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REGIONAL BANKS

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Response to the Interim Report of the Royal Commission into Banking, Superannuation and Financial Services Industry

Regional Banks

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EXECUTIVE SUMMARY

The Regional Banks[1] fully endorse the work of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (FSRC) and have been disappointed by the revelations to date. We are committed as individual banks and as a group to making things better and doing what we can to protect and promote the interests of our customers and the wider economy.

We generally concur with the Executive Summary of the Interim Report that conduct by financial services entities has brought public condemnation and it appears to have resulted from the pursuit of short term profit at the expense of basic standards of honesty. (Hayne, September 2018, pp. Vol 1, xix)

As a group, the Regional Banks' vision is for Australian customers to enjoy an innovative, vibrant, diverse and a sustainable banking sector which offers choice and better value. Misconduct has no place in this vision.

To achieve this, our view is that you need strong competition supported by best practice and fit-for-purpose regulation.

In terms of competition, the Regional Banks advocate initiatives to improve supply-side competition by promoting a level playing field. In our view, the market dominance of the largest banks, facilitated by regulatory advantages, may not be in the best interests of customers. One essential ingredient in improving consumer outcomes will be to improve competition.

In the Letters Patent establishing the FSRC, clause (k) requires the commission to have regard to four policy objectives, including 'competition' when proposing any changes to the law. It is this reference and the issues raised in the Interim Report that warrant, in our view, a Regional Bank submission to the Royal Commission.

Our submission makes three key points:

1. In balancing the policy factors in clause (k) of the Letters Patent establishing the FSRC, the commission should give appropriate weight to the factor of 'competition' in its deliberations and recommendations. Competition has long been a policy priority in financial services and, in our view, needs further promotion;

2. In determining possible reforms to mortgage broking remuneration, the Regional Banks urge the FSRC to put considerable weight on the competition and consumer choice implications, and to take into consideration the extensive efforts by the Combined Industry Forum (CIF) to reform practices and the support for the CIF work from second tier banks[2]; and

3. In determining a regulatory approach and recommendations to address misconduct in financial services, the FSRC should give due consideration to the

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[1] See Introduction section for definition of Regional Banks.
[2] Second tier bank support for the CIF process is in the context of the broking industry committing to exceed community expectations of conduct, in a similar vein to how the banking industry is committing to winning back customer trust and respect (See ABA media release: https://www.ausbanking.org.au/media/media-releases/media-release-2018/interim-report-of-the-royal-commission).

regulatory burden and how this disproportionally impacts the competitiveness of smaller players.

In addition, in defining a small business, Regional Banks recommend a $3m cut off is used. Businesses with limits above $3m are highly likely to utilise advisers for financial advice and have sufficient sophistication to protect their interests when contracting with banks.

INTRODUCTION

Who we are - defining the Regional Banks

This submission is made on behalf of six[3] Australian Authorised deposit-taking institutions (ADIs) in response to the Interim Report (Hayne, September 2018) of the FSRC. We refer to the group of banks as "Regional Banks", reflecting the fact that most of the banks have operations concentrated in a particular State and/or are non-major banks.

Our wider policy agenda is focused on addressing five issues we think are undermining a level playing field. They are:

(a) a regulatory capital regime that enables 'advanced' banks to estimate lower risk weights for mortgage loans;

(b) the lower funding costs (3 notches[4]) secured by major banks for being deemed by credit ratings agency Standard & Poor's (S&P) as having government credit support due to their systemic importance;

(c) the competitive advantage to non-bank lenders in mortgage finance due to the fact non-banks do not face the costs and restrictions associated with being prudentially supervised[5];

(d) the risks to the viability of the mortgage broker industry due to possible changes to the standard remuneration model, such as the banning of trail commissions[6]; and

(e) the regulatory burden that falls more heavily on smaller banks.

Each one of these factors provides the major banks and the non-banks with considerable competitive advantage over smaller ADIs. In aggregate, they represent a significant tilting of the playing field in favour of those providers. Since the Global Financial Crisis (GFC), we have observed stark differences in the profits of the largest four banks relative to the rest of the market.

Since 2014, in response to these and other issues, our Regional Bank group has contributed submissions to key inquiries with the aim of addressing them. We made two submissions to the Murray Financial System Inquiry, one submission to the Harper Competition Policy Review, and two submissions to the recent Productivity Commission review into Competition in the Australian Financial System.

Why Regional Banks are making a collective submission

As a group, the Regional Banks are advocates of ensuring strong competition within Australia's retail banking sector. As referred above, our strategy for achieving this is through policies to promote a level playing field on the supply-side of the market.

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[3] AMP Bank Limited; Bendigo and Adelaide Bank Limited; Bank of Queensland Limited; ME Bank; MyState Bank; Suncorp Bank.

[4] See (King, Abramson, & Harris, 29 June 2018, p. 184). See also APRA media release where the four major banks are assessed as being systemically important (too big to fail): (APRA, 2013)

[5] Defined as institutions not supervised by the prudential regulator, APRA.

