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Dear Sir/Madam

Comments on the Competition in the Financial System Draft Report

Industry Super Australia (ISA) welcomes the opportunity comment on the Commission's Draft Report ('the Draft Report').

Industry superannuation funds act as custodians of the retirement benefits of millions of Australians. They are run only to benefit members, and therefore place a heavy priority on the long-term financial interests of our members as employees, retirees and citizens within a growing productive economy. This 'member-first' approach implies a particular understanding of the role that our financial system should play in our economy.

An efficient financial system is one that serves primarily to mobilise savings for investment in productive capital, and in doing so seeks to promote sustainable growth, good jobs and shared prosperity. An inefficient system is one that because of its structure and dominant business model is able to extract economic rents from investors, investees and those individuals who must participate in the system to manage their incomes and save for their retirement.

These Comments focus on a particularly inefficient sector of the financial system: retail banking. In brief, we make the following points:

- Having identified significant problems on the demand and supply sides of contemporary retail banking, the Commission's draft recommendations are inadequate to the task of resolving these problems to the benefit of consumers and society.
- The Commission's hope that easing account switching will increase competitive pressures on the big retail banks to act in the interests of customers lacks an evidentiary base, and evades consideration of the behavioural and cognitive factors that cause low consumer engagement and poor decision making.
- The Commission's focus on the quantum of consumer-facing competition ignores the role of shareholder-driven business models in generating mimetic behaviours across the big banks that routinely leads them to exploit customers and to engage in miss-selling, confusion marketing and opaque forms of charging.

- Reform should focus not on increasing the number of shareholder-driven banks that consumers can choose from, but on encouraging competition between different models of banking business.
- In its Final Report the Commission should acknowledge the role of the RoE monoculture within Australian retail banking in generating poor outcomes for customers, and recommend that government and regulators give priority to promoting alternative business models as a key means of challenging and changing that culture.
- In its Final Report the Commission should support the recommendations made to the inquiry by ADIs in the alternative business model sector. In the absence of this support the Commission should make clear its reasons for not doing so.
- The Commission should make the growth of alternative business model banking a priority area for examination in future inquiries into financial system competition. If such banking is not building the scale and resources needed to place effective pressure on the big retail banks, the Commission should recommend that the government pro-actively engage with the sector to develop a reform agenda that will help to secure that growth.

Problems of retail banking

The current inquiry has its origins in the recommendation made by the Financial System Inquiry (FSI) in 2014 that the state of competition in the system be reviewed every three years. In its Final Report, the FSI concluded that ‘competition in the financial system is generally adequate at present.’¹

In its Draft Report, the Commission does not directly reflect on the accuracy of this assessment – although the balance of comment in the Report strongly suggests the Commission holds a more ambivalent view than that offered by the FSI.

For those who view increasing competition between profit-maximising firms for informed consumers as the key means by which the financial system in general (and retail banking in particular) can be made to deliver improved outcomes, the Draft Report makes for sobering reading. According to the Draft retail banking is a part of the system where:

- The number of ADIs has halved since 1999 to 148 institutions in 2017. Many small banks, credit unions and building societies have merged or been absorbed by large domestic banks.
- Australia’s four major banks continue to hold substantial market power, as a result of their size, strong brands and broad geographical reach. They have the ability to pass on cost increases and set prices that maintain high levels of profitability without losing market share.
- The large incumbent retail banks have consolidated their commercial power and reach by integrating horizontally across product lines and vertically up and down the supply chain.

¹ Financial System Inquiry Final Report (2014, p. 18)

- Most new fintech firms are not seeking to challenge the big retail banks, concentrating instead on areas of business that are less regulated than retail deposit-taking, or on providing products and services to large incumbent institutions. As such, these fintechs are unlikely to become a source of significant competition to the big four banks.
- In the decade to 2017, all new entrants to the banking system were branches of foreign banks. However, partly because of the high infrastructure and marketing costs that challenging the dominant Australian retail banks would entail, they are mainly niche operators with little potential to challenge the big four.

The Commission notes that these features of retail banking need not lead to uncompetitive outcomes if there is a ‘critical mass’ of engaged consumers who make informed decisions about the products and services they buy. However, there is little evidence in the Draft Report that such consumers exist. The Commission notes that:

- Few consumers actively shop around for financial services and are often unaware that the information they receive from providers and affiliated advisors is shaped by commercial arrangements and ownership.
- Financial institutions exploit consumer inertia and low levels of engagement by refusing to offer the same improved deals to existing customers that they offer to attract new customers.
- There is widespread use of proliferation and confusion-marketing that gives the appearance of competition while actually acting to inhibit consumers from being able to assess the real relative merits of different products.
- Many consumers feel powerless in the face of a blizzard of barely differentiated products that they find difficult to understand and evaluate in an informed manner. In this context behavioural biases take the place of rational decision-making, with the result that people do not take account of all relevant information, making it difficult for them to act in their best interests.

