Inquiry into Australia’s productivity performance

COBA submission to Productivity Commission

31 March 2022

Executive summary

COBA is the industry association for mutual banks, credit unions and building societies.

Collectively, our sector has more than $150 billion in assets and more than 4.5 million customers. Customer owned banking institutions account for around two thirds of the total number of domestic Authorised Deposit-taking Institutions (ADIs) and deliver competition and choice in the retail banking market.

This submission is focused on the role of regulation as a factor affecting productivity growth.

As noted in the inquiry's terms of reference, Australia needs policy settings that foster a flexible and dynamic economy, that is able to adapt in the face of economic challenges and opportunities.

Regulation and regulatory policymaking are critical policy settings.

The increasing pace, volume and complexity of regulatory change is a challenge for all regulated entities but has a disproportionate impact on smaller players with more limited risk and compliance resources. Better coordination and mapping of incoming regulation can help to reduce this burden.

In the UK, regulators and policymakers have implemented a measure which meets this need. The Financial Services Regulatory Initiatives Grid[1] is a single document that reveals the financial services sector regulatory pipeline for the next 2 years.

This document allows the financial services sector and other stakeholders to understand and plan for the regulatory change that brings significant cost and operational impacts. The Grid is provided by the Financial Services Regulatory Initiatives Forum (FSRIF). The Forum is a similar grouping of financial sector regulators to Australia's Council of Financial Regulators (CFR).

Importantly, participating in this Forum and Grid does not interfere with individual regulators' powers on sequencing of regulation but rather provides them with more information to make informed decision on the timing of regulatory initiatives.[2]

The Forum notes that "the Grid planning process may highlight potential synergies between the various regulatory initiatives", allowing for consideration of "how these may be best be identified and exploited."[3]

In COBA's view, an Australian version of the Grid is urgently needed to help the financial sector navigate the current pace, volume and complexity of change.

We have been discussing the case for an Australian Grid for some time with CFR members. Treasury is the most appropriate agency to be responsible for publishing the Grid. This could be resourced with a simple staffing increase. Priority regulators on this Grid should be APRA, ASIC, ACCC, AUSTRAC, RBA and Treasury. More regulators and policymakers can be added over time.

Implementing the Grid will increase the productivity of regulatory change and free up resources for productivity-enhancing investments. Quite simply, industry wants to meet any necessary regulatory requirements as efficiently as possible.

[1] https://www.fca.org.uk/publications/corporate-documents/regulatory-initiatives-grid

[2] As noted by the September 2020 FSRIF meeting minutes: "Decisions were reserved to the relevant members. Operation of the Forum was intended to ensure that members' decisions result in a fully and appropriately coordinated regulatory pipeline."

[3] See September 2020 FSRIF meeting minutes.

Regulation & productivity

Retail banking is highly regulated with multiple regulators with varying and sometimes overlapping mandates. The customer owned banking sector is regulated by the same financial regulators as the major banks, including:

- APRA as banking regulator
- ASIC as consumer protection and conduct regulator
- RBA as payments system regulator
- Treasury as chief financial sector policy adviser
- AUSTRAC as financial money laundering and terrorism financing regulator, and
- ACCC as competition and CDR regulator.

The Financial Services Royal Commission[4] observed that:

- given the existing breadth and complexity of the regulation of the financial services industry, adding any new layer or law or regulation will add a new layer of compliance cost and complexity
- the existing law has rightly been described, in at least some respects, as labyrinthine and overly detailed, and
- although regulatory complexity imposes burdens on business, the largest entities are very sophisticated and well-resourced [and] are well able to find out what the law requires of them.

Regulation intended to benefit consumers can have the opposite effect by dampening competition, dynamism and innovation.

High regulatory costs hurt consumers because resources are diverted away from investment in product innovation, better service and better pricing.

There is also the broader deadening effect on the economy's dynamism of too much regulation. As noted by the Reserve Bank Governor[5], over the past 20 years as a society we have gone too far in the direction of regulation as the solution to problems.

