Review into Small and Medium-sized Banks

An Issues Paper by the Council of Financial Regulators, in consultation with the Australian Competition and Consumer Commission

December 2024

Council of Financial Regulators

ISBN 978-1-7637270-1-4

Request for feedback and comment

Submissions

This paper seeks stakeholder views on the issues raised by the Council of Financial Regulators (CFR) and the Australian Competition and Consumer Commission (ACCC) in relation to small and medium banks in Australia. Stakeholders who wish to provide feedback should make a submission to the CFR by email by 7 February 2025.

Submissions should be sent to: CFRReview@treasury.gov.au

Glossary

ACCC	Australian Competition and Consumer Commission	MLH	Minimum Liquidity Holdings
ADI	Authorised deposit-taking institution	MFAA	Mortgage & Finance Association of Australia
APRA	Australian Prudential Regulation Authority	NAB	National Australia Bank
AML	Anti-money laundering	NOHC	Non-operating holding company
ANZ	Australian & New Zealand Banking Group	RADI	Restricted ADI
APS	Australian Prudential Standard	RBA	Reserve Bank of Australia
ASIC	Australian Securities and Investments Commission	ROA	Return on assets
AT1	Additional Tier 1 Capital	ROE	Return on equity
AUSTRAC	Australian Transaction Reports and Analysis Centre	RMBS	Residential mortgage-backed security
CBA	Commonwealth Bank of Australia	RWA	Risk-weighted assets
CCA	Competition and Consumer Act 2010	SA	Standardised approach
CDR	Consumer Data Right	SFI	Significant financial institution
CET1	Common Equity Tier 1 Capital	SME	Small and medium enterprise
CFR	Council of Financial Regulators		
COBA	Customer Owned Banking Association		
CPS	Cross-industry Prudential Standard		
CUBS	Credit unions and building societies		
D-SIB	Domestic systemically important bank		
FCS	Financial Claims Scheme		
FSI	Financial System Inquiry		
FSCODA	Financial Sector (Collection of Data) Act 2001		
GDP	Gross domestic product		
GFC	Global Financial Crisis		
IRB	Internal ratings-based (approach to credit risk)		
IRRBB	Interest rate risk in the banking book		
LAC	Loss-absorbing capacity		
LCR	Liquidity Coverage Ratio		
Major banks	The four largest banks in Australia (ANZ, CBA, NAB and Westpac)		

Contents

1. Introduction

The Council of Financial Regulators (CFR), in consultation with the Australian Competition and Consumer Commission (ACCC), has been asked to examine the state of the small and medium banking sector, with a focus on competition. The banking sector plays a key role in supporting sustainable economic growth and meeting the financial needs of Australians. A competitive banking system is critical to Australia's long-term prosperity. Small and medium banks are key contributors to competition and their communities.

Australia's financial regulatory framework aims to ensure that the banking system is resilient, competitive, fair, and maintains consumer protections. Although there are sometimes trade-offs between these objectives, they often complement each other. To achieve an appropriate balance, it is important that the regulatory requirements are tailored to a bank's size, systemic importance, complexity and risk profile.

Many factors impact the overall competitiveness of the banking system. For example, banks' competitiveness can be impacted by economic conditions, consumer expectations, market trends, and regulatory obligations. In the Review's engagement to date, stakeholders have raised a range of topics, for example: cost and access to funding and capital, capital requirements, proportional regulatory settings, the impact of scale, and the ease with which a new bank can be launched.

In recent years, there has been consolidation among small and medium banks and consumer expectations continue to shift. At the same time, technology is changing business models, new risks are emerging (e.g. cybersecurity, online scams) and the regulatory landscape is responding. Some factors may have a relatively larger impact on small and medium banks.

The Review is an opportunity to examine the involvement of small and medium banks in providing competition. The Review will consider whether they are facing competitive challenges that could be detrimental to Australian banking customers.

This paper outlines a range of issues that the CFR will consider. It provides an overview of the banking system and examines: the regulatory framework and its proportionality; banks' funding arrangements; and issues related to banks' ability to enter, scale, and exit the market.

The Review will consider and report to Government on options and approaches to improving competition in the small and medium bank sector, with this paper being the first step in that process. The CFR invites stakeholders to provide their views, supported by evidence, on the issues facing the small and medium banking sector and how these could be addressed. The CFR also welcomes views and perspectives on matters not specifically outlined in this paper (though submissions should relate to the Review's Terms of Reference).

2. Small and medium banks in the Australian banking system

This chapter sets the context for the Review by describing the Australian banking system and the role of small and medium banks.

Summary

Australia's 131 banks differ in size by several orders of magnitude.[1] Collectively, the 4 major banks account for around 72% of banking system assets, down from their recent peak of 77% in 2015. There are 5 medium banks in Australia with a joint market share of 12%; this group includes most banks commonly referred to as mid-tier or regional banks. The medium banks' market share had expanded around 3 percentage points in the 5 years preceding Australia and New Zealand Banking Group's (ANZ's) acquisition of Suncorp Bank (a medium bank) in July 2024. The 74 smallest banks make up 6% of the banking system and are mostly mutual institutions; the number of mutual institutions has fallen from over 200 in the year 2000 as credit unions and building societies (CUBS) have consolidated. Foreign branches – of which there are 48 – make up around 9% of the banking system and mostly serve wholesale customers.

Over the past 2 decades, the Australian banking system has been consistently profitable, although profitability has generally declined. Overall, there is little difference in the implied funding costs across banks when split by size. This is in part because smaller banks tend to be majority funded through by deposits, which are a cheaper source of funding than market-based financing. However, new wholesale funding is more expensive for smaller banks, in large part due to their lower credit ratings. Small banks consume a greater share of their income in operating expenses than the major banks. This partially accounts for the generally higher returns of major banks compared to small banks.

Composition

The Australian banking system has more than $5 trillion in resident assets (around 200% of GDP). It is similar in size, relative to GDP, to the banking systems in Canada and the euro area.

The number of banks in Australia has fallen significantly in the past 20 years as CUBS have consolidated (Graph 1).[2] This consolidation occurred largely through mergers and acquisitions within the sector, motivated in part by the potential for increased profitability and benefits from

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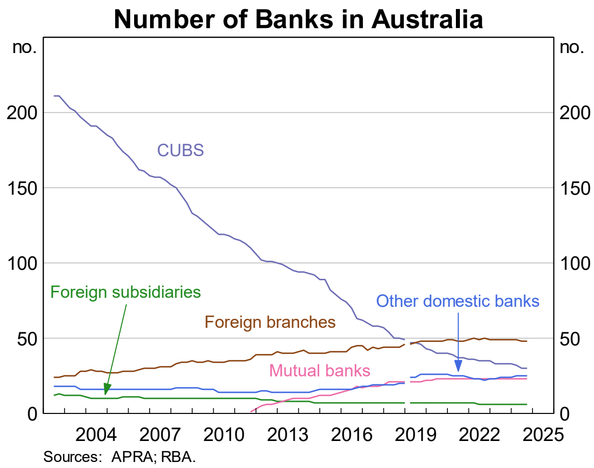
[1] Throughout this review the term bank includes all authorised deposit-taking institutions licensed by APRA, including credit unions and building societies and foreign branches.

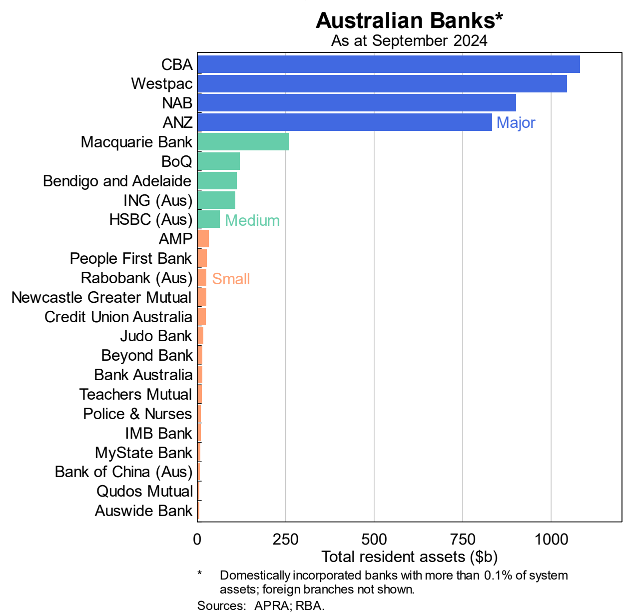
[2] APRA (2017), 'Final Submission to the Productivity Commission – Competition in the Australian Financial System', September.

increased scale and scope.[3] Some CUBS also converted to mutual banks after 2011. The decline in the number of CUBS has been only partly offset by a small increase in the numbers of smaller other domestic banks and foreign branches. The overall trend of consolidation in the numbers of smaller banks matches the experience in peer jurisdictions.[4]

Graph 1



Graph 2



Australian banks differ in size by several orders of magnitude (Graph 2):[5]

- The 4 **major banks** jointly hold around 72% of banking system assets, somewhat below the post-Global Financial Crisis (GFC) peak but within the 60-80% range observed since banking deregulation in the 1980s (Graph 3).[6] APRA has designated the major banks as domestically systemically important banks (D-SIBs), which are subject to increased regulatory and supervisory requirements.[7] They are also subject to the Australian Government's four pillars policy, which states that there should be no fewer than 4 major banks to maintain competition.

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[3] Laker J (2009), 'Mutuals after turbulent times', Speech at the Abacus Australian Mutuals Convention, Gold Coast, 9 November.

[4] See, for example: the United Kingdom (de-Ramon S, Francis W and Milonas K (2017) 'An overview of the UK banking sector since the Basel Accord: insights from a new regulatory database', Bank of England Staff Working Paper No 652); the United States (Federal Deposit Insurance Corporation (2024), BankFind Suite Historical Bank Data, accessed 1 December 2024); and the euro area (Figueiras et al (2021), 'Bank mergers and acquisitions in the euro area: drivers and implications for bank performance', ECB *Financial Stability Review,* November).

[5] Major banks are defined as banks with more than 10% of system assets ($530 billion as at June 2024); medium banks between 1% ($53 billion) and 10%, small banks between 0.1% and 1% and very small banks less than 0.1% ($5.3 billion). Banks are categorised each calendar year, so may move between categories over time.

[6] RBA (2017), 'Submission to the Productivity Commission Inquiry', September.

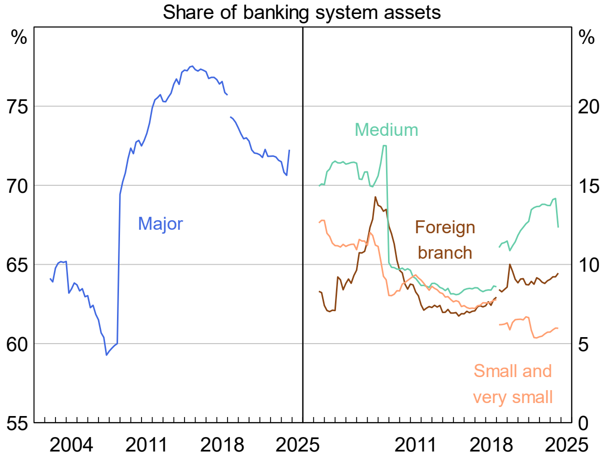
[7] APRA (2023), 'Domestic systemically important banks in Australia', Information Paper, December.