[6] For example, the Productivity Commission has recommended that 'trail' commissions should be banned (King, Abramson, & Harris, 29 June 2018, p. 2)

In the Letters Patent establishing the FSRC, clause (k) requires the commission to have regard for 'competition' in any proposed changes to the law:

> *(k) We direct you to have regard to the implications of any changes to laws, that you propose to recommend, for the economy generally, for access to and the cost of financial services for consumers, for competition in the financial sector and for financial stability;... (Sir Peter Cosgrove, 2017, p. Clause (k))*

In terms of the Regional Banks' current policy agenda, we believe the FSRC is particularly relevant to the issues of mortgage broker remuneration and regulatory burden.

PROTECTING COMPETITION

The Regional Banks urge the FSRC to give sufficient weight to competition issues when it is proposing changes to the law regarding retail banking. This is a key ingredient in protecting consumers long term. We note that clause (k) of the Letters Patent requires the FSRC to have regard for the following factors when proposing recommendations:

- The economy generally;
- Access to and the cost of financial service for consumers;
- Competition in the financial sector; and
- Financial system stability.

When proposing changes to the law or legal framework there are inevitably trade-offs between these policy objectives and initiatives to strengthen financial stability which may have adverse implications for competition. Policy factors identified in clause (k) can also be mutually reinforcing. For example, initiatives to promote competition can reduce the cost of financial services and it can also promote financial system stability by reducing concentration levels.

Competition has been a primary objective of banking inquiries

Promoting competition has been a primary policy objective in Australia since the 1970s. Indeed, a key rationale of deregulation of the financial system in the 1980s was to use competition to drive greater efficiency and improve access to financial services.

In January 1979, the Treasurer Hon. John Howard established a financial system inquiry that was chaired by Mr J.K.Campbell. Its final report was released in 1981 and emphasised the primary role of competition in shaping its recommendations:

> *1.1The Committee starts from the view that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention…the discipline of the market remains the most economically efficient basis for allocating funds and resources, from the viewpoint of the community as a whole. (Campbell, et al., 1981, p. 1)*

In June 1996, the Treasurer Hon. Peter Costello established a financial system inquiry to be chaired by Stan Wallis. It reported in 1997 and, once again, emphasised the importance of competition:

> *A principal aim of the Inquiry is to achieve a more competitive and efficient financial system…In designing regulatory arrangements, it is important to ensure minimum distortion of the vital roles of markets themselves in providing competitive, efficient and innovative means of meeting customer's needs. (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 15)*

In 2008, the Productivity Commission (PC) undertook a review of Australia's Consumer Policy Framework, which highlighted the importance of competition in the final report:

> *The overarching objective should be to improve consumer wellbeing by fostering effective competition and enabling the confident participation of consumers in markets in which both consumers and suppliers can trade fairly and in good faith. (Fitzgerald, Potts, & Weickhardt, 2008, p. 2)*

On 20 December 2013, the Treasurer Hon. Joe Hockey established a financial system inquiry that was chaired by former Commonwealth Bank chairman David Murray. The final report noted:

> *Competition and competitive markets are at the heart of the Inquiry's philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system's efficiency. (Murray, Davis, Dunn, Hewson, & McNamee, 2014, p. xvi)*

Recent concerns about the level of competition in banking

Notwithstanding the importance of competition set out by the key financial system and other inquiries, there is recognition that the current level of competition is inadequate.

In a recent review of competition in the Australian financial system by the PC, the final report concluded:

> ***Current state of competition***
>
> *Australia's financial system is dominated by large players — four major banks dominate retail banking, four major insurers dominate general insurance, and some of these same institutions feature prominently in funds and wealth management. A tail of smaller providers operate alongside these institutions, varying by market in length and market share (figure 1). Market shares of major banks are highest (over 75%) in markets for loans to small businesses, housing loans, personal deposits and issuance of credit cards…*
>
> *The major banks' market power is a defining feature of the financial system. (Productivity Commission, June 2018, pp. 4-5)*

In a recent review, Australia's competition regulator, the Australian Competition and Consumer Commission (ACCC), made interim findings suggesting there was inadequate competition in the financial system's main lending market of residential mortgages. The ACCC noted:

> ***Signs of a lack of vigorous price competition***
>
> *The internal documents of the Inquiry Banks reviewed by the ACCC to date reveal a lack of vigorous price competition between the Inquiry Banks, and the big four banks in particular…*
>
> *The big four banks focus largely on each other when they determine headline interest rates and discounts on variable rate residential mortgages. The actions and reactions of over 100 other residential mortgage lenders do not appear to have had a significant bearing on interest rate decisions… (ACCC, March 2018, pp. 7-8)*

The Regional Banks note in particular the ACCC's interim finding that the biggest banks focus largely on each other when they determine headline interest rates and discounts on variable rate residential mortgages and don't appear concerned with the reactions of more than 100 other residential mortgage lenders in the marketplace. In our view, this competitive situation reflects in part the risk weight and funding cost advantages of the largest banks.

