

Competition in the Australian Financial System

Supplementary Submission to the Productivity Commission Inquiry

March 2018

1. Introduction

The Reserve Bank of Australia (the Bank) has prepared this Supplementary Submission in response to the Productivity Commission's *Competition in the Australian Financial System Draft Report* (PC 2018).

The Bank's initial submission (RBA 2017) sought to present the available data on competition in the banking sector and discuss developments in the key markets highlighted in the Inquiry's terms of reference. This Supplementary Submission is narrower in scope, focusing in particular on issues raised in the Draft Report related to the role and implications of financial sector regulation and the payments system.

The Bank supports many of the key themes set out in the Commission's Draft Report, including the importance of consumers being able to exert competitive pressure on financial institutions and, in turn, the importance of transparency and reliable advice. The Bank also agrees that regulators should clearly take account of the potential effects of their actions on competition, although it does not believe that prudential regulation has erred in its pursuit of financial stability or that it has been unresponsive to competition concerns.

The remainder of this submission covers discussion of: the Commission's proposals for empowering consumers; the role of the cash rate; the role played by regulation; some specific prudential regulation measures addressed in the Draft Report; the Draft Report's payments system recommendations; and the regulatory structure, including the Commission's proposal for a 'competition champion'.

2. Demand-side Factors: Information and Advice

One significant focus of the Draft Report is the capacity of consumers to impose discipline on financial services providers – 'demand-side factors' (PC 2018, pp 84–91). The Commission considers a number of challenges to this capacity, including the level of financial literacy and engagement by consumers, the complexity of products, behavioural biases, information asymmetry and the need for 'properly motivated' consumer agents, such as advisers and brokers. The Commission finds that consumers are often limited in their ability to put competitive pressure on providers (draft finding III.1). This flows through into a number of draft recommendations, largely focused on improving the availability and quality of information and advice, and minimising any barriers to the mobility of customers. The Bank noted the importance of improved availability of information to both consumers and lenders in its

earlier submission. It fully supports the Commission's focus on these issues and the thrust of its draft recommendations.

Of note, the Bank supports the draft recommendation to require lender-owned aggregators and the brokers who operate through them to act in consumers' best interests (draft recommendations 8.1 and 8.2). We would support extending this to all brokers. While there may be some benefit in enhancing mortgage broker disclosure requirements to consumers to improve transparency, it is important to recognise that some consumers may nonetheless still not fully understand the information provided (given its complexity and the backdrop of consumers not taking out a mortgage frequently). Steps to address the underlying conflicts of interest and misaligned incentives are therefore crucial to improving consumer outcomes. We note that there are also a number of other factors that inhibit the effectiveness of competition through mortgage brokers. These include the following:

- Smaller lenders find it harder to get onto aggregator panels due to fixed costs (ASIC 2017).
- Brokers need to be accredited with a particular lender to sell their loans and they have incentives – partly due to variations in commissions and the burden of seeking accreditation – to concentrate their recommendations on a small number of lenders rather than the whole panel of potential lenders (ASIC 2017).
- Lenders may compete on their incentives to brokers, rather than on the quality of their loan products, creating competitive barriers for smaller lenders who find it too costly to offer such incentives. Higher commissions for brokers may also drive up costs for consumers (ASIC 2017).

The Bank also supports enhancing the transparency of mortgage interest rates paid by borrowers (draft recommendations 8.3 and 8.4). Possible ways to do this at the level of detail suggested by the Commission might include asking the banks to publish these rates directly, or conducting a survey of the largest mortgage brokers to obtain representative rates. While the new Economic and Financial Statistics (EFS) collection will gather more information on interest rates than is currently available, this might not be the most effective vehicle to meet the Commission's objectives, as it will not include median interest rates or all of the detailed breakdowns envisaged by the Draft Report. Reopening the scope of the EFS collection at this stage would be costly and delay the collection and publication of other important data.

3. Regulation and Competition

The Draft Report argues that regulation has a significant influence of the level of competition in the financial system. It suggests that regulators have focused too much on ensuring financial stability and too little on competition (PC 2018, pp 415–417). In the Bank's view, the Draft Report overstates some of the competitive effects of regulation and understates the importance of a focus on financial stability. In particular, the Commission argues that the role of the cash rate and prudential risk weights constrain banks' ability to compete on price. But while these influence the funding costs of banks, operating costs are largely independent of regulatory settings and there are no regulatory constraints on the returns that banks seek to achieve. Further, while we agree that the effects of regulation on competition should always be taken into account, it is also important to note that financial crises have a very high cost and can reduce competition through bank failures.

