whole range of different costs and charges at different points is unnecessarily complex for consumers and for merchants. And we know that international and Australian experience shows that when interchange is cut it's cardholders that pay the price.

The RBA has acknowledged that the costs to consumers for using their cards are now higher since regulation began in 2003, and they also acknowledge that the higher the interchange fee, the lower the cost to the consumer. So while cardholders are now paying more to use their cards, there's no proof that any savings to merchants have been passed on to consumers.

Banks and credit unions have already said that with lower interchange they'll have trouble continuing to offer low interest rate cards, and will have to look at interest rates. They've also previously warned that changing interchange will reduce their ability to fund innovation that benefits consumers like tap and go. Setting interchange at zero means the cost of running the system has to be made up elsewhere, and what we know is that elsewhere tends to fall on consumers in terms of higher fees, higher interest rates, shorter interest free periods and a curtailment of other benefits.

The way the system should work is that participants in the system get tremendous value from using cards that's greater than the costs associated. Merchants and cardholders benefit, and interchange is a good way of apportioning the costs to achieve that value.

Very quickly I want to touch on merchant routing as well. We will work with our customers to implement the Reserve Bank's efforts relating to least cost routing of transactions on contactless cards. We intend to remain competitive in a least cost routing environment, and indeed we believe that for low value transactions we're already the lowest cost.

So in conclusion, I'd just like to say we strongly believe interchange is an efficient way of allocating and managing costs in the payment system. We think interchange arrangements in the Australian market have been thoroughly examined several times already and are regulated by the Reserve Bank, and we don't see the need for further changes and we would urge the Commission to reconsider this recommendation as you work towards your final report. We have commissioned some research to help inform our submission that we will be making, and we will be happy to sit down with Commission staff to share the information we get from that research and to provide more information as required.

MR HARRIS: Thank you for that, and in fact particularly thank you for the data offer. I mean, you might have noted yesterday we did ask Westpac a little bit about their data sources that they thought might be available for this because they did make a comment on it, and we have found, as I have said in my speech on Monday, we've found quite an unusual lack of data in some areas, particularly where we're interested in making policy shifts. And so I think we do want to ask you for some more data based information, and therefore we would be taking advantage of your offer where you're able to provide it, and I guess it's - - -

MR SIOROKOS: Happy to help where we can.

MR HARRIS: - - - still a matter for judgment, but I guess - I don't think this context is going to go away as you've noted in there, but I'm going to turn the coin over and say yes, this has been reviewed many times in recent, well in relatively recent, in the last decade or so. And often the recommendation has been to cut it back to zero but the outcome has not been because the RBA will then take it on and it becomes a negotiation and most of us know in commercial negotiations that rarely one side walks away with all the goodies, and therefore zero is an unlikely outcome via a negotiated solution.

But anyway, that's all yet to be seen and experimented with. We are interested in getting better data and in particular we're quite interested in trying to separate out the trends in the use of debit and credit cards for transactions across the economy and the different cost impacts that are being imposed as a consequence of them. We know there are different prices, there appear to be different costs. Cost isn't the sole driving factor in all of this. I know it's often used as the basis for settling the negotiation. Let's find some costs and therefore we can attribute them and that will set the new price. But in this particular case I guess we're very much interested in the trend in the utilisation of different cards and the prices that seem to accompany them.

MR SIOROKOS: I don't have that information to hand on me today but we would be happy to sit down with the Commission and go through that stuff.

DR KING: I mean, just on that there's been a variety of what we can call natural experiments over time. We've seen a significant drop in Australia in the interchange fees. You've had - on credit particularly. You've seen debit cards interchange fee reverse at the same time as you've had ATM reforms, which obviously impact on debit. I don't know if Mastercard has done any work to try and tease apart the various effects that these have had. If you have done that sort of work then we would be very interested in seeing it and being able to understand it.

MR SIOROKOS: We have commissioned some research that is underway now and we're happy to share that with you. But I'd also say that what we have seen where interchange has been regulated is that benefits have been cut and those costs have been shifted. The costs don't leave the system.

DR KING: No, no.

MR SIOROKOS: They have to be paid somewhere.

MR HARRIS: Someone has got to pay the costs.

MR SIOROKOS: That's right. We believe interchange is an efficient way of allocating those costs.

MR HARRIS: It's interesting, because you did use some data points in your presentation and just so in a generic sense if I can refer to this as the half a per cent charge for interchange, you noted though as well that banks absorb two to four per cent every year in terms of fraudulent transactions, so clearly the pricing of the system overall involves a number of points in the chain where different parties are paying different fees. And I think the question with interchange fees is really whether it isn't a unique sort of factor of the Australian market that

we've developed for historical reasons, and that in other markets it doesn't seem to feature. So that's a point I'd like to get your view on. Clearly Mastercard is a global operation and it must know how these things operate in other jurisdictions. We read that they're different. Is it different and, if so, why is it different?

MR SIOROKOS: Look, interchange features to the best of my knowledge across most of Mastercard's network around the world. There are different regulatory arrangements in different countries. The thing about interchange is it tends to cover system wide costs. Fraud is a system wide cost. Processing and transactions are a system wide cost. Fraud prevention is a system wide cost. They need to be covered and met somewhere, and in Australia those costs are regulated. There's a 50 per cent weighted average and an 80 basis - sorry, a half a per cent weighted average and an 80 basis point cap. So the costs, as I said before, those costs still exist. It's much trickier in a regulated environment to manage those effectively, and what we have seen overseas as well, particularly in Europe and in the US where interchange has been regulated as well, is that those costs tend to fall on consumers even though merchants and others get value from using electronic payment products.

DR KING: Just on that - - -

MR HARRIS: Can I just ask one thing on that?

DR KING: Sorry, yes.

MR HARRIS: But it is quite hard for the small business to pass on a set of specific fees in the way that the Commission, sorry, the way the fee structures are set up here. As you say there are multiple, clearly there are multiple charges for the utilisation of the payment system. If for no other reason we can say that because this one is covered by a half a per cent and, as you say, it's apparently linked, mentally at least, to generic costs across the system but banks are losing two to four per cent every year just through fraud and there's more costs than just fraud. So clearly there's multiple charges here. It is just very difficult to imagine that a merchant is ever able to - a smaller merchant is ever able to pass it on in the sense of saying I've got to pay my contribution towards this interchange fee here, my contribution towards my general access to the payments. You know, all that set of fees. It's very hard to imagine that any smaller business is able to pass that on. We see larger businesses quite capable of doing this in their own utilisation of credit cards. We see, you know, hotels and airlines and things like that. But it's a relatively rare event it seems to me to encounter this at the bulk of smaller businesses.

And the motivation for us was really market power. This is a competition inquiry. Is market power being exercised here by the payment system upon the small to medium enterprise via this kind of charge, and might it not be better for there simply to be a single cost for utilisation of the payment system which then at least a merchant is able to say well, I know what it is in total. I can pay it or I can pass it on. But you get greater clarity. So it is almost a philosophical question about your preferred approach. Does multiple fees allow market power to be exercised? That's what it comes down to.

MR SIOROKOS: Can I just go back a step just to clarify something?

MR HARRIS: Sure.

MR SIOROKOS: The two to four per cent I mentioned, that was credit losses, not necessarily fraud. That could be me walking into a department store, buying a TV on my card and deciding not to pay back the bank because I've lost my job.

MR HARRIS: Sure, sorry if I - - -

MR SIOROKOS: No, that's okay.

MR HARRIS: - - - wrongly shorthanded you. I was more thinking there's a lot of costs.

MR SIOROKOS: Yes, absolutely.

MR HARRIS: They're being recovered. We know they're being recovered.

MR SIOROKOS: Absolutely.

MR HARRIS: We're all going to agree someone is recovering them somewhere, and so this threshold question is do these multiple allocations of fees allow exercise of market power which larger businesses are probably able to track and aggregate it and make sure that they're getting it all back. Smaller businesses are just there copping it. That's the question.

MR SIOROKOS: Look, I guess from our perspective I will just reiterate the point that we don't make money from interchange. Our interest is in growing the electronic payments network because the more the payments network grows the better it is for us and our revenue because we make small amounts of revenue on transactions. So for us, we don't make money from interchange. So we have no interest in seeing interchange being distorted in a way that doesn't maximise the efficiency of the system. Like I said earlier, that means making sure that there are incentives for people to issue cards and there are incentives in the marketplace for people to, for merchants to accept electronic payments and not try to deter them.

So in terms of a payment system, that's where we sit and we think that interchange is an efficient way of allocating some of those costs. And there's absolutely an argument to be made about transparency, particularly for smaller merchants, in the information they get from their acquirers about how costs are made up, and I think the ACCC has gone some way to helping deliver that by providing, by requiring the acquirers to provide statements that kind of, to a degree, break down and give smaller merchants better information about the costs of acceptance. And we think there needs to be more done in that regard, particularly in relation to education.

But I would also go back to the point that - and again, happy to share this with the Commission in separate discussions - that merchants get more value out of accepting electronic payments than the costs associated with accepting them.

MR HARRIS: I don't think anybody here is going to debate the immense value of having, as you pointed out, a reliable payment system that simply says if you accept this piece of plastic and it goes "beep" you're going to get the money. I mean, as a confidence inducing measure,

as a technological advance, fine stuff, absolutely. The question is really mentally for us how does the structure of fees translate into the potential exercise of market power where we know some parties are probably better able to deal with this via their ability to onward charge than, for example, I think smaller businesses in sort of the highly competitive markets that you get in - you know, spaces without trying to pick out particular businesses, although I could if anyone wanted to. But anyway, we won't. I think that's a - - -

DR KING: Can I call on an example of that, because until recently - and I understand the Reserve Bank rules changed in July last year - but one of the issues that creates some concern for us is when merchants face very non-transparent acceptance fees. So I can wander in with a card, let's say a Mastercard issued by a bank in Australia, and depending on the colour of that card, for want of a better term, whether it's a platinum or a black or a gold or a grey, the merchant can be paying quite different fees and they go back to the interchange fee. So there's different interchange fees, or there has been different interchange fees, for each of those cards. Some of those you can say well, they reflect different costs to the issuer, and certainly they do. But some of those costs are reflecting payments by the issuer to customers to use the card. I mean, reward points being obviously a negative payment by the customer. They're a reward to the customer for using that card.

So it concerns us from a competitive perspective when we see a bank on one side paying customers an incentive to use a card that has a very high interchange fee, that leads to a very high merchant service fee, where that merchant cannot know the exact cost of accepting that card when they accept it. Maybe we're naive, but it sounds to us like that's a route for an abuse of market power.

MR SIOROKOS: Well, I think at the end of - and I'm just trying to jog my memory here. It's either at the end of every month or after a period of months the ACCC now requires acquirers to provide cost acceptance information to merchants and split up between debit and credit. So they can start making decisions based on that information about how they accept cards and what they want to do in terms of things like surcharging, which we don't support but we understand that the ACCC allows acceptable costs to be passed on. Most merchants don't do that.

MR HARRIS: Mostly by big businesses who are successful at passing on a surcharge.

MR SIOROKOS: Well, most merchants don't do that because they recognise the value of card payments. And I know anecdotes don't prove anything, but my local butcher shop is now run by the sons of the butcher who recently retired and I was talking to them a couple of weeks ago, and one of the first things they said is they love tap and go because it speeds up their Saturday mornings. It's just one of those things. They understand the value and they're happy to do it. Dad didn't have any form of electronic payments. It was one of the first things that they did when they took over.

MR HARRIS: Yes. No, I don't think anyone is questioning the quality of the technological advance. It's more the ability of the smaller business to decide for itself whether it must absorb this or - simply because it's too complicated a), to work out the nature of the fees they're being charged, and b), to decide how potentially to pass that on to a customer. And thus, you did make the point which says when the interchange fees came down there's no evidence

consumers got a benefit out of that. And here is the crucial question. But did they ever, did consumers ever receive in the first place the higher charge impact or did the merchant absorb it because - particularly again this is at the small to medium enterprise level where it's a complicated thing to decide how much to pass on and there's such ruthless competition in their space of the business, versus the larger duopoly businesses that do operate a lot in Australia who can pass on those fees and have got the capability in the back office to work out what the hell they were and what's a reasonable number.

That's the big question. It comes as Stephen said, we're trying to emphasise this is not about us saying isn't it dreadful that there's a cost to using the payment system. That is not our view. We're simply saying does the structure of this create the potential for exploitation of market power? That's the key question for us.

MR SIOROKOS: We certainly think that there should be more transparency for merchants in costs so that they can make informed decisions and have negotiations with their acquirers about what those costs should be. And, for example, you know in a merchant routing context least cost routing is an important thing but there - in order for that to work properly merchants need to understand what the breakdown of their costs are, interchange, acquirer fees, everything else, so that then they can - - -

MR HARRIS: They know what least cost is.

MR SIOROKOS: That's right. That's right, they know what least cost is and then they can have that negotiation with their bank or their acquirer. And we have no issue with that kind of transparency.

MR HARRIS: And you will have seen in the draft report, because we were advised this and we think it's right - in fact, I think you guys might have advised us this as well. But anyway, we received information which says in other markets this choice of least cost pathway is relatively readily available. In some cases it's actually mandated, but in other cases it's driven by market pressures, I assume. But it's relatively readily available. And in Australia it may be the case that it is available more optionally, and so for us it is a threshold question. Is this going to, as it were, take hold without any regulatory support, or does it need regulatory support to see this choice made readily available?

MR SIOROKOS: Last week the Payment Systems Board released the update of their meeting and they said that they were happy with the progress being made to date and they look forward to it being rolled out. So the indications are that it will happen, but for it to be effective there needs to be that price transparency in our view. And ultimately the other thing we think is important in that whole discussion and debate is consumers need to have the final choice about what rails, I guess, their payment goes down.

MR HARRIS: Quite, and so they need to know what is least cost as well. Again, and we shouldn't do anecdotes - so I tried this in my younger daughter's business, just asking some customers did they know what the least cost payment was. And nobody knew what the - which is, you know, not surprising. But do you see what I mean? So they're not even able to make the choice either.

MR SIOROKOS: But again, it means different things to different people, I guess. I mean, to some people least cost might mean least cost of time or I don't want to be carrying cash around, or whatever.

MR HARRIS: And that's a good point, because it relates to tap and go doesn't it? It's the utter convenience. As you say, the throughput for the butcher shop example that you used, just the Saturday morning crush. So the utter convenience, and people - perhaps they don't really want to know. But it goes to this question mark about if they don't know can they ever exercise decent choice or not?

DR KING: Can I just follow up a couple of things on that approach? So Mastercard doesn't impose any conditions or put any barriers in the way to a merchant choosing, for example to use the EFTPOS network for a direct debit rather than the Mastercard network?

MR SIOROKOS: I will need to double check that. I'll come back to you on that.

DR KING: If you could that would be fantastic. You did say that it should be the customer's choice of the network, but the customer doesn't pay the difference in the network charges, as I understand it. That would be a merchant cost. So that's a bit like the customer saying, "Well gee, I want my stuff kept in the gold fridge over there, not my beer kept in that other fridge over there." I mean, we don't normally say that a customer should have a choice over a production decision by a merchant, and this is just a production decision.

MR SIOROKOS: Well, probably not in our view because, for example, our cards may hold different benefits to a generic EFTPOS card. There are certain merchants who say if you pay with your Mastercard you will get blah. Like, you will get a free packet of chips, whatever.

DR KING: I understand, but is that also down to the routing on the Mastercard network? So would you expect consumers to be rewarded for using Mastercard?

MR SIOROKOS: No. If the consumer thinks that they're - they have reasons for thinking they may get particular benefits using a particular - - -

DR KING: Points and things.

MR SIOROKOS: Yes. There's not that many points on debit cards, but there may be other reasons they may wish to use their debit card, and they should know that if they tap that they won't be using their debit card, and if they - it will be going down other rails because there may be reasons they may want to use that card, that Mastercard debit card, as opposed to an EFTPOS function for other reasons like a competition or something else.

MR HARRIS: Okay. I would actually - I must confess I'd be worried about the competition implications if it suddenly became the equivalent of please make sure that your merchant gets the beer out of the fridge branded - - -

MR SIOROKOS: No, no, we're not saying that at all. That's not what we're saying.

MR HARRIS: - - - because we'll give you some reward points.

MR SIOROKOS: No, no. People have - probably not a great example. People have different reasons for wanting to use different payment methods and ultimately it's their money. They should know what's happening and they should be able to override that in some way if they choose. And that's consistent with the RBA's position as well.

MR HARRIS: Yes, I understand all of that, but it just seems to be that it's the way that the network used to transmit the transaction, coming out of the same account for the customer, I must confess I have problems, that that's a production system that should be completely irrelevant for the customer.

MR SIOROKOS: Well, there are things like chargeback rights. That up until very, very recently you had much better chargeback rights using a scheme card than an EFTPOS card. There have been countless examples and every second weekend there's a story in the papers about a wedding dress shop that goes bust and the bride and groom lose the dress and their clothes. The chargeback rights with a scheme card are different, and up until recently were much different and much better using the international scheme cards. So they're the kinds of decisions that people may wish to make.

DR KING: And should be empowered to do so.

MR SIOROKOS: Yes.

DR KING: Just on that, I just wanted to come back to one of the figures you mentioned earlier which is the two to four per cent written off on credit cards. How much of that is borne by the merchant bank acquirers versus the issuing banks? I mean, are you able to - - -

MR SIOROKOS: Not right now, but I can see if I can get that information to you.

DR KING: Yes, because obviously if you are justifying the interchange fee on that basis it should only be the part that goes to the issuing banks.

MR SIOROKOS: Yes. I mean, I presume it's the issuing banks because they're the ones that are extending the credit but I'll - - -

DR KING: Yes. I'm not sure how much with the card not present, or something like that.

MR SIOROKOS: I don't - yes, I'll get back to you on that.

DR KING: That would be good, thanks.

MR HARRIS: Finally, new payments platform?

MR SIOROKOS: Yes.

MR HARRIS: Everyone is very keen on the new payments platform. It took us a while to work out what it actually did do beyond the impressive technology. So is Mastercard engaged with the new payments platform in a direct sense?

MR SIOROKOS: Not in a direct sense, no.

MR HARRIS: No?

MR SIOROKOS: No.

MR HARRIS: This goes to, I guess, the core concept of the business and therefore might be - I'm not asking you to bind Mastercard. Is it likely, do you think, that - let's just say entities in your part of the payments business would find the new payments platform a necessary and valuable place to take some form of - I guess "ownership" is a term that can be used here. Some form of ownership. Would you look to being directly engaged?

MR SIOROKOS: Look, I can't comment on that specifically. We do run faster payment networks in other parts of the world, but in terms of the NPP I'll have to get back to you on that.

MR HARRIS: And what about overlays, as they call them? Apps that run across the system, that kind of thing.

MR SIOROKOS: Potentially, yes.

MR HARRIS: So it's more likely - I'm going to put words in your mouth and you're going to tell me still I can't tell you that, but more likely that you're going to be a sort of - how can I put it? A one step removed user of the convenience, to the extent the convenience extends to your part of the payment system. Would that be right?

MR SIOROKOS: You're right. I will say I can't tell you that.

MR HARRIS: You can't tell me that? Okay.

MR SIOROKOS: It seems that yes, that what you said seems logical, yes.

MR HARRIS: Okay, that's fine. Anything else?

DR KING: Yes, just on that, I mean internally does - I mean, in a sense NPP is a competitor to Mastercard and to Visa so is it viewed that way? Is it viewed as a competitive threat by Mastercard?

MR SIOROKOS: Look, the payments landscape is changing incredibly. There are new competitors springing up all the time. We're confident that our system delivers what it needs to deliver to cardholders and to merchants, and will continue to do so. But having said that, we'll continue to evolve it as well to make sure it does.

MR HARRIS: The most interesting thing here is this app based utilisation. It's very popular I think in Australia. You know, we are quick technology adopters and interestingly it almost seems like it's another mechanism for a party that has a card based brand to use that brand without even a card. You know, the ways that you could potentially see the system being used

seem to be quite remarkable, and in that sense it could be quite a diversification opportunity where it's an app rather than a plastic card. The same sort of outcome though really.

MR SIOROKOS: Sure, and I think we've already got products that are non-card products. Bankwest recently released a ring that you just tap and off you go. There are payment bands. You're right, mobile phone applications, all these things are happening.

MR HARRIS: And almost everybody has to be in the game almost just in case, if you're a very large user, because there's the possibility of being disrupted by somebody else who - - -

MR SIOROKOS: Yes, the world is changing very, very quickly.

MR HARRIS: Yes. Anyway, I just thought you might have something that might have been put forward on that because we are interested in the adaptation of the system and its accessibility to all parties.

MR SIOROKOS: And again, happy to provide information on that.

MR HARRIS: Yes, we might - when we come - we might come and have a further discussion with you.

MR SIOROKOS: No, more than happy to do that.

MR HARRIS: Okay. Thank you very much for making your time today and for the offer of an information exchange and possibly some data. That would be great.

MR SIOROKOS: Again, thank you for giving me the opportunity.

DR KING: Thanks Chris.

MR HARRIS: Okay. I think people who have managed to sustain themselves through the first hour get the opportunity of a free cup of tea and a stale biscuit, or something better than that. So we're just going to suspend the hearing for 15 minutes while people take advantage of our generosity.

ADJOURNED

[11.01 am]

RESUMED

[11.17 am]

MR HARRIS: So we will be resuming hearings now in Sydney on the nature of competitiveness in the financial system, and I think we have the Business Council of Cooperatives and Mutuals.

MS MORRISON: That's correct, you have Commissioner.

MR HARRIS: When you have settled yourselves appropriately could you identify yourselves on the record for the purpose of the transcript?

MS MORRISON: Yes, thank you very much. Melina Morrison, I'm the CEO of the Business Council of Cooperatives and Mutuals.

MR HUNT: And I am Peter Hunt who is a consultant working with the BCCM.

MR HARRIS: And I think we have met with you before - - -

MR HUNT: Yes.

MR HARRIS: - - - in the course of this inquiry. Do you have opening comments you would like to make?

MS MORRISON: I do have a few comments. So, thank you very much. First of all, thank you for the opportunity to provide some follow up remarks on the draft report and speak at this hearing. The context for the inquiry into competition in the Australian financial system is vital to ensure that we have a world class competitive industry that provides the best outcomes for consumers of financial services, especially genuine choice and marketplace competition, to deliver the highest quality products and services at the most affordable price. And this competition and choice issue is very close to our heart.

The Business Council of Cooperatives and Mutuals represents a vast network of enterprises, some 2,000 in number, of cooperative and mutually owned organisations operating in sectors including finance and banking, insurance, agriculture, motoring services, health services, aged care, disability, education, indigenous, housing and retail.