We agree with these findings and observations made by the Commission. They constitute an important acknowledgment of how many real-world consumers actually engage with retail financial products and services. They signal a welcome departure from Wallis-era thinking when it was widely assumed by many economists and policymakers that consumers could be assumed to be rational and able to realise their own best interests in retail financial markets – if they were given the opportunity to do so.²

² This flawed approach to understanding consumer and provider behavior is currently the dominant approach in many recent superannuation-related policy proposals that assume if members are required to make a choice, that choice can be expected to be in their best interests. See, for example, Treasury’s 2017 discussion paper on Comprehensive Income Products for Retirement and the proposal that newly retired fund members be required to choose from a potentially large range of complex and unfamiliar longevity products.

We hope this sensitivity to the empirical realities of how consumers and shareholder-driven providers actually behave will inform the conclusions of the Commission's inquiry into the Efficiency and Competitiveness of the Superannuation System.

However, returning to the present Draft Report, as welcome as the Commission's observations are, there is a significant disconnect between the problems identified and the proposed policy solutions.

On the one hand, the Report identifies a number of important structural and behavioural characteristics of retail banking that mean the big four banks will very likely retain their dominant position and continue to extract economic rents from consumers. On the other, having identified significant obstacles to change, the Commission's policy recommendations are unlikely to result in meaningful improvement in consumer outcomes.

One example of the gap between the problem identified and the proposed solution is the Commission's proposal in respect of account switching.

The limits to switching

The Commission acknowledges that current retail providers have an insufficiently 'consumer-orientated approach' to business and this is unlikely to change. The burden of change therefore falls on consumers and implementing reforms that will enable them to more readily switch providers of financial services. In support of this view the Commission makes a draft recommendation (13.1) that the Open Banking system proposed for Australia should be implemented in a manner that enables the full suite of rights for consumers to access and use digital data.

Open Banking and enhanced rights to access and make use of digital data for those consumers who wish to make use of them appears to be a beneficial policy in the public interest. To the extent this is true, it should be adopted.

However, while it may be a good policy, it is unlikely to solve the problems identified in the Commission's Draft Report. There is no evidence from Australia or internationally that removing procedural barriers to switching will generate the scale of consumer pressure needed to make large retail financial institutions more responsive to consumer interests.

In some recent Australian commentary, the experience of the Current Account Switching Service launched in the UK in 2013 has been cited as indicating that switching can be increased – although the extent to which this increased activity has been to the measurable benefit of those consumers who have switched remains unclear.³

In the UK, as in Australia, there is much hope and expectation that new technologies and facilitative regulation will finally change the behaviour of the large retail banks for the better. However, the findings of a

³ See, for example, 'Simpler account switching would help keep our banks honest,' The Conversation, 04.10.16, <https://theconversation.com/simpler-account-switching-would-help-keep-our-banks-honest-66264>

recent academic assessment of the UK experience since 2013 offers no support for the view that attempts to stimulate switching hold transformative potential.⁴ The assessment concluded that:

- Despite the introduction of the Switching Service three years prior, switching rates in the UK have remained stubbornly low at between four and six per cent a year. These low rates are in line with other European countries, such as Sweden, Ireland and the Netherlands, where there have also been recent attempts by regulators to increase switching.
- Those who do switch tend to be from higher income groups and are already engaged consumers in financial services and other product markets.
- While many consumers report some degree of dissatisfaction with their account provider, in most cases this is not sufficient to result in an active switch.
- Consideration of switching is not encouraged by the attractiveness of offers from other banks.
- Most consumers would prefer that poor levels of service in banking were addressed by government and regulators.
- The evidence suggests that despite the greater ease with which switching can now take place, as many as 80 per cent of account holders are unlikely to consider doing so.

These findings should not be surprising because the primary barriers to switching in retail financial services are not procedural but behavioural. The widespread inertia and poor decision-making that characterises how most consumers engage with financial products and services results not from a lack of information or technical efficiency but from poor understanding of basic financial concepts and reasoning, and the consequent use of heuristics to make decisions.⁵

The current shop-worn policy response to this is to argue for greater investment in financial literacy programmes. The Commission discusses the importance of low financial literacy to explaining why many banks can treat customers so poorly, and notes current policy initiatives being undertaken by government and ASIC.

