



Australian Government

The Treasury

**Submission on the
Productivity Commission's Draft Report:
Competition in the
Australian Financial System**

4 APRIL 2018

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OVERVIEW

The Department of the Treasury welcomes the opportunity to comment on the Productivity Commission's Draft Report into Competition in the Australian Financial System.

Effective competition in the financial system is essential for consumers to benefit from competitive pricing, to drive innovation and productivity over time, and to support a more customer-focused culture in the sector. The Draft Report provides a valuable analysis of a wide range of issues, including matters such as mortgage broking and transparency around lending rates. Treasury looks forward to the Commission's final recommendations and findings.

This submission focuses on an overarching proposition in the Draft Report that, since the global financial crisis, financial stability has been given undue weight at the expense of competition by regulators. This claim is overstated. Key measures undertaken to improve stability have not come at the expense of competition and, in specific instances where they have, the Draft Report insufficiently balances financial stability objectives.

The Draft Report at various points appears to question the merits of the policy of requiring Australian banks to have 'unquestionably strong' capital requirements. It suggests that policy has come at the cost of competition and borrowers. In Treasury's view, the policy case for requiring unquestionably strong capital of banks is compelling and stronger overall capital requirements have not come — and nor should they — at the expense of competition. If anything they have improved competitive neutrality within the banking sector.

The Draft Report is also critical of the Australian Prudential Regulation Authority's (APRA) macroprudential policy interventions — in December 2014 and March 2017 — for being overly blunt. In our view, the Draft Report insufficiently reflects the need for *timely* interventions and APRA's concurrent and longer-term efforts to improve lending standards in a more targeted manner. Treasury also does not agree with the suggestion in the Draft Report that APRA decision-making should take account of incidental revenue effects, and notes that the claimed \$500 million revenue cost of the 2017 macroprudential interventions that is given prominence in the Draft Report is, at best, significantly overstated.

Relatedly, this submission also considers the Draft Report's recommendations for a 'competition champion' and for the Council of Financial Regulators (CFR) to take a direct role in the formal assessment of competition impacts. Treasury already has the role of championing competition issues at the CFR, and considers some of the draft recommendations impractical and unlikely to deliver the outcomes sought. Treasury supports heightened attention by regulators to competition matters, and agrees it is worth regulators and the CFR considering options to improve transparency and accountability more generally in respect of macroprudential policy.

The Annex to this submission also provides an update on the implementation of competition-related financial sector measures in government.

UNQUESTIONABLY STRONG CAPITAL REQUIREMENTS

The 2014 Financial System Inquiry ('the Murray Inquiry') was a comprehensive and independent review of the financial system. Its recommendations concerning resilience sought to strike a balance between financial system stability and competitiveness and improving the competitive neutrality of prudential settings.

Two key recommendations of the Murray Inquiry were that:

- capital standards should be set so that Australian authorised deposit-taking institution (ADI, or bank) capital ratios are 'unquestionably strong'; and
- the average internal ratings-based (IRB) mortgage risk weights should be raised to narrow the difference between average mortgage risk weights for banks using IRB risk-weight models and those using standardised risk weights.

Both recommendations require an increase in the capital strength of banks. They differ in that the first requires an aggregate or across-the-board increase in the capital strength of all banks to increase the stability and resilience of the financial system, and reduce systemic risks. The second requires an increase in the capital strength of certain banks relative to others, helping achieve unquestionably strong capital while also providing a more competitively neutral treatment of the major banks (which use IRB risk-weight models) as against the smaller banks (which use standardised risk weights).

By contrast, the Draft Report in draft findings 2.2 and 5.1, and in a number of places in the text, appears critical of the 'unquestionably strong' policy, which it associates with an overemphasis on stability at the expense of competition, and greater borrowing costs for consumers and businesses. The Draft Report suggests that competitive neutrality between banks in respect of capital requirements is best achieved by reducing standardised risk weights for the smaller banks, and without increasing capital requirements overall.

The Draft Report therefore potentially represents a major departure from the policy, accepted by Government and APRA and supported by the Treasury, of requiring banks to have unquestionably strong capital. Hence, it is also a departure from the international standards and consensus developed in light of the global and other financial crises. In doing so, it miscategorises the effect of 'unquestionably strong' on competition and downplays what in Treasury's view is a compelling policy case for higher capital requirements for banks.

UNQUESTIONABLY STRONG CAPITAL REQUIREMENTS AND COMPETITION

As the Draft Report makes clear, prudential capital requirements have the potential to affect competition by acting as a barrier to entry, for example by being opaque to new entrants, by disproportionately increasing their operating costs relative to established banks (particularly early on) or if minimum absolute capital requirements apply. Recent legislative changes and actions by APRA have been directly aimed at reducing these barriers (see Annex for details).

Unquestionably strong capital requirements do not, however, of themselves act as barrier. While higher capital requirements are likely to increase the aggregate funding costs of banks, and in turn lending rates, higher lending rates alone are not an indication of a negative effect on competition.¹ In-principle, a uniform increase in capital ratios across all banks should not have negative impacts on competition between them, and should be competitively neutral in its impact. Intuitively, an increase in funding costs that is proportional to firm size and applies to all firms is unlikely to affect the extent to which individual firms or new entrants can gain or lose market share.

