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AFC SUBMISSION TO THE INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANKING SECTORS

Introduction

The Australian Finance Conference (AFC) appreciates the opportunity to make a submission to the Inquiry. By way of background, the AFC (membership list attached) was formed in 1958 and has evolved to become a non-institutionally based financial services association. Our membership includes participants actively involved in both the banking and non-banking sectors – the subject of the Inquiry. AFC caters for members' needs in relation to their consumer and commercial activities across Australia, including consumer credit and housing finance, equipment leasing and finance, wholesale and receivables finance, deposit-taking and other fundraising activities.

General Comments

A competitive financial market contributes to strong economic outcomes and provides real benefits for consumers. These benefits are well recognised and include:

- lower housing loan interest rates
- lower fees and charges
- greater contribution to the Australian economy including regional communities
- greater customer satisfaction
- strengthening of the market provided by diversity.

Notwithstanding the significant competition in the Australian finance sector, there are a number of issues which are adversely impacting on the competitive ability of individual entities and the sector overall. These are detailed below. Of particular consequence is the impact of the global liquidity crisis, which is the major current concern to stability and competition in the finance market. In addition, we highlight some key areas of concern in the legislative arena – matters which could be addressed to improve competition in the finance sector.

Competition and the Global Funding Crisis

Competition in Australia's financial market place and the ability of individual institutions to provide for their customers' needs are being adversely impacted by the global funding crisis. In line with the growth in the Australian economy, the industry has had very buoyant years with a heavy demand for finance. This demand has been met by financiers with a variety of funding tools including direct wholesale funds and securitisation. Authorised deposit taking institutions (ADIs) have had to rely on these non-retail funds in an attempt to diversify their funding sources and because retail deposits have been insufficient – partly due to the diversion of money to superannuation as well as other competing investments.

The size and diversity of the market has meant the Australian finance industry has been very competitive with a large total number of banks, building societies, credit unions, non-bank mortgage lenders and finance companies. In fact, the fierceness of the competition along with the rising costs of legislative compliance has resulted in rationalisation of the industry with an ongoing number of mergers of financiers.

The finance industry has been anticipating a cyclical downturn in the market and had been preparing for it in recent years. However, what was not anticipated was the extent of the global liquidity crisis, which has created a reduction in wholesale funds far in excess of the reduction in demand by customers. This of course means the available wholesale funds are at a significantly higher price (interest rate). It appears from recent trends and available market information that the crisis is not over, and funding may be under serious pressure for some time to come. The impact is being felt in many countries with flow on to consumption of goods and services. For example, from UK news, building of new homes in the London region has virtually ground to a halt in what has been described as the biggest housing crisis since the great depression[1]. Appreciating the different economic fundamentals in Australia, it is clear Australia will continue to be affected by overseas markets and there is a risk that such trends will be replicated in Australia.

The market and the regulators in Australia recognise that the current funding difficulties are not due to poor balance sheets or prudential mismanagement. The asset quality has been good, the institutions have been well managed and have contributed to an efficient and competitive financial market. It is well recognised that the crisis is a result of international problems and confidence in the international market. Australian financiers, to varying degrees, have been frozen out of markets due to no fault of their own or a fundamental lack of demand. This means the double setback of: financial pain for consumers and businesses borrowing money because of higher interest rates (as shown by the increased spread of money market interest rates[2]); and financial pain for investors/shareholders because of lower profits.

In summary, financiers in Australia have been affected across a broad range of funding sources. Wholesale funding generally has become less available and more expensive. Some financiers have been more severely affected than others.

Securitisation has been particularly hit. Many financial institutions that have provided competition in Australia have been very reliant on securitisation of loans to fund their business expansion. Particularly many smaller institutions which are unrated have had to rely on securitisation because other wholesale funds are more expensive. The securitisation market has enabled financial institutions to compete on more equal terms because the pricing in the securitisation market has reflected the quality of the underlying assets in the pools. However, the securitisation market has effectively not been operating in Australia since August 2007. Some securitisation deals have occurred recently, but are limited and at very high cost. Other funding markets have been less accessible and more costly.

[1] www.lendingcentral.com/2008/07/03/crisis-in-the-uk-property-mortgage-market
[2] RBA Statement on Monetary Policy May 2008 page 41

In early 2007, the pricing for Class A notes was around 15-20 basis points over bank bill swap reference rate (BBSW). Currently the margin above BBSW for AAA rated securitised loans is about 1.2% to 1.4%. These rates reduce the margin a financial institution would make and would generally result in a loss for the institution – clearly a situation that is not sustainable. This is a result of the global liquidity crisis triggered by the sub prime crisis in the US and the subsequent disappearance of many structured investment vehicles (SIV) which were the major purchasers of securitised loans internationally. There is no sign of a recovery of SIVs in the short to medium term.