> "We stop the downside through regulation, but the culture that's coming together with that regulation is limiting the upside and the dynamism in the economy.
>
> "I fear that over time we've erred too far in the direction of regulation."

A decade ago, financial services regulation, while complex, did not have the same pace and volume of regulatory change. While banking was subject to increasing consumer and prudential regulation, since then a global financial crisis, various inquiries, a Royal Commission, exponential technological change and a global pandemic have created wave after wave of regulatory change.

Expanding mandates

The depth and breadth of financial regulator mandates are relentlessly expanding. While APRA was putting the finishing touches on its credit risk capital framework, i.e. 'traditional' banking regulation, it was also consulting on climate change guidance, increasing supervisory intensity on cybersecurity, piloting new data collection methods and expanding its GCRA[6] work. ASIC's mandate is also expanding with continually increasing consumer protection regulation, piloting new data reporting requirements and activity in the GCRA space as well. It will assume new responsibilities under the upcoming Financial Accountability Regime. The ACCC is the regulator of Australia's complex, new and continuously evolving Consumer Data Right (CDR) regime. Regulators such as the RBA, ATO and AUSTRAC are also increasing their activity. The significant community interest in financial services has led to a deluge of inquiries, each with their own set of potential responses to risks in the system. Regulator mandates are increasingly starting to overlap into each other's jurisdiction such as in the GCRA and lending space.

Regulator staffing growth matches this 'on paper' growth in regulation. Regulators are getting more resources and, consequently, regulated firms are spending more time interacting with regulators. The information collected by regulators is increasing and will continue to increase with new technology. This

[4] https://www.royalcommission.gov.au/banking/interim-report

[5] RBA Governor Philip Lowe, Hansard, Senate Select Committee on COVID-19, 28 May 2020

[6] Governance, Remuneration, Culture and Accountability.

tsunami of regulatory change is increasing operational risk in financial services and regulatory change programs now comprise a significant proportion of regulated entity's investment budgets.

This compulsory investment is crowding out funds that could also be used for customer, innovation, digital and growth initiatives. Mandatory deadlines for regulatory compliance obligations, backed by potential regulator enforcement action, are pushing higher value projects aside.

This compounds the competitive disadvantage for smaller, challenger banks in a market described in the most recent major inquiry into competition in the financial system[7] as an "established oligopoly" where the four major banks hold substantial market power over their competitors and consumers.

The market dominance of major banks, their sheer scale and brand recognition, coupled with significant customer inertia, is difficult for smaller banks to overcome.

Complexity problem

Regulation contributes to this environment. As noted by APRA's UK counterpart, prudential regulation can exhibit a 'complexity problem' when the same requirements are applied to all firms.[8]

> "This problem exists if the costs of understanding, interpreting, and operationalising prudential requirements are higher relative to the associated public policy benefits for smaller firms than for larger firms.
>
> "The complexity problem arises because there are economies of scale to understanding, interpreting, and operationalising prudential requirements, or because the factors driving smaller and larger firm distress are different, but the requirements have been designed with larger firms in mind. This problem could have adverse effects on PRA objectives because it could both reduce the resilience of small firms and diminish effective competition."

COBA supports action being taken by APRA to tackle this problem in the Australian regulatory framework. However, the complexity problem is not limited to prudential regulation. One of the most challenging regulatory compliance projects for small ADIs has been implementing the CDR regime. This is a major regulatory change which at the same time is a significant technology transformation project.

The Australian Law Reform Commission (ALRC) has found that financial services legislation is unwieldy and extraordinarily complex.[9] The ALRC's Financial Services Legislation Inquiry is concerned about the risk that the law will become, or already is, too complex, incoherent, or inaccessible to be understood or applied.

