


COMPETITION IN FINANCIAL SERVICES

Research Report
August 2015





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FOREWORD

August 2015

The Centre for International Finance and Regulation and UNSW Australia jointly funded this research under CIFR Project T20. The Centre for International Finance and Regulation is funded by the Commonwealth and NSW Governments and is supported by other Consortium members.

The research question for this project was ‘What are the optimal competition law and policy settings that should apply to the financial services sector?’

The research question was driven by two Australian Government inquiries which will affect competition policy in the financial services sector: the Financial System Inquiry chaired by David Murray and the Competition Policy Review, chaired by Professor Ian Harper.

The project has three objectives.

The first is to investigate the nature of competition in certain sectors of the financial markets. Meeting this objective will provide Australian evidence on which decisions as to the competitive settings in the sector can, or should be, adjusted.

The second is to consider the mechanisms by which competition in the financial services sector can be promoted. This includes an analysis of the approaches used on an international basis for the promotion of competition in financial services. Meeting this objective will provide evidence on which decisions as to allocation of responsibility for promoting competition can be made.

The third is to consider the sector-specific competition settings in the financial sector, including the balance between competition and stability. As the global financial crisis did not provide Australia with direct experience of the practical limitations of this balance, the work investigates theoretical approaches and international experience. Meeting this objective will provide evidence for appropriate policy settings if there are to be any sector-specific competition policy exemptions.

TABLE OF CONTENTS

Foreword	1
Table of Contents	2
Executive Summary	5
The Authors	8
1 Introduction	10
2 Positioning the work	13
2.1 Introduction	13
2.2 Sources	13
2.3 Before the financial crisis: period of liberalisation	14
2.4 The effects of the financial crisis	15
2.4.1 <i>Regulatory overview</i>	16
2.4.2 <i>Systemic risk</i>	16
2.4.3 <i>Supervisory and prudential regulation</i>	17
2.4.4 <i>Competition law</i>	19
2.4.5 <i>Basel II</i>	21
2.4.6 <i>Anticompetitive policies</i>	22
2.5 To promote competition	28
2.5.1 <i>Strength and independence of regulators</i>	28
2.5.2 <i>Competition and consumer policies</i>	29
2.5.3 <i>Barriers to entry and exit</i>	33
2.6 Conclusion	38
3 The nature of competition in financial services	39
3.1 Introduction	39
3.1.1 <i>Life after the financial crisis</i>	39
3.2 The Shape of Financial Services in Australia	43
3.3 The Regulatory Environment	47
3.4 Purpose and Approach	48
3.5 Market Definition	49
3.6 Market Characteristics	54
3.6.1 <i>Players</i>	54

3.7	Market Metrics	57
	3.7.1 <i>Indicators</i>	57
	3.7.2 <i>Stability: Assessment by the International Monetary Fund</i>	65
3.8	Evidence from Observation	66
3.9	Informing Policy Options	70
3.10	Enabling Economic Prosperity	71
	3.10.1 <i>Managing inherent risk</i>	72
3.11	Summary	74
4	Facilitating competition in financial services	75
4.1	Introduction	75
4.2	The contribution of competition to financial services	76
	4.2.1 <i>The importance of a competitive retail banking sector</i>	76
	4.2.2 <i>Consumer position</i>	76
	4.2.3 <i>The position of SMEs</i>	77
	4.2.4 <i>Innovation</i>	78
4.3	Concentration	79
	4.3.1 <i>Concentration: Herfindahl–Hirschman Index</i>	79
4.4	Competition in banking	83
	4.4.1 <i>Measurements other than HHI</i>	83
4.5	Indicators of competition in Australian banking	84
	4.5.1 <i>Overview</i>	84
	4.5.2 <i>H-Statistic</i>	84
	4.5.3 <i>Lerner Index</i>	85
	4.5.4 <i>Boone Indicator</i>	86
	4.5.5 <i>Data envelopment analysis</i>	86
	4.5.6 <i>Return on assets</i>	89
4.6	Applying competition law in the banking sector	91
	4.6.1 <i>Coordinated conduct – difficulties in cartel action</i>	91
	4.6.2 <i>Mergers and acquisitions</i>	91

4.7	Increasing competition – account number portability	93
4.7.1	<i>Introduction</i>	93
4.7.2	<i>Benefits of bank account number portability</i>	94
4.7.3	<i>Possible implementation of bank account number portability</i>	94
4.7.4	<i>Portability implementation in Australia</i>	95
4.7.5	<i>Additional detailed option for bank account number portability</i>	96
4.7.6	<i>Summary</i>	97
4.8	Returning customer data	97
4.8.1	Introduction	97
4.8.2	The data	97
4.8.3	Australian perspective	98
4.8.4	Next steps	98
5	The Rise of Crowd Equity Funding: Where to Now?	99
5.1	Introduction	99
5.2	The rise of crowd equity funding	102
5.2.1	<i>A Kingdon model</i>	102
5.2.2	<i>Application of the Model to CEF</i>	106
5.3	Australia’s position – what alternatives to adopt?	112
5.3.1	<i>The Status Quo</i>	112
5.3.2	<i>Law on Fundraising</i>	113
5.3.3	<i>Australian Small Scale Offering Board</i>	115
5.3.4	What Level of Regulation is Required?	116
5.3.5	<i>Getting the Balance Right</i>	118
5.3.6	<i>Proposals and Alternatives</i>	121
5.4	Conclusions	132
6	Issues in competition and stability in financial services	133
6.1	Introduction	133
6.2	Examining banking sectors	133
6.3	Is there a money creation problem?	135
7	Conclusions	137
8	References	140

EXECUTIVE SUMMARY

International work from central banks, international financial institutions and academic sources in this field is still dominated by the effects of the financial crisis. There are three critical themes:

- (a) an increased focus on macroprudential regulation;
- (b) a focus on regulations that respond to the globalisation of the financial markets; and
- (c) the introduction of anti-competitive policies such as government intervention and consolidation after the financial crisis.

