The Parliament of the Commonwealth of Australia

Review of the Four Major Banks (Second Report)

House of Representatives
Standing Committee on Economics

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Chair’s foreword

This Second Report into Australia’s four major banks follows the publication of the Committee’s First Report on 24 November 2016. It draws on the March 2017 public hearings held by the Committee with the Chief Executives of each of the four major banks. The March public hearings provided the Committee with an opportunity to scrutinise the banks over their response to the Recommendations of the Committee’s November Report. The Committee also scrutinised the banks on the Carnell Report’s Recommendation into the use of non-monetary default clauses in small business loans.

The Committee’s second round of hearings has confirmed that the Recommendations of the First Report should be implemented now in order to improve the Australian banking sector for the benefit of customers. The Committee reaffirms each Recommendation from the First Report. While the Committee is open to some modest variations to the Recommendations, it affirms the substance of each of them.

Recommendation 1 of the First Report proposed the establishment of a one-stop-shop where consumers can access redress when they are wronged by a bank. The Committee retains its view that one dispute resolution body should be established to provide straightforward redress for consumers. It is highly preferable to have one body dealing with these matters rather than two or more. The Committee believes that the Ramsay review should determine the precise administrative structure of this body – the key point is that it should be a one-stop-shop.

Recommendation 2 of the First Report calls for a new public reporting regime to be put in place to hold senior bank executives much more accountable. This Recommendation is essential to achieving a change in bank culture. It will place relentless pressure on CEO-reporting executives to focus on the treatment of customers. While all of the banks except ANZ oppose this Recommendation, in the Committee's view it will have a very substantial impact on the behaviour of banks, to the benefit of consumers. It should be implemented.

Recommendation 3 of the First Report proposed that a regulatory team be established to make recommendations on improving competition in the banking sector to the Treasurer every six months. The ANZ agreed with Recommendation 3 noting that 'analysis from a government agency would help demonstrate the nature and level of competition.' The other banks oppose this Recommendation, for reasons that the Committee does not find persuasive. This team should be put in place to fill a substantial gap in Australia's regulatory framework today: we do not currently have a permanent team focused on systemic competition issues in banking, and we should.

Recommendations 4 and 5 of the First Report seek to empower consumers. In particular, Recommendation 4 proposes that Deposit Product Providers be forced to provide open access to customer and small business data by July 2018. All four banks noted general support for data sharing. However, the banks are conflicted on this issue, as the process of opening up data means that an asset which is currently proprietary to the banks will be non-proprietary in the future. For this reason, it is critical that the banks are not allowed to control the process or set the rules by which consumer data is opened up. An independent body must lead the change and be responsible for implementation.

Recommendation 7 of the First Report proposes that there be an independent review of risk management frameworks aimed at improving how the banks identify and respond to misconduct. Each of the banks has responded claiming that APRA Prudential Standard CPS 220 performs this function. The Committee is not convinced that the CPS 220 risk management review process is sufficient in relation to misconduct. CPS 220 has a broad focus on the material risks to a bank. While these objectives are important for prudential reasons the Committee's focus in this Recommendation is the ongoing and serious nature of misconduct by the banks towards their customers. The Committee's Recommendation will ensure that the banks give top priority to developing a risk management framework that truly puts customers first. This risk management review should work in parallel to CPS 220.

As part of the hearings in March 2017, the Committee scrutinised the banks over their use of non-monetary default clauses in small business loans. This matter was examined by the Australian Small Business and Family Enterprise Ombudsman, Ms Kate Carnell, as part of her inquiry into small business loans. Ms Carnell recommended that for all loans below $5 million, where a small business has complied with loan payment requirements and has acted lawfully, the bank must not default a loan for any reason. The Committee commends Ms Carnell on her important work on this issue and has recommended that non-monetary default clauses be abolished for loans to small business.

The Committee's First Report makes several Recommendations that will materially improve the banking system for Australian consumers. The March hearings have confirmed the Committee's initial view that these Recommendations should be acted on. The Committee looks forward to the Government's response.

David Coleman MP
Chair

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Membership of the Committee

Chair	Mr David Coleman MP
Deputy Chair	The Hon Matt Thistlethwaite MP
Members	Mr Adam Bandt MP
	Ms Julia Banks MP
	Mr Scott Buchholz MP
	Mr Trevor Evans MP
	Mr Kevin Hogan MP
	Mr Craig Kelly MP
	Mr Matt Keogh MP
	Ms Madeleine King MP

Committee Secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Dr John White (from 20 March 2017)
	Ms Samantha Mannette (until 17 March 2017)
Technical Advisor	Ms Joanna Chang
Research Officer	Ms Marina Katic
Administrative Officer	Ms Jazmine Rakic

Terms of reference

On 15 September 2016, the Treasurer requested that the House of Representative's Standing Committee on Economics undertake – as a permanent part of the committee's business – an inquiry into:

- the performance and strength of Australia's banking and financial system;
- how broader economic, financial, and regulatory developments are affecting that system; and
- how the major banks balance the needs of borrowers, savers, shareholders, and the wider community.

In undertaking its inquiry, the committee was asked to hold at least annual public hearings with the four major banks, with a particular focus on the banks' perspectives on:

- domestic and international financial market developments as they relate to the Australian banking sector and how these are affecting Australia;
- developments in the prudential regulation, including capital requirements, and how these are affecting the policies of Australian banks;
- the costs of funds, impacts on margins and the basis for bank pricing decisions; and
- how individual banks and the banking industry as a whole are responding to issues previously raised in Parliamentary and other inquiries, including through the Australian Bankers' Association's April 2016 six point plan to enhance consumer protections and in response to Government reforms and actions by regulators.

The committee was also asked to, as appropriate, engage with Australia's key economic regulators and give due consideration to the Government's Financial System Program and other relevant financial sector reforms and reviews.

Abbreviations

ABA	Australian Bankers' Association
ACCC	Australian Competition and Consumer Commission
ACCP	Australian Council for Competition Policy (proposed)
ADI	Authorised Deposit-taking Institution
AFSL	Australian Financial Services License
ANZ	Australian and New Zealand Banking Group
API	Application Programming Interface
APRA	Australian Prudential Regulation Authority
BSB number	Bank-State-Branch number
CBA	Commonwealth Bank of Australia
CEO	Chief Executive Officer
CMA	Competition and Markets Authority (UK)
CIO	Credit and Investments Ombudsman
EDR	External Dispute Resolution
FCA	Financial Conduct Authority (UK)
FOFA	Future of Financial Advice
FOS	Financial Ombudsman Service

FSI	Financial System Inquiry
FSSA	*Financial Sector (Shareholdings) Act 1998*
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IDR	Internal Dispute Resolution
IRB model	Internal Ratings Based model
NAB	National Australia Bank
NPP	New Payments Platform
ODI	Open Data Institute
PRA	Prudential Regulation Authority (UK)
RBA	Reserve Bank of Australia
SCT	Superannuation Complaints Tribunal
SMR	Senior Managers Regime (UK)
SVR	Standard Variable Rate
TBTF	Too-big-to-fail
UK	United Kingdom

Recommendations

Recommendation 1

The second round of hearings with the banks focused on the Recommendations of the first report which was presented in November 2016. The committee affirms its support for all ten Recommendations of the first report.

In the committee's view each of these Recommendations should be implemented. The committee is open to some modest variations to the first report Recommendations but affirms the substance of each of them.

Recommendation 2

The committee recommends that non-monetary default clauses be abolished for loans to small business.

If the banks do not voluntarily make this change by 1 July 2017 then the government should act to give effect to this Recommendation.

1

Introduction

Background

1.1 On 4 August 2016 the Prime Minister and the Treasurer, in a joint statement, announced that the House Economics Committee (the committee) would conduct ongoing scrutiny and review of the four major banks for the life of the 45th Parliament.

1.2 The inquiry is one of the most important reviews undertaken by the committee. The four major banks have been involved in an unacceptably high number of failures in their treatment of customers.

1.3 At the same time, consumers are rightly sceptical of the level of competition in the market, and the adequacy of executive accountability.

1.4 The committee conducted its first round of public hearings with the four major banks in October 2016. In November 2016 the committee released its first report designed to improve the banking system for Australian consumers.

1.5 The second round of public hearings was conducted in March 2017.

1.6 This report focuses on the banks' responses during the hearings to the committee's first report, and reaffirms the committee's support for its original recommendations.

Conduct of the inquiry

1.7 The committee held three-hour public hearings with each of the major banks on 3, 7 and 8 March 2017.

1.8 The proceedings of the hearings were webcast over the internet, through the Parliament's website, allowing interested parties to view or listen to the proceedings as they occurred. The transcripts of each of the public hearings are available on the committee's website.

1.9 Following these hearings, the committee sent letters to each of the major banks' Chief Executive Officers (CEOs) seeking responses to questions on notice as well as a range of additional information on specific issues of concern to the committee

1.10 The banks' responses to these additional requests, excluding information that was reported to be commercial in confidence, are available on the committee's website.

Reader guide and structure of the report

1.11 The March 2017 public hearings provided the committee with an opportunity to scrutinise the banks over their response to the committee recommendations and the recommendations of the Carnell Report into banking practices. In line with this, Chapter 2 lists each of the committee's recommendations detailed in the first report. It details the response of the banks to these recommendations and the committee's view on their responses.

1.12 Chapter 3 deals with non-monetary default clauses in small business loans. As part of the hearings in March 2017, the committee scrutinised the banks over their use of non-monetary default clauses in small business loans. This matter was examined by the Australian Small Business and Family Enterprise Ombudsman, Ms Kate Carnell, as part of her inquiry into small business loans.

1.13 Appendices 1 to 8 reproduce in full the Recommendations and discussion in the committee's first report. This provides readers with a readily accessible list and discussion of the committee's original Recommendations.

2

Committee Recommendations to Improve the Banking System

Introduction

2.1 The committee in its first report made ten Recommendations to reform the banking sector. Each of the banks provided a response to the committee's Recommendations and they were scrutinised at the public hearings.

2.2 This chapter reviews the committee's original Recommendations in light of the responses of the banks and other information. This examination has confirmed that the Recommendations should stand and be implemented now in order to improve the Australian banking sector for the benefit of customers. The committee is open to some modest variations to the first report Recommendations but affirms the substance of each of them.

Recommendation 1

The second round of hearings with the banks focused on the Recommendations of the first report which was presented in November 2016. The committee affirms its support for all ten Recommendations of the first report.

In the committee's view each of these Recommendations should be implemented. The committee is open to some modest variations to the first report Recommendations but affirms the substance of each of them.

First Report Recommendation 1: Establish a Banking Tribunal

2.3 Recommendation 1 states:

> **The committee recommends that the Government amend or introduce legislation, if required, to establish a Banking and Financial Sector Tribunal by 1 July 2017. This Tribunal should replace the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.**[1]

2.4 The reasoning and argument supporting Recommendation 1 are reproduced at Appendix 1.

Discussion

2.5 The committee is strongly of the view that consumers should be able to access a one-stop-shop for external dispute resolution with banks.

2.6 Consumers need external dispute resolution (EDR) schemes that are simple to access and are not overly legalistic. In the previous report the committee recommended that one dispute resolution body be established with the following features list below. It 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/retirement savings account providers) to be a member;
- operate without lawyers (to the extent possible);
- be funded directly by the financial services industry;[2]
- have the power to refer potential systemic issues to ASIC for formal investigation. For example, this could occur when the tribunal receives a large number of similar complaints over a year; and
- make decisions that are binding on member institutions.

2.7 In December 2016, the review of the financial system external dispute resolution scheme (Ramsay Review or Ramsay) released its interim

1 House Economics Committee: *Review of the Four Major Banks: First Report*, November 2016, p. 5.

2 If direct industry funding is not possible, the government should recover any appropriated amounts from the financial services industry. Under such a model, appropriations to the body should respond to the number of cases that the tribunal handles each year.

report.[3] The Ramsay Review Interim Report draft Recommendation proposed the creation of a single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes).[4]

2.8 Ramsay proposed the establishment of a new industry ombudsman scheme for superannuation disputes. Ramsay noted that consideration was given to moving to a single dispute resolution scheme handling all financial system including superannuation disputes.

2.9 On balance Ramsay believed that initially it would be preferable to begin with a separate superannuation ombudsman scheme but with the future aim of combining the superannuation scheme with the financial, credit and investment dispute scheme.[5]

2.10 The committee repeats its previous conclusions that the scope of the existing schemes is inadequate. The Financial Ombudsman Service and the Credit and Investments Ombudsman can only consider complaints where the damages are alleged to be $500,000 or lower. This is a demonstrably inadequate amount given numerous instances where people are alleged to have lost millions as a consequence of poor financial advice.

2.11 In relation to this point, the committee notes that Ramsay considers that 'monetary limits and compensation caps should be higher than the current monetary limits and compensation caps of FOS and CIO.'[6]

2.12 The committee retains its view that a one-stop-shop should be established to provide straightforward redress for consumers. In the committee's view it is highly preferable to have one body dealing with these matters rather than two or more.

2.13 The committee believes that the Ramsay review should determine the precise administrative structure of this body – the key point is that it should be a one-stop-shop. It is critical that one easy to access body be established to give consumers genuine access to justice when they are wronged by a bank.

3 Review of the financial system external dispute resolution and complaints framework, *Interim Report*, 6 December 2016.

4 Ramsey Review, *Interim Report*, p. 17.

5 Ramsey Review, *Interim Report*, p. 20.

6 Ramsey Review, *Interim Report*, p. 18.

First Report Recommendation 2: Make Executives Accountable

2.14 Recommendation 2 states:

> **The committee recommends that by 1 July 2017, the Australian Securities and Investments Commission (ASIC) require Australian Financial Services License 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.**
>
> **This report should 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.**

2.15 The reasoning and argument supporting Recommendation 2 are reproduced at Appendix 2.

2.16 The committee is not concerned if the government, in implementing the Recommendation, extends the reporting period.

Discussion

2.17 This Recommendation is essential to achieving a change in bank culture. Senior bank executives must take responsibility for failures in their divisions. This does not occur now.

2.18 The NAB, CBA and Westpac indicated that the five business day reporting timeframe was too short and that natural justice could be compromised if an investigation is rushed.

2.19 It is important to note that the Recommendation is that the public report should be made within five days of the breach being reported to ASIC – not that it be made within five days of the breach occurring.

2.20 Nevertheless, the committee is prepared to accept more time may be appropriate in certain circumstances.

2.21 NAB, CBA and Westpac, under scrutiny, would not agree to this Recommendation.

2.22 The CBA stated that 'we believe it could be a breach of natural justice to 'name and shame' individuals before taking adequate time to properly investigate the alleged breaches.'[7]

2.23 As an alternative to reporting of specific breaches, Westpac noted that 'we report the outcomes for our group executives at the end of the year in a fairly fulsome disclosure in our annual report every year.'[8]

2.24 The NAB stated that 'public reporting may also act as a disincentive to report breaches unless strictly required, or may require a 'legalistic' view on what is reported.'[9] This argument reflects poorly on NAB as it appears to suggest that the bank believes that its staff may not follow legally binding rules.

2.25 In contrast, the ANZ noted that it largely supported the Recommendation and stated:

> AFSL holders could feasibly issue a public report that includes a description of the breach and how it occurred, the steps taken to ensure it does not reoccur and the senior executive responsible for the relevant business. Because the report would be issued soon after the breach report, it would, like those reports, be based on preliminary rather than conclusive findings.[10]

2.26 The ANZ noted that Section 912D of the *Corporations Act 2001* (the Act) is not crafted as a trigger for individual culpability. Instead, the ANZ proposed the possibility of inserting a new accountability provision into the Act which 'could recognise the circumstances in which individual executives should suffer personal consequences for serious failures of the AFSL holder to comply with the law.'[11]

2.27 The ANZ demonstrated a more constructive attitude in relation to Recommendation 2. In addition to the CEO, ANZ was represented at the hearing by Ms Alexis George, Group Executive for Wealth Australia, ANZ. Wealth management arms of the banks are where recent significant breaches occurred.

2.28 Ms George was asked specifically how she would react to the possibility of being named in a breach report. Ms George, to her credit, stated:

> We have obviously discussed this recommendation, and I am sure it is not something my children would be proud of to have me named and shamed, but I think it is appropriate that this be at the

7 CBA, Correspondence, 2 March 2017.

8 Mr Brian Hartzer, CEO, Westpac, *Transcript*, 7 March 2017, p. 4.

9 NAB, Correspondence, 1 March 2017.

10 ANZ, Correspondence, 6 March 2017.

11 ANZ, Correspondence, 6 March 2017.

> executive level, and I understand why the committee is asking for this. At the management level of shame, we all understand that we need to rebuild trust in the community, and, as a result, as a senior executive responsible for wealth, I am happy to take that.[12]

2.29 Recommendation 2 proposes an effective measure to introduce real executive accountability in the banks. Importantly, the Recommendation would apply to CEO-reporting executives, who have the greatest capacity to change bank culture.

2.30 The committee affirms Recommendation 2.

First Report Recommendation 3: Require New Focus on Banking Competition

2.31 Recommendation 3 states:

> **The committee recommends that the Australian Competition and Consumer Commission, 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 the relevant body does not have any recommendations in a given period, it should explain why it believes that no changes to current policy settings are required.**

2.32 The reasoning and argument supporting Recommendation 3 are reproduced at Appendix 3.

Discussion

2.33 The NAB, CBA and Westpac all noted that they support measures that encourage competition. However, they stopped short of supporting this Recommendation because Recommendation 30 of the Financial Services Inquiry (FSI) proposed that competition in the financial sector be reviewed every three years.[13]

2.34 FSI Recommendation 30 stated:

> 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

12 Ms Alexis George, Group Executive, Wealth, ANZ, *Transcript*, 7 March 2017, p. 73.

13 Financial System Inquiry, *Final Report*, November 2014, p. xxvi.

> financial services and include consideration of competition in ASIC's mandate.[14]

2.35 The Government agreed with this Recommendation and proposed that:

> 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.[15]

2.36 In the first report the committee noted and endorsed the work of the Productivity Commission (PC) in periodically reviewing financial sector competition. However, the committee noted that it does not believe that structural reviews undertaken 'as appropriate' go far enough. The committee reaffirms this conclusion.

2.37 It is essential that the ACCC establish a small team dedicated to continual monitoring of competition in the banking sector and reporting to the Treasurer every six months.

2.38 The ANZ agreed with Recommendation 3 noting that 'analysis from a government agency would help demonstrate the nature and level of competition.'[16]

2.39 It is highly regrettable that the other banks do not support this Recommendation, given that they argue that competition in the sector is essentially perfect now. The intention of the Recommendations is to ensure competitive issues in the industry are thoroughly scrutinised and this should be welcomed by the banks.

2.40 The committee affirms Recommendation 3 and believes it should be implemented for the reasons outlined in the first report.

First Report Recommendations 4 and 5: Empower Consumers

2.41 Recommendation 4 states:

> **The committee recommends that Deposit Product Providers be forced to provide open access to customer and small business**

14 Financial System Inquiry, *Final Report*, November 2014, p. xxvi.

15 Improving Australia's Financial System, *Government Response to the Financial System Inquiry*, 20 October 2015, p, 24.

16 ANZ, Correspondence, 6 March 2017.

data by July 2018. 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 safe guards are in place. Entities should also be required to publish the terms and conditions for each of their products in a standardised machine-readable format.

The Government should also amend the *Corporations Act 2001* to introduce penalties for non-compliance.

2.42 The reasoning and argument supporting Recommendations 4 and 5 are reproduced at Appendix 4.

Discussion

2.43 All four banks expressed general support for data sharing. However, the committee tested them on how strongly they supported this Recommendation taking into account the fact that customer data is currently a proprietary asset. This creates a conflict as the process of opening up data will lead to the asset being shared with other financial services companies.

2.44 This is why an independent regulator must lead the change and be responsible for implementation. The process of introducing data sharing cannot be left to the banks to lead.

2.45 During the hearings, all banks warned that it was essential to ensure that consumer data was protected and that the privacy of individuals was paramount. Westpac noted that 'a significant data breach under any open data regime could result in large scale identify theft and the loss of trust in payment system integrity.'[17]

2.46 The CBA stated:

> To be clear on this, we will support any solution if, ultimately, we can be very clear who is specifically accountable for privacy and security. That will need to be clear. We want to take that accountability and, if somebody else is going to take it, be accountable for that so we know where to address concerns if there are problems with this. We are open to that solution.[18]

2.47 Privacy and security of consumer data is a priority for the committee. That is why Recommendation 4 states that 'ASIC should be required to develop a binding framework to facilitate this sharing of data, making use of

17 Westpac, Correspondence, 7 March 2017.

18 Mr Ian Narev, CEO, CBA, *Transcript*, 7 March 2017, p. 8.

Application Programming Interfaces (APIs) and ensuring that appropriate privacy safe guards are in place.'

