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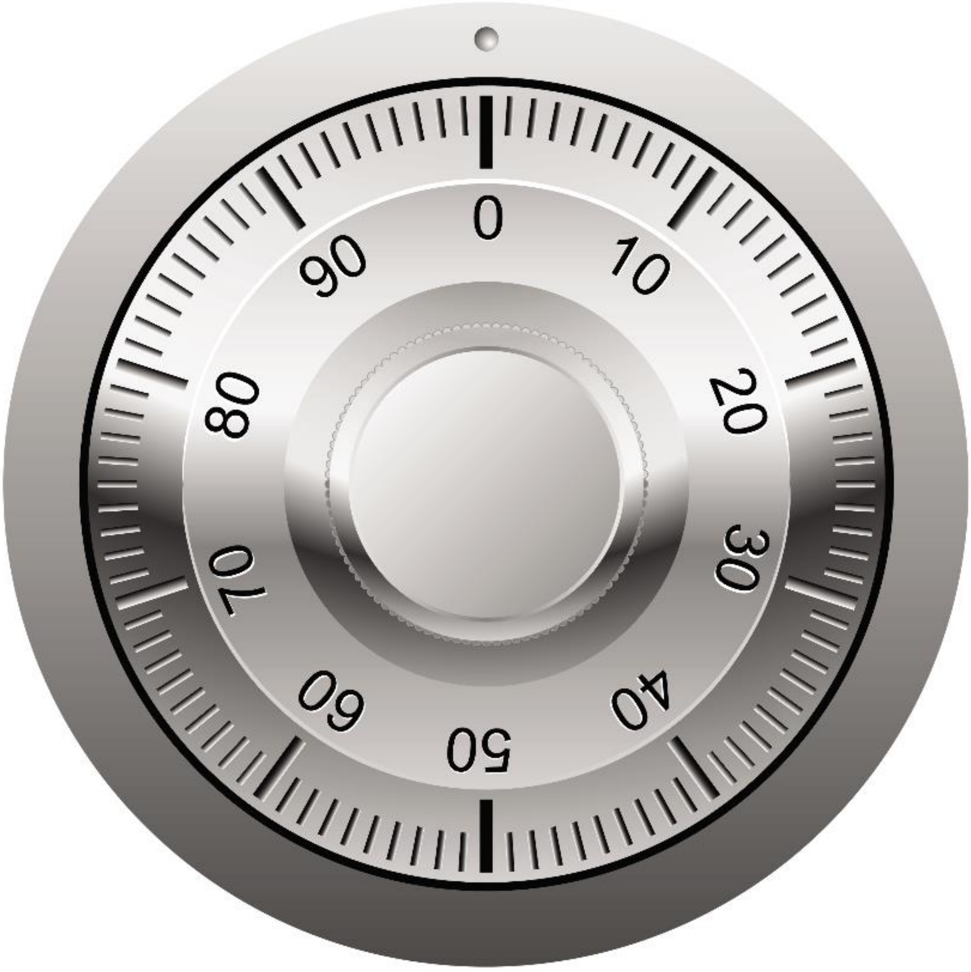

Progress on key recommendations of the Murray Inquiry

Commissioned by the Customer Owned Banking Association
December 2016

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Glossary

Acronym	Full name
ADI	Authorised Deposit-taking Institution
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
ARFP	Asian Region Funds Passport
ASIC	Australian Securities and Investments Commission
BCBS	Basel Committee for Banking Supervision
COBA	Customer Owned Banking Association
FSB	Financial Stability Board
FSI	Financial System Inquiry
GDP	Gross Domestic Product
IRB	Internal-ratings-based
PC	Productivity Commission
ROE	Return on Equity
RBA	Reserve Bank of Australia
SOE	Statement of Expectations
TLAC	Total loss absorbing capacity

Executive summary

The Customer Owned Banking Association (COBA) engaged Deloitte Access Economics to report on progress in implementing the following recommendations of the 2014 Financial System (Murray) Inquiry (FSI):

- **Recommendation 1:** Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.
- **Recommendation 2:** Raise the average internal-ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.
- **Recommendation 3:** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practices, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions (ADIs) and minimise taxpayer support.
- **Recommendation 30:** Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's (ASIC) mandate.

The Government released its response to the FSI recommendations on 20 October 2015, and agreed to 43 of the 44 recommendations.

While there has been some progress on all four recommendations, significant work remains. Some of the steps to strengthen the focus on competition in the financial system, such as amending ASIC's mandate and updating the regulators' statements of expectations, could likely have been progressed on a faster timeframe.

Progress on recommendation 1

The Government agreed that the Australian Prudential Regulation Authority (APRA) should ensure that the capital ratios of all Australian banks are 'unquestionably strong'. The FSI defined this as requiring capital ratios to be in the top quartile of internationally active banks.

APRA completed its second international comparison of ADI capital ratios in 2016, and found that the major Australian ADIs had increased their capital ratios to be broadly in line with the FSI's definition of unquestionably strong.

While the FSI's 'benchmark' may be broadly met by the major banks, it may not be maintained at this level continuously. APRA has, quite reasonably, taken a broader view of the definition of unquestionably strong, and has stated that it will consider other measures of strength. APRA will recalibrate its final capital requirements with these other considerations in mind.

The Basel Committee for Banking Supervision (BCBS) is expected to finalise guidance on reforms to the capital framework by end-2016. APRA is planning industry consultations in 2017 and will look to implement revisions to the capital framework during 2018.

Progress on recommendation 2

The Government agreed to narrow the gap between average mortgage risk weights employed by IRB banks and those employed by standardised banks.

In July 2015, APRA announced higher mortgage risk weights for banks using an IRB approach to capital, raising the average risk weight for mortgages to at least 25%. This requirement came into effect in July 2016.

However, this adjustment is an interim measure pending the BCBS finalising reforms to the capital framework, and APRA's subsequent implementation in Australia. As with Recommendation 1, full implementation of this recommendation is not expected until at least 2018.

Progress on recommendation 3

The Government agreed to address the perception of 'too big to fail', and noted that a greater loss absorbing and recapitalisation capacity will help to allay this perception. However, given the need to align with international practice, the Government noted that implementation will occur beyond 2016.

The final international standards for total loss absorbing capacity (TLAC) have now been published, providing clarity on the international approach to the issue. APRA is now expected to consider the application of TLAC requirements in Australia. However, given the likely time needed to monitor international implementation (which will be phased in between 2019 and 2028) and undertake industry consultation, it is unlikely that completion of this recommendation will occur in the short-term. Progress is inherently slow given the complexity and need to consider international developments.

While the international TLAC requirements only apply to Global Systemically Important Banks, APRA believes it will not be alone in extending the regime beyond this group.

Progress on recommendation 30

The Government agreed to the FSI's recommendations to: ask the Productivity Commission (PC) to review the state of competition in the financial system; introduce competition into ASIC's legislative mandate; issue Statements of Expectations requiring the regulators to explain how they balance competition with their other mandates.

As part of this recommendation, the Government also committed to establish the Asian Region Funds Passport to support cross-border activity in managed investment schemes. The Asian Region Funds Passport was launched in April 2016.

There has been little progress on the substantial aspects of this recommendation related to updating the regulators' responsibilities.

Conclusion

Delays to or not completing implementation of the recommendations would adversely affect the ability of the financial system to realise the benefits of these reforms. These benefits were identified by the FSI as helping to:

- ensure the robustness of the financial system;

- aid competition in the banking sector; and
- address the "too big to fail" issue in the banking sector.

Some progress has been made on all four recommendations, but significant work is still required to complete implementation. Much activity is scheduled over the next 12-24 months on Recommendations 1, 2 and 30, as industry consultation on regulatory and legislative change is required on many of the outstanding commitments. On the other hand, the phased implementation of TLAC at the international level and absence of a set timeframe for Recommendation 3 means that the process will probably unfold on a much longer timeline.

Furthermore, while progress against the four recommendations will help rebalance the competitive dynamics in the banking sector, it may not be enough to increase financial system competition substantially. With the PC's proposed financial system competition review expected to be completed in 2017, but terms of reference yet to be established, we propose potential terms of reference for the inquiry, focusing on the banking sector.

Suggested terms of reference for the Productivity Commission
The PC should conduct an inquiry into the state of competition in the financial system.

In undertaking this inquiry, the PC should consider:

1. **What are the competitive dynamics of the financial system?**
   Including examining trends in:
   a) industry consolidation;
   b) horizontal and vertical integration;
   c) exit of existing participants and new entrants, such as fintechs;
   d) innovation, such as digital disruption; and
   e) customer switching.

