

The Commissioners
The Productivity Commission
4 National Circuit
Barton ACT 2600

27 March 2017

By email: financial.system@pc.gov.au

Dear Commissioners

Inquiry into competition in the Australian Financial System

The Australian Finance Industry Association (**AFIA**) thanks the Productivity Commission for the opportunity to comment on the Commission's *Draft Report: Inquiry into Competition in the Australian Financial System (Draft Report)*.

AFIA is well placed to advocate for the finance sector given our broad and diverse membership of over 100 financiers operating in the consumer and commercial markets through the range of distribution channels (including digital access). Further detail on our Association are available through: www.afia.asn.au.

As stated in our submission to the Commission of 28 September 2017, the Australian financial services system is, in our view, a heavily regulated market at risk of becoming an over-regulated market. Over-regulation favours market incumbents since they possess the existing expertise and resources to better cope with the regulatory burden impacting new entrants and consequently competition.

AFIA's comments on the Draft Report are restricted to the following key areas of relevance to our members:

- Draft Finding 4.3 – Most fintechs are focusing on less-regulated services;
- Draft Finding 4.4 – Fintech collaboration and competition;
- Chapter 8 – The residential home loan market (including Draft Finding 13.1 and Information Request 13.2); and
- Draft Recommendation 14.1 – Deferred sales model for add-on insurance.

Draft Findings 4.3 and 4.4 - Fintechs

AFIA notes the Commission's discussion on fintechs (pages 132 to 142 of the Draft Report). In particular, AFIA notes the Commission's:

- finding that the onerous prudential regulation (eg with retail deposit-taking) sees few fintechs looking to be challenger banks, instead the vast majority currently operate in relatively less-regulated areas of the financial system (eg small scale lending)¹; and
- observation that ASIC's regulatory sandbox currently appears to be a measure of limited relevance to fintechs, in particular for those looking to provide credit to consumers.²

Based on feedback from our members, AFIA agrees with the Commission on these aspects. Our fintech members' portfolio focus is small scale lending and the majority confine their operations to the small business segment rather than also looking to operate in the consumer market. Similar to the impact that the onerous prudential regulation has on decisions to provide retail banking services, a key reason for this is the complex, onerous and high-compliance cost regulation that applies to consumer credit providers, together with the limitations of ASIC's regulatory sandbox for fintech credit providers as noted

¹ Page 136, Draft Report

² Page 140, Draft Report where the Commission notes that just four businesses used the fintech licensing exemption by the end of 2017 and suggests some reasons.

above. In turn, this impacts the ability of fintechs to compete with traditional credit providers in the consumer credit market.

More specifically, significant up-front costs to meet compliance obligations and obtain an Australian Credit License (ACL) need to be borne before a fintech can commence providing credit in the consumer market. Further, the ASIC approach to responsible lending which inhibits reliance on automated credit-decisioning processes, for example, limits the key differentiator of a fintech consumer credit provider from others, namely its utilisation of innovative digital solutions to assess or offer credit. Additional costs are imposed as a result of Government policy that sees consumer credit market participants directly bear the costs of their regulatory supervisors (eg ASIC, APRA, AUSTRAC etc) together with mandatory participation in an External Dispute Resolution Scheme [EDRS] for complaint-management. We acknowledge these features apply equally to non-fintech entities looking to offer consumer credit in the Australian market. And in this regard note that even large financial institutions currently operating in the market for whom secured consumer finance is a relatively small proportion of their overall business appear to be struggling with these costs.³

These various design features of Australia's regulatory regime may individually be desirable for particular policy reasons, but AFIA suggests they have a cumulative effect on competition in the financial system. The high-regulatory cost of Australia's consumer credit regulatory regime acts as a barrier to entry. Fintechs, like most start-ups, are extremely cost aware and cost sensitive. And we anticipate a number that have opted to bear the regulatory costs as the price of being able to enter and compete in the consumer market are presently operating at a loss while they gain brand and market share, as is common in a start-up situation. Importantly, AFIA does not highlight the high cost nature of the regulatory regime to re-prosecute arguments previously advanced in different contexts. It does so to highlight the competition implications in much the same way as the Commission does in its discussion on individual fintech firms "*compete or collaborate*" decision:⁴ to highlight how "legitimate and sensible commercial" decisions at an individual business level can arguably lead to sub-optimal outcomes at a system competition perspective.

AFIA also queries whether the conclusion based on 2016 survey data that "*only one in three Australian fintech companies see government or regulatory issues as an external impediment to their expansion (EY2016)*"⁵ remains valid in 2018. The fintech industry in 2016 was an extremely young industry and it has enjoyed rapid growth since then. It may be that in 2016 many fintech companies had only limited experience of the financial sector's regulatory burden, particularly if they were not operating in the highly regulated consumer credit market. AFIA suggests that if EY were to resurvey the fintech sector in 2018 on this question we anticipate a marked increase in the number who regarded regulatory issues as an external impediment.

In relation to Draft Finding 4.4 AFIA notes the Commission's observations that "*many fintechs are attempting to work with and provide services to incumbent banks, rather than compete with them*".⁶ Further, that many incumbent banks are looking to collaborate with fintechs. Hence the Commission considers that "*fintechs are unlikely to provide the basis for vigorous competition against incumbent banks in the near future*".⁷ As an important aside, we note member feedback that suggests while there is collaboration it has not proved to be effective. Further, the incumbent financial institutions to date have shown little interest in an acquisition strategy. Consequently, the lack of competition is likely to be for reasons separate from fintech participants' collaboration with or acquisition by the major banks, for example. And AFIA encourages the Commission to focus on discerning these reasons and AFIA and its members would welcome the opportunity to work with the Government on solutions to address these.