The Murray Inquiry did, however, find that it was the largest banks that benefited most from the “perceived implicit government guarantee” given their systemic importance, and thus derived a competitive advantage over smaller banks — as evidenced by the superior credit ratings and consequent lower funding costs of the major banks.

The implementation of unquestionably strong capital requirements may go some way towards reducing perceptions as to the value of any implicit guarantee, and so improve the competitive neutrality of prudential settings.² The Draft Report at times, however, appears to oppose any unwinding of that perceived implicit guarantee (for example, at page 157) and, hence, can be read as supporting an outcome that favours one subset of banks over others.

Competitive neutrality will also be improved by narrowing unjustifiable differences in risk weights. The Draft Report suggests that rather than lifting IRB risk weights, standardised risk weights should have been lowered (for example, see pages 431 and 432). While both options improve competitive neutrality, the key difference is that raising IRB risk weights had the added benefit of improving the resilience of the IRB banks and does not reduce capital requirements for other banks — consistent with ‘unquestionably strong’. Indeed, the IRB risk weight change will have contributed around one-third of the improvement in capital strength of the major banks once they meet the unquestionably strong capital benchmark set out by APRA.

In addition, increasing the risk weights for IRB banks relative to standardised banks is consistent with the direction of international standards, which (as noted below) is important to Australia given our dependence on foreign funding.

In 2014, the Basel Committee on Banking Supervision (BCBS) proposed additional revisions to the Basel III framework in 2014 to reduce excessive variability in risk weights. The BCBS argued that the difference in risk weights could not be explained by differences in underlying risk. Further, it argued that the IRB approach created undue incentives for banks to refine their balance sheets such that they minimised risk weights relative to the banks using the standardised approach. These views are reflected in the final reforms announced by the BCBS in December 2017, and APRA's February 2018 discussion paper outlining a number of revisions to the capital framework.

1 The Draft Report makes the separate and plausible claims that the existing level of competition can affect the extent to which a change in funding costs feeds into lending rates and that regulator actions such as increasing capital requirements can be used as an opportunity by banks to reprice their lending rates.

2 The Murray Inquiry also recommended that APRA also develop a total loss absorbing framework — in part to reduce perceptions of an implicit government guarantee of the major banks. This measure, endorsed by the Government, will further improve the competitive neutrality of prudential settings. The implementation of this measure is still being considered by APRA.

THE POLICY CASE FOR UNQUESTIONABLY STRONG CAPITAL REQUIREMENTS

The Draft Report notes that stronger capital requirements have implications for bank funding costs and, in turn, the interest rates banks set when lending. This is the cost side of the ledger. What the Draft Report does not bring out fully is the strength of the case that there are a range of benefits from stronger capital requirements that outweigh those small costs.

The benefits of stronger capital requirements are considerable

The Murray Inquiry identified a number of reasons to support stronger capital requirements.

Capital is essential to absorb shocks and maintain investor confidence: capital, particularly equity capital, is an essential element of financial soundness. This is because equity acts as a shock absorber – once equity has been exhausted, a bank is generally non-viable. A key lesson from the global financial crisis was that banks around the world did not hold enough capital to absorb losses. Capital is also essential for investor confidence because it makes creditor funds relatively safer. Making banks safer and enhancing investor confidence both contribute to reducing the likelihood of a financial crisis.

Financial crises are extremely costly to the financial system and wider economy: the financial system is an essential component of the economy, matching savings with investment and funding growth. Financial crises – whether emanating from directly within the financial system or a result of external shocks – tend to be deeper, and the recovery more protracted than other types of economic crises. In that regard, a financial crisis can have major costs for both the financial system and the wider economy. Key impacts of a financial crisis include large falls in GDP, significant increases in unemployment and substantial direct fiscal costs as well as social costs. For example:

- A review by the BCBS of 21 empirical studies showed that the median estimate of the cost of a financial crisis was 63 per cent of one year's GDP, with a range of between 19 and 158 per cent of GDP. Combined with a 4-5 per cent chance of occurring in any given year, the median estimates suggests an annual expected loss of around 2.5-3.0 per cent of GDP (Basel Committee on Banking Supervision, 2010). For the Australian economy this would amount to between \$45 billion and \$54 billion as of 2017.
- A study by the OECD found that the impact of banking crises on potential output (defined as the trend level of output which can be sustained without generating inflationary pressures), for the 19 OECD countries which experienced a banking crisis over the period 2007-11, was a median loss in potential output of about 5.5 per cent in 2014 (OECD, 2014).
- An analysis by the IMF of a systemic banking crises database for the 1970-2011 period showed that the median output loss (computed as the cumulative loss in income relative to a pre-crisis trend) in advanced countries was 32.4 per cent of GDP (Laeven & Valencia, 2013).
- Reinhart and Rogoff's examination of the history of financial crises found that the 'average' financial crisis led to an increase in the jobless rate by roughly 7 percentage points (Reinhart & Rogoff, 2009).

- While social impacts are dependent on country-specific factors and level of development, research based on data on 187 banking crises over the period 1970-2009 found that in the six years following a crisis, average life expectancy declines by nine months, primary school enrolment drops by 3.5 per cent, and fertility falls by 5.5 per cent (but adolescent fertility rises by 4.5 per cent). There is also considerable short-run worsening of poverty and income equality (Dijk, 2013).