In a review of the four Major Banks, the House of Representatives Standing Committee on Economics described Australia's banking system as an oligopoly which used pricing power to the detriment of consumers:

> *Oligopolies are problematic when they are able to use pricing power to the detriment of consumers... Australia's banking system is such an oligopoly. Australia's four major banks have significant pricing power, higher than average returns on equity and large market shares.*
>
> *A lack of competition in Australia's banking sector has significant adverse consequences for the Australian economy and consumers. (Standing Committee on Economics, 2016, p. 22)*

The FSRC Interim Report has also identified the problem of lack of competition. We fully agree with the following statement:

> *Competition within the banking industry is weak. Barriers to entering the industry are high. To participate in the economy, to participate in everyday life, Australians need a bank account. But they are reluctant to change banks. Each of the four largest banks is a powerful player in the market. Important deterrents to misconduct are, therefore, missing from the banking industry. Competitive pressures are slight. (Hayne, September 2018, pp. 268-9)*

The Regional Banks highlight the point made that there is little threat of failure for Australia's banks. It should be acknowledged that four banks are formally designated (APRA, 2013) by the Australian Prudential Regulation Authority (APRA) as being systemically important (i.e. too big to fail).

The protection against risk of failure may contribute to poor conduct towards customers or poorer customer service. The four banks deemed by APRA as systemically important also have, on average, lower customer satisfaction[7] levels.

Increasing the importance of competition

Since the GFC, the government has focused on undertaking regulatory initiatives to strengthen the resilience of the financial system. This has involved tighter supervision by regulators, higher capital requirements, and use of macro-prudential rules to contain potential risks to the wider economy from financial risks.

The PC is recommending that competition be given greater policy weight in regulation. The Regional Banks fully agree with the PC's finding 2.2:

> *FINDING 2.2 COMPETITION AND STABILITY MUST CO-EXIST*
> *Competition and stability are both important to the Australian financial system. Since the global financial crisis there has been a focus on requiring prudentially regulated institutions to be unquestionably strong. It is important to ensure that the essential role of competition in economic growth is not eroded by having stability as the default regulatory position, to the exclusion of competition. Competition can support stability, checking irresponsible behaviour of providers and improving outcomes for*

[7] http://www.roymorgan.com/findings/7514-satisfaction-with-banks-up-again-in-january-201802270121

> *consumers, and must be allowed to flourish. (Productivity Commission, June 2018, p. 36)*

Competition and conduct linkage

In addition to having regard to competition impacts when making recommendations to address misconduct, there is potentially a link between conduct and the level of competition.

For example, a banking system where the mindset and ability of consumers to switch providers will raise the commercial cost of operational failures. It will also increase the potential cost of allowing the development of bank cultures that do not give consumer interests sufficient priority.

Regional Banks note the very recent speech by the Productivity Commission's deputy chair, Karen Chester:

> *"Much of the financial services royal commission's evidence can also be explained by recent public policy playlists being more one of the incremental, and not reshaping policy architecture that no longer serves us," she said.*
>
> *"For, in the absence of effective competition - fostered and nurtured by good public policy and confident regulators - firms not doing the right thing will go unchecked, with consumers ultimately paying the price, and often regressively so." (Irving, 2018)*

Conclusion

In balancing the policy factors in clause (k) of the Letters Patent establishing the Royal Commission, the FSRC should give appropriate weight to the factor of 'competition' in its deliberations and recommendations. Competition has long been a policy priority in financial services. We would submit, there is significant evidence that the current framework does not facilitate or promote adequate competition and, in our view, needs further promotion.

MORTGAGE BROKING COMPETITION & REMUNERATION

In determining possible reforms to mortgage broking remuneration, the Regional Banks urge the FSRC to put considerable weight on the competition and consumer choice implications.

Mortgage lending is the primary form of lending undertaken by Australian banks. There is currently $1.6 trillion lent by banks[8] for the purposes of housing (APRA, 2018, p. Tab 1b), with about two thirds for owner occupation and one third for investment purposes. Mortgage debt accounts for nearly 80% of household debts (The Treasury, 2018, p. 56).

Table 1
Basic Statistics on Bank Mortgage Lending
June 2018

Institution	Owner-occ	Investment	Total	% of ADIs
Major Banks	$844.4	$454.5	$1298.9	80.1%
Regional Banks[9]	$153.4	$64.3	$217.7	13.4%
Credit Unions	$28.1	$8.0	$36.2	2.2%
Foreign Subs	$50.2	$17.1	$67.3	4.2%
TOTAL ADIs	$1076.4	$544.0	$1620.3	100%

Source: Derived from APRA data **(APRA, 2018, pp. Tabs 3b,4b,5b,6b)**; Benchmark Analytics

Mortgage broking forms a critical role in the mortgage finance industry, accounting for more than 50% of all originated loans (The Treasury, 2018, p. 56). The Interim Report has identified the remuneration structure of mortgage lenders as potentially causing poor consumer outcomes, primarily due to the use of commission-based remuneration.