Cooperatives and mutuals, CMEs, cooperative and mutual enterprises, are distinguished by their ownership model. Regardless of what legal form they use, they are owned by their members and operate for member benefit. Member benefit can mean a wide range of social and non-financial benefits as distinct from the financial returns enjoyed by an investor in a publicly listed entity. Membership is tied to contributing to or making use of the cooperative or mutual, and this ensures that the CME is made up of people who share its common purpose. We know that all businesses exist to serve their owners. The difference in a CME is that the owners are the members.

The draft report of the Productivity Commission's inquiry discussed here today does recognise the competition effect of this business model. In addressing the topic of price competition in banking, the Productivity Commission writes on page 10, "An exception may be the mutual ADIs which do not face the same shareholder pressures as other ADIs. The Customer Owned Banking Association reports its members' standard variable rate on home loans average 0.4 to 0.8% points lower than the major banks' rates. However, their scope to lower lending rates further is probably even more limited than other ADIs simply due to narrower sources of funding." This statement also recognises one of the key barriers to competition for mutuals, and that is access to capital which my colleague, Peter Hunt, will elaborate on.

The BCCM represents a very important part of the Australian economy. Eight in ten Australians are members of at least one CME, with many Australians being members of multiple entities. There are 28 million memberships in total, which is more than the population. The sector provides core business support for over 174,000 SME businesses. And in some sectors, like private health insurance, automotive repair and independent liquor stores, CMEs are a bulwark against further concentration and market monopolisation by fewer and fewer entities. In retail banking, the credit unions, mutual banks and building societies represented by the peak body for customer owned banks, offer genuine marketplace choice to the consumer.

The Productivity Commission report in its draft report also examines the effect of the shareholder model on consumers, saying consumers have lost their market power to shareholders. Publicly listed institutions are required to act in the interests of their shareholders when devising their competitive strategies. This means they're motivated to keep prices high in order to deliver profits that are in line with market expectations. They're also motivated to give the appearance of a diverse market through sub-brand strategies. Mutual banks are genuinely autonomous, independent entities.

The BCCM supports diverse corporate ownership. Among policy makers a new awareness has emerged of the importance of spreading risk in economies by ensuring the presence of a plurality of business types. A vibrant economy requires businesses of all types to be able to compete, regardless of corporate form. This means that appropriate legislative frameworks are required that do not restrict particular types of firms from being able to access the finance capital they need to facilitate their growth and development. And that's why we recommend the soonest and full implementation of the recommendations of the independent inquiry into access to capital for cooperative and mutual entities, the Hammond Review.

I think I will close here and hand over to Peter for some opening remarks. I will just end by saying that the evidence of the global financial crisis is that CMEs, cooperative and mutual enterprises, have generally been more resilient than listed firms. During the financial crisis of 2008 and the following years of economic turmoil, CMEs in the financial sector have not faced the levels of difficulty encountered by the banking sector and by certain other insurers. The Australian CME sector plays an essential role in this stable and resilient economy, and including the global economy, especially in times of crisis by combining profitability with solidarity, creating high quality onshore jobs, and strengthening social, economic and regional cohesion. And that's why we recommend action to increase competition from the sector. thank you.

MR HARRIS: Peter?

MR HUNT: Thank you, Peter. So if we can concentrate on just the financial services part of the mutual sector, one of the aspects of the work that we've been doing with BCCM is to look at different countries and to see where there are interesting contrasts and interesting learnings that we can potentially apply in Australia.

The sort of headline to all of this is that in many parts of the world coops and mutuals in retail banking, for example, are very significant players. So you could choose Germany as an example, where a third of the retail banking market is in cooperatively owned banks. You can look at some anomalous situations, such as Rabo Bank which has a dominant market presence

in The Netherlands. And you can look at the French cooperative and mutual financial services businesses which are equally dominant in their sector.

But even if you take into account that there are very special circumstances in individual countries, if you start to look across, look at the European Union, and you can see that there are probably six or seven countries where cooperative and mutual banks are more than a quarter of the total retail market. So they're significant players in those countries. I mean, we're talking about France, Germany, Denmark, Italy - I will check my notes - Netherlands, Finland, and probably one other. But in all of those situations you can't just say there's just one local factor which is the cause for this particular difference. And as you know from that list of different countries, you've got some very sophisticated and successful economies there too.

So I would try and compare and contrast with the Australian situation. And I pick out three factors really which are significant in keeping down the size of the cooperative and mutual banking sector here. So the first is the lack of understanding of business purpose. And Melina has already talked about the differences that coops and mutuals have, and the different reason for doing business which is to serve their customer members. Now, this isn't just an interesting fact about them. It's actually part of the DNA of how they operate, and it changes the way they run their business strategies. It changes the way that they operate their businesses, and have done so for many years.

So this lack of understanding of this purpose is pretty widespread. I mean, you could actually say the same thing in the UK. You know, there's a very similar lack of understanding of business purpose. And so there's almost like an expectation that the right way of doing business is to do it through listed shareholder owned businesses, and everything else is a bit odd or a bit weird.

Now, the consequences of that lack of understanding and lack of appreciation of the different business purpose of mutuals is that as a result they get forgotten when it comes to regulation and legislation. And this a really big issue, a really crucial factor when you start to look at the different regimes in operation in different countries. Because the weakness in legislation and regulation isn't antagonistic towards coops and mutuals, as far as I can tell, but it's just that they're not thought of. They're not seen as important enough. And so effectively you've ended up with a self-fulfilling situation where the lack of understanding leads to lack of notice, and legislation starts to be less useful, doesn't keep up to date and regulation can be a bit one size fits all. And I think you will hear that from other witnesses who talk about the way that coop and mutual financial institutions operate.

Of course, the third factor in all of this is demutualisation. And if you hadn't had demutualisation you'd still have a much more significant sector. But demutualisation isn't just one of those things that happens like the weather. It's something that has been brought about by positive legislative action. And so if you look across the world, the only countries that have demutualisation are countries that have legislated to permit demutualisation. And going right back to the beginning of these types of businesses, they were never established with the intention that on one day at some point in the future the members of that organisation on that day would distribute the loot among themselves. But that's exactly what has happened, and that's why you don't have any conversation about an insurance mutual sector in Australia.

So the question is what do you do about it? The Hammond Review looked at capital raising because this is one of the, I guess, best examples of what happens when you don't get the environment right and you don't understand the purpose of the businesses. And so there are fewer options for those businesses to operate. And this capital conundrum, which has always been there and is shared around the world for coop and mutual businesses, is that if you take an external investment does that mean you're no longer a mutual? At which point does that take over the purpose of the business? And so, as a result you find that they stick with raising capital and spending the capital through retained earnings because they don't want to lose their independence.

The reason that that is a particular problem, I would say more so in the Anglo legal system countries, is that there are few options for those mutuals. And do if you follow the expected capital raising line then you demutualise, and that is seen as the natural conclusion. What you can, as an alternative, have are different capital instruments that have different features which mutuals themselves are only permitted to issue, and that's the work that's going on at the moment with Treasury which has the government's support for new legislation.

The idea is that it would do two things. So the first is that it would create a new type of capital instrument, a new type of security which only mutuals can issue. So they can safely issue it, raise investor money but they won't risk demutualising themselves by doing so. So the easiest way of describing it is it's a bit like a preference share. But it's more than that. It's actually setting the legislation as being safe to use within the mutual business without losing the mutual purpose.

Of course, the second part of that which is a corollary to it, which is that if you're going to say that only mutuals can issue this instrument you've got to define what a mutual is. And because of the lack of understanding of the business purposes, there is a big gap in the Corporations Act where there's no mention of the mutual type of business, except to describe how you can demutualise it.

So I wasn't around when the different pieces of legislation were rolled in together to create the Corporations Act, so I can only speculate on how it came about. But what it's left us with is a sub-optimal legislative system which has the consequence of keeping a very useful part of the financial services market small, of making it less able to grow, compete and to toe to toe it with the bigger institutions, and as a result you have less corporate diversity and less competition and less choice for the consumers.

MR HARRIS: So you've got a process therefore to enable or in train - it hasn't delivered yet - but that might enable you to access wider sources of capital than just effectively self-generated from the membership. Is it in some sense insufficient? Is that the proposition? Is it not going to deliver you the ability therefore for this sector to grow in a competitive fashion? Is that the proposition?

MR HUNT: Well, it hasn't happened yet so we're very keen that - - -

MR HARRIS: But I think you said it was under active consideration and blah, blah.

MR HUNT: Well it is, yes. But the legislation hasn't been drafted. It hasn't been presented to parliament, and it hasn't got the - there isn't a sufficient regime around it yet for how it will operate with the regulators. And so it's very important to BCCM to make sure that there is a concentration on this very significant change which is being proposed to ensure that it actually happens, it isn't forgotten, and that it actually delivers in the way that it was intended to do and as Greg Hammond recommended it ought to do. You know, we are in as interesting political times as ever. A change of government could change people's priorities. You know, we're very keen that developing legislation would actually be seen through to the final day, regardless of who is in power.

MR HARRIS: Is there a press release? Being a public servant of long standing I know that the second most powerful document in the government is a press release. A cabinet decision is your best, but after that then there's the press release.

MR HUNT: There was a videoed speech, and so

MR HARRIS: Oh.

MR HUNT: No, he was actually there.

MR HARRIS: Yes, I know.

MR HUNT: So the Federal Treasurer made an announcement on 8 November that he wanted to see this legislation brought before the Federal Parliament by September 2018. It's a tall order. There's a lot of drafting to be done. We've been working with industry and with the representative bodies within the industry, because this doesn't just apply to financial services mutuals, it applies to all types of mutuals because you can't do something for one industry sector when it's actually legislation for everybody that is affected.

So we're in the process now of seeking to influence the drafting instructions that Treasury are putting forward. But there's a great gap between what industry believes is necessary, what Treasury in principle supports, and what eventually gets to Parliament. So we want to keep people's eyes on this and to keep people's interest in it, and so as many people as possible should be aware that this is actually going on because it could actually have quite significant effects in a whole range of different areas, not least your own considerations of productivity in financial services.

DR KING: The direction though you're going - because there are, at least with regards to coops, with regards to any coops, they currently have mechanisms to allow them to raise some extra capital, the most obvious being the A class, B class type of shares that we've seen. So this will be a different type of form because when I think of who's done the A class, B class shares. I also think of AWB, and that was very - Murray Goldman and - okay. So how is this reform going to be sort of different to the sort of existing opportunity that's out there, at least for the coops? I don't know about the broader mutual sector.

MR HUNT: So, it borrows experience. Are you okay for me to carry on?

MS MORRISON: Yes.

MR HUNT: Yes. It borrows experience from legislation that has been brought forward in the United Kingdom for building societies in 2013, for mutual insurers in 2015, which has gone through the process of creating this particular new type of, let's call it - it's a security - which can only be issued by those types of businesses. Because one of the problems in all of this is that you can safeguard your firm through your constitution until your members have a problem, and you've alluded to one of the best examples of where something goes wrong and the whole thing ceases to be what it was initially intended to be.

The point of these instruments is to try to create in an Anglo legal system as close as possible to a mutual instrument that you might get in other jurisdictions. So in France, for example, it's not possible to demutualise. We're not going as far as to say it shouldn't be possible to demutualise, although there is an interesting philosophical discussion to be had about how that actually takes place and who actually ought to benefit from all of that.

But in the French legal system it's not possible to demutualise because the assets, the underlying assets, have to be transferred to either another mutual or not distributed to the individual members. So it just draws the poison out of the whole process.

We don't think it's possible in the Australian or the UK or the Canadian system to replicate that, but you can have an Anglo answer to it which is to have a different type of share which has limited rights in legislation so it's absolutely clear what people are getting for their investment, and what - - -

DR KING: Does it create - and again, sorry for my limited knowledge in this area, but it seemed a standard agricultural coop approach can create a conflict, an internal conflict, that there's a duty to the class A shareholders, who are generally farmers, but then there's also a fiduciary duty to the class B shareholders in terms of profit distribution and in at least one case we know that there were certain promises made on issuing those shares, and that's under investigation. But how do you get around that problem, that conflict of fiduciary duty?

MR HUNT: Well, you're describing what the problem is at the moment.

DR KING: Today, I know. So I'm wondering how this new instrument does it.

MR HUNT: Well, to begin with it doesn't carry those promises. So if you are looking at the institutional offer of say, for example, a large credit union wanted to issue these instruments to an institution, or a group of institutions, then the difference between that and what you've just described is that firstly, under no circumstances will the holders of any securities have more than one vote, which then - in many cases we expect they won't have any votes. They'll be non-voting entirely, to fit in with the government structure of the existing mutual. But more to the point, in terms of the offer document it will offer an indicative return. But it won't be a promise, and it would be reliant on the existing governance structure actually supporting it. So there'd need to be a vote, either through the board or through - depending on what each individual mutual wanted to do. Whether they wanted to do it through their membership every year or whether they wanted to do it through their board every year.

I will give you an example. A nationwide building society in the United Kingdom successfully got away 500 million pounds of these types of instruments, and there is no guarantee to pay a dividend on it but there is an indicative dividend which, of course, if you don't meet it you're not going to be able to market it. But there is no guarantee in all of that. And that again borrows from examples in Canada, from Dajavan Group and in France where there are external investments made into these businesses but they don't have the same ordinary share relationship that you might have in a listed firm. So it's a different type of share.

Now, then the question is is that worldly? Is it marketable? Do people want to buy it? Well, the nationwide one was three times over-subscribed. Rabo Bank have a slightly different approach because technically the certificates that they offer to institutions and to individuals are debt instruments, but they also have an indicative return attached to them. Again, no promise. And it's the strength of the institution, the strength of the individual business, which decides whether these instruments are successful or not.

MR HARRIS: The interesting question, Peter, really though is an expansion of capital for this sector, which is what you're saying is on the cards and you'd like to see occur by this instrument that in the end holds out some indicative perhaps, but some promise of a return, is a different source of funding than traditionally used by the sector, which is generated by the members themselves. In other words, the members' willingness to take a very low rate of return on deposits is an important source of capital. Mind you, you could probably say that for a lot of the financial sector now, a very low rate of return on deposits. But never mind. And that's translated to a willingness for mutuals to offer rates for certain loan purposes, not every loan purpose but some quite important ones, that are below the prevailing market rates. And so that's why we comment on - and Melina, you have read that out. So the question is what happens with this expansion of capital?

I mean, there's - how is it that a new style investor, this new instrument, is going to accept such a relatively low rate of return that you're going to be able to maintain that somewhat desirable, I would have thought, in a competitive sense, which is why you've mentioned it, the price in the marketplace which suggests that it is possible to be a sustainable institution and offer a cheaper price than the current generally prevailing price in the marketplace from the large businesses. I mean, that's the big question. What does this instrument do to the ability to maintain what looks like an attractive competitive rate? Because this is a competition inquiry, so we're really asking about the competition effect.

MR HUNT: Well, it's an interesting question because you don't know until it's happened what the actual effect is. But one of the things to take into account is that in some circumstances it will be a retail instrument and it will be offered potentially through existing membership networks. And so, although you talk about there being a new stakeholder of investor, it could actually be the customers themselves. And if you then look at a living, breathing example of this, the German Volksbanken. They get about 20 per cent of their capital from their individual customer members. So it's not impossible to see that kind of investment taking place in Australia too.

For institutions, you already have the larger ADIs, mutual ADIs, working in the medium term debt market and those are the types of investors that would be interested, from our experience in the UK, that would be interested in this kind of instrument.

So in many ways there's no single answer to it because it depends on the institution that's doing the issuance, it depends how much of it they're seeking to issue, and the manner in which they distribute it, whether it's wholesale or retail, or both. So if you think about what they would spend the money on, which is really the point in all of this, why do they need the money? They can sit in their niche, do a very good job, as they do at the moment, but be restricted in the way

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MR HARRIS: This is the question. This is the ultimate question.

MR HUNT: Yes.

MR HARRIS: So you're repeating back to me what I've said to you. So we're both sitting here thinking it's not clear whether access to this instrument will make mutuals a significant, or change significantly their ability to influence price in the market. Right now, it is a niche. It's an important niche and it's good for the members and all good as far as that goes, but we were really looking at who is an entity that could be a competitive force here, and we see the restrictions that mutuals impose upon themselves about how they access capital as being a natural and limiting factor. You're saying there might be a diversification opportunity here, and I'm really trying to work out whether it's a diversification opportunity that an inquiry like this can say hooray for because we could sustain the argument that this will translate into a wider part of the community. You know, at a price that says look, it's possible to be commercially sustainable, which these businesses are, and still be 0.4 to 0.8 below the prevailing home loan rate.

MR HUNT: Well, imagine a business that would be interested in growing through acquisition. Imagine a business that wants to invest significantly in fintech. Imagine a business that at the moment can only do that through its retained earnings or - and with the consequential effects that it has on its capital ratios. So actually what we're talking about here is an injection of new permanent capital which is about getting new stakeholders on board to go the journey with the business, and to expand the horizons of those businesses. They will only succeed if the management are up to it, and so there's no simple answer to say, "Oh well, this is a panacea", because it depends on how well it's actually executed in the individual cases.

MR HARRIS: Yes. The reason we're - I don't want to sound ultra-reluctant, but as you can tell from the rest of the report there has been quite a bit of relatively superficial advice which says lots more new entrants in banking will create lots more competition. Now, we indicate there have been quite a lot of entrants and it hasn't created a lot more competition. So we just don't want policy makers to imagine that expanding the nature of the number of competitors and the size of competitors - you know, this whole thing about ...(indistinct)... as far as the four pillars - the bigness of the competitors is actually a force for competition. It's not really. Not in the current regulated constraints that exist in this kind of unique market.

It's not undesirable, but it's not undesirable for other reasons, I think. You would like to see every business that is capable of doing more get the chance to do more. That's just sort of, just a - and your point, I think, made earlier was mutuals have been forgotten in the overall structure of corporations law reform and the role that mutuals could have played, and have played in other countries. Which makes it still desirable. It's just for us it's a question of, you know,

how firmly we can say this is a force for competition. That's why I'm really interested in that particular question.

Anyway, you might want to think a little further on that and if you've got some things to come back to us on with this that would be worthwhile, because it's not that we're against the principle, it's just that we'd like to firm up on if there's an opportunity how we demonstrate that it is actually an opportunity.

MS MORRISON: I think we would enjoy the, welcome the opportunity to provide some more evidence about that. I mean, you asked before is there anything you're sort of bringing here, in another proposition. It's really in what is a very - you know, we welcome the report. It's a very solid report and has a very broad view on the enablers of the competition. It is silent on the impacts of legislative reform so you've talked - - -

MR HARRIS: But not because we're not looking for it, but because I'm just identifying why, because we found it hard to convince ourselves that this would necessarily be a competitive force. We would like you to tell us this is how we can, and here's the possible benefit. Anyway, it would be good to see.

MS MORRISON: Yes.

MR HARRIS: Now, we have Bank of Queensland next so unless there is anything else you guys would like to add?

MS MORRISON: No, thank you.

MR HARRIS: Thank you very much for your attendance today and for the discussions we've had today, and hopefully for the possibility to be in touch again in the future.

MS MORRISON: Thank you. Thanks for the opportunity today.

MR HUNT: Thank you.

DR KING: Thank you.

MR HARRIS: Bank of Queensland. All the way from the sunny north. Thanks, for the record could you identify yourself please?

MR ROSE: Yes, Anthony Rose. I'm the Chief Financial Officer of Bank of Queensland.

MR HARRIS: Thanks, Anthony. Do you want to make some opening comments?

MR ROSE: That would be great. Thank you, Chair, for the opportunity to speak to the Commission today following the release of your draft report. We intend to provide a second round submission that will more formally address your recommendations and findings. By way of background, BOQ was established in 1874. Today it has a network of 190 retail branches across Australia. BOQ's market share in mortgages and business lending is less than

two per cent. Our unique franchise model network of owner managed branches form part of the two million small businesses contributing to the Australian economy.

BOQ notes the Productivity Commission's findings that the benefits of competition have been reduced in the quest for stability and promoting an unquestionably strong financial system. The objectives of stability and competition are not mutually exclusive and should co-exist. The banking regulator, APRA, has an important role to play in ensuring a competitive playing field, but we believe the ACCC as the competition regulator also has a role to play. We see the merit in the ACCC being an additional member of the Council of Financial Regulators.

The playing field is not level and, while there has been some progress, more needs to be done to deliver a truly competitive market. There are four key areas of focus for BOQ. Risk weights, funding costs, transparency in the mortgage broker space, and the impact of regulatory change.

The regulatory risk weighting framework has afforded the advanced banks a significant benefit over standardised banks. APRA's lifting of the mortgage risk weight floor to 25 per cent for advanced banks was a positive step, however the remaining gap is still too large. For example, for every \$2 of capital a major bank holds against a mortgage, BOQ holds around \$3.50 of capital. We welcome APRA's approach for more closely aligned risk weight calculations between advanced and standardised banks outlined in the discussion paper it recently released.

We also welcome APRA's consideration of applying the advanced bank floor to sub-portfolios rather than at an aggregate level. Our position is that the floor should be applied at each standardised risk weighting bucket to deliver a more competitive environment across the full range of customer segments. This approach would also enhance transparency and contribute to system stability, particularly in a crisis.

The cost of funding is also an area of significant competitive imbalance, which we estimate to be in the range of 15 to 25 basis points between the majors and the regional banks. The vast majority of this funding benefit is afforded through the implicit government guarantee of being seen to be too big to fail. This implicit guarantee is explicitly evident in the credit ratings positions. If we take S&P's ratings as an example, the major banks have a credit rating four notches higher than BOQ, with three of those notches solely related to the implicit guarantee.

BOQ supports the introduction of the major bank levy. While the principle of the levy is sound, the six basis points represents a small proportion of the overall funding cost benefit enjoyed by the majors. Major banks have a taxpayer provided insurance policy in the form of too big to fail, and it is appropriate that they should pay the taxpayer an insurance premium for this in the form of the levy. The current levy is clearly less than the funding benefit that the major banks receive.

We support the Productivity Commission's findings for increased transparency in the mortgage broker market around ownership structure and flow of business relative to market share. In the past brokers have played a positive role in driving competition in the mortgage broking sector, however the major banks' ownership of broker platforms has had a profound influence on the flow of business back to the majors. We fully support the Commission's draft recommendation 8.1 that ASIC should impose a clear legal duty on those mortgage aggregators owned by lenders to demonstrate they have acted in the customer's best interests.