2.48 The committee affirms Recommendation 4 and emphasises that ASIC or another independent regulatory body must lead the change process. The banks are conflicted in this process and must not be allowed to lead it.

2.49 Recommendation 5 states:

> **The committee recommends that the Government, following the introduction of the New Payments Platform, consider whether additional account switching tools are required to improve competition in the banking sector.**

2.50 All banks indicated that they were supportive of account switching tools to improve competition. The banks noted that on 9 March 2017 the ABA was holding a switching summit with consumer groups, government representatives and the credit card schemes. The ABA stated:

> …at the last hearings of this committee there was a lot of discussion about the ability of customers to move between banks—to switch banks. As a direct consequence of that, tomorrow we have a full-day round table with the industry, consumer groups, community organisations, the regulators, government departments, the credit card schemes and other participants to drill down and understand what the problems are that customers have in switching banks. So, that is a direct link to the October hearings, yes.[19]

2.51 The committee affirms Recommendation 5.

First Report Recommendation 6: Make it Easier for New Banking Entrants

2.52 Recommendation 6 states:

> **The committee recommends that by the end of 2017:**
>
> - **the Government review the 15 per cent threshold for substantial shareholders in Authorised Deposit-taking Institutions (ADIs) imposed by the *Financial Sector (Shareholdings) Act 1998* 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**

19 Mr Steven Münchenberg, CEO, ABA, *Transcript*, 8 March 2017, p. 48.

'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.**

2.53 The reasoning and argument supporting Recommendation 6 are reproduced at Appendix 5.

2.54 All banks broadly supported this Recommendation noting that ultimately this is a decision for government.

2.55 The committee affirms Recommendation 6.

First Report Recommendation 7: Force Independent Reviews of Risk Management Systems

2.56 Recommendation 7 states:

> **The committee recommends 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. These reviews should be completed by July 2017 and reported to ASIC, with the major banks to have implemented their recommendations by 31 December 2017.**

2.57 The reasoning and argument supporting Recommendation 7 are reproduced at Appendix 6.

Discussion

2.58 The committee drafted this Recommendation with a focus on achieving better outcomes for customers by ensuring that banks regularly review their risk management frameworks so as to better identify and respond to misconduct.

2.59 Each of the banks has responded claiming that APRA Prudential Standard CPS 220 performs this function. The background to CPS 220 is outlined below:

- CPS 220 is a cross industry standard intended to cover the material risks as identified by the entity's Board.
- CPS 220 commenced in January 2015 and entities (including ADIs) are currently in the process of completing the triennial risk reviews required under the standard.
- It is a risk management framework approach intended to cover the whole of the entity's operations.

- From a prudential perspective, CPS 220 is complemented by governance standards, including Fit and Proper requirements for senior management.

2.60 The ANZ stated:

> APRA Prudential Standard CPS 220 requires banks to have at least annual reviews of risk management frameworks by internal and or external audit. The standard also requires a comprehensive independent review of risk management frameworks at least every three years. We believe the current prudential requirement is significant and should remain. A further independent review would duplicate this existing regulatory requirement.[20]

2.61 The NAB commented that the 'Government could achieve the substance of Recommendation 7 by asking the banks to provide the conduct risk sections of these CPS 220 reviews to APRA.'[21]

2.62 The committee does not agree that the CPS 220 risk management review process is sufficient in relation to misconduct. CPS 220 has a broad focus on the material risks to a bank. While these objectives are important for prudential reasons the committee's focus in this Recommendation is the ongoing and serious nature of misconduct by the banks towards their customers.

2.63 The committee's Recommendation will ensure that the banks give top priority to developing a risk management framework that truly puts customers first. This risk management review should work in parallel to CPS 220.

2.64 In the March hearings numerous recent reports of unacceptable conduct by the banks were raised by committee members. For example, in February 2017 ASIC reported that NAB had been forced to pay $35 million in compensation after overcharging 220,000 superannuation accounts.

2.65 On 17 December 2016 it was reported that the NAB mistakenly sent information such as names, addresses and banking details of 60,000 migrant banking customers to a wrong email account.

2.66 On 6 December 2016 it was reported that the CBA provided a further $5 million in compensation to victims of poor financial advice, as a forensic review of the redress scheme found instances where the bank's Financial Planning and Financial Wisdom businesses failed to act within required timeframes. On 7 February 2017 CBA announced that all file

20 ANZ, Correspondence, 6 March 2017.

21 NAB, Correspondence, 1 March 2017.

assessments had been completed and $23 million would be offered in compensation to victims of poor financial advice.

2.67 In relation to ANZ it was reported in December that close to $50 million had been charged to clients in the wealth management division for services that were not in fact received.

2.68 In relation to Westpac it was noted during the hearing that:

> …in September you were refunding over 800,000 clients about $20 million for inappropriate fees on credit cards pertaining to foreign exchange fees. In October you acknowledge that your division had a 37 per cent rejection rate on claims in the total and permanent disability category of life insurance, which was the highest of any insurers investigated by ASIC. In November you had one of your financial planners, Anthony Bishop, banned for eight years for giving inappropriate advice to your clients between 2010 and 2014. In December ASIC said it was taking legal action against you for providing inappropriate advice in the process of selling products in your wealth management division, through BT in particular. In February ASIC alleged that you were providing loans to borrowers without actually checking adequately whether they could pay back those loans, and ASIC is now pursuing legal action against you in relation to that. In addition to that, later this year ASIC will be pursuing action against you in relation to the alleged rigging of the bank bill swap rate. So it is quite a significant list of allegations…[22]

2.69 The committee affirms Recommendation 7 and believes that an independent review of banks' risk management frameworks aimed at improving how the banks identify and respond to misconduct is essential. The risks that can damage customers must be identified and reduced.

2.70 The committee therefore affirms Recommendation 7.

First Report Recommendation 8: Improve Internal Dispute Resolution Schemes

2.71 Recommendation 8 states:

> **The committee recommends that the Government amend relevant legislation to give the Australian Securities and Investments Commission (ASIC) the power to collect recurring data about Australian Financial Services licensees' Internal Dispute Resolution (IDR) schemes to:**

22 Mr David Coleman, Chair, *Transcript*, 8 March 2017, p. 2.

- **enable ASIC to identify institutions that may not be complying with IDR scheme requirements and take action where appropriate; and**
- **enable ASIC to determine whether changes are required to its existing IDR scheme requirements.**

The committee further recommends 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.

2.72 The reasoning and argument supporting Recommendation 8 are reproduced at Appendix 7.

Discussion

2.73 All banks agree with this Recommendation. The NAB noted that it currently provides similar information on its IDR activity for Code of Banking Practice related disputes to the Code Compliance Monitoring Committee (CCMC). NAB commented that 'the design of further reporting obligations should take into account, and seek to utilise where possible, the existing reporting to the CCMC.'[23]

2.74 Westpac noted that it did not believe that legislative amendment was required to implement the Recommendation as ASIC already has the power to collect data on IDR arrangements and take action where an institution is not complying with ASIC's requirements.[24]

2.75 The committee affirms Recommendation 8.

First Report Recommendations 9 and 10: Boost Transparency in Wealth Management

2.76 Recommendation 9 states:

The committee recommends that the Australian Securities and Investments Commission (ASIC) establish an annual public reporting regime for the wealth management industry, by end-2017, to provide detail on:

- **the overall quality of the financial advice industry;**
- **misconduct in the provision of financial advice by Australian Financial Services Licence (AFSL) holders, their**

23 NAB, Correspondence, 1 March 2017.

24 Westpac, Correspondence, 7 March 2017.

representatives, or employees (including their names and the names of their employer); and

- **consequences for AFSL holders' representatives guilty of misconduct in the provision of financial advice and, where relevant, the consequences for the AFSL holder that they represent.**

The committee further recommends that ASIC report this information on an industry and individual service provider basis.

2.77 The reasoning and argument supporting Recommendations 9 and 10 are reproduced at Appendix 8.

Discussion

2.78 The ANZ, CBA and Westpac all indicated that they support this Recommendation. The ANZ commented that 'we support measures like this which help consumers regain trust in the wealth management industry.'[25]

2.79 The CBA noted that 'we already advise clients of an advisor under certain circumstances.' The CBA cautioned that 'we believe that reporting on minor breaches could cause confusion and negatively impact confidence in the system.'[26]

2.80 Westpac commented that 'a report on the wealth management industry, which presents reliable and comparable information based on standardised reporting templates and definitions, will improve transparency on any issues in the sector and enable comparison between participants.'[27]

2.81 In contrast, the NAB did not support the reporting regime as proposed by this Recommendation stating:

> Extending a report beyond settled prosecutions is procedurally unfair if cases are still being heard or considered by regulators. NAB believes that qualitative terms such as 'quality of advice' and 'misconduct' are not sufficiently defined metrics for the regulator to report on.
>
> As an alternative, NAB suggests an annual report on AFSL data such as complaints, levels of compensation, EDR statistics and the number of banned or formally sanctioned advisers.[28]

25 ANZ, Correspondence, 6 March 2017.

26 CBA, Correspondence, 2 March 2017.

27 Westpac, Correspondence, 7 March 2017.

28 NAB, Correspondence, 1 March 2017.

2.82 The committee rejects NAB's position.

2.83 In the best cases, poor financial advice leaves Australians' investments and retirement savings facing elevated levels of risk. In the worst cases, Australians have had their savings wiped out or incurred large debts.

2.84 In the first report the committee noted that poor financial advice has resulted in the CBA and NAB alone paying out approximately $85 million in compensation since 2009. Wealth management divisions of banks have been involved in misconduct far too often.

2.85 The committee affirms Recommendation 9.

2.86 Recommendation 10 states:

> **The committee recommends that, whenever an Australian Financial Services Licence (AFSL) holder becomes aware that a financial advisor (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 advisor's clients to advise them of the breach.**

2.87 All banks broadly support this Recommendation but noted that some lower level breaches may not warrant reporting. The ANZ advised that it has already put in place a process to write to an advisor's former clients if they are banned by ASIC but cautioned that:

> Our only concern with the recommendation is that some legal breaches are minor and/or inadvertent. These wouldn't need to be reported to ASIC as they are not 'significant'. We think there should be a sensible threshold before licence holders need to contact clients. This is primarily to avoid unnecessary alarm.[29]

2.88 Similarly, Westpac commented that:

> In implementing this recommendation, it would be important to set an appropriate materiality threshold that would trigger a requirement for notification to the client. We do not believe that clients would wish to be notified of administrative breaches that do not adversely impact on the quality of advice they received.[30]

2.89 Similarly, the CBA did 'not support the process for minor breaches, which could cause confusion and further impact confidence in the system.'[31]

2.90 NAB noted that it supports a requirement for licensees to take appropriate steps to contact all clients where an advisor has been banned by ASIC. However, NAB stated that 'deciding on whether to contact all clients

29 ANZ, Correspondence, 6 March 2017.

30 Westpac, Correspondence, 7 March 2017.

31 CBA, Correspondence, 2 March 2017.

should be assessed on a case by case basis, applying standard remediation protocols and ASIC regulatory guidance.'[32]

2.91 The committee is not persuaded by these arguments and similar points were dealt with in the first report. The committee concluded that irrespective of whether a customer has suffered financial harm they have a right to know if they have been advised by someone that has been found guilty of misconduct.

2.92 The committee affirms Recommendation 10.

32 NAB, Correspondence, 1 March 2017.

3

Carnell Inquiry: Non-monetary default

Recommendation 2

The committee recommends that non-monetary default clauses be abolished for loans to small business.

If the banks do not voluntarily make this change by 1 July 2017 then the government should act to give effect to this Recommendation.

Background

3.1 In December 2016 the Australian Small Business and Family Enterprise Ombudsman (ASBFEO or Ombudsman), Ms Kate Carnell, AO, released her report on the inquiry into small business loans (the Carnell Report).[1] Ms Carnell was tasked with inquiring into the adequacy of the law and practice governing financial lending to small businesses.

3.2 The Ombudsman found almost complete asymmetry of power in the relationship between banks and small business borrowers. She noted that this manifests itself in:

- extremely complex, one-sided contracts that yield maximum power to banks to make unilateral changes whenever they like and without the agreement of borrowers;
- inadequate timeframes around key loan milestones that leave borrowers vulnerable;

1 Australian Small Business and Family Enterprise Ombudsman, *Inquiry into small business loans*, 12 December 2016.

- misleading and conflicting signals between bank sales staff and credit risk staff which leaves borrowers vulnerable;
- lack of transparency and potential conflict of interest in dealings with third parties involved in impaired loan processes, such as valuers, investigative accountants and receivers; and
- significant gaps in access to justice with nowhere to go except the court system, with borrowers having limited resources and banks having overwhelming resources.[2]

3.3 To address these issues, the Ombudsman made 15 Recommendations. The response to these Recommendations is a matter for government.

3.4 Prior to the hearings, the committee wrote to each of the banks asking for them to respond to the Ombudsman's Recommendations.

3.5 The committee was particularly interested in examining the use of non-monetary default clauses, as these have been raised in previous inquiries and are a cause of great community concern.

Non-monetary default

3.6 Recommendation 3 of the Carnell Report states:

> **For all loans below $5 million, where a small business has complied with loan payment requirements and has acted lawfully, the bank must not default a loan for any reason. Any conditions must be removed where banks can unilaterally:**
>
> - **value existing security assets during the life of the loan**
> - **invoke financial covenants or catch-all 'material adverse change' clauses.**
>
> **Implementation by 1 July 2017.**

3.7 The reasoning and argument supporting Recommendation 3 can be found in the Carnell Report at: http://www.asbfeo.gov.au/sites/default/files/Master_Final.pdf

Discussion

3.8 The Carnell Report noted that 'non-monetary default clauses and covenants in loans contracts allow banks to trigger the default of a business loan where risk factors may have changed, even when the

2 ASBFEO, *Inquiry into small business loans*, 12 December 2016, p. 6.

borrower has continued to meet their regular payments against the loan.'[3] The Carnell Report stated:

> Non-monetary default clauses and covenants in loans contracts allow banks to trigger the default of a business loan where risk factors may have changed, even when the borrower has continued to meet their regular payments against the loan.[4]

3.9 Non-monetary default clauses offend basic principles of fairness. If a small business has done the right thing and made all payments to their bank on time and in full, why should the bank be allowed to default that borrower? This is the question that is at the centre of the Carnell Inquiry Recommendation.

3.10 The NAB advised that it needs to be simpler for customers to understand their loan contracts, and non-monetary covenants are used to assist customers facing financial distress.[5] The NAB argued that without the covenants risk would increase and the price of loans would reflect this. The NAB stated:

> But the main point here is that if we do not have the right to engage with the client and we do not have the right to have it as a serious covenant, it will affect two things: firstly, our ability to lend to the client and clients in aggregate—so not just that client but all small business clients; and secondly, the price for our small business client—the 5.59 [per cent]that I mentioned to Mr Kelly—is going to be higher because our risk has gone up. I understand your concern. We have to work through this because, as a banker, it would increase our risk dramatically if that was to be taken away and that is really all we are saying. We have to work through it.[6]

3.11 In relation to the $5 million limit the banks argued that this threshold was too high. The Carnell Report noted that banks claim that more than 98 per cent of lending to small business customers is under $5 million.

3.12 The ANZ stated:

> We do not agree that all businesses with an individual loan below $5 million would be small businesses. We are of the view that these reforms should apply to business groups with total business lending (sometimes referred to as total credit exposure) of up to $3

3 ASBFEO, *Inquiry into small business loans*, 12 December 2016, p. 28.

4 ASBFEO, *Inquiry into small business loans*, 12 December 2016, p. 28.

5 NAB, Correspondence, 1 March 2017.

6 Mr Andrew Thorburn, CEO, NAB, *Transcript*, 3 March 2017, p. 29.

> million, not based on the size of an individual lending facility. This ensures large companies are excluded.[7]

3.13 Westpac also supported a $3 million cap.[8] Westpac advised that 'we are also working toward removing them from all such loans under $3 million, and this would cover eight out of 10 small-business loans.'[9]

3.14 For loans less than $1 million the ANZ advised that generally covenants are not used. Similarly, the CBA agreed that covenants should be removed at this level and Westpac was in the process of removing all non-monetary default classes at this level. The CBA stated:

> Definitely $1 million and we are now doing the work to get it to $3 million. I think that ultimately—I do not want to pre-empt, because we have not finished the work—that is the right number. There is no magic number, but by our assessment that will cover about 99 per cent of small businesses in Australia. This is $3 million in total facilities. Based on our experience, roughly above that number you start getting into very complex lending. I concede that that is not a bright line, but we think that is about the right number.[10]

3.15 During the hearing, the CBA was scrutinised on its commitment to reduce non-monetary covenants for loans up to $3 million. The CBA advised that 'the $1 million we are fully agreed, but in moving from $1 million to $3 million there may be some carve outs as part of that.'[11]

3.16 Westpac explained how it uses non-monetary covenants at various levels:

> The way we handle it today is: for loans under $1 million we simply do not apply a non-monetary covenant, though it is true that they are in the contract terms. We do not apply them but they are in the contract terms. As we go from $1 million to $3 million, there is a bit more complexity. For those we essentially do not apply them, and they have never used a non-monetary covenant in isolation to put a customer into default. But there is a small section where we do apply non-monetary covenants. What we are doing right now—and we are doing this proactively and not waiting on the government's recommendations—is we are actually eliminating from our contracts all non-monetary covenant clauses

7 ANZ, Correspondence, 6 March 2017.

8 Westpac, Correspondence, 7 March 2017.

9 Mr Brian Hartzer, CEO, Westpac, *Transcript*, 8 March 2017, p. 2.

10 Mr Ian Narev, CEO, CBA, *Transcript*, 7 March 2017, p. 9.

11 Mr Ian Narev, CEO, CBA, *Transcript*, 7 March 2017, p. 37.

> for under $1 million and the majority, roughly nine out of 10, for the $3 million to one million. That is our position.[12]

How often are non-monetary default clauses used?

3.17 Each of the banks was asked the number of times that they made use of non-monetary default clauses, of any kind, for loans of less than $5 million and $3 million in 2014/15 and 2015/16. The NAB advised that in 2014-15 it used non-monetary default clauses five times for loans between $ 1m and $3m and once for loans between $3m and $5m. In 2014-15 NAB used non-monetary default clauses 13 times for loans between $1m and $3m and once for loans between $3m and $5m.[13]

3.18 Westpac advised that in 2016, it undertook a review of its small business and agribusiness loans under $3 million. This appears to indicate that non-monetary default clauses were not used at all for loans less than $3 million. Westpac commented that this review indicates that 100 per cent of recovery action has been based on monetary default.'[14]

3.19 The CBA advised that it did not keep aggregated records of the number of times it had relied upon non-monetary default clauses.[15] The CBA noted that 'it was exceedingly rare to instigate recovery proceedings on the basis of loan to valuation ratios or 'non-monetary' covenants alone and in the absence of missed payments.'[16]

3.20 ANZ advised that 'a total of 116 customers were identified as being in some form of ANZ enforced insolvency administration as at 31 March 2015.'[17] ANZ advised that 'of the 116 customers identified, 113 were in monetary default at the time of ANZ enforcement and the monetary default was relied upon to take possession of property held as security by ANZ.'[18] ANZ stated:

> ANZ has updated its procedures to introduce more senior oversight and approval requirements before any enforcement action can be initiated and we are not aware of any instance during the ANZ financial year 2015/2016 where ANZ has used a mon-monetary default to take enforcement action against a customer in its Corporate and Commercial loan portfolios.[19]

12 Mr David Lindberg, Chief Executive, Westpac, *Transcript*, 8 March 2017, p. 9.
13 NAB, Answer to question in writing, NABQW13.
14 Westpac, Answer to question in writing, Wespac24QW.
15 CBA, Answer to question in writing, CBA21QW.
16 CBA, Answer to question in writing, CBA21QW.
17 ANZ, Answer to question in writing, ANZ19QW.
18 ANZ, Answer to question in writing, ANZ19QW.
19 ANZ, Answer to question in writing, ANZ19QW.