These sources have also offered key policies to promote competition, which include the independence and strength of regulators, consumer policies such as the facilitation of switching, financial literacy, and easing entry and exit restrictions.

There are three characteristics of retail banking in Australia:

- (a) the stability of the sector is sound and retail banking had a relatively soft landing in the aftermath of the financial crisis;
- (b) there is limited competitiveness and this is reflected in the static state of market share between the four major banks and very slow and marginal improvement gains even by strong second tier competitors; and
- (c) product and service innovation is limited.

There are two important implications that flow from these issues:

- (a) the absence of vigorous rivalry, whilst providing stability, is likely to mean that the welfare of retail banking consumers is not optimised; and
- (b) the level of innovation may not be as high as is feasible and barriers, including prudential regulatory barriers to entry or expansion, mean that the extent of rivalry is unlikely to change without some form of promotion of competition.

We recommend the removal of the ‘four pillars’ policy for the following reasons:

- The four major banks are protected by an implicit government guarantee that impacts market operation with little observable benefit to consumers, and may be a source of consumer disutility.
- The four pillars policy has prompted increased vertical integration within the sector, particularly in the area of mortgage products.
- There are sufficient merger protections provided by Part IV of the *Competition and Consumer Act 2010* (Cth).
- Competition and contestability arise when there are reasonably low barriers to entry and exit from the sector. It is not clear that low barriers to entry exist in Australia, and evidence to support this view comes from the failure of international banks to gain a significant toehold in the retail banking sector in Australia. One deterrent to entry is the regulatory focus on the four pillars.

We recognise that this position is at odds with the view of the Financial System Inquiry. The rationale in the report of the Inquiry was to prevent mergers between the four pillars, and the current competition law achieves this objective.

The report examines crowd equity funding as a disruptive force in the banking sector. We recommend that crowd equity funding be permitted with the following safeguards:

- The Australian Securities and Investments Commission (ASIC) should take an active role in monitoring crowd equity funding and be willing to sue in case of fraudulent action.
- Any intermediary online platform should have a financial services licence with limited duty of care.
- There should be a cap for business raisings through crowd equity funding of \$2 million in a 12-month period.

In terms of competitiveness, Australia's banking sector lies broadly between the US and the UK, and is comparable with the world overall. However, statistical measures indicate that competition in the domestic sector peaked in 2004.

We recommend two specific policies to promote competition in retail banking without the structural intervention that would otherwise be required to improve the intensity of competition in the retail banking sector:

- Introduce bank account number portability. This would use 'know your customer' and central database systems in a similar form to those that have been used for mobile number portability in Australia for the last decade and a half.
- Introduce customer access to data held by banks to allow third parties to compare bank offerings across all banks.

It is interesting to note that these two recommendations are consistent with the productivity proposals issued by the UK Government in July 2015.

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1 INTRODUCTION

This report sets out some of the findings of a research project funded by the Centre for International Finance and Regulation (CIFR) and UNSW Australia under CIFR project T20. The research question for this project was ‘What are the optimal competition law and policy settings that should apply to the financial services sector?’

The research question was framed by two government inquiries that were commissioned by the government in 2014 and which have now finalised their reports. These are the Financial System Inquiry, chaired by David Murray, and the Competition Policy Review, chaired by Professor Ian Harper. The reports will affect competition policy and the financial services sector.

In general, there is an assumption, which has been supported by empirical evidence, that competitive markets yield optimum outcomes for consumers measured in terms of consumer welfare. One of the characteristics of a competitive sector is low barriers to entry and to exit. In vibrantly competitive sectors, there is ease of exit and one mechanism for that exit is the failure of a firm. When a firm fails, its unsecured creditors may receive some portion of their debt from the sale of assets of the firm in insolvency.

In the financial services sector, the failure of a single institution can have a compounding effect on the sector and on national and global economies. In particular, there is systemic risk from inter-institution lending and this effect is more complex in Australia due to the small number of major players. In retail banking in Australia, following a similar practice in most developed countries, if an unsecured creditor is a retail depositor, their deposit is insured by the government. If a retail bank fails, the Federal Government will make the depositors whole.

The financial regulatory system, particularly the prudential regulatory system, is designed to protect depositors’ and borrowers’ interests and this protects the interest of the government. The effect is that policy on banking has prioritised stability in consideration of the sovereign risk associated with the risk of retail bank failure.

This approach also creates a policy dilemma. The dilemma concerns the extent to which the retail banking sector can attain the benefits of vigorous rivalry from effective and efficient competition without unduly risking stability and the potential of a devastating call on the public purse.

In any given economy, analysing policy options to resolve that dilemma is made more complex when there are sectoral disruptors. Entry through disruptive and innovative service offerings is important to an understanding of the competition/stability balance and creates regulatory challenges.

This report investigates these issues and makes a number of recommendations that are designed to promote competition without substantially increasing instability risks. It does this in six parts.

To begin, 'Positioning the work' locates the research in the context of work on the competition/stability compromise. It begins by reviewing the available sources, which include international financial institutions and other international bodies such as the Organisation for Economic Development (OECD) and the Bank for International Settlements (BIS). It goes on to consider the deregulatory and liberalisation period before the financial crisis and sets the scene for the post-crisis reform process, which is the context for the current research. The chapter looks at the effects of the financial crisis on the forms of regulation in the financial services sector and investigates responses in terms of systemic risk, the prudential regulatory response to that systemic risk and the effects of competition law as a regulatory input. It also looks at the effects of Basel II and the anticompetitive policies that were an immediate response to the financial crisis. The chapter ends with a section that sets the policy scene in terms of regulator independence, consumer policy and the issues associated with entry and exit in the financial services sector.