The Australian banking system is highly dependent on foreign funding: Australia's growth has been assisted by the banks' role as a conduit for foreign savings to fund domestic investment. Thus, maintaining foreign investor confidence in the strength of the Australian banking system is essential to maintaining the banks' access to foreign funding. This also means the relative strength of the Australian banking system, which also depends on the degree to which our system is in line with international standards such as Basel III, is critical.

The Australian banking sector is highly concentrated: Australia's banking sector is highly concentrated, with a few interconnected major banks with similar business models and similar balance sheet compositions. Thus disruption to the functioning of one major bank could be expected to lead to contagion to other banks and result in substantial costs to the wider economy.

In addition, as discussed above, stronger capital requirements should reduce distortions caused by perceptions of an implicit government guarantee.

The costs of higher capital requirements are small

An incremental increase in capital requirements should only have a small impact on the interest rates charged by banks since it only affects the cost of a very small proportion of their overall funding. Using a stylised example of a one percentage point increase in capital requirements, the Murray Inquiry calculated the increase in the average interest rate on a loan would be 6 basis points and concluded, conservatively, that it would be less than 10 basis points.

Even then, this is a mechanical calculation that assumes banks respond to increased capital requirements by raising their lending spreads to fully offset the decline in their return-on-equity, implying that they face no constraints in repricing loans. Market competition (even if imperfect) would, therefore, help dampen the increase in lending rates.

Further, it assumes that the cost of debt and of equity remains unchanged following the increase in capital. In reality, banks with greater equity are safer (other things being equal), so the risk premium built into both the cost of debt and equity funding should fall. International evidence supports the existence of such an offset.³ For example, the Bank of England suggest that any increase in banks' overall funding costs due to higher capital requirements is likely to be around half of what it would have been in the absence of such offsets (Bank of England, 2015).

3 The Draft Report references a recent paper (Atkin & Cheung, 2017) in observing that recent increases in capital requirements have not obviously resulted in a lower cost of equity for the major banks. However, that paper does not claim to provide conclusive evidence that there is no link between leverage and the cost of equity (let alone debt). There are also other factors that may have put upward pressure on the cost of equity during the relevant period, including concerns about risks associated with the domestic housing market.

As a result, while an increase in capital requirements will likely affect interest rates, any increase is likely to be less than implied by a simple mechanical calculation. Regardless, even using an upper bound estimate of 10 basis points, the impact of higher lending rates on GDP is likely to be small. The Murray Inquiry presented evidence that an interest rate increase of this magnitude would likely reduce the level of real GDP by less than 0.1 percentage points. A more recent (May 2017) Australian study also found that the macroeconomic impact of a one percentage point increase in capital ratios is small (Giesecke, Dixon, & Rimmer, 2017).

Using the average economic impact of a crisis estimated by the BCBS study referred to above in combination with the upper-bound cost estimate resulting from higher lender rates, the Murray Inquiry estimated that a one percentage increase in capital ratios would only need to reduce the probability or severity of a crisis by between 1 in 25 and 1 in 30 to provide a net benefit to the economy.

There are however diminishing benefits to an incremental increase in capital and, therefore, the benefit is only likely to outweigh the cost up to a point. The Murray Inquiry judged that capital levels at Australian banks were well below this point, and that increasing capital would provide a clear net benefit to the Australian economy. The Treasury supports this position and the Draft Report does not provide grounds for questioning this policy.

MACROPRUDENTIAL POLICY INTERVENTIONS

In Australia, APRA has implemented two rounds of what are commonly described as ‘macroprudential’ measures since 2014. These measures were introduced following consultation with other agencies through the CFR and were designed to curb systemic risks in the housing market and address concerns over poor lending standards. These measures were also supported by actions taken by the Australian Securities and Investments Commission (ASIC) to improve consumer lending practices by credit providers.

While each round of measures contained a range of measures to improve lending standards, the Draft Report focuses on the 10 per cent benchmark for investor lending growth and the 30 per cent cap on interest-only loans as a share of new lending. It argues that those interventions were blunt, have been detrimental to competition and consumers and that more targeted interventions could have been deployed.

Treasury agrees with the Draft Report that the measures have had some potentially negative effects on competition, including potentially for smaller banks. The recent Australian Competition and Consumer Commission’s (ACCC) *residential mortgage inquiry interim report* also brings out negative effects on competition. Notwithstanding this and other downsides such as the repricing of the back-book (which may reflect an existing lack of competitive pressure), which have been recognised in discussions within the CFR, in Treasury’s view the financial stability benefits of the interventions have outweighed the costs.

In particular, the Draft Report does not bring out the significance of the risks that justified the interventions and the need for *timely* measures to address these risks. It is also the case that the measures taken by APRA appear to have been effective so far. These matters are discussed briefly below.

The Draft Report also criticises the measures on the grounds of what is asserted to be a cost to taxpayers (by which is meant government revenue) of up to \$500 million. In Treasury’s view, the Draft Report is mistaken in suggesting that any such incidental revenue effects (whether positive or negative) should be taken into account by APRA (Box 1).

THE SYSTEMIC RISKS IDENTIFIED

Housing plays a critical role in the in the Australian economy. It is the key form of household wealth, accounting for around 53 per cent of total household assets. Further, mortgages dominate Australian household debt, currently accounting for around 79 per cent of household debt outstanding. Mortgages also represent over 60 per cent of bank lending.