2. **Why is there not more competition in the financial system?**
   Including considering:
   a) whether regulators' rules and procedures are creating inappropriate barriers to competition;
   b) whether other Government policies are creating inappropriate barriers to competition, such as taxation policy, and have appropriate regard to other business models, including the customer owned model;
   c) whether other factors have affected competition, such as other non-regulatory or policy-related barriers to entry and broader economic conditions;
   d) the appropriate balance/trade-offs between competition and:
      - financial system performance;
      - access to financing, including for different segments of users
      - systemic stability; and
      - growth.

3. **What needs to be done to support more competition?**
   Including considering:
   a) removing barriers to competition by modifying or removing inappropriate regulatory rules and Government policies; and
   b) taking actions to support greater competition, such as:

- additional support for standardised ADIs to achieve IRB accreditation including technical assistance (see Chapter 3.1.1); and
- requiring a competition impact statement to be undertaken as part of all regulatory impact assessments (see Chapter 2.4.1).

In considering question 3, the PC should have in mind the impact of changes on the long-term interests of consumers, i.e. consumer welfare.

The PC should draw on the experiences in overseas jurisdictions, the expertise of academics, industry and Government subject matter experts, and consult widely and broadly, including with participants and consumers.

Deloitte Access Economics

1 Introduction

The Customer Owned Banking Association (COBA) represents the customer owned banking sector in Australia. Its members are mutual banks, credit unions and building societies.

This report provides an update on the implementation progress of key recommendations of the 2014 Financial System (Murray) Inquiry (FSI). The focus of the update is on the recommendations which have implications for competition in the banking sector, including the markets in which smaller Authorised Deposit-taking Institutions (ADIs) operate, such as COBA's members.

The total assets of Australia's major banks was $3.5 trillion as of September 2016 (APRA 2016e). While the total assets of mutual ADIs—including mutual banks, credit unions and building societies—is small in comparison, it is growing as a share of all ADIs. The total assets of mutual ADIs increased to $104 billion in September 2016, representing year-on-year growth of nearly 8%, compared to a 1.3% contraction in the total assets of all ADIs over the same period (APRA 2016e).

The FSI examined how the Australian financial system was positioned to meet Australia's evolving needs. The FSI made 44 recommendations seeking to promote efficiency, resilience and fairness of the financial system. As part of its review, the FSI recognised the role played by smaller ADIs such as mutual banks, credit unions and building societies particularly with regard to encouraging a competitive financial system.

On 20 October 2015, the Government responded to the FSI recommendations by setting out a reform agenda aimed at improving Australia's financial system. The Government agreed to 43 of the 44 FSI recommendations, and added three additional actions. These included initiatives to be implemented over a number of years. A number have implications for mutual banks, credit unions and building societies as well as the broader banking sector in which they operate.

One year has now elapsed since the Government published its response. Furthermore, the Government is shortly expected to task the Productivity Commission to review the state of competition in the financial system, which is expected to be completed by the end of 2017, three years after the completion of the FSI.

Against this background, COBA engaged Deloitte Access Economics to report on progress in implementing the following FSI recommendations that were endorsed by the Government:

- **Recommendation 1:** Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.
- **Recommendation 2:** Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.
- **Recommendation 3:** Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practices, sufficient to facilitate the orderly resolution of

Australian authorised deposit-taking institutions and minimise taxpayer support.
- **Recommendation 30:** Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

Given the interdependency of these recommendations and other reforms, and the need to coordinate with international efforts to address some of these issues, the progress of implementation to date has been varied. The Customer Owned Banking Association seeks to promote greater impetus for continued progress on the implementation of these recommendations.

1.1 Report structure

The subsequent sections of the report are structured as follows:

- Chapter 2 explains key concepts behind the four recommendations, summarising the background from the FSI final report;
- Chapter 3 reports on progress in implementing the four recommendations, drawing from publicly available information;
- Chapter 4 discusses the costs and benefits of each of the four recommendations, drawing from existing analysis; and
- Conclusion, which summarises the state of play of the four recommendations, and considers potential terms of reference for the proposed Productivity Commission inquiry into competition in the financial system, with a focus on the banking sector.

2 Summary of selected recommendations

2.1 Recommendation 1 – Capital levels

Recommendation 1

Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.

The FSI recommended that Australian authorised deposit-taking institutions (ADIs) increase their capital ratios such that they are 'unquestionably strong'. The main objective of the recommendation is to improve the resilience of the banking sector and consequently reduce the risk of financial failure in the case of an external shock to the financial system.

ADIs fund their assets, for example mortgages, using a mix of liabilities, including deposits, other debt, and equity capital. The Australian Prudential Regulation Authority's (APRA) prudential regulations require that ADIs hold a certain portion of their funding as specific types of capital (see Appendix A). The type and amount of capital required to be held is determined through an assessment of the weighted risk of the assets which comprise the ADI's balance sheet. The share of capital held against the ADI's risk-weighted assets is known as the capital adequacy ratio.

The FSI (2014) noted the importance of capital in the banking sector:

> *"Capital, particularly equity capital, is an essential element in both actual and perceived financial soundness, acting as a shock absorber for unexpected losses. Once equity has been exhausted, a bank is generally non-viable — and could well have been before that point. Equity capital is therefore an important determinant of how likely a bank is to fail. Capital is also a safety buffer for creditors, as it is typically exhausted before the bank defaults on its obligations. By making creditor funds relatively safer, high levels of capital assist to maintain confidence in a bank, even in times of market stress."*

The FSI suggested that a capital ratios within the top quartile of internationally active banks is the appropriate benchmark for Australian ADIs to qualify as unquestionably strong. The FSI also judged that this standard should apply to all ADIs, not just the major banks. However, the focus so far has been on the major banks (see Chapter 3.1). The FSI indicated at the time that it considered the capital ratios of the major Australian banks not to be in the top quartile of their internationally active peers.

The FSI recommended that the increase in capital ratios should primarily take the form of Common Equity Tier 1 (CET1) capital, which represents the highest quality form of capital (see Appendix A). This type of capital comprises tangible equity such as shareholder common equity. The FSI noted that evidence available at the time suggested that the CET1 capital ratios of the major Australian banks were likely to be between 10.0% and 11.6%.[1] On the other hand, the Basel Committee on Banking Supervision (BCBS) estimated the global 75th percentile of CET1 capital ratios was 12.2% in December 2013. At the time, the FSI judged that capital ratios of the major Australian banks were *"likely to be above the global median but below the top quartile."*

However, capital levels are difficult to compare across jurisdictions as national prudential regulators adopted different approaches to measuring capital (APRA 2015a). In other words, it is not straight-forward to compare capital ratios based on APRA regulations with those in other jurisdictions. In recognition of this, the FSI recommended that APRA *"develop a reporting template for Australian ADI capital ratios that is transparent against the minimum Basel capital framework."* This was proposed under Recommendation 4 of the FSI Final Report.

2.2 Recommendation 2 – Narrow mortgage risk weight differences

Recommendation 2

Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

The level of capital required to be held by an ADI is determined by the capital adequacy ratio set by APRA as well as the risk weight target which is applied to specific asset classes. All other things equal, a lower risk weight applied to the asset class will mean that the ADI will not have to hold as much capital in reserve.

The standardised risk weights are a common set of risk weights that reflect the general risks of different broad asset classes. These risk weights are not tailored to specific ADIs and are set by APRA at a conservative level to ensure ADIs are adequately capitalised. These standardised risk weights are used by financial institutions that have not achieved accreditation for IRB models.

[1] The CET1 capital ratio for mutual banks, credit unions and building societies was 15.9% as at December 2013 (RBA 2014). This relatively higher capital ratio compared to the larger banks is partly due to their less diversified business models and different corporate structures.

IRB risk weights are used by banks accredited by APRA to use IRB models for calculating capital ratios. In Australia, so called 'accredited ADIs' include the four major banks and Macquarie Bank. Accredited ADIs use their own IRB models to determine risk weights for certain credit exposures. These are based on assessed risks of the asset and institution, thereby achieving a tailored risk weight.

ADIs determine the relevant risk weights to apply in one of two ways: (i) using an internal-ratings-based (IRB) model; and (ii) based on a set of standardised risk weights. The FSI recommended APRA adjust the requirements for calculating risk weights for housing loans to narrow the difference between the average mortgage risk weights for ADIs using the IRB approach and those using standardised risk weights. The FSI thought that this would improve competitive neutrality of capital regulation between different classes of ADIs.