However, and in common with pro-switching initiatives, there is no evidence from Australia or elsewhere that financial literacy programmes actually translate into better financial outcomes for consumers. ASIC has acknowledged that there is 'little reliable, conclusive research about whether financial literacy campaigns

⁴ Hartfree, Y., J. Evans, E. Kempson and A. Finney (2016) Personal current account switching: Why don't more people switch and what could encourage them to do so? Personal Finance Research Centre, University of Bristol. See also: Colgate, M. and B. Lang (2001) 'Switching barriers in consumer markets: an investigation of the financial services industry', *Journal of Consumer Marketing*, Vol. 18, No. 4, pp. 332-347.

⁵ An overview of heuristics and the behavioural biases they give rise to is provided by Baddeley, M. (2013) *Behavioural Economics and Finance*, Taylor & Francis. See also: Tversky, A. and D. Kahneman (1974) 'Judgement under Uncertainty: Heuristics and Biases', *Science*, Vol. 185, No. 4157.

and programs work (i.e. whether they result in sustained changes in behaviour and improved financial outcomes).⁶

Despite this dearth of evidence, the conviction held by some that there is a 'literacy-fix' to the problems of financial systems remains unshakable. Will the Commission now take the opportunity of the present inquiry to chart an evidence-based path?

But even if more consumers did switch in response to a mix of greater technical ease and regulator-led exhortation, this begs the question of how beneficial to consumers such switches are likely to be.

The Commission acknowledges that many providers actively market their products and services with the intent of confusing consumers and cultivating inertia.⁷ In this context, having decided to switch because it is technically easier to do, how likely is it that consumers will then be able to effectively navigate a confusing 'blizzard' of relevant services in a manner that actually secures real long-term financial advantage?

In sum, the balance of the findings and recommendations contained in the Commission's Draft Report offers few reasons to believe that customers of our highly concentrated retail banking industry can expect better quality products and services anytime soon.⁸

Providers are driven by shareholders to maximise revenues and profits, which leads them into an exploitative relationship with their consumers. If consumers became more informed, rational and active, this exploitative behaviour might change. But because consumer behaviour in markets for complex products is constrained by time, cognition and the marketing strategies of producers, there is no reason to expect that they will.

Promoting competition between business models

The Commission has chosen to approach the problems of retail banking through an analytical framework focused on consumer-facing competition in which outcomes are largely dependent on the number of firms who are competing for the business of informed consumers. The more firms who compete for this business, the more responsive they will be to consumer preferences and interests.

⁶ ASIC (2011) Report 230: Financial literacy and behavioural change (REP 230), p. 4. ASIC's caution is shared by others who conduct independent critical research into the effectiveness of financial literacy e.g. Willis, L. E. (2009) 'Evidence and Ideology in Assessing the Effectiveness of Financial Education', 46 San Diego Law Review 415. Such critical research is not common, given that it rarely attracts funding from governments and financial institutions who hold prior political and commercial commitments to proving the effectiveness of literacy initiatives as a way of forestalling more effective public regulation and policing of retail financial services.

⁷ Draft Report, pp. 2 and 29

⁸ We note that in addition to the matter of switching the Commission has also recommended reducing regulatory barriers to entry and expansion for new and existing banks (Draft Recommendation 4.1). However, given the recent history of concentration and consolidation in retail banking, and the accumulated advantages of the large incumbent institutions ably documented in the Draft Report, we see no reason to expect that the reduction of such barriers will make a substantive difference to the retail sector except at the margins and in niche markets.

As outlined above, the Draft Report contains ample discussion and evidence of why this model of competition does not apply to retail banking. But that has not stopped the Commission from assuming that encouraging more market entrants is the only real solution to the many problems it has identified – even though it is far from clear who these challengers will be, where they come from and when they will appear.

The problem with this approach is that it distracts from the main source of the problems: the monoculture of the major banks, whose business activity prioritises Return on Equity to shareholders. In this context, the primary problem is not that there are only four major retail banks, but that they all operate with the same business model and associated set of shareholder-first values.

This has given rise to a set of mimetic behaviours across RoE banks in areas such as: (i) asset and liability mix, including a heavy emphasis on residential property lending; (ii) closing uneconomic branches (usually in poor and regional areas); (iii) off-shoring work; (iv) encouraging employees to sell products, not serve the best interests of customers; and (v) treating disengaged and low-information customers not as people to be helped and served, but as a vulnerable resource to be squeezed for maximum possible revenue.

This monoculture is part of the reason why major retail banks in Australia (and the UK and USA) have become entangled in a seemingly endless stream of scandals, law-suits and regulatory investigations relating to miss-selling, fee gouging, market-rigging and the provision of misleading information.