This section comments on some areas that have been highlighted by the Draft Report as placing a regulatory constraint on competition, as well as regulators' approach to balancing competition and financial stability. More detailed prudential measures are considered in the subsequent section.

a. The effect of regulation on price competition

The Draft Report argues that ADIs' 'ability to compete on price is constrained significantly by regulatory price setting (the cash rate and prudential risk weights)' and that 'price setting by the Reserve Bank facilitat[es] price coordination by banks' (PC 2018, pp 157, 2). The Bank believes that the setting of the cash rate neither constrains competition nor substantively facilitates price coordination. The cash rate has been an effective instrument of monetary policy and has served Australia well over a number of decades, just as short-term policy interest rates have also been effective monetary policy tools in many other countries. There is nothing in the design of Australia's framework that could be expected to lead to less competition-friendly outcomes than in other countries.

Monetary policy is effective because the cash rate influences all interest rates in the wider economy, though not necessarily via a one-to-one relationship. This broad relationship between the cash rate and other interest rates means that monetary policy is transmitted throughout the aggregate economy and affects borrowing and lending behaviour, aggregate demand and inflation. However, the cash rate is only one, albeit significant, influence on banks' funding costs; several other factors are also important, including the extent of competition for deposits, the structure of bank funding and changes in the level of compensation demanded by investors for holding bank debt. Further, while the cash rate itself changes discretely with announced monetary policy changes, the timing of its effects is more dispersed because changes are generally anticipated and reflected in financial market prices well ahead of the announcement.

Interest rates are not regulated prices. It is each bank's commercial decision how much and when to adjust lending and deposit interest rates, and the degree to which it competes on margins when funding costs change (regardless of whether the timing of rate changes is aligned with changes in the cash rate). Indeed, the spread between mortgage lending rates and the cash rate has varied over time because other factors also influence lending rates. For example, in the early to mid 1990s, a marked increase in competitive pressures, alongside a reduction in risk premia, drove down the spread between household mortgage indicator rates and the cash rate by around 250 basis points. From the late 1990s until 2007, there was a strong correlation between movements in the advertised indicator lending rates and the cash rate, with the cash rate appearing to be a key driver of changes in funding costs over this period.

More recently, a reassessment of risk factors has led to more dispersion between different lending products and banks have decoupled the extent of movements in mortgage interest rates from cash rate decisions to some degree, because other influences on their funding costs also have had an important impact. Notably, some of the market-determined components of banks' funding costs, such as risk premia, typically move together across different lenders. This can cause similar movements in banks' funding costs and consequently their lending rates. One notable driver of the post-crisis increase in mortgage rates relative to the cash rate has been greater competition for deposits, which has seen deposit interest rates rise relative to the cash rate (McKinnon 2018).

In summary, the cash rate is a significant influence on funding costs but does not determine them, nor does it determine banks' margins. The Bank believes this neither constrains price competition nor facilitates price coordination and the experience in other countries supports this conclusion.

At a general level, the same argument can be made for risk weights. As part of the Australian Prudential Regulation Authority (APRA)'s capital framework (the product of risk weights and capital requirements), risk weights have a bearing on the relative cost to banks of making different types of loans. However, in the same way that the cash rate does not constrain banks' ability to compete by

adjusting margins, capital requirements and risk weights do not constrain the return on capital that each bank seeks, and it is this that contributes to the competitiveness of a market. There is no regulatory constraint that prevents banks from undercutting their competitors by accepting lower returns on equity.

Nonetheless, differences in risk weights applied to the same loan *across institutions* can influence competition by providing some banks with a lower cost base. However, the importance of this issue – in the context of internal ratings-based (IRB) modelling versus the standardised approach (SA) – can be overstated. In particular, we believe the Commission’s analysis (centred on Table 5.3 of the Draft Report) should take greater account of the fact that the major banks will face a capital requirement that is 2 percentage points higher than smaller ADIs by 2020, to reflect the additional risk posed to financial stability by the systemic importance of these banks. This implies a significant reduction in major banks’ funding cost advantage from IRB modelling, which is further reduced by the additional compliance costs associated with IRB status and the major bank levy.¹

b. The weight given to competition by regulators

The Bank agrees that competition in the financial system can be promoted without necessarily increasing risk. Likewise, we agree that a lessening in market concentration in the Australian financial system would not necessarily be detrimental to financial stability. The Bank fully supports measures that provide a sustainable increase in competition – that is, measures that would not sow the seeds for a later financial disruption. Many of the types of measures discussed in Section 2 above fall into this category and are supported by the Bank.