Accredited ADIs can refine their models to achieve lower risk weights. Should an IRB bank determine a risk weight for a given asset type that is lower than determined under the standardised approach, the accredited ADI can use a much smaller proportion of equity funding compared to banks using standardised risk weights. As equity is a more expensive funding source than debt, all other things equal, this translates into a funding cost advantage for IRB banks. At the time the FSI was published, the average mortgage risk weight determined under the standardised approach was 39%, which was significantly higher than the average mortgage risk weight of 18% for banks using IRB models.

The FSI considered both reducing the average mortgage risk weight for those ADIs using standardised risk weights and raising the average mortgage risk weights for ADIs using IRB models. However, as reducing the average mortgage risk weight for ADIs using standardised risk weights was considered to potentially increase vulnerability of the system, the FSI recommended the latter option.

At the same time, the FSI acknowledged that there should remain a difference between the mortgage risk weights under both models to retain the incentive for standardised banks to develop IRB models. As such, it did not seek to eliminate the gap between the two approaches.

2.3 Recommendation 3 – Loss absorbing and recapitalisation capacity

Recommendation 3

Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practices, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.

The FSI recommended that APRA implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice. While higher capital ratios seek to reduce the risk of failure of an ADI, a loss-absorbing and recapitalisation framework seeks to support the orderly resolution of an ADI in the event of its failure. That is, to mitigate the effects of a failure by ensuring that any critical economic functions can continue to operate and to ensure losses are borne by shareholders and creditors rather than taxpayers. The framework would set out the equity and debt instruments on an ADI's balance sheet upon which losses would be imposed in the event that the ADI fails and enters resolution. This is also known as 'bail-in'.

More broadly, by implementing such a framework, the objective would be to reduce public perceptions of an implicit government guarantee being provided to banks deemed 'too big to fail'.

International practice on loss absorption and recapitalisation focuses on global systemically important banks (G-SIBs). G-SIBs are identified by the Financial Stability Board (FSB) to be financial institutions whose distress or failure, because of their size, interconnectedness, lack of substitutability, extent of global activity and complexity, would cause significant dislocation in the global financial system and have adverse consequences for the wider economy (BCBS 2013).

While the Australian banking sector does not include institutions considered to be G-SIBs, many countries indicated they may also apply to Domestic Systemically Important Banks (D-SIBs).[2] Furthermore, the FSI noted that *"As a small, open, capital-importing economy, Australia cannot stand outside international practice."*

As this was a still unfolding area of international practice, the FSI suggested that Australia proceed with caution. Nonetheless, the FSI recommended that an Australian framework should follow a number of guiding principles:

- Clearly set out the instruments eligible for inclusion in a loss-absorbing and recapitalisation capacity requirement.
- Ensure clarity of the creditor hierarchy with clear layers of subordination between classes.
- Ensure clarity of the mechanisms and triggers under which creditors will absorb losses.
- Seek to ensure eligible instruments can be exposed to loss without adverse consequences for financial stability, including being held by investors who can credibly be exposed to loss.

The FSI also specified that an ADI's deposit liabilities should not be subject to bail-in, so as to maintain the practice of depositor preference in Australia.[3]

[2] Similarly, D-SIBs assessed by APRA as domestic banks which are systemically important in Australia due to their size, interconnectedness, lack of substitutability, and complexity, and include Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, National Australia Bank Limited and Westpac Banking Corporation (APRA 2013).

[3] Depositor preference gives depositors a priority claim on the assets of a failed ADI ahead of other unsecured creditors (Turner 2011).

2.4 Recommendation 30 – Strengthening the focus on competition in the financial system

Recommendation 30

Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

The financial system *"being subject and responsive to market forces, including competition"* was central to the FSI's philosophy. While the FSI assessed competition in the Australian financial system to be *"generally adequate"*, it recognised that the highly concentrated banking sector had the potential to limit the benefits of competition in the future.

Some of the FSI recommendations were aimed at promoting competition in specific circumstances. However Recommendation 30 sought to deliver a stronger overall focus on competition in the financial system. In particular, the FSI suggested that regulators and policy makers do not place sufficient emphasis on competition in their decision making.

Some of the regulators' mandates formally recognise their roles with respect to competition:

- the *Reserve Bank Act 1959* specifies that the duty of the Reserve Bank of Australia (RBA) Payments System Board includes ensuring that it exercises its powers in a way which best contributes to *"promoting competition in the market for payments services, consistent with the overall stability of the financial system"*.
- the *Australian Prudential Regulation Authority Act 1998* requires that *"In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia"*.

However, competition is not explicitly reflected in the mandate of the Australian Securities and Investments Commission (ASIC). The *Australian Securities and Investments Commission Act 2001* requires that ASIC to promote commercial certainty and economic development and efficiency while reducing business costs.

In the context of this inconsistency, the FSI recommended that ASIC's mandate should include a requirement to *"take competition issues into account as part of its core regulatory role."*

In addition, the FSI recommended that the regulators improve their reporting of how competition is factored into their decisions. For those that have a competition mandate, there is no requirement to explain how they balance competition considerations with their other regulatory objectives. Thus, the application of the competition mandate is ad hoc.

- For example, APRA is currently required to consider competition and contestability in its mandate but the FSI concluded that the industry framework used by APRA does not adopt a consistent approach to the issue.

The FSI noted that conduct and prudential regulators have a tendency to prioritise fairness or stability over competition – the benefits of competition are typically long-term and hard to value, while the costs of instability or unfair outcomes are often immediately visible. The FSI recommended that the effect of regulatory proposals on competition should be explained in consultation documents and annual reports.

While the Financial Stability Review produced by the RBA regularly assesses the state of financial stability, the FSI noted that there is no regular assessment of the state of competition in the financial system. The FSI also suggested that introducing an external review of the state of competition in the financial sector every three years could put additional pressure on the issue.

The FSI acknowledged that no single solution will guarantee the 'right' level of competition in the future, particularly given the concept can change over time. However, periodic reviews could help regulators keep up with the latest developments. In particular, the FSI suggested that the review should include a focus on changes in barriers to international competition, such as identifying impediments to cross-border competition and other barriers to the free flow of capital across borders, such as tax impediments.

The FSI also recommended that, as an immediate first step, regulators should examine their rules and procedures with the aim of modifying or removing those which create barriers to competition, and identify *"alternatives and more pro-competitive approaches."* It asked each regulator to report to Government ahead of the external review.

2.4.1 Other examples

The FSI is not alone in suggesting that regulators may not give adequate consideration to the competitive implications in their rule-making. For example, the Senate Economics Reference Committee (2016a) inquiry into co-operative, mutual and member-owned firms, noted that these firms operate differently from regular companies and should be appropriately regulated relative to their size and operations.

The Senate Committee identified that APRA's application of the regulatory capital framework does not recognise certain capital instruments issued by mutual ADIs (mutual equity interests; MEI) as CET1 instruments, which it suggests may have implications for competitive neutrality. That is, APRA's regulations currently do not recognise MEI issued by mutual ADIs in the ordinary course of business as equivalent to ordinary shares of non-mutual ADIs.

With respect to this issue, APRA's General Manager of Policy Development, Pat Brennan, noted (Senate 2016b):

> *"The structure of the banking industries and the regulatory frameworks are different in each country, but it is fair to say that some jurisdictions have found a way to accommodate the mutuals in ways that Australia has not. Sometimes that is due to the different legislative frameworks that they work in; at other times I feel it is sometimes regulators taking a different approach."*

More broadly, the Senate Committee inquiry recommended that co-operative and mutual sector be considered when the Government is preparing a Regulatory Impact Statement that accompanies new regulatory policies.

'One-size-fits-all' regulations can have implications for competition. For example, APRA's policy to address the risks it sees in the housing sector may have unintended consequences (APRA 2014):

> *"…strong growth in lending to property investors — portfolio growth materially above a threshold of 10 per cent will be an important risk indicator for APRA supervisors in considering the need for further action"*

A cap on the growth of investor housing credit may have the effect of preventing competition playing out in this market. On balance, systemic stability concerns may outweigh this, but there may be value in APRA providing greater transparency that it has considered the broader impacts of such policies, including on competition.

3 Progress on recommendations

The Government released its response to the FSI recommendations on 20 October 2015, by setting out a reform agenda aimed to improve Australia's financial system. The Government agreed to 43 of the 44 FSI recommendations, and added three additional actions.

This report focuses on the Government's commitments related to FSI Recommendations 1, 2, 3 and 30. To the extent that the Government outlined specific timeframes for implementation, these have been taken into account in assessing the state of play.

