PRODUCTIVITY COMMISSION INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM

RESPONSE TO CONSULTATION PAPER

October 2017

Public

CONTENTS

EXECUTIVE SUMMARY

1. ANZ thanks the Productivity Commission for the opportunity to comment on competition in Australia's financial system. Our comments are primarily directed towards competition within the banking market.

2. We have welcomed reviews of banking market competition.[1] These offer the hope of a compelling evidential base for the development of future policies. Australia's banking system successfully supported our economy through the global financial crisis and has helped fund Australia's economy through a record period of growth. Future banking market policies must be grounded in good evidence and truly directed towards competition to ensure banking can continue to fund the economy safely and efficiently.

3. ANZ is one of the smaller four major banks in Australia. In that position, we face competitive pressure each day. In the years since the crisis, concentration initially increased but has since moderated, arguably due to the increased number of providers. Australians can now select from a growing range of sophisticated providers for their loans, deposit accounts and credit cards. These providers include the other major banks, regional and foreign banks, credit unions, non-bank lenders and, for some financial services, technology firms. Consistent with competitive pressure, bank returns, interest margins and fees have declined since the crisis while banks have added more capital to increase systemic stability. These historical dynamics suggest that enhanced contestability can drive competitive outcomes.

4. Future bank competition policy can underpin Australia's economy and systemic stability if it fosters open, accessible and safe markets. This will occur through competitor-neutral and stability-reinforcing policy settings that minimise unwarranted barriers to entry and empower consumers. Such policy will allow us (and our rivals) to secure customers' loyalty through safe products and services that meet their needs. This will benefit Australian consumers and our economy.

5. We think that the Commission should:

   - **Make it easier for new and smaller banks** – we support making it easier to become a bank and an appropriate recalibration of the requirements for banks to use internal models to calculate their capital with the caveat that stability remains a critical objective

[1] Letter from Mr Shayne Elliott to Mr David Coleman MP, Chair of House of Representatives Standing Committee on Economics (6 March 2017); available at: http://www.aph.gov.au/~/media/02%20Parliamentary%20Business/24%20Committees/243%20Reps%20Committees/Economics/Review%20of%20the%20Reserve%20Bank%20second%20report/Documents/ANZ%20response%20to%20recs%20for%20web.pdf?la=en

- **Embrace innovation** – open data and comprehensive credit reporting, along with innovations like digital identities, should help consumers choose products and switch banks while appropriately reducing customer acquisition costs and helping innovation

6. To support our recommendations, we have the following observations on bank competition.

7. **First, the Commission should ask whether the market is contestable.** The relative freedom to enter the market puts consistent competitive pressure on incumbents, regardless of their market share. Policies aimed at promoting contestability, together with stability, are the right ones.

8. **Second, Australian banks have reduced prices and costs to deliver better outcomes for customers and shareholders.** While banking market concentration increased in the immediate post-crisis years, it has been falling recently including, on some measures, to pre-crisis levels. Through this time, Australian bank margins have decreased and returns on equity fallen. The market has delivered better prices and services for consumers despite bank costs increasing due to higher levels of stability-reinforcing capital and liquidity levels. To ensure Australians continue to benefit from investing in banks, operating costs have fallen.

9. **Third, technology is changing how banks compete and who they must compete with.** The digitisation of finance involves new technologies and changing consumer expectations and preferences. It is reducing historical barriers to entry (for example, branch networks and information requirements) and, through this, has seen new competitors enter traditional banking markets, including lending and payments. Assessments of competition must be forward looking if they are to benefit Australia.

POLICY RECOMMENDATIONS

1. We have two key recommendations for the Commission.

Make it easier for new and smaller banks

2. As a broad proposition, we support making it easier to become a bank and to compete as a smaller bank. This includes reforms such as an appropriate recalibration of market entry requirements and the basis on which banks can use internal models to calculate their capital. Such initiatives can support contestability. APRA and Government have announced initiatives in this respect.[2] We firmly believe, however, that bank and system stability must remain critical objectives.

3. In general, we would prefer to see regulatory policy initiatives that reduce the costs of small banks over initiatives that increase the costs of large banks solely in the name of competition.

Embrace innovation

4. We support evidence-based policies that encourage innovation. Open data and digital identities are two initiatives that offer hope for greater competition.

Open data and comprehensive credit reporting

5. ANZ supports open data for consumers across the economy.[3] Consumers will benefit from open data, including through understanding their own behaviour and comparing products and services. Working out which bank offers the best deposit account will be easier for consumers when they can use data about their past account usage and a comparison site's algorithm. ANZ has proposed a deliberately safe and simple form of open banking to the Government's Independent Review into Open Banking that will provide a pathway to economy-wide open data.[4]

6. We also note that the Government has proposed mandating comprehensive credit reporting (**CCR**). Both open data and CCR will increase the amount of information flowing through the banking system, lowering barriers to entry and encouraging innovation.

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[2] See Treasury's proposal to remove restrictions on the use of the term 'bank' https://www.treasury.gov.au/ConsultationsandReviews/Consultations/2017/Reducing-barriers-to-new-entrants-to-the-banking-sector; APRA's proposal for a phased bank licensing regime http://www.apra.gov.au/AboutAPRA/Pages/0817-Consultation-Licensing.aspx; APRA's proposal to make it easier for smaller banks to use internal models http://www.apra.gov.au/adi/Publications/Documents/20151216LetterADIsStagedDecoupled.pdf

[3] Letter from Mr Shayne Elliott to Mr David Coleman MP, Chair of House of Representatives Standing Committee on Economics (6 March 2017); available at: http://www.aph.gov.au/~/media/02%20Parliamentary%20Business/24%20Committees/243%20Reps%20Committees/Economics/Review%20of%20the%20Reserve%20Bank%20second%20report/Documents/ANZ%20response%20to%20recs%20for%20web.pdf?la=en

[4] https://static.treasury.gov.au/uploads/sites/1/2017/09/c2017-t224510_ANZ.pdf

7. The specific long-term pro-competitive impacts of these information-enhancing initiatives could be:

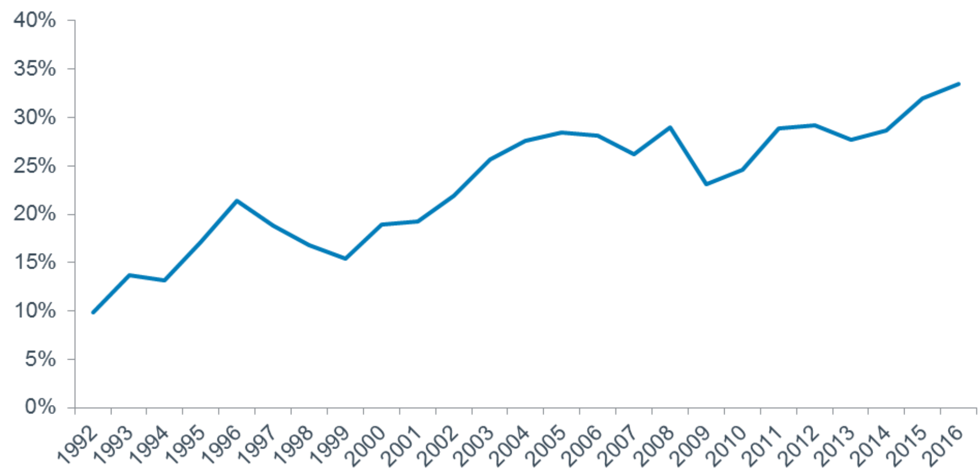
- Empowering consumers to understand their financial position and options, allowing them to place more demand-side pressure on providers
- Reducing the time it takes to understand borrowers and generally lowering barriers to entry for new bank market entrants
- Allowing innovation to improve the bases of competition (ie new products and services and ways of delivering them)

8. We think open data's true potential lies in its economy-wide application, as recommended by the Productivity Commission. This will allow data from disparate parts of the economy to come together and firms from across sectors to compete for business. Open banking should be used a pathway to implementing this broader form of open data.

Switching – digital identity in addition to open data

9. Greater consumer pressure on banks could be achieved by making it easier for consumers to switch between banks. Our experience is that consumers readily open new mortgage, deposit and credit card accounts, often in response to price. For example, the level of mortgage refinancing (owner occupier) has steadily increased over time.

Chart 1.1 – Average annual percentage of owner occupier financing that is refinancing[5]



[5] Based on Australian Bureau of Statistics data, data series A2420406F, A2420407J, A2420408K, A2420409L, licensed under Creative Commons Attribution 2.5 Australia (https://creativecommons.org/licenses/by/2.5/au/); ANZ calculations

10. Open data is posited as potentially facilitating consumers to switch between providers. Open data would help consumers port their data from one bank to another and enhance their ability to compare products.