Financial institutions are accordingly under continued funding pressure. In the last six months, a number of members have significantly curtailed their lending activity in order to effectively manage through the liquidity crisis.

Many financial institutions are facing the need to undertake a term issue within the next six to nine months because they have reached the capacity in their warehouses or they need to pay out older trusts as they fall due. If these financial institutions are forced to undertake a term issue at current prices they will suffer a loss on the assets sold for a term of about five years, being the average term of trusts. This provides a five year funding disadvantage - a significant risk to respected financial institutions that have supported the Australian marketplace for many years. Lending rates would have to increase, loan numbers would have to be reduced and in the medium to long term those financiers may be forced to significantly curtail their activities or to merge.

The crisis in wholesale mortgage funding is so serious that many non-bank lenders will effectively be frozen out of the market in the coming period. In any case, within the finance market there continues to be concern that funding markets will not return to a stable, balanced "norm" in the short or even medium term and the price of securitisation will remain too expensive for most financial institutions for some time to come. By that time the damage will have been done to the market and otherwise viable competitors may be lost, including organisations which provide valuable competitive services in regional areas. As stated in the Bank for International Settlements 78th Annual Report released on 30 June 2008 (page138):

> "Given the variety of the influences underlying current economic and financial difficulties, their interactions and their long-standing nature, we should not expect a quick and spontaneous return to normalcy. Nor should we expect quick and easy policy solutions."

Furthermore, as mentioned above, in this increasingly globalised economy there will continue to be interdependencies which will adversely affect the Australian economy again in the future regardless of whether the underlying economy including the financial sector is strong or not. Long lasting solutions to encourage stability and competition are required.

As Reserve Bank Governor, Glenn Stevens, stated in his address, "Liquidity and the Lender of Last Resort", on 15 April 2008: "My own view, given what we know at present, is that in periods of particularly unusual market duress, central banks should be prepared to move beyond the normal scope of operations to provide liquidity against a broad range of assets and over a longer maturity than might normally be considered". The Governor had some provisos. However, the statement highlights a recognised need for government intervention – not only for reasons of competition but also financial stability.

These comments recognise the need for a framework which distinguishes between inefficient, financially unsound or poorly managed institutions on the one hand and on the other hand, well run, financially sound institutions which are capable of long term survival except for the disruption of destabilising externally created distortions in the market. It is the latter institutions which need to be encouraged and supported. Measures which can be undertaken by governments and central banks to restore access and stability to funding markets should not be perceived as providing special treatment or promoting 'moral hazard', but rather as addressing dysfunctional imbalances in these markets.

However, we recognise the requirement for early solutions needs to be balanced with careful consideration to ensure sustainable policies.

Whilst the Government has yet to make a formal statement on the possibility of creating a government-backed mortgage lender, there is a range of other measures which can be examined to generally overcome the funding market imbalances. These may include: open market operations by the RBA; and purchases/investments by the Office of Financial Management – particularly given their powers under the *Commonwealth Securities and Investment Legislation Amendment Act 2008*, to invest in a broader range of eligible investments that the Treasurer can make under the Financial Management and Accountability Act. The aim of these amendments as stated by the Treasurer in the Second Reading Speech was also to "support the efficient functioning of the Australian financial market"[5] .

Legislative Issues – Impact on Competition and Efficiency

AFC believes there is a range of legislative issues which could be investigated by the committee with a view to increasing efficiency and reducing costs within the financial system. In general, there has been a proliferation of 'reforms' and regulations affecting the finance industry over the last decade. We have seen an uncoordinated regulatory agenda across a range of Governments and regulatory policy makers with isolated approaches. Each Federal or State Government policy maker has understandably focussed on their area of concern without necessarily considering the accumulative impact on the financiers' compliance costs, systems and products offered as well as the increased costs to consumers. Such approaches inhibit the effectiveness of the regulatory system as a whole and the efficiency in the finance market. A more co-ordinated Government approach to regulation would be beneficial. As identified by AFC in other submissions to the Federal Government, AFC supports the Government's moves for a national approach in relation to regulation in areas such as consumer credit, finance broker regulation, personal property securities, model occupational health and safety laws and a national electronic conveyancing system. In addition, we draw the Committee's attention to the some other specific issues as follows.

<u>Anti-Money Laundering and Counter-Terrorism Financing Legislation</u>

The *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* and Rules (the AML/CTF laws) apply to financial services offered by bank and non-bank financial institutions, including consumer lending, credit cards and deposit accounts. The purpose of these laws is to ensure that Australian laws are consistent with the Recommendations of the Financial Action Taskforce (FATF) on anti-money laundering and counter-terrorism financing. Financial institutions must implement procedures to identify, manage and mitigate the money laundering and terrorism financing risks they may reasonably face when providing financial services. The

[5] http://parlinfoweb.aph.gov.au/piweb//view_document.aspx?TABLE=HANSARDR&ID=2830101

AML/CTF laws extend the scope of the *Financial Transaction Reports Act 1988* which, in general, only requires identification of customers of products that allow deposits and withdrawals of currency or provide cheque payment and collection facilities.