3.21 The ABA was highly critical of Recommendation 3 cautioning that it would force banks to raise lending rates to small business. The ABA stated:

> At the moment what I perceive as the biggest threat to the levels of risk of small business lending is recommendation 3 of the Carnell report. The small business ombudsman has made it very clear publicly and privately that recommendation 3 is intended to cause banks to carry more risk when they lend to small business. It is exactly the same thing as saying that lending to small business will become more risky. The prudent thing for banks to do when lending becomes more risky is to raise the cost, reduce the availability and reduce the term of that lending.[20]

3.22 The ASBFEO was quick to reject the ABA's claims arguing that they were contradictory. Ms Carnell stated:

> On the one hand the banks say they rarely use non-financial default clauses, but on the other, they say to remove them would increase risk for the banks. If you don't use them, how on earth could it possibly increase the banks' risk to get rid of the clauses?
>
> It is disingenuous to say that removing these clauses would drive up the cost of borrowing for small businesses, given the banks already take into account a higher level of risk in their small business loan costs.
>
> You can't have it both ways; you can't have a loan agreement that moves all the risk to the borrower, while also imposing a higher interest rate on small business customers.[21]

3.23 Ms Carnell concluded that the commitments by Westpac, CBA and the ANZ to reduce, to varying degrees, the use of non-monetary defaults up to $3 million were positive steps. Ms Carnell stated:

> Aside from NAB, these are all steps in the right direction, and we're listening to what the banks are saying on carve-outs, but fundamentally non-financial default clauses must be removed from small business contracts under $5 million if we're to ensure all small businesses are safeguarded against what can be the devastating impacts of these clauses.[22]

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20 Mr Steven Münchenberg, CEO, ABA, *Transcript*, 8 March 2017.

21 ASBFEO, *Media Release*, ABA Walking Both Sides Of The Street On ASBFEO Loan Contract Reform, 9 March 2017.

22 ASBFEO, *Media Release*, ABA Walking Both Sides Of The Street On ASBFEO Loan Contract Reform, 9 March 2017.

3.24 The committee commends Ms Carnell on her important work on this issue. It is very difficult to support the continued use of non-monetary default clauses in small business loans. Action should be taken on this issue by no later than 1 July 2017.

Mr David Coleman

Chairman

20 April 2017

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Appendix 1 – Establish a Banking Tribunal

> In terms of dispute resolution mechanisms...if there are other mechanisms for people to take their disputes, particularly people without much resources who are in dispute with a very large entity, as a general proposition that really does improve access to justice. *Mr Rod Sims, Chairman of the ACCC*[1]

Recommendation 1

1.1 **The committee recommends that the Government amend or introduce legislation, if required, to establish a Banking and Financial Sector Tribunal by 1 July 2017. This Tribunal should replace the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.**

1.2 **The Government should also, if necessary, amend relevant legislation and the planned industry funding model for the Australian Securities and Investments Commission, to ensure that the costs of operating the Tribunal are borne by the financial sector.**

1.3 Australia's system of EDR schemes is overly complex and overly legalistic. Too often, consumers and small businesses are not able to access justice.

1.4 Currently there are two EDR schemes authorised by ASIC. These are:

1 the Financial Ombudsman Service (FOS), which deals with complaints across a diverse range of financial services (including complaints relating to most Authorised Deposit-taking Institutions (ADIs)); and

1 Mr Rod Sims, Chairman of the ACCC, *Committee Hansard*, 14 October 2016, pp. 14-15.

2 the Credit and Investments Ombudsman (CIO), which broadly handles complaints about some credit unions and building societies as well as a range of non-bank lenders.

1.5 In addition to the FOS and CIO, the Superannuation Complaints Tribunal (SCT), an independent government body, handles complaints relating to superannuation funds, annuities, deferred annuities and retirement savings accounts.

1.6 This system, given the various schemes' overlapping jurisdictions, can create confusion. For example:

- a customer in a dispute with a major bank would need to approach the FOS;
- a customer in a dispute with a credit union would need to approach either the FOS or the CIO, depending on which scheme the credit union was a member of; and
- a customer in a dispute with a bank or a credit union relating to a retirement savings account would generally need to approach the SCT.

1.7 In addition to creating confusion for consumers, the existing multi-scheme framework is very duplicative. As noted by ASIC, each EDR scheme currently has its own:

- board of directors;
- case management systems and support infrastructure;
- administration and regulatory reporting arrangements for licensees and representatives including members switching schemes; and
- statistical, systemic issues and serious misconduct processes and reporting requirements. [2]

1.8 The CIO have argued that this duplication was justified because the 'existence of two ASIC-approved EDR schemes allows each scheme to benchmark its performance against the other...[which] produces better outcomes for FSPs [financial services providers], consumers and regulators.'[3] The committee does not find this argument persuasive for two reasons.

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2 ASIC, *Review of the financial system external dispute resolution framework: Submission by the Australian Securities and Investments Commission,* October 2016, p. 30.

3 CIO, *Credit and Investments Ombudsman's response to the Issues Paper for the Review of External Dispute Resolution schemes,* October 2016, p. 2.

1.9 Firstly, tribunals operating in other industry sectors (and the courts system) manage to deliver good outcomes for consumers without competition between duplicative schemes.

1.10 Secondly, given difficulties in comparing and ensuring consistent outcomes for FOS and CIO complainants (due to the use of conciliation and different reporting standards)[4] – a significant problem in its own right – it is hard to imagine how the benchmarking referred to by the CIO could meaningfully occur.

1.11 The scope of existing schemes is also inadequate. For example:

- the FOS and CIO can only consider complaints where the damages are alleged to be $500,000 or lower. This is a demonstrably inadequate amount given numerous instances where people are alleged to have lost millions as a consequence of poor financial advice;[5] and
- not all business lenders have to be a member of an EDR. This can force small businesses to rely on the courts.

1.12 Given the system's shortcomings, the committee endorses the Government's decision to:

- conduct a review, Chaired by Professor Ian Ramsay, of Australia's external dispute resolution and complaints schemes; and
- have ASIC and the FOS conduct a concurrent review of the FOS's small business jurisdiction.

1.13 As these inquiries are ongoing, the committee will not make firm recommendations on appropriate complaint or compensation limits. As a general observation, however, the committee is of the view that both should be increased.

1.14 The committee does recommend that the Government replace the three existing EDR schemes with a 'one-stop' Banking and Financial Services Tribunal to handle complaints from consumers and small businesses. It should:

- reduce confusion for consumers;
- enhance small businesses' EDR scheme coverage;

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4 ASIC, *Review of the financial system external dispute resolution framework: Submission by the Australian Securities and Investments Commission,* October 2016, p. 29.

5 A. Ferguson, 'Misconduct claims widen in CBA's planning scandal', *The Sydney Morning Herald,* 14 June 2014, <http://www.smh.com.au/business/misconduct-claims-widen-in-cbas-planning-scandal-20140613-3a2wn.html>, viewed 20 October 2016.

- help ensure consistent outcomes for complainants; and
- improve scheme efficiency by eliminating unnecessary duplication.

5.1 The committee is aware of the concerns that a number of consumer groups have with the establishment of a tribunal (though notes that they do support the consolidation of the existing EDR schemes).[6]

1.15 In the committee's view it is critical that, if the Government were to proceed with the establishment of a tribunal, these concerns be adequately addressed.

1.16 To help address many of the consumer groups' concerns, the committee proposes that the new banking and financial services tribunal have the following features. It 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/retirement savings account's providers) to be a member;
- operate without lawyers (to the extent possible);
- be funded directly by the financial services industry;[7]
- have the power to refer potential systemic issues to ASIC for formal investigation. For example, this could occur when the tribunal receives a large number of similar complaints over a year; and
- make decisions that are binding on member institutions.

Existing External Dispute Resolution schemes

1.17 Currently, all AFSL holders, unlicensed product issuers, unlicensed secondary sellers, ACL holders and credit representatives are required to have a dispute resolution system that consists of:

- internal dispute resolution (IDR) procedures that meet ASIC standards; and

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6 Care Inc et al., *Submission to Review of the Financial System Dispute Resolution Framework – Issues Paper*, 10 October 2016, p. 3.

7 If direct industry funding is not possible, the government should recover any appropriated amounts from the financial services industry. Under such a model, appropriations to the body should respond to the number of cases that the tribunal handles each year.

- membership of one or more ASIC-approved EDR schemes (that is, the FOS or the CIO).[8]

1.18 Additional detail on the three existing EDR schemes is provided in Table 2.1.

Table 5.1 Overview of Australia's External Dispute Resolution schemes

Scheme	Jurisdiction	Complaint Cap	Compensation Cap
FOS	Handles complaints against banks, credit unions, foreign exchange dealers, deposit takers, credit providers, mortgage brokers, general insurers, insurance brokers, life insurers, funds' managers, financial advisers and planners, stockbrokers and some superannuation providers.	$500,000	$309,000[9]
CIO	Handles complaints about credit unions, building societies, non-bank lenders, mortgage and finance brokers, financial planners, lenders and debt collectors, credit licensees and credit representatives.	$500,000	$309,000
SCT	Handles complaints about superannuation funds, annuities and deferred annuities and retirement savings accounts.	Uncapped	Uncapped

Source: ASIC, FOS, CIO, and SCT

The Financial Ombudsman Service

1.19 The creation of the FOS provides a useful precedent for the establishment of a 'one-stop' banking tribunal.

1.20 On 1 July 2008, the FOS was formed by the merger of three existing ASIC-approved EDR schemes:

- the Banking and Financial Services Ombudsman;
- the Insurance Ombudsman Service Limited; and
- the Financial Industry Complaints Service.

1.21 Two other pre-existing ASIC-approved EDR schemes also joined FOS:

- the Credit Union Dispute Resolution Centre; and
- the Insurance Brokers Disputes Limited.

1.22 When the FOS was launched, Mr Colin Neave AM (the FOS's inaugural Chief Ombudsman) stated that:

8 ASIC, *Regulatory Guide 165 Licensing: Internal and external dispute resolution,* July 2015, p. 4.

9 Separate caps apply for general insurance broking ($166,000), income stream life insurance ($8,300 per month) and uninsured third party motor vehicle claims ($5,000).

> Both industry and consumers will benefit from the creation of the new Financial Ombudsman Service...By simplifying the structure of financial services dispute resolution, the new Financial Ombudsman Service will allow greater consumer awareness of the service and will be more streamlined and efficient and able to respond when there are peaks in demand.[10]

1.23 These arguments were compelling in 1998. They remain compelling now.

Funding External Dispute Resolution schemes

1.24 To ensure that the financial sector has an incentive to minimise complaints, it is critical that EDR schemes are industry funded.

1.25 While the FOS, CIO and SCT are all funded by the financial sector they use significantly different models.

- The FOS and CIO are funded directly by members (that is, they do not receive a government appropriation). Each member is required to pay regular membership fees, as well as additional fees related to the number of complaints that the EDR receives relating to their operations.
- The SCT is funded by government appropriation. The costs of the SCT are recovered from the superannuation industry by APRA and returned to consolidated revenue. There is no direct link between the SCT's funding and complaints received.

1.26 The committee believes that direct funding is preferable to cost recovery. This is because:

- it is administratively simpler;
- it is more responsive to the number of complaints received (because additional funding does not require a government appropriation); and, for this reason,
- it provides additional incentives for AFSL holders to resolve disputes prior to them being referred to an EDR scheme.

1.27 Timely dispute resolution is critical in situations where consumers may have suffered substantial financial losses. This depends on adequate EDR scheme resourcing. The committee therefore recommends that the proposed Banking and Financial Services Tribunal be funded directly by industry.

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10 Financial Ombudsman Service, 'New National Financial Services Ombudsman Launched', *Media Release,* 10 July 2008, <www.fos.org.au/public/download/?id=3027&sstat=341803>, viewed 28 October 2016.

2

Appendix 2 – Make Executives Accountable

> "There are certainly individuals...who have had some consequences relating to remuneration...we have not had individuals terminated" *Mr Ian Narev, CEO of the Commonwealth Bank on the mishandling of claims in CommInsure*[1]
>
> "It is not just a problem with the bad apples; there is generally often a problem with the tree...let us deal with the tree" *Mr Greg Medcraft, ASIC Chairman*[2]

Recommendation 2

2.1 The committee recommends that, by 1 July 2017, the Australian Securities and Investments Commission (ASIC) require Australian Financial Services License 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.

2.2 This report should 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.**

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1 Mr Ian Narev, CEO of CBA, *Committee Hansard*, 4 October 2016, p. 16.

2 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard,* 14 October 2016, p. 3.

2.3 The FSI concluded that the interests of financial firms and consumers are not always aligned.[3] The major banks' appearance before the committee confirmed it.

2.4 According to the evidence presented, no senior executives have so far been terminated in relation to the extremely serious cases of:

- the provision of poor financial advice at NAB;[4] and
- the mishandling of life insurance claims at CommInsure.[5]

2.5 Similarly, no senior executive was terminated following:

- NAB's failure to pay 62,000 wealth management customers the amount that they were owed;[6]
- the poor administration of hardship support at CBA;[7]
- ANZ's OnePath improperly collecting millions of dollars in fees from hundreds of thousands of customers;[8] and
- ANZ improperly collecting fees from 390,000 accounts that had not been properly disclosed.
  - In regards to ANZ's improper collection of fees, the bank did not believe that any staff members were responsible for the breach because:

> The issue existed for a number of years...and there have been a number of organisational and staffing changes through that period.[9]

2.6 This is unacceptable and clearly demonstrates the accountability deficit that exists within these organisations.

2.7 The major banks seem to believe that it is appropriate that no senior executive has been terminated for these failings and that a reduction in responsible executives' remuneration will be sufficient to improve consumer outcomes. For example, Mr Andrew Thorburn, NAB's CEO, noted that:

> I think the people in this line of business definitely feel accountable...I think reputations have suffered.[10]

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3 D. Murray et al., Financial System Inquiry, *Final Report,* 2014, p. 217.

4 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 4.

5 Mr Ian Narev, CEO of CBA, *Committee Hansard*, 4 October 2016, p. 16.

6 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 5.

7 CBA, *Response to Questions on Notice: Question Six,* 18 October 2016, p. 6.

8 Mr Shayne Elliot, CEO of ANZ, *Committee Hansard,* 5 October 2016, p. 40.

9 ANZ, *Response to Questions on Notice: Question Two*, 27 October 2016, p. 3.

2.8 NAB also argued that more severe consequences for executives were not appropriate because they were not directly responsible for the misconduct. For example, in justifying his decision not to terminate any executives, Mr Thorburn stated that 'the [financial] planners were the culpable parties, really.'[11]

2.9 The committee disagrees with this assessment.

2.10 The major banks have a 'poor compliance culture'[12] and have repeatedly failed to protect the interests of consumers.[13]

2.11 This is a culture that senior executives have created.[14] It is a culture that they need to be held accountable for.

2.12 The committee is aware of the progress that is being made to improve culture and accountability within the sector. The committee supports:

- the Government's decision to allow ASIC to ban managers guilty of poor conduct from operating in the financial services industry;
- the industry's work to develop a register of 'rogue' employees to help ensure that they cannot rotate between financial services firms; and
- Mr Stephen Sedgwick AO's review of commissions and payments (including referral payments) made to bank staff and third parties to ensure that they do not encourage behaviour contrary to consumers' interests.

2.13 However, even with these measures in place gaps will remain.

2.14 Clearly there will be some cases where an executive's conduct has been sufficient to justify banning. However, not all misconduct is severe enough to warrant ASIC taking this action.

2.15 The proposed framework does not strengthen the consequences for responsible executives where banning would be excessive, but where mere reputational or remunerative penalties are grossly inadequate.

2.16 To fill this gap, and better align executives and consumer interests, the committee recommends that ASIC require all AFSL holders to publicly report on any significant breaches of their regulatory obligations within five business days of reporting the breach to ASIC, or within five business days of ASIC or another regulatory body identifying that breach.

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10 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 5.

11 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 10.

12 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard*, 14 October 2016, p. 5.

13 D. Murray et al., Financial System Inquiry, *Final Report*, October 2014, p. 218.

14 APRA, *Information Paper: Risk Culture*, October 2016, p. 16.

2.17 Critically, in addition to explaining how the breach occurred and what steps will be taken to ensure that the breach does not occur again, the report should include:

- the names of the senior executive/s responsible for the team/s where the breach occurred; and
- the consequences for those senior executives and, if this did not include termination, why termination was not appropriate.

2.18 The committee believes that this will have two significant benefits:

1. the risk of being publicly named will create further incentives for executives to prioritise good consumer outcomes; and
2. 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.

2.19 To further increase institutional accountability these reports should be sequentially numbered so that consumers and investors can easily determine how many significant breaches a licensee has had in a given year.

Australia's breach reporting framework

2.20 AFSL holders must advise ASIC in writing as soon as practicable (and within 10 business days) about any significant breach (or likely significant breach) of sections 912A, 912B and 912A(1)(c) of the *Corporations Act 2001*.

2.21 In 2015-16, ASIC received 1,172 breach reports from AFSL holders and managed investment schemes.[15]

2.22 Table 2.1 summarises the obligations that, if not met by an AFSL holder, could trigger the need for a breach report.

15 ASIC, *ASIC Annual Report 2015-16*, 31 October 2016, p. 93.

Table 2.1 Australian Financial Services License obligations that can trigger a breach report

Obligations under sections 912A and 912B	Obligations under section 912A(1)(c)
An AFSL holder must: • do all things necessary to ensure that the financial services covered by your AFS licence are supplied efficiently, honestly and fairly; • have adequate resources to provide the financial services covered by your licence and to carry out supervisory arrangements (unless you are regulated by APRA); • be competent to supply the financial services covered by your licence; • have trained and competent representatives; • take reasonable steps to ensure that your representatives comply with the financial services laws; • have a dispute resolution system for retail clients; • have adequate risk management systems; and • have compensation arrangements for retail clients.	An AFSL holder must comply with the following financial services laws: • Chapter 6 of the Corporations Act (takeovers); • Chapter 6A of the Corporations Act (compulsory acquisitions and buy-outs); • Chapter 6D of the Corporations Act (fundraising); • Chapter 7 of the Corporations Act (financial services and markets); and • Division 2 of Part 2 of the ASIC Act (unconscionable conduct and consumer protections for financial services).

Source: ASIC, *Regulatory Guide 78: Breach reporting by AFS licensees*, p. 6.

2.23 A failure to report is also a significant breach. This has a maximum penalty of $42,500 for a company and $8,500 or imprisonment for one year (or both) for an individual.

2.24 Under this framework, breaches that must be reported to ASIC include failures such as:

- an AFSL holder or their representatives providing inappropriate financial advice to clients;
- fraud by an AFSL holder or their representatives or the AFSL holder's failure to prevent that fraud from occurring;
- the AFSL holder or their representatives supplying financial services that they are not licensed to supply; and
- an AFSL holder's failure to detect previous breaches.

2.25 When such a breach is detected, the AFSL holder must report to ASIC on:

- the type of breach (or likely breach), why it was significant, and how long it lasted;
- how the breach (or likely breach) was detected;
- information on any authorised representatives involved in the breach (or likely breach); and
- how the breach (or likely breach) has been rectified as well as the steps that will be taken to ensure that it does not happen again.

2.26 The committee believes that expanding this framework to include public reporting of this information, as well as additional detail on the consequences for responsible executives, is an appropriate response to the numerous cases of serious misconduct that have occurred in recent years.

2.27 Notwithstanding this conclusion, the Government – as part of its review of ASIC's enforcement regime (which includes a review of penalties and the financial services licensing breach notification network) – should consider whether additional penalties are required to support a more public breach reporting regime.

Potential future reforms

2.28 The committee is committed to increasing executive accountability in the financial sector.

2.29 In seeking to achieve this outcome, the UK recently published new rules for senior managers. These are known as the Senior Managers Regime (SMR).

2.30 The SMR introduces specific prescribed responsibilities for senior managers (among other measures) and is expected to focus supervision and enforcement action on the actions of individual managers rather than the overall actions of the institution.[16]

2.31 The committee is aware of potential problems with the SMR. In particular, concerns that parts of the regime may undermine businesses' internal accountability structures[17] and that the SMR runs counter to traditional concepts of criminal and civil liability.[18]

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16 Deloitte, *Senior Managers Regime Individual Accountability and Reasonable Steps*, 2016, p. 5.

17 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 11.

18 Argent, J and Colvin, J, 'Liability for Corporate Culture, *Company Director*, Vol. 31. No. 11. December 2015-January 2016, p. 57.

2.32 The committee will monitor the effectiveness of the UK's regime as well as reforms announced but not yet enacted in Australia and consider the need for additional reforms throughout future inquiries.

3

Appendix 3 – Require New Focus On Banking Competition

> "There seems a lack of very robust competition in banking...We are not seeing as much robust competition as we would like"
> *Rod Sims, Chairman of the Australian Competition and Consumer Commission*[1]
>
> "We are in a market which is, frankly, an oligopoly"
> *Greg Medcraft, Chairman of the Australian Securities and Investments Commission*[2]

Recommendation 3

3.1 The committee recommends that the Australian Competition and Consumer Commission, 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.

3.2 If the relevant body does not have any recommendations in a given period, it should explain why it believes that no changes to current policy settings are required.

