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Briefing paper

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Review of the four major banks: what now?

Advancing consumer protection or an exercise in bank bashing? Meaningful change or more burdensome red tape? A win for consumers or a feast for consultants?

On 24 November 2016 the Standing Committee on Economics of the Parliament of Australia ("Committee") tabled its report entitled Review of the Four Major Banks ("Review").

The Government has not yet confirmed how many of the recommendations it will accept – and if accepted, how they would be implemented.

The Review was conducted against a backdrop of widespread public dissatisfaction with the major banks and several high-profile scandals, particularly in the wealth management and insurance areas. Between 4 October and 6 October 2016, each CEO of the four major banks was grilled by the Committee for three hours, with proceedings televised and streamed on the internet.

Establishing a one-stop Banking and Financial Sector Tribunal

The Committee recommended that the Government establish a Banking and Financial Sector Tribunal ("Tribunal") by 1 July 2017. The Committee believes that a Tribunal should:

- reduce confusion for consumers about where to make a complaint;
- enhance small businesses' EDR scheme coverage;
- help ensure consistent outcomes for complainants; and
- improve scheme efficiency by eliminating unnecessary duplication currently existing with three separate EDR schemes.

In addition, to address concerns raised by consumer groups, the Committee has recommended that the Tribunal should:

- be free for consumers to access;
- have equal numbers of consumer and industry representatives on its board;
- require all firms holding a relevant ASIC or APRA licence (in the case of superannuation or retirement savings account providers) to be a member;
- operate without lawyers to the extent possible;
- be directly funded by the financial services industry;
- have the power to refer potential systemic issues to ASIC for formal investigation (such as where the tribunal receives a large number of similar complaints); and
- make decisions that are binding on member institutions.

The Committee recommends that the Tribunal replace the three existing dispute resolution services: the Financial Services Ombudsman ("FOS"), the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal. The

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Committee believes that FOS is a useful precedent for the establishment of a "one stop" banking tribunal. The Review did not make firm recommendations on appropriate complaint or compensation limits.

Already the Government is distancing itself from this recommendation and its commitment to establish a banking tribunal. The Review of the financial system external disputes resolution and complaints framework ("EDR Review") interim report released on 6 December 2016 essentially rejects a statutory tribunal model in favour of a consolidation and expansion of the existing industry ombudsman framework. The EDR Review recommends the abolition of the Superannuation Complaints Tribunal in favour of a less formal superannuation ombudsman. The EDR Review's final report is due to be provided to the Government by 31 March 2016.

ASIC and FOS are also conducting a concurrent review of FOS' small business jurisdiction, and the Australian Small Business and Family Enterprise Ombudsman, Kate Carnell, is currently undertaking an inquiry into small business loans, which may also make recommendations in regards to dispute resolution and small businesses.

The Committee has further recommended that the Government implement the planned industry funding model for ASIC to ensure that that the costs of operation of the Tribunal are borne by the financial sector. On 8 November 2016, the Government announced consultation on its industry funding model for ASIC, and these consultations close on 16 December 2016.

Publicising significant breaches of AFSL

The Committee recommends that by 1 July 2017 ASIC require AFSL holders to publicly report on any significant breaches of their licence obligations within five business days of reporting the incident to ASIC or within five business days of ASIC or another regulatory body identifying the breach ("Breach Report"). Breach Reports would include:

- a description of the breach and how it occurred;
- the steps that will be taken to ensure that it does not occur again;
- the names of the senior executives responsible for the team(s) where the breach occurred; and
- the consequences for those senior executives and, if the relevant senior executives were not terminated, why termination was not pursued.

The Breach Reports would be sequentially numbered so that consumers and investors could determine how many significant breaches a licensee has had in any given year.

The Committee believes that the Breach Reports will have the following benefits:

- the risk of being publicly named will create further incentives for executives to prioritise good consumer outcomes; and
- the need for AFSL holders to publicly justify the consequences imposed on senior executives will force institutions to more comprehensively engage with questions of executive accountability on a more regular basis.

This recommendation is in reaction to the disclosures made during testimony before the Committee that no senior executives have so far been terminated in relation to a range of errors and misconduct by the major banks. The Committee views the recommended public disclosure as filling the "gap" between ASIC's power to ban individuals for unacceptable or unlawful behaviour and misconduct not rising to the level to warrant invoking ASIC's banning powers.

Periodic reporting to Treasurer on ways to improve competition in the banking sector

The Committee recommends that the ACCC, or the proposed Australian Council for Competition Policy, establish a small team to make recommendations to the Treasurer every six months to improve competition in the banking sector. If no changes are recommended, the small team would need to explain why it believes no changes to current policy are required. This recommendation arose out of the Committee's concern that there has been insufficient regulatory monitoring of competition in the banking and finance industry.