As a result, an overly exuberant housing market with rapid changes in the value of housing and increases in household debt are likely to have material consequences for the macro-economy and financial stability. Following the start of the housing cycle upswing in early 2013, there was a significant increase in the share of investors as a proportion of mortgage lending. APRA noted the Reserve Bank of Australia’s (RBA) concern that the strong growth in investor lending could be funding additional speculative activity.

It was also seen as relevant that, with nominal GDP declining during that period, continued bank credit growth at levels the major banks had become accustomed to would necessarily result in a significantly more leveraged private sector, notwithstanding already high debt levels by historic standards and when compared to other countries. Further, and of particular concern to APRA, there was a deterioration in lending standards, with loan-to-value ratios increasing as well as the share of interest-only loans. This was a reflection of the banks competing to attract greater market share by offering looser lending standards, a potentially unhelpful form of competition that can create risks for both financial stability and individual consumers.

While lending standards improved and investor credit growth moderated following the implementation of the 2014 measures, credit growth picked up again during the tail-end of 2016. The improvements in lending standards occurred at the same time that the RBA started easing monetary policy again. Amid weak inflation pressures, the RBA cut interest rates twice over 2016, taking the cash rate to the historic low of 1.50 per cent. Following this, strong house price growth continued in the lead up to the March 2017 measures.

Potential risks arising out of this landscape have been the subject of ongoing scrutiny by regulators. Firstly, greater household leverage makes households more sensitive to adverse changes in their circumstances and broader economic shocks. Further, with much of the debt secured by housing, rapid changes in housing prices in either direction can also present their own risks. In addition, the rise in the share of investor lending was seen as additional sources of risk because the expectations for ongoing capital gains can mean that investors induce a more pronounced cycle in housing price growth and activity than would otherwise occur.

Interest-only mortgages also have two features that potentially amplify systemic risk. Firstly, in the absence of significant offset balances, the lack of principal repayment during the interest-only period leaves banks more susceptible to losses from defaults in a falling house price environment. Secondly, the step-up in repayment at the end of the interest-only period presents a risk to mortgage servicing, particularly if it occurs at a time when banks are reluctant to facilitate refinancing. In combination, these features potentially create a link between house prices and defaults — a borrower may not be able to meet the step-up and a bank is unlikely to refinance a loan with negative equity. In this way, a high proportion of interest-only loans in the stock of mortgages represents a structural vulnerability.

OPTIONS CONSIDERED

At the CFR, regulators have discussed a broad number of options to manage these risks since late 2014. The options discussed included measures which were primarily targeted at improving the resilience of banks in the event of a downturn, broader measures which would look to moderate the housing cycle, and measures more directly targeted at improving lending standards.

In evaluating options, the CFR considered three key criteria:

- the likely effectiveness of the measure in managing the identified risks, including having regard to international experience;
- the ease of implementation, noting that the measures would need to be implemented in a timely manner; and
- unintended consequences that could arise, particularly the impact on economic growth and competition.

Following discussions within the CFR, APRA ultimately implemented two rounds of measures in December 2014 and March 2017. The tools chosen were judged as the most effective way to manage the identified risks in a timely manner while minimising unintended consequences.

Since 2014, APRA has also taken other steps to strengthen lending standards and related supervisory arrangements that represent a more targeted, longer-term, solution to some of the problems that gave rise to the 10 per cent investor lending benchmark in particular. Changes to the capital framework are also relevant.

The Draft Report suggests (at page 453) that in addition to strengthening lending standards a more targeted intervention could have been achieved if APRA had supplemented the investor benchmark and interest-only cap with explicit directions to banks to take no action that affects their existing borrowers. Doing so would, however, have represented an even more far-reaching regulatory intervention into commercial practices and been fraught with difficulties.

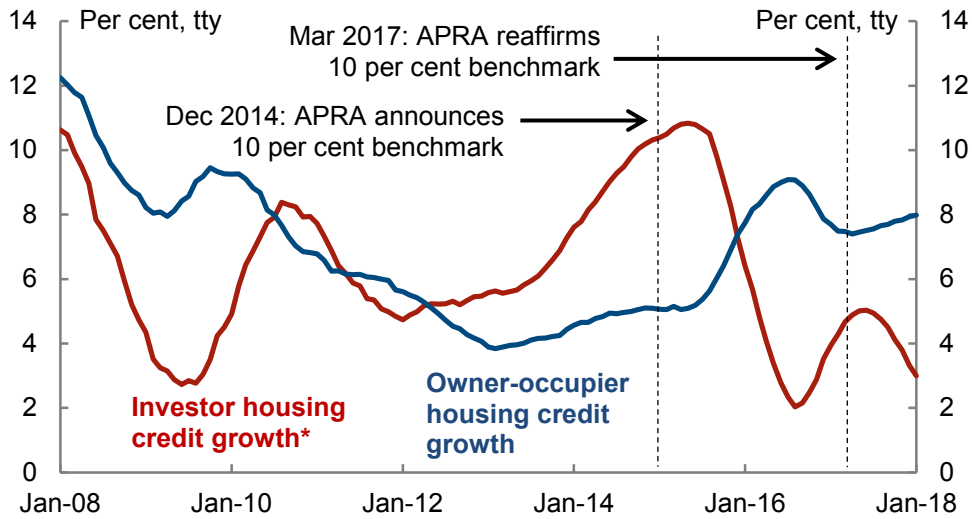
EFFECTS OF MEASURES

While it is still too early to make a conclusive and full assessment of the 2014 and 2017 measures, the interventions by APRA appear to have been broadly effective in achieving their desired outcomes. Investor lending growth has moderated significantly (Chart 1) while there has been a material decline in interest-only lending (Chart 2).