11. However, consumers may still need to establish their identity with new providers. In lieu of relying solely on open data to catalyse switching, we think the Commission could usefully consider the role that digital identities might play in making it easier to switch banks. Digital identities were proposed by the Financial System Inquiry.[6] A digital identity is an electronic token that allows individuals to authenticate their identity to third parties. Instead of consumers needing to verify their identity through licenses and passports, they could present their digital identity to banks and other financial service providers. This would allow them to open accounts online and reduce the need to visit a branch.

12. From the provider's perspective, a digital identity may meet some (but not all) of the KYC requirements that apply in connection with anti-money laundering and counter-terrorism financing laws. The provider would be able to rely on the digital identity to establish who the customer is, although this would not relieve them from the obligation to otherwise risk assess the customer. This would reduce barriers to entry for new providers.

13. Fostering a digital identity framework in Australia will take commitment and collaboration from Government and industry. We would encourage the Productivity Commission to consider what recommendations it could make to catalyse reform in this space.

14. We note that the New Payments Platform (**NPP**) will help switching to some degree by allowing consumers to maintain a constant payment receipt address (PayID) that can be attached to any bank account.[7]

Make digital finance easier

15. Less exciting but just as important as open banking and digital identity are minor reforms that can smooth the way to digitised finance. ASIC's recent reforms to allow innovative and digital disclosure documents are important to facilitate online banking.[8] We think it is important that Government continues to identify barriers to finance going digital. Regular dialogue with industry would help with this.

16. For example, it is difficult to provide customers with online statements for credit contracts. This arises because section 9 of the *Electronic Transactions Act 1999* (Cth) (in addition to

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[6] See recommendation 15 that Government 'develop a national strategy for a federated-style model of trusted digital identifies': The Australian Government The Treasury *Financial System Inquiry: Final Report* (November 2014), 151.
[7] http://www.nppa.com.au/payid/
[8] ASIC Regulatory Guide 221 Facilitating digital financial services disclosures (March 2016); available at: http://download.asic.gov.au/media/3798806/rg221-published-24-march-2016.pdf

Regulation 10 of the *Electronic Transactions Regulations 2000*) requires proactive consent in writing for electronic communication of documents required under the credit law. To enable the digitisation of credit processes, it may be beneficial to align the credit laws with the position on non-credit accounts. This position has seen a significant increase in customers using online statements. If aligned, credit providers could opt customers into electronic communications while still giving consumers the ability to opt out if written communications are preferable.

BANKING MARKET CONTESTABILITY

17. We believe that the Commission needs a sound framework for thinking about bank competition. Policies grounded in strong analytical constructs will help banking market competition, economic growth and systemic stability. We believe the Commission should emphasise contestability and note the relationship between competition, bank stability and economic growth.

18. The World Bank recognises that contestability is the best prism through which to view the competitiveness of a bank market.[9] Contestability primarily concerns the barriers to entry of market. Commercial barriers include network costs (eg branches or membership of payment systems), fixed costs (eg core banking systems) and customer switching propensity (driven by loyalty, search and switching costs and financial literacy).[10] Regulatory barriers are the licensing and capital requirements that a jurisdiction imposes.

19. In contrast, relying solely on concentration analyses of competition is problematic. Such analysis may miss the dynamics which have given rise to higher market shares, such as intense competition and minimum efficient scales. Further, performance measures that support concentration analysis such as net interest margin and profitability may reflect other factors, such as an economy's performance.[11] Analysis based on concentration alone may lead to erroneous conclusions about bank competitiveness.

20. The relationship between competition, stability and economic growth is not straight forward. Bank competition could help decrease bank size, making them easier to resolve, and enhancing stability. Conversely, excessive competition may undermine asset quality.[12] Academic inquiry into the relationship between bank competition and stability is

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[9] The strength of contestability analyses over approaches based solely concentration is recognised by the World Bank which states that '…concentration measures are generally not good predictors of competition' and that '[t]he predictive accuracy of concentration measures on banking competition is challenged by the concept of market contestability': The World Bank Banking Competition http://www.worldbank.org/en/publication/gfdr/background/banking-competition (last accessed 21 August 2017). Analyses which look at concentration derive from the 'structure-conduct-performance' (SCP) paradigm of competition. Claessens states that '[t]heoretically and empirically there are a number of problems with the SCP-paradigm and its implications that, directly and indirectly, structure determines performance [ie competitiveness]': Stijn Claessens 'Competition in the Financial Sector: Overview of Competition Policies IMF Working Paper (WP/09/45), 7. Claessens notes that this was the 'the dominant paradigm in industrial organization from1950 till the 1970s…'.
[10] See Jacob A. Bikker and Laura Spierdijk 'Measuring and explaining competition in the financial sector' for a discussion of some of these barriers; available at: http://www.rug.nl/staff/l.spierdijk/competition_bikker_spierdijk.pdf (last accessed 21 August 2017).
[11] See Organisation for Economic Cooperation and Development Roundtable on Competition, Concentration and Stability in the Banking Sector (DAF/COMP(2010)9), 20.
[12] See, for example, Chay Fisher and Christopher Kent 'Two Depressions, One Banking Collapse' (RBA Research Discussion Paper 1999-06), 33; available at: http://www.rba.gov.au/publications/rdp/1999/pdf/rdp1999-06.pdf discussing the Victorian banking collapse in the late 1800s. Victorian banks and non-bank providers used cheap money from Europe to lend for real estate speculation. The unwinding of the speculation saw multiple institutions fail due to poor lending standards. In part, this dynamic was driven by competitive pressure: as Fisher and Kent note, 'banks allowed their level of risk to increase in an attempt to maintain market share in the face of greater competition from a proliferation of new non-bank financial institutions'.

inconclusive.[13] For example, one cross-jurisdictional study found that 'crises are less likely in more concentrated banking systems' but also that countries with higher contestability (engendered through lower regulatory barriers) and institutions facilitative of competition have a lower likelihood of financial crises.[14] The OECD Secretariat helpfully notes that '[i]f appropriate regulation and supervision are in place, competition need not reduce stability' and that '[c]ompetition could increase risk taking, in particular if the risk taking is not controlled by appropriate regulation'.[15]

21. Similarly, there is some academic ambiguity concerning whether competition supports bank credit extension. While competition may drive credit availability, banks may also require some degree of market stability to be incentivised to take the time to understand borrowers.[16] For example, one study of European banking found that bank competition increased credit costs in line with the idea that some stability is needed for credit extension.[17] Again, however, the academic results are generally inclusive.

22. In this light, Commission should consider that contestability within a stability-reinforcing framework is the optimal state for bank market competition.

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[13] See Martin Goetz 'Competition and Bank Stability' (2017) *Journal of Financial Intermediation*, 1-13 noting at 1 that '[w]hether an increase in competition increases or decreases bank risk is an open debate in economic research'. Michelle Bullock, Assistant Governor, (Financial System) Reserve Bank of Australia noted that the academic literature does not help Australia determine whether the pro- or anti-stability views of competition are instructive:Michelle Bullock, Assistant Governor (Financial System) Reserve Bank of Australia, 'Big Banks and Financial Stability' (Speech, 21 July 2017). See Carol Ann Northcott 'Competition in Banking: A Review of the Literature' Bank of Canada Working Paper 2004-24, 16 for a useful, albeit now dated, summary of the literature.
[14] Thorsten Beck, Asli Demirguc-Kunt and Ross Levin 'Bank Concentration, Competition and Crises: First Results' 30 (2006) *Journal of Banking and Finance* 1581
[15] OECD, above n 11, 31.
[16] See Zuzana Fungacova, Anastasiya Shamsur and Laurent Weil 'Does Bank Competition Reduce the Cost of Credit? Cross-country evidence from Europe' 83 (2017) *Journal of Banking and Finance* 104, 104 for a pithy explanation of these hypotheses.
[17] Ibid, 118.

AUSTRALIA'S PERFORMANCE

Introduction

24. If contestability within a stability-reinforcing framework is the optimal state for bank market competition, then it is important to consider how the Australian banking market has performed in recent years. This can be done by looking at metrics such as:

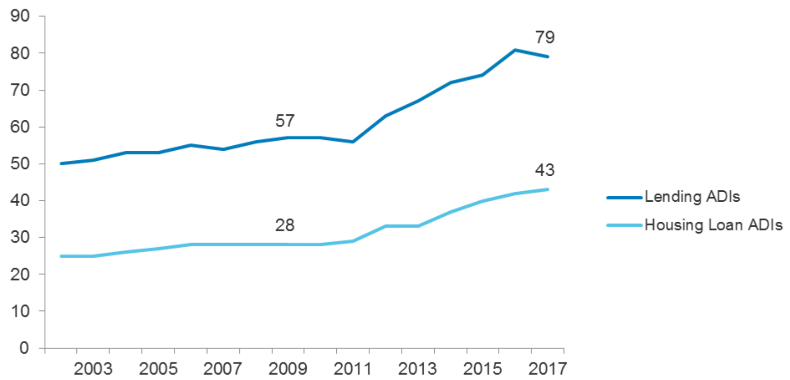
- Concentration measures that accommodate the degree of entry into the market
- Returns of incumbents
- Margin and fee trends
- Bank stability
- Customer satisfaction levels

25. While not completely dispositive of its historical competitive state, these metrics (set out below) indicate that, since the financial crisis, the Australian banking market has exhibited declining concentration, returns and margins while adding more capital. This suggests that the market has generally performed well against the standard that we have proposed.