The next chapter has the title 'The nature of competition in financial services' and it examines retail banking competition in Australia. It describes the shape of the financial services sector in Australia with a focus on retail banking. It then describes the banking regulatory regime before setting out the markets that have been found by the Australian Competition and Consumer Commission (ACCC). Having defined the markets, the chapter then characterises those in terms of the participants, metrics and observations. The chapter looks at policy issues, including in relation to risk management, and finds that the 'four pillars policy' has been reinforced through merger and acquisition activity by the four major banks in Australia.

The third chapter, 'Facilitating competition in financial services', begins with an examination of the contribution of competition to financial services. As the financial services sector interacts

so importantly with the ‘real economy’, the chapter looks at some of that interaction along with the theory of innovation in the context of competition. The chapter then uses analytical tools to determine the level of competition in retail banking, reviewing traditional measures of concentration such as the Herfindahl–Hirschman Index and more recent approaches to measuring intensity of competition in the financial services sector. The chapter uses data from the World Bank to benchmark Australian retail banking competition with other parts of the world. It then examines the application of competition law in the banking sector before proposing two mechanisms for increasing competitive rivalry in the retail banking sector. The first is the introduction of bank account number portability. This would use ‘know your customer’ and central database systems in a similar form to those that have been used for mobile number portability in Australia for the last decade and a half. The second is the introduction of customer access to data held by banks to allow third parties to compare bank offerings across all banks.

The fourth chapter examines competitive entry through the process of crowdfunding. The chapter begins by reviewing the long history and recent rise of crowd equity funding. It presents a Kingdon model and applies that model to crowd equity funding, and considers the alternatives available in Australia. It describes the status quo and its limitations, before examining the current law on fundraising. It reviews the option of a small scale offering board before providing a detailed review of the regulatory safeguards that are required and the balance of protection for investors and the fundraiser. The chapter next examines a series of proposals and alternatives before offering some conclusions.

The chapter, ‘Issues in competition and stability in financial services’, briefly introduces some of the competition and stability issues which have not otherwise been addressed in the balance of the report. In particular, it raises the issues of money creation if there is significant disruption of the retail banking sector by entrants which are not deposit-taking institutions.

The report ends with some brief conclusions that highlight the results of the research presented in this report.

The authors of the report and CIFR welcome feedback on the views that we have expressed.

2 POSITIONING THE WORK

2.1 Introduction

This chapter examines the issues of the mechanisms by which competition in the financial services sector can be promoted. To this end, it traces the implicit and explicit obligations of competition regulators, consumer protection regulators and financial service regulators in relation to competition in the OECD. The literature on the role of regulators is divided between before and after the financial crisis, as new approaches to the financial sector were sought to prevent future economic meltdown. This transition has led to the promotion of prudential regulation to maintain financial stability in the financial sector both in the academic literature and in policy whilst there is a paucity of literature on the role of competition in financial services in the context of stability. There are a number of policy narratives on promoting competition and the role of regulators on this issue. Accordingly, the chapter is divided into four sections. First is an outline of the primary sources used by the literature, including background information on thinking before the financial crisis. The section provides an understanding of the root causes of the changes in economic policy. The chapter then investigates the effects of the financial crisis, including advocacy for macroprudential regulation and tolerance of policies and practices that would normally breach competition law. Following this, the chapter examines the specific policies highlighted in the literature for the promotion of competition, which include, but are not limited to, the strength and independence of the financial regulators, consumer policies and entry and exit policies. The chapter concludes by highlighting the overall framework of the literature on the promotion of competition in OECD countries.

2.2 Sources

Even though the financial crisis began seven years ago, the data used in many studies, especially in the case of the OECD reports, is restricted to pre-crisis indicators. This is despite much of the literature itself being written after the financial crisis. The analysis is mostly derived from two sources: the World Bank and the International Monetary Fund (IMF). The World Bank publishes the Bank Regulation and Supervision database and the latest data is from 2012 (World Bank Global Financial Development 2013). The IMF provides information on prudential regulation in insurance markets from the Financial Sector Assessment Program (FSAP). The World Bank survey data covers all OECD countries, whilst the FSAP is more selective in its scope of data collection. Whilst using pre-crisis indicators may be beneficial to determine why the financial

system failed and what steps can be taken to improve the model such as strengthening financial regulation, it is important to note that it is limiting in the sense that it cannot show the results of the implementation of new regulatory roles on the promotion of competition. As is highlighted in the next section, the financial crisis has created a significant change in terms of the structure and operation of the financial system. In particular, a new approach with an emphasis on macroprudential regulation has emerged. This means that new data is required to find evidence on the outcome of this approach on competition and, more broadly speaking, the financial system as a whole. It is important to note however, that the literature that is more country-specific tends to provide more up-to-date data. Sources include the European Central Bank (ECB) for information on countries in the European Union (EU), the Federal Deposit Insurance Corporation and the Federal Reserve for the United States (US) and the Australian Prudential Regulation Authority (APRA) for Australia.