Finally, greater consideration needs to be given to the impacts on regional banks before any new regulation is introduced. In periods where there is a high degree of regulatory change it has a disproportionate impact on regional banks who lack the same resources as the larger players. A great recent example was the sensible pragmatism applied to the approach to defer the commencement of the banking executive accountability regime for small and medium ADIs. I am happy to elaborate on these issues as well as other findings in the draft report, and welcome questions.

MR HARRIS: Thank you very much. So risk weights, people have to read the chapters in the draft report to find the nature of some commentary we made on what appears to be a bit of a developing thematic. You mentioned the levy as well. That says it is sort of desirable to add costs to the major banks as a way of responding to their natural advantage in the marketplace, either induced by rating agencies too big to fail kind of view, or perhaps the possibility that risk weights were inadvertently too generous to big banks in the past.

But as we do comment in the draft report, that simply raising costs if nothing else changes is probably going to increase prices to a bunch of consumers, and you wouldn't necessarily say that's terribly desirable. So tell me a little more about this idea that risk weighting should still be lifted for the large banks rather than, in the alternative as we have tried to comment with our two suggestions on risk weighting, in both cases they were suggestions about how APRA might consider varying risk weightings to recognise the possibility of banks that are currently capital constrained, and you might be strongly in those circumstances, being able to lend more if those risk weightings are a little more generous.

So I guess what I'm trying to characterise is we're very interested in things that might actually reduce costs in the marketplace. Of course, if risk weightings are unutterably wrong and you're prepared to substantiate that of course they should be fixed. But isn't the greater interest to try and get that cost of capital necessarily held against risk down a little? Isn't that the greater interest for all of us?

MR ROSE: So you've captured a number of points there.

MR HARRIS: Yes, but a homily I know - but I'm just trying to get - - -

MR ROSE: No, no. I get you. They're all really valid.

MR HARRIS: If you can come back and tell me where I'm wrong that's great.

MR ROSE: So I might start with the bank levy. So at the moment the major banks benefit, and I think I mentioned there's a four notch credit rating differential between BOQ and the major banks, and three of those notches in S&P's methodology relate directly to the implicit government support.

They get a natural funding benefit because of that implicit support, which prior to the introduction of the levy they got for free. So there is a question of equity around if the taxpayer is providing a contingent, has a contingent liability in the form of a too big to fail insurance

policy, then should it not receive a regular insurance premium for providing that? And we believe that's the merit of the structure of that.

It has a secondary benefit of yes, providing a more competitive landscape by levelling the playing field between those banks who don't have as large an attribution to implicit government support as the four majors. So that's I suppose - it's reducing, if you like, an artificial benefit that they are getting today.

As far as the risk weighted assets point is concerned, APRA and off the back of the FSI position, have a determination, if you like, to make sure Australia is unquestionably strong, and one of the elements of that is ensuring that the capital levels meet the desired targets that APRA have determined relative to global industry comparisons. And so I think our point is not about where APRA determines that position should be. Our point is that the gap between advanced and standardised measurement shouldn't be \$2 and \$3.50. It should be significantly converged. So ultimately we'll let the regulator determine where that hurdle should be in the interests of the balance for the community, and then - you know, but we do believe that competitive piece needs to be reduced.

The other element I would then go to in your discussion around costs of capital, we - the construct of our economy in Australia is such that we are arguably the most reliant banking system of developed economies across the globe on foreign capital for funding, and as a consequence of that we need to run settings that reflect that degree of reliance. Now, part of that goes to unquestionably strong capital that we've just covered, but there are a range of other factors.

I would argue that another factor that is critically important is unquestionably strong capital levels in and of themselves are never going to guarantee against a disaster scenario, and for the foreign investors to continue to be as long Aussie bank paper as they are, overweight Aussie bank paper, that they need a reason to suggest that that industry will always be appropriately capitalised if there was a shock event. And I think that actually by outcome means that our banking sector needs to deliver premium returns for equity investors to ensure that that capital will always be there, over and above the returns that would be expected in a banking industry that is domestically funded.

If we had a domestically funded industry we would probably be sitting in a position where the return profile of the participants would be lower. But I think there is that balance that it's in all of our interests to make sure that that funding source from offshore is not turned off. The implications of that are obviously significant, as we have seen.

MR HARRIS: I understand that up to the point when you consider a crisis. And we've had an example, possibly an extraordinary one, but you know, we've had one in 2008/09, and it wouldn't have mattered what the returns were earned by the Australian industry, banking industry from lending for domestic purposes surely. It was a freezing up. It didn't matter what the price was. I mean, we're all creatures of our own existence but I was running a very large infrastructure project at the time and so saw at first hand the utter unwillingness to lend by international parties to a project that was, whose customer was the State Government of Victoria. And for a product that was undeniably essential for the people of Victoria. And so, you know, the markets froze up in the way they did and so the question is - I sort of understand

the theory behind what you've said, but surely we're not advocating the earning of premiums in this market in order to have confidence of foreign investors in the assumption that come a crisis, a genuine crisis, they will keep providing money to us. Because that example, which is our only real piece of evidence, is no, they won't. They'll do what happened globally. And regardless of the quality of the party, no one could be sure apparently who was of genuine quality.

So surely we can't advocate having a system that guarantees the earning of premiums simply because of foreign investors. I understand we need to have market capital, but I can't go as far as to accept that we could justify premiums simply on that basis.

MR ROSE: I would argue that if this was an industry that simply returned the levels that would be expected of a domestically funded sector, there is a question mark as to whether or not in the post-GFC environment all of the government guaranteed debt that was on issue could have been refinanced in global markets such that the world would be prepared to continue to go along. You've got to recognise that a fixed interest investor will do the credit analysis on the underlying credit that they're exposed to, but in such a situation where they are so overweight as a cohort to that investment class they've actually got to do the "what if" analysis that says what happens if another big bear fund down the road suddenly decides that they want to go market weight Aussie bank paper? What's going to happen to the refinance market for that maturity that I'm currently holding when it comes to needing to be refinanced? And therefore there is a spread volatility risk that is real, and therefore they'll charge us for it. They'll charge us for that.

So there is an argument that says an element of that excess return lowers the cost of debt, right, for the institutions and it's balancing those two elements. I don't think you can simply say the market will always be there at the degree of overweight position it is today, that - yes, at a much lower return level. So it is a balance between those two things. And I do think by having that strength you do end up with lower funding costs in the wholesale markets that ultimately do come through into improved pricing for customers.

MR HARRIS: Yes. Stephen?

DR KING: Yes, I just want to chase up a couple of the other issues that you mentioned there. I wonder if - implicitly you've sort of got the major banks paying twice for the implicit government support. So you've suggested the levy may be a way, and we discuss the levy in our report. You also mentioned unquestionably strong, and obviously the systemically important institutions, which the majors are, face and have faced increasing capital requirements, even though they're IRB banks. Isn't that also in a sense to try and pick your terms, getting them to pay for that investment, that government guarantee, protecting the government because they are unquestionably strong? So in a sense why do you need both? Why do you need to push up the risk weights to make them essentially unquestionably strong whilst also imposing that levy?

MR ROSE: I think the two points are distinctly different. One is where does Australia as an economy want to balance the degree of unquestionably strong? And I think it's broader than just capital - [part of that is capital and part of the other things that I've covered - versus the implicit guarantee is something that they benefit from because the taxpayer provides this

contingent obligation. And it does seem just sensible and equitable that the taxpayer would receive an appropriate fair valued premium for that cost. And I think at the level that it sits at the moment - and we're agnostic to where it moves from here. I mean, obviously we can see arguments for, you know, you could probably double it and you would say you wouldn't have created any anti-competitive position for the major banks in that scenario relative to the actual underlying benefit they get from that implicit guarantee. But I think that that's the nature of the framework of that charge, and it does seem eminently sensible. It has a second order effect on obviously helping to level the playing field.

MR HARRIS: I am less concerned about - this is a radical statement so I struggle with my - I am less concerned about the levy per se and the concept of whatever its rationale was, and a number of rationales were used, about these risk weights and the driving up of risk weights. This fascination with saying there's a problem here with risk weights and the solution is that they should be, they should impose effectively a higher carrying cost of capital. It does seem to me to impact far more on competitiveness in the marketplace than the question of - well, let's accept the argument, it's an insurance policy and someone should be paying for it.

So let's accept that and say well, that's logical. If it was an unpriced insurance policy it should be priced, and park it. I'm not trying to make that argument as an acceptable one, I'm simply saying I don't think it's the bigger problem. The bigger problem is this fascination with risk weights are misaligned and the solution is that they should rise. As I said, we've tried to point out well, here's some examples where they could fall. And you would expect at least as much emphasis on that as this endless search for reasons to raise them.

It is sort of one of the things that indicates to us that this - there's no satisfaction yet that unquestionably strong is sufficiently unquestionably strong. And the person paying for that at the end of the day is the consumer, notwithstanding anybody else. There's no ACCC inquiry into stopping the passage of risk weights into the marketplace. The consumer is going to pay, and thus we see this intersection between stability and the potential impacts on competition. And I guess I'd be always more impressed if people can offer examples of how perhaps by greater willingness - you mentioned in passing, you mentioned some portfolio kind of risk weightings. This would presumably be driven towards here is a sub-class of borrower who shouldn't be subject to a bank holding a, if you like, the default level of risk capital against them because they're a better risk and so we should reduce them. That seems to be a more interesting and pro-competitive kind of thing rather than the fascination of just let's lift some risk weights because we think they're misaligned.

So is there much in that? I mean, we found what we found. We were sort of hoping to find a bit more, but do you think there's any more in that for us?

MR ROSE: Look, I think - completely would support the greater granularity of risk weighting buckets in the standardised approach. Now, APRA have started down that path and there's arguably - you know, we could take that further and we'd be very supportive.

MR HARRIS: And that would benefit you guys because presumably - - -

MR ROSE: Absolutely.

MR HARRIS: - - - then you could run a model around the particular attractive sub-classes and demonstrate that you should qualify for that revised, more generous risk weighting and potentially offer a different price or a different willingness to lend into the marketplace as a consequence.

MR ROSE: Yes.

MR HARRIS: So surely that's going to - you know, it's almost like some people have proposed, the breaking down of the complete IRB modelling exercise into more accessible chunks. That would be desirable surely as a sort of proposition.

MR ROSE: Definitely.

MR HARRIS: And do you think that's a direction APRA is heading in?

MR ROSE: The discussion paper does suggest there's a lot more granularity than the 35 per cent bucket that was one size fits all. So I think that is definitely positive. You know, there is a shift in SME risk weights in the standardised approach that's under discussion from 100 to 85, but again that's a one size fits all for that cohort rather than a graduated approach to that, which certainly would be - we would be supportive of.

I think the other point that we've been very keen to try and make is that wherever you decide to maybe try to pick up the best of both worlds, and your comment around do we just go to a more granular standardised framework, you know, not wanting to dismiss potentially the benefits of having advanced modelling techniques around that - but we do advocate if you're going to apply a floor of an advanced model to the standardised approach, rather than applying it to an aggregate bank level if you actually applied it at each individual standardised bucket in that granular piece you've immediately got less likelihood of cohorts of customers within the portfolio that - where the standardised framework is uncompetitive with the advanced framework. And that would be something, you know, we've been strong advocates about.

We think the other additional benefit that that actually provides in a reporting sense - if you start to have advanced banks in their modelling report against each of those standardised buckets, there's transparency around the degree to which your models provide benefit below the standardised approach and you will enable external scrutiny across all the market participants which adds a degree of transparency and resilience that was actually lost during the GFC because everybody turned around and said, "We don't believe the advanced bank models. They're a black box." That would go a long way, I think, to providing stability.

DR KING: Just a clarification for my own perspective, so when you're talking about those floors, you're talking not just about the three and four per cent floors in the first APRA discussion paper, you're talking about floors on the IRB rates over a loan class?

MR ROSE: Yes.

DR KING: Okay, that's all right. Just to make sure I understood what you were getting at there. Okay.

MR HARRIS: I haven't got anything more on this. Do you want to ask about our publication of real time pricing? Can I go to that?

DR KING: Yes. I just wanted to do a little bit on brokers as well.

MR HARRIS: Yes, okay. Well, you can do brokers. I'll do this. So yesterday we did get a proposition from I guess what you say might be from another member of the cohort of banks, where Bank of Queensland is, from Bendigo and Adelaide. They made a comment on our proposition that ASIC should be able to gather information from banks on quite a structured basis about the actual median price for a negotiated loan in a particular location for a particular kind of borrower, and ensure that the market was informed by as close as possible to real time actual prices rather than mooted potential discounts against a standard variable rate, and propositions like a comparison rate and general, you know, prices that certainly aren't the actual price being paid in the market.

Now, Bendigo and Adelaide didn't like that. Yesterday they told us that this would advantage the larger banks. I guess it's an interesting proposition for us that real and actual prices, which are viewed generally in markets as being a desirable thing, and certainly occur in - you know, go to the supermarket and see it - isn't - is going to advantage a larger competitor here. What is your reaction to that recommendation?

MR ROSE: Look, the industry already has a comparison rate reporting regime. I think we'd need to do some more work to determine what are you actually achieving. I think it's quite easy for people to compare published rates on websites. We also know that there is discounting that occurs off the back of that. But we also have a broker space which also plays a part in understanding the differences in offers that exists at any particular point in time. And then you've got individual credit risk settings and portfolio appetite that each individual institution plays, which probably adds to the degree of complexity that isn't clear and apparent from those other mechanisms that I've just mentioned. Because certain customer types may be more attractive in the mix of building your portfolio than others, that you might be more interested in.

But I think the question is do we really think customers are getting a materially different outcome when they come to the market for a new loan, given the degree of new loan competition? We only have to look at the owner occupier principal and interest market at the moment where customers - it is a borrowers' market in that environment.

MR HARRIS: Yes, I think I understand all the points you made, and I could make a set of counterpoints to each of them too. But I think the in principle proposition we have is it is now quite possible in a technical sense to say what the December median price loan in a particular location for a particular kind of borrower was. That's information that traditionally would be accepted as being of value to a consumer in a marketplace, and the uncertainty that otherwise arises does encourage a consumer to go to a broker. And increasingly we've seen brokers now owned by banks.

So whilst a broker is a source of information, the question is what information and how far does it go? And yet if the consumer went to either the broker or the branch knowing that a particular bank that they're now in in December offered them at their level of income for a

property in this particular location a median price of this, they would at least know whether they were indeed that customer that wasn't desirable for the portfolio of the bank, when the proposition they get back across the counter or from the broker is sorry, we can't offer you that price. It has to be higher. We'd just call that truth in advertising. We'd say it's just a desirable contribution to information in the marketplace.

But I'd like to add to that as well, the question is for the existing borrower who otherwise is apparently unconscious of the fact that there are better propositions out in the marketplace and would in fact be better informed by this. So we're still struggling to see in terms of the question I want to put to you is this question of how does it advantage a large bank versus a medium size or smaller bank? It's not clear how that advantage falls to them, and that's what I'm really interested in getting your response on.

MR ROSE: Yes. On that specific point, I mean I think if we separate the ownership of brokers as a separate issue for the time being.

MR HARRIS: Yes. I'm just saying there are answers to many of the points here. The core one is that.

MR ROSE: Just assume that ownership issue doesn't exist, so that it is perfect in that sense. You know, there is a risk in that environment that greater transparency does see a diminished utilisation of the broker space. That is a risk. And we have seen that the broker market has certainly been official in allowing the non-major banks to compete in the mortgage space.

MR HARRIS: I see. So the proposition really is - and we do acknowledge, and I think everyone accepts, that banks, medium and smaller size banks have been assisted by the broker revolution and have saved the need to occupy branch space in locations. Particularly I guess if you're a regional bank that is certainly true. And you're saying therefore if that pricing impact did encourage more people to, as it were, look for a branch then the entities with the biggest branch network are advantaged by that. Okay, it's worth us thinking about that.

MR ROSE: Yes.

DR KING: And on that same point, reverse your assumption now and say well, we know that a large number of the brokers are owned by the major banks. Bank of Queensland, I don't know off the top of my head the percentages of your loans that go through brokers versus branches, but I would be interested if you know off the top of your head. Do you have concerns about that level of integration, given you have a dependence on the brokers? Does that change your own strategies? Do you tend to try and push more loans through the branches rather than the brokers, even though the brokers may have better client accessibility or may even be cheaper? And do you think our recommendation on the duty of care obligation is a useful recommendation or a useful way to address those problems, if there are problems? I don't want to pre-judge. You may say no, it's fantastic. There's no problem.

MR ROSE: So to start with, I think we've only more recently as an institution moved into the broker space. So we've been in it for about the last three to four years. At the end of the day its customer behaviour and choice as to which channel they choose to interact with to obtain a mortgage. And we've seen about half of customers use that channel across the whole market.

So it was - we saw it as important for BOQ to make sure that we had access through that channel for customers who chose to go through that way. We've only got about 25 per cent because we're early to the market of our flow through brokers.

As far as that duty of care obligation is concerned, and we do think that is important because the degree to which major banks are getting flow of business over and above their natural market share is in effect market access that would have been available to the non-big four, that is now no longer available to us, you know, for whatever reasons are driving that type of outcome and it does appear that there is quite a trend towards an over-allocation of flow back into the proprietary products of the owned businesses, which I think is addressed by putting that duty of care obligation in.

DR KING: I mean, you're on the ground in a sense so when you're saying well, it does change the flow, the ownership does change the flow of product, are you relying in a sense on the same as us, simply looking at the macro level and saying well, it doesn't seem right, or is there intel that you get back on the ground sort of saying well, yes sir, we'd love to sell more of your product through this but you've got to recognise there are other forces at play. Sure we don't know explicit statements, but we're interested in that micro level. We can see the macro, but the micro story, the story on the ground, and if you want to take that away and consider for further submission on that that's fine.

MR ROSE: We've been monitoring that ownership structure with a concern and a premise, and we raised this at the FSI directly, that we thought it was important that those that own aggregated networks should actually be required to publish the degree of flow relative to their market share for the public interest, to understand whether is there anything to see here or not, and to be honest the information that you have provided in your report is new information to us as well, but doesn't surprise us. Again, it's hard for us to access that information as well.

MR HARRIS: Nevertheless we will persist there. So I think we've reached the end of our questioning. Is there anything you would like to add in closing, which you're not obliged to do, or otherwise I want to thank you very much for making the time today and for the contribution that your input has made to the inquiry, and we may be back in touch with you at some later point for clarification if that's necessary. In the meantime, thank you very much to the Bank of Queensland.

MR ROSE: Thank you.

MR HARRIS: We are going to have an adjournment now so that people can go out and buy a sausage roll and then we're going to start again at 1.15 according to my schedule.

ADJOURNED

[12.27 pm]

RESUMED

[1.15 pm]

MR HARRIS: Okay, we're going to recommence Sydney hearings for this inquiry and I think the Customer Owned Banking Association is next up. If you gentlemen would identify yourselves for the purpose of the record that would be great.

MR LAWRENCE: Okay, thank you, Michael Lawrence. I'm the CEO of the Customer Owned Banking Association and I will open up with some comments, if I may, just in terms of an opening statement.

COBA speaks for mutual banks, credit unions, building societies. It's the Customer Owned Banking institutions that provide the important competition and choice in the retail banking market and being unmatched for customer focus in that market. The success of our model is demonstrated by the sector's consistently market-leading satisfaction ratings compared with other banks and particularly listed banks.

The Customer Owned Banking is distinguished by prioritising custom benefit over profit maximisation, conservative business models and prudent risk management, and deep community engagement and strong customer loyalty.

The first point that I'd like to make is in relation to making regulators more accountable about competition. We agree with the Commission that there is a need to increase the focus on competition in the Prudential Regulatory decision-making.

Our view is that APRA does give some consideration to competition and its performance in this regard has improved since the financial system inquiry. However, there are multiple examples of where APRA may not have given enough consideration to the impact on competition. We support the use of the statements of expectations to deliver further improvement, but a more effective way forward is to change APRA's legislative mandate to introduce an exclusive secondary competition object.

APRA's mandate currently mentions competition but elevating its status as a clear secondary objective behind financial safety and stability will increase APRA's focus on competition. This secondary competition objective does not mean APRA would have to sacrifice its other objectives in pursuit of a more competitive environment, but APRA would be more accountable about its approach to competition.

APRA's peer regulator in the UK, the PRA, was given a secondary competition objective in 2014 and the outcome is a material change of gear where competition is gaining air time and traction at all levels and there are numerous instances where competition considerations influence policy outcomes.

Moving on to our second point around competition and the champion of the Council of Financial Regulators. The draft reports proposal for a competition champion on the Council of Financial Regulators is welcome, but not necessarily address all the problems that we have identified. The Council of Financial Regulators is concerned with macro-prudential policy, but many of APRA's micro-prudential decisions can, and do, affect

compensation.. These decisions wouldn't typically be matters for consideration for the CFR.

Our proposal for a change in APRA's mandate would supplement the concept of another regulator, the ACCC or ASIC having the role of competition champion on the CFR. Our preliminary thinking is that the ACCC is more naturally suited to the role of competition champion and would therefore become the permanent new voice of the council, while ASIC would have an obligation to consider competition added to its mandate.

We agree that the lack of an advocate for competition is a mistake that should be corrected. APRA's excessively blunt macro-prudential interventions, that was brought out in the report, into the home loan market has harmed competition and unfairly affected the smaller banking institutions. One of the major issues on the agenda of the CFR that will affect competition is tackling the too big to fail problem that gives major banks an unfair funding cost advantage over the smaller competitors.

The government endorsed the financial system inquirer recommendation to reduce the implicit government guarantee and perception that some banks are too big to fail. The recommendation was made in 2014, and accepted by government in 2015. APRA announced recently it expects to commence consultation later in 2018 on the proposals to implement the FSI recommendation.

Our third point around mortgage risk rates, we agree with the PC draft report recommendations for a review of mortgage risk rates to better reflect risk. APRA has recently issued a paper on proposals to revise the capital framework, including changes to mortgage risk rates

COBA and its members are examining these proposal and we note that APRA will also carry out further analysis on the impact of the proposed changes in banking institutions. We want to see further narrowing in the capital requirements for mortgages held by small banks compared to the major banks. The financial system inquiry identified this as a significant anti-competitive problem and APRA has since taken interim steps to reduce that gap.

There is still some way to go, but we are encouraged by APRA's statement that the revised risk-weight framework is likely to reduce any competitive differential in regulatory capital requirements between the large and small ADI's, improving the competitive position of the latter.

Our fourth point around cumulative regulative compliance burden. The key concern to our members, and key factor influencing the competitive capacity of smaller challenges to the major banks is the regulatory compliance burden. The fixed cost of complying with regulation falls more heavily on smaller firms. The regulatory compliance burden provides yet another advantage to the major banks because they can spread their cost over a vastly bigger revenue base.