Concentration

26. While the authorities cited above warn against referring to concentration in isolation when assessing bank market competitiveness, it is useful to consider it for context. For example, using APRA data, we can see that the number of banks reporting participation in the lending and home loan markets have increased over time.

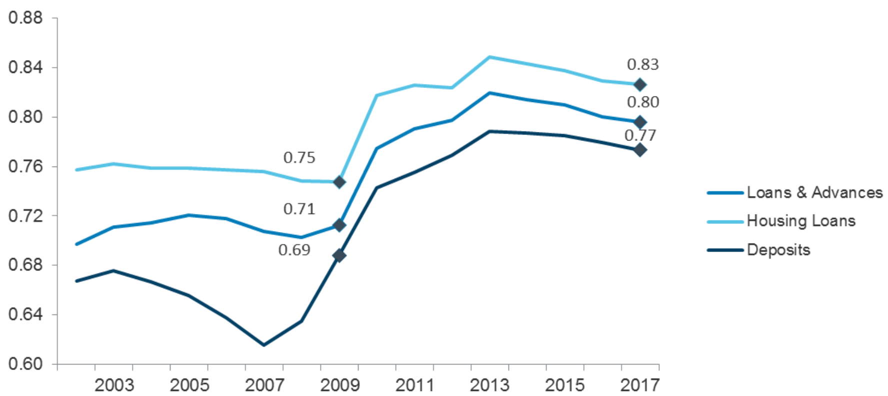
Chart 3.1 – Number of banks reporting participation[18]



[18] Data source: APRA Monthly Banking Statistics (August 2017) © Australian Prudential Regulation Authority (APRA) This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0); ANZ calculations

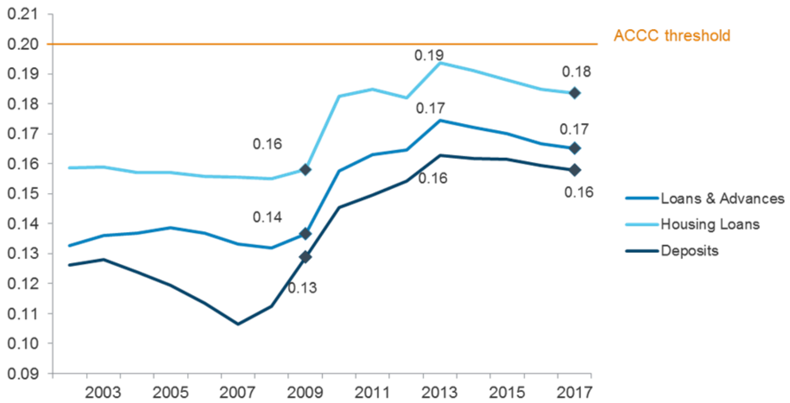
27. Conclusions concerning the competitiveness of Australian banking often rest on the share of the major banks. For example, the four-bank concentration ratio increased in the post-crisis years (due to crisis-era mergers and acquisitions) before moderating of late.

Chart 3.2 – Four bank concentration ratios[19]



28. However, these ratios do not reflect competition occurring outside of the four majors. To look at the whole market, the Herfindahl-Hirschmann Index (**HHI**) takes into account the market share of all market actors. It is a measure of concentration that is widely used as a screening tool by competition authorities to determine the state of post-merger industry structure. For example, the Australian Competition and Consumer Commission (**ACCC**) is less likely to identify horizontal competition concerns where the post-merger HHI is less than 0.2 (or 2000).[20]

Chart 3.3 – Herfindahl-Herschmann Indices[21]

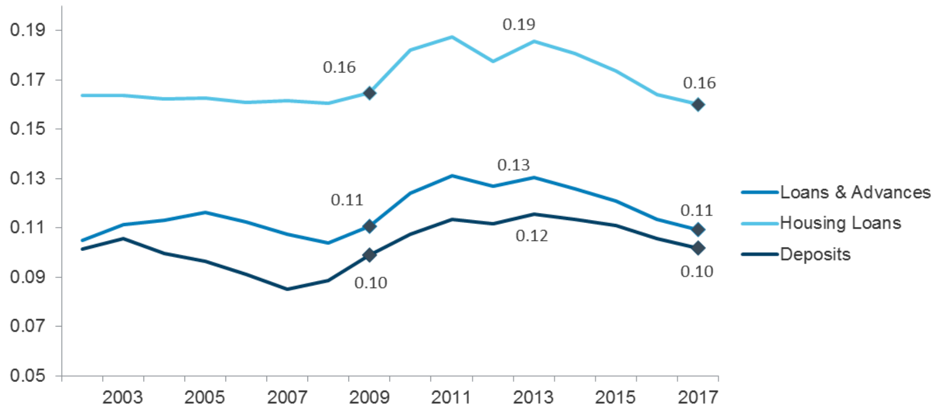


[19] Data source: APRA Monthly Banking Statistics (August 2017) © Australian Prudential Regulation Authority (APRA) This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0); ANZ calculations
[20] Australian Competition and Consumer Commission *Merger guidelines* (November 2008), 37; available at: https://www.accc.gov.au/system/files/Merger%20guidelines.pdf
[21] Data source: APRA Monthly Banking Statistics (August 2017) © Australian Prudential Regulation Authority (APRA) This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0); ANZ calculations

29. Our calculations of the HHI indicate that the Australian banking market has not exceeded the screening threshold used by the ACCC in assessing mergers.

30. While the HHI is based on market share, the Hall-Tideman Index enriches the HHI by considering the number of banks in the industry. Generally, the more banks (however small their share), the lower the index value and the indicated level of concentration. The Hall-Tideman Index thus allows an articulation of how new entrants are changing the concentration of an industry. As calculated for the Australian banking market, the index indicates a reversion to pre-crisis levels of concentrations, ostensibly due to new entrants as well as a declining market share of incumbents.

Chart 3.4 – Hall-Tideman Indices[22]



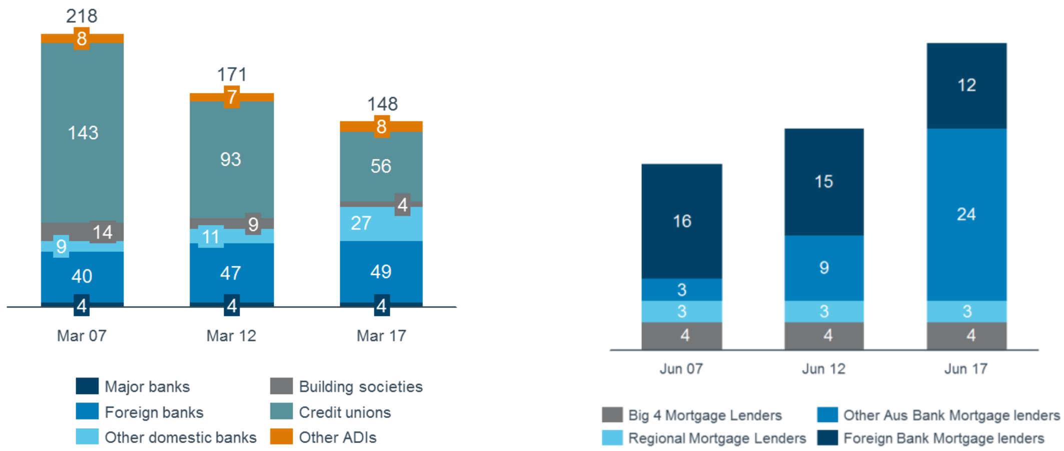
31. While the number of authorised deposit-taking institutions (**ADI**s) has fallen, this has largely been because of the consolidation and conversion of credit unions into banks.[23] In the last ten years, APRA has granted ADI authorisations to 26 applicants.[24] Further, the number of ADIs reported by APRA as offering mortgages has increased in recent years. Both these measures indicate entry into Australia's banking is open. This is particularly seen through the additional nine foreign ADIs that have entered the market since 2007.