- There are currently 5 **medium banks** with an aggregate market share of around 12% (Graph 4). Medium banks include most institutions commonly referred to as 'mid-tier' or 'regional' banks. Some medium banks – such as Macquarie Bank and Suncorp Bank (prior to its acquisition) – are part of larger financial services groups and some others are foreign subsidiaries of large global banks such as ING and HSBC. There have been 5-7 medium banks in Australia since 2000. Their market share increased by around 3 percentage points between 2019 and June 2024, driven in large part by Macquarie Bank's growth in retail mortgages, but the acquisition of Suncorp Bank (discussed below) has reduced the medium bank market share back to 2020 levels.
- There are currently 74 **small and very small banks**. Two-thirds (by share of assets) of small and very small banks are mutual institutions which are owned by their members. The market share of smaller banks has declined since the early 2000s to 6% of system assets.
- **Foreign branches** make up 9½% of banking assets, down from a peak of 14% prior to the GFC. They are generally not permitted to accept retail deposits from Australian residents of less than $250,000 and tend to focus on wholesale customers.[8]

Graph 3

Banking System Composition*

Share of banking system assets

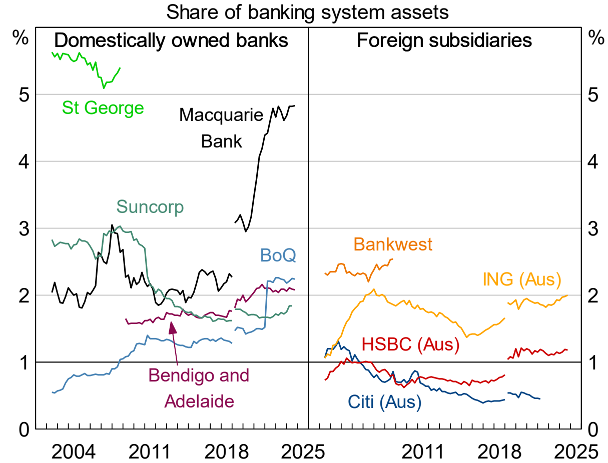


* Includes loans to resident intra-group entities after 2019.
Sources: APRA; RBA.

Graph 4

Medium Banks*

Share of banking system assets



* Any banks with between 1% and 10% of resident assets since 2003; assets include loans to resident intra-group entities after 2019.
Sources: APRA; RBA.

While the number of small banks has declined overall, there have been some new entrants in recent years. Since 2017, when the Australian Prudential Regulation Authority (APRA) introduced a restricted licensing pathway for new banks (see Chapter 5), 10 new domestically incorporated banks have gained a banking licence. However, 5 of the new entrants have subsequently exited, with several citing difficulties in raising capital and growing loan books.[9]

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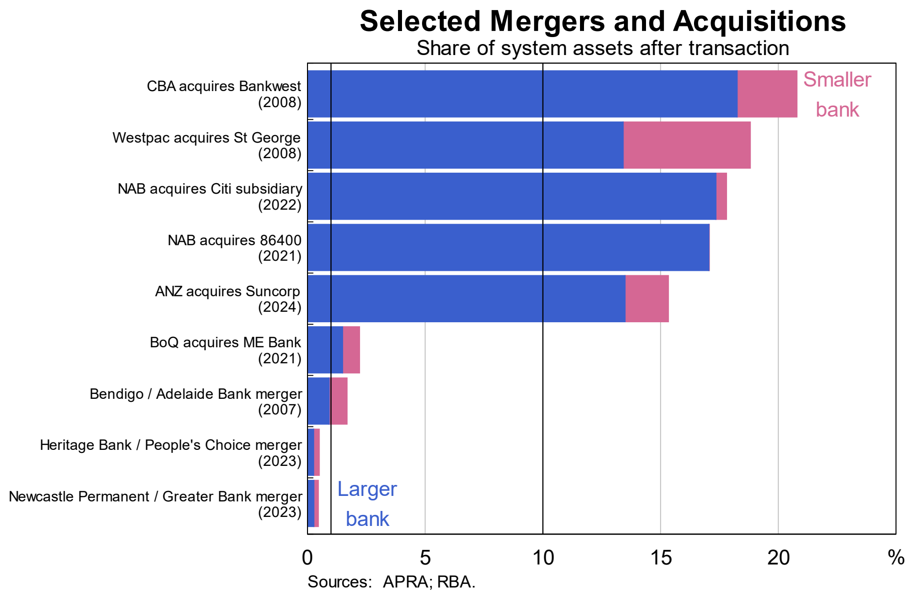
[8] RBA (2012), 'Box A: Foreign-owned Bank Activity in Australia', *Financial Stability Review*, March.
[9] ACCC (2023), 'Retail Deposits Inquiry', Final report, December.

There has also been consolidation in the banking system through mergers and acquisitions (Graph 5). The major banks' market share significantly increased in 2008 with Westpac's acquisition of St George (5th largest bank at the time) and CBA's acquisition of Bankwest (8th largest). Most recently, ANZ acquired Suncorp Bank in July 2024. Further, there have also been mergers and acquisitions outside the major banks, such as Bank of Queensland acquiring ME Bank in 2021.

Graph 5

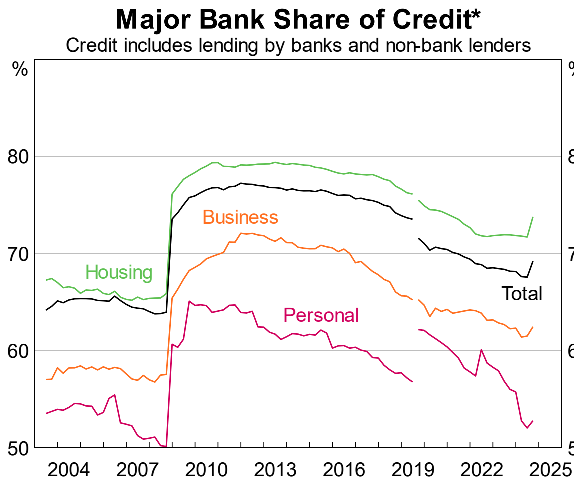


Lending markets

Lending is the main source of income for Australian banks. It currently represents 85% of revenue, up from 70% in 2011.

The major banks' share of lending markets has declined from its recent peak in 2009 (Graph 6). In housing lending, several small and medium banks have increased their market share in the past 5 years. However, ANZ's acquisition of Suncorp Bank unwound around a little over half of the major banks' decline in housing market share since 2019. In business lending, foreign branches have captured most of the major banks' lost market share; foreign branches mostly lend to large businesses (Graph 7). Non-bank lenders have also increased their share of business lending in recent years, mostly in lending to small and medium enterprises (SMEs). Personal lending constitutes only 5% of total credit, with non-bank lenders comprising around a third of this. These non-bank lenders include automotive lenders and buy now pay later providers, as well as other personal lenders who offer personal loans for a variety of purposes.

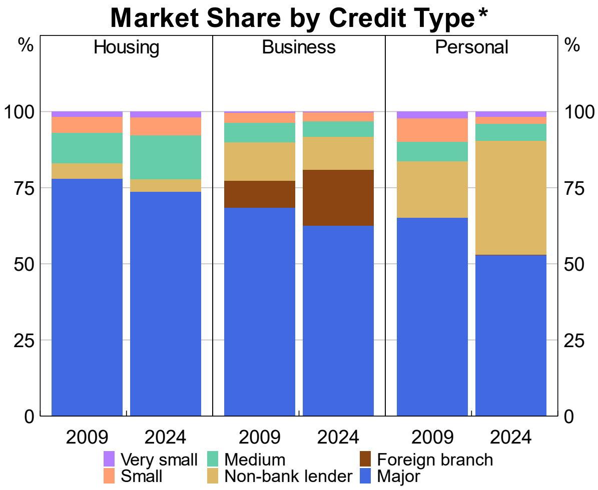
Graph 6



* Break in 2019 for the EFS collection which reclassified some housing loans as personal and provided more accurate estimates of the level of non-bank lending; seasonally adjusted and not break adjusted.

Sources: APRA; RBA.

Graph 7

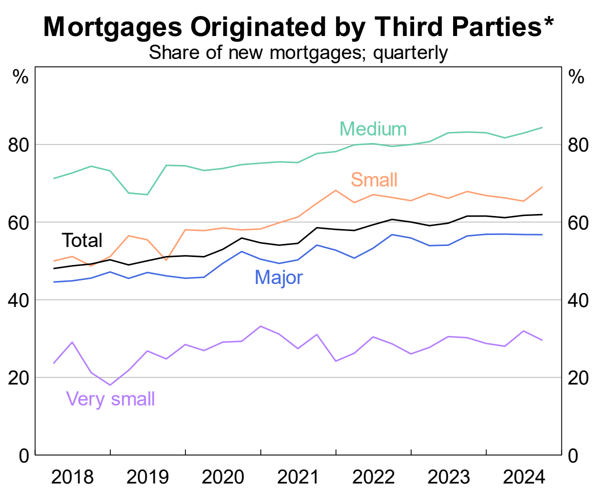


* Data as at September of each year.

Sources: APRA; RBA.

In housing lending, brokers have become an increasingly important source of origination (Graph 8), as well as lowering the barriers to customer switching. In the first half of 2024, around 60% of mortgages were written via brokers.[10] Small and medium banks source a greater share of new mortgages from brokers than the major banks, but very small banks only originate a quarter of their new mortgages via brokers.

Graph 8



* Share of new mortgages funded in the quarter which were originated by a third party such as a mortgage broker; includes internally refinanced loans.

Sources: APRA; RBA.

[10] For more information on the role of brokers, see MFAA (2024), 'Industry Intelligence Service Report', September. The Mortgage & Finance Association of Australia (MFAA) use different data sources for calculating broker market share, but the overall trends are broadly the same as discussed here.

Past reviews of banking in Australia have considered the competitiveness of lending markets. In its 2018 inquiry, the Productivity Commission found that all banks have a 'degree of pricing power'.[11] However, the major banks were the 'dominant force in the market' and could charge higher premiums above their marginal costs. The Productivity Commission also described price rivalry as 'constrained'; unlike in other industries, prudential regulation and the setting of the cash rate 'indirectly determine and broadcast the cost of funds' for banks. The ACCC's inquiries on housing lending found that banks' opaque discounting contributed to higher search costs and stifled competition.[12] The difficulty associated with discovering the actual rate paid on these products adversely impacted borrowers' willingness to shop around.

Sources and costs of funding

Banks fund their assets with a mix of deposits, wholesale debt, and equity. Their funding mix is influenced by a range of factors including cost, prudential regulations, risk, diversification, access to and stability of funding sources.

Deposit funding

On average, domestically incorporated banks source more than half their funding from deposits, and this share has increased steadily over the past decade (Graph 9).[13] Use of deposit funding tends to be negatively correlated to the size of the bank; the smallest domestic banks typically have the greatest share of their funding in deposits, while larger banks access a broader range of funding sources. Smaller banks' growth plans are therefore strongly linked to their ability to attract additional deposits.

In 2023, the ACCC examined competition and price-setting in the retail deposit market.[14] In addition to being a source of funding, retail deposits provide consumers with a safe way to transact, store funds and earn interest income. The ACCC's inquiry found that competition in deposits is often selective and opaque, with strategic pricing strategies leading to greater complexity and poorer outcomes for consumers. The ACCC observed some competition from smaller banks seeking market share but little broad-scale competition from larger banks.