Regulation should be targeted, proportionate, risk-based and where possible graduated. Decisions to improve new regulations should be coordinated and cumulative impact should be assessed. Seen in isolation, a particular regulatory measure may appear relatively benign, but the continual introduction of new measures can amount to death by a thousand cuts for the smaller players in the market.

Our sector, with a strong customer focus and good compliance culture, is caught up in the backlash against some of the conduct and culture that's playing out in the market at the moment, particularly through the Royal Commission. For example, all banking institutions are subject to the Banking Executive Accountability Regime, but we were pleased at the recent announcement that the smaller banks had a 12-month extension on the implementation of that. Another example where regulation could be better targeted is the government's proposed financial product issue around the design and distribution regime.

In relation to banking, basic banking products such as savings accounts and debit cards, there is no evidence that the regime will improve consumer outcomes, and there is a clear risk that it will lead to worse consumer outcomes, and finally, a proposal on the ban of interchange freeze, I'll make some brief comments about the draft report recommendations to ban the interchange fees.

We do oppose this recommendation. Interchange fees are a mechanism to enable sharing of costs on certain benefits and card issuers provide to merchants. These benefits include processing transactions, preventing fraud and authorising transactions. Merchants should bear at least some of the cost of benefits provided to them by the card issuers.

Banning interchange fees would affect competition by having a disproportionately greater impact on smaller card issuers that do not participate in the merchant acquiring market. Major banks dominate both the card-issuing and merchant acquiring sites of the payment card market.

The loss of competition for costs sustained by the card issuing side of their business could be balanced by not having to pay interchange fees for the merchant acquiring side of their business. I note that the payment system board carry out a comprehensive review of the card payment interchange fees in 2015 and 16, and the new benchmarks commenced only a year later.

So thank you for the opportunity here, and sorry it was remiss of me to introduce my colleague, Luke Lawler, who's the Director of Policy at COBA.

MR HARRIS: Sure.

MR LAWRENCE: Thank you.

MR HARRIS: All right. Do you want to go in reverse order and do interchange fees- - -

DR KING: Yes.

MR HARRIS: - - - and disproportionate impacts? So can you explain to me how it's disproportionate impact, the interchange fees? Why would it be a disproportionate impact on smaller institutions?

DR LAWRENCE: Because a lot of the small institutions don't participate on the merchant side, so they're only on the card issuing side, and so, you know, if you are - it's that balancing act in terms of removing that interchange fee where you pick it up on one side and lose it on the other. If it's removed and you're only a card issuer, then obviously there's a disproportionate cost because you can't - you're not going to offset it.

DR KING: So, I mean, the interchange fees have dropped substantially more - if you move from current level to zero, they've dropped more than that since the RBA started regulating them, so are you using fewer credit cards today than you were back in 2003 when the original regulations came in?

MR LAWRENCE: No, I wouldn't say that there's less being issued. You know, the decisions that are made as a business you've got to deal with, doesn't necessarily mean you exit the market. You need to absorb it, but the point is you become less competitive because, you know, the costs burden is great.

DR KING: So fewer reward points on your cards, has that been a consequence? So you're not paying customers as much or - - -

MR LAWRENCE: Look, you know, I can't talk about the specific arrangements across 75 of our members. They are different, but we can certainly look to provide some of that detail in terms of where some of those benefits might sit.

DR KING: That would be very helpful if you can do that, yes.

MR HARRIS: I still don't quite see the quid pro quo that you're identifying here. The fact you're not on the acquiring side, and the fees are abolished, so what's - what stops you still, if as a card issuer, ensuring that the price you charge for access to that card includes whatever costs that you residually still incur after the interchange fees are abolished. What stops you doing that?

MR LAWRENCE: There's nothing stops you from doing that, and - and obviously you can and you would need to pass those costs on, but if you're a larger organisation where you're getting the benefit of the others on the other side you may not be in a position where you need to pass those cost on because then - - -

MR HARRIS: So you're saying your card issue might have to have some kind of higher charge structure inside versus a larger institution?

MR LAWRENCE: Potentially.

MR HARRIS: Yes, good. Well, we've got them next. We'll ask them.

DR KING: You're getting a request, by the way, from the absent Commissioner to speak up.

MR HARRIS: Sorry, I'm leaning back too far. Yes, okay, well, we'll ask them their view on that as well, so that's - that's interesting. I hadn't imagined that the cost was, you know, of that nature that it was likely to be reflected in, so, actual competitive advantage for - between different card issues. Anyway, we can ask them their view too. All right, that's interchange.

What do you want to do next? Because you made some observations - because you're generally supportive of the idea of a competition champion, but you want to add the secondary competition objective that the UK has put in place as well. That secondary competition objective is - was imposed on the Bank of England in the - by its Prudential Authority in 2014, I think, or something like that, so you want both a regulatory shift which deals with micro-prudential as well as the competition champion at a micro-prudential level?

MR LAWRENCE: Yes, that's correct.

MR HARRIS: So that's pretty clear-cut. Can I just pursue - you seem to suggest that was fairly successful. I mean, and it's been put to us that the way that's been interpreted by the prudential authority in the UK is, well, any, you know, competition is all making sure the right people are paying for everything and stability is all about making sure that you've got the right people paying for anything, therefore anything that's good for stability is good for competition, so therefore it's been put to us at least that they don't pay any more than lip service about secondary objectives. I would be interested in, if you've got a different view I'd be very interested in it.

MR LAWRENCE: I mean, I don't - I don't believe that the comment is correct in terms of if it's good for stability it's good for competition. I mean, you take the macro-prudential policies that are in place and, you know, the one that we keep bringing up, which is an obvious one, is the 10 per cent cap on investment lending.

Now, if you've got a balance sheet of \$500 million, 10 per cent relative to 10 per cent on a \$500 billion book it is significantly different. So if you're a smaller player it doesn't take much for you to hit your cap earlier because you're talking, you know, smaller numbers.

Added to that, generally speaking our sector, investment lending only represents about 20 per cent of the book relative to the majors at 40 per cent. So again you've got another disproportionate impact on 10 per cent of 20 per cent versus 10 per cent of 40 per cent, we could do the maths on that. It's fairly simple in terms of two and four.

So there's that - there's an additional impact, so if you've got just a small level to play with, then you're going to hit the caps pretty quickly, and therefore you're going to have to exit the market around investment lending, and when you're - our members are, a lot of them are region-based, and if they stop the investment loan, we were seeing evidence of them seeing their owner occupier lending as well because they'll go across to the major, the customer, who has greater capacity to accommodate them on that investment loan that'll be done on the basis of, yes, but bringing across your owner occupied as well.

So I mean, there's an example of understanding where, you know, I understand the nature of the policy and stability perspective that it's disproportionate when you break it down.

MR HARRIS: It wasn't so much what I was claiming about stability and competition or aligned. It's just something that has been put to us that that's how it's being interpreted in the UK.

MR LAWRENCE: Oh, right.

MR HARRIS: And you seem to have a very different view. You seem to view the secondary objective as being effective in the UK.

MR LAWRENCE: Well, I mean, APRA, as I said, we're already seeing that from APRA now in terms of any of the papers that they put out there is always a discussion upfront around competition, but the question is, is it going into the level of detail that we think is necessary, and arguably it's not. So you know, it's - by making it exclusive around an objective, we just think that there would be a heightened level of focus on it.

MR LAWLER: And if I can add, it certainly increases accountability because the reporting on that, the explicit reporting requirement on the secondary competition objective is that there's just a much higher level of accountability than there was before when there was criticism, even though there was a requirement for the regulatory to have regard to competition. They did only, you know, effectively pay lip service to that, whereas independent evaluations of the executive competition objective to date have been fairly positive.

MR HARRIS: Yes, all right. And you say the cumulative regulatory compliance burden is another advantage to major banks because they can spread it across a larger base. I guess the principle of that is pretty evident. Have you got examples of the sort of practice that we, you know, is there - has there been a recent change that would create a good example to run in this?

MR LAWRENCE: Yes, I think one that comes to mind, it's still to play out because it hasn't been implemented, but that's the BEAR, the Banking Executive Accountability Regime where the smaller banks are being given an extra 12 months. We cannot underestimate the amount of work that is required on that front, and, you know, there obviously is going to be a lot of toing and froing between the regulator and the banking

institutions as a work towards an acceptable position on what the BEAR might look like within organisations.

We don't have to be putting resources in that initial phase, and it's probably not the best term, but you know, riding off the coat tails of the heavy lifting that the majors will do on that front when we come in in 12 months' time, and that's not to say that we shouldn't be doing work from day one, but we can certainly pick up a lot of those learnings and apply them. So that's an example of where that will - just that 12 month delay alone will reduce the cost burden for the smaller players.

MR HARRIS: All right. I think I see that, and you're supporting more finely calibrated risk-weighting which we talked quite a lot about today so this is your general view in support of that?

DR KING: Sorry, can I - a couple of things. Firstly, the APRA discussion paper is obviously, it only came out, I think, last week in that respect, but it was focussing on residential mortgages or mortgages backed by residential property. Any thoughts on the SME space in terms of those risk works?

MR LAWRENCE: Yes, look, we've had discussions with APRA on that, and there is acknowledgement that there is really no differential in that paper around, you know, secured versus unsecured SME lending, so you know, we will continue to have those dialogues with the regulator, that that is acknowledged as there is an ending differentiation on secured versus unsecured on personal loans, which moving from 100 per cent to 125 per cent, and then you can have the debate, well, you know, 125 per cent risk-weighting on a personal loan versus a credit card, and you look at the risk of a credit card default versus a personal loan default, you know, why would a personal loan be 125, where again, generally speaking across our member base, most of the personal loans are for car purposes, and there is an asset.

So all these things - it is a discussion paper, and APRA are obviously receptive and they're looking for the feedback. We need to unpack it in terms of all of the risk-weightings that have be proposed. You know, there's - under the Basel framework it talks about reliance on the cash flow from that property and what does that mean. You know, again, that's problematic because that information hasn't been captured to date, so - and again, the regulator is aware of that and so, you know, there's still a lot more to play out on that.

You know, non-standard loans, for example, non-standard loans is, you know, if you're outside of your lending policy, because that means banks loosen their policies so they don't

- - -

MR HARRIS: They're not going outside - - -

MR LAWRENCE: It's not the behaviour that anyone is looking for, but, you know, potential unintended consequences of some of that, but as I said, these are the conversations

and the regulator is certainly listening to these and everyone has the opportunity to feedback.

MR HARRIS: You mentioned the too-big-to fail premium, and I'd like your opinion on, sort of, you know, there's a range of arguments that have been put to us with regards to risk-weights and the difference between the IRB and standard risk-weight, so in no particular order, the IRB banks made large fixed investments in getting their internal risk models up and running. Of course you would expect them to have significantly lower risk-weights because it made that investment.

The pay-off from that investment is that they made a cost lowering investment that they're able to at least, in terms of the regulator weighting and from APRA they're able to show a benefit there, so if you like, that's the first one.

The second one is that, you know, there's some sort of too-big-to-fail premium that's hidden in there and somehow that raising the risk-weights, I'm never quite sure how I see that, but raising the risk-weights is somehow a compensation for this too-big-to-fail premium, and obviously also for levy which I put to one side has also been suggested, but that, I think is really a different issue.

The third one is that while the risk-weights, the IRB risk-weights have to be pushed up for stability reasons, and the fourth one is that this is just an attempt at protectionism by the small banks, the smaller non-IRB banks just want to be protected from the fact that the bigger banks invested in cost-reducing technology. They don't like the fact that they now can't compete as well against the big banks so they want the big banks' rates pushed up. They want that cost advantage reduced.

So your view on those four different arguments, because they've all been put to us quite passionately.

MR LAWRENCE: Yes.

MR HARRIS: I would be interested to know what you feel.

MR LAWRENCE: Look, I would acknowledge the level of investment that the majors have made. You know, the question comes down to, we're not saying that the risk-weights should be the same, but the debate is, should they be as wide as what they are.

And you don't have to go back too far where, you know, if you had my house as security with a major versus my house as security with one of our smaller members, the asset's the same, but the differential, as I said, not that long ago was 17 versus upwards of 45. Does that level of investment to get to IRB status justify that magnitude of the differential, bearing in mind that the capital ratios of the majors are generally lower than at the smaller players who are required to hold more capital in the first instance. So, you know, there's different issues at play there.

So, you know, the argument is more, from my perspective I don't think the level of investment justifies the difference that we set out, and particularly when you've got recommendations from the Basel Committee and, you know, we are at the very top end of that from a risk-weighting on residential mortgages. So there's that aspect.

The too-big-to-fail, well, that's effectively implicit guarantee. I mean, we can get into the debate about charging a levy, start doing that, makes it quite explicit in terms of a guarantee, but as has been said already today, it does have an impact in terms of your cost of funds.

MR HARRIS: But to the degree that that's relevant for risk-weights or - is it at all relevant to the risk weights? Is that something that's just simply a separate part of the discussion?

MR LAWRENCE: No, I don't think you can isolate it because again, what the regulator is looking at is stability, and if you can ratchet up the amount of capital, then potentially the reliance on that guarantee down the track is going to be less. So I don't think you can isolate it. You know, they're looking at those risk-weightings, and you know, the unquestionably strong, yes, the regulator came out and said there's an extra 150 basis points on majors and extra 50 basis points on the smaller.

What the regulator is actually endeavouring to do with this capital framework paper is to look at that in terms of, well, you know, could it possibly, with the changes and the lowering of the less risky assets, become a net-net situation where it's actually no change.

MR HARRIS: Okay, and what would you say to the final figure that I mentioned which has been put to us that the attempt to even the risk-weights, at least raise the IRB risk-weights closer to the standardised rates is just, you know, what you'd expect in terms of protection for the smaller banks that's anti-competitive?

MR LAWRENCE: No, so lower the - lower the risk weighting for the smaller banks. I mean, you'd look at it different ways, and that would then definitely be passed on to the consumer, but again, you know, we have to be mindful that the regulators, and certainly APRA, their primary objective is stability, so for us it comes back to that differential, and our view is that it is just too wide.

DR KING: But you've seen from our report that certainly in some areas there are reasonable examples of how risk-weights could be brought down, and I ask you, I think you were here earlier when I, I guess one of the most interesting aspects of our report is, for us anyway, was the limited number of people who were actually arguing for reduced risk weights.

Almost everybody had an opinion, and dating back to the Murray Inquiry, in favour of higher risk-weights regardless of the supposed effectiveness of this very large investment in modelling, and as you've just noted there are two choices, I guess, but the inclination appears almost by default to be if the gap is, in judgment terms too wide, we'll just lift less expensive risk-weight closer to the more expensive one, and as I noted in the end that means

the customer pays, leaving aside the levy and its claim as to whether the customer will ever pay for that. It's a limited risk-weight shift the customer's going to pay because - unless you expect shareholders to take it and generally speaking, as you can see from the theme of report we'd say, no, shareholders appear to have it over customers most of the time.

MR LAWRENCE: Yes, look, we would certainly advocate for lower risk-weightings, and it goes back to the point I made around where the Basel Committee sits in terms of range, and we are at the top end of that range, so you know, the regulator could potentially look at, well, do we move more back towards the mid, which is effectively a lowering of the risk-weights.

MR HARRIS: Yes. Anyway, we would be interested in more contributions on this question about where else could risk-weights shift besides the two that we've indicated in different loan evaluation ratios for, I think for owner-occupying housing or for some versions of housing, but anyway, different loan evaluation ratios, so some differentiation there, and some change to small to medium enterprise lending and the nature of the assets placed at risk by that business owner in support that lending.

Both those areas look like they're prospective by comparison with overseas experience. If there is more, we'd be interested in knowing towards that end because, you know, it can only be a positive contribution if it gives people competing, even if it's fairly weak competition, nevertheless competing in a market a chance to differentiate their product and appeal a little bit more to a class of consumer.

MR LAWRENCE: Yes, and we potentially will be able to feed more back into the Commission on that front as we and our members individually look at the impacts of the capital framework paper, and obviously we're out there seeking feedback from our members as to what that specifically means to them because I mean, not all our members, for example, do SME lending.

MR HARRIS: No.

MR LAWRENCE: But there are quite a number who do and they will have views on that, and as we obtain that information we'll be able to consolidate and bring something back to you.

MR HARRIS: Okay, that will be worth doing. Do you have anything more yet?

DR KING: Just one tiny thing. You haven't raised it so far, but obviously your members, with, I would assume, a substantial number of your members would be reliant on brokers as a channel to the market. Any comments to make on the degree of aggregation there, the fact that we have seen a large amount of integration, not by your members but by the major banks into the broking space which must have an effect on your members' ability to access the market. Any thoughts on that?

MR LAWRENCE: Look, we, as an association, have spent a lot of time on that. I mean, clearly some of - a number of our members do use brokers. You know, I think that what the Commission's paper is showing around greater levels of disclosure I think is a very important thing, because at the end of the day it then comes back to, you know, the consumer and them being able to make decisions, eyes wide open, with all the information and the facts in front of them, and, you know, some of this information around where the aggregators, where the ownership sits, I think they should be disclosed.

MR LAWLER: We've participated in the combined industry for lenders and the broking industry to respond to the ASIC report which looked at issues like that, and we certainly have supported the decisions to increase transparency so consumers know who owns who, and who we're dealing with.

MR HARRIS: Okay. Yes, done? Other final comments that you guys would like to make or - - -

MR LAWRENCE: No, all good, and appreciate the opportunity.

DR KING: Thank you.

MR HARRIS: Thank you for your contribution to this inquiry and to - are you going to put in a subsequent submission or is this - - -

MR LAWRENCE: Yes, we will.'

MR HARRIS: Okay, and I've asked them for that too. Okay, now, we're running a little early which is always desirable in these things.

DR KING: I don't know if the next people are here.

MR HARRIS: Commonwealth Bank present? Excellent, they're ready to go. All right, we'll do the swap. There's obviously organising going on here logistically.

So I'll stick with our normal process and just ask, once you gentlemen have settled, if you could identify yourselves for the record.

MR JESUDASON: My name's Rob Jesudason. I'm the Chief Financial Officer of Commonwealth Bank, and this is Angus Sullivan, the EGM responsible for retail banking.

MR HARRIS: Do you want to make some opening remarks of some kind?

MR JESUDASON: If I could, absolutely.

Well, firstly, thank you for the opportunity to discuss your report and share our views. We recognise that any point in the economic cycle, there will be opportunity for regulatory

change, and we support balanced regulatory change that increases competition and encourages innovation.

We are supportive of many of the recommendations of the financial system inquiry which led to many reforms, and we look forward to seeing how these improvements play out. We also support the majority of the Productivity Communication's draft recommendations.

We believe a highly competitive banking system that balances system stability, prudential supervision and customer protection through the cycle is good for customers. We are fortunate in Australia that we are one of the most stable banking systems in the world. It is also highly innovative and competitive and customers have high degrees of choice. They also receive high degrees of service. You can see this in the fact that customer satisfaction has improved over 80 per cent for the major banks and also there's a decreasing trend of dissatisfaction which sits at roughly 5 per cent today.

Our primary goal as an organisation is to secure and enhance the financial wellbeing of people, businesses and communities. This guides us to be highly customer-centric. However, it's important that we get the balance right between delivering a highly competitive value proposition to customers, and ensure fiscal responsible management of Australia's largest financial institution.

In the last five years we've invested over \$6 billion in improving the Commonwealth Bank franchise. Our scale and profitability enables that investment. We believe that Australia's regulatory framework is superior to most mature markets. We supported the clear division of accountability between the Reserve Bank, APRA and ASIC. It ensures a system that's stable, good with strong prudential supervision and also strong customer protection.

We also support the role of the Council of Financial Regulators to balance these objectives. It ensures Australia's economic prosperity and the financial wellbeing of customers. This system has worked. It has contributed greatly to the prosperity of the country and it's also been recognised externally.

In November the CEO of Standard and Poor's said that the regulations governing Australia's banks are amongst the strongest in the world. Therefore, it's important that a discussion around competition must not lose sight of two fundamental characteristics of the market. Firstly, the nation's economic prosperity relies on access to global funding markets. This has been achieved through stable banks with sufficient scale to fund the economy.

We saw through the global financial crisis that funding markets can be highly volatile. The strength of our system enabled the major banks during this period to continue to extend credit, both to individuals and businesses. This is an important consideration for Australia because the concentration of the banks to facilitating private sector growth is much higher in this economy than other mature markets.

To put this into perspective, the major banks alone raised almost \$100 billion of long-term, wholesale funding and offshore markets last year. During this period, CBA raised \$27 billion in long-term offshore wholesale funding. We also renewed \$32 billion of offshore wholesale funding in terms of short-term debt. This was renewed very month. The ability to access offshore markets to scale was critical to enable CBA to provide \$135 billion of new lending to Australian customers.

The second consideration is that Australia has enjoyed over 26 years of uninterrupted economic growth. This is globally unprecedented. Given the pro-cyclical nature of banking it has naturally led to strong performance of Australian banks. It should not be ignored that the profits of major banks have in turn benefitted the wider community. Approximately 75 to 80 per cent of profits are returned to shareholders as dividends and the major banks are amongst the nation's largest taxpayers.

However, at some point in the future Australia will experience a recession. When this happens Australia's regulatory settings must ensure that the financial system has the strength and the stability to absorb losses. The global financial crisis gave us clear evidence of how banking systems with regulatory settings not attuned to macro-economic downturns can ultimately fail to protect customers.

Governments in the UK, US and Europe were required to bail out major banks, or in some cases let them fail. This is in contrast to Australia. Our major banks were not only able to help the economy, but also to continue to extend credit to consumers and businesses. There were also no bank failures.

On this basis, we support most of the Commission's recommendations. However, we encourage caution with regard to three matters. Firstly, the proposal to abolish interchange fees. The payment system is critical infrastructure for the country. Investment is necessary to provide security, stability and continuous innovation. There have been successive reforms that have aimed to optimise interchange. Australia's interchange fees are low by global standards. In our opinion, there should be no further changes in these regulations until the RBA has had the opportunity to evaluate the effects of the most recent reforms introduced last year.

Secondly, the proposal for APRA to develop an on-line tool to report median interest rates on housing loans. Our concern is that this is likely to have a number of significant, unintended consequences. Mortgage pricing is determined by a number of factors. These include a risk assessment of individual customers and external factors such as wholesale funding costs. Publishing historical median interest rates without the relevant personal context could mislead customers.