2.3 Before the financial crisis: period of liberalisation

The academic literature points to a shift from liberalisation starting in the 1970s to the increase in prudential regulation after the financial crisis from 2007-2009, as economists and policymakers questioned why the supply of liquidity in financial markets failed. There is general agreement that prior to the financial crisis, competition was promoted through liberalisation, which essentially entailed deregulation and breaking down barriers that may have impeded competition. The management of financial services was left for the market actors to self-regulate. For example, De Serres (2006a: 7) notes the period of liberalisation in the 1980s that removed price controls, eliminated barriers to cross-order capital flows and, overall, reduced regulation on the banking sector. Although this OECD working paper was written prior to the financial crisis, it demonstrates the period in which liberalisation combined with technology is seen as raising competition levels. It argues that the crises that occurred in the early 1980s were due to a lack of regulation, macroeconomic policies and flawed incentives due to the tax system. Vives (2011), whilst also noting the contrast between the period of tight regulation from the 1940s followed by the liberalisation era in the 1970s that was aided by advances in information technology and financial globalisation, argues that liberalisation, coupled with inadequate macroeconomic policies and poor institutions, increased banking fragility. An OECD report (2010a: 149) provides evidence of this as a period of liberalisation in the OECD countries and in many developing countries by referring to a study that found that out of the 'world's 57 largest economies from 1970 onwards, 56 out of these 57 countries have become less regulated over the period' (the only exception

being Venezuela). The following year the OECD (2011) released a further report confirming that in the last two decades, the EU and the US had been implementing a series of deregulatory changes to stimulate competition and to strengthen financial integration.

As is evident, there is ample literature on the subject of liberalisation and on the opening of trade via financial globalisation and deregulation prior to the financial crisis to give a greater understanding on the failings of the financial system to prevent future crises. It is for this reason that prudential macroeconomic regulation and supervision have become important issues for policymakers – an area that will be explored in the following section.

The implementation of deregulation and liberalisation during this period was coupled with a dominant discourse in the literature that endorsed these economic and financial policies. For example, De Serres (2006a: 6) notes the importance of removing barriers to promote competition and cross-border integration of financial markets. Guiso et al. (2004) also highlighted the integration of the financial market in the EU and its benefits to the economic zone as free capital mobility was encouraged. An OECD report (2005: 124) begins by stating:

Regulation is perhaps the most pervasive form of state intervention in economic activity... Over recent decades, however, policymakers have become increasingly concerned about the potential for regulation to be too intrusive and stifle market mechanisms, possibly affecting resources allocation and productive efficiency.

While this report highlights the benefits of regulations that enhance competition, it is predominately concerned with regulations that inhibit competition, as is most of the literature before the financial crisis.

2.4 The effects of the financial crisis

Since the beginning of the financial crisis in 2008, there has been a plethora of literature that highlights the need for financial regulation and supervision to mitigate the risk of another financial crisis and to ensure economic stability (for example, Ahrend, Murin and Arnold 2009b; Dam 2010; Barth, Caprio and Levine 2008). While most policymakers and economic researchers since the global financial crisis highlight the need for prudential regulation, the importance of competition has been, to an extent, sidelined.

2.4.1 Regulatory overview

International governance and transnational regulation has gained much international scholarly and political attention as a result of the repercussions of the financial crisis (for example, Pihon 2010; Papademos 2009; Goodhart 2010; Bank of England 2009). As such, there has been a realisation that financial globalisation requires an international response and that there is a need to look at the stability of the financial system as a whole rather than examining individual firms. Gossé and Plihon (2014) argue that, due to the interconnectedness of individual financial institutions and markets, and the pro-cyclical behaviour of the financial system, microprudential regulation is not enough. As demonstrated by the financial crisis, financial institutions will seek the least restrictive supervision system to avoid compliance with standards set by the regulator, and attempts by individual institutions to remain solvent can push the system to collapse. The article therefore argues that there is a need for an international response through macroprudential regulation.

2.4.2 Systemic risk

An OECD (2009) report concurs with the possibility of systemic risk and the need for prudential regulation, whilst omitting the push for Keynesian macroeconomic regulations. It sets out the theory of systemic risk that is based on the idea that if there is a loss of confidence in one major financial institution, there may be a domino effect, with the result that no participant is able to meet its obligations. (Further work in this area is provided by Haldane and May 2012; Battiston, Delli Gatti, et al. 2012; Battiston, Gatti, et al. 2012; Roukny et al. 2013). Therefore, the financial system requires regulation to ensure systemic crises do not occur (OECD 2009: 7). Lyons (2009b: 1) also refers to the problems of a microprudential approach noting that the repercussions of a systemic crisis will not just affect the financial sector but that the contagion could impact all areas of the economy and argues for an improvement of the current international regulatory system.

The high level of interconnectedness of banks leads to the potential for systemic risk. Because banks syndicate risks between themselves, the failure of a single bank can have an impact on all of the other banks. This leads to the problem of banks that are 'too big to fail'. In the financial sector, increasing interconnectedness does not necessarily maximise resilience. Acemoglu et al. identify two separate streams of thinking (Acemoglu, Ozdaglar and Tahbaz-Salehi 2013). The first suggests 'a more equal distribution of interbank claims enhances the resilience of the system

to the insolvency of any individual bank'. The second takes an opposite view and models interbank contagion as an epidemic. The Acemoglu et al. approach demonstrates that both of these approaches are correct. For small perturbations, interconnectedness provides stability. However, for large shocks, weakly connected networks show the highest resilience. Acemoglu, Ozdaglar and Tahbaz-Salehi (2013) refer to the proposition by Haldane that the interconnection might best be described as a complex adaptive system (Haldane 2009). This type of system has been extensively described (for example, Mitchell 2006; Walker and Cooper 2011; Boccaletti et al. 2006; Farmer et al. 2012; Gai, Haldane and Kapadia 2011; May, Levin and Sugihara 2008). This section of the article reviews each of financial (supervisory and prudential) regulation and competition law.

2.4.3 Supervisory and prudential regulation

The basic business model for a bank is to borrow funds from depositors and from capital markets at one interest rate and to lend those funds to borrowers at a higher rate. The bank needs to cover its costs, including the risk of bad debt as well as tax from this interest margin. The bank is profitable when there is sufficient margin to more than cover costs. There are two issues with this model. The first is that there is usually a higher margin available for riskier loans. In order to assess this risk, the bank conducts a review of the risk or relies on a credit rating agency to provide their opinion as to the level of risk. The second is that in many countries, deposits below a certain level are insured by the state for the benefit of the depositor. This creates a moral hazard, as the lending bank knows that the state will cover losses on bad loans. Prudential regulation is concerned with reducing the probability of the deposit insurer bearing losses (Hanson, Kashyap and Stein 2011: 4) by supervising the bank to ensure that only appropriate loans are made.