Mortgage brokers exist to provide a middleman or matching service between those seeking housing loans and those offering mortgage loan products. For borrowers, brokers aggregate information about mortgages (rates and product features), to assist with identifying loan products and to help explain how the features of the loan will operate. For lenders, the broker will identify prospective customers and assist them in filling out the necessary paper work to apply for a loan.

[8] Note – this excluded non-ADI mortgage lending.
[9] In this context, Regional Banks is used to represent 'Other domestic banks' as defined by APRA in in its Quarterly Authorised Deposit-taking Institution Property Exposures, see: https://www.apra.gov.au/publications/quarterly-authorised-deposit-taking-institution-property-exposures

Table 2
Percentage of housing loan approvals sourced from third-parties
12-months to June 2018

Institution	New housing loan approvals (% originated through third-parties
Major Banks	48.1%
Regional Banks[10]	57.0%[11]
Credit Unions	36.3%
Source: Derived from APRA data **(APRA, 2018)**; Benchmark Analytics	

Mortgage brokers support choice and competition

Mortgage brokers play an important role in the Australian market, providing consumers with convenience, choice, and information about competitive products.

The value brokers provide to customers has been acknowledged by numerous regulators and other independent bodies. The Australian Securities and Investment Commission's (ASIC) recent review of mortgage broker remuneration agreed that:

> *Brokers can play an important role in promoting good consumer outcomes and strong competition in the home loan market. (ASIC, March 2017, p. 8)*

The independent Sedgwick review acknowledged that:

> *...many potential borrowers value the service that Mortgage Brokers provide. As well as advice about where to source a loan, this service may include assistance to new borrowers to navigate the home loan process and education about this type of debt instrument and its implications. (Sedgwick AO, 2017, p. 33)*

The PC's Draft Report into Competition in the Australian Financial System stated that:

> *...brokers can benefit consumers by being more effective at selecting the best loan and negotiating with lenders because they are more familiar with the home loan market. This can also increase competition among home loan providers. (Productivity Commission, January 2018, p. 213)*

And the Reserve Bank of Australia's (RBA) 2017 submission to the PC stated that:

> *For borrowers, brokers reduce search costs by efficiently comparing deals across lenders. The introduction of a wider range of mortgage products, partly in response to prudential regulations, has increased the benefits for consumers of using brokers. (RBA, September 2017, pp. 23-24)*

[10] In this context, Regional Banks is used to represent 'Other domestic banks' as defined by APRA in in its Quarterly Authorised Deposit-taking Institution Performance Statistics, see: https://www.apra.gov.au/publications/quarterly-authorised-deposit-taking-institution-performance-statistics

[11] Please note this represents an average across banks identified as 'Other domestic banks'. Some banks, such as Bendigo and Adelaide Bank, originate a materially lower proportion of loans through the broker channel than represented by the average.

Customers value the services provided by brokers. Brokers are used by a significant, and increasing, proportion of the community. Brokers are now responsible for roughly 55 per cent of all residential mortgages written (FSRC, 2018), up from 44 per cent at the end of 2012 (MFAA, 2017, p. 15)[12]. In the first quarter of 2017, brokers originated more than $46 billion of new residential home loans, up from $24 billion over the same period in 2013 (MFAA, 2017, p. 14).

While securing a lower interest rate is one reason why some customers will use a mortgage broker, it is not the only reason. It is also important to highlight the value of the broader service offering brokers provide. In addition to sourcing cheaper interest rates, customers said that the convenience of the broker channel was just as important (Ernst & Young, May 2015, p. 9). Customers felt that brokers were better at achieving outcomes such as matching a product to their needs and providing a stress-free arrangement process. (Ernst & Young, May 2015, p. 9)

In addition to supporting the customer directly, brokers also deliver better outcomes to all customers (irrespective of whether they use a broker) by increasing competition between lenders.

Brokers make it easier for smaller banks to access customers in geographic regions where they do not have a direct branch presence. This is a significant issue for smaller banks, given the upfront costs and scale requirements needed to operate a fully national branch network. The four major banks have large and well-established national branch networks, operating more than 3,600 branches between them (APRA, 2016). In contrast, the Regional Banks (with the exception of Bendigo Bank which has a national network of over 500 branches) tend to have branch networks of a few hundred branches (typically clustered in a few geographic regions rather than spread nationally), and other banking institutions operate networks of less than 100 branches (APRA, 2016).

As Ernst & Young (EY) noted:

> *For regionals and non-bank lenders the broker channel provides scale to penetrate into new customer segments and geographic markets that otherwise would not have been accessible given the prohibitive cost of a physical branch network. Consequently brokers account for significantly more of new mortgage flow with many noting the broker accounting for c.90-95% of new flows. The use of brokers by these lenders has enabled them to compete more effectively in the market with the majors. (Ernst & Young, May 2015, p. 9)*

The significant role played by brokers in overcoming this scale barrier should not be overlooked. The PC estimated that, in the absence of brokers, smaller lenders would each need an average of an additional 118 branches to achieve the same market share outcomes as currently exist (Productivity Commission, January 2018, p. 213)

As a group, customers who use brokers end up with a choice of a more diverse range of mortgages than those who go directly to lenders. While major banks have an 80 per cent market share in residential mortgage lending, customers who use brokers are referred to a major bank less than 70 per cent of the time (Felton, 20 March 2018, p. 8).