3.3 Oligopolies are problematic when they are able to use pricing power to the detriment of consumers.

3.4 Australia's banking system is such an oligopoly. Australia's four major banks have significant pricing power, higher than average returns on equity and large market shares.

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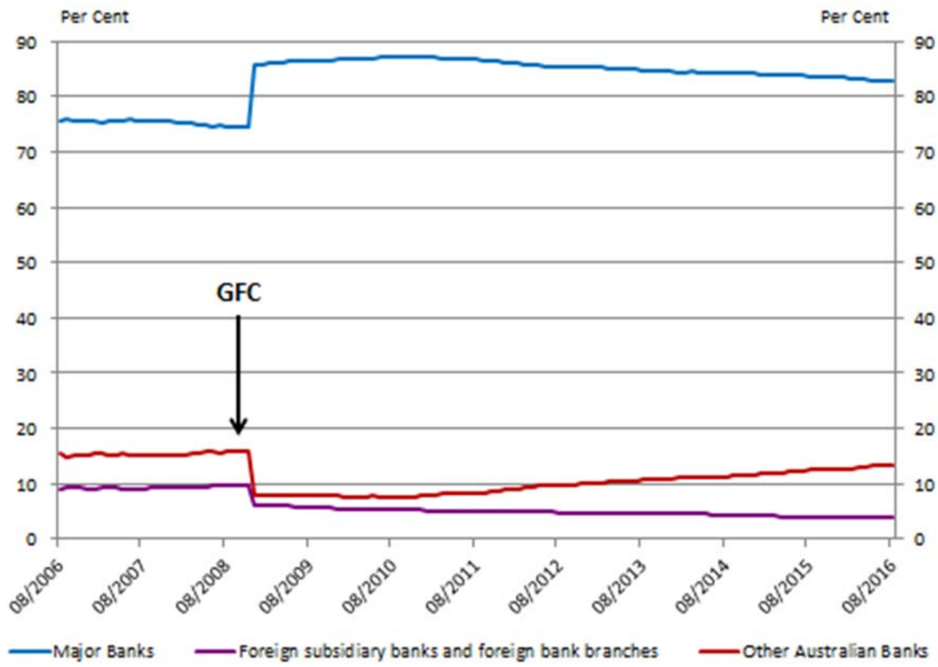
1 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 2.

2 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard,* 14 October 2016, p. 5.

3.5 This is particularly the case post-global financial crisis (GFC), due to:

- a significant degree of consolidation around 2008 as the major banks purchased a number of smaller competitors (Figure 4.1); and
- a collapse in securitisation markets, which had previously allowed the major banks' competitors to access cheap wholesale funding.

Figure 3.1 Market Shares of Bank Housing Lending



Source: APRA Monthly Banking Statistics (August 2016)

3.6 A lack of competition in Australia's banking sector has significant adverse consequences for the Australian economy and consumers.[3] It:

- creates issues around banks being perceived as too-big-to-fail (TBTF) (such as moral hazard);
- reduces incentives for the major banks to innovate and invest in new infrastructure; and
- can allow banks to use their pricing power to extract excess profits from consumers.

3.7 The committee finds it very surprising that no Australian government has completed a wholesale review of competition in the banking sector in recent times.

3 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 16.

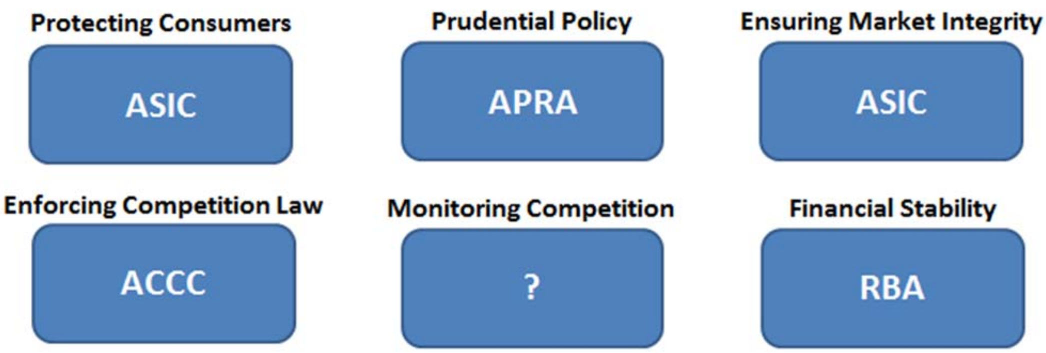
3.8 More surprising, however, is that despite the Australian Competition and Consumer Commission's (ACCC's) clear concerns about the level of banking competition, it has acknowledged not closely monitoring the sector because 'the RBA, APRA and ASIC are...observing the banks.'[4]

3.9 None of these regulators, however, have a clear mandate to promote competition in the financial sector. The ACCC does.

3.10 The Reserve Bank of Australia (RBA) are primarily concerned with financial stability; ASIC with ensuring market integrity and protecting consumers; and APRA with ensuring the financial soundness of prudentially regulated institutions.[5]

3.11 This means that no regulatory agency is regularly considering the level of competition in Australia's banking sector and whether change is required (Figure 4.2).

Figure 3.2 Regulatory oversight of the banking sector



3.12 The committee endorses the Government's decision to have the Productivity Commission periodically review financial sector competition. However, the committee does not believe that structural reviews undertaken 'as appropriate'[6] go far enough.

3.13 To create this accountability, the committee recommends that the ACCC (or the proposed Australian Council for Competition Policy (ACCP)) establish a small team dedicated to the continual monitoring of competition in the banking sector.

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4 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 3.

5 While APRA must balance the need for competition against its other mandated objectives, this is secondary to APRA's need to promote financial stability.

6 Australian Government, *Attachment: Government response to Financial System Inquiry Recommendations*, http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt-response-to-the-FSI/html/08-Attachment>, viewed 20 October 2016.

3.14 This team should make recommendations to improve competition in the banking sector to the Treasurer every six months.

3.15 Given repeated statements from the ACCC that the sector is uncompetitive, if the ACCC/ACCP does not make any recommendations for policy change in a given period, it should explain why that is appropriate.

3.16 Ongoing monitoring of the banking sector's competitiveness will fill an important gap in Australia's regulatory framework.

3.17 In addition to filling a regulatory gap and improving the sector's accountability for its conduct and the pricing of interest rates and fees, the creation of this team would significantly enhance the ACCC's understanding of competition in the sector. This would better equip the ACCC to assess whether any potential future mergers or acquisitions are likely to significantly lessen competition.

3.18 This is of particular importance given that ASIC[7] and the ACCC[8] both advised the committee that prior mergers had lessened competition and that other competitors had not emerged as the ACCC had expected.

3.19 The committee does not imply that the ACCC acted inappropriately in its decision to not oppose many of these transactions. The committee is suggesting that enhancing the ACCC's understanding of competition in the sector on an ongoing basis should leave it better equipped to assess the effect of any future transactions.

Pricing Power

3.20 One of the most powerful indicators of an oligopoly is pricing power.

3.21 The evidence suggests, and the ACCC Chairman agrees,[9] that the major banks' have significant pricing power. They have effectively lifted average interest rates across the economy; have passed increased costs on to consumers; and do not always compete aggressively for increased market share.

7 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard*, 14 October 2016, pp. 21-22.

8 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 14.

9 M Roddan, 'Sims: ACCC 'covering most sectors', won't confirm banks', *The Australian*, 25 July 2016, <http://www.theaustralian.com.au/business/financial-services/sims-accc-covering-most-sectors-wont-confirm-banks/news-story/7201c237ed1362d861449e8bce29e511>, viewed 20 October 2016.

3.22 In the wake of the GFC, a comprehensive set of financial sector reforms have been progressed to improve ADIs' resilience. This includes increased capital and liquidity requirements, the introduction of a Net Stable Funding Ratio in 2018, and the development of a Loss Absorbing Capacity framework in line with international developments.

3.23 While these are necessary and critical reforms, they have come at a significant cost. In Australia this cost appears to have been borne largely by consumers.

3.24 There have been two clear recent examples of this.

3.25 Firstly, post-GFC, banks have been required to increase the share of their assets that are held in securities by around five per cent. The average return on these liquid assets is less than one per cent, which is significantly lower than the return on, for example, residential mortgages.[10]

3.26 In response to these lower rates of return, Australian ADIs have widened their lending spreads. This has forced consumers to bear the costs of holding these additional liquid securities, rather than shareholders.[11]

3.27 Secondly, in October 2015, the major banks announced out-of-cycle increases in mortgage standard variable rates (SVRs). This was attributed to APRA's interim work to implement the Financial System Inquiry's (FSI) recommendation that APRA:

> 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 [the major banks and Macquarie] and those using standardised risk weights [all other ADIs].[12]

3.28 APRA's changes to mortgage risk weights for banks using IRB models have increased the capital that the major banks have to hold against residential mortgages.

3.29 However, the magnitude of the interest rate increases in October 2015 (between 15 and 20 basis points for each of the major banks) indicates that the cost of higher capital requirements was borne largely by mortgage holders as opposed to shareholders.[13]

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10 Dr Philip Lowe, Governor of the RBA, *Committee Hansard*, 22 September 2016, p. 7.

11 Dr Philip Lowe, Governor of the RBA, *Committee Hansard*, 22 September 2016, p. 8.

12 D. Murray et al., Financial System Inquiry, *Final Report*, 2014, p. 60.

13 UBS, *Westpac Banking Corporation strengthens the balance sheet & reprices mortgages*, 2015, p. 1.

3.30 The major banks' pricing power is also observable in the fact that they closely follow one another's price changes, rather than attempting to increase their market share.

3.31 Since 2000, the spread between the interest rates charged on many retail and small business products and the cash rate has increased (Figure 4.3).

3.32 The committee understands that funding for these products comes from a range of sources, at costs that can differ widely from the cash rate.

3.33 The committee also understands that these products can have differing levels of risk that may have been inaccurately priced pre-GFC (such as small business loans).

3.34 However, it is notable that post-GFC:

- spreads have increased on all consumer and small business products, including on low-rate credit cards - a product where providers ostensibly compete on price and not features;[14] and
- spreads have increased by less on lending to large businesses, that likely have access to a wider variety of non-ADI funding sources, than small businesses and retail customers.[15]

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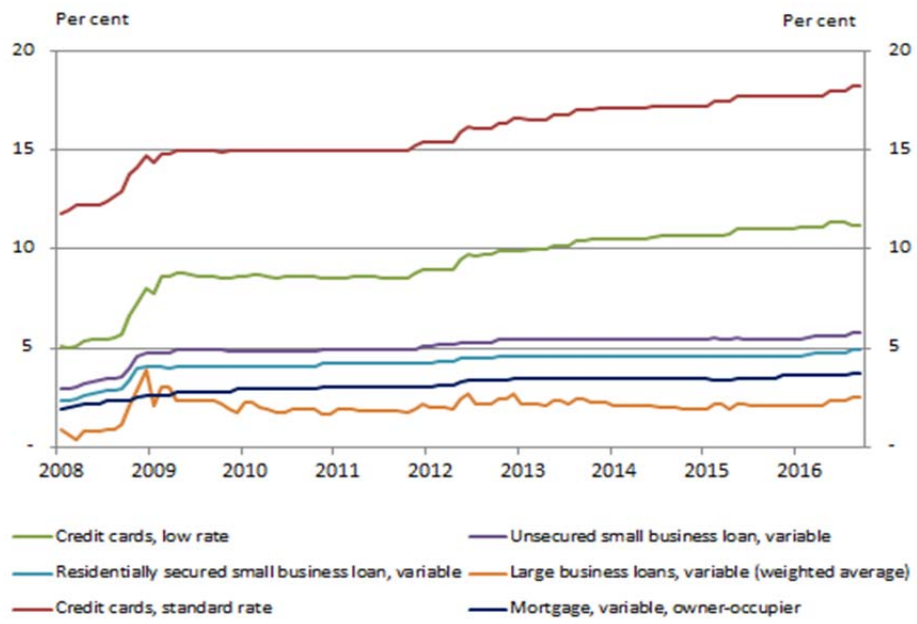
14 Mr Antony Cahill, Chief Operating Officer NAB, *Committee Hansard*, 6 October 2016, p. 25.

15 From January 1990 to August 2016, following the deregulation of the banking sector, this effect is more pronounced. The spread on loans to large businesses has declined by 20 basis points while the spread on SVRs, for example, has increased by 400 basis points.

Figure 3.3 Consumer and business credit products' spread to cash rate



Source: RBA Indicator Lending Rates (September 2016)

3.35 This means that the gap between the cash rate and the interest rate on a broad range of consumer and small business products has become larger.

3.36 The major banks' pricing power is also observable in the net effect of their changes to mortgage SVRs that have been to consumers' relative benefit or detriment since 2000.

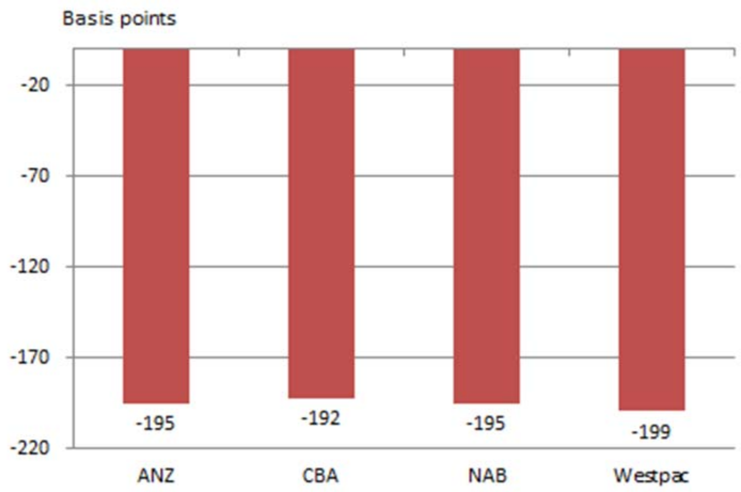
3.37 Mr Wayne Byres, APRA's Chairman, noted that in a competitive market, over the economic cycle, the net effect of these changes should be around zero.[16] This has not been the case in this century.

3.38 Since 2000, the major banks have made changes to their SVRs that have left mortgage holders with rates at least 195 basis points higher than they would be if the interest rate had simply tracked the cash rate (Figure 4.4).

3.39 In fact, since 2000, the major banks have averaged around one SVR change to consumers' relative benefit, compared to an average of around 19 SVR changes that have left consumers relatively worse off (Figure 4.5).

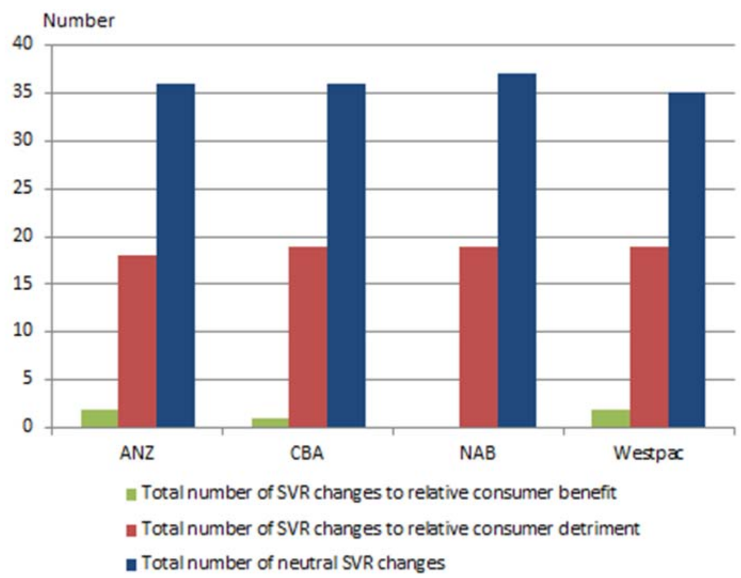
16 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 24.

Figure 3.4 Net consumer impact of major bank interest rate changes relative to RBA cash rate changes (2000 - 2016)



Source: RBA (October 2016), committee calculations.

Figure 3.5 Number of bank interest rate changes, by type, relative to RBA cash rate (2000 - 2016)

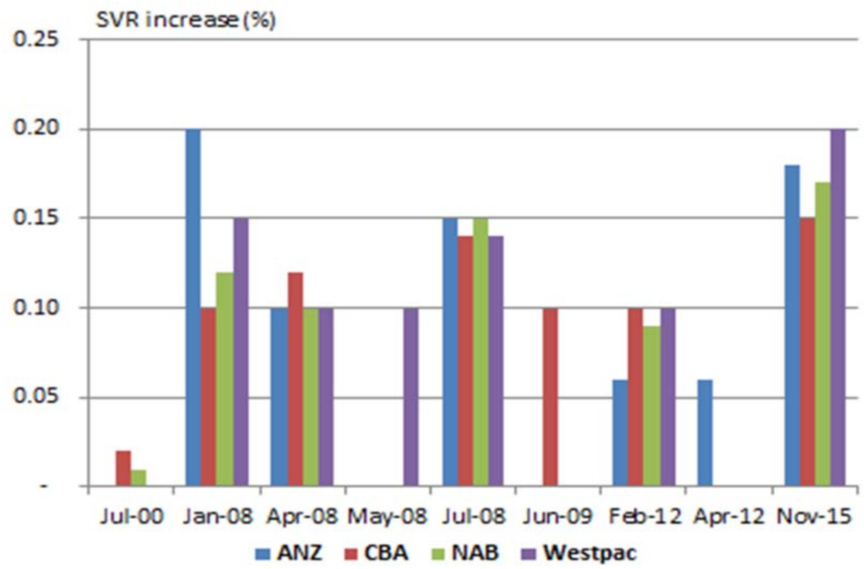


Source: RBA (October 2016), committee calculations

3.40 In addition to regularly using their pricing power, the major banks also tend to follow each other's price increases rather than compete to gain market share.

3.41 Since 2000, at least one of the major banks has increased their SVR out-of-cycle nine times. On five of these occasions, each of the other major banks has followed in the same month (Figure 4.6).

Figure 3.6 Major banks' out-of-cycle standard variable rate changes (2000 to current)



Source: RBA (October 2016)

Drivers of a lack of competition

3.42 The lack of competition in Australia's banking sector has a number of causes. These are primarily: the major banks' lower cost structures; the sector's high barriers to entry; and consumer inertia.

Cost Advantages

3.43 The funding and operating costs of the major banks are lower than their domestic competitors. Three important reasons for this are discussed below.

3.44 Firstly, the major banks are highly vertically and horizontally integrated, which provides them with significant economies of scale and scope.

3.45 Secondly, the market believes that the major banks are TBTF.

3.46 The credit rating agencies provide the major banks with a two-notch credit rating uplift due to a perceived implicit government guarantee, which effectively lowers their funding costs relative to other ADIs.

3.47 The RBA estimated that this implicit guarantee was worth as much as $3.7 billion to the major banks in 2013.[17]

3.48 Finally, the major banks (and Macquarie) use IRB models, as opposed to standardised models, to calculate their regulatory capital requirements.

3.49 IRB models allow banks to use sophisticated statistical techniques to determine what 'risk weights' to apply to their assets. These risk weights are used to calculate the value of the bank's 'risk weighted assets'.

3.50 In many cases, these models produce lower risk weighted asset values than the standardised model. This allows banks using IRB models to hold less capital against similar assets than banks using the standardised approach.

3.51 While APRA recently required ADIs using IRB models to increase residential mortgage risk weights to an average of at least 25 per cent, this is still substantially lower than the average risk weights that apply to ADIs using the standardised model (which can be up to 45 per cent).

3.52 APRA has calculated that the use of IRB models allows the major banks to cumulatively hold around $19 billion dollars less capital than if they were using the standardised model.[18]

3.53 The size of the major banks' funding cost advantage is shown in Figure 4.7.[19]

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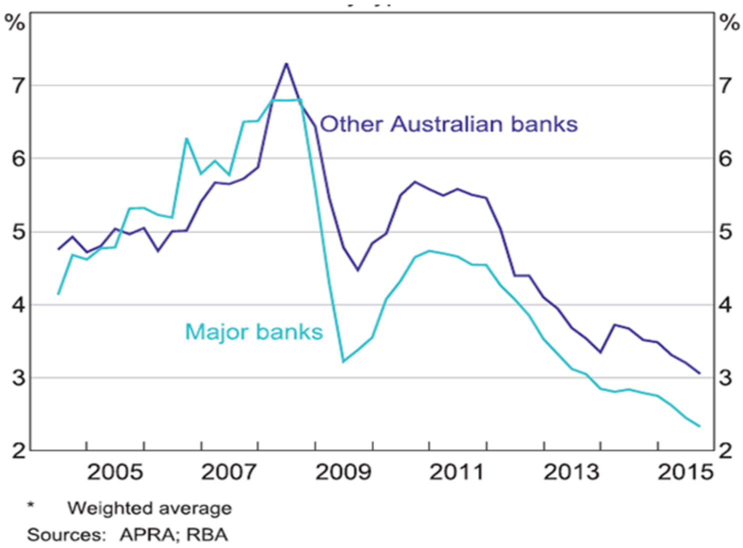
17 RBA, *Parliamentary Briefing, 24 February 2012 – Implicit Guarantees for Banks*, 2012, p. 44.