Internationally, APRA's macroprudential measures have been viewed favourably. The IMF's *Staff Report for the Australian Article IV Consultation* considered that Australia's multi-pronged policy for addressing housing imbalances and vulnerabilities including tightening of prudential policies was appropriate (IMF, 2018). The IMF acknowledged the resulting developments, including a reduction in riskier types of lending, slowing of growth in lending to housing investors and fewer interest-only loans being made, as positive.

The OECD has also acknowledged that the measures implemented by APRA (including the interest rate buffers and floors used in loan serviceability assessments) together with increased mortgage risk weights for IRB banks, have seen investor credit growth slow and an improvement in the quality of credit being extended in the mortgage market (OECD, 2017). In its 2017 *Economic Survey of Australia*, the OECD recommended that Australia maintain tight macroprudential measures.

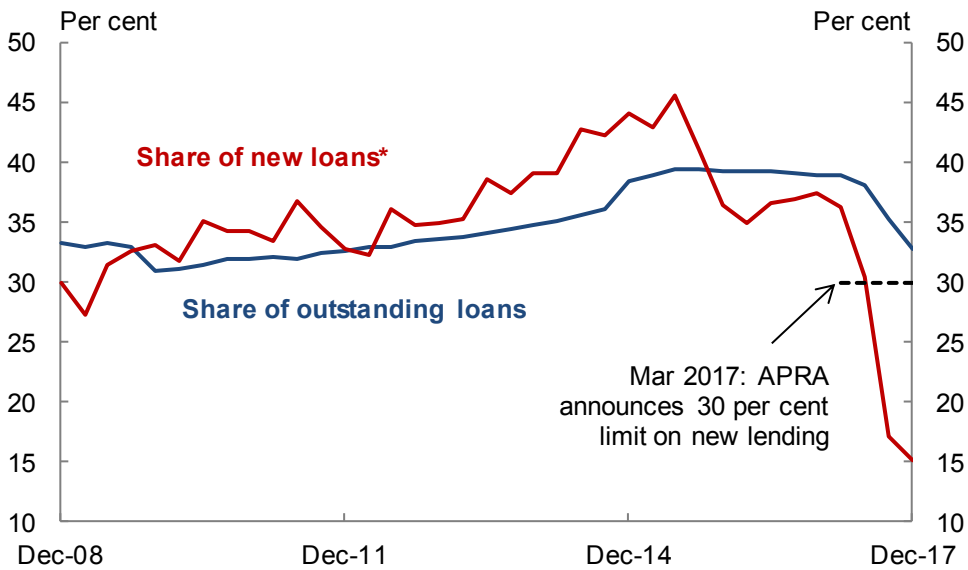
CHART 1: HOUSING CREDIT GROWTH



Source: RBA.

* There are a number of factors which may lead to some variance between investor credit growth for the purpose of APRA's benchmark and the figures published by the RBA.

CHART 2: ADI'S INTEREST-ONLY LOANS APPROVED AS A SHARE OF TOTAL MORTGAGES APPROVED^ (BY VALUE)



Source: APRA.

^ Figures are for ADIs with greater than \$1 billion of term loans.

* For the purpose of the interest-only cap, APRA monitors ADI's new interest-only lending using data on loans funded rather than approved. As a result, there is some variance between the figures published by APRA and the cap.

BOX 1: REGULATORS AND INCIDENTAL REVENUE IMPACTS

In discussing the impact of APRA's 2017 macroprudential measures, the Draft Report makes much of a resulting cost to 'taxpayers' (by which is meant government revenue) of up to \$500 million a year given interest paid on investor loans is tax deductible. The inference is that this 'cost' is a negative that APRA should have taken into account in its decision making.

In Treasury's view, the Draft Report is mistaken in suggesting that such incidental revenue effects (whether positive or negative) should be taken into account by APRA.

APRA is a prudential regulator and should focus on achieving its primary objectives, and nor does its legislative mandate ask it to take account of revenue effects whether positive or negative. To require APRA to favour measures or actions that increase government revenues would only distract them from meeting their primary objectives. It would place undue weight on effects that essentially represent transfers between different parts of the community or transfers over time, and that are not economic gains or losses overall.

In general, given that regulators' actions can be expected to have at times both positive and negative effects, the aggregate revenue impacts would also likely be neutral over time. It is noteworthy that in the Draft Report's discussion of stronger capital requirements that no estimate was made of the potential revenue gains from requiring banks to hold relatively more equity (returns on which are subject to corporate income tax) and relatively less debt (for which interest paid is tax-deductible for the bank). Nor was an estimate made of the average expected fiscal benefit of reducing the risk and cost of a financial crisis.

The revenue cost estimate of \$500 million that the Draft Report gives prominence to ignores a number of factors in its calculation and appears significantly overstated at best. Factors not accounted for in that headline figure and that would reduce it if taken into account include:

- not all investment loan holders have a marginal tax rate of 49 per cent as the estimate assumes (for example, self-managed superannuation fund investors have a marginal rate of 15 per cent);
- additional interest income for banks would result in higher corporate income tax paid by them; and
- changes in the rate of growth of investor lending resulting from macroprudential measures would reduce total interest paid by investors and hence deducted for tax purposes. As Chart 1 illustrates, following the 2017 interventions, the then increasing rate of investor lending growth was reversed.