> "Or, that it imposes a disproportionate burden on those who are required to try and understand it — including consumers of financial products and services (and their lawyers), financial firms, courts, and regulators.
>
> "The daunting volume of law is cause for concern enough, but even more concerning is its 'Byzantine complexity'.
>
> "New law has simply been added to the old. The accretion of law has reflected varied approaches to risk, but there has been little desire to revisit or dismantle what came before."

APRA recently warned regulated entities[10] that it wants to see them giving the same attention and prioritisation to compliance risk management that they give to cyber risk, operational risk management and other risk classes.

APRA says businesses need robust processes to identify relevant obligations and keep up-to-date with regulatory change.

> "APRA has observed that entities face challenges in developing and maintaining a complete view of obligations that apply to their business operations.

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[7] *Competition in the Australian Financial System*, Productivity Commission, 2018

[8] UK PRA A strong and simple prudential framework for non-systemic banks and building societies

[9] https://www.alrc.gov.au/news/shifting-sands-in-regulation-of-financial-risk/

[10] https://www.apra.gov.au/news-and-publications/how-to-manage-compliance-risk-and-stay-out-of-headlines

> "Even when entities use regulatory compliance subscription services, complexities arise – such as identifying all relevant obligations, and the need to manually supplement the information provided by subscription services. This complexity is compounded when entities operate across multiple jurisdictions, which creates multiple sets of regulatory and prudential obligations for them to identify, maintain and follow."

In a one-week period in October 2021, five significant new key regulatory regimes commenced for banks and other financial services providers:

- The **new deferred sales model for add-on insurance**, to introduce a mandatory four-day pause between the sale of a principal product and the sale of "add-on" insurance products
- **Expanded prohibitions on the hawking of financial products**, to apply when a consumer is being offered a financial product during or because of unsolicited contact
- An **enhanced breach reporting regime**, imposing obligations on credit licensees and imposing a range of new regulatory obligations on financial services licensees
- The **new design and distribution obligation** requiring issuers and distributors of financial products to develop and maintain effective product governance arrangements across the lifecycle of financial products, and
- **Enhanced internal dispute resolution (IDR)** obligations that require financial firms to have a dispute resolution system that consists of IDR procedures that meet the standards or requirements made or approved by ASIC.

In addition to this, the phased introduction of CDR obligations commenced for non-major banks in July and November 2021.

The implementation of multiple, complex new regimes within such a compressed timeframe posed considerable compliance challenges. In addition, critical elements of the new regimes were not finalised until extremely close to commencement, exacerbating the planning, resource-allocation and compliance challenge.

Pace of change

Emerging risks and technological innovation are driving regulatory responses, highlighting the need for all stakeholders to have visibility about incoming regulation and the regulatory policy pipeline.

Recent developments have shown an increasing demand for regulation in environment, social and governance areas, a new payments reform regulatory agenda and steps toward a regulatory response to digital finance.

APRA Chair Wayne Byres recently provided some comment on the pace of change:

> "Regulation rarely keeps pace with the leading edge of innovation (and nor should it be expected to): more typically, the regulatory frameworks and supervisory methods we use today are a product of the financial institutions of yesterday. That may not be too concerning if the pace of change is relatively sedate. But the pace of change today seems extremely rapid."[11]

With innovation and other factors driving change, the regulatory communication and coordination system must be modernised to manage this change in a more efficient manner.

In a recent consultation paper[12], the Department of Prime Minster and Cabinet said that regulatory uncertainty for both industry and government risks inhibiting Australia's ability to achieve its goal of being a top 10 digital economy by 2030.

> "The safe and responsible development and deployment of new and emerging technologies, such as artificial intelligence (AI) and automated decision making (ADM), presents significant

[11] APRA Speech - Remarks to the AMF-BCBS-FSI High-level meeting on the post COVID-19 banking system

[12] https://www.pmc.gov.au/sites/default/files/automated-decision-making-ai-regulation-issues-paper.pdf

opportunities, underpinning improvements in productivity, facilitating economic growth and high quality jobs, improving our health, raising our living standards, protecting the environment and improving our defence and national security capabilities."

