Productivity Commission urges more competition in Australia's financial system

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In brief

On 3 August 2018, the Productivity Commission (Commission) publicly released its inquiry report, *Competition in the Australian Financial System* (Report), with a number of far reaching recommendations aimed at improving consumer outcomes and enhancing the competitiveness of Australia's financial system and the wider economy.

The Commission has recommended that:

- banks, brokers and advisers be subject to a new statutory obligation to act in the best interests of customers in relation to home loans
- mortgage brokers' trailing, volume-based and campaign-based commissions be banned
- mortgage brokers' clawback arrangements be restricted
- banks be required to appoint a "Principal Integrity Officer" who would be obliged by law to report directly to their board on the alignment of payments made with the new duty to act in customers' best interests
- a new formal access regime be established for the "New Payments Platform"
- a Treasury-led working group be established to extend the deferred sales model to all other add-on insurance products, with the model to be set in legislation
- the Australian Prudential Regulation Authority (APRA)'s prudential measures be evaluated as to their impacts on competition, and
- the Australian Competition and Consumer Commission (ACCC) be appointed as a permanent member of the Council of Financial Regulators to promote and advise on competition issues.

In detail

The Commission has recognised that the Australian economy has generally benefited from having a financial system that is strong, innovative and profitable. However, the Commission has found that the stability of the financial system has shielded large banking and insurance institutions from rigorous competition, which has diminished value for customers.

The Report follows the draft report released by the Commission in February 2018 (see our summary here). The Commission has proposed 34 recommendations aimed at getting Australia's financial markets to be workably competitive and yield better consumer outcomes.

The current competition landscape

The Report identifies a number of reasons for flagging price competition in Australia's financial market. Major market participants - the big four banks and major insurers - command entrenched market power due to favourable regulatory arrangements, funding advantages and operational efficiency, vertical and horizontal integration, and consumer inertia and disengagement from financial services.

Financial advisers are presented with conflicting incentives to sell and recommend in the face of an overwhelming array of products and associated prices, in circumstances where regulation is heavy-handed and often misdirected.

The Commission believes that policy initiatives, including intervention by APRA, have largely favoured the stability of the financial system to the detriment of competition in the financial services industry.

As a direct result, the Commission has proposed 34 recommendations seeking to alter the incentives of Australia's banks, brokers, insurers and advisers, in order to reform financial system governance, with the aim of stimulating competition and yielding better consumer outcomes.

We briefly discuss some of the key recommendations below.

A "best interest" obligation in the home loans market

The Report recommends an amendment to the *National Consumer Credit Protection Act 2009* (Cth) to introduce a "best interest" obligation to all credit licensees who provide home loans or home loan services, such as mortgage brokers operating under a credit licence.

This best interest obligation mirrors the language of the obligations involved in the provision of personal advice to retail clients, which was introduced in 2012 as part of the Future of Financial Advice reforms and contained in Part 7.7A, Division 2 of the *Corporations Act 2001* (Cth).

Namely, the provider of credit in the form of home loans – whether a lender or mortgage broker – will have a duty to:

- act in the best interests of the client
- issue recommendations appropriate to the client, having regard to the duty to act in their best interests
- prioritise the interests of the client in the event of conflict, and
- ensure certain information is disclosed to the client.

Credit licensees would also be responsible for ensuring that their representatives comply with these obligations. The Commission has also recommended that legal responsibility be extended to lenders who have an ownership interest in firms that hold a credit licence.

Ban on trailing and other specified commissions

Despite substantial industry contention, the Commission is of the view that the existing practice of offering trailing commissions provides brokers with a strong incentive to recommend lenders and products that pay higher commissions on their products, irrespective of what may be in their clients' best interests.

As a result, the Commission recommends that:

- all trailing, volume-based and campaign-based commissions be phased out, starting from 2019

- an alternative system under which up-front commissions be paid by lenders, rather than a fixed-fee structure paid by customers, to ensure customers do not desert brokers and smaller lenders, wiping out competition in the industry
- in the absence of shifting broker remuneration from lenders to customers, a formal best interest obligation be introduced, as an offset to conflicts of interest, and
- the current industry practice of restricting commission clawback arrangements to 18 months to two years should be imposed by ASIC across all lenders and include a ban on commission clawback being passed on to borrowers.

Creation of Principal Integrity Officer role

To further establish compliance with the best interest duty, the Commission has recommended that all banks or authorised deposit-taking institutions (ADIs) appoint independent Principal Integrity Officers (PIOs).