REGULATORY ARRANGEMENTS TO SUPPORT COMPETITION AND TRANSPARENCY

The Draft Report set out a number of recommendations to adjust regulatory arrangements to strengthen the consideration of competition by financial system regulators. In particular, it recommended that the Government designate ASIC or the ACCC as a competition champion to assess the competition impacts of measures proposed by regulators and that these assessments then be discussed at meetings of the CFR (draft recommendations 17.1 and 17.2).

The CFR is the key forum where Australia's financial sector agencies exchange views on, principally, financial stability concerns and provides a sounding board on the merits of options to address them. It assists in sharing information and co-ordinating actions between the CFR members as well as other agencies, such as the ACCC, who sometimes also attend. The CFR does not have a formal mandate, nor does it have powers separate from its members and hence is not a decision-making body.

A key feature of the success of the CFR is the collegiate workings of its members and, in particular, the shared sense of responsibility across all its interests.

All that said, Treasury brings to the CFR perspectives from its broader policy advising responsibilities and involvement in progressing the Government's legislative agenda. In doing so, Treasury sees itself as having a particular responsibility for raising competition issues and testing whether appropriate trade-offs are made, when necessary, between financial stability objectives and competition and efficiency. Treasury has performed this role when macroprudential and other financial stability measures are discussed. Treasury also chairs a CFR competition working group that includes the ACCC and has examined measures to pro-actively improve competition in the financial system.

The CFR then already has in effect a competition champion at the table, and one that can draw on its broad policy experiences and knowledge of the economy. The additional, formal, mechanisms set out in recommendations 17.1 and 17.2 will not add much to that and, as currently written, are impractical. They would involve housing in the designated agency a team whose function is reviewing the actions and policies of other regulators and potentially other parts of its own agency. Such a team would struggle to develop the expertise to understand and review effectively what is being proposed, while adding a bureaucratic overlay and slowing down regulator decision-making.

Imposing a formal process of discussing or clearing competition assessments on the CFR would also detract from its core function, and the relatively informal and flexible way in which it functions.

Treasury is, however, supportive of the underlying motivation for recommendations 17.1 and 17.2, of heightened awareness and consideration of competition issues by regulators, including a more pro-active agenda to strengthen competition. In addition to the role that Treasury itself plays in CFR, these outcomes will be best achieved by encouraging and building on recent initiatives and efforts by the regulators themselves to give greater weight to competition.

Notably, APRA has recently made significant steps toward a more pro-active approach by establishing a central licencing unit and by moving to adopt a two-phase licencing approach, both of which will assist potential new entrants, and in actively considering how to make prudential arrangements simpler and less costly for the smaller regulated entities. The Government is also working towards incorporating competition into ASIC's mandate, and recent additional funding for the ACCC has allowed that agency to heighten its financial sector focus, as evidenced by the current mortgage pricing inquiry. Over time, as the ACCC continues to develop its financial sector-specific expertise and build deeper relationships with the other regulators, we would also expect the ACCC's involvement in the CFR to increase.

The efforts by regulators to more actively consider and support competition in part reflect what are already (or soon to be introduced) significant features of policy and regulatory arrangements that require or exert pressure on regulators to consider competition issues appropriately. These include regulators' legislative mandates giving explicit weight to competition and efficiency, the statements of expectations provided to regulators by Government,⁴ and broad-ranging external reviews — most recently by the Murray Inquiry, the House Economics Committee's recent inquiries into the major banks and this current Productivity Commission inquiry. The Government has also committed to further periodic reviews of the state of competition.

The Draft Report also brings out issues of transparency and accountability in respect of the 2014 and 2017 macroprudential interventions, including around the role of the CFR. The investor lending benchmark and interest-only loan cap were, for Australia in recent times, unusual interventions with wide-ranging effects. Given what has been the evolving nature of Australia's approach to macroprudential type policies, and that the recently commenced IMF Financial Sector Assessment Program review of Australia is also likely to consider these issues, it is an opportune time to consider whether the processes and regulatory arrangements that underpin them can be improved.

4 The Minister for Revenue and Financial Services' *Address to the ASIC Annual Forum 2018* of 19 March outlines how the new Statement of Expectations for the Australian Securities and Investments Commissions relates to its new competition mandate.

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FINANCIAL SYSTEM REFORMS IMPLEMENTED OR IN PROGRESS TO BOOST COMPETITION