3.1 Progress on Recommendation 1

Key points

- The Government agreed that APRA should ensure the capital ratios of all Australian banks are 'unquestionably strong'. However, the focus so far has been on the Australian major banks.
- APRA published an international comparison of ADI capital ratios in 2015, which was updated in 2016. The most recent comparison found that the major Australian ADIs had capital ratios in the top quartile of internationally active bank capital ratios. This was driven by increases in capital holdings by the major banks.
- While the FSI's 'benchmark' may be broadly met by the major banks, it may not be maintained at this level continuously. APRA has, quite reasonably, taken a broader view of the definition of 'unquestionably strong' compared to that proposed by the FSI, and has stated that it would be considering other measures of strength. APRA would recalibrate its final capital requirements with these considerations in mind.
- The BCBS is expected to finalise guidance on reforms to the capital framework by end 2016. APRA is planning industry consultation in 2017, and will look to implement revisions to the capital framework during 2018.

The Government response (Australian Government 2015a):

> *"The Government agrees that the capital ratios of Australian banks should be unquestionably strong. This will ensure the financial system remains resilient during difficult times and will maintain investor confidence.*
>
> *We support and endorse APRA as Australia's prudential regulator to implement this recommendation and will continue to closely monitor the resilience of our banks.*
>
> *APRA released an international capital comparison study on 13 July 2015, which found that Australia's major banks' capital levels are currently below the top quartile of internationally active banks (the baseline target proposed by the Financial System Inquiry), even after adjusting for APRA's conservative approach to measuring capital."*

While the FSI's proposed a definition of 'unquestionably strong', that is, Australian banks' capital ratios within the top quartile of internationally active banks, APRA has, quite reasonably, taken a broader view of this definition.

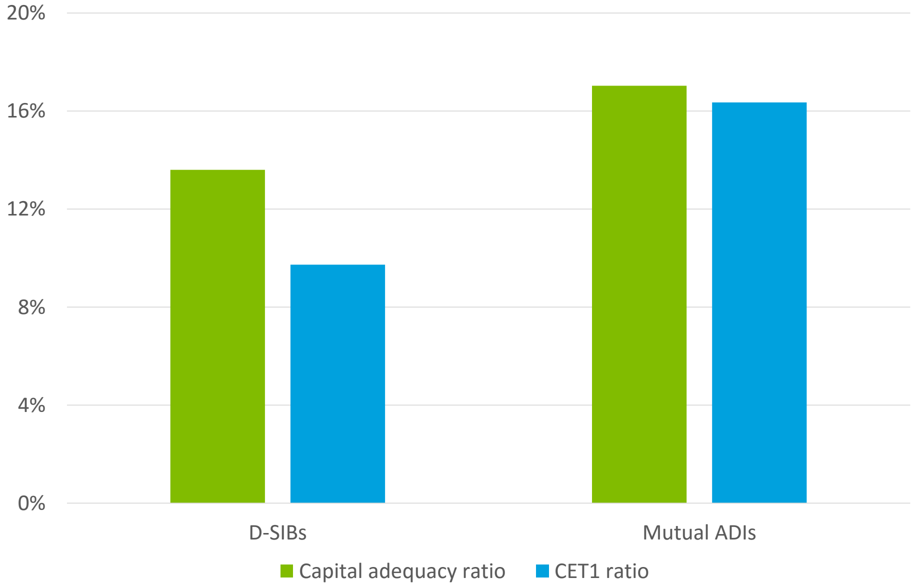
The Government tasked APRA to take additional steps to ensure Australian banks have unquestionably strong capital ratios by the end of 2016. Although it recognised that *"the content and timing of regulatory changes will take into account developments in the Australian economy and in international financial regulatory frameworks"* (Australian Government 2015a).

In July 2015, APRA released its initial study comparing the capital ratios of Australia's major banks with a group of their international banking peers (APRA 2015a). The study found that, as at June 2014, the capital ratios of Australia's major banks were well positioned compared to international peers yet below the top quartile. APRA suggested that to reach the bottom of the top quartile would require an increase of around 70 basis points in CET1 capital ratios (Byres 2015a). However, the 2015 study did note the difficulty in comparing capital positions across jurisdictions – there is no internationally harmonised capital ratio that provides a measure of capital adequacy for the purposes of cross-jurisdictional comparisons.

APRA updated the study in 2016, and found that as of December 2015, the ADIs' combined CET1 ratios had moved into the top quartile of internationally active banks. This was a result of the major Australian banks raising around $20 billion of new equity and an additional $7 billion from retained earnings since the start of 2015 (RBA 2016a).

As of end September 2016, the average CET1 ratio of the Australian D-SIBs was 9.7%, while the mutual ADIs had an average CET1 ratio of 16.4% (Chart 3.1:). Similarly, the average capital adequacy ratio of the D-SIBs was 13.6%, while the mutual ADIs had an average capital adequacy ratio of 17.0%.

Chart 3.1: Capital ratios by institution type (end September 2016)[a,b,c]



[a] Capital ratios have not been adjusted for international comparability.

[b] Capital ratios for some mutual ADIs are as at end June 2016.

[c] Capital ratios are a simple average of all institutions.

Source: Deloitte Access Economics, APRA (2016e), financial institutions' reports

While APRA (2015a & Byres 2015a) viewed the top quartile positioning of Australian ADIs in the internationally active banks as a useful indicator of strength, given the variability of such a benchmark, it took a broader view of what 'unquestionably strong' should mean:

> *"APRA sees fourth quartile position as a useful 'sense check' of the strength of the Australian capital framework against those used elsewhere, but does not intend to directly link Australian requirements to a continually moving benchmark such that frequent recalibration would be necessary."*

This means that while the top quartile positioning of Australian ADIs relative to their international peers was achieved, APRA does not consider the maintenance of this positioning to be the sole objective of being unquestionably strong.

APRA has noted that there are other measures which it will consider, including for example, calibrating the final capital requirements with regard to (Byers 2016b):

- rating agency measures of capital strength; and
- the results of banks' stress tests.

APRA has yet to clarify how it will account for the quality of prudential supervision in Australia, or other institutional factors that may have contributed to the resilience of the sector during the global financial crisis.

Nonetheless, the international capital framework has yet to be finalised. APRA expects that a complete package of reforms will be endorsed by the

Governors and Heads of Supervision of BCBS member countries in January 2017 (Byers 2016b).

In terms of the timeframe, APRA Chairman Byers noted that:

> *"Given the number and potential impact of the changes that will be proposed, 2017 will be a year of consultation. We don't expect to have final standards before this time next year. And even if that is the case, they would not take effect until at least a year after that."*

While the FSI recommended that, and the Government committed to, all Australian ADIs having capital ratios that are unquestionably strong, APRA's focus so far has been on the Australian major banks. Understandably, this may be reasonable from a systemic stability perspective. It remains unclear how the commitment to unquestionable strength will be implemented more broadly.

3.1 Progress on Recommendation 2

Key points

- The Government agreed to narrow the gap between average mortgage risks weights.
- In July 2015, APRA announced higher mortgage risk weights for banks using an IRB approach to capital, raising the average risk weight for mortgages to at least 25%. This requirement came into effect in July 2016.
- This remains an interim measure while the BCBS finalises the reforms to the capital framework, and APRA's subsequent implementation in Australia. As with Recommendation 1, full implementation of this recommendation is not expected until at least 2018.

The Government response (Australian Government 2015a):

> *"The Government agrees that the gap between average mortgage risk weights should be narrowed. This will aid competition in the banking sector.*
>
> *We support and endorse APRA as Australia's prudential regulator and its initial actions announced on 20 July 2015 to raise the average IRB mortgage risk weights to at least 25 per cent from 1 July 2016 to implement this recommendation. The major banks have subsequently undertaken capital raisings to increase their capital levels.*

> *We will take an active and ongoing role in monitoring developments as a result of these changes."*

Prior to the release of the Government's response to the FSI in October 2015, APRA had announced in July 2015 an increase to the mortgage risk weights for the IRB banks to an average of at least 25% to come into effect from 1 July 2016. The major banks subsequently undertook capital raising to increase their capital levels.