The Bank also agrees that, when formulating prudential regulatory measures, it is important that any potential effects on competition be considered. This should include consideration of both whether the prudential benefits outweigh any costs to competition and whether there are alternative approaches that would meet prudential objectives just as effectively but provide better competition outcomes. As discussed below, the Council of Financial Regulators (CFR) and its member agencies take account of competition issues, and a number of the actions taken by APRA in recent times highlight that its competition obligations are an important element in its decision making.

That said, financial stability goals necessarily attract a high weight in regulators’ considerations because the cost of instability is high. As an illustration, the Bank for International Settlements (BIS) estimates that the cost of past financial crises has ranged from 19 to 158 per cent of annual GDP, with a median of around 63 per cent of GDP — an equivalent of around \$1.1 trillion for an economy of the size of Australia (BIS 2010). Crises also tend to be detrimental to competition as providers fail, withdraw from the market or merge, and funding tends to be more readily available to large, established institutions. Indeed, an increase in concentration was observed in a number of economies, including Australia, following the global crisis (CGFS 2018). Financial crises are low frequency but very high cost events.

One circumstance where regulators may weigh competition and stability very directly is where there is a concern that competition may result in increased lending to non-creditworthy customers. This would not be in the long-term interest of consumers, financial institutions or the financial system more broadly. Such concerns have arisen in the housing market over recent years, compounded by

1 Accounting for the higher capital requirements in the calculated cost of funding would almost halve the Commission’s estimated funding cost advantage from IRB modelling (to 8 basis points).

high levels and growth of mortgage debt relative to income (which itself indicates that competition in the mortgage market has been sufficient to ensure that households have not been constrained in their access to finance). This situation provided the backdrop for the regulatory measures taken in 2014 and 2017, which are discussed further in the next section.

It is also important to consider the role that prudential regulation plays in promoting confidence among consumers of financial services and competition among financial institutions. Consumers have little capacity to assess the creditworthiness of individual financial services providers – a situation that is aggravated by sometimes poor financial literacy and the limited ability (and willingness) of consumers to obtain the necessary information from investment disclosures. One function of prudential regulation is to give consumers a degree of confidence in the safety of regulated financial institutions. This is a benefit to consumers that should be weighed against the costs of prudential regulation. It also means that regulation that may seem to constrain competition in lending adds to competition in deposits, as consumers can compare deposit interest rates with the confidence of knowing they are looking at products with broadly comparable risk characteristics.

4. Specific Regulatory Measures

The Draft Report questions aspects of a number of specific prudential regulation measures, which are discussed further below. Subsequent to the release of the Draft Report, APRA has announced some proposals (which have been under development for some time) that are in line with the Commission's draft recommendations.

a. Housing market measures

The Draft Report is critical of the housing market measures adopted by APRA and supported by the CFR in 2014 and 2017, suggesting that they were detrimental to competition (PC 2018, p 20). The Bank remains supportive of these measures. We note that the need to balance competition and stability was a relevant consideration in the formulation of these policies, and the financial sector agencies continue to consider and monitor their effects. This includes input from the Australian Treasury, which has a broad mandate over financial sector issues, including on competition.

The Bank's view is that the 10 per cent benchmark growth rate for investor lending and the 30 per cent cap on the flow of new interest-only (IO) loans were warranted by the evolving macrofinancial risks to stability at the time. The interventions occurred when household debt was rising significantly faster than income, with evidence of loose lending standards in some riskier segments of the market. Competition among lenders for market share through the easing of lending standards can lead to undesirable outcomes, both for consumers and the financial system as a whole, if it increases lending to non-creditworthy customers. There is some evidence of this occurring in recent years.

The restrictions on investor and IO lending were targeted to contain these key sources of systemic risk without constraining households' access to credit more broadly. Moreover, the speed with which these measures were implemented reflected the scale of, and rate of increase in, the potential risks at the time.