"Complexity in the regulatory environment deters innovation within government and industry. While legal frameworks are generally designed to be technology-neutral, they have not been designed with the challenges of emerging technologies in mind. As a result, Australian regulators are sometimes perceived to be lagging behind industry in responding to rapid technological change, and not keeping pace with international counterparts developing regulation that facilitates innovation.

"Siloed, sector and regime specific regulatory approaches have intensified problems of overlapping regulation creating barriers to the development and effective use of AI and ADM."

Better regulatory coordination

Existing regulation of financial services is labyrinthine and complex. Activities such as the ALRC review[13], individual regulator initiatives and enhanced regulator accountability will help reduce the burden of the existing regulation. However, these initiatives will not address the cumulative impact of the increased pace, volume and complexity of new regulation flowing from multiple regulators, policymakers and legislators.

While regulators are demonstrating greater sensitivity at an individual level to the "should we" (decision for new regulation), the "how we" (proportionality) and the "when we" (timing) of new regulation, the degree of coordination between creators of new regulation as a collective is far from clear.

All significant regulatory policy decisions must be considered at a 'whole of system' level to acknowledge the reality that financial sector firms are subject to multiple layers of regulation and multiple regulatory bodies.

A whole-of-system approach to financial sector regulatory change is needed to ensure that regulatory change is proportionate, orderly and coordinated. This will reduce the impact that regulatory change has on financial system competition and efficiency and on customers in terms of cost and opportunity cost.

In the UK Government's 2020 Budget, the Chancellor of the Exchequer announced a proposal to improve regulatory coordination through the introduction of the Financial Services Regulatory Initiatives Forum and the Regulatory Initiatives Grid.

Regulatory Initiatives Grid

As part of the Forum's work, they successfully piloted a Regulatory Initiatives Grid ("the Grid") over the COVID year (see Figure 1). The Grid sets out financial services regulators' planned regulatory workplan over the next two years in one document.

The Grid outlines key milestones for various financial services regulation, supervisory and data initiatives. It also classifies them according to impact on firms and flags any that may be of interest to consumers. The Grid allows regulators to better consider the cumulative impact and timing of regulation.

The Grid includes information on each initiative including:

- name, lead agency and links to public information on it,
- estimates of operational impact such as whether it is higher impact, lower impact or has an unknown impact,
- any expected key milestone dates and any changes to these milestone dates,
- whether the initiative is a newly announced initiative, and
- whether the initiative is expected to have a retail consumer impact as a flag to consumers and consumer organisations.

Now in its fourth edition, the Grid has continuously evolved over this period based on stakeholder feedback and Forum discussion. Recent updates have included:

- adding new regulator members and their initiatives,
- including a flag on consumer interest,
- introducing sub-categories for the largest sector chapters,
- compiling an annex setting out completed/stopped initiatives that have been removed from the Grid between editions,
- developing an interactive online tool, and
- highlighting key examples of closely interconnected initiatives to help stakeholders more readily identify them.

The Grid's development has been an iterative process with financial sector stakeholders. For example, in response to the feedback that consultations and data requests contribute to the administrative burden on firms, the Grid will include all supervisory or policy initiatives that will, or may, have a significant operational impact.

[13] Review of the Legislative Framework for Corporations and Financial Services Regulation

As noted above, the Grid continues to evolve and now includes an online dashboard and a spreadsheet.

It is now a regular feature of the regulatory landscape, with Forum members seeking opportunities to embed it further into their planning processes and to identify opportunities for earlier collaboration.

The Forum says feedback on the Grid has been extremely positive, with stakeholders seeing it as a useful tool in preparing for upcoming regulatory initiatives.

Monitoring cumulative impact

The November 2021 Grid[14] describes the Forum's "ambitious agenda" to help develop a more effective and efficient UK regulatory model.