The AML/CTF laws require financiers to carry out customer identification procedures and ongoing account monitoring and to report various matters to AUSTRAC. Many of the FATF Recommendations refer to applying such measures on a risk sensitive basis, depending on the type of customer, business relationship or transaction and having regard to the risk of money laundering and terrorist financing. However the current AML/CTF laws only permit a risk-based approach to be applied in limited circumstances, and instead impose a number of prescriptive operational requirements which apply regardless of the financier's assessment of the money laundering or terrorism financing risks involved. For example, all financiers must collect and verify minimum identification information about their customers and carry out ongoing customer due diligence. These requirements may exceed a financier's own commercial practices and those applied generally in the market; and result in additional up-front and ongoing administrative costs (for example the cost of collecting, storing and verifying customer information) and potential delays in settling facilities.

The financial services industry has made submissions to the Minister for Home Affairs and to AUSTRAC on a number of matters in relation to the AML/CTF laws, including a request for an over-arching risk-based approach to be applied across the AML/CTF Act. It is submitted that such an approach would assist competition by removing unnecessary costs and procedural requirements imposed on the financial services sector and its customers under the AML/CTF laws.

<u>Access to credit information</u>
To compete and respond to pressure from customer requirements, the finance sector has had to develop an application processing system that is highly effective but streamlined to enable a quick turnaround of processing and decision making while capturing all the information needed to manage a finance portfolio. The system needs to receive, validate and manage the flow of data and applications in a consistent, timely and cost-effective way. An electronic interface with credit reporting agencies to enable consideration of credit reporting information has been included in the process.

However, because of current privacy regulation, the type of information available to credit providers within a credit file is restricted to identity, inquiry (applications for credit) and negative (default/bankruptcy) information. A Review of the Privacy Laws by the Australian Law Reform Commission is considering whether a more comprehensive credit report should be permitted. The AFC response supported inclusion of more information (eg date and type of accounts opened / limit together with customer's repayment history) on the basis that it would enable our Members to better manage risk and consequently make better informed lending decisions. Its inclusion should see a boost in competition among financiers and lead to lower interest rate credit products for low-risk consumers. It would also enable Australian financiers to better compete on a global basis, given comprehensive credit reporting systems presently exist in all OECD countries with the exception of Australia, New Zealand and France.

Our Members have also sought to incorporate e-verification of customer identity information in the application and decision-making process to minimise the everincreasing risk of fraud and for regulatory compliance purposes (eg with the anti-money laundering / counter terrorist financing reforms). However, implementation has been inhibited, if not prevented, by the limited accessibility to reliable and independent data sources to validate specific categories of customer identity information based on perceived privacy concerns by government administrators of public registers. In particular, an ability to verify or validate driver licence information and motor vehicle registration details would be of considerable assistance to not only meet compliance obligations but importantly mitigate fraud risk and thereby reduce costs and improve competitive pricing. The expansion of electoral roll information (accessible for AML / CTF compliance purposes) to include date of birth information would also be valuable.

<u>Debt Collection</u>
Members, whether they collect debts on a contingency basis or as a creditor, are faced with inconsistent requirements under various laws and official codes (e.g. in Victoria and Queensland). While the ACCC/ASIC debt collection guideline provides a useful base for consistency, the reality is that State and Territory laws undermine what could be a national framework. In addition, efforts to collect debt through effective and efficient means are often stymied by privacy concerns inhibiting access to electronic public registers of information (eg electoral roll) to validate or verify current address details for debtors. Given current access to a paper copy of the electoral roll for debt collection purposes at the offices of the AEC, we question the justification for the policy inhibition.

Further, in the current economic climate which has seen customers of our Members increasingly facing financial issues outlined above, we see the potential for a correlated increase in default or non-payment in the near future. The ease with which a customer can walk away from their contractual obligations to repay by changing residence and impediments to easily locating them is of concern to the industry. Yet again, customers that do the right thing will bear the consequences with the attendant increase in the costs of products or services to offset the default losses. In our view, there is a strong economic and public interest argument to support the reinstatement of access by the finance industry to an electronic copy of the electoral roll to assist with debt recovery and receivables management. In addition, the current access provisions within the Commonwealth Electoral Act recognise that at times the balance must shift from privacy in favour of other public interests, like protection of the public revenue. For example, a number of Government Departments and Agencies (eg Centrelink, Comsuper, Department of Human Services, Department of [Education], Employment and Workplace Relations) are able to use the electoral roll to locate persons for debt recovery purposes. There is equally a public interest in the private sector recovering what it is owed. For this reason we submit that the Committee support a recommendation for re-opening access to an electronic version of the electoral roll by our Members for debt collection purposes.