Lastly, the proposal related to mortgage aggregators and brokers. We support any recommendation that aims to protect customer and put their interests first. Our objection is the recommendation as currently expressed would only apply to aggregators owned by lenders. We support equal treatment of all brokers and aggregators. We look forward to

discussing these topics further today. We will also respond in greater detail to all recommendations and findings in our written submission.

As I said, we are broadly supportive of the draft recommendations, subject to thoughtful consideration as to how they will be implemented. We look forward to working constructively with the Commission, the Government and our regulators to address important design considerations and improve competition and help maintain the strength of the Australian financial system.

Thank you.

MR HARRIS: Thanks, Rob. Okay. Just on the broader question, the way you presented the essential nature of having a system, a banking system in Australia that sources of offshore finance have a high level of confidence to ensure that we get access to money in Australia. I don't think anybody has tried to dispute that. In fact, the core issue for us is not whether we have maintained such a system. I think the general perspective is that we have and different parties have different claims to credit for this and the Government itself thinks the only party that didn't actually get a mention in your presentation. It probably would say it did something as well.

So I'd say, yes, everybody managed the circumstances quite well, but I don't know whether you had a chance to look at yesterday's transcripts, but we had a little bit of a debate yesterday at one point as to whether, or why it is that the UK, which certainly had a worse global financial crisis than we did, nevertheless has recognised some three years ago now that it had gone too far in generating a sole focus on stability and introduced a secondary competition objective for its prudential supervision entity within the Bank of England.

Now, we haven't done that, although we did get a proposition today that literally we should adopt that secondary objective, we haven't gone that far in our draft report, but I'm going to ask you to go on the record here and say whether or why it is, as I was trying to ask, I think it was Westpac yesterday, but it might have been somebody else, what it is then that UK, which has a worse GFC than we did, and with general levels of congratulation all round about how conservative we were before the GFC as a big contributor to this and we've seen former Governors of the Reserve Bank say just that, we've nevertheless really, really gone in hard on this unquestionably strong issue.

So why have the UK decided to do some rebalancing back in favour of competition and not us?

MR JESUDASON: So I'll make two or three points. I think firstly before I get to the UK, if I make a couple of comments about their system, in 2007 the Commonwealth Bank had an equity tier ratio of 4.5 per cent, and the banking system did perform well during the global financial crisis, but today we sit at 10.4, 10.5 per cent, and there's no doubt that the system today is stronger than it was even before the GFC.

What Australia didn't experience during the GFC is actually a recession in the country, so we saw the impact of volatility in global funding markets which did impact all banks but was particularly acute to smaller institutions that didn't have scale, and so we're very supportive of some of the changes that APRA and the RBA have made over the last ten years because for all countries, all regulators and all financial institutions, there were some big lessons to learn from 2008/2009.

Moving to UK, I had the fortune, or misfortune to have worked in the UK banking system, particularly in the late 90s, and actually some of the changes that you have mentioned might be emerging now were actually implemented then, and the UK moved very much away from a four-pillar banking system to very strong competition, and many of those institutions that drove that competition were smaller banks, Northern Bradford & Bingley, HBOS was a stand-alone bank, and what happened is, in the short-term credit was extended, and credit became cheaper, but over the medium term many of those institutions failed and the solution was either larger banks to rescue them or the government in many cases to rescue those institutions.

And that, you know, I don't think there's much debate that that has placed a huge burden on the national finances, and on consumers, and one of the big issues that came out post even the rescuing of the banking industry is when you've got unprofitable banks with broken business models, even after the Government bails them out, their extension of credit decreases, right? And you would have seen lots of debates in the UK around why aren't banks lending, particularly to the SME sector. So that becomes a real issue, and this dynamic of strong countries and strong financial systems, and banks with scale, I think, is a really critical dynamic in a successful functioning economy.

Part of that, as it relates to wholesale funding, is particularly when you fund significant parts of the banking system offshore, one of the things that offshore investors look at is, are these businesses economically viable? Are they profitable? Do they have sufficient returns to make this an attractive investment? Because at the end of the day when I, in my current role as CFO, travel around the world and meet investors, including debt investors, they are benchmarking buying our debt or any Australian bank's debt, against a range of other global opportunities, and so profitability scale and the regulatory environment are the ingredients that go into their decision-making.

MR HARRIS: Yes, no, I think we are all on utterly common ground there, but in summary it says the UK have a shocker, we didn't, but they post the GFC have gone, "Gee, even though we've had a shocker, we really have to lift our standards towards", I'll just use our terminology, unquestionably strong, "Ah, but then now we might have gone slightly too far and now we're going to have a secondary objective for the Prudential Supervision Regulator in favour of competition which was, in their own terms, a review of the same kind of functionality that APRA is asked to do; that is, have regard to competition was replaced by a secondary objective is competition.

So we actually have that same terminology, "have regard to", so I'm still left with this question, why are we like this, and the only halfway decent answer is, we're more

dependent than they are on foreign parties, but as you pointed out yourself, SMP is out there, you know, saying, “We are fantastically strong here”, so for us it just contributes to this overall impression of other parties appear to be doing some rebalancing that might be, you know, reasonable parallels for us.

Shouldn't we be at least considering competition more than we are, and we then say, and we have some evidence that shows that, you know, pricing, we agree with you on services, but pricing has moved in a direction which says, for example, you know, that the gap between official cash rates and market rates has roughly doubled since the GFC in some key products, and you say, well, that's a notable move, and perhaps competition isn't as strong as it ought to be.

So we ask the question, and we're asking it more of the regulatory structure because our view is, it substantially drives the ability to be competitive in the marketplace which we've been discussing most of this inquiry, risk-weightings, things like that..

MR JESUDASON: So maybe I could respond.

MR HARRIS: Still interested in this direction question?

MR JESUDASON: Well, the first point I would make, and I should have made it in my previous answer, this is a highly competitive market, and I'll give you a couple of examples of this.

Firstly, if you look at the major banks across some of the key products, including Commonwealth Bank, we have been losing share, so as you think about, if you take home lending, demand by consumers for housing, and therefore home loans, has been extremely strong, to the point that APRA had to bring in some speed bumps which we were very supportive of, and you're quite right, price was adjusted. Price was adjusted as a mechanism of meeting a regulatory hurdle to match supply and demand.

But as a result of matching and manage the objective we needed to reach, which is to be below 30 per cent of interest only mortgages on flow, we lost share, so the market is efficient because you're quite right, price is one of the factors in the marketplace and every organisation takes a view on where they price, but that has a direct correlation to your market share performance.

The second point I'd say is, if you look at the broader banking environment, the gap between the ROEs of the big banks and the small banks have narrowed. It was 9 per cent and today it's 3 per cent, and again, you can see a dynamic over the last 12 months where the major banks lost share in home lending. The regional banks grew and the non-banks grew even faster.

So actually, rather than fewer and fewer competitors, the number of competitors is increasing, and you see that not just in that product, but in credit cards in a number of products, in payments across the financial system, and the point we would make quite

strongly is, competition is alive and kicking. What we want to balance, and we come into the market every day having invested in the franchise to meet that competition, our organisational response is to invest in technology, is to invest in the customer experience.

And you can see that translate into high satisfaction levels, but this is an industry where the solution to the competition has been high degrees of investment by the banks, and the customer experience benchmarks extremely well in Australia versus global, you know, global - other offerings around the world, yes. Yes.

MR HARRIS: We have a comment on a draft report but I'll be diverting to go into it so I won't go into that.

DR KING: Well, I wanted to actually follow up to some - on that, yes. Where is the nexus of competition? If you take - you've got the Big Four and I want to come to four pillars in a second. You've got the Big Four, and you then have five through to whatever, and you add them all up and they don't come anywhere near the Commonwealth Bank in terms of size. So it's essentially fallen, you know, so are you saying that it's just, you know, effectively is competition just between the four?

MR JESUDASON: I'm not saying that. I might hand to Angus who can - who, you know, leads our branch distribution business and he can give you a few examples of how competition plays out in retail products.

MR SULLIVAN: Thanks, Rob. Yes, maybe to build on Rob's remarks, I think even as recent as early this week in their financial review, there was material coverage of the pricing behaviour of second and smaller tier players in the interest only segment of the market quite aggressively pricing that, and it's having a material impact on our business at the moment.

So it's certainly not the case that we operate in an environment where we singularly focus on the other three large banks in the credit card market which has been the subject of a lot of discussion is in excess of 30 providers of credit cards in the market. There are some very successful second tier players. Qantas are making a big push into that space as well at the moment with their own proprietorially branded offer now that they've decided to go with on their own.

So I think, you know, from our perspective this is a market with a number of examples of competition at the manufacturing level. In addition at the distribution level, obviously the existence of mortgage brokers gives a range of additional competitive pressures in the provision of mortgage products to customers, and as you mention in part of your recommendations as well, there are a range of on-line provides for all types of different products, savings products - on-line comparison sites for savings products, credit cards, mortgage rates. They're prevalent, Mozo, iSelect, RateCity, Canstar, are all providing opportunities for price discovery and comparison.

DR KING: And then we can get into more particulars, I think brokers were raised here, but just on that - - -

MR HARRIS: And whether comparison websites are an ideal tool - - -

DR KING: - - - as we said in the draft report, we're not saying competition doesn't exist or is neutered everywhere, and there are some competitive areas and you mentioned the credit card issue which I think is one of the areas we say in the draft report is at currently derived by competition, but when you start getting into the core business which is the lending business, in particular the residential lending business, we don't see the effects of this competition from outside the Big Four.

We don't see that reflected in market share. We don't see it reflected in your return on equity. We don't see it reflected in your interest margin. It's all very well to say that, "Well, we're doing stuff", but that's fine, they don't actually seem to have an effect on the Big Four banks, and in what sense is that useful competition?

MR JESUDASON: I think we've got to take a step back and - market share does not necessarily, or translate to a lack of competition because I the retail bank we have a business with 12,000 people, 11 and a half thousand people who come into work to try and run that business successfully for the long-term benefit of customers, and run a good, growing business, and we, you know, as I mentioned, we invest billions of dollars in the customer experience, not just in technology, but we've added more lenders.

And so even with all of that, you would see in the last 12 months we've lost a bit of share and we've lost a bit of share because it's really competitive. But these are businesses that don't stand still, and to actually compete in the marketplace, which is very competitive, you've got to invest and you need good people at the top of their game, but even with that it's - you've got a lot of people trying to take share.

MR SULLIVAN: I might, if I may, can I forward on to your question on the core products? From my perspective, both our deposits and the home lending portfolios are critically core to the operations of the group. I noted in watching last night the representative of Westpac making a similar point around deposit margins at the moment and their relative - their relativity of pricing to a cash rate, which over the past eight years has moved substantially from below to quite materially above the cash rate, which I think is evidence of very aggressive competition.

DR KING: Remember that APRA post-GFC put a great deal of emphasis on the banks moving to domestic funding between deposits and you'll see the spike in deposit rates, so I mean, the suggestion that that's due to competition rather than regulatory intervention, I think, is a disputable proposition, if I can put it that way.

MR SULLIVAN: Possibly, but the end result of the intervention from regulators was that there was significant competition in the marketplace over the last, I think the data here, seven or eight years which meant that margins in that particular part of the portfolio and across the industry came under pressure. Similarly on the mortgage side, as Rob said, there

are a range of factors that have contributed to the recent margin, which I know is an observation in your draft report as well.

Our strong impression is, when looking across the range of different competitors in the marketplace, the range of products, the range of different providers, and the proportion of business that's originated through broker channels in particular, there's many indicators that it's a highly competitive marketplace.

MR HARRIS: Yes, I guess our proposition's a little less. I mean, Rob, you've mentioned the last 12 months and shifts in market share, you know, and periods even going back to eight years ago, which is squarely in the GFC period and therefore, whereas you notice in the report we did a 20-year analysis and we definitely tried to characterise what had happened, and we can see competitiveness show up in those two key metrics, the difference between the official cash rate and the home lending rate and the difference between official cash rates and the deposits, the rate available to depositors.

And on those kind of trends we can see the periods of serious competition and then long periods with limit apparent movement in that, and we added to it the overall conclusion which said, and notwithstanding that the larger banks, even with two very large shocks, first the freezing up of markets in the GFC, and then secondly, the unpredictably rapid fall in the official cash rates, still managed to maintain what are called quite a stable business that I'm sure it was the duck on the surface, you know, paddling like crazy underneath to keep it, but our proposition therefore isn't, you know, year to year or even back a couple of years.

Our proposition is, are we seeing, particularly today a highly competitive marketplace. We would say there are challenges for everybody running businesses without a doubt, but it does not look highly competitive, and so those - the ability to maintain relatively advantageous positions, or at least stable, that's when market share comes in, at least relatively market shares, suggest that we're having - we're in a circumstance of less competition, but our proposition hasn't been and isn't it dreadful you're running profits, which we debated yesterday was Westpac and have to look at that again, but it wasn't at our volition, it hasn't been that at all. It has been what can be done to encourage greater levels of competitiveness.

And to that extent we look at the activity that's created by regulatory intervention because the capacity to compete is substantially influenced by that, not an evil thing either, just is what it is, and the question is, what more can we do about it?

So I'm still interested in the fact, this was done twice now, I'm just going to mention it for the third time, I mean, here's the UK's benchmark. They had a shocker, we didn't, and yet they've decided that they need more competitiveness and we haven't go there yet, apparently. Anyway, we'll see. We'll see.

I did want to ask you about this caution that you expressly needed to do about our on-line median rates and the possibility of consumers being misled, and it's an interesting

proposition where it says, I can tell you what everybody around the country paid in the market you're interested in who had your income last month, and get misled.

Now, I can see people perhaps foolishly convincing themselves that they were in a particular category and they weren't in that category and therefore making life difficult for a broker or a branch loans officer educating them that they weren't but I can't see how anybody can be misled by a simple statement of reality. So can you expand it more on the deception that comes from actually knowing the real price last month?

MR SULLIVAN: Yes, happy to. Maybe by way of introduction, you know, I think we're of a similar mind that we support the provision of quality information to customers. We see that as an important ingredient in ensuring that there's a competitive market where customers understand well the products that they're buying.

Maybe a couple of thoughts around why we get to the conclusion that there's a risk of unintended consequences by the way that I've described them. Firstly, this is a very, very crowded and complex marketplace. I did have a quick search last night and came up with no fewer than ten on-line rate comparison websites. So it's certainly not a marketplace where customers are devoid of, let's call it data as opposed to genuine insider information as opposed to insight.

Hundreds of products, probably thousands, and the pattern of behaviour that we tend to observe is that 99 per cent plus of Australians decide that they want to go and see a person to help them make sense of that barrage of information, quite overwhelming at times, I think especially when you put yourself in the shoes of a first home buyer, someone who's never been through this before. Being supported with guidance through that process is very, very helpful to them.

Specifically with regard to it and I'll come to where I think their opportunity is in the marketplace, with the provision of the median price there are two concerns from our perspective. One is obviously the price-setting process in mortgages is deeply connected to risk, and there will be an incentive undoubtedly for lenders within any sub-category of products to risk select away from the poorest risks towards the best risks within any box of the matrix so their price presentation appears more favourable to customers, despite the fact that once they get into the fullness of a process and all the particulars of their circumstances are considered that may not be an appropriate or accurate price for them.

Back to my consideration beforehand of the reality that 99 per cent plus of people end up seeing another person, the range of comparison sites that exists today, they present by and large the best or lowest rate that a customer could expect to receive. So if you go into these sites the rates, there is not the median.

MR HARRIS: No.

MR SULLIVAN: It's much closer to the best possible rate available, and so I put it that the motivator for customers to compare where they are today, relative to that information,

is already materially greater than the motivator that would exist if one was comparing one's rate today with the median because inevitably mathematically you're going to end up with half of the people look at that rate and say, "Well, that's higher than my rate. There's no need for me to have a discussion with anyone", when perhaps there may well be some segments of that people of customers who would benefit from a discussion and would reveal a lower rate at the end of it.

I think finally maybe just, you know, I think our lenders, many of whom work for me and do a great job, and the brokers that serve our customers, they do a great job of providing customers with that transparency today. Once they get into the detail that's required to properly understand the right product for them, that process of understanding price comparison is one that I would suggest all of the brokers, and I know for us all of our lenders, have that discussion front of mind with customers to ensure that they can talk to the customer and describe to them why the rate that they're getting is a great rate for them.

MR HARRIS: Sure. Sure, can I go back to the second-last point though.

MR SULLIVAN: Sure.

MR HARRIS: So in fact it sounds to me like you've just offered us some support for the idea because you're saying that comparison websites were offering people like an unnaturally rosy view of their capacity by being the very best, whereas the median won't do that. The median will be the median. It will be last month's median, your income for a house in the western suburbs of Sydney. You know? So aren't we actually helping those people not have an unnaturally rosy perspective, you know, versus our comparison website, and we've written on comparison websites more than once before, so we have some, you know, experience in this area. We did it in data last year as well as the inquiry so - - -

DR KING: I think the position would be that, given the range of data, information that's available today which provides more than ample opportunity for customers to provide a point of comparison that motivates the next step, so given that range of data that motivates the next step, and given the 16,000-odd brokers that exist in the marketplace and the 5,000-odd proprietary lenders who are delighted to help a customer understand the best rate available for them, I think our view is that, given the risks of potential misrepresentation with the median, the risk selection issues that could become apparent from it and the unintended consequence around lender behaviour, I think there's relatively modest upside from that additional set of information into that quite complex landscape that exists today.

MR HARRIS: Okay, just one other question before I let Stephen loose on brokers. A number of the smaller banking institutions have said to us, you know, they're not very comfortable with this idea as well, but they characterise it as an advantage to you, and clearly you don't see it as an advantage otherwise you would be in here today saying you actually love this idea and it's of advantage to us, and I'm a little intrigued as to your - well, can you give me your reaction to that?

I don't want to over-interpret the reasons why it might be in the smaller institutes an advantage to you, but I think possibly the best simple argument I could put forward is, you've got more branches than they do. If this is an encouragement to consumers to bypass brokers because they now feel well informed and go into branches, you'll be an unnatural beneficiary of this. Now, I'm not sure that - delete the word "unnatural". You'll be a beneficiary of this. So what's your reaction to that?

MR SULLIVAN: As simple as I think at the end of all that discussion it's going to be the consumer making a choice about how they want to interact with the e-Bank, history over the past 20 years has indicated an increasing trend and moderation recently towards customers seeking out brokers, I'd be surprised if the provision of any single tool on-line materially shifted customers' behaviours between brokers and proprietary channels.

MR HARRIS: I tended to that view, I did a speech on Monday and there's a half a page effectively on just that, and I don't think it was our expectation that simply by having a more accurate view of what last month's price and profile was in the area that they were interested in, people would avoid going to a broker because of this complexity that is associated necessarily with something like that alone, but nevertheless we plan to consider this further because it's a point we made earlier, but anyway, I'm going to drop off that and ask Stephen does he want to ask anything about brokers.

DR KING: Yes, so thank you for your support, although you feel we haven't gone far enough.

MR HARRIS: Your cautious recommendation.

DR KING: We applied any recommendation about an obligation to the customer to be brokers and aggregators associated with a lender for the simple reason that that's where the obvious conflict arises, so CBA, as I understand with Aussie, for example, and explicitly or implicitly, and I won't ask about that, but the numbers show that CBA product are over-represented compared to the market in Aussie product. I think it's something like 37 per cent versus 21 per cent of mortgages in the data that we had available.

More general, just common sense says that if you're a broker or an aggregator working for a Commonwealth Bank owned body, you're going to feel some obligation, loyalty or perhaps explicit pressure to write more Commonwealth Bank product. So that's why we focussed in on those aggregators. I would be interested in your response to that, and also, depending on that, why you feel that the non-owned aggregator, non-lender owned aggregators should have an additional duty.

MR SULLIVAN: Sure, happy to. So maybe I'll turn first to the question of Aussie specifically for you and our relationship with them and I could come back to the core issue of applicability across the marketplace. Our acquisition of Aussie was motivated by the opportunity to acquire a high quality franchise, one that was very highly regarded by Australians and one that spoke to a segment of customers to whom the Commonwealth Bank brand doesn't. Candidly, we saw it as additive to us.

Our business through Aussie, I think it's very important to separate into two quite materially different categories of loans that originated through the Aussie platform. There are loans that are branded CBA or Bankwest, for example, what an average consumer would think of as a CBA group branded product.

Over the past number of years I think introduced about three or four years ago, Aussie launched their own Aussie-branded mortgage product. Funnily enough that was actually how Aussie started out for, sort of, remember the days way back when - - -

DR KING: When they were securitised.

MR SULLIVAN: Exactly, when John Simmonds started it and - - -

MR HARRIS: I remember the ad. I remember nothing else, but yes, it's still in my - - -

MR SULLIVAN: So you know, John was very keen to rebuild that part of the business. I think he had a great affinity for it after the business starting that way, and so we provided to them effectively, think of it like a wholesale facility that provides the funding for an Aussie-branded product. If you look at just the CBA - - -

DR KING: But just to clarify - - -

MR SULLIVAN: Sure.

DR KING: - - - for my own point of view, those mortgages now aren't securitised. They remain on CBA books, don't they?

MR SULLIVAN: Correct, yes.

MR JESUDASON: Yes.

DR KING: So that's a significant difference from the original model.

MR SULLIVAN: Correct, and happy to talk to the position of the Aussie-branded product as well because it's a - so the CBA-branded products are our share, so CBA and Bankwest together runs at roughly 16 per cent, just slightly below the average share that we received from the top ten hit groups.

So there is - I accept there's the potential for the perception of a conflict of interest, but we've run that business very deliberately quite independently from the CBA Group to ensure that the brand and the trust that customers place in the Aussie franchise is maintained through our ownership of it. We saw that as absolutely critical to the value of the franchise, and we've been obviously delighted to be able to work with Jai and the team at Aussie to provide their support their aspirations to grow the business in a slightly different way.

So I understand, exactly to your question, I understand the potential to see it that way. In fact, it is not that way. That isn't how we've run the Aussie business and it's not how we've run the Aussie business and it's not how we've overseen and governed it.

Back to the broader issue of our interests around why apply this standard across the entire industry, yes, I think that's as simple as, we're enormous supporters of, as we've done with the recent changes around accreditation of broker space, we're supporters of growing the standards of the industry as a whole, and for the broker segment in particular, and the best interest duty that you outlined. We see that as a positive development. If it was applied consistently across the industry, I think it would be peculiar for consumers to have one standard with one set of brokers where they could be assured that the broker is acting in their best interests and they'd go to another broker around the corner and there would be a different standard applied. I think that would be highly counter-intuitive to your average consumer.