As long as retail banking utilises the RoE business model these mimetic behaviours (and others yet to be invented in response to changing regulation) will dominate the sector and consumers will lose as a result.

Put differently, would it matter if consumers can choose between four large retail banks or six?

While having an additional two banks to choose from may give the superficial appearance of more competition and consumer-empowering choice, if they operate to maximise RoE they will adopt very similar strategies and modes of behaviour – none of which will involve prioritising the real financial interests of low-information retail customers.

The way forward for policy and regulation that wants to see much improved outcomes for consumers of retail banking services is not more competition between banks with the same business model, but competition between different business models.

Not-for-profit banking

Alternative banking business models currently exists in Australia in the form of 79 customer-owned ADIs trading as mutual banks, credit unions and building societies. In addition, ME Bank operates as a quasi-mutual with a customer-first philosophy in which profits are returned to members of the not-for-profit superannuation funds that own the bank.

These models have a long history and there is evidence that they are regarded with higher levels of trust and satisfaction by their customers compared to the big retail banks, and that they can offer lower interest rates on personal and mortgage lending.⁹

⁹ The Australia Institute (2012) The rise and rise of the big banks: concentration of ownership, Technical Brief No. 15.

However, that they can outperform the big retail banks in terms of customer satisfaction and loan pricing, and yet collectively hold less than 5 per cent of all ADI assets,¹⁰ is testimony to the power, scale and marketing clout of the big four and their resultant ability to marginalise institutions that offer better service and lower cost products,

The potent mix of disengaged customers and the cumulative advantages that have accrued to the largest institutions is affording the big four ample opportunities to extract economic rents. There is a need for policy intervention to help correct this situation to the potential benefit of millions of customers, and yet the Draft Report offers no specific recommendations to do so.

A number of ADIs¹¹ have made recommendations to the Commission that they believe will help them to build scale in terms of customers and assets, and in doing so increase competitive pressure on the big four.

These recommendations include the following:

- a) Further policy reform is needed to reduce the artificial funding cost advantages enjoyed by the major banks. While the recent Major Bank Levy has reduced this advantage, it only recoups a small proportion of the overall credit rating uplift enjoyed by the majors, and further reform should be considered.
- b) Further reform of risk weights is needed, to address the significant gap that still exists between the capital requirements of the major banks and standardised banks. While there has been some risk weight narrowing following the FSI, the gap remains significant, and is particularly stark for loans with the lowest risk.
- c) APRA should engage with regional banks to design macroprudential rules that better balance macro outcomes such as stability, without undermining banking competition. One option would be for APRA to give greater policy weight to minimum capital requirements. Macroprudential rules set by APRA have effectively 'locked-in' market share of loan books at current levels, leaving smaller banks with no room to challenge the already dominant position of major banks.
- d) Mortgage aggregators and brokers, owned by major banks should publicly report on the proportion of loans they direct to their owners. While major banks should not be restricted from owning broker networks, where this occurs it should be managed in an open and transparent way.
- e) Before any new regulations are introduced, greater consideration should be given to the impacts on smaller banks. The unprecedented pace and volume of new regulation and compliance has a disproportionate impact on smaller banks which stifles sustainable competition.

¹⁰ Consumer-Owned Banking Association (2017) Submission to the Productivity Commission Inquiry into Competition in the Financial System.

¹¹ See the submission by ME Bank and others to the current inquiry.

In addition, some member-owned banks are calling for the introduction of a 'secondary competition objective' into APRA's legislative mandate as one way of reducing the anti-competitive impact of some ADI regulation.¹²

These recommendations have received little or no consideration in the Commission's Draft Report. The Commission should use the opportunity of its Final Report to do so.

ISA recommendations

In light of the preceding discussion, our recommendations to the Commission are as follows:

1. In its Final Report the Commission should acknowledge the role of the RoE monoculture within Australian retail banking in generating poor outcomes for customers, and recommend that government and regulators give priority to promoting alternative business models as a key means of challenging and changing that culture.
2. In its Final Report the Commission should support the recommendations made to the inquiry by ADIs in the alternative business model sector. In the absence of this support the Commission should make clear its reasons for not doing so.
3. The Commission should make the growth of alternative business model banking a priority area for examination in future inquiries into financial system competition. If such banking is not building the scale and resources needed to place effective pressure on the big retail banks, the Commission should recommend that the government pro-actively engage with the sector to develop a reform agenda that will help to secure that growth.

If the Commission wishes to discuss any aspect of the comments made in this letter, please contact Michael Fisher at ISA:

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¹² See the Consumer-Owned Banking Association's submission to the Commission's current inquiry.