6. 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

6.1 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.**

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

6.2 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.

6.3 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.

6.4 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.

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

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

6.6 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.

6.7 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.

6.8 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.

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

6.9 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]

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

6.11 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.

6.12 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.

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

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

6.13 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.

6.14 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.

6.15 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.

6.16 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 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.

6.17 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

6.18 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.

6.19 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.

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

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.

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

Obtaining a Banking License

6.21 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]

6.22 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.

6.23 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.

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

6.25 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.

6.26 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:

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

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

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

- 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.

6.27 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]

6.28 These measures have since been further enhanced.

6.29 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.

6.30 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]

6.31 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.

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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).

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.

The Financial Sector (Shareholdings) Act 1998

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

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

6.34 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.

6.35 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.

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

6.37 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).

6.38 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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13 APRA has been delegated responsibility for signing off on FSSA exemptions for ADIs with less than $1 billion in resident assets.

6.39 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]

6.40 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]

6.41 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.

6.42 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.

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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.