DR KING: A couple of follow-ups on that. The first one, do you think most Aussie home loan, they talk about three directions ... (indistinct) ..., cut me off, do you think most Aussie home loan in customers who are buying the Aussie home loan product would know that that is actually a CBA product? It is a rebranded CBA product?

MR SULLIVAN: I'm not sure candidly. What I do for a fact is our ownership of Aussie is fully disclosed on the website and in the materials.

DR KING: You'd be happy, though, for the customers to know the - - -

MR SULLIVAN: This is agnostic. You know, we're very proud of our affiliation with Aussie, but we also see the importance of maintaining that as an independent brand. The - - -

MR HARRIS: The marketing people would be very unhappy with you subsuming one brand inside another when they've paid quite a lot for the brand, I assume. I assume.

DR KING: Second direction, given your investment in Aussie, and I'm not sure if this is something that is relevant, but I'm interested. One of our other main directions that we're exploring from the draft report on brokers is, having wealth advisers able to more readily offer credit advice, and operate more in that space, I'd be interested to know your feedback on that. I know Commonwealth has its wealth advice area as well as its broking, but I'd be very interested to know by the way how many of your wealth advisers also have a credit licence because that's something that - - -

MR HARRIS: It seems to be very hard for us to get numbers on, but your view on that. Do you feel that's appropriate?

DR KING: So happy to, if we can, we'll take on notice the exact number and try and come back to you with something that would be helpful.

MR SULLIVAN: Maybe two thoughts on the planners into the credit space. If I recollect correctly from the discussion I watched yesterday, I think some of that was pointed at, might there be more forward-looking commission-based or, you know, fee for service type of models that the financial planning industry could bring to the table by being involved in the distribution of mortgages.

So, two comments. One, you know, with 16,000 brokers out in the marketplace, certainly not in a position where I think we need more people to serve Australians well and meeting their mortgage needs in terms of broker comparison.

So for me it's certainly not a quantity issue. I don't think that the industry is short brokers and I don't think a move to bring planners into the credit space, given the important role that they play and their special set of skills, I think that's not necessary. More directly to your observations or thoughts from yesterday, I guess, on the might there be more forward-looking models, obviously the ASIC and ADA work under Sedgwick have outlined the serious recommendations around what forward-looking models might look like for the brokerage industry.

I think we've come out quite explicitly saying that we've supported both of those reviews and we'd be supportive of the industry moving forward if there's a better model that we could support in a prudent and proper way executed over time.

MR HARRIS: So other businesses, of course, in Australia have got out of paying trailing commissions substantially, insurance, for example, and overseas, we know that brokers do exist. This doesn't. This particular proposition. WE have that from - ING told us a bit about how broking works in continental Europe and others have told us how it works in the UK, and Rob, you've obviously been there, so - and I say, this is uniquely Australian, but it doesn't suggest that the world will collapse if this proposition isn't there and the question is, what incentive structures would be preferable to this kind of incentive structure from our perspective.

We haven't got a recommendation on this, but it's an area where we're interested in finding out a bit more, and there's a reason why we haven't. We just don't think we had enough to have an opinion absolutely on it, which is sort of why we're running the argument as publicly as we can now. Let's get some more response on this. It's not something that we would expect necessarily occurs to everybody, but this transparency of the whole commission structure equally deserves a little bit more exposure, but it's the incentives that we're primarily interested in, I think, by way of public comment.

DR KING: I just want to pick up on one thing there.

MR SULLIVAN: Yes.

DR KING: On that separation, so, yes, I don't think there is a shortage of mortgage brokers, but from the customer perspective, you know, isn't it a bit odd when you go and see a wealth adviser that that wealth adviser in a sense isn't able to offer advice about -

effective advice and loan advice, credit advice about what, for most Australians, is their biggest asset, and it does seem to me, and maybe this is naivety on my part, it just seems to me to be bizarre that we don't have those two key elements, you know, wealth for most Australians is housing.

MR SULLIVAN: Look, very practically, and I can comment obviously in more detail and with regards to CBA and I think across the industry there might be others who have a deeper view than I do. You know, in our branch network, our planners and our lenders, our mortgage lenders sit side-by-side in offices in the same building, in the same branch, so the distinction between the two roles, you know, it's a - you know, I sit here, Rob sits there. I'm the planner, he's the lender. We work very closely together because customers often have the need for that type of financial planning advice concurrently with when they're taking out a home loan. They might want to think about protection or a time of planning down the path.

You know, one of the other reasons that I think it bears real consideration, I just know very practically and in my experience running the branch network, there's a real limitation given specially the complexity of process and regulation for our people of how much you can get across any one person, and as you all appreciate, the financial planning landscape in terms of regulations, vote for reforms, et cetera and the obligations upon planners are very - they're heavy, and they're complex, and the obligations upon our lenders are also quite complex. It would be quite hard, in my practical experience, to find an individual who would be able to easily get across both of those domains.

MR HARRIS: But people, surely in a competitive market where choice rules, should be allow to try. That's - we see this is a competition initiative. I mean, it's competition in the service provider space, and because we've asked the regulators and no one is yet to come up with a good reason why it is as it is. It just has been as it is, although we're still going to investigate that further, but as competition initiative perhaps it will be complex and difficult and not too many people will try, but the fact that we're proposing to put professionally trained wealth manager into a sphere where professional training is less emphasised, or professional qualifications as we heard from FINSIA earlier, is less emphasised, suggests to me that we're certainly not adding to risk here for the consumer. We might be offering them something better.

MR SULLIVAN: I don't have a particularly strong view one way or the other. I suggest that if the Commission's concern is around the quality of the brokers, there are probably more direct ways to go at the quality of brokers. We've obviously made a big investment in that accreditation in ensuring that all of the brokers we work with meet the right professional standards, and - - -

MR HARRIS: yes, well, there's price as well, just before we leave this, not just professional standards. You might have noticed in the report, but we find it hard to get information, so I would really appreciate if you've got any better information on this but it appears that a wealth adviser for about - placing about the same amount of money as the average mortgage, and we know that the average mortgage is a nationwide number, so in

Sydney it sounds like a meaninglessly low amount, but not elsewhere, or not in many places elsewhere, but for the \$300,000-odd that the average mortgage is, it appears that you can get wealth management advice for a factor significantly lower than the upfront charge by a broker to place a borrower in a home loan. So we'd say perhaps there's a capacity for price competition here because the wealth adviser is obviously used to getting paid somewhat less for placing \$300,000.

Now, again, I don't know whether that's literally true, but I'd appreciate any data that the Commonwealth Bank might be able to offer on just that kind of price comparison, but we saw it as being - here's another way of just looking at competition. Anyway, we've probably pushed that tremendously hard. Did you want to run any other issues?

DR KING: There's a couple of quick ones that I do want to - - -

MR HARRIS: Well, you mentioned one that I'd rather you didn't.

DR KING: A couple of quick ones. We're running out of time.

MR HARRIS: No, we're not quite out of time which is a pity because - - -

DR KING: Now, you don't - if I - I hope I've got it right, you don't have an internal LMI operation? You work through the externals?

MR SULLIVAN: Both arrangements.

DR KING: You've got both. So you do have them internal. Do you mind just clarifying for me how that goes with the customer - so this is - I'm still a bit in the dark or unsure about exactly how that relationship goes, so a customer has, let's say, an LVR of 90, you know, and I've picked a figure above 80, so right, you need a - you need LMI. A customer, you have to pay for it. What choice is available to the customer at that stage? So do you say, well, we've got Genworth over here and this is how much they'll be, and we've got QBE, I think off the top of my head is the other one, over there, and the internal Commonwealth LMI and you can choose between them and, you know, do you have competition, or is it simply that the person writing the loan at that stage says, "Well, here's what LMI's going to cost you"?

MR SULLIVAN: So two introductory thoughts for you. I mean, first and foremost I would have said the choice that is available to customers and a small, or a number of them take it if they take more time to save the deposit to buy the house and not buy the LMI - - -

DR KING: I understand that it's an alternative but - - -

MR SULLIVAN: That is something that's available to customers.

DR KING: But let's assume they're going to take LMI.

MR SULLIVAN: So we have a one LMI rate for us, for our customers, plus there's obviously available to - they can go to a competitive bank or they can go to a broker and cover their different range of offers available for them, but for simplicity, we have one rate that we put to customers in terms of LMI.

DR KING: Okay.

MR HARRIS: I mean, given that the customer again pays that, I mean it's just a transfer through to the customer, I mean, on what basis does Commonwealth have the incentive to make sure that the customer's getting the best possible deal?

MR SULLIVAN: Customers would still pay much attention to the rate that they're paying in addition to the LMI premiums for - - -

DR KING: I'm sure, but LMI, I mean, on a 90 months and LVR, the LMI premium, as I understand it, is pretty substantial. I think you could be looking at about \$10,000, I suspect, on a standard home loan for the 90 per cent LVR, so that's - that's non-trivial from the customer's perspective. You just give them a rate, so where's the competition? There's alternative LMI providers, but it doesn't seem like the person whose interests in the competition gets any say in that.

MR SULLIVAN: So, you know, obviously this is a segment of the population which is high risk in terms of assets, gentlemen, and obviously we use the LMI insurance as a way of being able to lend to customers who we may otherwise not be able to lend to, and often that's of enormous value to those customers, to be able to get into their home a year or two earlier than they might otherwise be able to do that.

As we've noted beforehand, in the mortgage market there's a range of different providers and broker and lenders who can help customers uncover and compare the rates for a 90 plus zone, a 95 loan, an 85 loan. That information is available and clearly disclosed to customers for comparison if they so wish to do.

DR KING: I just find it odd that, I mean, I find it odd that the Commonwealth wouldn't want, you know, a more competitive rate and, you know, and want their custom - the customer's more likely to take out a Commonwealth Bank loan if you say to them, "Look, here are the alternatives. We can get you a great LMI rate to help you". I mean, otherwise, you know, it just strikes me as a bit odd when you're saying, "Well, the customer can go elsewhere", and the Commonwealth can lose the loan.

Are there any other reasons, any other incentives we should know about with regards to LMI? Does the Commonwealth receive rebates, for example, if it relates more to Genworth or QBE contracts? I mean, I just seem to be missing something here because it seems like a no brainer that the Commonwealth would help customers on this and you're telling me, no, they can go away to somebody else.

MR SULLIVAN: On the contrary, we feel like it's a - it's an offer that we're very proud of and obviously we put a lot of work into making sure that that's competitive with the marketplace so that the LMI price, and the rate as I mentioned beforehand, obviously that's front of mind for customers as they go through that origination process, and so we've put a lot of time and energy into making sure that that LMI rate and the offering of those with it and the mortgage rate are competitive to the marketplace, so it's certainly not in any case the instance that we want a customer not to take their product with us. I'm simply saying that there's a range of obviously competitive offers in the marketplace.

For reasons of simplicity, we put one rate, in terms of LMI, to our customers and we work with them to ensure that's appropriate for their needs.

DR KING: Is Commonwealth able to use its buying power with one of the insurance companies? I mean, again, I would have thought in your position you would have gone to one of the insurers and said, "Well, I'll tell you what. You make sure that you're providing this great rate, and we'll, you know, perhaps with volume discounts and some rebates back to the Commonwealth, so that we get a better deal for our customers", and you know, does the Commonwealth do that? is that the sort of thing that I'm missing here?

MR SULLIVAN: Certainly not in any way primarily in the decision that we make around the offering to our customer. I mean, that's guided us, as I mentioned beforehand, a very competitive market. We look across the marketplace at the - our competitors, LMI or, you know, loan insurance offers and premiums, and we make sure that we're highly competitive with those rates for customers.

MR HARRIS: The claim rate struck me as being quite, well, as a product, if I understand rightly, claims against LMI are quite low. Premiums are quite big, and I think I can recall something suggesting that the claim rate's about 50 cents in the premium dollar. It might be even lower than that. Does that sound right to you?

MR SULLIVAN: I'd need to take it on notice. I wouldn't want to estimate it.

MR HARRIS: Yes. If it was of that ilk, it sounds like a premium price might be a bit higher, doesn't it, because we've got this ASIC data on other insurance products where claims are in the 85 to 90 per cent category versus premium, so you know, a 10 per cent, I don't want to say profit because it's not, but I'll say some margin of some kind, but you know, a generalistic kind of term here, but - and that seemed to be considered to be acceptable. Maybe not great, but acceptable.

MR SULLIVAN: I think to Rob's opening remarks, you know, that rate or the claim rate obviously in strong economic times will represent something that's not reflective of a through the cycle claim rate and the experience obviously when customers which we obviously work very hard with and to avoid them going into a position where they lose their home and need to claim on that insurance, but that rate would be reflective today of a very different point in the cycle than the claim for - and the magnitude of losses that both we and our reinsurers would experience in a stressed scenario which would be material.

MR HARRIS: Right, and we might try, if we go down this, we might try to get some better data. As you say, it'd be a more sort of through the cycle proposition, and maybe see if we can find a comparable benchmark, kind of, so whether that's a, you know, reasonable sort of risk, and then - because there is a risk obviously.

DR KING: I have one question to start with.

MR HARRIS: Yes, go for it.

DR KING: General advice.

MR HARRIS: Ask.

DR KING: Unfortunately one of our Commissioners is unable to be here because of - - -

MR HARRIS: Yes, but anyway, go on.

DR KING: But you did want to get your views on general advice, and the Commission has obviously recommended changes in that area with regards to both, you know, what is potentially a misleading name for advice, just general advice rather than personal advice. Your views on that whether that change would be desirable, and if so, how - can you aid us in getting to a recommendation implementation rather than our recommendation or draft recommendation which is to say something needs to be done, but - - -

MR SULLIVAN: Yes, I'm happy to offer one thought. It's a very practical and quite tactical thought, given the majority of the time that I spend in our branch network.

I would just suggest there's been an incredibly large amount of time and effort that's gone in to build the current level of awareness, albeit if your assessment of it is that's insufficient, it's your view perhaps.

To educate customers around what general advice is today and what personal advice is today has been an enormous effort for the industry. You know, those words don't have what I would describe as an immediately intuitive common sense interpretation for Australians, but we have worked very hard to help them understand what those mean so that they're getting the products and services that meet their needs.

The only thought that I would offer in regards to that is, anything that we started, the naming convention would restart a process of very material education again, and one would just need to give due consideration to the relative upside of any new name, vis-à-vis the cost and effort that would be required in helping Australians understand what that practically meant.

MR HARRIS: This morning, I asked one of the participants, though, another option is not to rename general advice, and another option is to abandon it because it was singularly

failed to convey what it was intended to convey which is, this is not tailored to your particular circumstances, which I know is in the script immediately afterwards, but it doesn't seem to - I think a number of participants have said to us, it's a fairly common view that this hasn't worked very well, regardless of - I'm not questioning the effort at all.

The question is, were the words themselves an adequate foundation for all the effort that has subsequently gone in. Whether we might not be better over-emphasising something as professional advice, or it's just things that you heard, in other words, to abandon the - anyway, it's a question. If you were to have a view on that we'd interested in that by way of a further submission.

MR SULLIVAN: Okay.

MR HARRIS: So do you have anything else?

DR KING: I think that probably does me.

MR HARRIS: Excellent. Managed to avoid at least once - - -

MR SULLIVAN: We all thought we'd go for more than an hour.

MR HARRIS: No, no, you guys probably - thank you, anyway for making the effort to come along. Thank you for your cooperation - - -

DR KING: Thank you very much.

MR HARRIS: - - - and help so far in the course of inquiry and we'll look forward possibly to asking you some more database questions when we frame our next round of requests. Thank you very much.

MR SULLIVAN: Thank you.

MR HARRIS: Okay, I think just to continue the pressure upon us to comment at the highest possible level, I think we have the National Australia Bank. Thanks, Rob.

When you're settled, if you'd like to identify yourselves for the purpose of the recording, thank you.

MR CAHILL: Antony Cahill, Chief Operating Officer, National Australia Bank.

MR DOOLEY: Shaun Dooley, Group Treasurer, National Australia Bank.

MR HARRIS: And do you have a statement or something that you'd like to read?

MR CAHILL: Yes, I do, Chairman, thank you.

Good morning, and thank you, Chairman and Members of the Commission for having us here today. Today I am joined by Shaun Dooley, NAB's Group Treasurer. We welcome this opportunity to speak with the Commission on the competitiveness of the financial system in Australia and assisting with this important inquiry.

I have worked within the financial services industry for 20 years and believe Australians have access to world-class financial products and services designed to meet their needs and circumstances within a competitive market environment.

We note you define competition as being where customers benefit from high quality products at low prices. While we agree with this point, we also believe the market must have the characteristics of being both secure and sustainable, in addition to being capable of functioning efficiently throughout the entire credit cycle.

Stability and competition, however, are not mutually exclusive. A competitive, resilient and well-regulated financial industry is critical to Australia's ongoing economic stability and the growth of the broader economy. We believe Australia's financial system is both efficient and well-regulated, and in the vast majority of cases delivers positive outcomes for both consumers and businesses.

In 2018 the level of competition in the market is truly intense. In addition to the established competition from 148 ADIs and other non-ADI lenders in the market, we are now seeing the emergence and rapid growth of new competitors such as fin techs and tech giants.

Last year KPMG reported Australia had seen a more than five-fold increase in the number of fin tech companies from less than 100 in 2014 to 579 companies at the end of 2017. While we do look for opportunities to work with start-ups, fin techs and emerging technologies where there are opportunities to create new experience for our customers, we are acutely aware the majority of these new players will likely act as direct competitors.

We are now also seeing the global tech giants such as Apple and Facebook continuing to move into financial services, particularly in the payments environments through services such as Apple Cash and Facebook Messenger. These tech giants are truly global businesses. They're many times larger than any Australian bank, and have multi-billion dollar budgets which dwarf the investment capacity of any Australian company.

Customers, however, are the net beneficiaries of this situation. Overall borrowing rates are now approaching the lowest levels on record. Many fees and charges have been reduced or removed while services such as digital payments and mobile banking are widely considered to be amongst the best in the world.

Most importantly, this is delivering high levels of customer satisfaction with industry satisfaction rates moving from 58 per cent in 2001 to 80 per cent today. Competition is clearly reflected by key performance indicators, and that interest margin has halved over

the past two decades and ROE has dropped by 740 basis points or 40 per cent over the past 15 years.

While margins are under pressure, it is important to note that price is not the only factor consumers take into account when selecting a product or service. We work hard to understand what our customers want, and our research consistently tells us that customer advocacy is driven by multiple factors with customers often valuing the overall experience and outstanding service as being equal to, or more important than, price.

It is for these changing market conditions that we know we must respond. We are doubling our investment in our innovation hand-up brief, NAB labs, and in 2018 we will invest more than 200 million in our customer journeys program as we seek to complete the re-engineering of our key customer experiences. It is also while we place a key focus on improving the net promote to school in our priority segments. We already have the number one score of the four majors in our priority segments. However, we recognise it won't be sufficient to win in the long term and we have set goals that will place us amongst the best in the world.

We have also recently announced a multi transformation program designed to improve customer experience, increase agility, whilst also removing more than \$1 billion in annual operating costs from our company, in part to respond to the growing pressure generated from strong competition. This competitive dynamic has been created within an environment that has also delivered long-term stability. It's widely acknowledged that Australia's regulatory framework for financial services was the envy of the world during the turmoil of the global financial crisis, and today we continue to be viewed as a well-regulated and stable industry.

As a nation, Australia is a net borrower of funds, and as stability plays an important role in enabling us to borrow money at competitive rates in offshore money centres to on win to customers to buy a home or grow a business. I firmly believe this situation needs to continue and any changes designed to increase competition must take into account the overall impact on stability as we need the system to deliver for customers through all stages of the economic cycle.

From a global perspective, the stability has not stifled competition or innovation. On key metrics relevance competition across the globe, such as ROE and net interest margin, the Australian financial system is not an outlier. For example, the ROE of Australia's banks is comparable to Canada where the banking system is similar in structure and also void of significant losses in the GFC, and broadly comparable with banks in Sweden and Denmark.

In 2017, the RBA observed that Australia's major bank NIM is in the range of large banks in other countries and close to that of Canada. Since 2008, there have been more than 50 Government or regulatory policy inquiries or reviews, 12 of which are ongoing. One of the key inquiries, the Financial System Inquiry, or FSI, made the point that competition in the financial system is generally adequate at present, but we do note a call for this to be monitored over time.

Following the publication of the FSI, numerous industry changes have been introduced that are designed to improve customer outcomes such as a new code of banking practice; changes to remuneration following Sedgwick; the upcoming establishment of the Australian Financial Complaints Authority; and reforms to credit cards. A number of significant changes are still to be implemented. These include the introduction of comprehensive credit reporting and the open banking regime. At NAB, we've taken leadership positions on CCR and its introduction since 2015.

On Monday 19 February this year we became the first major bank, ahead of legislative mandate, to participate in CCR for personal loans, credit cards and overdrafts and we look forward to this being rolled out more broadly. We do believe it's good for competition and it will mean better outcomes for customers.

Building on the work of this Commission's inquiry, open banking will introduce new opportunities for customers given them control of their data and improving the way data can be shared, introducing an open banking regime will place Australia at the cutting edge of competition regulation alongside the European Union which is in the process of introducing a regime known as PFD2.

Last month also saw the launch of the new payments platform, NPP, in Australia. NAB is one of 13 institutions working together to develop the NPP at a significant cost to the industry to make payments faster, easier and more convenient for customers. Importantly, NPP also enables customers to set up a pay ID, an identity such as a mobile phone number or an email address which will make it far easier for customers when they seek to change financial institutions.

From an innovation perspective, Australia is viewed as a leading market in terms of innovation. As it stands today, Australia has one of the highest penetration rates for contact less payments in the world, and the uptake of mobile banking is also equally high.

In 2017, as Australia's largest business bank, we saw an opportunity to create an unsecured digital lending product for small businesses for up to \$100,000 with a fully digital application process. This allows small businesses to apply on-line for a quick process, have approval in minutes and cash in accounts within 24 hours. We've also partnered with realestate.com.au to provide a seamless search and finance experience for home buyers and we're working closely with Xero to provide market leading experience for Australia's small business customers. These three examples represent real innovation and they have delivered world-class experiences for our customers.

So in conclusion, given the breadth and scope of this review in the limited time we have available today, there are three areas that we feel best placed to provide further context on in line with some of the observations I've made today, namely the competitive landscape and market dynamics; ensuring a balance between stability and competition; and thirdly, the extent to which customers can exert competitive pressure. We feel these topics are the cornerstones of the competitive landscape.

In closing, we do support the work the Commission is undertaking to ensure our system remains a highly competitive one. We hope our comments today and our written submission, which will follow, helps to inform your views and understanding of the competitive financial services landscape in Australia.