18 From 14 October 2016: APRA, *Response to a Question Taken on notice: Question Seven*, 1 November 2016.

19 Prior to the GFC, this funding cost gap was less pronounced due to mortgage lenders access to cheap funding through securitisation. As of 2015, issuance of Australian Residential Mortgage Backed Securities was only around one-third of the level that it was at its peak. RBA, *Structural Features of Australian Residential Mortgage-backed Securities*, 2015.

Figure 3.7 Weighted average funding costs (per cent) for the major and other Australian banks



Source: RBA, Developments in Banks' Funding Costs and Lending Rates (2016)

3.54 The committee expects that, over time, the size of 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 in line with international developments (both of which will reduce the perception that the major banks are TBTF);[20] and
- work by the Basel Committee on Banking Supervision (that APRA expects to adopt) to address excessive variability between the capital requirements for banks using IRB and standardised models.[21]

3.55 The committee strongly endorses these measures to improve competition.

20 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 18.

21 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 6.

High Barriers to Entry

3.56 Australia's banking sector has high barriers to entry. These arise for regulatory and commercial reasons.

- To operate as an ADI, institutions must obtain a banking license from APRA.

  Once licensed, ADIs must comply with APRA's prudential requirements on an ongoing basis.

- Under the *Financial Sector (Shareholdings) Act 1998* (FSSA), a shareholder or group of associated shareholders cannot hold more than 15 per cent of the prospective ADI's voting shares without an exemption.[22]

- Existing ADIs (particularly the major banks) hold significant amounts of consumer and business data that allows them to accurately model and price risk.[23]

- Existing ADIs (particularly the major banks) have strong brands and sophisticated distribution networks that are expensive to replicate.

3.57 The committee's findings and recommendations in relation to barriers to entry can be found in Section 6.

Consumer Inertia

3.58 Customer inertia also limits effective competition.

3.59 Despite efforts to reduce consumer switching costs over recent years, switching rates remain low. For example, only 46 customers approached ANZ using the government's formal switching process to change their bank accounts in September 2016.[24]

3.60 A critical factor behind these low switching rates is that switching costs are perceived to be high. This can leave customers unwilling to seek out better priced products from alternative providers.

3.61 Customer inertia is also encouraged by non-transparent pricing and product bundling.

- Non-transparent pricing (for example, fee-free accounts with costs recouped through overdrafts) make it difficult for consumers to identify whether an

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22 There are reports that the FSSA is limiting bank start-ups where a small number of individuals necessarily hold the majority of the institutions shares.

23 The Productivity Commission recently noted that the data that banks hold 'provides some degree of competitive advantage for incumbents (Productivity Commission, *Data Availability and Use Draft Report*, November 2016, p. 545.)

24 ANZ Bank, *Response to Questions on Notice: Question Nine,* 23 October 2016, p. 2.

alternative provider's product is a better deal – both at a point-in-time and over the life of the product.

- Product bundling reduces customer switching by both decreasing price transparency and increasing switching costs (because to switch ADIs consumers would need to move multiple products).

3.62 The introduction of a 'tracker rate' mortgage (that is, mortgages that have an interest rate equal to the official cash rate plus a fixed margin) by AusWide Bank in October 2016 represents a notable response to some of these problems.

3.63 The committee welcomes the launch of this product. ASIC's Chairman, Mr Greg Medcraft, noted that, '[tracker rate mortgages] allow...true comparability and...true competition.'[25]

3.64 The committee believes that more needs to be done to empower consumers. The findings and recommendations in relation to these matters can be found in Section 6.

The Australian Council for Competition Policy

3.65 The Competition Policy Review (the Harper Review) recommended that the Government dissolve the National Competition Council and establish the ACCP.[26]

3.66 The Harper Review recommended that the ACCP have a broad role encompassing:

- advocacy, education and promotion of collaboration in competition policy;
- independently monitoring progress in implementing agreed reforms and publicly reporting on progress annually;
- identifying potential areas of competition reform across all levels of government;
- making recommendations to governments on specific market design issues, regulatory reforms, procurement policies and proposed privatisations;
- undertaking research into competition policy developments in Australia and overseas; and
- ex-post evaluation of some merger decisions.[27]

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25 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard,* 14 October 2016, p. 4.

26 I. Harper et al., *The Competition Policy Review*, March 2015, p. 76.

27 I. Harper et al., *The Competition Policy Review*, March 2015, p. 77.

3.67 The Government has endorsed the creation of the ACCP, however this requires the agreement of the states and territories.[28]

3.68 If the states and territories agree to the establishment of the ACCP and its proposed mandate, the Government should consider whether the ACCP or the ACCC would be the more appropriate body to regularly make recommendations to the Treasurer to improve competition in the banking sector.

28 Australian Government, *Response to the Competition Policy Review,* 2015, p. 34.

4

Appendix 4 – Empower Consumers

> “We are strongly in favour of ensuring that consumers have better access to...data and that third parties can then use it to...offer services and identify opportunities” *Mr Peter Kell, Deputy Chairman of ASIC*[1]
>
> “We are supportive of a well-governed process of opening data up more. We are supportive of more competition; we think that it is healthy for customers and healthy for our industry as well” *Brian Harzter, CEO of Westpac*[2]

Recommendation 4

4.1 **The committee recommends that Deposit Product Providers be forced to provide open access to customer and small business data by July 2018. 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 safe guards are in place. Entities should also be required to publish the terms and conditions for each of their products in a standardised machine-readable format.**

4.2 **The Government should also amend the *Corporations Act 2001* to introduce penalties for non-compliance.**

4.3 Enhancing access to publicly and privately held data has the potential to make a strong contribution to economic growth.

1 Mr Peter Kell, Deputy Chairman of ASIC, *Committee Hansard*, 14 October 2016, p. 4.

2 Mr Brian Hartzer, CEO of Westpac, *Committee Hansard,* 6 October 2016, p. 41.

4.4 In 2013, the McKinsey Global Institute estimated that increasing access to data in consumer finance could add between $210 - $280 billion a year to global GDP,[3] with up to 50 per cent of this total flowing through to consumers through:

- enhanced price transparency;
- tailored product offerings; and
- consumers' ability to actively shape the products that they consume.[4]

4.5 Increased access to financial sector data, as noted by the Productivity Commission, should also intensify competition in the financial sector.[5]

4.6 This is because markets work best when customers are informed. At present banks, not consumers, hold the data. This gives banks a significant degree of power.

4.7 The UK's Competition and Markets Authority (CMA) recently found that both Small and Medium Enterprises and consumers find it difficult to understand the cost and quality of bank products and to compare the products that they have with products available from other providers.[6]

4.8 The CMA also found that up to 90 per cent of consumers could be around £92 (approximately $150AUD) better off each year by changing their current account.[7]

4.9 This is unsurprising. The cost of banking products is generally opaque, which increases switching costs for consumers and limits competition. Data sharing, however, can help to overcome these problems.

4.10 For example, data sharing could increase price transparency with comparison services able to accurately assess how much a product would actually cost a consumer based on their usage and recommend the most appropriate products to them.

4.11 Increased price transparency will boost competition. As noted by the ACCC Chairman, Mr Rod Sims:

> ...consumers' ability to provide their data to alternative service providers will facilitate additional sources of competition in many

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3 McKinsey Global Institute, *Open Data: Unlocking innovation and performance with liquid information,* October 2013, p. 9.

4 McKinsey Global Institute, *Open Data: Unlocking innovation and performance with liquid information*, October 2013, p. 7.

5 Productivity Commission, *Data Availability and Use Draft Report*, November 2016, p. 553.

6 CMA, *Retail Banking Market Investigation Final Report,* 9 August 2016, p. XIV.

7 CMA, *Retail Banking Market Investigation Final Report,* 9 August 2016, p. XI.

> markets. In many ways, data as an asset belonging to the consumer may well be the ultimate disrupter of concentrated markets. [8]

4.12 In addition to enhancing price transparency, the Financial System Inquiry (FSI) concluded that data sharing would 'better enable innovative business models.'[9] This could occur through the creation of products better tailored to individuals and by enabling, for example, rapid assessment of individuals' credit-worthiness.

4.13 The UK Government has recognised these benefits and has taken action.

4.14 The CMA will require banks to enable retail customers and small businesses to share their data securely with other banks and with authorised third parties using Application Programming Interfaces (APIs) by early 2018.

4.15 The committee believes that the Australian Government should amend the *Australian Securities and Investments Commission Act 2001* and, if required, the *Privacy Act 1998*, to empower ASIC to develop a data sharing framework for Australia's banking sector (with due consideration given to the need to protect individual's privacy and the confidentiality of their data).

4.16 In their appearance before the committee, each of the major bank's CEOs supported government action to facilitate greater data sharing in the banking sector (despite ANZ's,[10] CBA's,[11] and the ABA's[12] recent opposition to further government intervention). The Customer Owned Banking Association[13] and FinTech Australia[14] have also expressed support.

4.17 Sharing of consumers' and small businesses' data should be supplemented by the full release of standardised, machine-readable terms and conditions for each

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8 Sims, R. 'Data will give consumers upper hand', *The Australian Financial Review*, 9 November 2016, p. 43.

9 D. Murray et al., Financial System Inquiry, *Final Report*, 2014, p. 182.

10 ANZ, *Submission to Productivity Commission Issues Paper: Data Availability and Use,* 29 July 2016, p.12.

11 CBA, *Submission to the Productivity Commission Inquiry on Data Availability and Use*, July 2016, p. 2.

12 Productivity Commission, *Issues Paper: Data Availability and Use*, 29 July 2016, p. 2.

13 Customer Owned Banking Association, *Productivity Commission Inquiry on Data Availability and Use*, July 2016, p. 2.

14 FinTech Australia, *Productivity Commission Inquiry into Data Availability and Use: Open Financial Data*, July 2016, p. 3.

affected entity’s full product suite. This is necessary to overcome the information asymmetry in the market.

4.18 To ensure that the banking sector meets its obligations, the committee also recommends that the Government amend the *Corporations Act 2001* to introduce penalties for non-compliance.

The benefits of data sharing

4.19 Data sharing allows authorised entities to transfer data, with consent, between each other using secure and encrypted connections.

4.20 Research by the Open Data Institute (ODI) and Fingleton Associates in the United Kingdom (UK) indicates that data sharing has a potentially significant role to play in overcoming many of the sector’s structural limits on competition. Some of the potential benefits of data sharing are summarised in Table 5.1.

Table 4.1 The potential benefits of data sharing and open data sets

Structural Problem	Example of problem	Role for data sharing
High barriers to entry	The large data sets that major banks hold on individual customers and in aggregate allows them to better assess risk and price loans.	If other ADIs and alternative lenders were able to access all lending and credit data, firms could then better compete on their ability to assess and price risk.
Opaque pricing	Transaction accounts, credit cards and other loans are priced as a blend of charges, foregone interest/interest and penalties. This makes it hard for consumers to compare products.	If a customer’s actual usage data was available, comparison websites could tell customers precisely how much they paid for their account in the previous year. If data on banks’ products was also made open access, such comparison services could point users towards the cheapest product based on their historical usage.
Consumer Inertia	A lack of transparent pricing coupled with the difficulty of transferring payments can make account holders reluctant to change banks.	More transparent pricing reduces the information costs of switching. Open access data on debits may make it easier to transfer them to new providers.

Source: ODI and Fingleton Associates, *Data Sharing and Open Data for Banks,* 2014, p. 12.

4.21 In addition to improving competition, better data sharing should also increase economic efficiency. For example, data sharing should drastically reduce data entry costs for businesses and consumers.[15]

What data should be made available?

4.22 Generally the greater volume of data shared, the greater the potential benefits. However, for technical, legal, cost and regulatory reasons it is not appropriate to make all data sets accessible.

4.23 The committee believes that there is a strong case for increasing access to, what the banks themselves regard as, customers' data.[16] This includes, for example, a customer's transaction history, account balances, credit card usage, and mortgage repayments.

4.24 This data is critical to overcoming the problems of consumer inertia and opaque pricing that exist in the banking sector. However, the sharing of consumers' data is not sufficient on its own.

4.25 To maximise the data's usefulness, the committee believes that each data-sharing participant should also release the terms and conditions for each of their banking products in a standardised and machine-readable format.

4.26 These two data sets are critical to the development of products tailored to individual consumers as well as better aggregators that can offer personalised advice to consumers.

How should data be made available?

4.27 Data sharing arrangements and open data sets can take a number of forms. The Government's role is to set rules, templates, and access requirements to ensure that data can be accessed and manipulated efficiently with adequate privacy and data protection safeguards.

4.28 In order to reap the potential benefits, any data sharing framework must have the following characteristics:[17]

- data should be available to all licensed users;

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15 Productivity Commission, *Data Availability and Use Draft Report*, November 2016, p. 553.

16 Mr Antony Cahill, Chief Operating Officer of NAB, *Committee Hansard,* 6 October 2016, p. 33; Mr Shayne Elliott, CEO of ANZ, *Committee Hansard,* 5 October 2016, p. 6.

17 McKinsey Global Institute, *Open Data: Unlocking innovation and performance with liquid information*, October 2013, p. 3.

- data should be able to be processed automatically (that is, data should be machine readable); and
- data should be accessible at no or negligible cost on an ongoing basis.

4.29 There are four common ways to facilitate data sharing. Their pros and cons are detailed in Table 4.2.

Table 4.2 Sample pros and cons of different data sharing methods

Method	Description	Pros	Cons
APIs	APIs are standards that allow software components to interact and exchange data.	Provides up to date data that is easy to read and process. Can be automated. Only read-access is provided. Access can be restricted to certain data sets and types. Access can be restricted to authorised users. Does not require log in credentials to be shared.	Of the options listed, APIs are the most expensive to establish. Access to API data would have to be regulated.
Comma Separated Values (CSV) files	CSV files are a standard file-type that can be read by a wide range of programmes.	Easy and cheap to produce. Easy to read and process.	Files are a 'point in time' measure which limits ongoing usability. Can be user-manipulated.
'Screen Scraping'	Screen scraping involves consumers providing firms with their log-on credentials so that they can retrieve up-to-date data from users' service providers using algorithms.	Provides up to date data that is easy to read and process. Can be automated.	Can be difficult to establish, limiting usability. Scrapers breach banks' terms and conditions. The credentials provided to screen scrapers can be used to 'read and write'. No restrictions on use.

Method	Description	Pros	Cons
Manual file handling	Manual entry of printed documentation.	Simple. Impact of hardware failure is limited.	Inefficient to process. Files are a 'point in time' measure which limits ongoing usability. Human errors are likely.

Source: Data Sharing and Open Data for Banks, 2014, p. 22.

4.30 It is clear to the committee that APIs present the largest number of benefits in terms of data security, data credibility and accessibility.

4.31 APIs will, however, require meaningful upfront investment.

4.32 Despite the associated costs, the UK Government has endorsed the establishment of an open API standard in the UK's banking sector to commence in 2018.

4.33 The committee similarly recommends that the Government require ASIC to develop a binding framework to facilitate the sharing of customers' and small businesses' data between Deposit Product Providers and relevant third parties (as deemed appropriate by ASIC) through APIs by July 2018.

4.34 The committee disagrees with the Productivity Commission's view in its draft report on data availability and use that CSV files (or similar) should be used to share financial sector data at this time.

4.35 This is because the data reported in CSV files must be standardised to support machine readability before the scheme can commence. This severely curtails the framework's ability to support innovation and competition. The Productivity Commission note that:

> The substantive argument in favour of making data more available is that opportunities to use it are largely unknown until the data sources themselves are better known, and until data users have been able to undertake discovery of data.[18]

4.36 The Productivity Commission's proposal for data sharing in the financial sector fails this test. The committee is further disinclined to support the use of CSV files because:

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18 Productivity Commission, *Data Access and Availability Draft Report*, November 2016, p. 2.

- the need to standardise the data in CSV files means that their contents could not rapidly change in response to the market's changing data needs;
- CSV files are point-in-time and subject to manipulation;[19] and
- using CSV files is more complex than using APIs, increasing transaction costs for consumers and service providers.[20]

4.37 The committee also disagrees with the Productivity Commission's preliminary view that implementing APIs would be prohibitively expensive. This is for two reasons:

- while detailed modelling has not been completed in Australia, the ODI has estimated that establishing an API framework (from scratch) would cost around £1 million per institution in the UK;[21] and
- given the detailed work that has already gone into the development of a data sharing framework for the UK, Australia has the opportunity to learn from this process, rather than seek to create an entirely new domestic system from the ground up.

Recommendation 5

4.1 The committee recommends that the Government, following the introduction of the New Payments Platform, consider whether additional account switching tools are required to improve competition in the banking sector.

4.38 Enhanced data sharing and increased price transparency are of little value if it is difficult for consumers to change product providers. Knowing that a better deal exists is worthless if it is too hard to take advantage of.

4.39 If it is difficult for consumers to switch, the competitive impact of data sharing will be muted. As noted by APRA's Chairman:

> Efforts to improve the capacity of customers to be able to switch between financial institutions is important because, if there are barriers to customers switching, it obviously lessens the

19 *Data Availability and Use Draft Report*, November 2016, p. 555.

20 For example, using CSV files for comparison services would require users to download the relevant file from their ADI and upload it to the service provider and service providers must then verify the file. APIs remove the need for these processes.

21 Converted from the £1 million per institution calculated by ODI on 2 November 2016: ODI and Fingleton Associates, *Data Sharing and Open Data for Banks*, 2014, p. 87.

> competitive instinct and the desire for organisations to look after their customers.[22]

4.40 It is therefore critical that efforts to enhance data sharing are accompanied by measures to reduce switching costs. Switching costs, whether they are high or just perceived to be high, can present a significant barrier to competition.

4.41 In 2011, the previous Government made a number of policy changes to improve competition in the banking system. This included measures to reduce switching costs.

4.42 Since 1 July 2012, when consumers establish a new bank account they have been able to sign a form that requires their new financial institution to transfer regular direct debits and credits from their old financial institution to their new account.

4.43 However, the service cannot be used to switch regular BPAY transactions, 'internet pay-anyone' transactions, or payments to and from debit and credit cards.

4.44 Further, despite its significant limitations the process can take up to two weeks to complete.[23] In 2016, this is unacceptable.

4.45 Given that transferring payments from one account to another is one of the most significant barriers to switching, it is clear that existing switching tools have failed. This is evidenced by the fact that, as outlined in section three, only 46 customers approached ANZ using the government's formal switching process to change their bank accounts in September 2016.[24]

4.46 In light of the system's severe flaws, a number of ADIs have developed their own switching services.

4.47 These switching services are more common among larger and more sophisticated institutions and their existence may actually limit competition by steering consumers towards the largest ADIs by default.

4.48 It is clear that there is a role for government in reducing switching costs for all consumers – not just those switching to Australia's largest banks – to improve competition.

4.49 The committee is therefore heartened by the planned introduction of the New Payments Platform (NPP) in the second half of 2017.

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22 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 16.

23 ME Bank, *The Hands-free Switch*, <https://www.mebank.com.au/personal/bank-accounts/switch/the-handsfree-switch/>, viewed 19 October 2016.

24 ANZ Bank, *Response to Questions on Notice: Question Nine*, 23 October 2016, p. 2.

4.50 The NPP should spur competition in the sector by simplifying the process for switching payments from one account to another (Figure 5.1).[25]

4.51 This is because payments will no longer have to be routed to or from a combination of a Bank-State-Branch (BSB) and account numbers, but instead to an individual's phone number or email address that would be linked to the relevant bank account.

4.52 In this world, as noted by the RBA Governor, shifting a customer's regular outgoing and incoming payments will be as simple as changing the relevant link.

> One of the traditional issues for customers has been not necessarily moving bank accounts but is in relation to direct debits or credits going into and out of that particular account. The new payments platform will provide all Australian consumers with an alias ID—they can use their mobile phone number or an email address—and they can associate that alias ID with their bank account. So...you would be able to go to the new payments platform and go to your alias ID and change your account number. [26]

4.53 The NPP is not the only way to achieve this outcome. Full bank account portability would also dramatically simplify the process of re-directing payments as part of the switching process.[27]

4.54 However, introducing full bank account portability would be expensive. This is because:

> It [full account portability] would involve the replacement of the bank, state, branch (BSB) system of numbering, and wholesale revamping of the existing payments infrastructure and the systems of all the financial institutions which interface with it.[28]

4.55 While these costs have not been determined in Australia, the CMA has estimated that introducing full account portability in the UK would cost at least £2-£3 billion (around $3-$5 billion AUD).[29]

4.56 It is not clear that this expense is justified prior to the introduction and reviews of the NPP's effectiveness in 2017.