> "Many of these changes will enhance firms' and the economy's competitiveness and ease operational burdens in the long term, or are meeting important Government priorities, such as on the transition to a net zero economy. That is why after careful consideration, we are satisfied that the burden of the current regulatory pipeline, whilst significant, is appropriate.
>
> "Nevertheless, we want to reassure you that Forum members are monitoring the cumulative impact of regulatory initiatives and considering if and where changes may be needed. Additional coordination has the potential to reduce burdens, and Forum members are working hard to realise these benefits.
>
> "But this is not just about the most high-profile initiatives. We will also need to consider how to align bigger, longer-term strategic changes with more technical, shorter-term initiatives. This is also something Forum members are keen to keep a close eye on because, if initiatives are well aligned, it should create synergies in implementation, reduce burden on firms and deliver positive outcomes for consumers, markets and firms."

Such a document and its underlying processes would be invaluable in the Australian context to help the financial sector navigate the current pace, volume and complexity of change.

In COBA's view, the Grid should be produced by Treasury given its role as the 'line agency' for the financial sector, utilising the CFR as the coordinating body. Treasury is the key policy body and adviser to the Government on financial system regulation. Treasury hosts the Government's detailed policy announcements on regulatory reform, including reform implementation timetables, and undertakes consultations, reviews and inquiries on regulatory policy matters.

Priority regulators on this Grid should be the ACCC, APRA, ASIC, AUSTRAC, RBA and Treasury. More regulators and policymakers can be added over time.

We acknowledge and welcome that the CFR has begun discussions on improving regulatory coordination.[15]

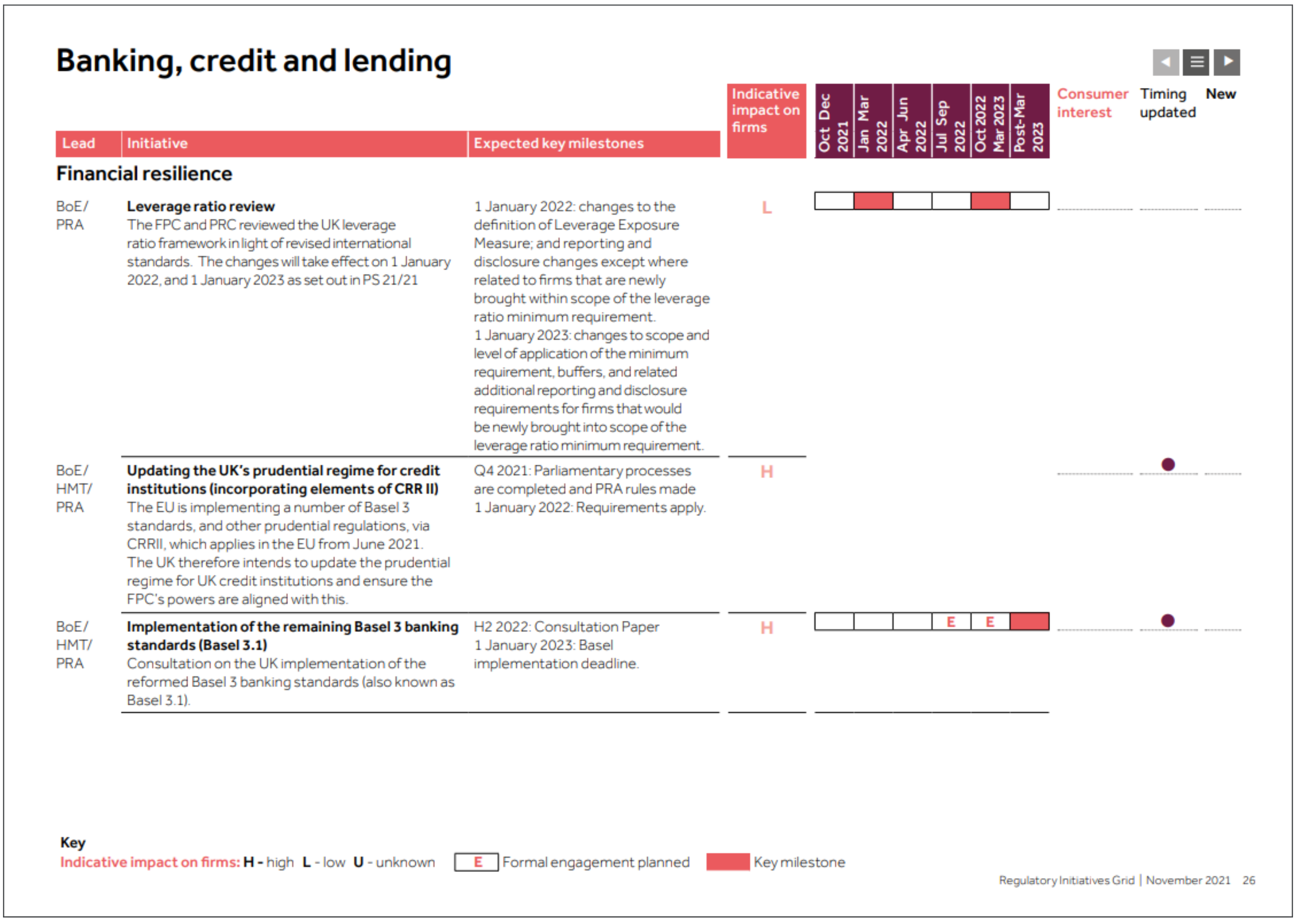
COBA appreciates the opportunity to contribute to this inquiry. We look forward to engaging with the Commission on the next stages, including consultation reports and public hearings.