In practice, there are two forms of prudential regulation. The first, microprudential regulation, is associated with a single firm. The second, macroprudential regulation, is associated with the financial system. Borio sets out the distinctions between micro prudential and macroprudential regulation and these are reproduced in Table 1 (Borio 2003: 183).

TABLE 1: Comparison of microprudential and macroprudential regulation

	MACROPRUDENTIAL	MICROPRUDENTIAL
Proximate objective	limit financial system-wide distress	limit distress of individual institutions
Ultimate objective	avoid output (GDP) costs	consumer (investor/depositor) protection
Model of risk	(in part) endogenous	exogenous
Correlations and common exposures across institutions	important	irrelevant
Calibration of prudential controls in terms of:	system-wide distress; top-down	risks of individual institutions; bottom-up

One of the issues raised by the global financial crisis is the extent to which the focus of regulators has been on microprudential regulation when a global crisis required a macroprudential view (Galati and Moessner 2013).

There has been a degree of coordinated internationalisation of the regulation of the financial sector. Global regulatory coordination has had mixed results with both ‘race to the top’ as well as ‘race to the bottom’ outcomes. Consistent with regulatory theory (Drahos and Braithwaite 2001) global prudential regulation has ratcheted up and Levi-Faur argues that this process will continue as a result of the global financial crisis (Levi-Faur 2010). However, one of the striking results of work by the World Bank is that there has been little in the way of regulatory change as a result of that crisis (Čihák et al. 2012b). This is consistent with the analysis that there has been a post-global financial crisis response to re-regulate banking but using the traditional forms of banking regulation (Young and Park 2013) or perhaps an attempt to ‘create settled stories’ as part of a ‘repetitive liturgical incantation’ (Froud et al. 2012).

One of the critical issues is the role of the ‘politics of international prudential regulation’ in aligning regulatory responses to the global financial crisis (Helleiner and Pagliari 2011: 185), if the crisis is over from a regulatory perspective (Mügge 2014). The regulatory alternatives include changes in culture (O'Brien 2014) or the centralisation of international banking supervisory standards. Against this, is the argument that there is no ‘one size fits all’ approach (Garicano and Lastra 2010). Indeed, some scholars suggest that changes in financial regulation are as cyclical

as the events (or crises) that trigger them (Martinez-Moyano, McCaffrey and Oliva 2014), follow a sine curve (Pan 2013), or that the search for ideal regulation should be likened to a quest to find the Holy Grail (Masciandaro and Quintyn 2013). Even if the global financial crisis was ‘an elite political debacle’ requiring a ‘dramatic simplification of finance’ (Engelen et al. 2012), this line of argument still assumes the same tools of financial regulation.

These tools and a common approach to supervision and prudential regulation are well supported. Barth et al. take the view that the regulations and supervisory practices that work best: force accurate information disclosure; empower private-sector corporate control of banks; and foster incentives for private agents to exert corporate control, work best to promote bank development, performance and stability (Barth, Caprio Jr and Levine 2004). Additional work has shown that a strong bank supervisor can reduce total banking risk, even in the presence of acquisitive international banks (Buch and DeLong 2008).

The key difference in the implementation of financial regulation is the extent to which the supervisory element also includes self-regulation. For example, the UK has attempted to use principles based regulation (Black, Hopper and Band 2007). The effect has been muted by a desire for ‘light handed’ regulation of the sector. There is also the risk that liberalisation may increase moral hazard (Hellmann, Murdock and Stiglitz 2000):

Financial liberalization tends to increase the intensity of competition between banks at the same time that banks are given greater freedom to allocate assets and to determine interest rates

2.4.4 Competition law

Competition law is primarily concerned with the protection of consumers by promoting competition between suppliers. This promotion of competition occurs through orderly markets that are not distorted by anti-competitive conduct. In order to minimise such distortions, competition law has three pillars:

- (a) cartel prohibition;
- (b) prohibition on the abuse of market power; and
- (c) merger control.

Most competition law, regardless of jurisdiction, will have these pillars and they are disseminated to developing economies through the United Nations Conference on Trade and Development (UNCTAD) 'Model Law on Competition'. In many countries, the national competition authority regulates the three pillars and sector specific competition regulation is in the hands of the sector regulator. Australia is exceptional in this respect as the Australian Competition and Consumer Commission (ACCC) is the sector competition regulator in the telecommunications and energy sectors. Regardless of structure, it is the national competition authority that has responsibility for regulation and enforcement of cartel matters.

Enforcement of competition law and the supervisory and prudential regulation of banking have traditionally followed distinct regulatory paths with 'regulatory pyramids' that share merely a common base (Braithwaite 1985; Wood et al. 2010). However, the liberalisation of the financial sector was one aspect of a more general liberalisation process, which relies on competition law to protect consumer interests by promoting competition in the context of the replacement of state operated monopolies with privatised businesses.