This adjustment was always designed to be an interim measure, with the final calibration pending the outcome of the deliberations of the BCBS to finalise reform of the capital adequacy framework and APRA's subsequent consideration of how these reforms should be applied in Australia. In the House of Representatives Standing Committee on Economics (2016b) hearings, APRA Chairman Byres stated:

> *"… given that the Basel international framework is currently up for grabs, it is being revised, and potentially the rules around mortgage risk weights will be changed – I think it is almost inevitable they will be changed in some way – we put in place an interim measure that has closed the gap."*

The BCBS released a consultative document in March 2016 looking to introduce constraints on the IRB risk weights (BCBS 2016a). The consultative document recognised the dispersion in the levels of estimated risk weights that banks were attributing to the same exposures. Consequently, the BCBS proposed to place a floor to ensure a minimum level for IRB risk weights.

As part of the ongoing maintenance of IRB models by ADIs, and supervision by APRA, a range of changes have been made to banks' IRB models since the July 2015 announcement. The impact of these modelling changes, as well as the July 2015 adjustment would have made the average mortgage risk weight for IRB banks well in excess of the 25% target. To address this, in August 2016, APRA reaffirmed its original mortgage risk weight target of 25% (APRA 2016b). That is, allowing some ADIs to readjust their settings to ensure the outcomes are closer to the target.

While full implementation of this recommendation is not expected to be complete until at least 2018 (Byres 2016b), APRA did take steps to put in place an interim measure even prior to the release of the Government response.

3.1.1 Supporting ADIs to achieve IRB accreditation

In their submissions to the FSI, some major banks suggested that standardised banks should be supported to achieve IRB accreditation as a means to aid competition between the major banks and other banks (ANZ 2014, Commonwealth Bank, 2014, Westpac 2014). The FSI suggested that APRA could consider how to make the IRB accreditation process less resource intensive. In December 2015, APRA (2015c) announced two changes to make the IRB accreditation process easier for ADIs:

- **Staged IRB accreditation**, which no longer requires ADIs to meet accreditation requirements for all their credit portfolios before any model can be used; and

- **Decoupling operation risk modelling from IRB accreditation**, to allow an ADI to use the standardised approach for operational risk modelling.

3.2 Progress on Recommendation 3

Key points

- The Government agreed to address the perception of 'too big to fail', and noted that a greater loss absorbing and recapitalisation capacity will support this. However, given the need to align with international practice, the Government noted that implementation would occur beyond 2016.
- The final international standards for TLAC have now been published, providing clarity on the international approach to the issue.
- APRA will now be expected to consider the application of TLAC requirements in Australia. However, given the likely time needed to monitor international implementation (which will be phased in between 2019 and 2028) and undertake industry consultation, it is unlikely that completion of this recommendation will occur in the short-term.
- While the international TLAC requirements only apply to Global Systemically Important Banks, APRA believes it will not be alone in extending the regime beyond this group.

The Government response (Australian Government 2015a):

> *"The Government agrees that steps should be taken to reduce any implicit government guarantee and the perception that some banks are too big to fail. Should an ADI fail, greater loss absorbing capital will facilitate orderly resolution.*
>
> *We endorse APRA as Australia's prudential regulator to implement this recommendation in line with emerging international practice."*

Recognising the need to proceed with caution and align with emerging international practice, the Government stated that implementation would probably occur beyond 2016.

In November 2015, the G20 leaders endorsed the Financial Stability Board's Principles on Total Loss-absorbing Capacity (TLAC) for G-SIBs (FSB 2015). The FSB standard was developed in consultation with the BCBS, and comprises a set of guiding principles and the terms of the minimum TLAC requirement for G-SIBs, including its size and the characteristics of financial instruments that can be counted towards the requirement.

In October 2016, the BCBS (2016b) released its final standards on TLAC holdings, which outlined how banks' investments in TLAC instruments would be treated in regards to regulatory capital. For example, banks should deduct from their regulatory capital investments in the TLAC of other banks.

The international TLAC standards only apply to G-SIBs, so no Australian bank is required to conform in accordance to international timeframes – with phased implementation between 2019 and 2028. However, in light of the Government's commitment, APRA has noted (Byres 2015c):

> *"The Government's response endorsed APRA to implement this recommendation, and I am sure we will not be alone in extending the TLAC regime beyond G-SIBs."*

The FSI recommended that this requirement be implemented slowly in Australia based on international practice. In addition to considering international developments, APRA has noted that it will be important to consider what best suits the particular characteristics of the Australian financial system (Byres 2015c). Nonetheless, the scope of this regime remains uncertain.

While the international framework is now clearer, slow implementation of TLAC requirements have previously been supported by APRA (2016a), which has stated that it will *"take advantage of [the] lack of fixed deadline and hasten slowly"* (Byers 2015a).

3.3 Progress on Recommendation 30

Key points

- The Government agreed to the FSI's recommendations to: ask the Productivity Commission to review the state of competition in the financial system; introduce competition into ASIC's legislative mandate; issue Statements of Expectations requiring the regulators to explain how they balance competition with their other mandates.
- The Government has also committed to establish the Asian Region Funds Passport to support cross-border activity in managed investment schemes.
- There has been little progress on the substantial aspects of this recommendation related to updating the regulators' responsibilities, however, the Asian Region Funds Passport was launched in April 2016.

The Government response (Australian Government 2015a):

> *"The Government agrees to implement periodic reviews of competition in the financial sector.*
>
> *We will task the Productivity Commission to review the state of competition in the financial system by the end of 2017, three years after the completion of the Inquiry. Subsequent periodic reviews will be undertaken as appropriate.*
>
> *We support inclusion of competition in ASIC's mandate and we will develop legislation to introduce an explicit reference to consideration of competition in ASIC's mandate in the second half of 2016.*
>
> *We will also be clear in the Statements of Expectations that regulators should explain in each annual report how they have balanced competition with other elements of their mandates.*
>
> *We are addressing barriers to cross border trade in managed investment schemes through establishment of an Asian Region Funds Passport and we will legislate to give effect to the Asian Region Funds Passport in the second half of 2016."*

To date, the Government has yet to issue its terms or reference to the Productivity Commission (PC) for the review of competition in the financial sector. The Government is expected to task the Productivity Commission with this review by the end of 2017 (Senate 2016c).

The scope of the competition review will be determined by the Government. However, as the PC's inquiry into the efficiency and competitiveness of the superannuation system is expected to begin in mid-2017, it is likely that the competition review will not focus on the superannuation system. The FSI Final Report included a number of potential avenues of inquiry:

- assessing changes in the barriers to international competition; and
- examining the rules and procedures of regulators to assess whether those that create inappropriate barriers to competition can be modified or removed, or whether alternative and more pro-competitive approaches can be identified.

The Government committed to include competition in ASIC's legislative mandate and stated it would develop legislation in the second half of 2016. ASIC (2014), in response to the FSI, supported the inclusion of competition into their mandate:

> *"The pursuit of this objective would not take precedence over ASIC's other objectives. Rather, it would enhance them, by recognising the importance of competition in encouraging commercial certainty, efficiency, consumer confidence and the development of the economy. We think that this is a vital step in the development of Australia as a centre of financial excellence and a regional financial hub."*

While the Government has yet to publish the draft legislation to amend ASIC's mandate, in part the FSI's emphasis on competition was a consideration for ASIC to make the *ASIC Corporations (Repeal and Transitional) Instrument 2016/396* in September 2016. This legislative instrument extends the temporary relief from additional regulatory burden provided to foreign financial services providers. This relief was otherwise due to expire on 1 October 2016.

The next opportunity to introduce this amendment to Parliament will be in February 2017 – however, this will depend on other legislative priorities.

In the meantime, other aspects of the recommendations could contribute to enhancing regulator's consideration of competition. The Government committed to clarify in regulators' Statements of Expectations (SOE) that they should explain in each annual report how they have balanced competition with other elements of their mandates. However, the Government has not yet updated the SOEs of ASIC or APRA.