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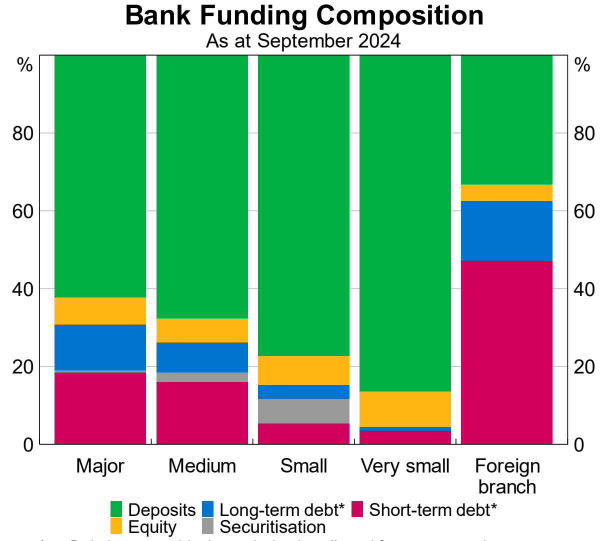
[11] Productivity Commission (2018), 'Competition in the Australian Financial System', Final report, no 89, June.

[12] ACCC (2018), 'Residential Mortgage Products Price Inquiry', Final report, December; ACCC (2020), 'Home Loan Price Inquiry', Final report, December.

[13] De Zoysa V, Dunphy J and Schwartz C (2024), 'Bank Funding and the Recent Tightening of Monetary Policy', RBA *Bulletin*, April.

[14] ACCC (2018), 'Residential Mortgage Products Price Inquiry', Final report, December.

Graph 9



* Debt is on a residual maturity basis; adjusted for movements in foreign exchange rates. Short-term debt includes deposits and intragroup funding from non-residents. Long-term debt includes senior unsecured bonds, covered bonds and hybrid securities.

Sources: ABS; APRA; Bloomberg; LSEG; RBA.

Wholesale funding

On average, wholesale funding makes up around one-fifth of Australian banks' funding. Smaller banks tend to access wholesale funding from a few domestic sources, while the major banks access a broad range of domestic and international wholesale markets.

The cost of wholesale funding is influenced by a bank's credit rating and wholesale market investors generally require a bank to obtain a credit rating. Smaller banks tend to have lower long-term credit ratings than the major banks (Graph 10). S&P for example, cites more constrained business positions, less access to diverse and stable funding sources, and lower expectations of government support as drivers of lower credit ratings for smaller banks.[15] S&P applies a one notch uplift to the ratings of the major banks, Macquarie Bank and Cuscal to take into account higher levels of systemic importance and expected government support.[16] Moody's and Fitch apply a similar adjustment to the major banks and Macquarie Bank.[17]

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[15] S&P (2024), 'Most Non-Major Australian Banks Upgraded On Strengthened Institutional Framework; Outlooks Stable', 2 April.

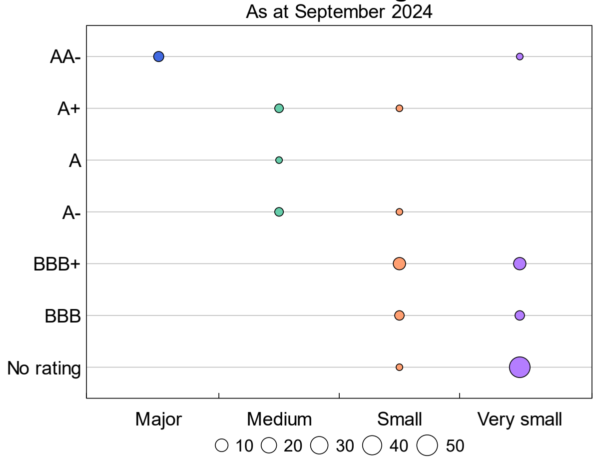
[16] S&P reduced the ratings uplift due to expected government support in 2024 after it upgraded the stand-alone credit ratings of the major banks and Macquarie Bank.

[17] Moody's (2024), 'Moody's takes rating actions on 11 Australian banks follow Banks methodology update', 6 March; and, for example, Fitch (2024), 'Fitch upgrades Australia and New Zealand Banking Group to AA-; Stable Outlook', 26 May.

Graph 10

Credit Ratings*

As at September 2024



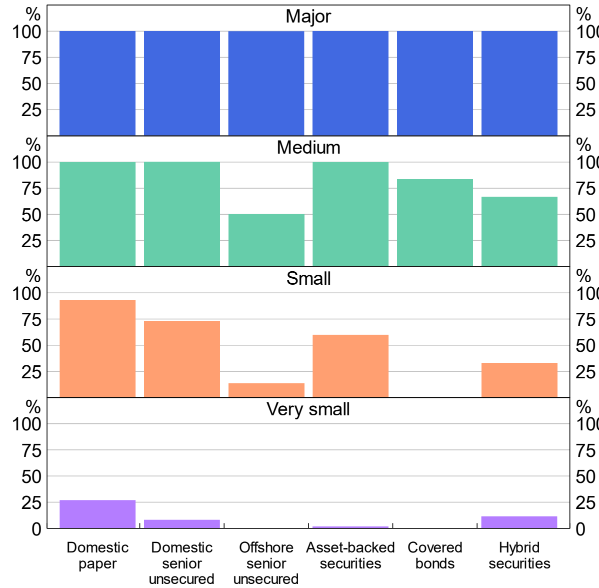
* Long-term domestic S&P rating, otherwise Bloomberg composite rating; circle size corresponds with number of banks at each rating.

Sources: Bloomberg; RBA; S&P.

Graph 11

Access to Wholesale Funding Markets*

Share of banks that have issued; 2019–2024



* Domestic paper is short-term issuance maturing in less than 1 year. Hybrid issuance includes both AT1 and T2 securities.

Sources: Bloomberg; KangaNews; LSEG; RBA.

Use of different wholesale markets has varied across the banking system in the past 5 years (Graph 11):

- All banks except the smallest have issued **short- and long-term unsecured debt** in Australia. Outside the major banks, only half the medium banks and a few small banks have issued offshore unsecured debt in the past 5 years. Issuing offshore is typically more costly than issuing domestically, but it provides access to a broader and deeper investor base and the ability to issue larger deals at longer tenors. However, banks have more recently increased the share of their issuance in Australia, as the domestic market has become deeper and more mature.[18]
- A greater range of banks have issued **asset-backed securities** compared to unsecured debt in offshore markets. Asset-backed securities are secured by a segregated pool of assets, such as residential mortgages. The major banks choose to use less securitisation funding than other banks as they can access alternative forms of less expensive debt with similar maturity profiles. For banks with lower credit ratings than the major banks, asset-backed securities allow them to source long-term funding from investors who demand highly rated securities (and would otherwise not invest in their unsecured debt). Prior to the GFC, some very small banks operated sizable securitisation programs but have since generally moved away from issuing asset-backed securities.

[18] Johnson C (2022), 'Trends in Australian Banks' Bond Issuance', RBA *Bulletin*, September.

- Only major banks and some medium banks have issued **covered bonds**, which are secured by ring-fenced assets in the event the bank defaults on their obligations. Banks cannot encumber more than 8% of their total Australian assets in covered bonds, to ensure a sufficient share of assets are available for depositors in case of a bank failure.[19] Of the 8 Australian banks who have issued covered bonds, they have on average used around a third of their limit.
- Banks can issue **hybrid securities** to meet some of their capital requirements (discussed below); as with other wholesale funding, larger banks are more likely to have issued hybrid securities. APRA has released a discussion paper proposing that Additional Tier 1 (AT1) hybrid securities would be phased out for the purposes of meeting regulatory capital requirements to simplify and improve the effectiveness of bank capital in a crisis.[20]

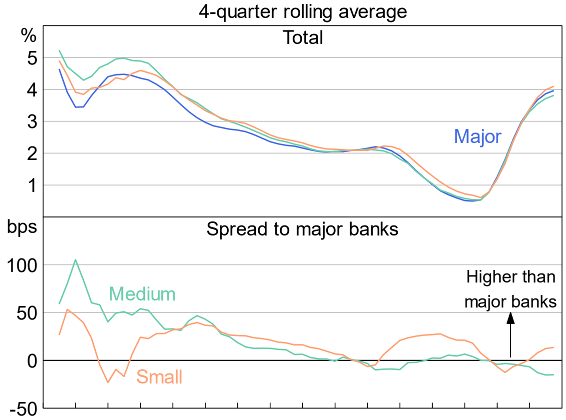
Funding costs

Over the last couple of years, there has been little difference in the implied funding costs for the major banks and small to medium banks (Graph 12). The major banks have historically had lower funding costs than other banks, though this gap closed around 2017. Funding costs also vary significantly within bank size categories; some smaller banks have costs comparable to those of the larger banks, while others face higher funding costs (Graph 13).

Graph 12

Implied Funding Costs*

4-quarter rolling average



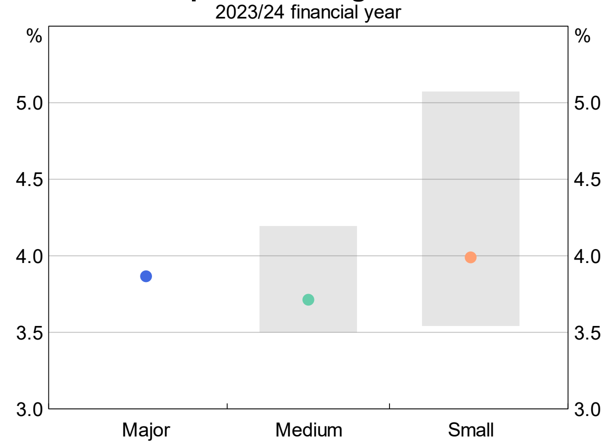
* Total interest expense divided by average interest-bearing liabilities; includes non-interest bearing deposits.

Sources: APRA; RBA.

Graph 13

Implied Funding Costs*

2023/24 financial year



* Total interest expense divided by average interest-bearing liabilities; includes non-interest bearing deposits. Ranges show 25th and 75th percentiles; no range shown for major banks due to insufficient observations.

Sources: APRA; RBA.

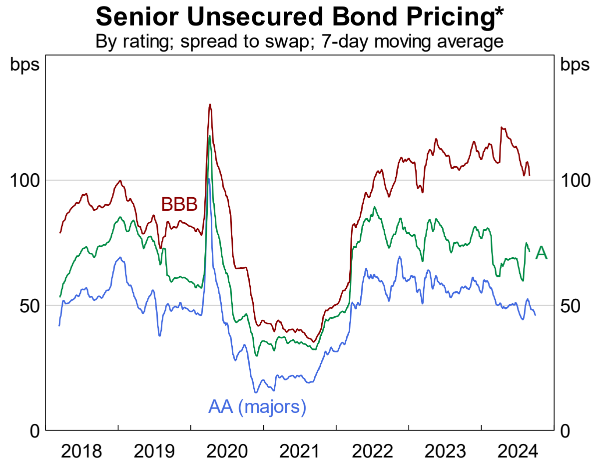
The marginal cost of new funding differs across the banking system. Major banks have a cost advantage in issuing new funding in wholesale markets. This is largely due to their perceived risk profile, reflected in higher credit ratings. They also benefit from better name recognition and

[19] Watson, B (2017), 'Covered Bonds in Australia', RBA *Bulletin*, September.