One of the outcomes of the liberalisation of the financial sector has been consolidation. For example, there have been significant structural changes in the European Union as a result of the liberalisation of the banking sector. The effect has been for there to be significant concentration and the consequence that banking regulation could have unintended, and potentially undesirable, consequences in the non-financial sector (Cetorelli 2004b). Even the concept of competition in the financial sector raises potential stability risks (Allen and Gale 2004: 478):

Our analysis suggests that the issue of regulation and its effect on competition and financial stability is complex and multi-faceted. Careful consideration of all the factors at work both at a theoretical and empirical level is required for sound policy

On the other hand, competition law has the potential to ensure the public interest in financial regulation (Duke and Cejnar 2013: 156):

Competition law should not be subordinated in the name of promoting stability as the efficiencies brought about by the rigorous application of competition law are also in the 'public interest'

One of the critical questions that needs to be addressed is whether competition regulation should be relaxed in times of crisis and there are increasing demands that coordination between prudential and competition regulators should be used to avoid such relaxation (Hasan and

Marin 2013). There have been alternative and resisted suggestions that there might be a sector specific competition regime for the finance sector. The resistance is in the form of an argument that the finance sector should not be considered as having ‘natural monopoly’ characteristics and that consequently there is little scope for control of monopoly power (Goodhart 2011). The extension of this view is that the regulation of banking should be left to bankers with an understanding of the system.

One issue arising (at least in the UK) out of the need for bank rescue was to provide a power to over-ride competition law. Specifically, (Cejnar 2011):

providing that financial stability, along with national security, is a public interest consideration, therefore justifying an exception to the referral of relevant merger situations to the UK Competition Commission

There is interaction between financial services regulation and competition law and this is particularly apparent in the EU (Nicholls 2014; Nicholls and O'Brien 2014).

2.4.5 Basel II

The main globally agreed regulatory system for banking prior to the pre-financial crisis consisted of the Basel II Accords that provided an international framework on capital standards in the banking industry to address credit risk. Prior to the financial crisis, these international instruments were seen as sufficient. For example, De Serres (2006a) underscores the importance of instruments that have less adverse effects on competition such as the Basel II Accords. He argues that the financial system only needs measures such as capital requirements, disclosure rules and risk-based deposit insurance to promote prudent behaviour by banks, which ensures stability, as well as, competition. Moreover, he points to stronger competition not risking greater instability because authorities have ‘refined the tools’ for prudent behaviour with minimal effects on competition (De Serres 2006a: 32).

There is now however, consensus that the Basel II Accords have proven to be insufficient to guarantee against systemic financial risks. For example, Lyons (2009b: 9) highlights that the Basel II had three ‘pillars’: ‘minimum capital requirements; regulatory supervision; and risk disclosure to facilitate market discipline’, which he argues proved to be inadequate. Gossé and Plihon (2014) further note that until recently the Basel approach, based on principle, was to ensure the soundness of individual institutions against the risk of loss on their assets. It was based on the idea that actions by individual firms would provide for the overall stability of

the financial market, which failed to encompass a macroeconomic approach. Demirgüç-Kunt and Servén (2010b: 103), whilst agreeing that the Basel II framework has a flawed approach, argue that the system of external rating is also a key problem. The article points to the fact that capital requirements are based on external ratings, and these proved to be too optimistic. It adds that a conflict of interest arises as issuers pay agencies for ratings required by regulators. Moreover, these 'ratings are based on expected default rates', but capital is meant to be there for 'unexpected losses' (Demirgüç-Kunt and Servén 2010b: 103). Demirgüç-Kunt and Servén (2010b) also note that the other key problems in the Basel Accords were the weaknesses in its disclosure provisions and the lack of investigation into transparency of financial firms.

As concluded by scholars and economic researchers such as those already mentioned (Lyons 2009b; Gossé and Plihon 2014; Larosière 2009; De Larosière 2009), these measures held that the Basel II Accords to deal with the increased globalisation and integration of the financial sector were not sufficient for the soundness of a system as a whole. Since the financial crisis however, the literature points to various new proposals to avert further crises. For example, the OECD (2010c-b) report refers to the Financial Stability Board, the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and the European Commission that have recommended policies to increase economic stability and competition. It further gives reference to the Basel III Accords that have been adopted, which is a new instrument with the aim of boosting stability whilst having minimal effects on competition. The OECD (2010c) also released guidelines for financial regulation. The aim is to improve confidence and trust in the financial system by providing a framework to guide financial enterprises. It underscores the importance of not just having a vibrant competitive market but also one with a sound regulatory and supervisory framework with a balanced tax system, transparency and legal infrastructure, as well as ethical prudent risk-taking behaviour.

2.4.6 Anticompetitive policies

There has been a dominant narrative on the concern of a number of anticompetitive policies that have been implemented as a result of the financial crisis, which have been aimed at ensuring stability, but that may have negative consequences for the competitiveness of the financial sector. A number of recent OECD reports along with economic researchers highlight the need for prudence when enacting regulation so as to not jeopardise competition and to enhance the effectiveness of the financial system, which, in turn, allows for long-term economic growth (OECD 2010d, 2010b, 2009; Lyons 2009b). This also includes measures such as mergers of large

financial institutions and intervention such as injections of capital, guarantee schemes and asset purchases.

The first example concerns large-scale government interventions in the financial system where asset purchases and injections of capital may distort the level playing field. The prevalent view of the literature is that government ownership and intervention in the financial system is negatively correlated with competition. This view is based on empirical studies such as Barth, Caprio and Levine (2004a) and La Porta, Lopez-De-Silanes and Shleifer (2002). For example, in the OECD (2010d) report it notes the number of OECD countries such as Iceland, Ireland, the Netherlands, Portugal, the UK and the US, have nationalised some of their banks, while Germany, Ireland, Korea, Switzerland, the UK and the US have also moved to purchase and/or 'ring-fence toxic assets' following the financial crisis. Whilst noting that this has minimised the effects of the financial crisis in those jurisdictions, it also points to the potential harm these initiatives could have on competition, and their negative consequences for long-term growth. It therefore argues for reduction in government aid, and enforcement of regulation and exit strategies. Demirgüç-Kunt and Servén (2010b: 97) concur referring to *The Economist* newspaper and stating: 'By the end of 2008 governments will be the largest shareholders in most developed economies' financial industries, reversing a trend of state retreat over the last 20 years'. They argue that empirical research shows that state intervention in the financial sector correlates with less innovation, growth, productivity and cronyism (Demirgüç-Kunt and Servén 2010b: 98-99). The article overall associates state ownership with a lessening of competition and increased financial instability.