Table 1: Government response to the Murray Inquiry

MEASURE	STATE OF PLAY
<p>Rec 2: Narrow mortgage risk weight differences</p> <p>The Government agreed that the gap between average mortgage risk weights should be narrowed.</p>	<p>APRA announced in July 2015 an increase in IRB mortgage risk weights to at least 25 per cent from 1 July 2016.</p> <p>APRA is undertaking a review of its capital adequacy framework in 2018, including risk weights under the standardised and IRB approach. The review will incorporate the finalisation of the Basel III standard.</p>
<p>Rec 14: Collaboration to enable innovation</p> <p>The Government agreed to establish an Innovation Collaboration Committee to assist public-private collaboration.</p>	<p>On 24 February 2016, the Government established a FinTech Advisory Group. The Group advises the Treasurer on issues important to Australia's FinTech industry.</p>
<p>Rec 15: Digital identity</p> <p>The Government agreed to develop a Trusted Digital Identity Framework to support the Government's Digital Transformation Agenda.</p>	<p>The Digital Transformation Agency is the lead agency developing the Digital Identity policy.</p> <p>Version 1.0 of the Trusted Digital Identity Framework was made available in February 2018 following community and industry consultation.</p>
<p>Rec 16: Clearer graduated payments regulation</p> <p>The Government agreed to review the framework for payments system regulation and develop clear guidance on a graduated framework.</p> <p>The Government also committed to mandate the ePayments Code.</p>	<p>In relation to a graduated framework for payments regulation, Treasury is working with the regulators to review and implement changes through a working group process.</p> <p>In relation to the ePayments Code, the ASIC Enforcement Review Taskforce presented its report to Government in December 2017. The report includes recommendations on 'Industry Codes in the Financial Sector'.</p>
<p>Rec 17: Interchange fees and customer surcharging</p> <p>The Government agreed to take action to improve interchange fee and surcharging arrangements to achieve a more efficient system and fairer outcomes for consumers, merchants and system providers.</p>	<p>In December 2015, the Government legislated to ban excessive credit card surcharging. In May 2016, the RBA's Payments System Board also finalised new standards on surcharging. The ban came into effect for large merchants on 1 September 2016 and for all merchants on 1 September 2017.</p> <p>In May 2016, the Payments System Board also finalised its standards on the regulation of interchange fees, effective from 1 July 2017.</p>
<p>Rec 18: Crowdfunding</p> <p>The Government agreed and committed to develop a regulatory framework to facilitate crowd-sourced equity funding.</p>	<p>Legislation to implement a crowd-sourced funding framework for public companies commenced on 29 September 2017.</p> <p>Legislation for the extension to proprietary companies is currently before the Parliament.</p>

MEASURE	STATE OF PLAY
<p>Rec 19: Data access and use</p> <p>The Government agreed to improve the use of data and committed to task the Productivity Commission with reviewing options to improve accessibility to data.</p>	<p>On 8 May 2017, the Productivity Commission published the final report of its <i>Data Availability and Use</i> inquiry.</p> <p>In Budget 2017-18, the Government announced that it would introduce an open banking regime in Australia that will increase access to banking products and customer data by customers and third parties, if the customer consents.</p> <p><i>The Review into Open Banking</i>, which was publically released on 9 February 2018, was prepared on the basis that banking will be the first sector of the economy to which the broader Consumer Data Right – announced by the Hon. Angus Taylor MP (then Assistant Minister to the Prime Minister for Cities and Digital Transformation) on 26 November 2017 – is to be applied.</p>
<p>Rec 20: Comprehensive credit reporting</p> <p>In response to the Murray Inquiry and the Productivity Commission Inquiry into Data Availability and Use, the Government has committed to mandating comprehensive credit reporting.</p>	<p>Consistent with the Productivity Commission's report on <i>Data Availability and Use</i>, in November 2017, the Government announced that it would legislate to mandate participation in positive credit reporting, to commence 1 July 2018.</p> <p>The Treasury released the Exposure Draft Bill and explanatory memorandum on 8 February 2018. The National Consumer Credit Protection Amendment (Mandatory Comprehensive Credit Reporting) Bill 2018 was introduced into Parliament on 28 March.</p>
<p>Rec 27: Regulator accountability</p> <p>The Government agreed to reconstitute the Financial Sector Advisory Council with refreshed terms of reference to include providing advice on the performance of the financial regulators.</p>	<p>The then Minister for Small Business and Assistant Treasurer announced the reconstitution of the Financial Sector Advisory Council (FSAC) on 6 May 2016 with refreshed terms of reference that include providing advice on the performance of the financial regulators.</p>
<p>Rec 30: Strengthening the focus on competition in the financial system</p> <p>The Government agreed to implement periodic reviews of competition in the financial sector.</p> <p>The Government also committed to task the Productivity Commission to review the state of competition in the financial system by the end of 2017, three years after the completion of the Inquiry. Subsequent periodic reviews will be undertaken as appropriate.</p> <p>Further, the Government also committed to including competition in ASIC's mandate and to update Statements of Expectations such that regulators report how they have balanced competition with other elements of their mandates.</p> <p>Finally, to address barriers to cross border trade in managed investment schemes, the Government agreed to establish an Asian Region Funds Passport.</p>	<p>The Government tasked the Productivity Commission to commence a review on 1 July 2017 of the state of competition in the financial system.</p> <p>The Government has revised ASIC's statement of expectations to require ASIC to publicly communicate how it is balancing its regulatory objectives including competition aspects.</p> <p>In addition, the Government is expanding ASIC's mandate to require consideration of the effects on competition, introducing into Parliament on 28 March 2018 the Treasury Laws Amendment (Enhancing ASIC's Capabilities) Bill 2018.</p> <p>In line with the recommendations of the Murray Inquiry, the Government is working to issue APRA with a revised statement of expectations and issue the Payment System Board with an inaugural statement of expectations.</p> <p>The Government has recently introduced a bill to implement the Asia Region Funds Passport into Parliament.</p>