[20] APRA (2024), 'A more effective capital framework for a crisis', Discussion paper, September.

deeper secondary market liquidity compared to other banks (Graph 14). Asset-backed securities also tend to be cheaper for the major banks to issue than for other banks, despite the senior tranches from both groups being rated AAA. However, as wholesale funding is more expensive overall than deposits, and with major banks choosing to use wholesale funding more heavily than other banks, there is little difference in implied total funding costs across key bank size categories.

Graph 14



* Domestic secondary market, 3-year target tenor. Excludes foreign branches.

Sources: Bloomberg; RBA; S&P.

Capital

Banks issue equity as a source of funding and to meet regulatory capital requirements. Banks typically maintain capital well above their minimum requirements (Graph 15). Over the past 10 years, the major banks' capital ratios have increased significantly, particularly at the Total Capital level, following the implementation of unquestionably strong capital benchmarks and loss absorbing capacity requirements for D-SIBs.[21] Other banks' capital ratios have increased by less or been broadly stable.

The major banks have access to broad sources of new capital, including retained earnings, ordinary shares, and hybrid securities (Graph 16). Similarly, medium banks and other non-mutual banks tend to access all sources of new capital, although have used hybrid securities less than the major banks. By contrast, mutual banks (including CUBS) rely primarily on retained earnings to increase capital, as they cannot issue ordinary shares consistent with their mutual structures. This could be a constraint on their ability to expand their balance sheet quickly. Since 2018,

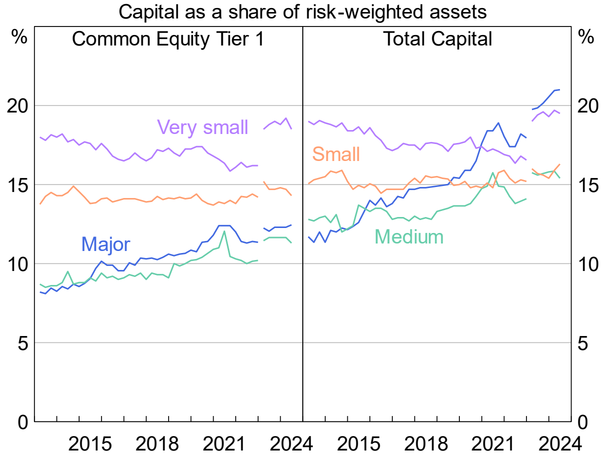
[21] APRA (2017), 'APRA announces 'unquestionably strong' capital benchmarks', media release, 19 July; APRA (2021), 'Finalising loss-absorbing capacity requirements for domestic systemically important banks', letter, 2 December 2021.

mutual banks have also been able to issue mutual equity interests that meet the requirements for Common Equity Tier 1 (CET1) capital, but there has been very little issuance to date.

Graph 15

Median Capital Ratios*

Capital as a share of risk-weighted assets



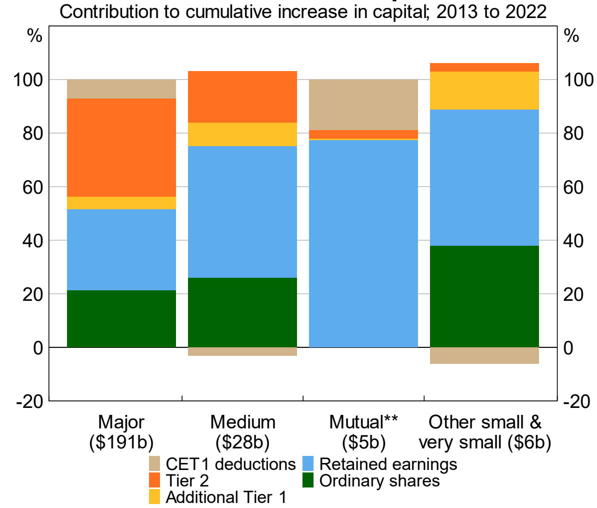
* Break in 2023 for the implementation of ADI capital reforms.

Sources: APRA; RBA.

Graph 16

Sources of New Capital*

Contribution to cumulative increase in capital; 2013 to 2022



* Capital issued in brackets; all columns sum to 100, with negative values indicating capital from that category declined over the period; CET1 deductions includes other income; ordinary shares includes dividend reinvestment plans.

** Mutual banks are all small or very small banks.

Sources: APRA; RBA.

Operating costs

Through scale and scope, larger banks are generally more cost-efficient than smaller banks, although there is reasonably wide dispersion in cost ratios across the banking system. Over the past decade, the major banks have sustainably reduced their costs as a share of their total assets (Graph 17). The directional trend for other banking cohorts has been varied over this period. Smaller banks continue to face disproportionately higher operating costs; for example, very small banks' median operating costs were around 85% of their operating income in 2023 (Graph 18). The Productivity Commission noted in its inquiry that larger banks benefit substantially from economies of scale, although they also note scale delivers efficiency benefits only up to a point.[22]

Technology costs (excluding IT staff) account for around 15-20% of operating expenses for banks; the share is slightly higher for larger banks. Anecdotal evidence suggests competition for IT staff is also very strong.

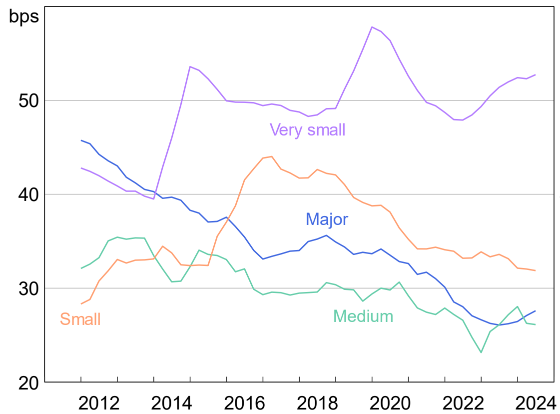
All banks have spent a larger share of operating expenses on technology over time to automate processes and to meet customers' preference for digital channels. Technology expenses include adopting new technologies such as API-enabled architecture and cloud-based services, as well as responding to growing challenges such as scams and cyber threats. However, the major banks

[22] Productivity Commission (2018), 'Competition in the Australian Financial System', Final report, no 89, June.

allocate a greater share of their overall spending to technology, compared to small and medium banks.

Graph 17

Median Costs-to-assets Ratio*



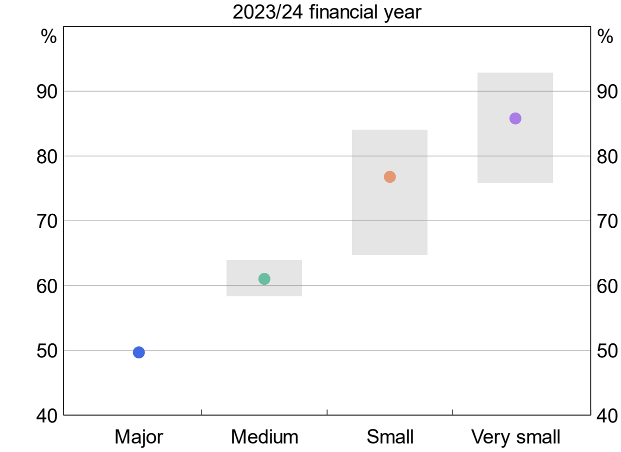
* Operating costs relative to total assets; 4-quarter moving average.

Sources: APRA; RBA.

Graph 18

Cost-to-income Ratio*

2023/24 financial year



* Operating costs divided by operating income; ranges show 25th and 75th percentiles; no range shown for major banks due to insufficient observations.

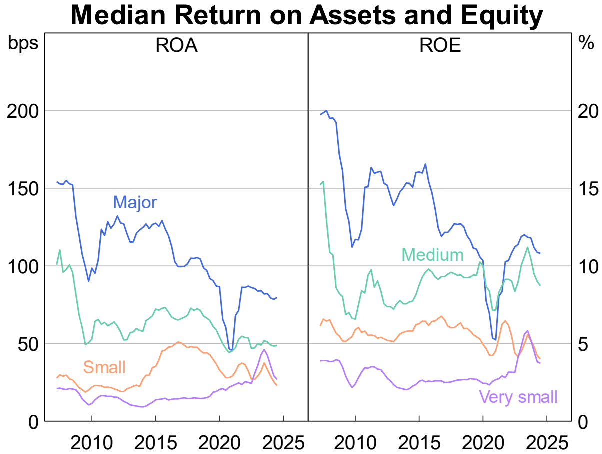
Sources: APRA; RBA.

Profitability

In aggregate, the Australian banking system has been consistently profitable over the last two decades (Graph 19). Australian major and medium banks have tended to be more profitable than large banks in overseas jurisdictions, although there has been little difference in recent years as overseas banks have improved their profitability and returns have declined in Australia (Graph 20).

Graph 19

Median Return on Assets and Equity



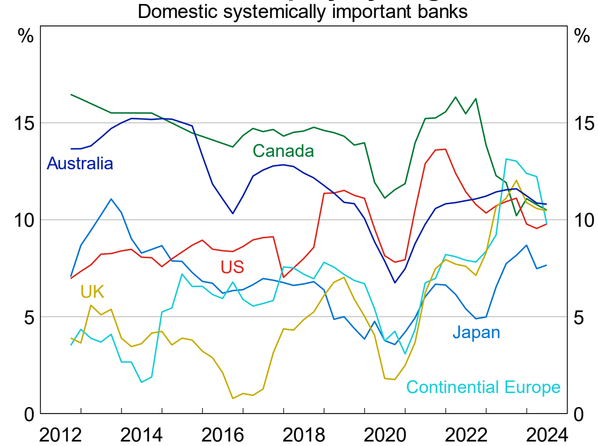
* 4-quarter moving average.

Sources: APRA; RBA.

Graph 20

Return on Equity by Region

Domestic systemically important banks



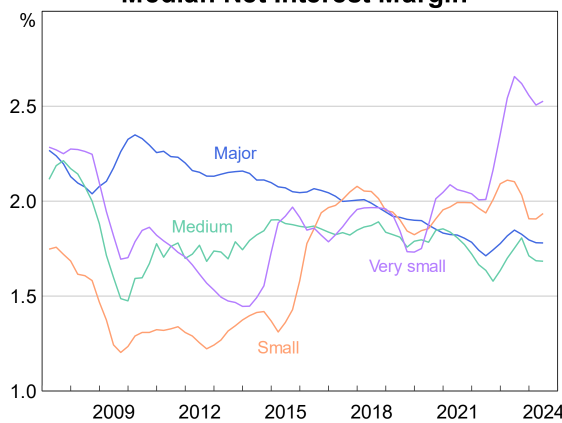
Sources: RBA; S&P Global Market Intelligence.

Medium banks have typically had lower returns on assets than the major banks due to a lower net interest margin, but the gap in return on equity has narrowed in recent years, in part as the major banks' capital has increased by more than medium banks (Graph 15 above).

The profitability of small and very small banks in Australia remains comparatively low. While small and very small banks had a somewhat higher net interest margin than the major and medium banks in recent years (Graph 21), this has been more than offset by their higher operating costs (Graph 18 above).[23]

Graph 21

Median Net Interest Margin*



* 4-quarter moving average.

Sources: APRA; RBA.

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[23] Net interest margin is a measure of the difference between a bank's interest earnings and interest expenses, expressed as a proportion of their interest-earning assets.

3. Proportionality in regulation

Purpose

This chapter sets out Australia's financial regulatory framework, focusing on key areas of difference between small, medium, and large banks. This Review seeks views on the proportionality of regulation and the balance between financial stability, competition, innovation, and fairness.