By being able to consider a broader range of products, brokers present more options to a customer, allowing them to make a more informed choice. Brokers are doing much of the

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[12] MFAA stands for the Mortgage & Finance Association of Australia. See https://www.mfaa.com.au/

heavy lifting needed to allow customers to consider lenders beyond the major banks, particularly in regions where smaller lenders have little or no physical presence.

The share of loans originated via brokers directly to non-major lenders has increased as the non-majors continue to offer quality products well-aligned with customer needs. Mortgage & Finance Association of Australia (MFAA) data shows that this shift has been significant in recent years, with the share of broker loans directed to the major banks falling from 74 per cent in 2013 to 66 per cent in 2017. (Felton, 20 March 2018, p. 8)

The loan offerings of smaller lenders are already competitive. The delivery of broader policy reforms to help level the regulatory and prudential playing field, will further enhance the capacity of smaller lenders to offer products that meet customer needs. These issues have been extensively canvassed in submissions from Regional Banks to the Productivity Commission (Regional Banks, March 2018) & (Regional Banks, September 2017) and the Financial System Inquiry (Regional Banks, 2014).

In considering any potential reforms to the current arrangements, it is important to be cognisant of the significant benefits the sector already delivers and ensure that any changes do not undermine the sector's capacity to deliver on these positive customer outcomes.

Mortgage broker remuneration and concerns over conflicts

Most mortgage brokers are remunerated using what is termed the 'standard commission model'. Under this model the broker is directly paid by the lender in the form of two main commissions.

The first is an 'upfront' commission payment which is a one-off payment based on a percentage of the loan size. The second is a 'trail' commission that is also based on a proportion of the outstanding loan balance and typically paid monthly through the duration of the loan. Both commissions are subject to 'clawback' arrangements whereby the mortgage broker is required to rebate some or all of the commission if the loan goes into significant arrears or is terminated within a certain timeframe.

In addition to these payments, brokers have in the past been remunerated with what are called 'volume' or 'campaign' bonuses, or hospitality events and other 'soft' dollar benefits that are paid to encourage selling. These additional payments are typically triggered when brokers reach certain loan origination volume targets.

While acknowledging the importance of mortgage brokers to fostering competition, aspects of the broker remuneration model have been found by both ASIC and the independent Sedgwick review to raise concerns with conflicts of interest. ASIC categorised the conflicts as falling into two categories, that of (a) product strategy conflicts, and (b) lender choice conflicts.

Product strategy conflicts refer to the incentive for brokers to earn greater commissions if they convince borrowers to take out a higher loan, or apply for a loan product that will keep the average loan balance higher over the duration of a loan, such as an interest-only loan. This conflict is relevant to both the upfront commission, but particularly the trail commission.

Lender choice conflicts arise from the possibility that lenders will pay brokers different commission rates. Therefore, there is a potential for brokers to favour lenders that pay the higher rates. This potential conflict is relevant to both the upfront commission payment and also the trail commission.

Sedgwick's remuneration review raised similar issues to that of ASIC and made a series of recommendations to address those conflicts.

Industry response to concerns

In response to the ASIC review, a body was formed called the Combined Industry Forum (CIF) to review the findings and to reach industry agreement on how to respond to identified problems. The CIF is also the body that is responding to the Sedgwick review recommendations. The Regional Banks strongly support the CIF process as the vehicle to facilitate changes to the broking industry.

The body ensures compliance with competition law, recognising that any agreed changes to lender and broker practices have commercial implications and there was a need to overcome the barrier of 'first mover disadvantage' when introducing changes. The CIF is working to implement a reform program across the mortgage broking industry to facilitate better customer outcomes. The CIF has established three workstreams and is facilitating a number of initiatives, including proposals to:

- Move away from bonus commissions and bonus payments which increase the risk of poor customer outcomes (CIF, July 2018, p. 9) ;
- Base commission payments on the utilised amount of a loan, not the approved limit – helping address product strategy conflicts;
- Move away from soft dollar benefits which increase the risk of poor customer outcomes and can undermine competition (CIF, July 2018, p. 9);
- Have a clearer disclosure of ownership structures within the home loan market to improve competition (CIF, July 2018, p. 9);
- Establish a new public reporting regime of customer outcomes and competition in the home loan market (CIF, July 2018, p. 9);
- Introduce an improved governance and oversight of brokers by lenders and aggregators (CIF, July 2018, p. 9); and
- Develop an industry code that enables enforcement, applies cross the industry, and includes new participants over time (CIF, July 2018, p. 9).

The Regional Banks are confident these initiatives undertaken under the CIF will help address some concerns regarding broker remuneration and incentives, albeit we understand they do not address the issues of commissions based on loan size or the proposal for fee-for-service.