The Draft Report is critical of the means by which the objectives of these policies were achieved, including the banks' response to the measures by APRA (PC 2018, pp 168–173). The Bank's view is that it was appropriate for APRA to have allowed individual banks to determine the most effective way to implement the measures. APRA's measures were targeted at new lending only. Banks individually took the decision to also reprice their 'back books'. This should be seen as a commercial decision by each bank rather than a direct consequence of regulation.

The Draft Report suggests that these interventions could have been made through a tightening of lending standards for certain institutions, rather than on an industry-wide basis. However, the Bank notes that – by definition – the purpose of macroprudential regulation is to impose stricter prudential standards than are warranted based on the risks posed by individual ADIs, recognising that there can be situations where the risks to the system are greater than the sum of risks to each individual entity.

b. Risk weight framework

i. Residential mortgage lending

The Bank supports the Commission’s draft recommendation to make risk weights under the SA more sensitive to risk (draft recommendations 9.1 and 16.1). APRA has historically allowed more variation in risk weights under the SA than was contained in Basel standards, and its recently proposed changes to the capital framework will increase this sensitivity (APRA 2018). In particular, APRA is proposing reductions in risk weights for owner-occupier principal-and-interest loans with a loan-to-value ratio (LVR) of 80 per cent or less, and for all other residential mortgages with an LVR of less than 60 per cent.

ii. Warehouse funding

The Commission recommends excluding warehouse loans to non-ADIs from the scope of Prudential Standard APS 120 (draft recommendation 7.1). The Bank does not support this recommendation as it opens the possibility of regulatory arbitrage by treating loans of identical risk differently depending on who the ultimate lender is. In doing so, it focuses on a relatively small component of non-ADI funding costs when, in fact, the principal disadvantage of non-ADI lenders is the relative cost of residential mortgage-backed security (RMBS) funding.

The intention of the capital framework contained within APS 120, as with all of APRA’s capital standards, is to ensure that banks hold capital that is commensurate to the risk to which they are exposed. When providing warehouse funding, that risk is largely determined by the quality of the loans contained in the warehouse pool, and APS 120 treats those exposures as if the bank had written them itself and retained them on-balance-sheet. The Bank does not see this as imposing the risk weight regime on non-ADIs, since non-ADIs are not required to hold any capital against their loans. A more appropriate characterisation is to say that the cost of warehouse funding rises with the riskiness of that lenders’ portfolio.

The Commission’s proposal would mean banks hold less capital against loans they have not originated than those they have, despite having less visibility and control over the lending standards applied to those loans. This would re-create an opportunity for regulatory arbitrage that APRA’s revised standards sought to correct. While that may improve the competitive position of non-ADIs, the Bank believes that a competitive advantage derived in this way is not a sustainable or desirable business model.

It should be noted that the cost of warehouse funding is not the main constraint on non-ADIs’ ability to compete. Warehouse funding is required to build up a pool of loans of sufficient size to securitise, but this typically happens within a year or so. In contrast, the weighted-average life of RMBS is around three to four years, implying that warehouse funding accounts for only one-fifth of the total funding needed by non-ADIs when writing loans. The cost of financing via RMBS markets has declined notably over the past two years, but it remains more expensive than the cost of senior unsecured bonds issued by banks and well above the cost of deposit funding. This appears to be a more important cause of the much higher funding costs faced by non-ADIs relative to banks.

5. Retail Payments

The Reserve Bank welcomes the Commission's assessment of the extent and nature of competition in the payments system. The Commission's assessment echoes much of the analysis done by the Bank in the two decades since the creation of the Payments System Board (PSB) with a mandate for promoting competition and efficiency and for controlling risk. The Bank strongly agrees that even small improvements to competition in retail payments can produce material improvements in outcomes for consumers. The Bank appreciates the Draft Report's support of the regulatory actions of the PSB over the past 15 years and the recognition of their positive effects on competition and efficiency. In relation to the specific findings and recommendations of the Draft Report, the Bank would like to offer the following comments.

a. Regulation of Purchased Payment Facilities (PPFs)

The Bank agrees with the Commission that the regulatory regime for PPFs is complex and potentially confusing, although it is not clear that it has been a material barrier to the growth of PPFs to date. While the Commission's recommendations on this issue are directed at APRA (draft recommendation 10.1), the current framework also entails a role for the Bank in the authorisation and supervision of some types of PPFs. The Bank agrees that a review of the regulation of PPFs would be desirable and that a tiered prudential regime is likely to be appropriate. The Bank has begun work with APRA, ASIC and the Treasury on this issue. It is likely that this work will also include a number of other 'regulatory perimeter' issues such as access to payment systems by non-ADIs (including tech companies) and a clarification of the ability to regulate cryptocurrency systems. Experience from other jurisdictions suggests that a broad project such as this will require significant consultation with stakeholders, including to ensure some future-proofing of the regulatory framework.