Defining proportionality

Proportionality is an important feature of effective regulatory frameworks. Proportionality aims to ensure that rules and requirements reflect differences in risk profiles and complexity across banks, with due regard to the systemic risk they pose. More comprehensive and stringent requirements can sometimes be necessary for larger and more complex banks, given the greater risk of harm these entities can pose to the financial system or customers.[24]

Importantly, proportionality is about ensuring regulation is commensurate to risk. It does not always imply less stringent requirements for smaller institutions, since some risks cannot be effectively mitigated in this way. For example, cyber risks are a key threat for large and small banks.

Background

Responsibility for regulation and the supervision of the Australian financial system is spread across several key agencies:

- APRA is the financial safety regulator, with a focus on the financial soundness and stability of APRA-regulated entities (Australian deposit-taking institutions (ADIs), insurers, and superannuation funds);
- The Australian Securities and Investments Commission (ASIC) is the conduct regulator, responsible for regulating companies, market conduct, and consumer protection.
- The Reserve Bank of Australia (RBA) is responsible for monetary policy, financial stability, and payment systems regulation;
- The ACCC is responsible for competition enforcement; and
- Treasury is responsible for advising Government on the legislative and regulatory framework underpinning the financial system.

[24] Basel Committee on Banking Supervision (2022), 'High-level considerations on proportionality', July.

There are also other agencies, such as the Australian Transaction Reports and Analysis Centre (AUSTRAC), that impact the banking industry.[25]

Over the past decade, there has been an increase in banking regulation, which has generally increased costs such as those relating to capital, reporting, and compliance. These effects may be magnified for small and medium banks given their size, as discussed in Chapter 2. For example, following the GFC, Australia implemented international reforms aimed at strengthening the resilience of banks to future shocks. Instances of poor conduct identified in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry and the Financial System Inquiry (FSI), resulted in changes to conduct regulation, including governance and product design.[26] Set out below is a summary of key regulatory requirements, including where these differ between small and medium banks.

Prudential regulation

Strong regulatory settings and a robust crisis management toolkit are essential to protecting both financial stability and the interests of depositors. An unstable banking system can have profound and long-term negative impacts on the economy. This was demonstrated by the impact of instability in overseas banking sectors during the GFC of 2007-08, which led to a tightening in credit availability and a prolonged recession in these jurisdictions. Australia's prudential frameworks have served it well, including during the GFC and the heightened risks to liquidity following international banking failures in 2023.

Prudential and reporting requirements in Australia have generally increased across the banking sector over the last decade. This included changes from the introduction of the Basel III framework (aligning Australia to international standards, while adjusting for domestic differences), recommendations adopted following the findings of the FSI and Banking Royal Commission, and lessons learnt from recent episodes of financial disruptions. In recent years, APRA has had a greater focus on introducing simpler requirements for smaller and less complex banks, as set out below.

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[25] AUSTRAC performs a dual role as Australia's money laundering and counter-terrorism financing regulator and financial intelligence unit helping build resilience in the financial system and disrupt money laundering, terrorism financing and other serious crime.

[26] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019), Final report, February; Financial System Inquiry (2014), Final report, December.

APRA's prudential requirements

In giving effect to its mandate, APRA seeks to adopt a risk-based and outcomes-focused approach with proportionality embedded throughout its policy frameworks, by way of its:

- banking prudential framework, which differentiates between Significant Financial Institutions (SFIs) and non-SFIs, as well as applying different requirements in some areas for banks using the internal ratings-based (IRB) approach for credit risk (Figure 1);
- supervisory approaches, where intensity is determined as a function of the bank's tiering and risk profile; and
- routine and ad hoc data collection requirements, which are significantly more comprehensive for larger and more complex ADIs.

Key differences between APRA's prudential requirements for SFIs and non-SFIs are summarised below.

Figure 1 – Simplified summary view of key aspects of APRA's current prudential framework for ADIs

<table>
<tr><th>Topic</th><th>Non-SFIs</th><th>SFIs</th><th>SFIs that are IRB ADIs</th></tr>
<tr><td>Capital</td><td colspan="2">Lower CET1 and Total Capital ratio requirements compared to IRB ADIs.
No additional loss absorbing capacity (LAC) requirements.
No minimum leverage ratio applicable by default.</td><td>Higher CET1 and Total Capital ratio requirements.
Additional LAC requirements may apply.
Minimum leverage ratio requirement.</td></tr>
<tr><td>Liquidity</td><td>Subject to the Minimum Liquidity Holdings (MLH) Regime where not designated a Liquidity Coverage Ratio (LCR) ADI. MLH Regime significantly less onerous than LCR.</td><td colspan="2">For LCR ADIs, more stringent liquidity requirements including the Liquidity Coverage Ratio, the Net Stable Funding Ratio, higher quality liquid assets e.g. no bank debt securities, and additional stress testing requirements. Higher expectations regarding capability and capacity vis-a-vis valuation frequency and valuation techniques.
Subject to MLH Regime where not designated an LCR ADI.</td></tr>
<tr><td>Credit Risk</td><td colspan="2">Australian Prudential Standard (APS) 112 provides a simple approach for ADIs to calculate credit risk under the standardised approach (SA).
Recent reforms further narrow the difference between average mortgage risk-weights under SA compared to IRB ADI.</td><td>All ADIs may apply for accreditation to utilise IRB approach to calculate credit risk capital, subject to APRA parameters.
In-built safeguards ensure that any capital benefit to IRB ADIs not excessive and does not unfairly disadvantage ADIs subject to SA (e.g. a capital floor that limits the capital benefit to IRB banks to 72.5 per cent of risk-weighted assets (RWA) under SA; input and output floors for risk estimates and risk-weights under the IRB approach etc).
IRB ADIs are required to calculate and report RWA under both IRB and SA.</td></tr>
<tr><td>Interest Rate Risk in the Banking Book (IRRBB)</td><td>Nil IRRBB capital charge, unless APRA determines otherwise, under APS 117 (October 2025).</td><td>Qualitative IRRBB requirements under APS 117 (October 2025) for SFIs.
Nil IRRBB capital charge for non-IRB</td><td>IRRBB capital charge for IRB ADIs under Pillar 1.</td></tr>
</table>

		ADIs, unless APRA determines otherwise, under APS 117 (October 2025).	
Counterparty Credit Risk	• No counterparty credit risk charge.	• Counterparty credit risk charge.	
Market risk	• No market risk capital requirements.	• Market risk capital requirements where ADI has trading book, FX or commodity exposures.	
Governance	• Applicable to all ADIs but Cross-industry Prudential Standard (CPS) 510 requires governance arrangements appropriate to the nature and scale of operations.		
Risk Management and Operational Risk Management	• Applicable to all ADIs, but explicitly on basis that implementation commensurate to the size, business mix and complexity of the institution. • Under new operational risk management standard (CPS 230) effective 1 July 2025, non-SFIs have a 12-month extension on certain requirements relating to business continuity and scenario analysis.		
Remuneration	• Tiered obligations – lower requirements for non-SFIs.	• Tiered obligations - significantly more prescriptive requirements for SFIs (e.g. deferred remuneration requirements).	
Public disclosure	• No public disclosure requirements under new APS 330 (effective January 2025).	• Public disclosure requirements.	
Recovery and Exit Planning (CPS 190) and Resolution Planning (CPS 900)	• CPS 190 applies but CPS 900 only applies to non-SFIs determined by APRA to provide critical functions	• CPS 190 and CPS 900 apply.	

APRA also considers proportionality as part of policy implementation. For instance, APRA may consider staged implementation which provides for longer timeframes for small and medium banks compared to larger banks.

APRA's resolution mandate

In addition to APRA's supervisory responsibilities, one of APRA's core functions is to plan and implement prompt and effective responses to the failure (or pending failure) of a regulated institution, or a crisis in the financial system. In this context, if a regulated institution is failing or likely to fail, APRA's aim will be to minimise losses to beneficiaries, and disruption to the broader financial system, by managing an orderly exit of the institution. By contrast, a disorderly failure would be one in which there is material disruption to the critical economic functions and services that the institution provides, resulting in significant impacts on beneficiaries, the financial system and the wider economy. APRA's recovery and exit requirements apply to all ADIs, but only SFIs and non-SFIs that provide critical functions are required to support APRA in developing bespoke resolution plans.

APRA has access to a broad resolution toolkit, including the use of the Financial Claims Scheme (FCS) for banks. The FCS was put in place by the Australian Government in 2008. It is designed to protect depositors of locally incorporated banks in the event of a financial institution's failure, thereby maintaining confidence in the financial system. The FCS was last reviewed in 2011.[27] In

[27] The Treasury (2011), Financial Claims Scheme Post-implementation Review and Regulation Impact Statement, August.

2014, the government further adopted the recommendation from the FSI for the FCS to remain funded following a failure, given the "unquestionably strong" framework is likely to mitigate risks of bank failures. It was also noted that pre-funding FCS imposes an ongoing cost on ADIs.

The FCS provides protection up to $250,000 per account-holder per ADI. Latest data indicate that more than 90% of deposit accounts (comprising 45% of deposit balances) are fully covered by the FCS. Depositors with balances exceeding this limit may not have their entire deposits protected in the event of a bank failure, notwithstanding there also being depositor preferences in insolvency. The protected monies cap is not indexed.

Recent overseas episodes of deposit runs and bank failures, and the strategic responses by regulatory agencies, highlight an opportunity to update the FCS to respond to an evolving banking industry and customer expectations. In particular, the failures of Silicon Valley Bank and Signature Bank highlighted the greater speed with which deposits can 'run' during a crisis, enabled by increased digitisation. The US regulatory response involved greater flexibility in responding to emergent systemic risk, including by extending deposit insurance coverage where appropriate. Lessons learned from this experience provides Australia an opportunity to assess the appropriateness of its regulatory settings.

Potential trade-offs

There are important interactions between resilience requirements e.g. capital and liquidity requirements, and resolution arrangements. For example, weaknesses in resolution arrangements could lead to a higher reliance on measures aimed at maintaining a high level of bank resilience. In contrast, highly effective resolution arrangements could support a higher appetite for bank failures, since agencies would have greater confidence that these could be resolved in an orderly manner, without disruption to deposit holders, critical functions, or financial stability.

The balance between resilience requirements and resolution arrangements has important implications for banks' operations, such as the amount of capital they are required to hold. This review presents an opportunity to consider if the current balance is appropriate and whether mechanisms to mitigate deposit risks and contagion risks could be strengthened. For example, the Review could consider changes to FCS arrangements, such as to funding, depositor coverage, or speed of access to insured deposits.

The frameworks discussed above also operate within the context of broader crisis management tools, such as the RBA's Exceptional Liquidity Assistance or the Term Funding Facility that was introduced during COVID. Separately, the Government has also previously introduced extraordinary support measures, such as the Structured Finance Support Fund and Government wholesale debt guarantee, to support the banking sector in providing credit to the economy in periods of severe stress.

Conduct regulation

ASIC's statutory function is to promote market integrity and consumer protection in the financial and payments systems. ASIC's legislative responsibilities require it to:

- maintain, facilitate and improve the performance of the financial system and entities within it, in the interests of commercial certainty, reducing business costs, and increasing efficiency and development of the economy;
- promote confident and informed participation of investors and consumers in the financial system; and
- consider the effects of its functions and exercise of its powers on competition in the financial system.