The unresolved issue from an industry perspective is that of Sedgwick's recommendation to sever the direct link between loan size and upfront and trail commissions (Sedgwick AO, 2017, p. Rec 18). The Regional Banks are continuing to participate in forums looking at how this recommendation could be delivered, and while we are open to investigating options in this space, any potential reform should:

1. Support the ongoing viability of the broker model;
2. Meet a clear cost/benefit assessment, i.e. that the benefits of the change clearly outweigh the costs; and
3. Be consistently applied across all participants.

Changes to commissions linked to loan size

As discussed, the Regional Banks believe any change to the upfront and trail commissions model needs to meet three principles, that of ensuring viability of mortgage brokers recognising the benefits, and competition, that mortgage brokers bring, to the benefit of consumers; ensuring the benefits clearly outweigh any costs; and ensuring any alternative is consistently applied across all participants.

Our concern about viability stems from the important role brokers play in the business model of many smaller banks, such the Regional Banks, enabling those smaller banks to provide competitive alternatives to the major banks, to the benefit of consumers. Some smaller banks have no public facing branches and rely on brokers to secure customers. By supporting competition, brokers also support lower costs for consumers that do not use brokers.

At an aggregate level, Regional Banks originate around 57 per cent of loans through brokers, compared to around 48 per cent for major banks. (See section above on competition and choice.)

The conflict inherent from the linkage between loan size and commission cannot be denied.[13] However, concerns may be overstated. We see a number of factors that will constrain the issuance of unnecessarily large loans:

1. The starting point for a mortgage loan origination is an actual customer wanting to buy a house and enjoy the benefit of home ownership. In Australia, demand for home ownership is very strong and this primarily drives loan demand, not broker recommendations.
2. Borrowers have no obvious incentive to apply for loans that they do not need. It is important not to under-estimate the intelligence of consumers and we note that banks are obligated to provide sufficient information to make informed choices.
3. The mortgage broker is not the loan supplier and does not face credit risk. Credit risk is borne by the lender, so the lender's credit policy is a check against any broker recommendation for a loan that is unsuitable. In addition, higher loan-to-value ratio (LVR) loans attract higher capital requirements and may be less commercially attractive to banks/lenders compared to low LVR loans. The banks will also suffer reputational risks and collection costs if loans default.
4. There are also two important regulatory checks against unsuitable loans:
    a. Responsible lending obligations under the *National Consumer Credit Protection Act 2009*; and
    b. APRA's Prudential Practice Guide (APG 223), which sets out a series of sound underwriting practices. (APRA, 2017)
5. It is expected that responsible lending and APG 223 is likely to be more heavily supervised and enforced. Regional Banks understand that ASIC is currently reviewing the responsible lending guide RG 209 (ASIC, 2014) this year[14].

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[13] The Regional Banks are working with CIF to address identified concerns with mortgage broking, including conflict of interest issues.
[14] https://complianceco.com.au/2017/11/30/asics-2018-credit-focus/

6. The broker has a financial incentive to ensure the any loan has a reasonable prospect of repayment. If a loan falls into arears, it will trigger 'claw back' terms, and the broker will lose commission payments and may not recover the costs associated with having arranged the loan. The broker will also damage his/her professional standing if lenders detect higher than normal default rates stemming from that particular broker.

7. The broker also has a legal obligation under *National Consumer Credit Protection Act 2009* (NCCP) to ensure that the loan is not unsuitable by undertaking preliminary assessment. This involves the broker making inquiries and verifications about the consumer's requirements, objectives and financial situation.

The Regional Banks consider that real checks and balances exist to ensure borrowers do not take out unsuitable loans.

We also see potential problems with replacing the current upfront and trail commission model with alternatives.

One alternative is to replace upfront and trail commissions with 'flat' fees, where the commission does not vary with loan size. In our view, this would increase complexity. It could also result in brokers attempting to 'split' loans, or for lenders to issue fee schedules that vary with loan type.

Another alternative policy option is to force the borrower to pay for the brokerage service directly, rather than the current model where the broker is paid by the lender.

This would fundamentally change the model. It is not recommended by Sedgwick and the Regional Banks believe that it would lead to a negative effect on competition in that it would provide a significant benefit to the major banks. The smaller banks would be vulnerable to the major banks cross subsidising branch-based loan origination services from the loan interest rate.

For example, in order to win market share, a bank with a large branch network could decide to charge no fee for originating a home loan with them. The consumer could then go into the branch and get a housing loan without paying an upfront fee.

In contrast, customers of banks without any or many branches would typically come through a mortgage broker. The mortgage broker could not cross-subsidise, so the broker would have to charge the borrower an upfront fee.

Conclusion

In determining possible reforms to mortgage broking remuneration, the Regional Banks urge the FSRC to put considerable weight on the potentially significant negative implications for competition and consumer choice implications, and to take into consideration the extensive efforts by the CIF to reform practices and support for the CIF work from second tier banks.

REGULATORY BURDEN

In determining a regulatory approach and recommendations to address misconduct in financial services, the Regional Banks request the FSRC give due consideration to the regulatory burden and how this disproportionally impacts smaller players.