[22] Data source: APRA Monthly Banking Statistics (August 2017) © Australian Prudential Regulation Authority (APRA) This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0); ANZ calculations

[23] For example, through 30 June 2015 to 30 June 2016, Australian Defence Credit Union Limited became Australian Military Bank Ltd and Qantas Staff Credit Union Limited became Qudos Mutual Ltd while Canadian Imperial Bank of Commerce, E.SUN Commercial Bank, Ltd, Shinhan Bank Co., Ltd and Union Bank of India were granted ADI authorisation. See Australian Prudential Regulation Authority Statistics ADI Points of Presence June 2016 (released 24 August 2016), 4; available at: http://www.apra.gov.au/adi/Publications/Documents/2016_PoP_PDF.pdf

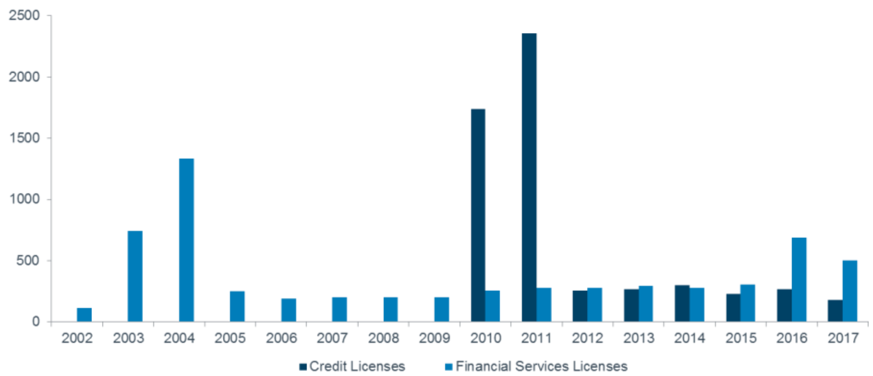
[24] *APRA Discussion Paper: Licensing: A phased approach to authorising new entrants to the banking industry* (15 August 2017), 12; available at: http://www.apra.gov.au/AboutAPRA/Documents/Phased-licence-discussion-paper.pdf

Chart 3.5 – Number of ADIs/Number of ADIs reporting as mortgage lenders[25]



32. Importantly, none of these concentration calculations reflects the full market for housing loans or loans and advances. Banks compete with entities that only hold an Australian Credit Licence (for loans) and/or an Australian Financial Services Licence (for advice, and other financial services). The qualitative regulatory requirements for gaining these licences are substantially less than those required for a full-service banking licence. This allows firms to enter product-specific markets and put competitive pressure on banks without becoming banks. The number of these types of licenses granted has been relatively steady after spikes associated with their introduction, indicating a consistent in-flow of new entrants. We note that ASIC's initiatives including its Innovation Hub and regulatory sandbox are designed to make it easier for start-up businesses to test their services and become licensed.[26] Further, corporates can access the capital markets for credit.

Chart 3.6 – Credit and AFS licences granted each year[27]



[25] Data source: APRA Monthly Banking Statistics © Australian Prudential Regulation Authority (APRA) This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0); Regional Banks: 2007 and 2012 rebased to reflect future mergers. Data includes all ADI's reporting mortgage lending as reported in APRA's monthly banking statistics released 31 July 2017.
[26] http://asic.gov.au/for-business/your-business/innovation-hub/
[27] ASIC – Credit Licensee Dataset & ASIC - Australian Financial Services Licensee Dataset both sourced from data.gov.au; ANZ's organisation of the data

33. For example, ASIC's licensing regime has allowed developments such as broker channels. These are increasing contestability, with more consumers choosing a broker to access their home loan. Instead of needing to visit multiple banks, consumers using a single broker can access a range of providers. In ANZ's experience, over half of our home loans are originated through brokers.

34. Comparison sites offer similar ways for diverse providers to reach consumers. Indeed, the contestability of the market can be evidenced, in part, by the number of products listed on comparison sites, such as Canstar.[28] The total number of products in the market far exceeds these specific iterations.

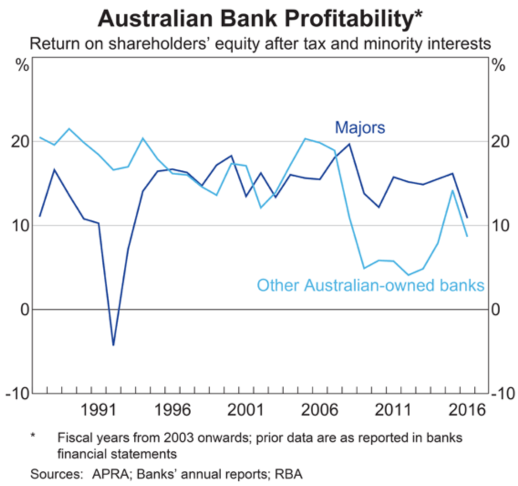
Indicative product	Number listed on Canstar's website
Low Rate Credit Cards ($2,000 spend per month)	187
Home Loans (Refinance, $350,000 loan amount, in Victoria)	1140
Savings Accounts (Regular saver, $1,000 in savings, in NSW)	140
Personal Loans ($20,000 loan amount, 3 years, NSW)	166

35. These factors suggest that both the HHI and the Hall-Tideman Index would be lower if they captured all participants in the markets that can be contested by non-bank firms. We would also expect these indices to continue their downward trend as barriers to entry fall through technology developments and reduced need for branch networks.

Returns of incumbents

36. Together with a decline in concentration, there has also been a decline in returns of incumbents. Australian bank return on equity has fallen since the crisis, with a notable convergence between the returns exhibited by major and other Australian banks.

Chart 3.7 – Returns on equity[29]



[28] https://www.canstar.com.au/. We note that Canstar's product listing may not be exhaustive.
[29] RBA Chart Pack; available at: http://www.rba.gov.au/chart-pack/banking-indicators.html

37. The drivers for these declining returns are diverse. Banks have needed to hold higher levels of capital. In turn, cost management has been essential to stay competitive and maintain attractive levels of returns for Australian bank shareholders, which include almost all superannuation beneficiaries. Competitive pressure on prices has depressed revenue. These dynamics are seen in the impacts on bank industry returns set out below.

Chart 3.8 – Dynamics affecting Australian bank industry returns on equity[30]

38. While Australian bank ROE is higher than other developed countries (with the exception of Canada), those other countries suffered severe economic shocks as a result of the global financial crisis while Australia did not. As we noted above concerning the utility of concentration analyses, this different economic experience reduces the meaningfulness of cross-jurisdictional comparison. Further, Australian banks are less profitable than comparable Australian companies. This is true whether we look at return on equity or total shareholder return (the mix of dividends and share price increases enjoyed by shareholders).

[30] Company filings, cash basis, ANZ calculations. ROE based on cash earnings (Statutory ROE FY15 = 14.5%). Note that the absolute contribution of individual drivers varies depending on the order of changes, but the relative contributions are comparable. Further, productivity has been aided by increased asset prices (i.e. a larger denominator)

Chart 3.9 – Statutory returns on equity – jurisdictional and industry comparison[31]