We welcome your questions, and thank you.

MR HARRIS: Thanks, Antony. I think we can stick with the three, sort of, general topics that you have proposed, although we undoubtedly here will dive into others, and you will, as best you can, respond, but this general question, I don't know whether you have observed some of the other participants here, or whether you were present for the discussion earlier.

This general question of the competitive landscape, I don't think we're going to have much to differ over about the, if you like, the quality of services that are attempted to be offered to customers in Australia and the rapid adoption of technology and the equivalent, but this question of price, although I do note you emphasised that your survey works suggests consumers value quality as much as price, it may well be true, but price competition, as you can see from the report, is the area we think weaknesses are reasonably evident for pretty substantial periods.

And certainly since the global financial crisis and the emphasis on it are unquestionably strong, it appears to be the case that price competition, even though as we acknowledge at any point in time firms are under pressure from other firms, but price competition itself hasn't resulted in any kind of substantial shift in favour of consumers, and to the extent you use different benchmarks you can find different numbers, but it does not appear to be the case that that's - we have a strongly price competitive market from our perspective.

Anyway, we're interested in the debate and discussion that that undoubtedly generates. Yesterday we were encouraged to think about different measures of profitability. We're not that bothered, we've been trying to say continuously, about profitability per se. We're interested in the nature of competition and its measurable effect, particularly in pricing, so to the extent obviously that you feel a need to talk about profitability that's fine, but our focus is really on those measures which tend to show as far as we can tell that consumers aren't necessarily benefitting a great deal in the pricing space, and we've used, for example, the increase in the gap between the official cash rate and the rate paid by consumers, or in the case of deposits, the rate received by consumers, just as a kind of benchmarking exercise.

So do you have an opinion or a judgment on those?

MR CAHILL: I think the, and I'll ask Shaun to touch on it, but that's certainly a vision we're taking a look at in terms of what are the returns that it would generate compared to the cost of capital within the business, and I think that's a particularly important measure to look at, but from a competition perspective, if we look at mortgages for example, at the moment, absolutely in the last six to 12 months mortgages now, and it's near the lowest

rates on record. In terms of competition for flow, the January stats were published yesterday, for example. All four of the majors grew below the system, and the second tier banks or the smaller banks are growing well above system. So the smaller banks are absolutely winning market share at this point in time.

We are competing fiercely in the marketplace to win new mortgage customers, and you're seeing very significant discounting playing out at the moment and really all the majors and the smaller banks are all competing very hard for those customers to effectively join the banks, so I think this discussion around is our price competitive? Absolutely, and you would have seen that play out at the moment in terms of the rates that are available to borrowers, and secondly where the growth is actually occurring, that the four banks traditionally have been seen as the largest players in the mortgage market, but that absolutely the other players are winning market share and growing faster than the rest of the market.

MR HARRIS: The fact that rates are historically exceptionally low for borrowing is one thing, but official cash rates are also at, depending on which nice historical parallel you like to read, 200 or 500 year lows, so of course we've only been around for 200 years so - but in Europe 500 year lows, so I mean, we are in a really unusual circumstance and the gap is our, sort of, one of our more substantive indicators of the gap between official cash rates and rates paid by borrowers is just an indicator. It's not a perfect judgment one way or another, but it's an indicator, and it's definitely grown since the global financial crisis.

So we say to ourselves, it's most likely that there are many contributors to that, but one factor that suggests this is, you must have market power in place if no party is prepared to jump outside, as it were, the pricing paradigm, and force that down towards the official cash rate, while still maintaining a reasonably healthy margin.

MR CAHILL: And then I'll hand to you, Shaun, but probably just make two points. The new in the business has halved over the last 20 years, so the net interest margin that is generated across the company has halved and we think that absolutely demonstrates there is strong competition.

Secondly, the bank has to generate its cost to capital, and our statutory ROE last year was effectively equal to the bank's cost of capital. Secondly, if we don't generate returns above our costs of capital, we can't continue to grow our lending to our customers because clearly we have to have capital, tier one capital to on lend to customers. So when you look at NIM and then you look at how that relates to ROE, I think that very clearly demonstrates very strong competition, but Shaun, you may wish to add to that.

MR DOOLEY: Thanks, Antony. What I was going to add to that is the comment around the cash rate and the relevance of the cash rate. What I would say is we don't fund ourselves as a bank around at the cash rate. Our funding profile is - it comes from many sources, both in terms of mix, but also tenor, and there's been a lot of change in the way bank balance sheets have been funded over the past few years, so really since the GFC.

Some of that really are decisions made by management teams of the banks to continue to strengthen their overall balance sheets to ensure that we're able to withstand a series of shock scenarios so - and we've very much run our bank about - around scenarios that could play out, but also responding to regulation, and so regulators around the world have sought to strengthen the system by ensuring that certain liquidity and funding ratios are met which will change the mix of both our funding profile and therefore the cost of funds, so we will be borrowing in two markets, so for instance, last year we raised about \$36 billion of wholesale term funding that occurred across a number of markets.

About 75 per cent of that came from outside of Australia and New Zealand, and that was from a range of tenets, everything from sort of three year through to ten year, and we need to continue to manage the funding profile of the bank to ensure that it's stable, and the costs associated with that are not directly linked to the cash rate. The cash rate does have an influence, but we don't fund ourselves with the cash rate.

MR HARRIS: No, no, I think we understand that. We just chose it because it's a benchmark that everybody can understand; everybody meaning everyone who's familiar enough with it will know the weaknesses and strengths or otherwise, but in terms of your own off-shore cost of funds, which as you said is a big contributor to that, so off-shore costs of funds appear to have been, you know, incredibly low themselves during this period, not so they aren't, you know, I mean, they're positive.

They're not negative as for temporary periods people were happy to accept from the official sources in Europe, and in Japan, but they're low as well. So it appears, although we don't have the data and I guess maybe you could help us with some data which shows just on that - there's a nice graph in our draft report which does show the difference between official cash rates and market borrowing rates, and how they have increased notably, or near doubling since the GFC, how has that occurred as a consequence of off-shore borrowing? We'd be very interested in trying to sort of break it down for that.

Our overall commentary on the NIM, for what it's worth, has been, we agree, 20 years ago. Just as brokers came in, there's a very significant reduction in margins and it's again a benchmark in our report, but going on the data throughout the shocks of the GFC and the way it's falling, the NIM is very stable.

I mean, admittedly slightly down as a group for the larger banks, but pretty stable for a period of, you know, absolute, once in a couple of generations kind of thing, which does suggest to us again an ability to maintain a margin, you know, I'm sure a great deal of investment, but nevertheless an ability to maintain it suggests that it's not a strongly competitive market. We would have expected to see more shocks in the NIM line for you, pretty much like some of the smaller banks, but perhaps not as bad, but you are very good at maintaining, you know, probably because you were very well rated, maintaining your healthy position in the marketplace.

And so that's not a criticism. That's an observation which leads you to a conclusion that we're not in a circumstance of ruthless competition. We're in a circumstance of wealth

of stability and calm, and so we're - everyone's in favour of stability and so are we, but we're looking therefore at what we can do to alter the competitive paradigm.

MR CAHILL: I think my one response, my key response, though, is that interest margin, the ultimate returns of it generated. Bloomberg estimated, or estimates our costs of capital for external estimate is around about 11 per cent. Last year our ROE was 10.9 per cent. So as an institution now, if NIMs and returns go any lower, we're not actually covering our costs of capital.

So as a bank, as I'm sure many other institutions are, this is why we're spending hundreds of millions of dollars and seeking to ensure we provide customers with additional value-add products and services, given the best possible experience they're looking for because we have to be able to generate a return that covers our costs of capital, and so when we undertake our net promoter score surveys, and when we talk to customers around what are the key drivers of their choice, yes, price factors into it, but there are other factors that they use being just as important, if not more important, and really that's how we're seeking to manage this, Chairman, in terms of ensuring that we can generate a return that covers our costs of capital, and therefore how do we have a conversation with customers that isn't just purely about price? What are the other areas that they do value? Why would they choose to come to NAB as opposed to another institution?

MR DOOLEY: As Antony said before, in order to continue to support lending in the marketplace, we need to be able to generate core capital. That's in order to enable us to continue to grow a balance sheet. I think it's worth pointing out that the environment within Australia over the last couple of years, the economic performance of the country has been very stable, as we all know. As a consequence we're seeing the incidence of bad debts across the Australian banking sector really of long-term lows, so when we think about our bank and forecasting of our capital position, we need to look through the cycle, and you would expect in time that obviously the cycle of the economy will change, and we might see bad debts vary from what we're seeing today.

And so we need to prepare ourselves, and we do run our bank, as I said before, with the ability to withstand a downturn which requires us to manage not only a strong balance sheet, but continue to generate capital as an institution.

In terms of the NIM, the NIM, obviously there's the cost of funds and then there's the interest revenue that we generate from our customers. So I'll talk about cost of funds. We have seen a fair bit of volatility in spot cost of funds, and I want to make the distinction between average cost of funds and spot cost of funds. Spot costs of funds is the price that we pay when we go into the market today for a transaction, but given that the, I guess the tenor of our funding book is about five years on average, so 20 per cent of the funding book is maturing in any one year and we're having to go back and replace that and so on, so it takes a while for spot costs to move into average costs in the ...(indistinct)... hence why the slow change, and that's appropriate. You don't want volatility in those key financial measures because that would imply that you're running a very volatile balance sheet and

that's clearly - that's not what we want to do as a bank, and that's the sort of thing, what our regulator or our counterparts or our investors would like see as well.

But really since the GFC, and it's important, I think, with the - to the state of the GFC, it was more of a financial crisis in liquidity and asset markets that were largely outside of Australia. It had an impact on Australia because we participated in global markets. We rely on global markets for our funding, and so we saw credit spreads move out a lot through that period. We also saw a number of markets completely seize up through that period, and the most notable one was the securitisation market in Australia in 2008/2009 largely disappear with the exception of the intervention from the Government through the Australian Office of Financial Management.

We have seen a significant return to health of the securitisation market over the last couple of years. 2017 was one of the strongest markets that we've had for some time, and we, as a bank, are very proud of our leadership role in the securitisation market, and really to facilitate access to funding of smaller banks and none-bank KDIs, who rely on the securitisation of the market to fund their businesses.

All participants need sustainable funding models, and the securitisation market and our role within that is key to that. We were involved in most of the transactions in the market last year. We are the leader, in our view, of arranging transactions for other players, and we were pleased to see a return to health of the securitisation market last year after some quite difficult years.

But since the GFC we've also seen volatility and credit spreads come things like the Europe crisis, and we saw a lot of event risk occur through 2015 which saw a lot of volatility and credit spread, so when we think about the cost of funds, there's the base cost. As you observed, the official cash rates in many countries are at historic lows, but credit spreads move around, and the other factor that we have to consider is the cost of bringing that currency back into Australia.

So there's cross currency costs because we bring everything back to Australian dollars and we manage the risk here, and so there are a number of drivers that go into the land of costed funds that are not solely linked to what's happening in official cash rates, so it's breaking up those components.

And then what we're also seeing is the influence in different markets. So we raise money in Japan, in the US, in Europe, in Taiwan, in a number of markets in a number of formats, all of which different drivers in terms of the funding costs, and they vary over time.

MR HARRIS: Yes, that's why we're interested in that cost of funds line which is - in our - we don't have that data, and so we just have official rates and market rates because they're both, relatively speaking, publicly available, but they do show that shift and that's one of the key foundation stones of our report.

I think we're interested in securitisation, but we probably don't want to narrow it down just yet, or do you want to ask - - -

DR KING: No, I would like to come back to securitisation later.

MR HARRIS: Later, yes.

DR KING: Yes, but just on the - I want to flip the competition story here instead. You said that the smaller institutions are gaining market share. It's still a long way behind obviously. I think if you get to the size of the NAB you'd have to take home loans and assets and take everybody from Macquarie on down outside the Big Four and add them all up and I think you'd just about get to an ANZ or NAB in terms of assets, so we've obviously got a long way to go.

When we talk to the smaller groups, and their response to some of our recommendations, there's been, well, the systems biased against the smaller banks, smaller ADIs at the moment for several risk weights. They appear to favour APRA basing the risk weights on the IRB banks. Further, I note that the SSI suggested that and that's been carried out. The RBA says there's still an advantage, a too-big-to fail advantage. There's still an advantage to the big banks. What is your response to that?

MR CAHILL: So there's probably two parts to the question. So part one in terms of competition in the market today, when you talk about mortgages it's very important to look at the stock market so that the existing mortgages are seen on balance sheets and flow. When you look at flow in the marketplace today, the non-majors are absolutely picking up the market share and for the last few months they've been growing between 1.5 and to two times the system, double the rest of the market.

All four of the major banks are currently losing market share, so the competition and intensity of price competition at the moment in the market today is particularly intense. When we - we've just recently gone through all of the pricing requests that we had in the last quarter in relation to mortgages, and we saw more pricing requests from one of the regional banks than we did from one of the- against one of the Big Four competitors. So they are absolutely competing very aggressively to win their customers. They're putting very sharp prices into the market, and so customers are absolutely seeing a very competitive market when they look at going to different providers for mortgages.

Part two, then, I think you're picking at the point in relation to risk weights, and the majors and those that are operating under advanced status have an advantage. Sure, we can talk in depth about that, but our belief, we strongly believe actually that there is very little to no advantage now that is in play given not only the risk weights that are held for mortgages, but the adjustments that are made for banks operating under advance status. We believe there is very little competitive difference in relation to those overall risk weights, but Shaun, you may want to go deeper on that.

MR DOOLEY: Yes, thanks Antony. As you noted, the emphasis on inquiry report highlighted the gap between the standardised and the advanced methodology for all the IRB methodologies we'd describe for risk weights. There's been actions taken since the publication of that report. APRA made some changes to the amount of capital that the advance banks hold against the mortgage portfolios back in 2015 with some changes that brought the average risk weights for advance banks for about, on average, about 16 per cent up to about 25 per cent was the change that they made in mid-2015.

Subsequent to that, there's been a lot of work done globally through the Basel Committee, and more recently APRA have published a number of papers, including a paper about three weeks ago, two to three weeks ago on proposed revisions to the capital framework. Those proposed revisions are directional at this point. It's quite hard to quantify exactly what the impacts will be until there's further work and consultation and impact studies, but suffice to say is that it's continuing to narrow the perceived gap between advanced methodology and the standardised methodology. In fact, there is a floor that is being applied globally, and APRA has a regulator that seeks to deploy the Basel standards where appropriate within Australia and we'll consider that in those consultations.

As Antony said, the perceived difference between the two is not as great as we think people believe it to be. The other factors that need to be considered, because there'll be the headline numbers between the advanced and the standardised, but the advance banks have to carry higher capital in terms of the surcharge for domestically strategic important banks, so that's a surcharge of more capital we have to carry. We need to carry more capital for other types of risks that are not picked up in the standardised model, so the interest rate risk that emerges out of the banking book is one piece.

We have a different way of calculating risk weights which take into account overdrawn balances. There's actually a significant ongoing investment that's required to maintain accreditation involving a considerable number of people and systems to maintain the data and the quality of the modelling that is expected by APRA, and the portfolio diversification that we actually have as a major bank, we tend to have more diversified portfolios as well, and all of these factors, including types of lending that are done by a bank such as ours, so they're not done by all competitors, are projected and structured finance, but particularly infrastructure finance is a case in point where the risk weights and the methodology calculating those risk weights are evident in the major banks, but they're not always coming through in smaller banks that are more concentrated in mortgage lending.

MR CAHILL: We will be putting more information in our full response in two weeks' time as I think that would be very helpful because, if we can lay that out I think maybe that may even mean a subsequent conversation beyond that.

MR DOOLEY: The other point I'd make is, the IRB banks, there's a - the risk weights will move much more substantially in a downturn scenario than under a standardised model too, so we get a fair bit more volatility in both risk weights and also capital. That's an outcome of the IRB approach.

DR KING: Which is the right approach. So the IRB investment was substantial by the banks. I'm trying to think of a polite way to put this. The polite way is, would NAB now look back and sort of say, yes, we did that and we've done our dough. I guess the polite way of doing it is, if you didn't have the IRB system in place today and you were thinking of it as an investment for the bank, would it be the sort of investment that would - to meet your hurdle requirements or is essentially you've done your dough.

MR DOOLEY: No, I don't think we've done our dough. I think one of the core principles around advanced accreditation, it's the usual experience of your own data and understanding your customer base in a much more granular, sophisticated way than under a standardised approach.

So the knowledge that the systems and the models give us around performance of our client base, the ability to stress our portfolio to a range of different scenarios is all really an outcome of the investment that we made. So the investment is really stronger risk management. So that's the payback for us, and we have a, I think, and I can't speak for other banks on their experience, but what I can speak for our bank is that it's given us a much more sophisticated view of our portfolio, and the potential performance of our portfolio in a number of scenarios, and advanced accreditation assists for that.

DR KING: The trouble I have with that is that you better understand the risks of your customers, and yet that's not being reflected, as I understand it, from your position, it's not being reflected sufficiently enough in the risk, the individual risk weights that you face or your able to have compared to the standardised rates that don't depend on any of that information.

MR DOOLEY: So within IRB Bank you'll have a range of risk weights. So a standardised bank is prescribed a risk weight for a set type. So I talk about averages of 25 per cent. We always have some assets, some of our exposures will have risk weights in the teens and some will be above 40 per cent because what we're actually doing is applying our granular risk weight to each, effectively each customer which is a product of their potential for risk.

And so what the advanced approach allows us to do is to drill down into literally arrangement by arrangement to look at the probability of default in each case, you know. The exposure that might be, and - - -

MR CAHILL: So on a mortgage, for example, just to give some context, a high risk loan that you may take on to the books, you would be required to hold 40 times the amount of capital compared to a low risk loan, so from my perspective, it's absolutely giving us critical information as we think about going forwards. How do we compete? Where do we compete? What's the risk that's coming on to the book? How should we price the product and I think, as you start to move into more and more personalised pricing for individuals, and we're starting to see that, we actually see that now in mortgages. We're starting to look at far more factors when we price what is the actual end rate for the customer having this modelling place, understanding what's the true risk associated with the loan and the capital that you hold. I think there is - it's been a worthwhile investment.

And what we haven't yet seen in the marketplace, and I think this will start to happen over the next three to five years, and we've had this conversation with a number of the regulators in prior - in previous months is, you will start to see far more individualised pricing, be it on loans personal loans, credit cards, home loans over the next three to five years, as we start to see more use of data analytics, and this an important contributor to that.

MR DOOLEY: And we see that in lending to businesses, for instance. You know, they're a price risk across the business portfolio reflecting our assessment of the individual risk characteristics of those borrowers including their potential for default, but also what happens in this case.

MR HARRIS: So you thought Murray was right then, lifting your risk weights? You agree you were getting a really good that you shouldn't have got and you put your hands up and go along with the regulator? Is that the idea?

MR DOOLEY: No, look, I'm not saying that Murray was wrong. What I would say is, we've adjusted our capital and our business to reflect the requirements that a regulator has on how much capital we should hold for certain asset classes. I'm just going to add to that, that there's regulatory capital and there's also our internal view of risk, which would be an economic capital number, and you will get quite significant differences between the two. Economic capital is an internal tool that all banks will use to assess their own view of risk versus a regulatory view of risk, and they will vary depending on where, you know, we see the environment and underlying assumptions. We're holding the capital that we're asked to hold against the mortgage book, but our internal models would suggest a different number.

MR HARRIS: So is the other way of looking at, "We got the risk weight relativities wrong when we first established IRB standards", which, you know, appears to be the logic for the change back in 2014 or thereabouts, is, "Well, we should perhaps lower the risk weights for the smaller banks". In other words, perhaps we - and we have - well, there are some. We have put two examples into ours with SME lending where it looks like we have a single line standard and we perhaps should have had a, you know, standard that certainly other countries appear to have been able to differentiate in some aspects of SME lending to have more than a simple understanding.

MR CAHILL: So I don't think, and Shaun you should reflect, but I think the original question was, have we done our dough in putting this methodology in place.

MR HARRIS: I'm not so worried about that, although my wife's a shareholder and she is worried about it.

MR CAHILL: Our view is, we haven't done our dough because having their information more inside, truly understanding the credit risk within the business, what's the risk profile represented by certain types of lending and customers can only be a good thing, and so

therefore we believe this methodology and undertaking this work was the appropriate thing to do.

As Shaun has said, we have internal views on economic capital versus regulatory capital. I think we've now moved to a second question which is actually are the risk weights right or wrong which is slightly different to this. This was a view that the regulator gave. Shaun, you might respond to that.

MR HARRIS: That is true, Antony but my interest is primarily from the point of view of what this inquiry is all about.

MR CAHILL: Yes.

MR HARRIS: Which is, have we gone too far in favour of stability. Now, I did note you had a very good line in there which someone has written in your presentation about the fact that - - -

MR CAHILL: I wrote that last night.

MR HARRIS: Even better. Big tick to you for - that the competition must always take into account stability, which is the inverse of everything else that we've been doing here. It would be good for stability to occasionally take into account competition. So I think there's a gold star coming from that line alone, but see, that - the reason I ask the question that I did of Shaun was, there are two ways of resolving the fact that the risk weighting differentials on one is to say, "Perhaps we have been too strenuous in our single line standardised approach".

Now, I don't know. It just seems odd that the preference is always towards increasing the risk weights, and in the end this is an area where customers must pay. If banks are retained, you argue that you have to be able to finance the bank and you have to be able to justify your balance sheet expansion, and so in the end, all other factors being equal, that says high price for customers, or some customers are going to miss out. You will fund it instead by simply saying, "These are now too risky for us and we're going to ditch some of them."

MR DOOLEY: So on the second point about high price for customers, I think as we've said a number of times that, you know, that NIM and ROE has been coming down all the time, and mortgage costs as the key indicators have been coming down all the time.

In terms of the risk weights themselves, I think APRA's paper a couple of weeks ago that I referred to is really starting to address a number of the points that you've made and that's taking the lead from some of the Basel Committee changes, and we're looking at the proposals for risk weights for small business over time, and also mortgages, and I think what the Basel Committee have been attempting to do is to reduce some of the variability that exists across the financial sector around report of capital numbers for, and differences in capital numbers for portfolios that should ultimately produce a similar outcome.

So I think we're also looking at how capital should be calculated for a sector such as the one you describe, so it's probably a live debate at the moment, and something that we'll be consulting with APRA as will many of the other market participants will be consulting with APRA over the course of really the remainder of this year.