The extent of regulation enacted to ensure stability of the financial sector since 2008 has resulted in a substantially increased regulatory burden on banks and the sector. It has not, however, necessarily been effective in preventing misconduct as demonstrated by the FSRC.

It is a genuine concern of the Regional Banks that post the FSRC Final Report, the Federal Government will embark upon a significant revamp of the regulatory system, including conduct regulation and the structure of the regulatory bodies.

Regional Banks accept the need for regulatory improvement and we fully accept the need to ensure consumers are properly protected with fit-for-purpose regulations. However, there is a balance to be struck to ensure that regulation is effective and efficient. It should also be recognised that regulation and implementation processes entail significant cost to banks and, that these costs fall disproportionally on, smaller banks. These costs are ultimately borne by consumers, either directly in pricing or through impaired competition. Larger banks have access to more resources.

Regional Banks strongly agree with the Interim Report regarding layers of regulation

> *As noted elsewhere in this report, I begin from the premise that breaches of existing law are not prevented by passing some new law that says 'Do not do that'. And given the existing breadth and complexity of the regulation of the financial services industry, adding any new layer of law or regulation will add a new layer of compliance cost and complexity. That should not be done unless there is a clearly identified advantage. It should be considered recognising that there is every chance that adding a new layer of law and regulation would serve only to distract attention from the very simple ideas that must inform the conduct of financial services entities:*
>
> - *Obey the law.*
> - *Do not mislead or deceive.*
> - *Be fair.*
> - *Provide services that are fit for purpose.*
> - *Deliver services with reasonable care and skill.*
> - *When acting for another, act in the best interests of that other.*
>
> *These ideas are very simple. Their simplicity points firmly towards a need to simplify the existing law rather than add some new layer of regulation. But the more complicated the law, the easier it is to lose sight of them. The more complicated the law, the easier it is for compliance to be seen as asking 'Can I do this?' and answering that question by ticking boxes*

instead of asking 'Should I do this? What is the right thing to do?' (Hayne, September 2018, p. 290)

And:

Although regulatory complexity imposes burdens on business, the largest entities are very sophisticated and well-resourced. They are well able to find out what the law requires of them. (Hayne, September 2018, p. 295)

Foundations of sound regulatory practice

Even though years of banking system scandals have shaken the community's faith in the financial system, we still believe that there is a need to apply sound policy principles to the regulatory system.

The starting point for regulation must be that it seeks to remedy a market failure or some potential for serious market breakdown. Market-based solutions to identified problems provide the greatest chance of minimising the costs associated with adopting rules and restrictions on market participants.

If market-based solutions are not possible or are likely to be inadequate, the next level of consideration is whether the identified problem can be addressed with self-regulation through industry codes or agreements. Once again, self-regulation has the prospect of remedying a problem at less cost than legislative options.

However, the Regional Banks recognise that self-regulation can also suffer from a level playing field issue in that self-regulation often enables some market participants to opt out of the rules.

Self-regulation can take many forms and dimensions and typically offers more flexibility to truly target a problem.

The Wallis Inquiry outlined a key principle of regulation, that is the need to show the benefit outweighs the costs:

Like the Campbell Committee before it, the Inquiry has proceeded in the knowledge that the performance of the financial system relies heavily on maintaining free and competitive markets. However, where such markets cannot alone meet performance objectives, it is essential to provide effective regulation by government. Regulation is necessary only to the extent that markets may fail, and then only where it can be demonstrated that the benefits of intervention outweigh its costs. (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 15)

Cost of regulation - compliance

A key issue associated with regulation is the compliance cost. Complying with regulations is a resource constraint which impacts smaller institutions disproportionally. These costs are:

1. IT and system changes needed to meet new or revised rules;
2. Employment of staff dedicated to policy, regulatory change, and compliance; and
3. The hours spent by the bank's board, senior executives and staff in dealing with regulatory issues.

The ability of various banks to absorb compliance costs is indicated in Table 2. It shows that the major banks operate with an average cost-to-income ratio of 44.5 per cent, compared to Regional Banks at 62.7 per cent and Credit Unions 79.8%.

As a proportion of assets, the operating expenses of Regional Banks is 1.8%, compared to only 1 per cent of the major banks. For credit unions, the figure is 2.4 per cent.

Table 2
Cost ratios
Average over 12 months to June 2018

Institution	Cost to income ratio	Operating expenses to assets
Major Banks	44.5%	1.0%
Regional Banks	62.7%	1.8%
Credit Unions	79.8%	2.4%
Source: **(APRA, 2018)**; Benchmark Analytics		

There are several means of offsetting higher compliance costs. Banks can charge a higher rate of interest on loans or reduce interest on deposits. They can increase fees and charges, or reduce returns to shareholders.

However, these options are limited. Smaller banks are heavily reliant on customer service and customer satisfaction, so there is little opportunity to increase product prices. The only real option for absorbing compliance costs is to reduce shareholder returns, yet smaller banks already have lower returns on equity.