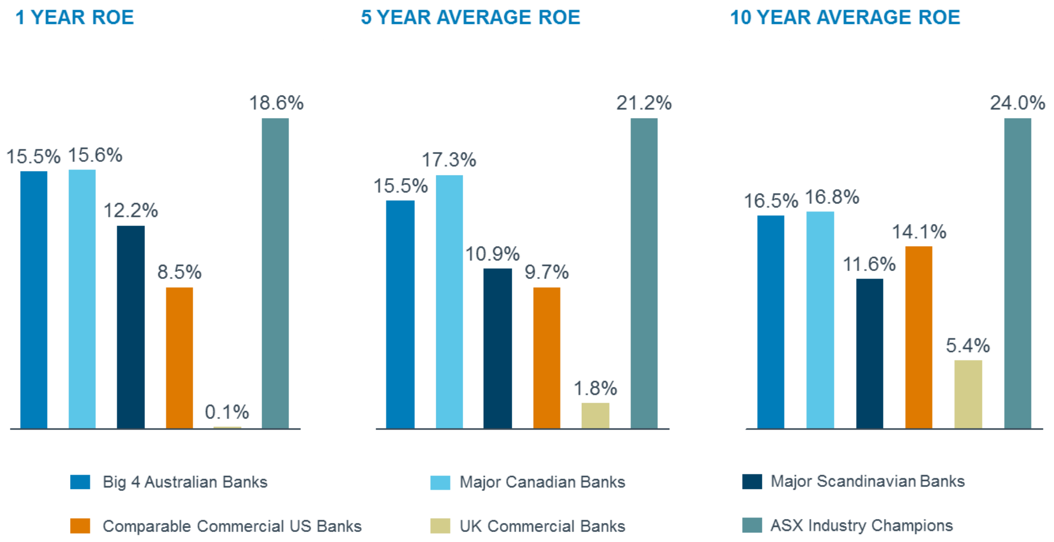
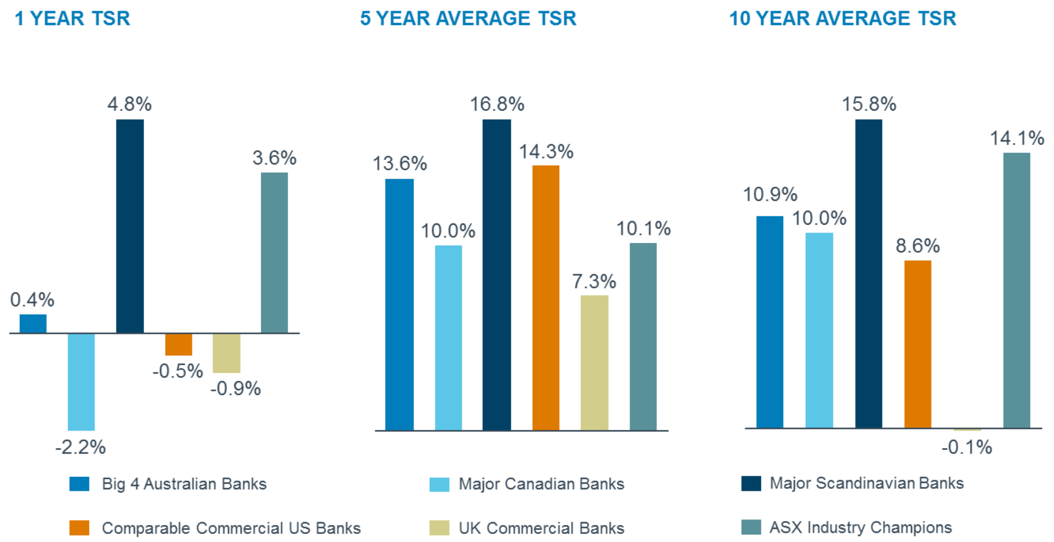


Chart 3.10 – Total shareholder returns – jurisdictional and industry comparison[32]



39. While these returns are trending down, there is still the question of whether current returns are 'excessive'. As noted in research on Australia published by the OECD, it appears that Australian bank returns were not excessive in 2010, although they were

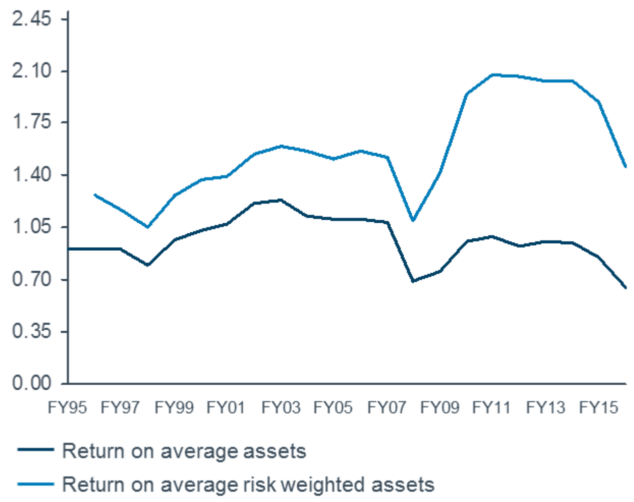
[31] Company fillings, Statutory basis, ANZ analysis. Simple arithmetic average of latest full year data (calculated in October 2016). Canadian banks: Bank of Montreal, Royal Bank of Canada, Canadian Imperial Bank of Commerce, Toronto-Dominion Bank and Bank of Nova Scotia. Scandinavian banks: Danske Bank, DNB, SEB, Nordea and Swedbank. US banks: US Bank and Wells Fargo. UK banks: HSBC, Lloyds Bank and Royal Bank of Scotland. ASX Industry Champions: Telstra, BHP, RIO, CSL and Wesfarmers. We note that Scandinavian banks are very well capitalised, driving their ROEs lower: http://www.reuters.com/article/sweden-cenbank-regulations/update-1-sweden-should-ease-its-bank-capital-rules-after-basel-iii-cbanker-idUSL5N1FL20Y

[32] Bloomberg, ANZ, simple annualised average. Simple arithmetic average of latest full year data (calculated in October 2016). Canadian banks: Bank of Montreal, Royal Bank of Canada, Canadian Imperial Bank of Commerce, Toronto-Dominion Bank and Bank of Nova Scotia. Scandinavian banks: Danske Bank, DNB, SEB, Nordea and Swedbank. US banks: US Bank and Wells Fargo. UK banks: HSBC, Lloyds Bank and Royal Bank of Scotland. ASX Industry Champions: Telstra, BHP, RIO, CSL and Wesfarmers

better than average for the financial institutions surveyed.[33] Again, this may reflect Australia's superior economic performance.

40. When returns are spread over assets, including risk-adjusted 'risk weighted assets', there is also a recent downward trend.

Chart 3.11 – ANZ return on assets[34]



Margin and fee trends

41. As indicated above, part of the pressure on bank returns has been better pricing for consumers. The revenue that banks earn on each dollar of interest earning asset has been declining. This revenue comes from both the fees that are charged for the services and the net interest margin that banks apply to loans. The net interest margin is the interest rate charged by banks on loans less the interest rate paid on the bank's funding for those loans. It is calculated before expenses. We acknowledge that these trends have been driven, in part, by a low interest rate environment and other pressures on fees.

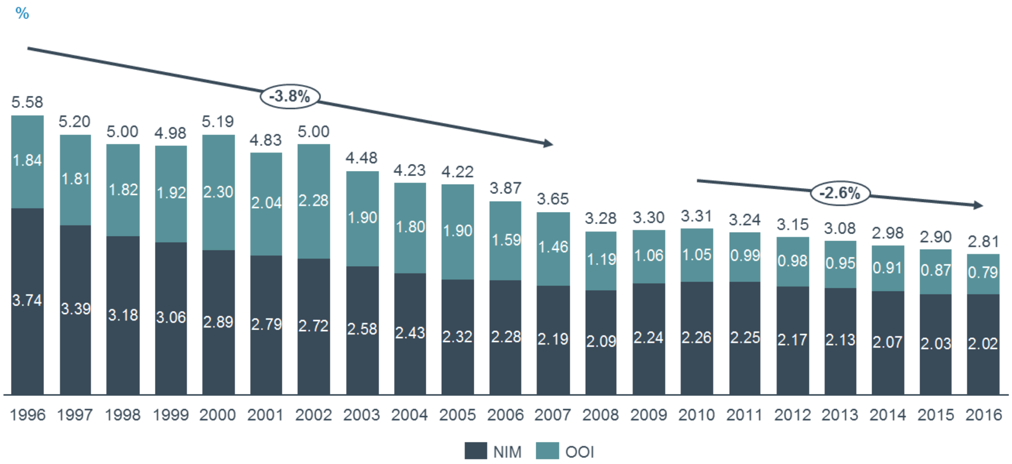
[33] OECD, above n 11, 82 noting that:

> An alternative measure, designed to improve on total shareholder return, is the Wealth Added Index (WAI). This index measures the value of the 'excess return' to shareholders over the cost of equity over a period and is comparable across industries and across countries. It is based on adjusted movements in share price. Internationally, only a single financial institution (in Brazil) of the 100 surveyed by Stern Stewart & Co reported a positive WAI across the most recent business cycle. However, Australian banks reported a smaller average negative WAI than many of the jurisdictions covered. Further, all four major Australian banks reported a WAI better than the average for the 100 institutions examined.

Note: WAI is a trademark of Stern Stewart & Co.

[34] ANZ annual reports

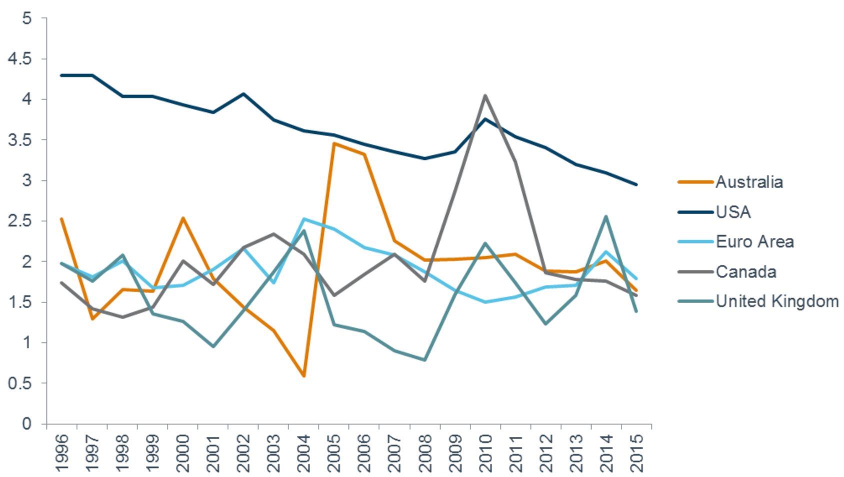
Chart 3.12 – Australian majors' revenue per $ of average interest earning assets[35]



42. These dynamics have played out in ANZ. Since 2007, ANZ's net interest margin has declined by around 10%. A similar decline has occurred in our other operating income. ANZ's dollar profit has increased since 2007 despite these trends due to a growth in activity.