The PIO would be accountable to the board and advise on remuneration and other practices inconsistent with the best interest duty, as well as reviewing internal business practices for compliance. The PIO will also report to the Australian Securities and Investments Commission (ASIC) in the event that the board persistently fails to comply with the best interest duty, or where the board provides unsatisfactory responses to the PIO's reports on compliance.

The Commission expects the consultation process on the creation of the PIO role to start by the end of 2018.

Deferred sales model for add-on insurance sales

ASIC has already published its proposal to mandate a deferred sales model for all sales of add-on insurance by car dealerships. The Commission echoed its support for the proposal and suggested a proposed minimum deferral period of 7 days running from the day on which the consumer applies for or purchases the insurance product.

The Commission further urged the establishment of a Treasury-led working group to extend the operation of the deferred sales model to all other add-on insurance products, to ensure consumers are better placed to exert competitive pressure on prices and quality for such products.

Open access regime for the New Payments Platform

Australia's digital payment system, the New Payments Platform (NPP), supports over AUD 1 trillion in real-time transactions each month and acts as a substantial source of payment data, allowing money and data to be transferred instantaneously.

The Commission has suggested the establishment of a formal access regime, to be monitored by the Payments System Board (PSB), to open the NPP to other market participants. The Report specifically recommends that the RBA "reduce technical barriers" for new financial institutions to enter the NPP, and enable existing institutions to provide more efficient services by:

- broadening access to the NPP for specialist payment providers, without the need to hold a banking licence in the form of an ADI;
- reviewing the fees set by participants of the NPP and transaction fees set by NPPA; and
- requiring that all transacting participant entities that use an overlay service to share de-identified transaction level data with the overlay service provider.

The Commission further recommended that by mid-2019, the ACCC together with the PSB complete an investigation into methods to improve functionality of the NPP, including additional functionality for PayID which is to be implemented by end of 2019.

Impact of APRA's prudential measures on competition

The Commission has pointed to stifling effects on competition by recent APRA interventions, in particular its directive in 2017 to ADIs to limit the flow of new interest-only lending to 30% of their new residential mortgages. The Commission linked this intervention to static market shares, increased interest rates on new and existing investment loans, and higher lenders' profits. As interest on investment loans is tax-deductible, the Commission has attributed an estimated loss of $500 million per year in tax revenue. To prevent curtailing effects on competition in the future, the Commission has recommended that APRA avoid blanket rules on the industry and instead look to the underlying risk of each individual ADI's loan book. It is further suggested that APRA undertakes and publishes annual quantitative reviews of its prudential interventions, incorporating a cost-benefit analysis as to its effects on market participants and competition.

ACCC to champion competition on Council of Financial Regulators (CFR)

The Commission has identified that no single Australian financial regulator has been tasked with the discrete responsibility to promote competition in the financial services industry. In the past, APRA has intervened to negotiate the balance between maintaining systemic stability and inducing competition, but inevitably it must prioritise its mandate of stability.

Building on APRA's submission to the inquiry that APRA has appreciated engaging with the ACCC prior to CFR discussions, the Commission has suggested that the ACCC is best placed to be a 'champion of competition' within key industry forums. The Commission urges the appointment of the ACCC as a permanent member of the CFR to guide consideration of competition implications resulting from potential regulatory intervention.

The takeaway

The Federal Government is expected to frame its formal response to the Commission's recommendations later this year, after receiving the first report of the Royal Commission into misconduct in the banking industry.

The implementation of any recommendations accepted by the Federal Government is likely to require the involvement and cooperation of a number of key government agencies as named in the Report, including APRA, ASIC, ACCC and the Treasury. Some recommendations will also require new legislation such as that necessary to amend the *National Consumer Credit Protection Act 2009* (Cth).

The combination of these factors and pending response from the Australian Government, means that the actual implementation of measures may not readily satisfy the Commission's proposed deadlines commencing end-2018.

This insight focuses on high-level insights into a number of the key recommendations. The full Report can be found on the Productivity Commission's website: here.

Banking Matters

In such an environment it is more important than ever for banks to identify distinct and achievable catalysts for upside in terms of both revenue and costs. In our next edition of Banking Matters, we will focus on products and services being offered today – even those that may be commodities – and consider opportunities to improve how they are priced. We make the case that, perhaps contrary to intuition, more sophisticated pricing can create value for banks and their shareholders, and not necessarily at the expense of customers. It is not a zero-sum game. Rather, by improving the pricing, allocation and use of financial resources across the economy, it is possible to create value for banks and customers while enhancing the health of the financial system as whole. Subscribe here to receive a copy of our Banking Matters publication, launching week commencing 20 August.

Let’s talk

For a deeper discussion of how these issues might affect your business, please contact:

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