Cost of regulation - innovation

Regulation can also restrict product innovation and processes, pushing product and service homogeneity and thereby diminishing the ability of banks to differentiate.

This cost is potentially very damaging to smaller banks because it is only through differentiation on customer service and product offerings that smaller banks can compete against the larger scale banks, particularly given that larger banks also enjoy lower capital[15] and debt costs[16] due to regulatory factors.

Cost of regulation - accountability

An excessive regulatory regime is inherently unstable in that the more government attempts to influence the actions of private companies and their boards, the more

[15] The Productivity Commission notes: *"Regulatory arrangements can further entrench the market power of those incumbents that have the expertise and resources to cope with regulatory requirements. The cost of regulatory capital for major banks compared with smaller competitors is one instance of this…The net result of these regulatory measures is a funding advantage for the major banks over smaller Australian banks that rises in times of heightened instability."* (King, Abramson, & Harris, 29 June 2018, p. 6)
[16] The Productivity Commission notes: *"The cost of sourcing funds is the single largest expense for all lenders in the Australian financial system. It is, in turn, a key influence on institutions' ability to compete in the market for lending (or to increase profits). With their better credit ratings and a perception of being 'too big to fail', the major banks are able to source funds from investors and depositors at lower interest rates than are smaller institutions."* (King, Abramson, & Harris, 29 June 2018, p. 6)

accountable the community holds the government to account. In turn, this dynamic results in governments having to further regulate to address identified shortcomings.

This problem is particularly relevant to industries where participation is subject to licencing regimes, such as credit provision and deposit-taking. The fact a licence is granted is a signal that the government endorses that institution or business performing services. To some extent, a licence can replace the need for a business to secure customers solely through brand reputation.

Non-bank lenders

Another aspect of the regulatory burden regards the bank competitors that are not subject to prudential regulation. To the extent that changes to APRA's regulatory framework, approach or specific rules stems from the FSRC, then the cost of those changes will only apply to prudentially regulated banks, and not to the myriad of other financiers (such as mortgage lending specialists) that are competitors.

To use a metaphor, Regional Banks are at risk of being caught at the low point of a playing field that has major banks elevated at one end, and non-ADIs elevated at the other end. This also has adverse implications for consumer protection because prudential regulations are not designed to protect consumers per se, but prudential standards do improve consumer outcomes.

Definition of small business

The Regional Banks note there is commentary in the Interim Report suggesting a bias towards setting the monetary definition of small business as those with total debt of $5m rather than a maximum of $3m total debt in the 2019 Code of Banking Practice (Australian Banking Association (ABA), Commences 1 July 2019, p. 13), which is approved by ASIC.

Regional Banks support the $3m cut off. The vast majority of small business loans by volume fall below $3m and, in the case of smaller banks, a $5m limit would require a re-evaluation by smaller banks of being in the small business market. Lending on a less secured basis will likely have two impacts – less money being made available to that segment and at a higher price. This is because the economics of finance dictate that a higher return is demanded for a higher risk. APRA ensures this is properly applied to bank lending portfolios and effectively limits the supply of money available to higher risk segments through applying higher risk weights and thereby demanding greater capital support.

Businesses with limits above $3m are highly likely to utilise advisers for financial advice and have sufficient sophistication to protect their interests when contracting with banks. Increasing the limit may have adverse implications for the costs of finance and access to finance. The Regional Banks note the ABA submission has also covered this matter.

Conclusion

In determining a regulatory approach and recommendations to address misconduct in financial services, the FSRC should give due consideration to the regulatory burden and how this disproportionally impacts the competitiveness of smaller players. This will have a negative effect on competition and choice and will quickly lead to worse outcomes for consumers.

CONCLUSION

The Regional Banks fully endorse the work of the FSRC. We have been disappointed by the revelations of misconduct to date. We are committed as individual banks and a group to making things better and doing what we can to protect and promote the interests of our customers and the wider economy.

Our submission makes three key points:

1. In balancing the policy factors in clause (k) of the Letters Patent establishing the Royal Commission, the FSRC should give appropriate weight to the factor of 'competition' in its deliberations and recommendations. Competition has long been a policy priority in financial services and, in our view, needs further promotion;
2. In determining possible reforms to mortgage broking remuneration, the Regional Banks urge the FSRC to put considerable weight on the competition and consumer choice implications, and to take into considerations the extensive efforts by the CIF to reform practices and support for the CIF work from second tier banks; and
3. In determining a regulatory approach and recommendations to address misconduct in financial services, the FSRC give due consideration to the regulatory burden and how this disproportionally impacts the competitiveness of smaller players.

In determining the definition of a small business, Regional Banks recommend a $3m cut off is used. Accepting a higher limit may reduce total funding for the sector. Businesses with limits above $3m are highly likely to utilise advisers for financial advice and have sufficient sophistication to protect their interests when contracting with banks.

As a group, the Regional Banks' vision is for Australian customers to enjoy an innovative, vibrant, diverse and sustainable banking sector which offers choice and better value.

To achieve this, our view is that you need strong competition supported by best practice, fit-for-purpose regulation.

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