43. The net interest margin of Australian banks is consistent with the margins seen in our jurisdictional peers (as measured by the World Bank). Australian bank NIM is broadly consistent with levels seen offshore.

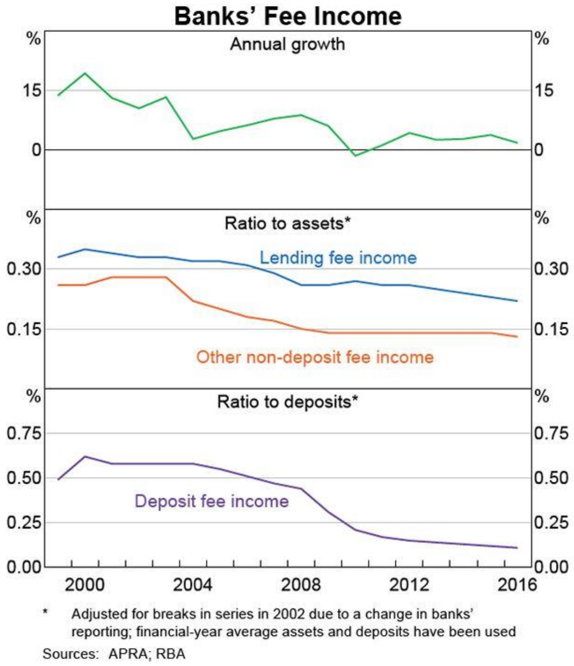
Chart 3.13 – Cross-jurisdictional comparison of bank net interest margin[36]



[35] Annual reports
[36] World Bank, Bank's Net Interest Margin [DDEI01EZA156NWDB], [DDEI01AUA156NWDB], [DDEI01CAA156NWDB], [DDEI01GBA156NWDB] , [USNIM] retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ September 23, 2017; USNIM is presented by World Bank as quarterly observations: to homogenise it with other jurisdictions, the simple average was taken of the quarterly observations to present a yearly average NIM figure. Data represents most current available.

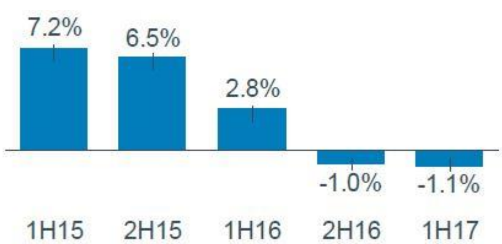
44. A downward trend is also seen in the ratios of fees to loan assets and to deposits as calculated by the Reserve Bank of Australia.[37] The Reserve Bank has noted that '[t]he decline in deposit fee income in 2016 was broad based across most types of fees on deposit accounts, consistent with continued competition between banks for households' deposits.'[38]

Chart 3.14 – Bank fee income[39]



45. With declining fees and margins, Australian banks have been under cost pressures to remain competitive, produce returns expected by shareholders and hold additional capital. As reported in our public results, ANZ has been exercising cost discipline in recent years. These cost pressures for the industry are reflected the return on equity dynamics of the industry as set out in chart 3.8 above.

Chart 3.15 – ANZ expense growth[40]



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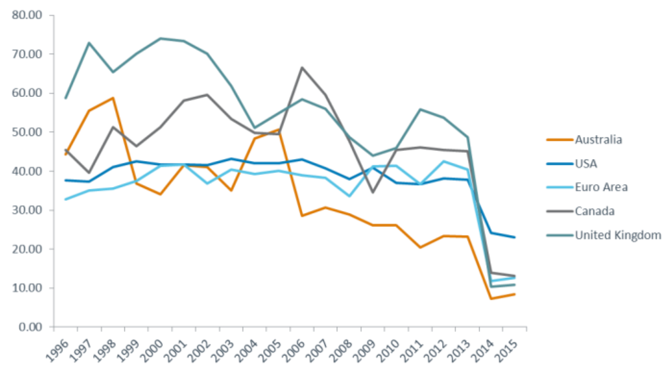
[37] Reserve Bank of Australia Banking Fees in Australia (June Quarter 2017), 36; available at: http://www.rba.gov.au/publications/bulletin/2017/jun/pdf/bu-0617-4-banking-fees-in-australia.pdf
[38] Ibid, 37.
[39] Ibid, 36.
[40] ANZ 2017 Half Year Results Presentation (2 May 2017); available at: http://shareholder.anz.com/sites/default/files/anz_1h17_results_presestation.pdf?_ga=2.124197902.58547158.1505963074-729656290.1487816405

Stability

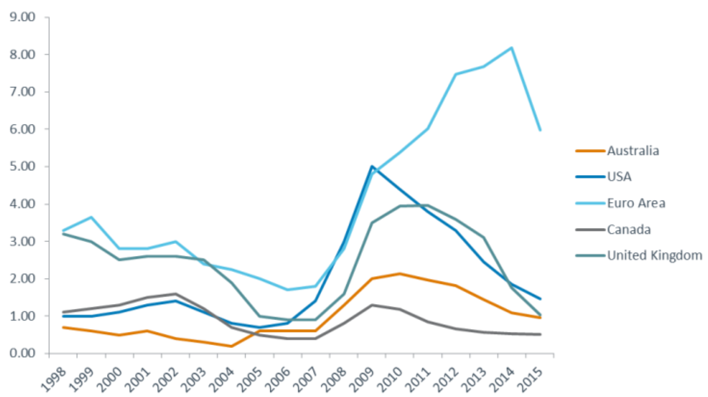
46. In this context of reducing returns, Australian banks have been stable and added more capital to become safer still. Pro-competition deregulatory arcs in jurisdictions such as the United Kingdom in the years preceding the crisis saw banks take on risk.[41] Non-interest income, which is drawn from activities other than taking deposits and making loans and associated with higher risk activities, was higher in other jurisdictions relative to Australia.[42]

Chart 3.16 – Banks' non-interest income to total income (%)[43]



47. In contrast, Australian banks were better managed and saw significantly fewer non-performing loans than other jurisdictions through the crisis-period.

Chart 3.17 – Non-performing loans to gross loans (%)[44]



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[41] See, for example UBS Investment Research Australian Banking Sector Update: Competition: Be Careful What You Wish For (9 November 2010); available at: https://www.commbroker.com.au/Net/Documentum/latest-news/Sector_Competition_-_Be_careful_what_you_wish_for.pdf discussing the role that pro-competition deregulation played in the amount of risk that UK banks took on.

[42] See Markus K. Brunnermeier, Gang Dong, and Darius Palia 'Banks' Non-Interest Income and Systemic Risk' available at: https://www.princeton.edu/~markus/research/papers/CoVaR_NonInterestIncome.pdf concluding that 'banks with higher non-interest income to interest income ratio have a higher contribution to systemic risk'.

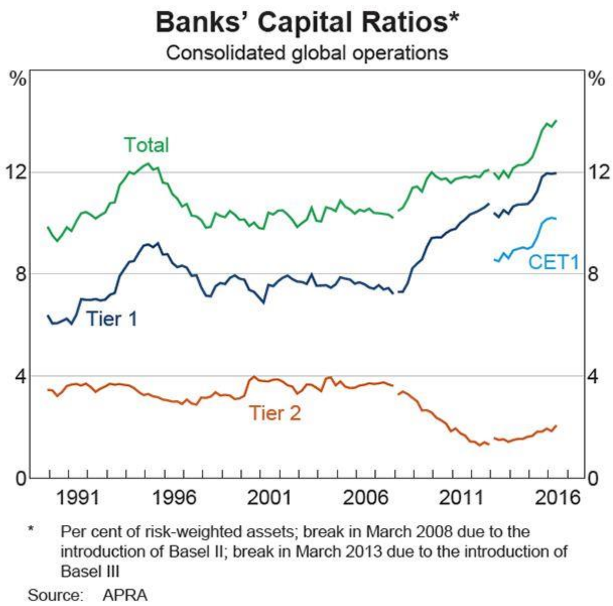
[43] World Bank, Bank's Non-Interest Income to Total Income [DDEI03GBA156NWDB], [DDEI03USA156NWDB], [DDEI03EZA156NWDB], [DDEI03AUA156NWDB], [DDEI03CAA156NWDB] retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ September 21, 2017. Data represents most current available.