Michael Lawrence Chief Executive Officer	Luke Lawler Director – Policy

[14] https://www.fca.org.uk/publications/corporate-documents/regulatory-initiatives-grid

[15] See CFR Quarterly Statement June 2021: "Members also discussed Government and Reserve Bank reviews of the payments system, progress on a new cross-agency response protocol for cyber security incidents, lessons from the recent exit of a small ADI, and regulatory coordination."

Figure 1: UK Regulatory Initiatives Grid Example



Banking, credit and lending

Lead	Initiative	Expected key milestones	Indicative impact on firms	Oct Dec 2021	Jan Mar 2022	Apr Jun 2022	Jul Sep 2022	Oct 2022 Mar 2023	Post-Mar 2023	Consumer interest	Timing updated	New
Financial resilience												
BoE/ PRA	**Leverage ratio review** The FPC and PRC reviewed the UK leverage ratio framework in light of revised international standards. The changes will take effect on 1 January 2022, and 1 January 2023 as set out in PS 21/21	1 January 2022: changes to the definition of Leverage Exposure Measure; and reporting and disclosure changes except where related to firms that are newly brought within scope of the leverage ratio minimum requirement. 1 January 2023: changes to scope and level of application of the minimum requirement, buffers, and related additional reporting and disclosure requirements for firms that would be newly brought into scope of the leverage ratio minimum requirement.	L									
BoE/ HMT/ PRA	**Updating the UK's prudential regime for credit institutions (incorporating elements of CRR II)** The EU is implementing a number of Basel 3 standards, and other prudential regulations, via CRRII, which applies in the EU from June 2021. The UK therefore intends to update the prudential regime for UK credit institutions and ensure the FPC's powers are aligned with this.	Q4 2021: Parliamentary processes are completed and PRA rules made 1 January 2022: Requirements apply.	H								●	
BoE/ HMT/ PRA	**Implementation of the remaining Basel 3 banking standards (Basel 3.1)** Consultation on the UK implementation of the reformed Basel 3 banking standards (also known as Basel 3.1).	H2 2022: Consultation Paper 1 January 2023: Basel implementation deadline.	H				E	E			●	

Key
Indicative impact on firms: **H** - high **L** - low **U** - unknown E Formal engagement planned Key milestone

Regulatory Initiatives Grid | November 2021 26

Source: https://www.fca.org.uk/publications/corporate-documents/regulatory-initiatives-grid