ASIC has a range of powers that enable it to respond flexibly and proportionately to a broad range of individual and corporate misconduct. ASIC selects and targets its enforcement actions to ensure it has the greatest impact on the most serious harms within its remit. ASIC has also embedded strong risk-based principles in its approach to supervision and surveillance enabling a harms-based and proportionate approach. ASIC reviews entities based on the size and the risk to consumers, with higher risk entities subject to a more detailed review.

ASIC uses its regulatory toolkit to drive good consumer and investor outcomes, act against misconduct to maintain trust and integrity in the financial system, promote strong and innovative development of the financial system, and help Australians to be in control of their financial lives.

Reporting

CFR agencies also require banks to report a range of information and data, to assist agencies in monitoring risks and understanding broader macro trends in the environment. For example, under the *Financial Sector (Collection of Data) Act 2001* (FSCODA), certain financial sector entities including banks are required to provide APRA with statistical reports regarding their operations on a periodic basis. APRA collects these statistics to perform its supervisory role and shares them with other agencies, such as the RBA and Australian Bureau of Statistics, to produce macroeconomic and financial indicators. An objective of FSCODA is to reduce duplication across agencies by establishing a central data collection agency for the financial sector.

Mandatory requirements to report to ASIC are governed by legislation and are usually equivalent across all banks, regardless of the size of the bank. Proportionality may be specifically incorporated into these statutory requirements or result from the requirement being linked to a bank's particular activities.[28] ASIC may also exercise its discretionary powers to grant relief (to omit, vary or modify) from the application of certain provisions in the legislation it administers.[29] For example, ASIC recently provided relief from reporting requirements for the reportable situations regime, and to prescribe record keeping requirements for personal advice situations.[30]

Competition enforcement

Mergers can enable an acquiring bank to achieve greater economies of scale or scope and diversify risk across a range of activities. However, in some instances mergers can substantially lessen competition causing a detrimental effect on prices, product or service quality, and choice and innovation in the market. The ACCC administers section 50 of the *Competition and Consumer Act 2010* (CCA) which prohibits acquisitions that would, or would be likely, to result in a substantial lessening of competition. Merger parties can currently manage this risk by seeking clearance from the ACCC prior to undertaking the acquisition through two avenues:

- Firstly, merger authorisation, where merger parties seek statutory protection from legal action under section 50 of the CCA, on the basis that the public benefits outweigh any detriment resulting from the acquisition.
- Secondly, informal merger review, where merger parties can seek informal clearance from the ACCC which does not provide statutory protection but does provide merger parties with the ACCC's view on whether it is likely to challenge the merger.

These regulatory functions sit outside of the scope of this review, to the extent that they are subject to current legislative reform processes.

In November 2024, the Treasury Laws Amendment (Mergers and Acquisitions Reform) Bill 2024 passed Parliament. This will replace the current judicial enforcement merger regime in Australia with a primarily administrative regime with the ACCC as the first instance decision maker, and mandatory notification for mergers that meet notification thresholds. The new regime will commence on 1 January 2026, with voluntary notifications possible from 1 July 2025.

Businesses planning to undertake conduct that might constitute a breach of certain other relevant provisions in the CCA can seek an exemption by the ACCC via a non-merger authorisation or notification. In some instances, these exemptions have been sought by banks to assist them in gaining potential benefits that would otherwise accrue from greater scale and to reduce overall

[28] For example, in respect of the Financial Accountability Regime, internal dispute resolution reporting, reportable situations reporting or the industry funding model.
[29] See ASIC (2020), 'Applications for relief', Regulatory Guide 51, July.
[30] ASIC (2024), Corporations and Credit (Breach Reporting–Reportable Situations) Instrument 2024/620; ASIC (2024) Corporations Record-Keeping Requirements for Australian Financial Services Licensees when Giving Personal Advice) Instrument 2024/508.

costs. For example, in April 2024 the ACCC allowed a notification from Customer Owned Banking Association (COBA) that enabled a subset of its members to engage a procurement company to negotiate with potential providers of a loan serviceability calculator.[31] Separately, in April 2024 the ACCC authorised industry participants to collectively acquire assurance services in relation to mortgage aggregators.[32]

Other regulation

Banks are also subject to a range of other regulatory regimes that are either banking specific, financial sector specific, or of more general application. As with the classes of regulation referred to above, these can also have disproportionate impacts on small and medium banks and therefore affect their competitiveness.

The terms of references for the Review specifies that the Government is not seeking advice on areas outside of the responsibilities of the CFR agencies, or subject to any current government legislative workstreams.[33] However, the cumulative burden placed on small and medium banks by these other regulatory frameworks remains relevant to the Review's consideration of the impacts and proportionality of those frameworks, within the scope of the Review.

Reform implementation

The capacity of firms to cost effectively implement changes in regulation and supervisory arrangements varies, influenced by factors such as available resources and expertise, the extent of outsourced functions, and the prevalence of legacy systems. Smaller firms are generally less able to implement changes in tighter timeframes and in parallel to other major changes. Shorter implementation timeframes create greater challenges for coordination and cooperative approaches to implementations. Approaches between regulators and reforms may vary – for example, different approaches to timing and phasing.

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[31] ACCC (2024), Statement of Reasons - Notification CB10000486 lodged by the Customer Owned Banking Association (COBA) on behalf of Small Australian Mutuals (SAM) in respect of collective bargaining with Widget Works Pty Ltd and other potential providers of a loan serviceability calculator for SAM members, April, p 1.

[32] ACCC (2024), 'ACCC grants authorisation for banks to establish a program to jointly procure assurance reviews of mortgage aggregators', media release, 11 April.

[33] For example, anti-money laundering and counter-terrorism financing laws and the Consumer Data Right.

Questions

1. Do the regulatory and supervisory frameworks strike an appropriate balance between safety, stability, and competition? Please provide examples.
2. Are regulators’ approaches to regulation and supervision (including tiering and implementation approaches) suitably proportionate, efficient and effective, having regard to the size, complexity and risks associated with different segments of the banking sector?
3. Are regulators’ data collections and reporting requirements proportionate? If not, please provide specific examples of requirements that could be adjusted (e.g. frequency) or removed.
4. Are current financial system protections for consumers appropriate? Are there any steps that could be taken to improve consumer outcomes?
5. Are there changes that could be made to resolution tools (including the FCS) that would enhance the balance between safety, stability and competition in the overall regulatory framework?

4. Funding

Purpose

This chapter seeks views on how bank funding is affected directly or indirectly by the organisational scale of banks, including operational, pricing, and market access effects. The chapter also seeks views on how other commercial or regulatory factors impact banks' ability to raise funding, and if they face structural impediments.

Background

Small and medium banks tend to have similar overall implied funding costs to the major banks (see Chapter 2). However, there are differences in funding profiles between these banks – smaller banks tend to utilise deposits more for funding and access fewer wholesale markets, while larger banks access broader funding sources across wholesale markets. Very small banks access very few wholesale markets.

Albeit generally more expensive than deposit funding, the ability to raise wholesale funding can provide banks with greater flexibility in funding their growth plans, in terms of rapid and sizable access to funds. Larger banks typically benefit most from this flexibility. There are several contributing factors to a bank's access to wholesale markets, but the key drivers are investor driven – smaller banks generally have lower credit ratings, which is reflected in wholesale investors' demands for higher risk premia to lend to smaller banks. Globally, smaller banks also tend to have lower credit ratings than larger banks; it is likely therefore that they also face higher wholesale costs, all else equal. Investors also prefer issuers that tap markets regularly and at scale, particularly those with name recognition.

Access to wholesale funding markets

The scale of a bank impacts its access to various funding sources. All else equal, unsecured wholesale funding costs will be higher for small and medium banks, reflecting the risk return criteria expected by investors. Investors consider a range of factors when assessing investments in a wholesale issue, including the structure and liquidity of the underlying issue, prevailing market rates, and the credit quality of the issuer or issuance.

Some small and medium banks are active in the securitisation market, but often run up against challenges in relation to scale – both in terms of size and frequency of issuance. Additionally, only larger banks have issued covered bonds (see Chapter 2). These banks' issuances have also been fairly limited, with banks indicating a desire to retain some headroom under the 8% encumbrance limit to be able to issue covered bonds in the event of troubled funding markets. Multi-seller securitisation has tried to address this, but is challenged by economic viability and allocation of credit risk among originators. While some temporary support programs for securitisation markets have been put in place at times, ongoing government support for securitisation does not form part of Australia's regulatory frameworks (unlike, for example, in the United States of America or Canada in respect of residential mortgage-backed securities (RMBS)).

Equity funding costs for mid-tier entities are generally assumed to be higher due to market perceptions of increased risk. Mutual institutions cannot issue ordinary equity without demutualising, which may limit their ability to significantly grow their balance sheets (see Chapter 2). Mutual institutions have issued only limited mutual equity interests to date.

Regulatory requirements

Some stakeholders have raised concerns that prudential capital requirements are an obstacle to accessing a competitive funding mix, despite the existing proportionality incorporated into those requirements.

Regulatory capital and liquidity requirements can have an impact on banks' funding costs. APRA requires banks to hold sufficient capital and liquidity to ensure their resilience in times of stress. These regulations influence a bank's funding costs because they can shape how a bank structures its funding profile.

APRA's capital requirements differ across banks, driven by two main factors: pillar 1 capital requirements, determined by the applicable prudential standards (e.g. risk weights) and pillar 2 capital requirements or supervisory adjustments, which are bespoke to individual banks and typically not disclosed. Both factors need to be considered when assessing differences in banks' capital requirements.

Risk weights determine how much capital ADIs are required to hold for certain types of lending. APRA allows two approaches to calculate capital requirements for credit risk. The standardised approach is simpler and less risk sensitive, while the IRB approach is more complex and risk sensitive, involving the use of internal ADI models that are approved by APRA. The IRB approach requires a significant investment by the ADI in risk management, with only six banks (the major banks, Macquarie Bank and ING (Australia)) using this framework. To facilitate IRB accreditation, APRA permits a degree of phased roll-out of the IRB methodology. APRA also engages with banks seeking accreditation to understand their project plans, delivery timeframes and resourcing and to assist in identifying their potential challenges or hurdles.

Under the IRB framework, banks, on average, generally hold slightly lower levels of capital, reflecting its more tailored risk management approach. This is nonetheless largely offset by the additional costs, complexity, and requirements imposed on IRB banks. Safeguards apply to prevent unreasonable divergence in capital treatment across standardised and IRB banks.[34] APRA has estimated that the average pricing differential for residential mortgage loans due to differences in the two capital models is 0.05%.[35]

As noted above, pillar 2 capital requirements are typically not publicly disclosed. They reflect APRA's supervisory views on the differences in risk profile between banks that are not accounted for by risk weights. Pillar 2 adjustments can commonly be referred to as capital overlays.

There are also two main approaches to liquidity requirements. In determining liquidity risk management requirements, APRA subjects large and complex ADIs to the more complex and risk sensitive LCR regime, while the MLH regime applies to smaller and less complex ADIs (see Chapter 3).[36]

Banks can adopt different group structures for their business, with some operating under a non-operating holding company (NOHC) that has been authorised by APRA. This can lead to differences in regulatory treatment for activity conducted in the bank and non-banking subsidiaries, which some stakeholders have suggested can provide a competitive advantage.

Questions

6. What are the key funding issues faced by the small and medium banks sector? What are the most important to you and why? Are there any further issues that you would like to raise?
7. What steps could industry or the government take to improve access to funding for small and medium banks to increase competition in, and the competitiveness of, the Australian banking sector? What are the costs and benefits of these, including for bank customers?
8. What changes could be made to existing regulations to contribute to a more competitive funding market? What are the risks and benefits of such changes? How would customers benefit from such changes?