MEASURE	STATE OF PLAY
<p>Rec 39: Technology neutrality</p> <p>The Government agreed to amend priority areas of legislation and regulation to be technology neutral.</p>	<p>Industry has identified improvements to reduce compliance costs for company meetings.</p> <p>Government considered reforms to electronic delivery of company meeting notices via a proposals paper, released for public consultation in 2016.</p>
<p>Rec 40: Financial advice and mortgage broking</p> <p>The Government agreed to rename 'general advice' to improve consumer understanding and to ensure that financial advisers and mortgage brokers adequately disclose their relationships with associated entities.</p>	<p>This measure has yet to be implemented.</p>
<p>Rec 42: Managed investment scheme regulation</p> <p>The Government agreed to develop legislative amendments to enhance the regulatory framework for managed investment schemes.</p>	<p>The Government has been working closely with stakeholders to develop a framework for new corporate collective investment vehicles and released draft legislation for the regulatory framework in August 2017.</p>

Table 2: Reforms announced since the Murray Inquiry

MEASURE	STATE OF PLAY
<p>Major bank levy</p> <p>The 2017-18 Budget announced a major bank levy set at an annual rate of 6 basis points applicable to ADIs with total liabilities of at least \$100 billion. Funding was also provided to the ACCC for a price inquiry related to the levy.</p>	<p>The levy has been effective since 1 July 2017.</p> <p>The ACCC released its interim report on the residential mortgage products price inquiry on 15 March 2018.</p> <p>One of the key findings of the report was that as of November 2017, no specific decisions had been made by the affected banks to adjust residential mortgage prices in response to the levy.</p>
<p>ACCC tasking to look at competition</p> <p>Following a recommendation from the House of Representatives Standing Committee on Economics report, Review of the Four Major Banks, the 2017-18 Budget provided \$13.2 million over four years to the ACCC to establish a dedicated unit to undertake regular inquiries into specific financial system competition issues.</p> <p>It seeks to facilitate greater and more consistent scrutiny of competition matters in the economy's largest sector.</p>	<p>The ACCC has established the unit, and that unit has been undertaking the one-year price inquiry into residential mortgage products (concluding on 30 June 2018).</p>
<p>Least-cost tap-and-go routing</p> <p>In December 2017, the House of Representatives Standing Committee on Economics <i>Third Review of the Four Major Banks</i> recommended that banks be required to give merchants the ability to send tap-and-go payments from dual-network debit cards through the channel of their choice.</p>	<p>In their most recent published minutes, the Payments System Board noted that it was encouraged by the progress some financial institutions have made towards providing least-cost routing functionality to their merchant customers and that it expects to make a decision at its May 2018 meeting as to whether the market is providing this functionality or if the Board should issue a draft standard for consultation.</p>
<p>Two-phase approach to bank licensing</p> <p>The 2017-18 Budget noted that APRA was reviewing its bank licensing processes to make them more accessible to new entrants.</p>	<p>APRA reviewed its prudential licensing arrangements in 2017 to ensure they are accessible to new entrants. APRA's final model is expected to be announced in 2018.</p>

MEASURE	STATE OF PLAY
<p>Removing restrictions on the use of the term 'bank'</p> <p>The 2017-18 Budget committed to reduce regulatory barriers to entry for innovative new entrants to the banking system by lifting the prohibition on the use of the word 'bank' by ADIs with less than \$50 million in capital.</p>	<p>On 19 October 2017, the Government introduced legislation into Parliament to amend section 66 of the Banking Act 1959 to allow any banking business with an ADI licence to describe itself as a bank. The legislation, which was passed on 15 February 2018, commences two months after the date of Royal Assent (5 March 2018).</p>
<p>Regulatory sandbox</p> <p>The Government committed to create an enhanced regulatory sandbox to allow businesses to test without a licence for 24 months a wide range of new FinTech products and services, subject to meeting minimum consumer protection obligations.</p>	<p>In December 2016, ASIC launched its regulatory sandbox to enable businesses to test financial services without facing the full suite of requirements and costs of regulatory licensing.</p> <p>Legislation for the enhanced regulatory sandbox was introduced into Parliament on 8 February 2018.</p> <p>The Government plans to conduct a review of the enhanced regulatory sandbox once it has been in place for 24 months.</p>
<p>Relaxing the 15 per cent bank ownership requirement</p> <p>In the 2017-18 Budget the Government committed to relaxing the legislative 15 per cent ownership cap for innovative new entrants to the banking sector.</p>	<p>The measure is being progressed by Treasury.</p>
<p>Mutual ADIs and capital (Hammond review)</p> <p>The Government appointed Mr Greg Hammond OAM to independently conduct consultation into the Mutual and Cooperative's sector. The report was provided to Government on 31 July 2017 and the Government has supported all the recommendations.</p>	<p>Treasury has begun consultations with the sector and is currently working to progress the implementation of the Hammond Review's recommendations.</p>
<p>Competition in clearing & settlement of cash equities</p> <p>The Treasurer announced on 30 March 2016 that the Government would legislate rule-making and arbitration powers for relevant regulators to enforce the Regulatory Expectations on ASX and to implement the Minimum Conditions to accommodate the potential emergence of a competing clearing and settlement facility.</p>	<p>On 12 October 2016, the Treasurer endorsed the release of the CFR's policy statements on the <i>Regulatory Expectations</i> and <i>Minimum Conditions for Clearing</i>.</p> <p>On 7 September 2017, the CFR released a policy statement on the <i>Minimum Conditions for Settlement</i> and the <i>Response to Consultation</i>, noting the Government's continued commitment to this legislation.</p>