b. Ban on interchange fees

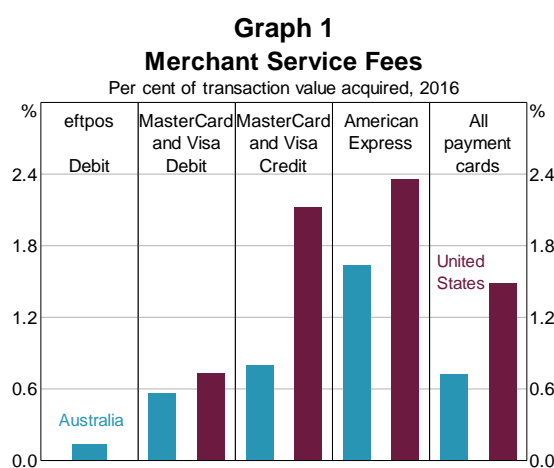
The Bank agrees with much of the Commission's analysis regarding the role of interchange fees in mature payment card systems (PC 2018, pp 297–299). As the Bank has noted previously, interchange fees are used by card systems to incentivise banks to issue cards and card holders to use them, with the international experience being that competition between unregulated card systems has the effect of driving up interchange fees. The results are higher payment costs for merchants, which are eventually passed on to consumers, as well as a reduction in efficiency if consumers are incentivised to use payment methods that have higher resource costs.

Australia was the first jurisdiction to regulate interchange fees. The Bank's reforms starting in 2003 have introduced benchmarks to cap weighted-average interchange fees, with these benchmarks currently at 50 basis points for credit cards and 8 cents per transaction for debit cards. The reforms also required the international schemes to remove some restrictive rules on merchants, such as their honour-all-cards and no-surcharge rules. The Bank's reforms have been followed by similar reforms in other jurisdictions, most notably the European Union. The Bank welcomes the Commission's assessment that the Bank's reforms have improved competitive outcomes, bringing down merchant service fees and reducing the incentives to use higher-cost payment methods.

The Commission has made a draft recommendation that the Bank should introduce a ban on interchange fees by mid 2019 (draft recommendation 10.3). The Bank notes, however, that the current regulations on interchange fees were announced in May 2016 following a detailed review of card payments regulation that engaged with a wide range of stakeholders. That review stated the

Bank's view that there appears to be little justification for significant interchange in mature card systems and noted that lower interchange rates would have a number of benefits. However, the Bank decided against setting benchmarks below 50 basis points and 8 cents after considering a number of factors. These factors include the risks of significant effects on the competitive balance between three- and four-party credit card schemes or of a significant increase in circumvention efforts.² The PSB noted that it would continue to monitor the regulatory framework but that it hoped that the regulatory framework resulting from the review would not need to be revisited for some time.

With some changes to the interchange regulation only having taken effect in July 2017, the Bank considers it appropriate to take some time before conducting a further review of the regulatory framework. The Bank notes that merchant service fees in Australia are already significantly lower than in many other jurisdictions; for example, overall average merchant service fees are around half the levels observed in the United States (Graph 1). The Bank notes also that no jurisdiction has gone as far as banning interchange fees in card systems. Accordingly, the Bank proposes to consider the Commission's draft recommendation, along with other relevant proposals, when it next reviews the regulatory framework.



Sources: RBA; The Nilson Report (2017)

c. Merchant choice of default network routing

The Bank agrees with the Commission's draft recommendation that merchants should be provided with the ability to determine the default network for contactless transactions using dual-network cards (draft recommendation 10.4). This recommendation adds to a significant number of voices (including merchant groups and the House of Representatives Standing Committee on Economics) calling for the industry to provide least-cost routing to merchants. The Bank appreciates that this draft recommendation helps build momentum for the industry to provide this capability.