Foer (2014: 26) also argues that for competition a level playing field must be maintained. He argues that governmental interference such as large financially weak companies receiving artificial and 'competitively unhealthy assistance' is detrimental to the financial system as it creates an uneven playing field. He emphasises the essential link between prudential regulation and competition policy. The article uses the EU as an example of this linkage, noting that the competition authority of the European Commission has been central in all decision-making processes. This is because under the Treaty Governing the Function of the European Union, it is the responsibility of the Competition Authority to monitor and respond to policies implemented by Member States. Policies of particular relevance are those that give special rights or advantages to local companies, including banks. Moreover, any bailout of a bank by a Member State calls for the approval of the Competition Directorate. As outlined by the College of Commissioners, competition policy is viewed as a necessary component of the solution to

the financial crisis (Foer 2014: 13). The then European Commissioner for Competition, Neelie Kroes, demonstrated this importance of competition policy by pointing out that ‘in the midst of massive government intervention, we need to make sure that we do not along the way also lose the level playing field and the future dynamics that comes from competition’ (Foer 2014: 12). Even when a bail out was approved, the Commission required that government aid was conditional on the unsound bank restructuring itself (Foer 2014: 15). This was in contrast to the response of the EU to that of the US financial crisis, noting that the US regulatory system did not harmonise its regulatory reforms with competition policy, as the antitrust authorities did not take an active role in the implementation of these reforms made by prudential regulators of financial institutions. Foer (2014) therefore, argues that the EU provides a sound model on the role of competition regulators such that competition is maintained and enhanced, even during crises. However, this model does not apply in jurisdictions outside of the EU as there is no obligation on states as set out in Article 4(3) of the Treaty on the European Union which gives members a duty of:

sincere co-operation to facilitate the achievement of the Union’s tasks and refrain from measures which could jeopardise the Union’ objects

Lyons (2009b: 20) concurs with this line of argument, noting that the European Commission relied on Article 87(3) (b) of the European Commission Treaty. This allows Member States to provide aid when there is a serious disturbance in the economy and adopts a ‘temporary framework’ for Member States to remedy the financial situation in a minimally distortive way. With the objective of keeping a level playing field in Europe, the idea was to only provide aid to firms that are struggling now, as opposed to those who have been in long-term decline. Lyons (2009b) also finds that this is a model that can be applied to deal with the financial crisis.

A second potential anticompetitive policy is the issue of mergers and acquisitions creating a high level of concentration in the financial market. Whilst there is less literature written on this subject, particularly in the case of OECD reports, it has still become an important issue to analyse. Ahrend, Murtin and Arnold (2009b), as a part of the OECD Working Papers, briefly mention in a footnote that concentration has increased as a result of public ownership and intervention in the financial industry, but fails to take into account private mergers. There is one OECD (2009) report that does consider mergers as being either partial nationalisation, or as the amalgamation of stronger and weaker financial institutions. The latter being a usual form of merger, subject to the competition law of the jurisdiction. The OECD (2009) report identifies

this as a problem that leads to less competition followed by lower deposit rates and higher loan rates and one that should only be used as an emergency measure to avoid a systemic crisis. It does however, note that nationalisations are preferable to private mergers, as they are easier to reverse and are more likely to be solvent.

Foer (2014) provides quantitative insight into the level of concentration in both the EU and the US as a result of the financial crisis. The article first refers to the Wall Street Journal noting that the four biggest US banks by assets (J.P. Morgan, Bank of America, Citigroup, and Wells Fargo) have combined assets of more than \$7 trillion, which amounts to an increase of more than a fifty per cent since the end of 2007. This can be attributed to 'J.P. Morgan's takeover of failed Washington Mutual Inc., Bank of America's acquisition of mortgage lender Countrywide Financial Corp. and Wells Fargo's purchase of Wachovia Corp' (Foer 2014: 18). Foer (2014: 18) gives further evidence to this accumulation of concentration as a result of mergers through economist Simon Johnson's observation that the 'Big Six' (JP Morgan, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley) have total combined assets equivalent to sixty per cent of gross domestic product. This is in contrast to the EU where Gert-Jan Koopman, Deputy Director General for State Aid in the European Commission Competition Directorate reported that, in the EU, there has not been much more concentration as a result of state aid.

Vives (2011) also measures bank concentration by examining the largest banks in the EU and in the US. He uses data from the Federal Deposit Insurance Corporation and the Federal Reserve for the US and the European Central Bank for information on the EU in order to determine the level of concentration. The review concurs with Foer's findings that there were smaller increases of concentration in the EU in comparison to the US, although, prior to the financial crisis, concentration in the EU was already high. It found that in the US, 'the ratio for assets rose from 23 per cent in 2001 to 36 per cent in 2008.' (Vives 2011: 482). This is in contrast to the EU-15, which had a smaller increase: from 52 to 54.5 per cent (Vives 2011: 482). Applying the Herfindahl-Hirschman Index (HHI) (Hirschman 1964), using the methodology of the United States Department of Justice (DOJ and FTC 2010), shows that concentration went up in Germany, Greece, Spain, Italy, the Netherlands, Portugal, Finland, and the UK, whilst it decreased in Belgium, Denmark, France, Austria and Sweden. Vives (2011) therefore concludes that the financial crisis signifies a pull towards greater concentration in the EU and, to a greater extent, in the US.