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25 Dr Philip Lowe, Governor of the RBA, *Committee Hansard*, 22 September 2016, pp. 25-26.

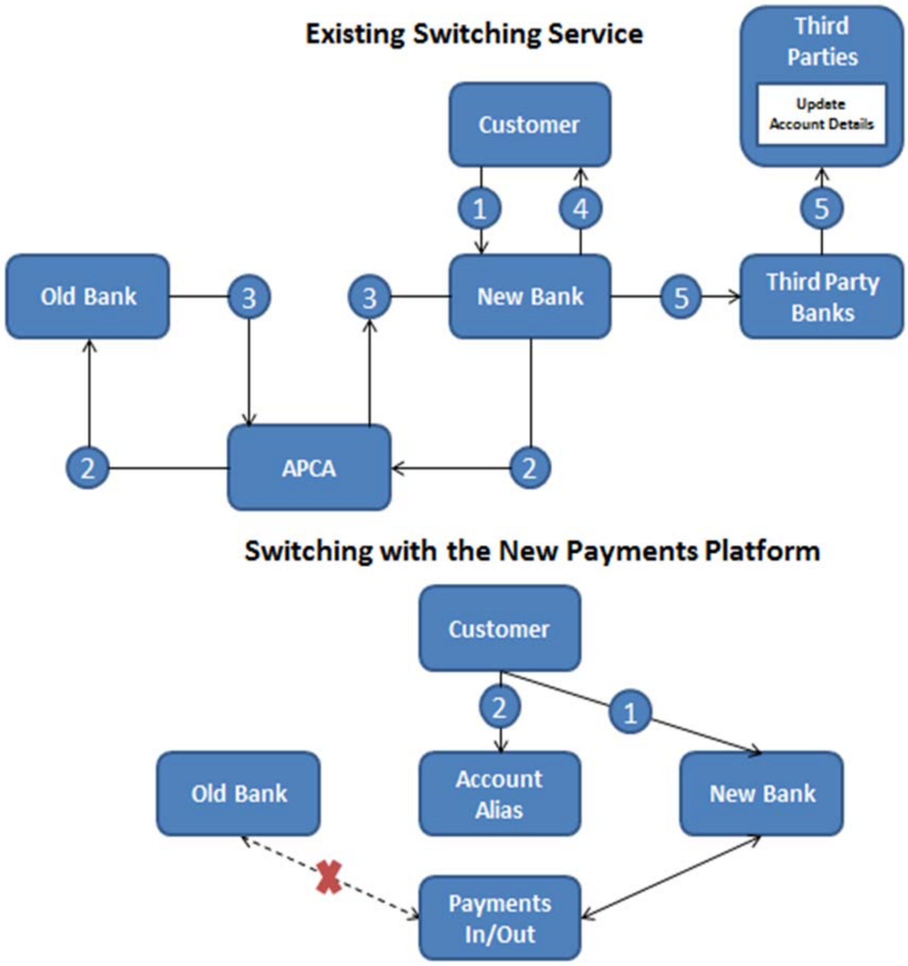
26 Mr Antony Cahill, Chief Operating Officer of NAB, *Committee Hansard*, 6 October 2016, p. 7.

27 CMA, *Retail banking market investigation Final report,* 9 August 2016, p. 502.

28 B. Fraser, *Bank Services Switching Arrangements*, August 2011, p. 7.

29 CMA, *Retail banking market investigation Final report,* 9 August 2016, p. 515.

Figure 4.1 Redirecting payments – existing switching service compared to the New Payments Platform



Source: Banking Services Switching Arrangements, August 2011, p. 14, Committee Hansard, 22 September 2016, pp. 25-26.

Note: APCA is the Australian Payments Clearing Association. It is a self-regulatory body that intermediates the redirection of payments between a consumer's old and new ADI.

4.57 While the NPP will increase consumers' power, it is too early to judge whether it will be enough to increase competition on its own. For example, the NPP may be of limited use to a customer with a number of different products (such as transaction accounts and credit products) to switch.

4.58 The committee therefore recommends that the Government, following the introduction of the NPP, consider whether additional measures to simplify switching are required to improve competition in the banking sector.

4.59 The committee notes that Bacs' work to improve the UK's Current Account Switching Service (due end-2017) may have findings relevant to Australia. [30]

30 Bacs is responsible for clearing and settling automated payments in the UK.

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Appendix 5 – Make It Easier For New Banking Entrants

> "Inevitably competition comes from the new entrants. It is not likely that all of a sudden existing incumbents will decide to compete a whole lot more aggressively" *Dr Philip Lowe, Governor of the RBA*[1]

Recommendation 6

5.1 **The committee recommends that by the end of 2017:**

- **the Government review the 15 per cent threshold for substantial shareholders in Authorised Deposit-taking Institutions (ADIs) imposed by the** ***Financial Sector (Shareholdings) Act 1998*** **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.**

5.2 Australia's banking sector has high barriers to entry. While the last decade has seen a number of foreign bank branches and foreign bank subsidiaries become ADIs, the situation for new domestic competitors is very different.

1 Dr Phillip Lowe, Governor of the RBA, *Committee Hansard,* 22 September 2016, p. 28.

5.3 In the last decade only one entity that was not associated with an existing bank has been granted a new banking license.[2] This suggests that Australia's start-up banking sector is effectively non-existent.

5.4 Oligopolies may maintain their dominant position in a market when it is too costly or difficult for potential rivals to enter. These barriers can be considered to be either commercial or regulatory in nature.

5.5 Commercial barriers to entering Australia's banking sector include:

- economies of scale and scope;
- large information costs; and
- sophisticated distribution networks.

3.1 Regulatory barriers to entering Australia's banking sector include:

- the need to obtain a banking license from APRA (or a relevant licence from ASIC);
- the *Financial Sector (Shareholdings) Act 1998* (FSSA), which limits individual's shareholdings in ADIs and insurance companies; and
- ongoing compliance with regulatory and legislative requirements.

3.2 The committee does not believe that it is the government's role to remove legitimate commercial barriers to entry. In a market economy it is up to prospective entrants to offer products and operate a business model that can overcome these challenges.

3.3 The committee does believe, however, that government and regulators should periodically assess the regulatory barriers that are in place to consider whether they remain appropriate.

3.4 This is particularly important in a regulatory environment where the FSI noted that 'there is complacency about competition' and there are limited structures in place to 'systematically identify and address competition trade-offs in regulatory settings.'[3]

3.5 This is especially problematic during periods when innovative new business models are emerging, such as the growth in FinTech firms today. The Productivity Commission has concluded that prescriptively enforcing existing regulations in the

2 According to APRA there have been 29 new ADIs licensed in Australia since 2006 including foreign bank branches and subsidiaries of foreign banks.

3 D. Murray et al., Financial System Inquiry, *Final Report*, 2014, p. 237.

wake of such models 'could lead to poor regulatory outcomes that stifle innovation.'[4]

3.6 While the committee welcomes the Government's decision to include competition in ASIC's mandate and to seek detailed information from APRA, ASIC and the Payments System Board on how they have balanced competition with other elements of their mandate in their annual reports, these are forward looking measures. These measures will not result in the formal assessment of existing regulatory structures to determine whether they are inappropriately limiting competition.

3.7 To fill this gap in the reform agenda, the committee recommends that the Government and regulators, with due consideration given to the maintenance of high prudential standards and financial stability, undertake a comprehensive review of:

- the 15 per cent threshold for substantial shareholders in ADIs under the FSSA;
- the licensing requirements for ADIs to determine whether they present an undue barrier to entry and whether a formal 'two-phase' process for licensing prospective applicants (similar to that in place in the UK) would boost competition; and
- whether APRA's processes in assessing and granting a banking licence could be made more transparent.

3.8 These measures would supplement ASIC's existing work to support new entrants. This includes the establishment of an 'Innovation Hub' and a 'Regulatory Sandbox', which will allow start-ups to test certain financial services for six months without a licence.

3.9 Given expected growth in the use of FinTech services over the next year (up to 150 per cent according to UBS)[5] and the potential for such firms to effectively disrupt traditional banking business such as payments, foreign exchange and remittance services, these are critical steps.

3.10 The committee does not believe, however, that they are enough on their own to sustain a culture of innovation and competition in Australia's banking and financial sector.

3.11 The creation of such a culture is necessary to improve consumer outcomes. This is because the committee expects that start-up firms will emerge with business models that effectively disrupt the status quo. For example, competition in

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4 Productivity Commission, *New Business Models and Regulation*, December 2015, p. 211.

5 UBS, *Global banks: Is FinTech a threat or an opportunity?*, 26 July 2016, p. 1.

Australia's mortgage market in the 1990s largely emerged due to a new group of firms taking advantage of securitisation markets to obtain cheap funding – not the entry of foreign banks.

3.12 It is start-ups' ability to 're-make the playing field' that makes them so critical to improving the competitiveness of Australia's banking sector.

Regulatory barriers to entry

3.13 A strong and stable banking sector is central to Australia's ongoing economic prosperity. Regulatory barriers to entering the sector are critical to achieving this.

3.14 Stability and competition in the banking sector can be seen as conflicting objectives. However, as noted by the Chairs of both APRA[6] and the ACCC,[7] this does not have to be the case.

3.15 Reducing barriers to entry as much as prudently possible should help spur a more competitive, contestable and innovative banking sector.

Obtaining a Banking License

3.16 To operate as an ADI, institutions must obtain a banking license from APRA. This process can take several years and anecdotal evidence suggests that 'APRA may take a more rigorous approach to licensing new ADIs and insurers, relative to some other jurisdictions.'[8]

3.17 To obtain a banking license, applicants must satisfy APRA that they are able to comply with capital adequacy and other prudential requirements from the date that their operations commence and on an ongoing basis.

3.18 To operate as a bank, prospective applicants require at least $50 million in Tier 1 Capital (generally common equity). There is no set minimum capital amount for other ADIs (such as credit unions and building societies), but APRA must deem it to be adequate.[9] Foreign ADIs are not required to maintain capital endowed in Australia.

3.19 On an ongoing basis, ADIs must hold regulatory capital equal to at least eight per cent of total risk weighted assets (however new ADIs can be subject to higher

6 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 2.

7 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 2.

8 APRA, *Financial System Inquiry: Response to the Interim Report*, 26 August 2014, p. 82.

9 APRA, *ADI Authorisation Guidelines,* August 2008, p. 6.

minimum capital requirements in their formative years)[10] and also comply with various liquidity, governance, risk management, information technology and audit requirements.

3.20 These ongoing requirements are prudent and necessary. There is evidence to suggest, however, that simplifications to the initial licensing process can have a significant effect on the number of market entrants and competition.

3.21 In 2014, in response to a report by the UK's Parliamentary Commission on Banking Standards, the UK's Prudential Regulation Authority (PRA) made a number of changes to its licensing process. This included:

- a reduction in capital requirements for new entrants to a minimum of £1 million (down from £5 million); and
- the introduction of a two-phase licensing process that allows new entrants to obtain a 'restricted license', after which they have a year to raise required capital, hire staff, and invest in technology systems.
  - In his appearance before the committee, APRA's Chairman noted that APRA have an 'iterative process' to granting banking licenses. However, this process is not as transparent as the UK's regime.

3.22 In announcing these changes, Mr Andrew Bailey, the former Chief Executive of the PRA, stated that:

> Reducing barriers to entry can be achieved alongside continuing to ensure new banks meet basic standards that prevent risks to the safety and soundness of the UK financial system.[11]

3.23 These measures have since been further enhanced.

3.24 In January 2016, the PRA established a bank start-up unit (jointly run with the Financial Conduct Authority (FCA)) to give information and support to newly authorised banks as well as prospective applicants. These reforms have greatly improved the transparency of the UK's licensing process.

3.25 These measures have been very successful. Fourteen new banks have been approved in the UK since 2014. As of July 2016, a further 20 entities were reportedly in talks with the PRA in regards to obtaining a license.[12]

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10 APRA, *ADI Authorisation Guidelines,* August 2008, p. 6.

11 Bank of England, *News Release – Prudential Regulation Authority and Financial Conduct Authority publish review of barriers to entry for new banks,* 7 July 2014, <http://www.bankofengland.co.uk/publications/Pages/news/2014/098.aspx>, viewed 22 October 2016).

3.26 This sits in stark contrast to the one new ADI licensed in Australia in the last decade that was not a foreign subsidiary or a branch of a foreign bank.

The Financial Sector (Shareholdings) Act 1998

3.27 In addition to APRA's licensing requirements, the FSSA can pose a barrier to entering Australia's banking sector.

3.28 Ownership in locally incorporated ADIs, including foreign bank subsidiaries, is governed by the FSSA.

3.29 Under the FSSA, all substantial shareholders of an applicant are required to demonstrate that they are well-established, financially sound entities of standing and substance. Applicants must also demonstrate that their involvement with the prospective ADI will be a long-term commitment and that they have the means to contribute additional capital to the bank, if required.

3.30 The FSSA limits shareholdings of an individual shareholder, or group of associated shareholders, in an ADI to 15 per cent of the ADI's voting shares, unless an exemption has been granted by the Treasurer or APRA (with or without conditions).[13] This limit has not been changed since the FSSA was introduced.

3.31 The FSSA gives the Treasurer an important tool to restrict investment.

3.32 This is particularly the case since changes to the *Foreign Acquisitions and Takeovers Act 1975* in 2015 that removed the requirement for foreign investment proposals to be considered under that Act where they would also be considered under the FSSA (subject to a few exceptions).

3.33 Often prospective ADIs (particularly start-ups, given their limited pool of owners) will need to obtain an FSSA exemption. Exemptions are granted as long as additional shareholdings are not found to be contrary to the national interest.

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12 T. Wallace, 'Twenty more banks want a license in flood of new competition', *The Telegraph,* 3 July 2016, <http://www.telegraph.co.uk/business/2016/07/03/twenty-more-banks-want-a-licence-in-flood-of-new-competition/>, viewed 22 October 2016.

13 APRA has been delegated responsibility for signing off on FSSA exemptions for ADIs with less than $1 billion in resident assets.

3.34 As in similar legislation governing significant investment, 'national interest' is not defined. However, the government does provide a list of potentially relevant factors. These include:

- national security;
- competition;
- impact on the economy and community; and
- the character of the investor.[14]

3.35 Start-up ADIs are unlikely to be barred under the FSSA on national security or competition grounds. However, one of APRA's key considerations in assessing an exemption relates to the ability of a prospective ADI's owners to provide capital to the ADI during periods of financial stress.[15]

3.36 In practice, FSSA requirements are therefore likely to work against prospective start-up ADIs without diversified ownership because individuals or families are unlikely to have sufficient resources to re-capitalise the ADI, if required. While there is clearly a logic to this approach, it is important that the FSSA requirements do not unduly limit the establishment of new ADIs.

3.37 Given it has been 18 years since the FSSA was introduced, a transparent assessment of the ongoing appropriateness of the FSSA is in the national interest.

14 Australian Government, *Australia's Foreign Investment Policy*, December 2015, p. 7.

15 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 6.

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Appendix 6 – Force Independent Reviews Of Risk Management Systems

> "When did I personally become aware of it?...As a result of the attention that it got earlier this year" *Mr Ian Narev, CEO of the Commonwealth Bank, on how Four Corners alerted him to CommInsure's alleged mishandling of claims*[1]
>
> "We made a mistake. It was poorly managed. We did not have the right controls and processes in place" *Mr Shayne Elliott, CEO of the Australia and New Zealand Bank on the incorrect allocations of funds between 1,400 superannuation accounts for up to 12 months*[2]

Recommendation 7

6.1 The committee recommends 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. These reviews should be completed by July 2017 and reported to ASIC, with the major banks to have implemented their recommendations by 31 December 2017.

6.2 Effective risk management and mitigation is central to protecting consumers and other stakeholders from problems before they have the chance to arise or become endemic.

1 Mr Ian Narev, CEO of the CBA, *Committee Hansard,* 4 October 2016, p. 19.

2 Mr Shayne Elliott, CEO of the ANZ, *Committee Hansard*, 5 October 2016, p. 3.

6.3 Over the last two decades Australia's major banks have demonstrated that they have robust, forward looking, financial risk management frameworks.[3]

6.4 It is disappointing that the committee cannot say the same of the frameworks that are in place to manage risks that threaten consumers.

6.5 The processes that the major banks have in place to protect consumers seem to be reactive, rather than proactive. APRA's Chairman, Mr Wayne Byres, agreed with this conclusion. He noted that:

> I think there has rightly been a lot of attention in the banking industry given to financial risks...There has probably not been the attention given to the soft stuff – to cultural issues and the impacts that they can have...[4]

6.6 For example, on numerous occasions bank CEOs only became aware of issues of serious misconduct and operational failings after – in some cases – thousands of consumers had been negatively affected. For example:

- the collection of around $178 million in financial advice fees for which no financial advice was provided;
- the provision of poor financial advice at NAB[5] (which has since resulted in more than $21 million in compensation);
- OnePath (ANZ's wealth management arm) charging more than 400,000 customers inappropriate fees on four occasions since 2015;[6]
- NAB incorrectly calculating returns for around 62,000 wealth management customers (for which it has had to refund $25 million);
- Westpac incorrectly collecting $29.2 million in fees from account holders and credit card customers;[7]
- Westpac failing to identify 11 financial planners guilty of misconduct;[8] and
- Capital Finance Australia (a Westpac subsidiary) breaching important consumer protection provisions in the *National Consumer Credit Protection Act 2009* 58 times during three months in 2015.

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3 For example: Mr Andrew Thorburn, CEO of NAB, *Committee Hansard,* 6 October 2016, p. 21.

4 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 9.

5 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 10.

6 Mr Shayne Elliott, CEO of ANZ, *Committee Hansard*, 5 October 2016, p. 5.

7 Mr Brian Hartzer, CEO of Westpac, *Committee Hansard*, 6 October 2016, pp. 44-45.

8 Mr Brian Hartzer, CEO of Westpac, *Committee Hansard,* 6 October 2016, p. 57.

6.7 As further evidence, there are a number of cases where CEOs only became aware of issues of serious misconduct after external parties brought it to their attention. For example:

- Mr Narev, CEO of the CBA, was unaware of poor claims handling practices at CommInsure prior to the ABC and Fairfax investigation;
- CBA was unaware of serious misconduct – including fraud – in its financial planning division prior to a whistle-blower going public in 2013; and
- Mr Elliott, CEO of the ANZ, would arguably still be unaware of highly unethical behaviour within his bank's institutional division had ASIC not commenced an investigation into that division of the bank.[9]

6.8 It is unacceptable that, in the case of CBA (and ostensibly other institutions), existing 'quality assurance systems ...failed to identify patterns of bad behaviour.' [10]

6.9 The committee is pleased to hear that each of the major banks has increased investment in the systems that they use to identify misconduct.[11] APRA's Chairman noted that:

> They [the banks] are looking harder for instances where things have gone wrong and people have been mistreated...to the extent that they are finding them...I think that is a cleansing of past issues.[12]

6.10 However, in most cases these changes appear to have been ad hoc and in response to known failures. They have been reactive.

6.11 From the testimony provided, it is not clear that all of the major banks have completely reviewed the processes that they have in place to protect consumers, despite the numerous observable failure of these systems. [13]

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9 Mr Shayne Elliott, CEO of ANZ, *Committee Hansard*, 5 October 2016, p. 15.

10 CBA, *Submission Senate Economics References Committee: Inquiry into the scrutiny of financial advice*, December 2014, p. 5.

11 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 10; Mr Ian Narev, CEO of CBA, *Committee Hansard,* 4 October 2016, p. 2; Mr Brian Harzter, CEO of Westpac, *Committee Hansard,* 6 October 2016, p. 41; Mr Shayne Elliott; CEO of ANZ, *Committee Hansard*, 5 October 2016, p. 15.

12 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 10.

13 Mr Hartzer's evidence suggests that Westpac has reviewed all of its processes to enable Westpac to identify risks – including conduct risks – on a more proactive basis.

6.12 Even in cases where reviews have been undertaken, given that 'approaches to understand and manage risk culture are at a relatively early stage of development [within prudentially regulated institutions]'[14] and that demonstrable links exist between poor risk culture and the potential for poor consumer outcomes, the committee believes that further reviews are required.