[44] World Bank, Bank Non-Performing Loans to Gross Loan [DDSI02AUA156NWDB], [DDSI02USA156NWDB] [DDSI02EZA156NWDB], [DDSI02CAA156NWDB], [DDSI02GBA156NWDB] retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/ September 21, 2017. Data represents most current available.

48. The relative health of Australia's banks saw taxpayers insulated from the expense that bank failures visited on offshore public balance sheets.[45] European Union taxpayers, for example, provided close to €300bn to save their banks, with liquidity support far exceeding that while United Kingdom banks were nationalised.[46] In addition, those other jurisdictions saw a larger number of crisis-era regulatory interventions as governments attempted to stabilise their banking systems.[47]

49. In the years since the crisis, Australian banks have been able to use their profits to become safer still through increased capital levels in line with regulatory requirements. Critically, the World Economic Forum recognises Australia's bank soundness as one of its strongest competitive factors. While Australia currently ranks 22nd in the world for competitiveness, it ranks 5th on the attribute of bank soundness in that assessment.[48]

Chart 3.18 – Australian bank capital ratios[49]



[45] Bank of England Financial Stability Report October 2008, 33 setting out the then expended taxpayer funds in a range of jurisdictions in supporting the banking system; available at: http://www.bankofengland.co.uk/publications/Documents/fsr/2008/fsrfull0810.pdf. The Government provided a guarantee of wholesale debt from 28 November 2008 until the end of March 2010; available at: https://www.guaranteescheme.gov.au/. Reflecting the sound position of Australian banks, no Australian ADI required a 'bail out' under the guarantees. Banks made use of the wholesale funding guarantee for around six months, allowing them to maintain or extend the contractual tenor of funding through this period. Cumulative fees paid over the life of the scheme were $4,489.9 million.

[46] Statement by the Financial Secretary to the Treasury, Mark Hoban MP; Banking reform: delivering stability and supporting a sustainable economy; available at: https://www.gov.uk/government/speeches/statement-by-the-financial-secretary-to-the-treasury-mark-hoban-mp-banking-reform-delivering-stability-and-supporting-a-sustainable-economy

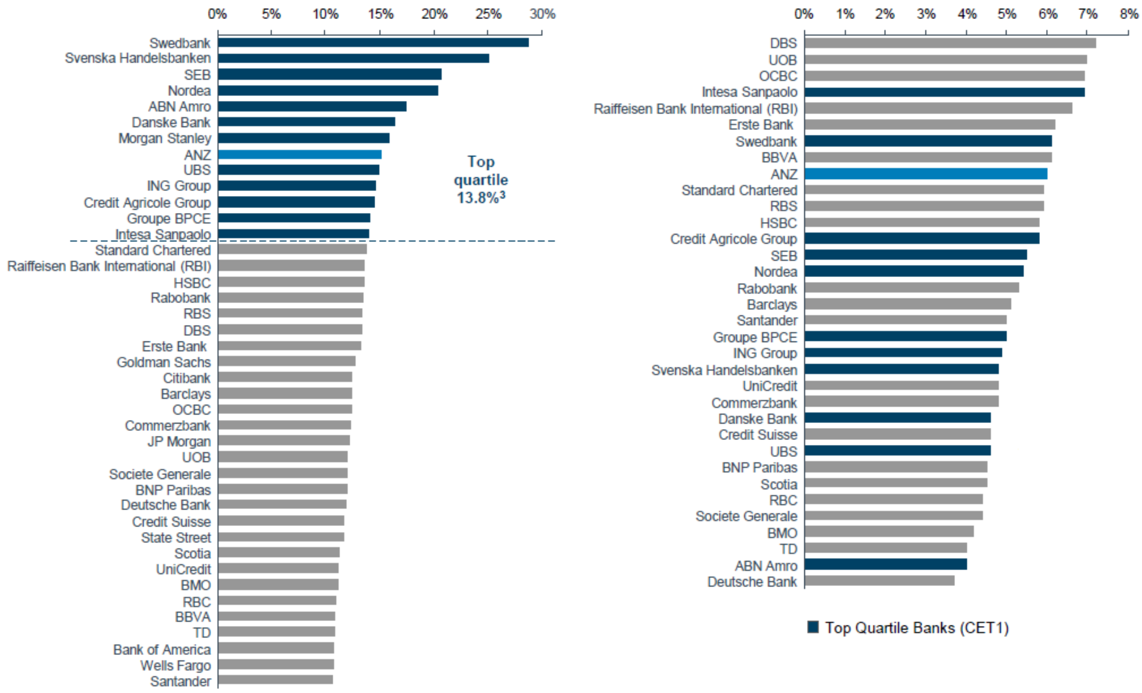
[47] See IMF Global Financial Stability Report (October 2012), 19 indicating the number of Government and central bank interventions following the crisis; available at: http://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/~/media/Websites/IMF/imported-flagship-issues/external/pubs/ft/GFSR/2012/02/pdf/_textpdf.ashx.

[48] World Economic Forum *The Global Competitiveness Report 2016–2017*, 103; available at: http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf

[49] RBA, Financial Stability Review (October 2016), graph 3.9; available at: http://www.rba.gov.au/publications/fsr/2016/oct/graphs.html

50. For example, ANZ ranks in the top quartile of the largest internationally active banks for common equity tier 1 and compares equally well on leverage (we note international comparisons of leverage are more difficult given favourable treatment of derivatives under US GAAP).

Chart 3.19 – ANZ common equity tier 1 and leverage in a global context[50]



51. Stable Australian banks have played a role in funding Australia. Australia runs a consistent current account deficient. This means we need to fund our economy through offshore borrowings. While the economy will always be able to find ways of meeting its funding needs, the strength and stability of the banks has, historically, helped do this at a relatively low cost. As Belkar, Cockerall and Kent found in 2007:

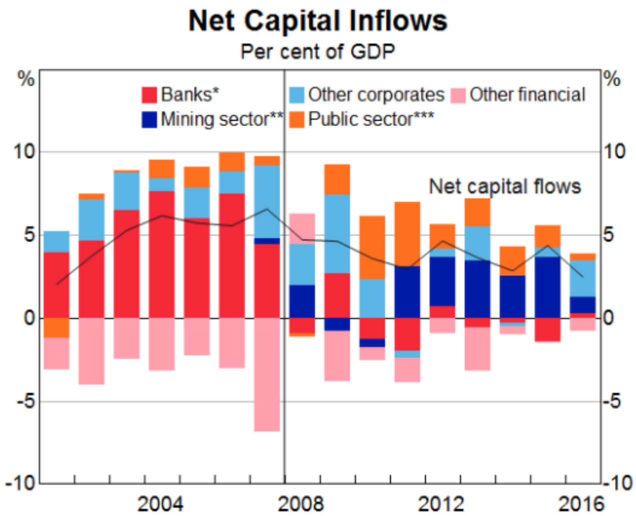
Nowadays, the bulk of Australia's non-government foreign debt is raised by the banking sector. These institutions are not only able to raise funds at a relatively low cost (given that they tend to be highly rated), but they are also in a good position to hedge exchange rate risks arising from these borrowings. It is advantageous, therefore, for these financial institutions to act as intermediaries for business and household sectors given that they can provide Australian borrowers

[50] ANZ 2017 Half Year Results Investor Discussion Pack (2 May 2017); available at: http://shareholder.anz.com/sites/default/files/anz_1h17_results_investor_discussion_pack_printer.pdf?_ga=2.107027590.58547158.1505963074-729656290.1487816405 CET1 and leverage ratios are based on ANZ estimated adjustment for accrued expected future dividends where applicable. ANZ ratios are on an Internationally Comparable basis. All data sourced from company reports and ANZ estimates based on last reported half/full year results assuming Basel III capital reforms fully implemented. Leverage ratio includes adjustments for transitional AT1 where applicable. Exclude US banks as leverage ratio exposures are based on US GAAP accounting and therefore incomparable with other jurisdictions which are based on IFRS. Internationally active banks are based on Group 1 banks as identified by the BIS (internationally active banks with Tier 1 capital of more than €3 billion). The top quartile of this group was 13.8% as at June 2016.

with relatively low cost and fully hedged access to foreign funds.[51]

52. In the years since the crisis, however, funding of the current account deficient has shifted towards governments, the mining sector and other corporates and away from banks. As discussed by Debelle, banks have shifted away from offshore (short-term) funding due to APRA's net stable funding ratio requirements, which incentivise more stable funding sources, and US reforms concerning money market funds.[52] These latter reforms have seen fewer holdings of Australian bank debt by US fund investors. As Debelle notes, however, banks 'have been able to tap other investors, in particular US corporates with large cash holdings, such as those in the technology sector.'[53]