The provision of least-cost routing is a priority for the PSB, and the Bank has been actively engaging with the industry to encourage it. The PSB is currently monitoring the industry's progress in providing least-cost routing and has indicated that it will consider the case for regulation if adequate progress is

² MasterCard and Visa are examples of four-party cards schemes, comprising the cardholder, the merchant, the card-issuing bank and merchant's (acquiring) bank. American Express and Diners Club are examples of three-party schemes, which comprise the cardholder, the merchant and the card scheme which acts as both card issuer and transactions acquirer. Three-party schemes do not involve explicit interchange payments between the issuer and acquirer and are therefore not subject to interchange regulation; in Australia, however, they have removed their no-surcharge rules.

not forthcoming. After its February meeting, the PSB indicated that it expects to make a decision at its May meeting as to whether the market is providing this functionality or if the Bank should issue a draft standard for consultation.

d. Access Regime for the New Payments Platform (NPP)

The Bank welcomes the Commission's support for the NPP – which was launched in February 2018 – and agrees that access to the NPP should not be restrictive. The Bank is aware of the possibility of access issues emerging given the role of incumbent banks on the NPP Australia Limited (NPPA) Board. Since the start of the project to design and build the NPP, the Bank has made it clear to member banks that it expected the system to be access-friendly and has worked to ensure that this is reflected in the rules of the system. The Bank's appointed director on the NPPA Board has noted this position and, if needed, will communicate any future access concerns of the Bank.

As the Draft Report notes, there are a range of options for ADIs and other entities wishing to access the NPP that involve different levels of functionality and cost (PC 2018, pp 307–308). The Bank considers that it is appropriate to allow this system to mature and assess if there are genuine access difficulties once new players submit concrete proposals for entry. At that point, if there are material access and public interest issues, the Bank would consider designating the NPP and imposing an access regime. This approach is consistent with the requirement of the *Payment Systems (Regulation) Act 1998* that the PSB must explicitly consider the public interest before taking such steps, as opposed to situations – for example, in parts of the telecommunication industry – where legislation requires the regulator to impose an access regime.

e. Facilitating customer switching through the NPP

The Bank shares the Commission's view that the NPP's addressing service, PayID, has the potential to improve competition by making it easier for customers to switch financial institutions or products (PC 2018, pp 311–312). While the initial functionality of the NPP does not provide for direct debits ('pull payments'), the NPP is currently working to add this functionality as one of the first enhancements. The Bank will be encouraging NPPA to progress this work and to take advantage of the potential for PayIDs to provide greater functionality for customers, including for account switching.

6. Regulatory Structure: A Competition Champion

The Draft Report argues the need to give competition appropriate weight in regulatory decisions related to the financial system, focused mostly on prudential regulation by APRA and the discussions of the CFR. It suggests the creation of a 'competition champion' in response (draft recommendation 17.1). As discussed above, the Bank agrees that competition considerations should be taken into account in the pursuit of financial stability.

As chair of the CFR, the Bank can give an assurance that the CFR considers, and gives due weight to, competition matters. For example the competition effects of housing regulatory measures have been considered in the decision-making phase and discussed regularly since. More generally, the Australian Competition and Consumer Commission is invited to attend CFR meetings where appropriate.

It is nonetheless reasonable to ask whether there is a framework that would deliver better competition outcomes without compromising financial stability. The Bank is open to this discussion, but is not convinced that the Draft Report's proposal for external analysis of the competition effects of proposed regulation by a competition champion, with review by the CFR, is the best way to achieve this.

The proposed external analysis process has the potential to slow down decision-making. Even compared with an identical internal process, the need to fully educate an unfamiliar team on technical issues, share relevant information and data, analyse those data and then send the analysis to a meeting of the CFR for consideration, will necessarily take additional time. While this would not be a concern for some regulatory measures, on other occasions a more timely response may be required.

We note that the CFR is not a decision making body. Rather, the decisions are taken by its member agencies, on occasion after consultation with the CFR members. Each agency is then responsible for publicising the actions it takes and explaining their justifications and consequences. The Bank believes that if there are any concerns that competition is not receiving due attention from regulators, this should be dealt with by increased transparency of the factors considered in decision-making, rather than increasing the complexity of the regulatory process.

The Bank is open to consideration of how the transparency of the CFR itself could be improved. Currently, the main outlet for information on its activities is a section in the Bank's half-yearly *Financial Stability Review* (FSR). Conscious of the benefits of transparency, the Bank increased the level of detail in the October 2017 FSR and intends to continue with this approach. Nonetheless, the CFR is open to considering other measures that could provide greater transparency of its discussions related to macroprudential and other policies.

Reserve Bank of Australia
20 March 2018

7. References

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