6.13 For this reason, the committee recommends that each of 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. These reviews should 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 power; and
- the appropriateness of existing training on, and frameworks to support, whistle-blowers and whistle-blower protections.

6.14 As noted by APRA's Chairman, improving the major banks' ability to detect and respond to risks to consumers is critical because:

> ...it [culture and compliance frameworks] is essential to long-run financial health and long-term community trust in the financial system. The financial system – banking in particular – is a business of trust. If you lose that trust, you lose your franchise.[15]

6.15 The outcome of these reviews should be submitted to ASIC. This will also allow ASIC to monitor the implementation of their recommendations.

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14 APRA, *Information Paper: Risk Culture*, October 2016, p. 14.

15 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 9.

7

Appendix 7 – Improve Internal Dispute Resolution Schemes

> "IDR appears to be broken – one talks to different members of staff every time one calls; emails go unanswered, letters from us claiming breach of responsible lending have been treated as requests for hardship" *Joint Consumer Group submission to the Review of the Financial System Dispute Resolution Framework*[1]

Recommendation 8

7.1 The committee recommends that the Government amend relevant legislation to give the Australian Securities and Investments Commission (ASIC) the power to collect recurring data about Australian Financial Services licensees' Internal Dispute Resolution (IDR) schemes to:

- **enable ASIC to identify institutions that may not be complying with IDR scheme requirements and take action where appropriate; and**
- **enable ASIC to determine whether changes are required to its existing IDR scheme requirements.**

7.2 The committee further recommends 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.

7.3 Even with appropriate internal governance and risk management processes in place, there will always be situations in which disputes arise.

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1 Care Inc et al., *Submission to Review of the Financial System Dispute Resolution Framework – Issues Paper*, 10 October 2016, p. 26.

7.4 Therefore it is critical that internal dispute resolution (IDR) schemes are properly designed and adequately resourced to ensure that any disputes with consumers or small businesses are resolved effectively.

7.5 Complainants must attempt to resolve disputes through a licensees' IDR scheme before their complaints can be considered by an EDR scheme. IDR is an important first step in the disputes handling process because:

- it gives product providers the opportunity to address consumer concerns efficiently and effectively and can alert them to potential problems within their organisation that need to be addressed; and
- it offers consumers and small businesses faster and less stressful dispute resolution than EDR schemes.

7.6 While ASIC has established regulatory standards for licensees' IDR schemes, existing legislation limits ASIC's ability to monitor compliance with these requirements on an ongoing basis.

7.7 There is very little accountability for the management of IDR schemes. If a licensee's IDR scheme was not functioning properly, it is not clear that ASIC would know.

7.8 Given that inadequate IDR schemes can significantly harm consumers, this is of concern. In the worst cases IDR schemes can operate as a delaying tactic that forces some complainants to give up on pursuing justice entirely.

7.9 Evidence provided to the Ramsey Review by a range of consumer groups suggests that there has been little change in the industry's approach to IDR since 2011, when ASIC reported that some IDR schemes could have 'the effect of frustrating and ultimately deterring some complainants.'[2]

7.10 This evidence is bolstered by the significant growth in the number of complaints handled by the FOS and CIO during their latest reporting periods (around seven per cent, respectively).[3]

7.11 These findings suggest that structural problems with IDR processes may currently be forcing consumers to seek redress through EDR schemes, if not abandoning their disputes all together. However, because ASIC cannot gather recurring data on licensees' IDR outcomes under existing legislation, it is not possible to draw firm conclusions at an industry and institutional level.

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2 ASIC, *Report 245: Review of general insurance claims handling and internal dispute resolution procedures*, August 2011, p. 34.

3 FOS, *Annual Review 2015-16*, 2016, p. 4 and CIO, *Annual Report on Operations 2014/15*, October 2015, p. 2.

7.12 The committee therefore recommends that the Government empower ASIC to collect additional data on licensees' IDR schemes, such as:

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

7.13 This data will enable ASIC to better understand the system's failings and take action, if required. The committee further recommends that ASIC use this data:

1. to identify entities with IDR schemes that are not operating as expected and take remedial and, if appropriate, enforcement action; and
2. to inform a review of ASIC's IDR scheme requirements, to determine whether changes are required (such as the inclusion of more formal rules) to improve consumer outcomes.

Monitoring compliance with Internal Dispute Resolution requirements

7.14 ASIC is a risk-based supervisor. ASIC focusses its activities on sectors and institutions that present the greatest potential harm to consumers and/or market integrity.

7.15 However, because ASIC does not have the power to collect recurrent data on licensees' IDR schemes,[4] it cannot determine which institutions' IDR schemes present the most potential harm to consumers. This makes it very difficult for ASIC to monitor institutions' compliance with IDR scheme requirements.

7.16 Given this knowledge gap, the committee is unsurprised that questions about whether ASIC dedicates sufficient resources to monitoring compliance with IDR requirements have been raised.

7.17 The committee is surprised, however, at suggestions by both Legal Aid NSW[5] and the Consumer Action Law Centre that ASIC has not responded to serious

4 ASIC, *Review of the financial system external dispute resolution framework: Submission by ASIC*, October 2016, p. 10.

5 Legal Aid NSW, *Submission to Review of the Financial System Dispute Resolution Framework – Issues Paper*, October 2016, p. 16.

complaints about certain institutions' IDR processes. These complaints included that:

> [CBA's] IDR appears to be broken – one talks to different members of staff every time one calls; emails go unanswered, letters from us claiming breach of responsible lending have been treated as requests for hardship.[6]

7.18 This is of serious concern to the committee. Given the importance of IDR within Australia's dispute resolution framework it is critical that it operates as intended.

7.19 The committee therefore recommends 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; and
- ASIC review its level of ongoing assessment of licensees' compliance with IDR scheme requirements to ensure that it is sufficient to ensure good consumer outcomes.

Internal Dispute Resolution Scheme Requirements

7.20 ASIC's IDR scheme requirements are set out in Regulatory Guide 165: *Licensing: Internal and external resolution*. Requirements include:

- IDR scheme compliance is to be self-certified;
- IDR procedures should account for the size and complexity of the business, the nature of the consumer base, and the likely number and complexity of disputes;
- disputes must be completed within 45 days (unless other timelines apply – for example, different timelines apply to some credit disputes);
- the licensee must have systems to identify disputes related to hardship so that these can be prioritised; and
- the IDR scheme must be capable of dealing with retail clients (which includes small businesses with less than 100 employees) at a minimum.

7.21 Australian Standard ISO 10002-2006 sets out additional requirements. For example:

- the organisation's top management should assess the needs for IDR resources and provide them;

6 Care Inc et al., *Submission to Review of the Financial System Dispute Resolution Framework – Issues Paper*, 10 October 2016, p. 26.

- the organisation should be actively committed to effective and efficient complaints handling; and
- all complaints should be classified and then analysed to identify systematic, recurring and single incident problems and trends, and to help eliminate the underlying causes of complaints.

7.22 Principles-based requirements such as these have a number of advantages over a more explicit rules-based approach. For example they:

- allow regulations to keep pace with technological and market developments;
- promote compliance with the spirit of the law; and
- can be appropriate for all regulated entities.[7]

7.23 As ASIC describes in relation to Regulatory Guide 165:

> ASIC's guidance provides significant scope for firms to tailor their IDR procedures according to the size and nature of their business, the range of products or services on offer, the profile of their customer base and the likely volume or complexity of complaints they may receive.[8]

7.24 However, principles-based systems can also create ambiguity about specific requirements and about minimum standards of expected compliance.[9] For this reason, in many cases regulations should be a 'hybrid' of principles and rules, where detailed rules provide clarity and structure to supplement high-level principles that remain flexible and promote a culture of compliance.

7.25 Given potential failings in the financial sector's application of ASIC's IDR requirements, the committee believes that ASIC must review Regulatory Guide 165 to determine whether changes, including the introduction of formal rules for matters such as scheme resourcing, are required to improve outcomes.

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7 Australian Law Reform Commission, *For Your Information: Australian Privacy Law and Practice*, 2008, p. 234.

8 ASIC, *Review of the financial system external dispute resolution framework: Submission by ASIC*, October 2016, p. 9.

9 Australian Law Reform Commission, *For Your Information: Australian Privacy Law and Practice*, 2008, p. 236.

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Appendix 8 – Boost Transparency In Wealth Management

> "We have very significant concerns about the way the financial advice industry has operated" *Mr Peter Kell, Deputy Chairman of ASIC*[1]
>
> "We did not report them at that time" *Mr Andrew Thorburn, CEO of National Australia Bank, on NAB's failure to report 43 dismissed financial planners to ASIC.*[2]

Recommendation 9

8.1 The committee recommends that the Australian Securities and Investments Commission (ASIC) establish an annual public reporting regime for the wealth management industry, by end-2017, to provide detail on:

- **the overall quality of the financial advice industry;**
- **misconduct in the provision of financial advice by Australian Financial Services Licence (AFSL) holders, their representatives, or employees (including their names and the names of their employer); and**
- **consequences for AFSL holders' representatives guilty of misconduct in the provision of financial advice and, where relevant, the consequences for the AFSL holder that they represent.**

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1 Mr Peter Kell, Deputy Chairman of ASIC, *Committee Hansard*, 14 October 2016, p. 13.

2 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 10.

8.2 The committee further recommends that ASIC report this information on an industry and individual service provider basis.

8.3 The provision of poor financial advice is a systemic problem.[3] Given that almost half of all Australian adults have unmet financial advice needs[4] this presents a serious risk to the long-term financial health of Australians.

8.4 In the best cases, poor financial advice leaves Australians' investments and retirement savings facing elevated levels of risk. In the worst, Australians have had their savings wiped out.

8.5 It is a practice that has resulted in CBA[5] and NAB[6] alone paying out approximately $85 million in compensation since 2009. These figures will likely continue to grow.

8.6 Further, the provision of poor advice is far from the sector's only failing. Over seven years banks systemically charged consumers ongoing advice fees, even where no advice was provided.

8.7 ASIC has estimated that between 1 July 2008 and 30 June 2015, the sector collected up to $178 million from consumers that it was not entitled to.[7]

8.8 Given the above, it is not surprising that only 20 per cent of Australians trust banks to provide them with unbiased advice.[8] This is a trust deficit that the industry must repair.

8.9 The industry's failure to deliver for its customers has occurred for a number of reasons, including:

- financial advisors receiving commissions that incentivised the sale of certain products irrespective of the investor's interests;
- financial advisors taking advantage of retail investors with poor levels of financial literacy;[9]

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3 Mr Peter Kell, Deputy Chair of ASIC, *Committee Hansard,* 14 October 2016, p. 13.

4 ASIC, *ASIC's Corporate Plan 2016-17 to 2019-20*, 31 August 2016, p. 11.

5 Mr Ian Narev, CEO of CBA, *Committee Hansard*, 4 October 2016, p. 4.

6 Mr Andrew Thorburn, CEO of NAB, *Committee Hansard*, 6 October 2016, p. 17.

7 ASIC, *Report 499: Financial advice: fees for no service,* October 2016, p. 21.

8 Ernst and Young, *The Relevance Challenge: What retail banks must do to remain in the game,* September 2016, p. 4.

9 Senate Economics References Committee, *Scrutiny of Financial Advice Part I – Land banking: a ticking time bomb,* February 2016, p. xii

- conflicts of interest between product designers and distributors in vertically integrated institutions (each of the major banks is vertically integrated in this way);[10]
- financial advisors acting fraudulently;[11] and
- a poor institutional culture that does not put consumers first.[12]

8.10 In response to the industry's repeated failings, government, regulators and industry have made a number of reforms to improve consumer outcomes.

8.11 These are critical reforms that are strongly endorsed by the committee.

8.12 The committee believes that further enhancing the transparency and public accountability of the financial advice industry would create the incentives necessary to better ensure that consumers' interests are prioritised.

8.13 For this reason, the committee recommends that by the end of 2017, ASIC establish an annual public reporting regime for the wealth management industry, providing detail 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 financial advisors found guilty of misconduct and, where relevant, the consequences for the AFSL holder that they represent or are employed by.

8.14 This information should be provided at an industry and institutional level and should build on the information provided in ASIC's August 2016 report on enforcement outcomes.[13]

8.15 This regime could be modelled on the proposed reporting regime for the life insurance industry, which will report claims data and claims outcome on an industry and individual insurer basis from 2017 onwards.

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10 ASIC, *ASIC's Corporate Plan 2016-17 to 2019-20*, 31 August 2016, p. 11.

11 For example: ASIC, '16-007MR Former Brisbane financial advisor jailed after pleading guilty to fraud charges', *Media Release*, 18 January 2016, <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-007mr-former-brisbane-financial-advisor-jailed-after-pleading-guilty-to-fraud-charges/>, viewed 27 October 2016.

12 ASIC, *ASIC's Corporate Plan 2016-17 to 2019-20*, 31 August 2016, p. 11.

13 That is: *Report 485: ASIC enforcement outcomes: January to June 2016*, August 2016, pp. 8-9.

8.16 The establishment of a reporting regime for the life insurance industry is an important outcome of ASIC's review into claims handling practices and will create incentives for life insurers to improve their practices. It should be replicated in other industry sectors of concern.

8.17 Regular reporting of this information in the life insurance and wealth management industries will effectively supplement the information provided in each institution's public regulatory breach reporting (Recommendation 2) and further empower consumers to take their business to firms with a history of delivering for their clients.

Measures to improve consumer outcomes (enacted and announced)

8.18 Since 2011, the financial advice industry has been subjected to increasing levels of regulation (Table 8.1). Given the potential harm that the industry poses to consumers, this is appropriate.

Table 8.1 Key measures to improve outcomes in the financial advice industry

Measure	Summary of Measure	Date enacted/expected to be enacted
Future of Financial Advice (FOFA)	The FOFA reforms aim to improve the quality of financial advice provided to consumers.	The FOFA reforms became mandatory from 1 July 2013, with ASIC's facilitative compliance ending on 1 July 2014. The Government's FOFA amendment Bill passed the Parliament on 2 March 2016.
Financial Advisors Register	A register of people who provide personal advice on investments, superannuation and life insurance. Includes details on qualifications and training.	31 March 2015.
New industry hiring standards for financial advisors	The industry has developed minimum standards for checking references and sharing information to ensure that rogue advisors cannot move between firms. *Note: according to the ABA only 38 per cent of the market has subscribed to these policies.*	Commitment announced on 20 September 2016.
Last resort compensation scheme for financial advisers	The ABA has announced the development of an industry model for a mandatory last resort compensation scheme covering financial advisers.	Model of last resort compensation scheme scheduled to be finalised in September 2017.

Measure	Summary of Measure	Date enacted/expected to be enacted
Life insurance advice remuneration	The Government is progressing reforms to improve the quality of life insurance advice. The reforms reduce the financial incentives for advisers to unnecessarily replace policies.	Legislation introduced on 12 October 2016. The reforms are scheduled to commence on 1 January 2018.
Raising professional standards	The Government is progressing legislation to raise education, training, and ethical standards for financial advisers.	Requirements commence 1 January 2019.
Enhanced ownership disclosure	The Government has committed to introducing legislation to ensure that financial advisers adequately disclose their relationships with associated entities.	Commitment announced on 20 October 2015.
ASIC's Wealth Management Project	ASIC's project aims to lift the standards of major financial advice providers – in particular, advice quality and the remediation of clients who have suffered loss as a result of their failure or action.	Ongoing.

Source: Government's response to the FSI, ABA

8.19 These reforms, coupled with the introduction of a product intervention power for ASIC (which will enable ASIC to modify, or if necessary, ban harmful financial products); product design and distribution obligations for financial service providers; and a broad review of ASIC's enforcement regime, should address the majority of the institutional drivers of poor financial advice.

8.20 However, they should be supplemented by the introduction of greater transparency. The committee believes that enhancing the public accountability of the sector will:

- empower consumers to make more informed choices in the financial advice market; and
- create additional incentives for institutions to improve consumer outcomes (including the ability for institutions to benchmark their performance against their peers).

Recommendation 10

8.21 The committee recommends that, whenever an Australian Financial Services Licence (AFSL) holder becomes aware that a financial advisor (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 advisor's clients to advise them of the breach.

8.22 In addition to the financial advice industry not being sufficiently accountable to the general public, the industry is not accountable enough to its own customers.

8.23 When a financial advisor is found guilty of misconduct, the committee believes that the clients of that advisor should be notified as soon as possible. The committee was disappointed to learn that this is not standard industry practice.[14]

8.24 AFSL holders should not expect consumers to be monitoring ASIC's website to learn of misconduct[15] – particularly misconduct that may have been systemic and may have resulted in their savings being placed at elevated levels of risk.

8.25 NAB has argued that in cases where the provision of poor advice was not systemic, and where some clients therefore did not suffer financial harm, that notifying all clients may create unnecessary stress.[16]

8.26 This argument is not compelling. Customers have the right to know if they have been advised by someone that has been found guilty of misconduct.

8.27 The financial advice industry needs to demonstrate that it has heard community concerns. In response to misconduct, the industry must demonstrate to each potentially affected client that the advice they received was good.

8.28 This is a necessary step to improve Australians' confidence in the financial advice industry.

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14 Mr Shayne Elliott, CEO of ANZ, *Committee Hansard*, 5 October 2016, p. 8 and Mr Andrew Thorburn, CEO of NAB, *Committee Hansard,* 6 October 2016, p. 8.

15 Mr Shayne Elliott, CEO of ANZ, *Committee Hansard*, 5 October 2016, p. 8.

16 NAB, *Response to Questions on Notice: Question Five*, 20 October 2016, p. 5.

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Appendix 9 – Hearings and Witnesses

Friday, 3 March 2017—Canberra

National Australia Bank

Mr Andrew Thorburn, Chief Executive Officer

Tuesday, 7 March 2017—Canberra

Commonwealth Bank of Australia

Mr Ian Narev, Chief Executive Officer

Australia and New Zealand Banking Group

Mr Shayne Elliott

Wednesday, 8 March 2017—Canberra

Westpac

Mr Brian Hartzer, Chief Executive Officer

Australian Bankers' Association

Mr Steven Munchenberg, Chief Executive Officer

Australian Labor Party Dissenting Report

Introduction

Again the second hearing of the bank CEO's allowed each member of the Committee just 20 minutes of questions to the bank CEO's. After the first hearing the Labor members said that it was clearer now than ever that a broader inquiry is needed, this policy approach remains true. The only way to achieve any form of justice for the victims of the banks, and the only way to truly shine a light on the practices that drive unethical behaviour in the banking industry is to hold a Royal Commission.

Deloitte Report

Commonwealth Bank appointed Deloitte to investigate its CommInsure Life Insurance arm following reports by the Four Corners program and Fairfax newspapers of serious misconduct. Those media reports highlighted very concerning allegations of claim denials based on outdated medical definitions and the manipulation of medical files.

The Deloitte report concluded that there were no systemic issues relating to declined claims without interviewing any of the claimants. This was put to CBA CEO Mr Ian Narev

> Mr THISTLETHWAITE: It has been reported that no customers were interviewed. That is true, isn't it?
>
> Mr Narev: Yes.

Mr Narev suggests that this does not make the report invalid because of all the other evidence utilised the report's findings. Again this represents evidence of why a broader inquiry with examination powers is patently necessary.

Scandals Continue

Despite the relatively short-time between the two House Economics Committee hearings the banking scandals kept on coming. A simple collection of the headlines since the last hearings from major news outlets relating to the banking sector shows a bleak picture:

NAB's former star Graeme Cowper's demise now complete – Sydney Morning Herald 07.12.16

NAB accidentally sends 60,000 overseas customers' banking details to wrong email – ABC News 16.12.16

CBA and NAB admit impropriety in foreign exchange trading – Australian Financial Review 21.12.16

NAB pays out $36.5 million to super customers – Australian Financial Review 02.02.17

CBA facing investor backlash on executive pay – Sydney Morning Herald 07.11.16

Commonwealth Bank criticised for paying lip service on small biz loans – Australian Financial Review 30.11.16

Commonwealth Bank pays extra $5m in compensation for poor advice – The Australian 05.12.16

Harrowing tales reveal 'worst' flaws of $44 billion life insurance industry – Sydney Morning Herald 22.02.17

ANZ Bank admits inability to control its Malaysian affiliate – Financial Times 12.11.16

ANZ and Macquarie Bank fined a combined $15 million for attempted currency price fixing – Business Insider 14.12.16

Ex-ANZ financial adviser Andrew TambyRajah banned for five years – The Australian 12.12.16

ANZ's new 'fairness officer' former Commonwealth Ombudsman Colin Neave to review products – Sydney Morning Herald 15.12.16

Former Westpac banker David St Pierre jailed over $4 million fraud – News.com.au 09.02.17

ASIC bans former Westpac financial planner – Sydney Morning Herald 28.11.16

ASIC suit over Westpac's super advice 'tip of the iceberg' – The Australian 03.01.17

Westpac's BT sends rejected TPD claims for review – The Australian 04.11.16

Many of these issues were discussed by the committee during the hearings and all the CEO's admitted such behaviour was unethical, inappropriate and in some cases illegal.