ASIC Chairman, Greg Medcraft, in the October 2016 hearings of the House of Representatives' Standing Committee on Economics (2016a), said *"At the moment [ASIC] have basically no involvement in competition power"*. He also stated that:

> *"… giving ASIC a competition power—extending competition to ASIC, which was recommended by the financial systems inquiry. I believe that is also very important. As with the Financial Conduct Authority in the UK, having that competition power will be very important in the future, particularly in the nature of our system."*

This suggests that the formal mandate will be an important part of changing the regulator's mindset. In contrast, APRA Chairman Byres stated (House of Representatives' Standing Committee on Economics 2016b):

> *"We have a statutory mandate that basically says 'Think about financial safety, and promote financial stability, but in doing that don't go to the ultimate extreme. Balance that with considerations of competition, efficiency, competitive neutrality and contestability.' The way we operationalise that is to say that it is not our job to set standards for competition, efficiency et cetera, but if we are faced with a policy choice that delivers prudential outcomes, which one is more likely to have a better competitive outcome? Or, how can we achieve prudential outcomes, first and foremost, without damaging any of those other considerations?"*

While there has been no formal changes to the SOE of APRA, APRA's approach suggests some implicit consideration of competition in its decision-making. In fact, APRA considers that its prudential role can help ensure the benefits of competition (Byres 2015b):

> *"Regulators like APRA will naturally have a strong focus on safety: that is what Parliament has tasked us to do. We can and do also play a role in encouraging sound competition, but first and foremost that will be driven by how financial institutions establish*

> *their own governance practices, culture and incentive structures. Strong governance, a culture of disciplined capital and risk management, and with rewards only for those who generate genuine risk-adjusted returns over the long term, will be critical for ensuring the benefits of competition can be harnessed in the interests of the community at large."*

In regards to the FSI's reporting recommendation, APRA (2016d) noted that:

> *"APRA will be looking to provide more information on how it balances financial safety with these other objectives, and more actively seek industry input on these issues so that policy choices are best able to balance these considerations without undermining prudential outcomes."*

More recently, in November 2016, the House of Representatives Standing Committee on Economics (2016d) found that:

> *"Australia's banking sector is an oligopoly. The major banks have significant market power that they use to protect shareholders from regulatory and market developments."*

The Committee recommended that the ACCC provide to the Treasurer six monthly reports with specific proposals to improve competition in the banking sector. It also suggested that if the ACCC does not identify specific proposals, it should justify its position. While such a role for the ACCC was not part of the FSI's recommendations, it represents further efforts to increase the accountability of regulators for competition in the banking sector.

As part of its response to the FSI, the Government also undertook to promote competition in managed investment schemes by establishing the Asian Region Funds Passport (ARFP) in second half of 2016. This initiative was originally recommended by the Australian Financial Centre Forum in its 2010 report (also known as the Johnson report). It has been explored through the Asia-Pacific Economic Cooperation Finance Ministers' Process, with a commitment to implementing the passport by 2016 (APEC 2016). In April 2016, representatives from Australia, Japan, Korea and New Zealand signed the ARFP Memorandum of Cooperation.

Overall, substantive implementation of Recommendation 30 has been limited.

3.4 Progress overview

The table below provides an overview of the key developments to date.

Table 3.1: State of play overview

	2015	2016	2017	2018	State of play
Recommendation 1 Capital levels	APRA published international comparison study of ADIs capital ratios – found that the major banks do not meet the FSI's definition of "unquestionable strong".	**1H2016** • APRA published results of updated international comparison study – found that the capital ratios of the major banks are now in the in the top quartile of international peers. **2H2016** • ***Govt. commitment:*** *APRA to take additional steps to ensure our banks have unquestionably strong capital ratios.*	• In January, BCBS expects to finalise deliberations of a complete package of reform to the international capital framework. • APRA expects to undertake Industry consultation on the application of the BCBS reforms to the capital requirements.	APRA expects to finalise the calibration of capital requirements to occur during 2018.	**Some progress, yet to be completed.** • Steps already taken which have seen an increase in the capital ratios of the Australian major banks. • Current schedule suggests that implementation may be completed in 2018.
Recommendation 2 Narrow mortgage risk weight differences	Prior to release of the Government's response to the FSI, APRA announced an increase in average mortgage risk weights to at least 25% for IRB banks.	**1H2016** • BCBS released consultative document for reducing variation in credit risk-weighted assets **2H2016** • Increase in average mortgage risk weights under IRB models came into effect. • APRA assessed major Australian banks to have average mortgage risk weights in excess of 25% target.	• In January, BCBS expects to finalise deliberations of a complete package of reform to the international capital framework. • APRA expects to undertake Industry consultation on the application of the BCBS reforms to the capital requirements.	APRA expects to finalise the calibration of capital requirements to occur during 2018.	**Some progress, yet to be completed.** • Still in progress, although interim steps have been taken. • Current schedule suggests that implementation may be completed in 2018.

	2015	2016	2017	2018	State of play
Recommendation 3 Loss absorbing and recapitalisation capacity	• In November, the FSB published the final TLAC standards for G-SIBs. • In November, G20 Leaders endorsed the FSB standard and implementation for G-SIBs set to occur gradually between 2019 and 2028.	• In October, the BCBS released standards on the treatment of TLAC holdings in regulatory capital.	***Govt. commitment:*** *APRA to set framework in place for minimum standards based on international practice beyond 2016.*	-	**Limited domestic progress; contingent on international developments.** • No set timeframe, but progress is expected to “hasten slowly”.
Recommendation 30 Strengthening the focus on competition in the financial system	-	• In April, the ARFP comes in effect. • ***Govt. commitment:*** *Develop legislation to include competition into ASIC mandate.*	***Govt. commitment:*** *Task the Productivity Commission to review of state of competition in financial system by end-2017.*	-	**Limited progress.** • Current schedule suggests that implementation could be completed by end-2017.

Source: APRA, ASIC, Australian Government, BCBS, FSB

4 Benefits and costs of selected recommendations

Chapter 3 identified that the progress of implementation for the selected FSI recommendations is varied. Delays to or not completing implementation of the recommendations will adversely affect the ability of the financial system to realise the benefits of these reforms. In this context, we revisit the key reasons for these reforms.

4.1 Benefits and costs of Recommendation 1

The Government response noted that (Australian Government 2015a):

> *"Our banks source a considerable share of their funding offshore, reflecting Australia's position as a net importer of capital. Banks provide close to 90 per cent of the domestic credit that local firms and households receive. Our major banks have also adopted similar business models, with home mortgages accounting for around 60 to 70 per cent of their domestic lending. This creates some concentration of risk in the system.*
>
> *For these reasons, Australia's financial sector regulatory framework needs to be stronger than those of comparable economies."*

In part, setting Australian ADIs' capital levels to be unquestionably strong seeks to ensure that the Australian financial system "remains robust in the face of severe external shocks". That is, to reduce the likelihood or cost of financial crises. Financial crises can have damaging economic and social impacts. The FSI (2014) noted that:

> *"Financial crises tend to be protracted, with unemployment remaining high for years. The average total cost of a crisis is around 63 per cent of annual gross domestic product (GDP), and the cost of a severe crisis is around 158 per cent of annual GDP ($950 billion to $2.4 trillion in 2013 terms)."*

At the same time, the FSI (2014) also noted that an economy with less frequent crises is likely to be less volatile, which *"has welfare benefits and promotes long-term trust and confidence to support investment in the economy."* Less frequent crises would also reduce the perceived benefit of an implicit Government guarantee.

However, there are costs associated with increasing capital levels – it increases the cost of funds for banks, which may be passed on to consumers in the form of higher lending rates or reduced lending in the economy. The FSI (2014) noted that increasing capital requirements by one percentage point, in the absence of other changes recommended in the inquiry such as increasing competition, would lead to an increase in the average interest rate on a loan by less than 10 basis points. Consequently, the FSI refers to RBA research which suggests that this would reduce GDP by up to 0.1%. The FSI (2014) also quoted estimates from other studies – the impact on interest rates has ranged from 5 basis points to 12 basis points, and the impact on the level of GDP is between 1 and 16 basis points. The implications may be broader, for example, if it results in a shift in activity to the unregulated sector.

The FSI also expects the increased use of capital to lead to a permanent decline in the ADI's return on equity (ROE). Some investors may accept that lower ROE is offset by a reduction in risk associated with higher capital strength; on the other hand, some ADIs could seek to take on more risks to maintain investor returns.

On balance, the FSI considered stronger capital to produce a net benefit to the economy.

4.2 Benefits and costs of Recommendation 2

Narrowing mortgage risk rates seeks to support greater competitive neutrality between IRB banks and standardised banks. That is, it would aid competition in the banking sector.

APRA (2016c) provided an estimate, under various assumptions, that the current difference in mortgage risk weights between the standardised and IRB approaches *"equates to a reduction in CET1 capital requirements of approximately $19 billion (14 per cent), in aggregate, for the four major banks' current Australian residential mortgage portfolios."* This is based on an assumption that IRB banks have 25% risk weights, standardised banks have 39% risk weights, and a target CET1 capital ratio of 9%. This estimate is subject to these assumptions and could be different under different parameters, for example, it may be higher if the differential between the CET1 ratios of IRB banks and other ADIs are taken into account.

The benefit for banks of a lower average mortgage risk weight is that they would be required to use less equity, which is more expensive than debt, and means that they would have a lower average cost of funding. Based on various assumptions, APRA (2016c) estimated that the funding cost differential between IRB and standardised banks to be 11 basis points.

