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Productivity Commission Releases Final Report on Competition in the Australian Financial System

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On 3 August 2018, the Productivity Commission (**Commission**) released its final report on Competition in the Australian Financial System (**Report**). The Report was a result of the Murray Financial System Inquiry in 2014, which recommended that a report be commissioned every 3 years.

While noting that the nature of financial services means that it will inevitably be regulated to some degree to ensure stability and the protection of consumers, the Report concludes, not surprisingly, that the system favours stability over and at the expense of competition.

Some of the major contributing issues to the lack of competition are noted as follows:

1. **Concentration of Market**. The Report notes the four major banks currently take up approximately 75% of the retail banking market. Labelling the Four Pillars policy as "redundant", the Report criticised this policy as acting as a protection for the big four banks from the threat of takeover, rendering them complacent and somewhat immune to discipline and market correction;

2. **Customer Loyalty.** The four major banks have a strong brand perceived by the market as safe and stable, and customers show a surprising reluctance to move across, allowing banks to keep generating high margins off them;

3. **Information Obfuscation.** The number of financial products in the market (labelled by the Report as a "blizzard of barely differentiated products"), often coupled with inadequate or an overload of information, confuses consumers and deters comparative shopping. One may be forgiven for thinking that this may have been a strategy for some;

4. **Regulatory Framework.** The need for stability led to a burdensome regulatory framework (such as the prudential requirements), which created barriers to entry for small to medium enterprises, and entrenched the major banks who by virtue of the size and experience, had the necessary expertise to meet the regulatory requirements. The Report even labels some of the market interventions by the Australian Prudential Regulatory Authority (**APRA**) as "blunt… with detrimental effects on market intervention".

The recommendations of the Report have the general aim to reset the balance so as to place equal priorities on stability and competition. This is clearly an admirable aim if it can be achieved.

We provide here an overview of some of the Report's recommendations which we consider are important or of particular relevance to the banking industry and its players:

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Transparency and an Open Banking System

The Report recommends that Australia implement an Open Banking regime which gives consumers access to and control of their banking data (e.g. banking transactions data). Further, the Report recommends that the Australian Securities Investments Commission (**ASIC**) engage in a number of measures to promote transparency in the banking system, including:

- collecting and publishing data from mortgage lenders on interest rates of new residential home loans and their characteristics, and develop an online interest rate calculator;
- publish data collected in all research projects and reports, as well as conduct evaluations of any material interventions;
- gather approved product lists from financial services licensees and publish this information annually.

General Advice vs Personal Advice to Consumers

Currently, certain Australian financial services licensees are authorised to provide “general advice”, defined as advice which is not personal advice (i.e. it does not take into account the objectives and financial situation or needs of the client). The Report states that this term is misleading, and has led to consumers unduly relying on general advice (in particular, sales and marketing material) to their detriment.

The Report recommends that the term ‘general advice’ be abolished by mid-2020. Instead, financial advisers should be given a broader permit to give personal advice to compete with mortgage brokers to promote competition and provide more holistic financial advice. This is to be recommended and apart from anything else, reflects common sense.

Best Interest Obligation in Home Loan Market

The Commission recommends introducing an obligation on all providers in the home loans market to act in the best interest of the client (even in a conflict) and ensure certain information is disclosed to the client. This is also to be recommended, particularly in view of the disclosures that have been made in the ongoing Haynes Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Further, it was recommended that this include the abolishment of all trail commissions and other volume or campaign-based commissions by the end of 2018, which were noted by the Report as creating conflicting incentives for brokers and is merely an outdated form of remuneration common in the 1990s.

Principal Integrity Officer

The Report recommended that all authorised deposit-taking institutions (**ADIs**) be required to appoint a Principal Integrity Officer (**PIO**) by the end of 2018. This is an interesting recommendation and this requirement may possibly extend to other financial service and credit licensees in the future.

The possibility of a mandated PIO has received some support in the political sphere, with the Australian Prime Minister Scott Morrison (then Treasurer) indicating that the government was giving “very serious consideration” to the recommendation, which could work well with the Banking Executive Accountability Regime (**BEAR**) recently implemented.

Some key aspects of the recommended PIO role are mentioned below:

1. an independent status within the entity with direct reporting obligations to the board of directors;
2. a statutory duty to advise the board on the entity's practices (including reporting breaches), including in relation to remuneration, compliance, and serving the customer's best interest, as well as providing reviews and recommendations of internal business practices; and
3. an obligation to report unsatisfactory responses or persistent failure of the entity to meet any relevant standards to ASIC.

It may be that this recommendation should be held in reserve at this point in time and BEAR be allowed to run its course. Whilst the PIO could perhaps be merged into BEAR, will it really add anything if BEAR operates as it is intended? In addition the costs for the smaller ADIs complying with BEAR and having to engage a PIO is not insignificant.

APRA Risk Weightings

The current Australian Prudential Standard 112 (Capital Adequacy) provides a single risk-weight to all small and medium business loans not secured by a residence. The Report recommends that a broader schedule of risk weights be inserted to take into account the different risk profile and type of lending. Not only would this better reflect Australia's commitment to the standards set by the Basel Committee on Banking Supervision, it would also better reflect the risk management practices of small and medium sized ADIs. The application of a broader schedule of risk weights should allow small and medium sized ADIs to have a better understanding of their risks here and could lead to increased business.

Expansion of ASIC Regulatory Sandbox

The ASIC regulatory sandbox is a policy where ASIC allows eligible fintech businesses to test certain services for up to 12 months without a financial services or credit licence. The Report recommends expanding the scope of eligible products to include certain household deposits or the provision of certain financial products or services. Further, it was recommended that ASIC take a "hands-on" approach to not only provide waivers from the law, but also actively support product or service testing, and advise on whether and how products may affect consumers. Whilst a more hands-on approach by ASIC may be welcome in some areas, we query whether it really is the role of ASIC to advise on products for the benefit of consumers.

A New Competition Advocate

The Report has called for an entity to be appointed as the champion for competition in the financial services industry. While the interim report indicated the Commission's support for ASIC to take on this role, the final report has recommended that the Australian Competition and Consumer Commission (**ACCC**) lead the charge. This would include a duty to analyse material market interventions by regulators and their impacts on competition, publish a bi-

> annual financial system competition report and conducting a market study on the effect of integration on competition in the financial system every 5 years. This is an interesting recommendation. Will a new competition advocate champion competition between all the players in the industry or just be skewed to those players with the greatest market share and therefore potentially the greatest impact?

The Report contains a large number of other recommendations which we have not covered, including in relation to general insurance and payment systems. The Report is not binding and it will be up to the Government to adopt any recommendations it sees fit. Hopefully at least, some of the recommendations will be implemented.

We have already seen the Government take steps to reduce barriers to entry to the banking industry by reducing red tape for an ADI that wishes to call themselves a 'bank' and creating of a restricted ADI license framework to encourage new entrants to the market. Further, the Government is currently considering legislation which relaxes the shareholding requirements for financial sector entities. The Report, coupled with the Financial Services Royal Commission will likely mean that more changes can be expected. Ash St. will continue to watch this space.

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Shaun leads the Ash St. Projects & Finance team. He is one of Australia's most experienced advisers on infrastructure and finance, including buying and selling infrastructure assets, public private partnerships, project finance, corporate finance, acquisition finance, capital markets and workouts.

Formerly a partner of both Corrs and Freehills, Shaun has over thirty years' experience advising local and international corporates on a wide range of transactions with particular focus on the infrastructure, power, energy and resources industries. He has a reputation for successfully completing major transactions, no matter how complex, and is sought for his strategic and negotiating skills.