³ See ANZ media release [16.03.18 - ANZ to suspend consumer asset finance in Australia](#).

⁴ Draft Finding 4.4, page 138, Draft Report.

⁵ Page 138, Draft Report.

⁶ Draft Finding 4.4, page 138, Draft Report.

⁷ Draft Finding 4.4, Page 138, Draft Report.

Finally, AFIA notes the Commission's discussion on improving access to information (pages 269 and 270 of the Draft Report). AFIA agrees the "*credit health of business owner/s as an individual remained the primary information source for credit decisions rather than information about the SME itself.*"⁸ Indeed understanding the credit health of business owners remains an important component to making a lending decision to SMEs. It is for this reason that the Report may take the opportunity to stress the importance of enabling the benefits of comprehensive credit reporting to be fully realisable by SME lenders, in particular by removing legislative impediments that limit access to repayment history information (RHI) to consumer credit ACL providers. We note that enabling access to RHI data for SME lending would generate direct benefit to SMEs both in terms of cost and access to finance.

Chapter 8 – The residential home loan market

As a member of the Combined Industry Forum (CIF), our views on relevant aspects of Chapter 8 are reflected in the joint submission lodged by the CIF.

Draft Recommendation 14.1 – Deferred sales model for add-on insurance

AFIA notes the Commission's comments on add-on insurance (pages 399 to 411 of the Draft Report). In particular, AFIA notes the discussion (pages 410 to 412) headed "Future reform – the deferred sales model" which appears to omit relevant material.

The interest of AFIA members to date in the regulation of add-on insurances has largely been due to its role as the key advocate for motor vehicle financiers in Australia. AFIA's Motor Finance Division includes the major financiers of new and used motor vehicles who are linked to vehicle manufacturers and importers, as well as independent financiers. However, other members of AFIA who provide consumer credit, whether by credit card or personal loans, also have an interest in this area.

AFIA observes that there are practical issues with the deferred sales model (**DSM**) which mean that to date it appears to be more of a solution in theory than in practice. Experience from the UK where the model was implemented in 2015 for GAP insurance sold by car dealers indicates that it has made little difference so far.

In AFIA's view this is primarily because the model fails to target the underlying problem: an apparent failure in some add-on insurance products to provide value for consumers. If this is the problem then the more logical solution is for ASIC to target the problem at source rather than attempt to do so downstream. This it would seem ASIC will be able to do under its new product design powers, once enacted.

The key difficulty with the proposed DSM solution for financiers in the motor vehicle space is that they neither:

- design the add-on insurance product. This is done by the insurer. Hence the financier is poorly placed to assess beyond the apparent value of the product since they are not in possession of the relevant information eg payout ratios etc. This information is in the domain of the insurer; or
- sell the product. This is done by the motor vehicle dealer.

Yet, under the DSM the motor vehicle financier is the entity who will largely end up bearing the costs of this solution. The role of the financier is to provide finance to the end customer if he or she wishes to purchase this insurance on credit. The supply of that finance is a credit supply to a consumer and hence the financier needs to do all the checks reasonably necessary to comply with its responsible lending obligations. For example, one practical outcome of the model is that the financier will have to reconfigure its credit processes to perform the same responsible lending checks twice – once for the initial supply of finance in relation to enable the purchase of the motor vehicle, twice for the subsequent supply of finance in relation to the purchase of add-on insurance.

⁸ Page 270, Draft Report.

These observations are not intended to indicate that financiers are disinterested, or do not have a role to play, in solving this apparent problem. The reality is that financiers want to help customers purchase the assets and services they want where financiers are commercially able to and can do so in accordance with their legal obligations.

Rather AFIA's point is that the particular regulatory approach used in a multi-party situation such as this should be well directed and only impose a regulatory burden proportionate to the particular party's position in that situation. If this does not occur then the apparent solution – such as the DSM, may have unintended detrimental consequences for competition. For example, if:

- the cost of financing these products becomes too great; or
- it simply becomes too hard or complex

financiers may elect not to finance add-ons so as to avoid slowing down establishment of the core credit product.

In this circumstance the unintended outcome would be a reduction of competition in the market as a result of financiers withdrawing from financing these products. Yet, the core concern of the DSM regulatory solution was that these products be better designed and/or better sold, not any concern that they needed to be better financed.

For example, if a potential purchaser is confused as to the merits to them of purchasing a particular add-on insurance product at the initial point of sale the mere lapse of time on its own of an arbitrary number of days is unlikely to bring clarity of understanding. This scepticism would seem to be borne out by the UK experience.

In conclusion in respect to Draft Recommendation 14.1 AFIA considers the case for the proposed extension of the DSM for add-on insurance has yet to be made given the UK experience and the capacity for ASIC to address any underlying problem through other means.⁹

If you have any questions regarding this submission please contact me
or alternatively Paul Stacey – Associate Director, Policy

Kind regards

Helen Gordon
Chief Executive Officer

⁹ AFIA notes given the breadth of its membership across multiple segments of consumer and commercial finance not all members share this view, given their specific market experiences. In particular, AFIA notes that its member CBA has taken the view to discontinue the financing of all add-on insurances.