Structure and Culture

The Australian Bankers' Association's Sedgwick review into retail banking remuneration was handed down on 19 April 2017. The review makes 21 recommendations around the sales culture, performance management and governance of the banking industry.

One of the headline findings of the Sedgwick report relates to a point that Labor has been consistently making - that the practice of paying incentives linked to sales targets promotes poor outcomes for banking customers.

One of the more significant issues is that sales targets are still used as a performance management measure. That is, if you fail to meet sales or referral targets as a frontline employee you risk being managed out of the business. The review's terms of reference, which were set by the banks, focussed on pay arrangements for the lower three tiers of retail banking jobs and meant Mr Sedgwick was prevented from properly scrutinising middle and senior executive pay and bonuses.

The structure and culture of the big 4 banks still promotes poor customer outcomes and this looks unlikely to change without a Royal Commission exposing the issues.

When Banks were questioned about making their submissions to the Sedgwick Review public, there was some agreement on the basis that commercial-in-confidence information be redacted. However, while some such information has been provided to the Committee for review, it has not be possible to review all such information prior to the tabling of this Report, as such information was provided on a confidential basis to be reviewed in person only after Parliament last adjourned. The actions of Government members of this Committee in requiring the tabling of this Report before the resumption of Parliament in May means that such information may not be reviewed or reported on until late 2017 at the earliest and is completely antithetical to the purpose of the Inquiry, thereby further demonstrating the Government's lack of resolve to apply proper scrutiny to the banks.

The Government Members Report Recommendations

Second Report Recommendation 1

The Chair's report reaffirms its support for all of the recommendations contained in the first report. The Labor members' views of these recommendations, as set out in Appendix B of the first Report of this inquiry, have not changed and are expanded upon below.

Second Report Recommendation 2

The Carnell report's recommendation that non-monetary default clauses be abolished for loans to small business has merit. However, that this is the sole new recommendation to come from the second round of hearings with the Banks and the first with the Australian Banking Association, is a demonstration of how much the Government merely sees this Inquiry as a means of distracting away from the need for a banking royal commission.

First Report Recommendation 1

It is notable that the Government members of the committee continue to hold to their recommendation for the creation of a banking tribunal, when Government Ministers have backed away[1] from the Prime Minister's promise last year to create one. This dysfunction is typical of this Government's desperate, floundering attempts to distract attention away from the need to hold a Royal Commission into the banks. A range of stakeholders expressed deep concerns about the prospect of a banking tribunal which may deliver worse outcomes for consumers. The current Credit Industry Ombudsman, Raj Venga, stated publicly that a new banking tribunal would be a huge mistake. The appropriateness of the structure relating to the board and members of the tribunal remain in doubt, while the nature of any decisions that the tribunal would make may require the body be invested with full judicial power. This is further complicated by the suggestion that lawyers not be permitted to be involved. Merely preventing lawyers appearing in a tribunal will not create a level playing field. Funding for legal assistance for customers would be of greater assistance in levelling the playing field. As can be seen, the Committee's recommendation, which it has reiterated, raises more questions than it answers.

First Report Recommendation 2

While Labor believes there is a clear need for more and better public reporting of breaches of corporate law or licensing requirements within financial institutions, this recommendation as outlined in the Government members' report unfortunately has holes and is symbolic of the Turnbull Government's rushed and slap-dash approach to the entire inquiry.

First Report Recommendation 3

Recommendation 3 proposes the creation of a new team within the ACCC, without any further funding or resourcing, an issue that has been outlined by ACCC Chairman in discussing the limited number and scope of market studies conducted to analyse levels of competition. Without further resources this recommendation is not workable.

First Report Recommendation 6

This recommendation highlights the confusion of the Turnbull Government in considering the licensing requirements for ADIs and for a 'two phase' licensing process. The proposal appears superfluous in light of evidence provided in a

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[1] See, for example, ABC, 6 December 2017, Tom Iggulden, 'Government backs away from banking tribunal, implements another ombudsman instead'.

separate hearing by Mr Byres, Chairperson of the APRA who clarifies that the licensing requirements are not necessarily acting as an impediment to be an ADI.

First Report Recommendation 7

It would be more appropriate to recommend that APRA direct banks to audit their risk management systems. Otherwise, AFSL holders are required to have adequate risk management systems and APRA-regulated institutions are currently required to have systems for identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating material risks that may affect its ability or the ability of the group it heads, to meet its obligations to depositors and/or policyholders.

First Report Recommendation 9

Labor agrees that additional transparency measures are needed but once again raises concerns about the workability of this recommendation as formulated in the report. A properly formulated recommendation would need to focus on breaches that relate to client files or work performed on behalf of or in relation to a client.

The House of Representatives Economics Committee is no substitute for a Royal Commission.

Nothing has substantially changed since the first hearings. If anything, many more troubling examples of poor banking culture and misconduct have come to light. This inquiry exists as a mechanism to avoid further scrutiny through a broader inquiry. Each member of the committee still gets around 20 minutes to question the Bank CEO's. The Coalition members report fails to again answer why Australia should not have a Royal Commission into the banks?

Through the questions in writing process over both the first and second hearing thousands of documents have been provided by the banks that remain sealed. These secret documents deserve greater scrutiny. This is made worse by the Government members' belligerent attitude to the second report, by tabling the report out of session when most committee members have not been given adequate opportunity to review this documentation, which for many would require significant travel time to Canberra.

Furthermore, it is of concern that for both this and the First Report of the Committee, the Government members have used their numbers to force premature reporting timelines upon the Committee. The difficulty of which was highlighted when the day after the first report was tabled in Parliament the banks started announcing increases in their interest rates. Once again, an unreasonably short reporting period has been foisted on non-Government members of this Committee by Government members, the necessity of which remains to be seen but which will no doubt become all to apparent in the not-to-distant future. In any event, such conduct of this Inquiry further reaffirms the Labor Members' view in support of our recommendation.

Labor Members' Recommendation

As the Labor members recommended after the first hearings, we again urge the Government to take responsibility, stop defending the banks and establish the systematic, thorough and transparent investigation that only a Royal Commission can provide.

Such a Royal Commission into the financial services industry should examine issues such as:

- how widespread instances of illegal and unethical behaviour are within Australia's financial services industry;
- how Australia's financial services institutions treat their duty of care to their customers;
- how the culture, ethical standards and business structures of Australian financial services institutions affect the behaviour of these institutions;
- whether Australia's regulators are really equipped to identify and prevent illegal and unethical behaviour;
- comparable international experience with similar financial services industry misconduct and best practice responses to those incidents; and
- other events as may come to light in the course of investigating the above.

Matt Thistlethwaite MP **Deputy Chair, Australian Labor Party**	**Madeleine King MP, ALP**	**Matt Keogh MP, ALP**

Australian Greens Dissenting Report

When the big banks start suggesting they might not give you a mortgage because sea-level rises will affect the value of your home, or that they'll second guess a loan to a farmer because global warming means less rain is falling in that region, it's time to sit up and pay attention.

The big four banks failed to see the Global Financial Crisis coming. Regulators were likewise blind to the looming catastrophe. The public paid a double price, first hit with job losses and wealth destruction, then left to pay the costs of government intervention to prop up the banks and to avoid the country plunging into depression.

We may be on the verge of two more massive shocks and, going by the evidence of the big four banks to this committee, it's not clear that we'll be any better prepared than going into the GFC. The first concerns housing and the second concerns climate change. While the housing outlook seems bleak, the steps being taken by 3 of the big 4 on the climate front give cause for hope, though Westpac unfortunately remains stubbornly of the view that new coal mines like the Adani Carmichael venture might be worth financing.

The housing crisis: the banks join the war on the young

Australia has a problem with housing. A very big problem. The price of a house is, depending on where you live, likely to be high, very high or ridiculous. We have the dubious honour of spending the highest proportion of income on housing in the world. The proportion of people who own their own home, particularly amongst the young, is in decline and is now at the lowest level in 60 years. Inequality is being created on a generational scale, the economy is being distorted, and the financial system is being loaded up with risk.

We have household debt over 120 per cent of GDP. In the US, it did not even reach 100 per cent before they got into trouble pre-GFC. We have household liabilities now getting up to almost twice the level of disposable income.

It has always been the case that the young and the poor are the less likely to own their own home.[1] But the widening gap in home ownership between the old and the young, and the rich and the poor is an enormously concerning trend. We are witnessing the creation of a structural divide in our society.

It's very easy to understand why home ownership is in decline. Housing in many parts of Australia is overpriced. Australians are paying world record amounts to

[1] HILDA statistical reports also show a marked difference between income equality, with a Gini coefficient of 0.30; and wealth equality—of which housing is the biggest single component—has a Gini coefficient of 0.63.

buy a house. As a result, people either can't afford to buy a house or, if they decide they can, they are being saddled with world record levels of debt. And it's the youngest who are hit hardest. In 1990 house prices were approximately six times the income of a young Australian. By 2013 that had doubled to a multiple of twelve.

Australia's housing market is being driven by a tax system that favours investors above owner-occupiers. The nexus between negative gearing and a concessional capital gains tax has created an uneven playing field that gives property speculators an unfair advantage over prospective home owners. On any given Saturday, young home seekers are being priced up or priced out because they don't have the taxpayers shoulder's to stand on. Tax concessions for investors have supercharged the housing market by increasing the number of prospective buyers. This is what is behind the decline in home ownership rates. This is what is behind the record levels of household debt. This is the problem that needs to be fixed first and foremost.

But it is also becoming clear through this inquiry that housing is becoming more and more important to the banks' bottom line. The higher the price of the house, the bigger the mortgage and the more profits banks make. Even better for the bank when the same investors who bid prices up and up and up can then be given an investor loan by the bank, because the bank knows the investor has the promise of tax break from the government in their back pocket. By pricing young people out of the market, the system helps big banks make even more money.

While many voices join the fray to argue that housing is overpriced and government must act, the big banks stand almost alone in backing the Liberal government and pretending there is no problem.

When asked directly whether the bank thought housing was overpriced, the CEO of NAB, Mr Thorburn replied that he still believed 'the answer is no' (p27 Hansard). And you could hear jaws dropping around the country when the head of Commonwealth Bank offered this astounding observation:

> "Mr BANDT: There are a lot of people, especially young people, who think that houses in Sydney and Melbourne are overpriced. Do you share that view?
>
> Mr Narev: I am not sure they are saying they are overpriced. I think they are saying it is difficult to afford it, and we share that view. …" (p31)

The median house price in Melbourne is now over $843,000, while in Sydney it is an eye-watering $1.15m.[2] If the people running our biggest banks think houses aren't overpriced, then they've joined the war against young people.

[2] https://www.domain.com.au/news/melbournes-median-house-price-soars-to-843674-in-march-quarter-domain-group-20170419-gvn64k/, including this observation: "The median is more than

There is an unstated 'big four' policy in Australia, which means that the government treats each of ANZ, Commonwealth, Westpac & NAB as 'too big to fail', implicitly promising to bail them out if times get tough. And as we saw during the GFC, when this government support crystallises, it helps the big banks increase their market share and maintain their oligopoly. But when the big four banks' business model involves profiting off the misery of young people by defending ridiculously high house prices, they have torn up their social licence.

Some commentators predict the housing bubble will burst rather than deflate, with significant potential consequences for the economy. If this happens, government would do well to remind any big bank coming cap-in-hand seeking assistance that they steadfastly denied there was a problem while quietly boosting their bottom line.

What does '2 degrees' mean for our banks?

In the 'Paris agreement' climate treaty, Australia joined many other countries in pledging to limit global warming to less than two degrees above pre-industrial levels. The treaty has been ratified in Australian domestic law. 'Two degrees' is a target that each of the big four banks has endorsed.

The world is now working out just what it will take to meet this target. As part of the treaty, governments have agreed to submit further pledges to cut pollution. Banks and the finance sector are now on notice that there will be significant economic shifts and that while current government policies may not be enough to meet the 2 degree target, one can 'work backwards' from the target to understand the series of massive changes required in the Australian economy over the next few years.

The big bank's regulator, APRA, has sounded the alarm bell. On 17 February 2017, one of the three members of APRA's Executive Group, Geoff Summerhayes, delivered a critical speech, stating (emphasis added):

> "while climate risks have been broadly recognised, they have often been seen as a future problem or a non-financial problem. The key point I want to make today, and that APRA wants to be explicit about, is that this is no longer the case. Some climate risks are distinctly 'financial' in nature. Many of these risks are foreseeable, material and actionable now. Climate risks also have potential

$110,000 higher than this time last year, and has more than doubled in a decade; in 2007, it was $386,411."; https://www.domain.com.au/news/sydney-median-house-price-hits-115-million-buying-becoming-out-of-the-question-20170419-gvmnp8/

system-wide implications that APRA and other regulators here and abroad are paying much closer attention to. …

we now have a much more sophisticated, granular, quantifiable understanding of the impacts, risks and probability distributions around climate change. This is true on the planetary scale. For example, it is estimated that in order to have a two-in-three chance of keeping global warming below 2 degrees, we need to restrict future global emissions to around 800 gigatons of CO2.[2] (That's equivalent to around 25 years or so of current annual global emissions). …

The [Paris] agreement establishes a binding global commitment to limit warming to between 1.5 and two degrees Celsius, and provides a pathway for more ambitious emissions reductions efforts if current policies are falling short of that goal. The host of new policies and commitments is significant. **Even more significant is the framework the agreement provides for monitoring and ratcheting up these commitments and contributions over time.**

The agreement provides an unmistakable signal about the future direction of policy and the adjustments that companies, markets and economies will need to make. This global agreement is being complimented by initiatives at national, state and city level. …

The general point is that the transition now in train could potentially lead to significant repricing of carbon-intensive resources and activities and reallocation of capital. This process will be highly sensitive to changes in regulation, technology, the physical environment and behaviour by investors and institutions – and interrelated perceptions and sentiment about all of the above. Inevitably, even under a sanguine view of how smoothly this transition happens, there will be systemic impacts and implications that have to be carefully monitored. …

There are two related, broader points I want to make here. First, while physical risks are obviously a very serious matter, it is transition risks that are likely to be especially important for financial entities. The developments I have spoken about today are bringing these transition risks forward. **The Paris Agreement provides a very reliable signal that policy and regulatory efforts will intensify.** …

Second, the transition risks that stem from existing and anticipated policy and regulatory changes may not be averted or minimised **even if these policy changes are delayed or do not eventuate in**

> **some jurisdictions. It may be that the latter scenario could make risks greater and more abrupt.** This is because there could be either sharper, more significant policy changes and market adjustments down the track, or the physical impacts of climate change could become more severe, more likely and more unpredictable.

One would expect the CEOs of the big four banks to be paying close attention to utterances from the senior members of their own regulator, but there was a mixed level of understanding and awareness of APRA's intervention.

The Commonwealth Bank CEO had read summaries of the speech and agreed conceptually that there is now only a finite amount of fossil fuel that can be burnt, but declined to nominate how big the remaining 'carbon budget' is nor whether any new fossil fuel projects have been refused finance because of the bank's commitment to 2 degrees.

The NAB CEO had read part of APRA's speech and said that it may cause the bank to review its policies during the year, including the bank's exposure to fossil fuels and potentially to 'stranded assets'.

The CEO of ANZ didn't disagree with APRA's 'carbon budget' assessment and perhaps went further than any of the other banks in displaying an understanding of what it might mean for the bank's balance sheet, noting also:

- the bank was seeking to understand the impact of changing weather patterns, rainfall and drought, so as to better inform lending practices. This included meeting with the Australian Bureau of Meteorology to better 'understand how climate change is affecting the suitability of farming land for crops or livestock that have traditionally been raised in any given location' (ANZ29QW); and
- mortgage lending might be affected by rising sea-levels because 'as a bank lender, that is probably where we have the greatest risk' (p66). This might affect LVR but also whether to grant a mortgage at all.

Either at the public hearings or in written answers provided later, each of the above three banks advised the Committee that they were reviewing their policies in light of the '2 degree' target. This approach is welcomed. The mathematics of '2 degrees' will keep asserting itself ever more strongly, with its demand that 80% of known fossil fuel reserves stay in the ground. This will drive massive economic change, creating both stranded assets and new wealth. Perhaps the strongest point made by APRA is that banks need to look past any immediate government policy on climate change and see the new legally-enshrined '2 degree' target as the destination we'll arrive at in only a couple of decades.

Unfortunately, Westpac is taking a different tack. Like the other banks, the CEO of Westpac was familiar with the APRA speech, agreed conceptually with APRA's 'carbon budget' and told the committee that sea-level rise and other climate impacts formed part of the bank's current approach to risk. Indeed, Westpac said that it was currently reviewing its loan book to see whether the '2 degree' limit meant that the bank was exposed to potentially stranded assets. Westpac was also in the middle of updating its policies in light of the '2 degree' target.

However, Westpac insisted on leaving the door open to financing new fossil fuel projects, including as soon as this year. Westpac also clearly wanted to have its cake and eat it too, accepting in principle that at some point it may be bank policy to not lend to expand coalmines but rubbishing a suggestion that it might happen this year, saying only that the transition would be supported 'over time' (p30). This raises the question as to whether the 'review' being currently undertaken is serious, given that the CEO has already ruled out having a policy this year against further exposing the bank by lending to new fossil fuel projects, notwithstanding what the '2 degree' target might require.

In particular, unlike the other banks, Westpac seemed particularly keen to signal it may support the Adani coal mine if approached. Whereas most other banks were willing to signal a reluctance to take on new coal projects like this mega-mine, Westpac headed in the other direction.

As the 'Stop Adani Alliance' makes clear (stopadani.com):

> Adani's mine won't just be the biggest coal mine in Australia, it will be the biggest new coal mine in the world, more than five times the area of Sydney Harbour.
>
> When we need to urgently reduce carbon pollution, this mine takes us in the completely wrong direction.
>
> The Great Barrier Reef has already experienced devastating coral bleaching from rising sea temperatures as a result of global warming. If current climate trends continue, scientists estimate that in less than twenty years, coral on the Great Barrier Reef will experience serious bleaching every second year. The Great Barrier Reef, now teeming with life, will become a graveyard in decades. Burning the coal from Adani's mine will help lock-in this tragic fate for one of the world's natural wonders.
>
> Climate change will also be accelerated by the land clearing required to build the mine. In total, 20,200 hectares of land, equivalent to over 28,000 soccer fields or 200,000 quarter-acre blocks, would be cleared. Over half of the land that would be cleared is mature woodland and bushland - important habitat for many animals including threatened species such as koalas and echidnas and endangered birds.

Burning 2.3 billion tonnes of coal is something we simply cannot afford to do if we are to remain within a carbon budget consistent with 2 degrees.

The penny doesn’t seem to have fully dropped when banks like Westpac still think they can commit to a 2 degree target but leave the door open to expanding coal mines. The days of dealing with climate change simply by putting a polar bear in your ad are long gone.

The Greens hope that when Westpac next appears before the Committee, it is in a position to advise that its new climate policy is consistent with the ‘2 degrees’ policy published on its website and that it will not aid in the extraction and burning of untapped fossil fuel reserves, including the Adani Carmichael mine.

Recommendations

The Greens repeat our recommendations from the first report, including that there be a Royal Commission into the big banks. None of the evidence to date persuades us that there has been any substantial shift in big bank culture. We also repeat our recommendations from the committee’s inquiry into home ownership, because the system is clearly broken and the big four banks have an interest in maintaining the status quo. We also have further recommendations arising out of this second round of hearings:

Recommendation 1: That banks expressly endorse APRA’s sentiment that to meet the banks’ stated goal of ‘2 degrees’, it will be necessary to keep the overwhelming majority of fossil fuel reserves in the ground.

Recommendation 2: Noting that there is currently a dissonance between banks’ publicly stated climate policies (which accept the 2 degree target) and some of their lending practices for new or expanding projects (which would likely directly contribute to exceeding the 2 degree target), if the banks refuse to rule out providing finance for new or expanding fossil fuel projects, APRA should be empowered to impose lending requirements on banks consistent with a ‘2 degree’ carbon budget. APRA’s power should be broad and should include the power to limit or stop a bank’s exposure to fossil fuel projects.

Recommendation 3: APRA conduct a ‘climate stress test’ of each of the big four banks, assessing each bank’s preparedness to deal with transition risks, liability risks and physical risks associated with climate change and meeting the Paris Agreement ‘2 degrees’ target.

Adam Bandt MP, Australian Greens