The Committee identified three primary drivers of a lack of competition:

- **The major banks have a lower cost structure than their domestic competitors.** This is because:
  - the major banks are vertically and horizontally integrated, which provides them with economies of scale and scope;
  - the market believes that the four major banks are "too big to fail." The credit rating agencies provide the major banks with a two-notch credit rating uplift due to a perceived implicit government guarantee. This effectively lowers their cost of funding relative to other ADIs (the RBA estimates this is worth as much as $3.7 billion to the major banks);
  - the major banks and Macquarie use IRB models, as opposed to standardised models, to calculate their regulatory capital requirements. In many cases IRB

models produce lower risk weighted asset values than the standardised model, allowing banks using IRB models to hold less capital against similar assets than ADIs using the standardised model. APRA required ADIs using IRB models to increase residential mortgage risk weights to an average of at least 25%. However, this is still substantially lower than the average risk weights that apply to ADIs using the standardised model. APRA calculated that the use of IRB models allows the major banks to cumulatively hold around $19 billion less capital than if they were using the standardised model.

The Committee expects that over time the major banks' cost advantages will decline due to the Government's commitment to clarify and strengthen APRA's crisis management powers, APRA's commitment to introduce a domestic loss-absorbing capacity framework and APRA's adoption of Basel Committee on Banking Supervision work on addressing the excessive variability between capital requirements for banks using IRB and standardised models.

- **High barriers to entry.** The Committee identifies these barriers to entry as:
  - ADIs need a banking license from APRA;
  - banks need to comply with APRA's prudential requirements;
  - shareholdings are limited to 15% of the ADI's voting shares;
  - major banks hold significant consumer data which allows them to accurately model risk and price; and
  - major banks have strong brands and established distributions networks that are expensive to replicate.

- **Consumer inertia**. Switching rates remain very low. Some of the reasons for this are:
  - switching costs are perceived to be high;
  - non-transparent pricing makes it difficult for consumers to compare; and
  - product bundling decreases price transparency and increases switching costs.

Empowering consumers

The Committee recommends that deposit product providers be forced to provide "open access" to customer and small business data by July 2018. The Committee believes that the data which should be available for sharing is what the banks themselves regard as customer data, including: a customer's transaction history, account balances, credit card usage and mortgage repayments.

Data sharing allows authorised entities to transfer data, with consent, between each other using secure and encrypted connections. The Committee believes that this would facilitate alternative providers to assess risk and price products based on an individual's banking data, and easier switching to alternative providers, and allow authorised third parties such as accountants, financial advisers or brokers to analyse the data to assess or formulate the most suitable product for their customers.

The Committee has recommended that ASIC should be required to develop a binding framework to facilitate this sharing of data, making use of Application Programming Interfaces ("APIs") and ensuring that appropriate privacy safeguards are in place. The Committee disagreed with the Productivity Commission's views that CSV (Comma Separated Values) files should be used, rather than the more expensive APIs.

The Committee sees the Government's role in data sharing as to set rules, templates and access requirements to ensure that data can be accessed and manipulated efficiently with adequate privacy and data protection safeguards. In the Committee's view the data sharing framework must have three key elements:

- data should be available to all licensed users;
- data should be able to be processed automatically (i.e. data should be machine readable); and
- data should be accessible at no or negligible cost on an ongoing basis.

The Committee has also recommended that each data sharing participant should be required to publish the terms and conditions for their products in a standardised machine-readable format. The Committee believes that this is necessary to "overcome the information asymmetry in the market".

The Committee proposes that penalties be enacted for non-compliance.

One of the findings of the Productivity Commission's draft report Data Availability and Use in November 2016 was that increased access to financial sector data should also intensify competition in the financial sector, with consumers having control over their data, opening up greater opportunities for price

transparency, tailored product offers and comparison of products. Similarly, the Financial System Inquiry ("FSI") found that data sharing would encourage innovative business models which create products better tailored to individual consumers.

The Committee cites actions taken by the Competition and Markets Authority ("CMA") in the UK to require banks to enable retail customers and small businesses to share their data securely with other banks and with authorised third parties using APIs by early 2018. The Committee recommends that the Australian Government adopt a similar course and have ASIC develop a data sharing framework for Australia's banking sector, incorporating appropriate privacy and confidentiality safeguards.