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[34] Including higher capital buffer requirements for IRB banks compared to standardised banks plus a range of parameter and output floors.

[35] Coleman A and Thavabalan N (2024), 'Demystifying credit risk capital requirements for housing loans', Information paper, March; and APRA (2023), 'Is the capital benefit of being an advanced modelling bank justified?', Information paper, May.

[36] APRA intends to undertake a broader review of liquidity risk next year.

5. Entry, scale, and exit

Purpose

This chapter sets out key factors that may influence entry to, and expansion in, the Australian banking market. The Review is seeking feedback on the challenges small and medium banks may face in gaining scale, and whether there are potential barriers to this that could be addressed.

Background

As set out in Chapter 2, small and medium banks tend to report similar net interest margins and overall funding costs to the major banks. The key area of difference relates to operating costs – smaller banks typically report higher cost-to-income or asset ratios.

While this is not a new trend, challenges associated with scale could be become more pronounced in the future – for example, the shift away from bank branches towards digital banking requires greater technology spend and maintenance. In turn, a digital offering increases operational risks such as downtime and cyber risks, requiring investment in controls. A recent US study on credit unions highlighted technology as the key driver in why younger customers switch banks.[37] Separately, Australian mutuals have pointed to information technology and cyber risk as their highest ranked concern.[38]

There are different ways banks can gain scale to help reduce their operating cost ratios. Some banks may seek to gain scale organically through growing their balance sheet, others might use mergers and acquisitions, while shared services and outsourcing generally represent more innovative solutions. The use of shared services or joint ventures can enable smaller banks to tap into specialised resources and share expenses and risks without undertaking a merger; however, they are a relatively newer feature of banks' strategies. This chapter sets out relevant context on potential challenges and opportunities to gaining scale.

Establishing a bank

APRA's current licensing framework was introduced in 2018 and provides potential new entrants with a choice of pursuing either a direct ADI pathway, or a restricted ADI (RADI) pathway.[39] APRA applies an initial capital requirement, which varies dependent on the pathway. No capital requirements apply for foreign branches as they form the same legal entity as their head office, but otherwise they are subject to similar prudential requirements as domestic banks.

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[37] McKinsey (2024), 'Six imperatives for credit unions to secure their future', June.
[38] KPMG (2023), 'Mutuals Industry Review 2023', November.
[39] APRA intends to review its ADI licensing framework in the first half of 2025.

The RADI pathway is for a maximum period of two years. During this time, a RADI will need to achieve a limited launch of at least one income-generating asset product to demonstrate revenue generating capacity, and one deposit product, before it can progress to an unrestricted ADI licence.[40] The pathway is designed to allow new entrants to seek the investment required to operationalise and test their business model, while progressing their application for an unrestricted ADI licence. A RADI must demonstrate it is compliant, on a proportionate basis, with APRA's prudential framework prior to being granted an unrestricted ADI licence.[41]

ASIC oversees the granting and holding of credit and Australian financial services licenses. Both licences are required for a new ADI to offer credit and financial services, in addition to a banking licence.

Depending on how a new ADI intends to access the payments system, it may also need to meet RBA requirements in relation to becoming a counterparty. ADIs must also meet regulatory obligations in relation to Consumer Data Right (CDR) and the *Anti-Money Laundering and Counter-Terrorism Act 2006*. These regulatory requirements sit outside of the scope of this review.

Requirements for exit and mergers and acquisitions

Mergers or acquisitions can provide a way for banks to gain scale quickly but can be associated with a range of risks e.g. operational hurdles for the merged entity or acquiring bank.

As noted in Chapter 3, banks undertaking merger activity can seek statutory protection from CCA requirements by applying for merger authorisation, or otherwise ask the ACCC to assess on an informal basis whether the merger is likely to substantially lessen competition.

Since 2007, the ACCC has conducted public merger reviews on multiple proposed mergers between the major banks and small and medium banks. Examples include ANZ and Suncorp Bank, NAB and Citigroup Consumer Business, NAB and 86 400, CBA and BankWest and Westpac and St George. The ACCC has also assessed proposed mergers between small and medium banks, including Bendigo Bank and Adelaide Bank, Bank of Queensland and Mackay Permanent Building Society, and connectfinancial and islandstate.[42]

In addition to competition law requirements, the legal process to undertake an acquisition or transfer of business of certain financial sector firms, whether for expansion or exit, also requires

[40] APRA takes action on a case-by-case basis where a RADI is not able to progress to an unrestricted ADI licence in the two-year timeframe.
[41] Stakeholders have noted that the approvals process to first launch a bank, and subsequently a product, can be opaque and time-consuming. Additionally, during this time a new entrant is using capital.
[42] Further information on these mergers can be found in the ACCC's merger authorisation register (2017 onwards) and the ACCC's public informal merger reviews register.

various approvals or consents to be issued by either APRA or the Treasurer.[43] Applications for which the target entity has assets less than $5bn may be assessed by APRA under a delegation from the Treasurer.

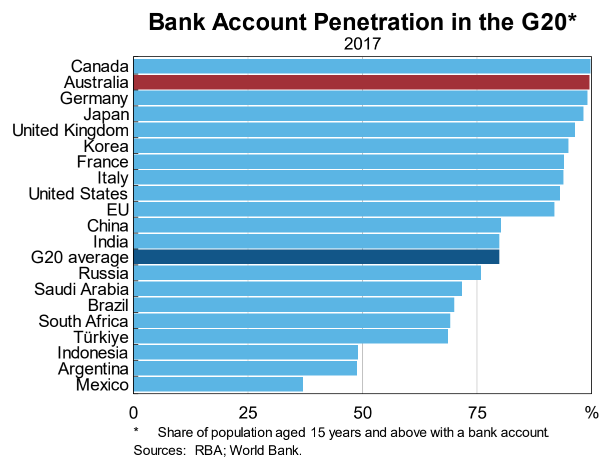
Factors influencing entry, expansion and exit

There are a range of factors that may influence an entity's decision to enter the banking sector, or for an existing bank to expand or exit.

Business opportunity

The key factor for entry or expansion into the banking industry will be the business opportunity it represents and the value proposition that can be offered. Where a market or segment is underserviced, in terms of product offering or customer service, there may be an opportunity to either enter that market or grow market share for new entrants or existing banks. The profitability of the industry or market segment will be a key factor that influences any entry or expansion. In broad terms, Australia is a highly banked market (Graph 22).

Graph 22



Generalisation or specialisation of offerings and target markets

Both larger and smaller banks may seek to compete across either a broad range of products, services, and target markets, or may be more focused on their offerings and customers.

Banks may, for example, focus on small business lending, agricultural lending or international banking. Additionally, some banks may seek to position themselves as an alternative to core

[43] The relevant legal instruments include the *Banking Act 1959*, *Financial Sector (Shareholdings) Act 1998*, *Financial Sector (Transfer and Restructure) Act 1999*, *APS 222 Associations with Related Entities* (applicable to the acquiring ADI in some circumstances).

banking service providers and may seek to provide limited complementary services (e.g. foreign exchange) to customers.

Servicing regional and rural Australia is core to the business strategy of some small and medium banks, and is a competitive differentiator, as some customers prefer to do their banking in branch. Branch placement in regional areas, where major banks may have closed branches, is an essential part of small to medium banks' business model; they often serve a specific geographic region or industry.[44] However, banks servicing regional and rural areas of Australia face pressures as maintaining branches can come with substantial costs.

Similarly, differentiation strategies that are based on connections to communities can be challenged by evolving customer expectations and the growth of mortgage brokers. Brokers can provide banks with access to a broader geographic footprint, but often comes at a cost in terms of, amongst others, technology spend and risk settings required to reduce the "time to yes".

Scale

There are economies of scale in banking. Larger banks typically spend a smaller share of their income on operating costs, given high fixed costs associated with, for example, technology, compliance, and risk management (see Chapter 2). As risks become more complex and dynamic, particularly with regards to information technology and cyber risk, the need to invest in controls and attract and retain staff with appropriate skills and experience can present greater challenges for small and medium banks. A recent survey of Australian mutuals highlighted information technology risk as their most heightened concern.

In broad terms, larger banks can typically benefit from:

- fixed costs, including technology costs, being defrayed across a larger pool of operating revenue and customers;
- a greater pool of resources that can be directed to the implementation of change, although implementing change can be more complex for larger banks;
- stronger bargaining power in attracting and retaining skilled staff;
- greater brand recognition, including around perceptions of safety; and
- larger firms can insource lenders mortgage insurance (LMI) in an environment where provision of LMI has declined to one key provider.

[44] Customer-owned banks are deeply rooted in servicing their geographic communities; see KPMG (2023), 'Sector impact assessment of Customer Owned Banking in Australia'.

Capital

A large amount of investment is typically required to establish a new bank. Start-up costs can be significant, given the need to:

- bring on and train new staff;
- invest in systems;
- build and market products; and
- build governance and risk controls.

This investment is in addition to regulatory capital required for new lending or to support the product offering.

New entrants in any industry may also face difficulties in raising capital, given start-ups are generally perceived as higher risk.[45] The rate at which new entrants consume capital prior to achieving profitability can make them more sensitive to commercial delays, market conditions, and regulatory requirements.

Technology

Technology is emerging as a key driver of competition in banking. Customers, particularly those who are younger, are increasingly switching to banks due to the technology offering, with a strong focus on streamlined apps and websites.[46] Technology can also support efficiencies, allowing banks to on board customers more easily, process loan decisions for standardised products more quickly (e.g. mortgages), or engage with customers in a multi-channel way.

To some extent, larger banks benefit from much larger technology budgets to support innovation. However, larger banks can also be constrained by legacy systems. New entrants, on the other hand, can introduce new technology without the burden of managing legacy systems.[47] Some existing banks have established subsidiary brands utilising modern technology.

Smaller banks can face significant challenges, given smaller technology budgets and heightened costs associated with replacing legacy systems. Use of third-party providers can help reduce costs but may also limit the ability of smaller banks to differentiate their offering from the competition, unless (sometimes significant) costs are incurred to customise an off-the-shelf offering.

The costs associated with technology can affect small and medium banks' ability to compete with large banks. This includes the technology investment required, and ability to access staff with the appropriate skills, to:

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[45] ACCC (2023), 'Retail Deposits Inquiry', Final report, December, p 44.
[46] McKinsey (2024), 'Six imperatives for credit unions to secure their future', June.
[47] ACCC (2023), 'Retail Deposits Inquiry', Final report, December, p 36.

- apply innovation in the sector;
- meet consumer demands for accessing banks via digital channels;
- maintain existing systems;
- meet new regulatory requirements; and
- address emerging scam and cybersecurity threats.

Small and medium banks have smaller technology budgets than major banks and less capacity to jointly run multiple technology projects. These technology costs could therefore have a greater impact on their overall profitability and their ability to invest in technology and associated staffing that drives innovation, customer growth, and operating efficiencies and effectiveness. The costs associated with updating systems for scams, anti-money laundering (AML) and payments system modernisation, such as the winding down of the Bulk Electronic Clearing System, can be material.