At the time, the FSI (2014) indicated that the required quantum of capital to increase the average mortgage risk weights of IRB banks from 18% to 25–30% would be roughly equivalent to a one percentage point increase in major banks' CET1 capital ratios.

The major banks have argued that the IRB approach recognises investments in stronger risk management, and that standardised banks should be supported to achieve IRB accreditation, rather than imposing greater imposts on the major banks (ANZ 2014, Commonwealth Bank, 2014, Westpac 2014). Westpac (2015) has indicated that an increase in IRB risk weights that is not due to an increase in risk would distort the allocation and pricing of credit and therefore affect the efficient allocation of resources in an economy.

The FSI considered the costs of narrowing risk weights to be modest, and are outweighed by the long-term competition benefits.

4.3 Benefits and costs of Recommendation 3

Similar to the discussion in Chapter 4.1, implementing a framework for an adequate loss absorbing and recapitalisation capacity has implications for the strength of the financial system, and reduces the cost of financial crises.

One of the Government's key objectives of implementing this framework is to require banks to take greater responsibility for their own resilience, thus reducing the need for taxpayer-funded bailouts. The experience of the global financial crisis, reinforced perceptions that some financial institutions were implicitly guaranteed by government, as they were deemed 'too big to fail'. As a consequence, the risk of failure (credit risk) of an ADI was implicitly transferred onto the government's balance sheet, leading to market distortions. For example, credit rating agencies factored in this implicit support through higher credit ratings for banks they perceived to benefit from being too big to fail.

The Reserve Bank of Australia (2012) found that this subsidy was worth between $1.9 billion and $3.8 billion. The research found that the size of the subsidy increased during periods of financial stress. The implicit subsidy peaked in 2009 at just over 100 basis points, compared to a 14-28 basis point advantage in 2013.

Reducing the implicit government guarantee seeks to reduce the moral hazard associated with it. The idea is that these institutions and their investors may have less incentive to manage risk. At the same time, addressing this issue assists with improving competitive neutrality by reducing the funding cost advantage for large institutions considered 'too big to fail' compared to their competitors.

On the other hand, the cost of introducing the loss-absorbing and recapitalisation capacity is that activating a bail-in could actually worsen a crisis. This could occur if activating the trigger to call in instruments leads other creditors to reassess the risk that they will take a loss, and consequently led them to withdraw funds. This would create a liquidity problem, causing distress in other banks, and potentially exacerbating a crisis. APRA (Byres 2016a) has noted that the high correlation in the banking sector amongst the four major banks suggests this effect could be amplified, creating systemic risk. This line of thinking led the FSI to recommend caution in this area.

Some major banks have argued introducing a loss absorbing and recapitalisation framework would increase the cost of funding, as the use of bail-in debt instruments would be considered higher risk for investors. Some banks suggest that changes in additional funding costs would be passed onto consumers in the form of higher lending rates. However, the FSI believed that competitive pressure should see banks share some of this cost with investors through a lower cost of equity funding.[4]

4.4 Rationale for Recommendation 30

The Government considers its measures to increase competition as a means to achieving better outcomes for consumers.

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[4] COBA (2014) has suggested another option; they propose doubling the D-SIB surcharge from 1% to 2%. Nonetheless, increasing the D-SIB surcharge could similarly have an impact on the cost of capital and, more broadly, on the economy.

The APRA Chairman, Wayne Byres, noted the benefits of improved competition (Byres 2015b):

> *"Competition delivers lower prices for, and greater choice and variety in, financial products; it encourages innovation; and it promotes efficiency in all its forms (operational, allocative and dynamic). Economics tells us that in the absence of market imperfections – obviously an important caveat – a genuinely competitive marketplace will deliver the best outcomes for consumers."*

When asked whether the banking sector is a well-functioning and competitive market, Chairman Byres (House of Representatives' Standing Committee on Economics (2016b) noted that:

> *"There is no doubt that you could have more competition. There are four banks that have a degree of market and pricing power."*

However, the state of competition is not simply measured by the level of concentration. Chairman Byres (House of Representatives' Standing Committee on Economics 2016b) acknowledged the role of other ADIs in reference to the point that some of the major banks were 'nervous' about offering a tracker mortgage product:

> *"My point was simply that in this country we have 110 APRA regulated entities making housing loans and then there are a range of other non-bank lenders making housing loans. If it were genuinely an attractive product you would have thought someone would have brought it to market…"*

The ASIC Chairman, Greg Medcraft, recognised the *"importance of competition in driving better consumer and investor outcomes in banking and financial services"* and that *"Strong competition from new entrants and incumbents encourages firms to innovate and has positive effects on both price and quality of what is delivered to the consumer and the investor"* (House of Representatives' Standing Committee on Economics 2016a). He also noted that:

- competition in the banking sector is lacking;
- the banking market is *"frankly, an oligopoly"* – a small number of firms have the large majority of market share and exercise market power; and
- competition in the banking market has declined ever since the global financial crisis, and the banking sector is more concentrated.

Furthermore, the Australian Competition and Consumer Commission (ACCC) Chairman, Rod Sims, opined that (House of Representatives' Standing Committee on Economics 2016c):

- there is a lack of robust competition in the banking market;
- banking is a cornerstone of the market economy and if competition is not strong in the financial sector, there are adverse effects for the economy; and

- the market share of the main four banks has gone up over the last 10 to 15 years and their profitability has gone up during that period.

While the FSI (2014) considered that competition was adequate at present, it also recognised that concentrated nature of the banking sector and increasing vertical integration could limit the benefit of competition in the future.

The debate around this issue is not about whether competition is beneficial, but how more competition can be achieved.

Conclusion

Overall state of play
The Government agreed to implement the FSI's Recommendations 1, 2, 3 and 30.

While there has been some progress on all four recommendations, significant work remains. Furthermore, much activity is scheduled over the next 12-24 months on Recommendations 1, 2 and 30, as industry consultation on regulatory and legislative change will be required on many of the outstanding commitments. On the other hand, the phased implementation of TLAC at the international level and absence of a set timeframe for Recommendation 30 means that the process will probably unfold on a much longer timeline. This will have implications for the realisation of benefits identified by the FSI of addressing the "too big to fail" issue.

Table 4.1: Overall state of play

	State of play
Recommendation 1 Capital levels	**Some progress, yet to be completed.** • Steps already taken which have seen an increase in the capital ratios of the Australian major banks. • Current schedule suggests that implementation may be completed in 2018.
Recommendation 2 Narrow mortgage risk weight differences	**Some progress, yet to be completed.** • Still in progress, although interim steps have been taken to narrow risk weights. • Current schedule suggests that implementation may be completed in 2018.
Recommendation 3 Loss absorbing and recapitalisation capacity	**Limited domestic progress; contingent on international developments.** • No set timeframe, but progress is expected to *"hasten slowly"*.
Recommendation 30 Strengthening the focus on competition in the financial system	**Limited progress.** • Current schedule suggests that implementation could be completed by end-2017.

Source: Deloitte Access Economics

Review of the state of competition in the financial system
While progress against the four recommendations will help rebalance the competitive dynamics in the banking sector, it may not be enough to substantially increase financial system competition.

With the PC's proposed financial system competition review expected to be completed in 2017, but with terms of reference yet to be established, we propose potential terms of reference for the inquiry, with a focus on the banking sector.

The FSI's findings provide a starting point:

- competition in Australia's financial system is generally adequate at present, but there is complacency about the level of competition that exists; and
- high concentration and increasing vertical integration within some parts of the Australian financial system have the potential to limit the benefits of competition in future.

Firstly, the review should assess the degree and dynamics of competition in the financial system, recognising that market concentration may not provide a complete picture. It will be important to consider factors such as changes in market structure, the pace of innovation and the ease of customer switching.

The review should also have regard to the competitive dynamics in different product markets (e.g. personal and business loans) and for different consumers groups (e.g. by socioeconomic background).

Secondly, the review should consider the reasons why there is not more competition in the financial system. The degree of competition could be a function of global or local economic conditions, or driven by barriers to entry such as economies of scope or scale. While the FSI began the discussion on how aspects of (prudential) regulation may be affecting competition, it also suggested that more needed to be done. The review should follow up on the FSI's recommendation that regulators examine whether their rules and procedures are creating inappropriate barriers to competition. The review should also extend examination to look more broadly at the Australian policy environment, e.g. taxation policy settings.