The final recommendation of the Committee in this area is in relation to the proposed introduction of the New Payments Platform ("NPP") in late 2017. The NPP will make it easier to switch direct debits or credits going into or out of a customer's account by tying the customer's account to an alias ID (such as the customer's phone number or email address). If the customer wishes to switch accounts he or she can change the account number attached to the alias ID. While the Committee sees the NPP as an encouraging step, it recommends that the Government consider whether additional account switching tools are required to improve competition once the NPP is operational. The Committee also notes the high cost of establishing full account portability and concludes that this cost is not justified at this stage.

Make it easier for new banking entrants

The Committee recommends that by the end of 2017:

- the Government review the 15% threshold for substantial shareholders in Authorised Deposit-taking Institutions ("ADIs") imposed by the Financial Sector (Shareholdings) Act 1998 ("FSSA") to determine if it poses an undue barrier to entry;
- the Council of Financial Regulators review the licensing requirements for ADIs to determine whether they present an undue barrier to entry and whether the adoption of a formal "two phase" licensing process for prospective applicants would improve competition; and
- APRA improve the transparency of its processes in assessing and granting a banking licence.

The Committee noted that there has been only one entity that was not associated with an existing bank that has been granted a new banking licence in Australia in the last decade, leading them to the conclusion that the start-up banking sector in Australia is effectively non-existent. The Committee cited the example of the United Kingdom, whose Prudential Regulation Authority ("PRA") reduced capital requirements for new entrants and introduced a two-phase licensing process that allows new entrants to obtain a "restricted licence", after which they have a year to raise required capital, hire staff and invest in technology systems. The PRA also established a bank start-up unit to give information and support to newly authorised banks and prospective applicants. These measures have resulted in 14 new banks being approved in the UK since 2014 and a further 20 entities in talks with PRA to obtain a banking licence.

The Committee suggested APRA adopt similar processes and that these measures would act as a supplement to ASIC's regulatory support for new entrants through the establishment of an innovation hub, and a regulatory sandbox to allow start-ups to test financial services for six months without a licence.

Mandatory independent reviews of risk management systems

The Committee recommended that the major banks be required to engage an independent third party to undertake a full review of their risk management frameworks and make recommendations aimed at improving how the banks identify and respond to misconduct. The reviews are to be completed by July 2017 and reported to ASIC, with the major banks to have implemented their recommendations by 31 December 2017.

The Committee was clearly concerned about the number of incidences of non-compliance and lack of oversight in the four major banks, and the apparent tendency to react to problems which are uncovered rather than preventing the conduct in the first place or fixing the problem in the early stages. The Committee has recommended mandatory reviews which focus on:

- the development of a proactive framework to identify and manage risks to consumers;
- the creation of an "early alert" system similar to those used in other industries to ensure that relevant executives are informed of emerging problems;
- the merits of a product recall tool that can be triggered in response to a range of fixed criteria, to supplement ASIC's proposed product intervention and banning powers; and
- the appropriateness of existing training on, and frameworks for support of, whistleblowers and whistleblower protections.

Improve internal dispute resolution schemes

The Committee has recommended that the Government amend relevant legislation to give

ASIC the power to collect data about an AFSL holder's internal dispute resolution ("IDR") schemes. This data would include:

- the number of disputes initiated;
- the number of disputes resolved;
- the number of disputes abandoned; and
- the average time taken to resolve a dispute.

This information should enable ASIC to identify institutions that may not be complying with IDR scheme requirements, ensure compliance and where necessary take enforcement action and determine whether changes are required to its existing IDR scheme requirements.

A further recommendation is that ASIC respond to all alleged breaches of IDR scheme requirements and notify complainants of any action taken, and if action was not taken, why that was appropriate. The Committee as has also recommended that ASIC review its Regulatory Guide 165 Licensing: Internal and external dispute resolution to determine whether changes, including the introduction of formal rules for matters such as scheme resourcing, are required to improve outcomes for consumers.

Transparency in wealth management

The wealth management industry has been marred by scandals over the last five years, despite additional legislative and regulatory action. The Committee has recommended further regulation which in its view would enhance transparency in the industry. These recommendations are:

- that ASIC establish an annual public reporting regime for the wealth management industry, by end 2017, to provide details on:
  - the overall quality of the financial advice industry;
  - misconduct in the provision of financial advice by AFSL holders, their representatives or employees (including their names and the names of their employer); and
  - consequences for AFSL holders' representatives being guilty of misconduct in the provision of financial advice and, where relevant, the consequences for the AFSL holder that they represent;
- that ASIC report this information on an industry and individual service provider basis; and
- whenever an AFSL holder becomes aware that a financial adviser (either employed by, or acting as a representative for that licence holder) has breached their legal obligations, that AFSL holder be required to contact each of that financial adviser's clients to advise them of the breach.

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