Customer switching

The ability for consumers to switch between banks drives innovation and continuous improvement of banking products designed to attract and retain customers.[48] For example, changing use of technology (e.g. data portability) and business models (e.g. mortgage brokers) have lowered some barriers to switching. This can create new opportunities for organic expansion. However, barriers to switching remain very high for some products. This can include strategic barriers to switching by banks that increase the difficulty of switching.[49]

Regulatory approvals

The costs of, and delays in, obtaining regulatory approvals may disproportionally affect new entrants as they are funded by investors' capital before they generate sufficient offsetting income. Delays in receiving approvals to launch a product may also hinder a new entrants' ability to raise more investment.

In 2018, the government introduced changes to the Financial Sector (Shareholdings) Act 1998 aimed at supporting start up banks to grow their business before needing to diversify their shareholders. Under the changes, start-up banks with less than $200m assets could be approved to have shareholders with > 20% stakes, so long as the holders were "fit and proper". This approval would typically last for two years, after which any shareholdings above 20% would need to be divested (or diluted by further share issuances), or the owners would need to seek further

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[48] ACCC (2023), 'Retail Deposits Inquiry', Final report, December, p 10; ACCC (2020), 'Home Loan Price Inquiry', Final report, December, p vii.
[49] ACCC (2023), 'Retail Deposits Inquiry', Final report, December; ACCC (2020), 'Home Loan Price Inquiry', Final report, December.

approval, subject to a national interests' test. This may hinder large investors from funding new bank entrants over a longer period of time.

Opportunities to achieve scale

Increased use of digital channels and investment in technology

Digital channels and new technology may present opportunities for small and medium banks to compete against the major banks, particularly in niche market sectors. Digital channels can make it easier for banks to connect with customers, enabling access to a potentially broader customer base. For example, investment in technology may allow a bank to process mortgage applications quickly, making the bank more attractive for customers of mortgage brokers (see Chapter 2). However, we note that small and medium banks with legacy systems may encounter challenges in keeping pace with technological offerings of new entrants or the larger banks.

Merging and collaboration to achieve the benefits of scale

The pursuit of economies of scale and other efficiencies may lead small and medium banks towards consolidation. A number of mergers and acquisitions have occurred amongst banks in the past two decades (see Chapter 2). Banks may consolidate to achieve scale at speed, and at a lower cost than investing in organic growth. Banks may also choose to merge with entities which have existing digital investments and capabilities, to achieve portfolio diversification and integrations and efficiencies, or increased scale to fund technology investments and compete with larger rival banks. [50]

Collaboration among banks can also provide a mechanism for gaining scale. If deemed to be in the public interest, it may be authorised by the ACCC. Such collaboration may provide benefits to the banks' customers such as reduced costs or more effective technologies.[51] However, some collaboration may be anti-competitive and detrimental to consumers and the economy, for example if it involves cartel conduct and/or concerted practices.

Outsourcing to achieve the benefits of scale

Outsourcing has become a key focus for banks including small and medium banks. By engaging third-party service providers, small and medium banks can access advanced technologies and specialised expertise that would otherwise be prohibitively expensive, or complex to develop and maintain internally. This includes critical skills in essential but niche areas that enable banks to

[50] Bank of Queensland (2021), 'BOQ completes acquisition of ME Bank', media release, 1 July.

[51] Examples include reducing transaction costs, achieving economies of scale and reducing search and switching costs. See ACCC (2024), Guidelines for Authorisation of Conduct (non-merger), August, pp 34–35.

continue to offer digital banking services including system integration, cyber testing, and response and network design.

Lastly, outsourcing of mortgage and other product distribution channels has the potential to allow greater efficiencies, provide access to scale, partially remove the geographical limitations of proprietary channels, and provide access to a broader potential customer base. However, the use of brokers to distribute mortgages can also reduce profitability relative to direct distribution.

Joint ventures or strategic alliances

Joint ventures or strategic alliances can be a useful way for smaller banks to reap the benefits of scale, without undertaking a merger or acquisition. These approaches can enable banks to pool resources, tap into broader expertise, and leverage their combined market bargaining power. Examples could include shared operating platforms. With the shift to more digital banking, there could be a stronger impetus to explore these options – the Review is seeking feedback from industry on whether there are potential impediments to using these options.

Questions

9. What is the role and impact of the small and medium banks in providing competition? How does this benefit consumers?
10. How does the nature and extent of competition differ across different banking products and market segments (e.g. mortgages, credit cards, small business lending)? Please provide examples.
11. How has consolidation in the banking sector impacted competition?
12. What are the regulatory, consumer and market trends affecting small and medium banks' competitiveness?
13. What specific barriers and challenges have entities experienced when trying to increase their competitiveness?
14. What would be the characteristics of high levels of competition in the banking sector?
15. What competitive pressures from sectors outside, or adjacent to, the banking sector are impacting the competitiveness of small and medium banks (e.g. mortgage brokers, non-bank financial institutions, payment providers, expansion of major tech companies and platforms in payment services and financial services)?
16. Are there barriers to entry (including inefficiencies in licensing frameworks), expansion, and exit? If so, what are these barriers and how could they be removed?

17. Are there private sector led initiatives that could address some of the issues being faced by the small and medium banking sector? Please provide examples.
18. How can the risks and benefits of utilising third-party providers be appropriately balanced when being used to achieve scale?
19. What regulatory or supervisory changes and/or initiatives could be made to assist small and medium banks in gaining benefits from scale?
20. How have customer trends relating to multi-banking changed over time? How does multi-banking affect the ability for banks to compete in the provision of different banking products?
21. Is there a minimum scale of bank necessary to compete effectively whilst meeting customer expectations with respect to a safe, “always on”, efficient digital environment (e.g. minimum downtime, effective scam mitigation, cyber risk mitigation, AML protections etc.)?

Appendix A: Submission Guidelines

In the course of undertaking public consultation on policy or regulatory matters, the CFR may publish an issues or consultation paper (Consultation Paper) and invite interested parties to make a submission responding to issues raised in the Consultation Paper (a Submission).

These Guidelines set out general information about making a Submission and the CFR's processes for considering and publishing Submissions. The Guidelines apply to all Submissions, except to the extent that a particular Consultation Paper specifies any contrary information with respect to Submissions made in response to that Consultation Paper.

Making a Submission

Submissions should be made in writing and sent by email to CFRReview@treasury.gov.au. Submissions provided by email should be in a separate document, in Word or equivalent format. Submissions in PDF format must be accompanied by a version in an accessible format such as .rtf, .doc or .docx.

Submissions can be submitted until midnight AEST on 7 February 2025 or such later date agreed by the CFR.

What happens to Submissions?

Your Submission will be shared with and read by RBA, ASIC, APRA, Treasury and ACCC staff working on, or involved with, the consultation.

In the interests of informed public debate, the CFR is committed to transparency in its processes and open access to information. Accordingly, the CFR aims to publish Submissions on its website where it is appropriate to do so. However, the CFR agencies reserve the right to edit (for example, remove defamatory material or, where appropriate, de-identify personal or sensitive information), publish or not publish Submissions on the CFR website at their own discretion. The CFR's publication of a Submission is not an indication of the CFR or its member agencies' endorsement of any views or comments contained in that Submission.

Most Submissions that are published on the CFR's website will include the name of the submitter (unless requested otherwise – see the Privacy section below). If a Submission is published, the information in it, including the submitter's name and any contact details, can be searched for on the internet.

You cannot withdraw or alter your Submission once the CFR has published it.

Submissions may be kept confidential

If you do not want some or all of your Submission to be published by the CFR, you should clearly indicate this (for example, by including the word confidential prominently on the front of your

Submission) and provide reasons for your request. Automatically generated confidentiality statements in emails are not sufficient for this purpose.

Where some parts of your Submission are considered to be confidential, the CFR requests that you provide two versions of the Submission at the same time prior to the closing date – one for consideration by the CFR agencies and one, with confidential information removed, for publication (this latter version may also have contact details or other personal information removed – see the Privacy section below).

Please also note that any Submission provided to the CFR may be the subject of a request under the Freedom of Information Act 1982 (Cth). Any request for access to a confidential Submission will be determined by the CFR agencies in accordance with their respective obligations under that Act, including any applicable exemptions (for example, those relating to material obtained in confidence or involving an unreasonable disclosure of personal information).

Privacy

Unless requested otherwise, published Submissions will usually include contact details and any other personal information contained in those documents.

Where you provide a separate version of your Submission for publication with contact details or other personal information redacted or removed, this will be taken as a request for the CFR not to publish such personal information.

For information about the RBA's approach to privacy as secretariat of the CFR and administrator of the CFR website, please refer to the Personal Information Collection Notice for Website Visitors, which is available at https://www.cfr.gov.au/privacy.html.

Intellectual property rights

In making a Submission to the CFR, you grant a permanent, irrevocable, royalty-free licence to allow each of the CFR agencies to use, reproduce, publish, adapt and communicate to the public your Submission on the CFR's website (except to the extent that you have specifically requested that all or part of your Submission is kept confidential), including converting your Submission into a different format to that submitted for the purposes of meeting relevant accessibility requirements.

To the extent that your Submission contains material that is owned by a third party, you warrant that you have obtained all necessary licences and consents required for the use of those materials (including for each of the CFR agencies to use, reproduce, publish, adapt or communicate to the public such material), and have made arrangements for the payment of any royalties or other fees payable in respect of the use of such material.

Appendix B: Treasurer's tasking letter

THE HON JIM CHALMERS MP
TREASURER

Ref: MS24-001141

Ms Michele Bullock
Governor
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear Governor

I am writing to you in your role as the Chair of the Council of Financial Regulators (CFR) requesting that the CFR conduct a review of the small and medium-sized banking sectors, in consultation with the Australian Competition and Consumer Commission (ACCC).

I am aware of the important roles that these banks play in our communities, supporting households and businesses and the broader Australian economy. However, it is clear that there are a range of current and emerging challenges facing small and medium-sized banks.

I am therefore asking the CFR to examine:

- the role and state of the small and medium-sized banking sectors in providing competition;
- the regulatory and market trends affecting their competitiveness; and
- current and potential future sources of and barriers to competition from these sectors.

I am seeking the views of the CFR on how we can better support competition and dynamism in these sectors of the banking industry, including on what steps might be taken to improve regulation to ensure increased proportionality and an appropriate balance between competition, innovation and stability.

I would like the review to include at an examination of:

- how mechanisms to mitigate deposit risks and contagion risks (such as the Financial Claims Scheme) may enable more proportionate ex-ante regulation for smaller banks and lower barriers to entry and expansion;
- access and costs of funding by small and medium-sized banks, including the impact of current statutory limits on the use of covered bonds; and
- the cumulative regulatory reporting obligations from across the CFR agencies for small and medium-sized banks.

I am not seeking a review of matters subject to any current government legislative workstreams (e.g. the regulatory initiatives grid; the consumer data right; facilitating mortgage switching; payments regulation), on matters outside of the areas of responsibility of CFR agencies (e.g. anti-money laundering / counter terrorism funding requirements) or on matters relating to agency funding or industry levies.

Parliament House Canberra ACT 2600 Australia
Telephone: (02) 6277 7340

I appreciate that the review would likely provide recommendations for consideration of system setting by both the Government and by CFR agencies themselves in the independent exercise of their regulatory functions.

I ask that the CFR seek to provide the Government with a final report by 1 July 2025.

Yours sincerely

The Hon Jim Chalmers MP

08 JUL 2024

CC: Chair Gina Cass-Gottlieb, ACCC
Mr John Lonsdale, APRA
Mr Joseph Longo, ASIC
Mr Steven Kennedy, Treasury