<u>GST – A proposal to reduce mortgage interest rates: zero rating of financial services</u>
The basic design of GST is that it is a tax on private consumption. To ensure GST is effectively borne only on consumers, and to prevent cascading, suppliers are generally entitled to an input tax credit for the GST component of their acquisitions.

However, financial services do not follow this ‘pure’ model. Financial services are input taxed, and there is no entitlement to input tax credits (apart from reduced input tax credits), and accordingly GST is embedded in the cost structure of Australia’s financial system.

It is generally acknowledged that this treatment of financial services is not optimal, but at the time a 'better' alternative had not been identified in other GST/VAT jurisdictions. Accordingly, when Australia introduced GST the Government noted that this treatment of financial services was consistent with the international model. (In fact, at that time the introduction of the reduced input tax credit regime produced a superior outcome than in other countries by addressing the internalisation bias that would otherwise exist.)

However, while in 2000 the Australian GST treatment of financial services was equal or superior to comparable jurisdictions, in the interim important developments have occurred elsewhere, whereas Australia's treatment has remained virtually unchanged. From 1 January 2005 New Zealand introduced 'zero-rating' of business-to-business (B2B) financial services. This approach integrates the supply of financial services more fully into the GST system by taxing (at 0%) such supplies and allowing financial service providers to claim input tax credits.

In Europe, there have been substantial changes to the European Union VAT directive for EU members, including an option to tax. Singapore has a GST system which enables business to overcome the GST distortions which would otherwise arise through input taxation, by way of pre-determined input tax credits. Hong Kong has considered, but rejected at this stage, introducing a GST regime, and accordingly the Hong Kong financial services industry is not subject to the embedded costs of input taxation. However, it is likely that if introduced, the Hong Kong regime would have incorporated zero-rating of financial services.

In summary, the GST treatment of financial services has always presented a challenge, but when introduced in Australia our approach was equal to or better than comparable GST/VAT jurisdictions. In the meantime, there has been much debate and the general consensus is that zero-rating of financial services is the most effective approach in addressing the inefficiencies of input taxation. The Australian approach is now inferior, particularly compared to approaches taken by GST jurisdiction in our local region. Zero-rating of financial services would remove the embedded GST costs inherent in Australia's financial system and encourage a more internationally competitive finance sector. Furthermore, zero-rating would both alleviate inflationary pressure (and consequently the pressure on official interest rates) and assist in compressing the margin between official rates and mortgage interest rates.

Conclusion

It is often assumed that financial institutions and other financiers are in a position in some way to reduce competition eg by raising prices or limiting choice. This is far from the case. There are in fact many participants in the finance market which ensure that competition is fierce – and sometimes too fierce for some participants to survive, particularly as regulation becomes more complex and demanding. It is therefore important that the regulatory framework enables financial institutions to operate in an efficient and competitive manner. This means policies which create stability in the marketplace, minimise unnecessary and costly regulation and provide equity in regulatory treatment.

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AFC Member Companies *

Adelaide Bank
AllCommercial Finance
Alleasing
American Express
Australian Finance Direct
Australian Integrated Finance
Australian Motor Finance
Bank of Queensland
BankWest
Bidgee Finance
BMW Australia Finance
Capital Finance Australia
Caterpillar Financial Australia
CBFC
Centrepoint Alliance
CIT Group (Australia)
Citigroup
CNH Capital
Collection House
Credit Corp Group
De Lage Landen
Dun & Bradstreet
Elderslie Finance Corporation
Enterprise Finance Solutions
Esanda Finance Corporation
FCA Holdings
Flexirent Capital Pty Ltd
FundCorp
GE Commercial Finance
GE Money
Genworth Financial
GMAC
Hanover Group
HP Financial Services
HSBC Bank
Indigenous Business Australia
Integrated Asset Management
International Acceptance
John Deere Credit
Key Equipment Finance
Komatsu Corporate Finance
Leasewise Australia
Liberty Financial
Lombard Finance
Macquarie Equipment Rentals
Macquarie Leasing
Max Recovery
Members Equity Bank
Mercedes-Benz Financial Services
MotorOne Finance
Paccar Finance
Profinance
RAC Finance
RACV Finance
RetailEase
Ricoh Finance
Service Finance Corporation
Sharp Finance
SME Commercial Finance
St George Bank
Suncorp-Metway
Suttons Motors Finance
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(*As at 14 April 2008)