Chart 3.20 – Funding Australia's current account deficit[54]



* Adjusted for the US dollar swap facility in 2008 and 2009
** Available from 2007 onwards
*** Excludes RBA
Sources: ABS; RBA

Customer satisfaction and innovation

53. Competition among banks has not only occurred on the basis of price. Australian banks have innovated to better serve customers. ANZ, for example, has introduced ApplePay for its customers, enabled VoiceID for biometric authentication for payments and partnered with a number of fintech organisations.[55] Australian consumers have been strong

[51] Rochelle Belkar, Lynne Cockerell and Christopher Kent 'Current Account Deficits: The Australian Debate' RDP 2007-02 *Reserve Bank of Australia Research Discussion Paper*, 25; available at: http://www.rba.gov.au/publications/rdp/2007/pdf/rdp2007-02.pdf
[52] Guy Debelle 'Recent Trends in Australian Capital Flows' (Speech, 6 April 2017); available at: http://www.rba.gov.au/speeches/2017/sp-dg-2017-04-06.html
[53] Ibid
[54] Ibid
[55] https://www.canstar.com.au/online-banking/anz-first-big-bank-voice-id-mobile-banking/

adopters of contactless card payments, with RFi Consulting finding that Australia has the highest rates in the world.[56]

54. Another example of innovation is the NPP. This platform, funded by banks, will enable real-time payments for the benefit of consumers. While we discussed the potential of the NPP to help with switching above, the NPP will also enable competition in payments. The NPP was purpose-designed to facilitate access and competition. It will provide a number of access options to potential payment service providers. These providers include overlay service providers that are able to sit on top of the NPP infrastructure and use other institutions' bank accounts. Subject to the resolution of security, authentication and fraud concerns, this may eventually include directing the payment of amounts from those bank accounts to other accounts. Such functionality would significantly increase innovation and competition in payments.

55. In this context, customer satisfaction with banks is at a 20 year high. As Roy Morgan found, '[i]n the six months to February 2017, satisfaction with banks overall was 81.9%, only 1.0% point lower than the 20-year high of 82.9% recorded in 2015.'[57] The major banks are also improving their satisfaction ratings relative to smaller banks:

> *For more than a decade the big four banks have been gradually closing the gap on the lead held by the other banks. In 2005, the overall satisfaction level of the smaller banks was 77.7%, a lead of 11.1% points over the big four (66.6%). The result for June 2017, shows that smaller or other banks still hold the lead (84.8%) but it is now reduced to only 5.0% points, with the big four on 79.8%.*[58]

Conclusion

56. In recent years, Australia's banking market has decreased prices for consumers while increasing equity for stability. This has occurred through a period of moderating concentration and strong economic growth. We would argue that this is consistent with the contention that contestability can drive competitive outcomes.

[56] http://www.abc.net.au/news/2016-08-01/australia-embraces-tap-and-go/7676816
[57] http://www.roymorgan.com/findings/7202-bank-satisfaction-in-february-still-close-to-record-high-201704100942
[58] http://www.roymorgan.com/findings/7258-roy-morgan-bank-satisfaction-june-2017-201707310909

COMPETITION IN THE DIGITAL AGE

Changing competitive environment

57. The experience of the Australian banking market in the period since the crisis indicates, in our view, strong contestability. This period has seen competition orientate around price and service and occur through variations of traditional channels including brokers and comparison sites. As we look ahead, however, this period of competition may be reaching its conclusion. In its lieu, we expect new forms of competition to emerge that are driven much more by technology. Digital innovation is changing who provides financial services, how those services are provided and what consumers expect from their services.

58. Financial technology start-ups (fintechs), large technology firms and existing banks are now competitors in the 'banking' market. The ability to use data to offer better pricing and services will become an important competitive differentiator. Consumers increasingly discriminate between providers on features such as user interfaces and analytical insights rather than branch locations and number of ATMs. These dynamics will likely enhance the contestability and competitiveness of the market, at least in the short term.

59. Importantly, technology is lowering certain commercial barriers to entry. Server space and banking systems can now be rented as needed rather than purchased. This is reducing the investment needed to start and run a bank, although proprietary systems may still offer cost and service advantages. Smartphone apps rather than branches will be the main customer interface for new entrants, giving them a lower cost of customer service. For completely online banks and financial service firms, there will be no need to safeguard and move cash.

60. Further, competitors can now seek to understand credit worthiness without a historical credit relationship with borrowers. Technology developments coupled with policies like comprehensive credit reporting and open data (discussed below) could reduce banking's informational hurdles. Increasingly, big data processes are developing by which the apparent repayment capability and motivation of an individual can be understood by looking at their non-financial behaviour (ie where they shop, what they buy).[59]

61. Consumer demand is also changing with technology. Research by EY indicates that, across 20 countries, adoption of fintech has reached 33% of the population in 2017, up from 16% two years prior.[60] Among those who use fintech, 64% prefer managing all aspects of their life digitally. As may be expected, fintech adoption rates are higher

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[59] See Mikella Hurley and Julius Adebayo 'Credit Scoring in the Era of Big Data' 18 (2016) *Yale Journal of Law and Technology* 148.
[60] EY EY Fintech Adoption Index 2017, 7; available at: http://www.ey.com/gl/en/industries/financial-services/ey-fintech-adoption-index

among 25-to-34 year olds. Importantly, this 'digital native' demographic is now entering the stage of life where finance is increasingly important to them.

Competitors in the digital age

62. In this digital world, the firms offering banking and other financial services are not just traditional banks. Instead, start-up fintechs, neo-banks and established technology firms are also offering financial services in competition with incumbent banks and firms. In Australia, for example, the number of fintechs '….has increased from less than 100 in 2014 to 579 companies today…'.[61] We already observe tech firms moving into finance and banking, particularly in the payments space.

63. How this competitive environment will play out is not yet clear. For example, the WEF recently stated that fintechs are succeeding in changing the bases of competition (eg customer expectations, deployment of technology) but 'have not yet materially changed the competitive landscape'.[62] Few customers have moved away from incumbents 'despite significant efforts from online and mobile challenger banks'.[63] This is because customers still value physical interaction with banks, challengers are struggling to offer broad or profitable services and incumbents are responding with better technology and focus on profitable customers. In short, competition is strong.

64. This view accords with one thesis that the main competitive pressure on banks in the digital age will not be from fintech start-ups but from large technology firms. While innovation will drop certain barriers to entry, it will perpetuate and erect others. Importantly, the elusive quality of trust will be paramount in the digital age with consumers needing to have faith that institutions protect not just their money but their data as well. For example, research by Accenture indicated that banks are still the most trusted by consumers with data security, followed by online retailers.[64] Further, competitors will need the capacity to fund and implement innovation. In this environment, some actors may have a greater capacity to compete than others.

65. While large technology firms have a narrow offering breadth at present, they are well-placed to win the banking business of customers if they wish to enter the market with their heavy investment in research and development, coupled with their existing customer relationships. Of course, shifting from technology to financial markets will attract different regulatory obligations which technology firms would need to assess.

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[61] KPMG Scaling the Fintech Opportunity: For Sydney and Australia (July 2017), 7.
[62] World Economic Forum Beyond Fintech: A Pragmatic Assessment Of Disruptive Potential In Financial Services (August 2017) 12; available at: http://www3.weforum.org/docs/Beyond_Fintech_-_A_Pragmatic_Assessment_of_Disruptive_Potential_in_Financial_Services.pdf
[63] Ibid, 86.
[64] Accenture Payments Consumers' initial reactions to the new services enabled by PSD2, 4.

66. Consistent with this, the WEF suggests that one path may be that technology firms move towards offering a broader set of products. They could use existing customer platforms to provide financial services, forcing banks to access customers through those channels and allowing the tech firms to increase their access to customer data.[65] To counter this, banks may seek to become 'controlled, curated platforms' where they offer their customers products and services provided by others. This would allow banks to maintain the relationship with the customer, while giving their customers access to a broad range of offerings.[66]

Policy settings

67. We think that policy interventions in this new landscape need to consider both stability and competition. The Basel Committee has recently set out regulatory considerations arising from fintech including 'the overarching need to ensure safety and soundness and high compliance standards without inhibiting beneficial innovation in the banking sector'.[67] While we support policy that makes innovation easier, we are conscious that barriers to entry like trust may be immune to intervention. Further, acquisitions of fintechs by banks could be pro-competitive, particularly as they seek to compete with larger technology firms.

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[65] Ibid, 96.
[66] Ibid.
[67] Basel Committee for Banking Supervision *Implications of fintech developments for banks and bank supervisors - consultative document* (August 2017); available at: https://www.bis.org/bcbs/publ/d415.htm