So I don't have an answer for that yet, other than I think APRA also recognised that, so - - -

MR HARRIS: It's an unfair question in a sense from me because I'm asking you to criticise risk weights in a circumstance where clearly everybody wants to be regulator compliant.

It's just that the sentiment, such as it's put in front of this inquiry, is continuously towards if - if there is a fault with a differential between IRBs and standards, the solution is a higher risk weight, not the solution is a lower one, and that's what inquiries like ours do. We zero everything. We go, well, why is it so, and this is a very hard one to get an answer from because of course, and so I'm not being critical here, it just is very hard to get an answer on because nobody wants to step out of line on a question of risk weight.

MR HARRIS: But we're actively engaged with the regulator on this topic, and absolutely from our perspective we want to hold the appropriate amount of capital against the appropriate lending through the cycle, and we'll continue to have the ongoing dialogue.

MR DOOLEY: That's right, and I think one of the points too is, capital is there to protect yourself against unexpected loss. So there's expected loss and unexpected loss. Capital is your unexpected loss and we set our capital positions thinking through the cycle, and as I said before we're actually at a low point of the credit cycle in terms of the cost of risk to financial institutions in Australia is at very low levels compared to where it's been historically, but we can't sort of manage our capital to today's environment. We have to manage it for a variety of cycles, and I think that looking through the cycle and what the long-run expectation will be for the cost of risk and ensuring that our capital is able to withstand those shocks, including severe but plausible shocks which is how we do our stress testing, that that speaks somewhat to this issue of should risk weights come up or down or stay the same, and I think again that's a broader discussion with the regulator around how we position for the future.

MR HARRIS: Yes. Yes. No, really, it's more a question asked in frustration than anything else because it's very hard to nail this down. It appears to be - - -

MR CAHILL: A default preference which goes to this whole question of stability versus competition.

MR HARRIS: Now, I'm going to get off it because one last - my last comment is that, you know, the problem that we face is the risk weights going up for the IRB banks reflecting stability or the risk weights going up to the IRB banks reflecting protectionism for the small

banks. Because if it's the latter then it's clearly anti-competitive, but if it's the former then there's clearly a relevant reason and we need to get to the bottom of that to the extent that we can, he says, being less of an optimist.

Okay, we do want to talk about securitisation so I want to leave a little bit of time for that.

MR CAHILL: Okay.

MR HARRIS: Transparency of pricing. So we have a proposition to publish what we call real time pricing, real time actual prices in a set of markets for a particular kind of borrower. We have had presentations from both the smaller lenders and the larger lenders for different reasons saying this is a bad idea. So can you give me a perspective on not so much the practicality of this because we think it's practical. If you think it's impractical we're interested in that, but the question of why it would do no good for consumers to know better when they go into a transaction what last month the equivalent consumer guide by way of negotiated price, why would it be no good?

MR CAHILL: So I think from my perspective, and I think we're probably talking about mortgages predominantly, is the product's in question.

MR HARRIS: It's easier to think about.

MR CAHILL: So we are seeing more granularity in the pricing that is made available to customers today, and the two main factors that I use when customers are seeking to understand what is the price available today is typically the loan size. Secondly, what's the LVR on the security because again that may have a different price point, and then whether it's for an owner-occupier investor. This is for a variable rate product.

And so we have our standard variable rate and that is used and that is adjusted from time to time depending on what happens to our input cost of funds for both new business and for our existing, and we have to be able to do that to manage against the changing cost of funds.

That published SVR on those criteria is the maximum a customer will pay when they come to the bank and say, "I'm interested in taking out a loan with you". Going back to that conversation we've just had in terms of risk weights, then the conversation starts and we begin to understand far more about the borrower themselves, and what is the actual, or how many borrowers are applying for example.

Depending on how many borrowers applying, that actually impacts the amount of capital you hold against the mortgage. What type of income are they earning; how stable is that. Where is the security, for example. So we are more prepared to negotiate on a price in a security that we believe is far more attractive, is likely to see capital growth in an area where there's a high risk associated with it where the actual security value may go down.

So that published price is the starting point, and I think customers now are seeing more of that in terms of loan size LVR; what's the actual purpose. Then the conversation starts, and I think the question that you have is, it is very difficult to give the precise price that a customer will pay because there are so many nodes now that are being developed.

So when a customer comes to NAB today or they go to see a broker, we have an instance pricing tool deployed in our front line. Our staff can put those - the criteria into the instant pricing tool and that will give a recommended price to the customer. At that point, then, the customer can choose to accept that or not, and even then the customer may say, "Is there any more room to move?", and there will be that competitive tension playing out about whether we're prepared to go any further or not below our lending floors to secure that loan.

So it's impractical to be able to publish a list of all the pricing nodes that are available at any one single point in time, but - so it's the starting point that the customers see and there are, sort of, those - we're starting to see those zones emerge now in terms of what's the loan size; what's the purpose type; is it above 80 per cent, less than 80 per cent; and then the further negotiation begins.

MR HARRIS: Well, think of it this. If your child was going in to negotiate their first loan, you're a banking executive, you know the nature of the market. Surely you're going to say, 'I know - I know that although the standard variable rate is like this, the kind of order of magnitude of price for some of your income that we've negotiated last month is X'. You're going to try and give them detailed information just so they've got a mental reference point. Even if they do then go to a broker, at least they know what a broker has said has some either ring of truth or perhaps there is more to be found.

And you know, one of the biggest tools you've got for increasing competition in the marketplace is better information to consumers. We've heard - just about everybody has agreed with us so far that there's an awful lot of data out there which is somewhere between meaningless and misleading, and that includes comparison websites which do provide people with rather optimistic perspective of what they might be capable of getting.

Whereas the median is the median is the median, and you know, it's last month's median, therefore, you know, once it's published every month, we'll have an ongoing series of medians, but we'll see gradually how the market is moving and we just can't really conceive of a case why it's harmful for consumers to be better informed now that digital data does enable us to do this.

The best argument we've had against it so far is that it might advantage larger banks versus the smaller banks. This is an argument which says that people believe - now know the price from a publication of the median. They won't bother going to a broker. They'll go into the branch and, gee, you've got more branches than the smaller banks and therefore you're going to be naturally advantaged. I am interested in your perspective on that if you want to offer one, but I'm not sure it completely makes the case against doing this. It does give

us reason to think a bit further about it, but it doesn't make a case necessarily against us doing it.

But I am very interested in why this is, you know, not just a pretty simple idea now that we have the data capabilities we didn't have five or ten years ago.

MR CAHILL: So as I said at the starting point, we're now very clear around, this is the SVR rate regardless of loan size. As you start to step up in loan size, these are the rates that you can expect to see, so a person already starts to get an idea of what the purpose type is; an owner-occupier investor, what the loan size is; what is the rate they're going to - they're likely to pay.

And then there are those other factors that we simply can't - we couldn't publish 50, 60 - - -

MR HARRIS: No, I don't think we actually, it wasn't going to every factor. In fact, the reverse. It would be - anyway, I'm sorry.

MR DOOLEY: I think the proposition that you raised before is the right one. People are better off with more information. The question, as you highlighted, is making sure the information is genuinely ...(indistinct)... and it can be dealt with. So I think as a proposition - - -

MR CAHILL: I mean, I think one of the things would be, from our perspective, we do think there is a proliferation of products in the marketplace, so within NAB we set a goal over the next four years of actually halving the number of products we have on sale across the whole company. Now, there are two reasons for that. One is, we think that will give more clarity to customers, and I think over time, we look over the last 20 years, there have been plenty of different products coming through with different features and service levels, but actually when you really look at this maybe you could have a smaller number of products and that will remove some of the confusion that's in the marketplace.

Secondly, from our perspective, we believe there's great efficiencies that can offer us through the company in terms of decommissioning systems that have been there for many years. How do we start to enable ourselves to be more agile, more efficient, and more streamlined. So the end goal for customers, we believe, by hopefully achieving that halving of the total product set will be to remove some of the - I think it can be quite a confusing landscape.

So that's sort of where we're heading and we're sort of trying to understand. Absolutely we're seeking to put more information on to our websites and to our digital tools and we will continue to do that and we always say to any of our mortgage customers, both new or even existing customers, if you want to have a discussion about your home loan, then talk to us, and one of the things we are doing now is, we phone all - we contact all of our customers now after 12 months to see are they happy with their home loan; are there any issues; and if they're existing customers, if they would like to talk about my rate.

That's where there is an opportunity to do that. So we're seeking to have that conversation with customers.

MR HARRIS: That's an interesting innovation. Do you want to do securitisation? We're getting on to five to four so.

DR KING: Yes probably. I intended to follow up on brokers and just trading commission given that they're reading back after 12 months.

MR HARRIS: All right. Do brokers.

DR KING: All right, very quickly, you've got three aggregators. You're aware of our recommendation. Happy to shout about that. But the other path that we were looking at is the way that brokers are currently paid. You've mentioned that you're planning to ring them back after 12 months to check on whether they're happy with product or what else you can do for them.

MR CAHILL: Yes.

DR KING: If we ask brokers and their representatives why they need to receive trail commissions, they claim that it's necessary for ongoing engagement with the customer, but quite frankly that doesn't seem to make a great deal of logical sense that you're guaranteed a payment whether you contact the customer or not, and in fact there's an incentive there not to contact the customer for a marginally better product because, you know, if you turn the customer to a marginally better product, yes, you gain a new - it's a different lender. You gain a new upfront fee, but of course you're losing the trail commission on the existing product.

So your views on the way that brokers, and particularly in your situation, the way that brokers are remunerated, if you think they should be remunerated.

MR CAHILL: So this is a complex question with many variables and I've spent a long time working in and around the broking industry. So I think firstly, just in relation to now, we have three aggregators which is quite different from some of the franchise models in the marketplace, so none of the brokers who aggregate under our three brands are employed by National Australia Bank, so quite a different model to the - - -

DR KING: The main type of model.

MR CAHILL: No, or quite different, for example, for mortgage choice or Aussie home loans. So we have the three aggregation businesses. The question in terms of best interest, for example, which I know has - is one of your recommendations, we would always say brokers need to act in the interests of customers first. I think in relation to the question of best interest, one of the - the question that I have is, how would you actually validate what constitutes best interest? Is it price, is it other factors and how would you work that through?

So I think the idea of requiring brokers to put their customers' interests first is appropriate, and I think the vast majority of brokers within Australia would absolutely argue that they do put their customers first. I know the industry is having a number of discussions about this in terms of how can they raise the bar from where they are today and how can they continue to ensure that customers benefit and that brokers are putting those customers' interests first.

In relation to the remuneration, I think this is the question - one of those questions around upfront commission versus trail. If there was an upfront commission only then you may say, to your point, is, would there be an economic driver for a broker to put the customer into a new product to receive the new commission. If there was a trail only, you may say the broker would win the customer and then they'd just go and try and win another new customer to build their ongoing trail book. So that's the pure economic argument, but the fact is, we, within NAB, absolutely expect brokers in relation to receiving a trail commission to have an ongoing relationship with their customers, and they should be talking to those customers on a regular basis throughout the time that they're receiving a trail commission, and Anthony Waldron, who runs our broking business, he's an absolute - he's absolutely working through how can we ensure that is taking place; what are the conversations that need to happen; and how might we think about the relationship with brokers.

But personally, I think brokers within Australia, they are a force for good. I think they, to your point earlier, they - when they came into the marketplace you actually saw - absolutely saw a concentration of NIM. I think they do offer a wide variety of product and they do allow smaller lenders who don't necessarily have large physical established networks to be able to distribute their product.

One of the things I would say is, if you look around the world today, and in Australia, the vast majority of mortgages are still sold on a face-to-face basis. There is still a conversation and a face-to-face conversation with a customer. The digital origination of mortgages is still very immature compared to what you might consider to be a simple product such as a transaction account, personal loan, credit card. That may well change over time and you may see more of that product being originated through digital channels, but physical channels at the moment in terms of the ability for a customer to sit down and have a conversation with somebody is still the predominant way that that product is distributed around the world, not just Australia. So I do think brokers play an important role in the marketplace.

DR KING: The hardest thing for us to accept at face value, the statement that the vast majority of brokers persist despite pay - well, despite the payment of trailing commissions to act in a customer's best interests is the statement the brokers themselves make or their leadership make that says this payment is to stop churn and yet churn is the competitive opportunity potentially for a customer. So I mean, it's almost like confessing the conflict, and no way when you're dealing with it, absent some duty of care, and it almost seems impossible to resist. In fact most of the presenters that have come along have said to us in

one form or another they're sort of pretty happy with the idea of a duty of care generally speaking as long as it applies to not just bank-owned or controlled broker - - -

MR CAHILL: Yes, I absolutely see that, and I think to your point, personally I'd be happy to see a more structured agreement requirement put in place. I think how that would play out, how it would be structured, how it would be implemented, how it would be tested, that's the area I would like to have a greater understanding of.

DR KING: Yes. No, I would think, as we said in the draft - it's only a paragraph, but it was a deliberately written paragraph inside the draft report, you know, this could have been done probably by a contract originally and might have been a better way - because you can design a contract, you see, to balance the competition. What occurs in someone's head between, you know, even if I am employed, directly employed by the bank, but I have to act in the customer's interests.

On the one hand, you know, we have these different incentive payment structures and then if I'm not, if I'm an independent broker but I'm still trying to build up my business and the trailing commission is a bit part of my ongoing value of my business, you know, these things are possibly, or all of those are possibly better managed by a contractual arrangement, but as we say, we're not in the business - can't recommend somebody on how they run their business. So we look at the regulated option because it's the most evident thing from the point of view of the public policy.

But it is a very interesting area and one that I think is going to be addressed regardless of whether it's done through our report or through other mechanisms. It looks pretty much like it's going to be addressed. We should ask about securitisation.

MR HARRIS: Yes, I notice the time actually. So do you want to ask or do you want to - - -

DR KING: Well, you know, because you're anticipating - although we have a big interest in this and you've volunteered it in this area. You are a leader in this area, so we sort of reserve this almost for you because we thought we'd get the best answers from you. So to what degree - so we had funding dried up post GFC. The securitisation market obviously effectively collapsed at that stage except for the Government intervention as you noted.

It has come back to some degree although at least from our outside view it doesn't seem to be a competitive force but it certainly was when, you know, Aussie and RAMS first started up in the 90s. We would be very interested in your views in where is securitisation going and your role in dividing the warehouse funding if needed of the securitisation. How difficult is that now under the current stability regime, the regulatory regime that you face? Could that be improved? Could there be more incentives provided, or could it be easier for you to provide warehouse funding to be able to help that sector to - - -

MR CAHILL: Shaun can talk about this for three hours on just - - -

DR KING: Yes, yes, yes.

MR HARRIS: We thought you would be it, so we're up for advice on this, and we're not going to presume that this is, you know, a business where the larger banks control this channel in order to manage non-banks. We're not going to presume that because they don't presume that. We've discussed it - - -

MR CAHILL: This is actually an important part of our bank. It's an area where we are very successful. Shaun can talk about the total issue and facilities and health of the market, so Shaun, why don't you touch on some of those?

MR DOOLEY: Yes, so as I said before, so all participants need viable funding models and the RMBS is important, market is an important part of ensuring that we have viable funding models.

2017 was a record year for securitisation, the most securitisation that we've seen since 2007, pre-GFC, 35.7 billion. Now, to put that into context in 2008 there was about 7 billion done and most of that was really by the Big Four. In 2013 it was about 25 billion, so we're seeing a significant ramp up of that. NAB is a leader in arranging deals. We were the leader range from 17 out of the 23 transactions done in 2017 and we were a joint leading manager on 23 of the 25 transactions, so we see ourselves as the leader.

And we arrange transactions for many counterparts. Some are smaller banks, some are non-bank ADIs. Some of those, in many cases, are direct competitors to parts of our business, and so we can talk about that in some detail, but it's important that we continue to provide credit in the form of warehousing, structuring, credit, due diligence, but out of that is increased liquidity and depth in bond markets which is important to all of us in terms of funding but it's also important to provide product to investors, so we have investors on the other side, institutional investors who are looking to take exposure to credit, and high quality credit and that's where the securitisation market falls in there. It's intermediating between the needs of the ADIs who need the funding to provide to their customers, and the investment requirements of large funds, and bank balance sheets. We also buy paper as well, as part of our investment requirements ourselves.

The market has changed a lot, so the pre-GFC/post-GFC, the number of participants and the character of the participants has changed a lot, and what I mean by that is, we saw a lot of buyers in the pre-GFC securitisation market that were the ones that were probably caught up the most in the turmoil in the northern hemisphere, so they would be what we call conduits or construction investment vehicles, and so were actually providing liquidity into the market at that time. They faced their own liquidity crisis, and therefore stopped buying in the marketplace. So people that were buying in those days are very different from the participants that are buying these days. So they're very different markets.

The other issue is that you had a number of international banks that were active in providing warehouse facilities. Pre-GFC they'd actually left Australia and they left Australia for

reasons not connected to Australia, but really they were retreating back to their home bases, and so we saw the providers of credit and buyers of credit disappear, and that led to effectively that shut down in the marketplace.

We saw a number of months through 2008 where there was virtually no activity at all. We did see some action taken by the Government through the AOFM to provide some liquidity into that market. They still own some of those assets and they're still selling some of those assets today. We see that our role is to continue, as I say, to provide credit in the form of warehouses and distribution of structuring.

The fact that last year was a record year I think indicates that conditions have certainly improved and you need the whole end-to-end process to be working effectively for those strong market conditions to prevail. There have been changes to the regulatory rules around securitisation, and they've had different impacts on different parts of the market depending on whether you're an issuer yourself, and so we're both an issuer and an arranger, and it changes the cost, particularly for the provision of warehouse facilities.

So I think there is an opportunity for a discussion about what do we really want to achieve out of the securitisation market in Australia, and what are the things that we can do to continue to promote liquidity and participation in the marketplace, and again that's probably a discussion with the APRA around their attempt, but it's an important market for us. It's one we take pride in our leadership and we'll continue to support that market.

MR CAHILL: I think one area that you might be interested in, so we often talk about, how do we generate greater depth within Australia, so when you think about the size of superannuation savings pool now, superannuation savings pool is predominantly weighted towards equities. So we believe there can be a far greater depth in the domestic market in terms of those pools taking out debt that's issued within Australia. So that is an area where we the ink you get potentially more competitive funding. There is a huge form of liquidity there. How do we start to bring very significant, very substantial savings pool to bear where that marketing funding can take place, and ultimately that can lead to greater market depth and therefore better pricing.

MR HARRIS: Yes, we seem to have a very thin corporate bond market - - -

MR CAHILL: Yes.

MR HARRIS: - - - in Australia by comparison with other countries.

MR CAHILL: Yes.

MR HARRIS: And we've asked this - it came up on our infrastructure inquiry.

MR CAHILL: Yes.

MR HARRIS: It came up in superannuation funds and their investment approach.

MR CAHILL: Very similar.

MR HARRIS: And the same deal. Well, we couldn't get a straight answer from the Treasury as to why this was.

MR CAHILL: No.

MR HARRIS: No one seemed to have a good - - -

MR CAHILL: We think there's absolutely an opportunity there for all participants in the market and there can be greater efficiencies generated if we can actually work through, how do we access that; how do we ensure that the assets are seen as attractive by those buyers.

MR HARRIS: And so it becomes quite important potentially not to kill this securitisation development off again by seeing it just as a, you know, a non-bank threat to the stability of the banking system, but to recognise that it's more than that. It's a nascent development of a set of buyers who then might be convinced to go and buy other kinds of corporate debt.

MR CAHILL: It's an important part of our funding profile as well.

MR DOOLEY: And we would encourage the continued development of that market. We think it's important for us in many ways, but also, you know, the depth of liquidity in the marketplace here will help funding for all players, including ourselves.

I think the - there is definitely a structural challenge around where super funds invest their money and where we like to see that over time. It's probably more into fixed income than it is today, but that's - - -

MR HARRIS: But that's what they were asking.

MR DOOLEY: Yes.

MR HARRIS: - - - and they were saying, otherwise, no, we've got to go offshore and take the exchange rate with us.

MR DOOLEY: Yes, and we're happy to talk to them.

MR HARRIS: That's right, but then I think - yes, so effectively what this is - - -

MR DOOLEY: And that's why this matters.

MR HARRIS: It comes back through the way the banks, so I think it's also looking at how super funds are measured, how they're measured and how they measure their own performance and how the consultants measure the performance of the super funds. There are a number of aspects there that we could look to - - -

MR DOOLEY: And emphasis on the need for liquidity.

MR HARRIS: Yes. Anyway in the exchanges - - -

MR DOOLEY: And more interest in the market to build more liquidity.

MR HARRIS: In the exchanges that have probably occurred between you and the regulator, more than they will occur with us, this seems to be tremendously important. It's not just about the interaction of the non-ADI sector with the ADI sector. It's got to be influence and it's an overall question of, do we have a, you know, what I might call differentiated forms of corporate borrowing in as.

MR CAHILL: Our view is there are multiple participants that need to come together to work this through, but it is absolutely an opportunity for the overall economy. There's a huge depth of liquidity available and how do we ensure that we present the assets in an appropriate form where they can take those on.

MR DOOLEY: But it's definitely heading in the right direction, I mean, last year being a record year as we said, but we'd like to see it continue to develop more rapidly.

MR HARRIS: We may write this up a little bit more, although again it's entirely tangential to the competition report, but sometimes when you find something is tangentially important we'll still - - -

MR DOOLEY: But we think it's key because in order to be competitive you have to have a ...(indistinct)... anyway.

MR HARRIS: No, no. Yes, quite, it's just that the thematic of running it on beyond the nature of the focus on non-ADI competition, it does go further than that.

Anyway, I would like to thank you guys very much for taking the time and trouble to come along here today for your continued participation and inquiry and for the possibility that we might have a bit of a further exchange with you on some of that data, rather than the discussion we had earlier about the actual cost of funds and what might we be able to further add to our report.

Anyway, otherwise, thank you very much for your time.

MR CAHILL: No, thank you.

MR DOOLEY: Thanks very much.

DR KING: Thanks a lot.

MR HARRIS: For the hardened souls who managed to make it entirely through the two days, I want to congratulate you. I can see at least one face that was here - - -

DR KING: A couple.

MR HARRIS: - - - 100 per cent of the time. Well, the secretariat's - - -

DR KING: Cut down by a couple of people.

MR HARRIS: I know.

DR KING: Headed off.

MR HARRIS: Running for the planes even though this chairman's banging on up here. So I will now formally close this hearing in Sydney and just advise anybody who's really a sucker for punishment that we're back doing this in Melbourne next week. Thank you very much.

**ADJOURNED AT 4.10 PM UNTIL
MONDAY, 5 MARCH 2018 10.00 AM**