At the same time, the degree of competition in the financial system may be the result of a trade-off with other objectives. The IMF (2009), noted:

> *"One has to consider competition as part of a broad set of objectives, including financial sector efficiency, access to financial services for various segments of users, and systemic financial sector stability, and consider possible trade-offs among these objectives."*

Therefore, more competition could be at the expense of other objectives which also benefit the economy. Although in some instances it may not be a trade-off. Nonetheless, the starting point should be competition.[5]

Third, the review should consider practical recommendations to address any identified regulatory or policy impediments to greater competition. The review should also propose practical recommendations to support greater competition where it is warranted.

In considering 'What more needs to be done…' the review should have regard to whether these recommendations would deliver on the intended benefits of competition. The Competition Policy Review (2015), also

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[5] Moves to increase competition in the financial system must be subject to the "public interest test", as outlined in the Competition Policy Review. In other words, competition should be the preferred outcome *except* when it can be shown that competition is contrary to the public interest *and* the only way to secure the public interest is to restrict competition.

known as the Harper Review, identified six attributes of 'fit for purpose' competition policy:

- focuses on making markets work in the long-term interests of consumers;
- fosters diversity, choice and responsiveness in government services;
- encourages innovation, entrepreneurship and the entry of new players;
- promotes efficient investment in and use of infrastructure and natural resources;
- includes competition laws and regulations that are clear, predictable and reliable; and
- secures necessary standards of access and equity.

This provides useful framework for thinking about what a competitive financial system should deliver. Drawing from this, the Government's response to the Harper Review (The Australian Government the Treasury 2015b) noted the following:

> *"Competition policy is about making markets work for the long term interests of consumers. Consumers benefit when businesses compete to deliver new and better products and services at lower prices.*
>
> *Competition also drives businesses to operate efficiently, innovate and invest in new technologies, which allows Australia to better compete in international markets.*
>
> *Competition is also one of the surest ways to lift long term productivity growth, which is what will keep wages growing and improve our living standards."*

Against this background, proposed terms of reference are offered below.

Suggested terms of reference for the Productivity Commission
The PC should conduct an inquiry into the state of competition in the financial system.

In undertaking this inquiry, the PC should consider three questions:

1. **What are the competitive dynamics of the financial system?**
   Including examining trends in:
   a) industry consolidation;
   b) horizontal and vertical integration;
   c) exit of existing participants and new entrants, such as fintechs;
   d) innovation, such as digital disruption; and
   e) customer switching

2. **Why is there not more competition in the financial system?**
   Including considering:
   a) whether regulators' rules and procedures are creating inappropriate barriers to competition;
   b) whether other Government policies are creating inappropriate barriers to competition, such as taxation policy, and have

appropriate regard to other business models including the customer owned model;

c) whether other factors have affected competition, such as other non-regulatory or policy-related barriers to entry and broader economic conditions;
d) the appropriate balance/trade-offs between the objective of competition and:
   - financial system performance;
   - access to financing, including for different segments of users; and
   - systemic stability.

3. **What more needs to be done to support competition?**
   Including considering:
   a) removing barriers to competition by modifying or removing inappropriate regulatory rules and Government policies; and
   b) taking actions to support greater competition, such as:
      - considering additional support for standardised ADIs to achieve IRB accreditation, including technical assistance (see Chapter 3.1.1); and
      - requiring a competition impact statement to be undertaken as part of all regulatory impact assessments (see Chapter 2.4.1).

In considering question 3, the PC should also have in mind the impact of changes on the long-term interests of consumers, that is, consumer welfare.

The PC should draw on the experiences in overseas jurisdictions and the expertise of academics and industry and Government subject matter experts, but also consult widely and broadly, including with participants and consumers.

In summary
Significant work remains to be made in order to complete implementation of the FSI's recommendations. The completion of these reforms is expected to deliver the benefits of a more robust and competitive financial system.

In regards to the capital framework, APRA has noted that 2016 has been the year for finalising the international framework, 2017 is expected to involve significant consultation on domestic application, and 2018 will be the year for implementation. At the same time, next year will be significant for progress in implementing some of the non-capital related recommendations, particularly around strengthening the focus on competition. Therefore industry participants should look to engage with the Government and regulators over the coming year.

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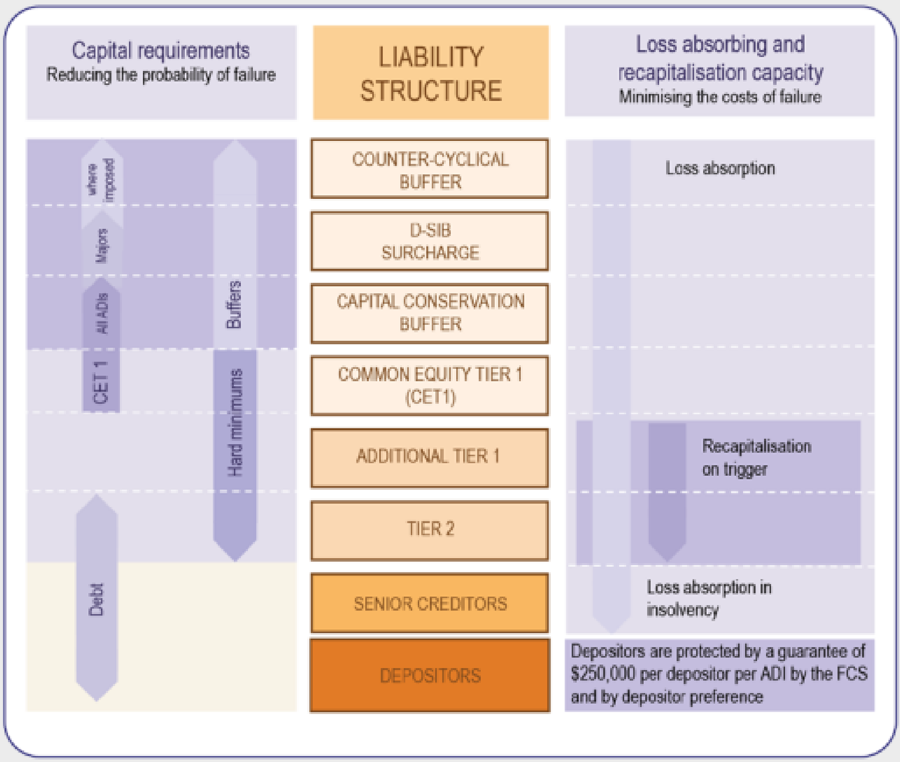
Appendix A: Forms of regulatory capital

The figure below shows the main components of an ADI's liability structure, and the relationship to capital requirements. Capital requirements comprise: (i) buffers; and (ii) hard minimums.

An ADI funds its activities using a mix of debt and equity instruments. The liability structure depicts the order in which losses are cascaded. This means that liability categories closest to the top are riskiest for investors and are the most expensive sources of funding for ADIs.

Figure A.1: ADI liability structure and prudential requirements



RWA: risk-weighted assets.
D-SIB: domestic systemically important bank.
CET1: common equity tier 1.

Source: FSI (2014)

A.2. Buffers

ADI are expected to maintain their capital levels above the levels specified by the buffers, but it can fall below this level subject to restrictions being placed on dividends and bonus payments.

Counter-cyclical buffer: is varied over time in response to market conditions. For ADIs' Australian exposures, it is currently set at a requirement to hold additional CET1 capital equal to 0% of risk-weighted assets. For ADIs' overseas exposures, the additional capital requirement is set at a weighted average of the countercyclical buffers applied by the jurisdictions in which it operates.

D-SIB surcharge: applicable to ADIs designated by APRA to be a domestic systemically important bank (D-SIB), is a requirement to hold additional CET1 capital equal to 1.0% of risk-weighted assets.

Capital conservation buffer: applicable at all times, is a requirement to hold additional CET1 capital equal to 2.5% of risk-weighted assets.

A.3. Hard minimums

ADIs much maintain their capital levels above these hard minimums. If it falls below this, the ADI would likely be declared non-viable.

Common Equity Tier 1 (CET1): comprises of tangible equity such as shareholder's common equity, retained earnings, and accumulated other comprehensive income and other disclosed reserves. This is recognised as the highest quality of capital, this because it is subordinated to all other elements of funding and it will absorb losses as and when they occur.

Additional Tier 1: refers to other forms of equity capital, such as preference shares, as well as some kinds of debt instruments with similar characteristics that can provide loss-absorption but do not satisfy all criteria as CET1.

Tier 2: includes subordinated debt that has a 'bail-in' clause, meaning it can be converted to equity or written off should a set condition be met.

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