Neal (2011), with the aim of understanding whether competition in the financial market in Australia has decreased since the financial crisis, uses data from the Australian Securities

Exchange. He notes that at the end of September 2010, the four major banks accounted for 56.3 per cent of the financial market and 19.3 per cent of the ‘total market capitalisation of the domestic stock market’ (Neal 2011: 3). The article further notes that prior to the financial crisis, major banks’ control over the financial market had dropped significantly as a result of the ability of regional and foreign-owned banks’ to compete using securitisation as a major funding source. From the September 2007 quarter to the June 2010 quarter however, ‘the major banks’ share of total banking assets rose more than 10 percentage points to 77.6 per cent’ (Neal 2011: 4). The article attributes this sharp increase to the acquisitions of St George by Westpac and BankWest by the Commonwealth Bank in 2008/2009. His evidence was HHI data derived from Australian Prudential Regulation Authority (APRA) reports. These figures reflect the increased level of concentration in the Australian banking industry between 2002 and 2010, particularly in 2009/2010. Rajapakse and Rajapakse (2011: 291) also note this high level of concentration, finding that 76.1% of all banking transactions in Australia come from the four pillars and worry that these banks have almost become ‘too big to fail’.

The Deloitte Access Economics (2014b: 28) report also underscores the change since the financial crisis in Australia and refers to the comments of the ex-ACCC head Graeme Samuel who publicly stated that some of the mergers that occurred may not have been allowed if financial stability had not been prioritised over competition. The report further underscores the level of concentration in retail banking in Australia by comparing it to European countries. Based on ECB statistics and APRA, the article finds that the level is higher in Australia than in the EU. The article however, suggests that the level of concentration in Australia’s retail banking sector remains below the ACCC threshold and competition in Australia is therefore not a cause for concern.

This issue of high concentration in the market is also linked to the risk of the formation of oligopolies, whereby there are a few firms that become systemically important and are therefore, as popularly referred to in the literature, ‘too big to fail’. The extent to which this is a problem in the financial sector and not a more general issue is also worth considering. As a small open economy, Australia has evidence of oligopoly (and often duopoly) industry structures in a number of sectors.

The OECD (2009) report illustrates that, prior to the financial crisis, the financial sector in many countries was already oligopolistic and that this structure, not competition, was partly responsible for the crisis. This was because the oligopolistic structure meant that many of the

banks were systemically important, creating ‘moral hazards, guarantees and excessive risk taking’ (OECD 2009: 8). Thus, the report argues that more competition (combined with prudential regulation) is required for stability. Beck (2008a: 5) concurs, noting the major reports by the Bank for International Settlements (2001), International Monetary Fund (2001) and the Group of Ten (2001) that have raised concerns about the accelerated concentration of banks within countries and across countries in the past decades. The article notes that, as a result of this, institutions that are ‘too big’ or ‘too-important-to-fail’ may make it more difficult for authorities to interfere and close them (Beck 2008a: 5). Moreover, due to the complexity of these oligopolies, it is difficult for authorities to properly supervise these businesses.

Most of the literature however, focuses on governments providing blanket guarantees to ‘too big to fail’ banks due to the systemic risk and increased oligopolistic nature of the financial sector. For example, Lyons (2009b: 6) refers to moral hazard in which major banks take excessive risks as they know that they will be bailed out by their governments to reduce the risk of systemic failures. Demirgüç-Kunt and Servén (2010b: 91) also exemplify this issue by referring to the US and European governments providing ‘blanket guarantees’ to bank depositors and creditors. Foer (2014: 10) also notes this problem by referring to the comments made by then Federal Reserve Board Chairman Ben Bernanke “having institutions that are too big to fail also creates competitive inequities that may prevent our most productive and innovative firms from prospering...Firms that do not make the grade should exit, freeing up resources for other uses”.

It is also important to note that there is a strand of literature which argues that the level of concentration is a good indicator of competition. For example, Neal (2011: 5) contends that, as illuminated by economists, the level of concentration, measured by concentration ratios or by HHI, is not enough to determine the level of competition. The article takes the view that contestability must also be examined, that is, evaluating the ability for firms to enter and exit markets. Contestability is an issue that will be examined in the next section on promoting competition.

Overall, the literature underscores the various economic policies such as mergers and acquisitions which would not be permitted other than in the financial crisis and governmental intervention to tackle the financial crisis, but which may have negative effects on competition in the long run.

2.5 To promote competition

2.5.1 Strength and independence of regulators

In the context of regulation as an important aspect of creating a stable and financially competitive market, one must consider the strength and independence of regulators themselves. As encapsulated by Ahrend, Murtin and Arnold (2009b), prudential regulation reflects the law but not necessarily the implementation of regulations in practice or reality. Accordingly, it is crucial to examine the strength and independence of supervisory institutions. This is a central issue in the literature, as it is viewed as one of the reasons that led to the financial crisis. For example, the OECD (2010d) report underscores the importance of effective global regulatory institutions as a result of the financial crisis, which demonstrated the weakness in the operation of financial regulatory and supervisory frameworks. Demirgüç-Kunt and Servén (2010b) concur by pointing to the lack of transparency in the financial sector and the need for regulators to be able to identify gaps in information and to respond appropriately. The article specifically finds that there is a lack of supervisory examination and publications of the decisions made by private accountants and credit-rating organisations. Demirgüç-Kunt and Servén (2010b: 105). Čihák et al. (2012a) provide further insight on this issue by analysing the World Bank's 2011-2012 Banking Regulation and Supervision Survey (BRSS) that found for example: 'in 83 percent of non-crisis countries the regulator had the power to request banks to put up new equity. This was true only in 65 percent of crisis countries', which meant, 'regulators in crisis countries were less able to demand banks to put up more equity'. The study found similar results that demonstrated regulators in crisis countries were less likely than non-crisis countries to enforce 'greater provisions or to suspend bonus and management fee payments' (Čihák et al. 2012a: 9). It concludes that the evidence suggests that crisis countries suffered from a weakness in their bank regulations and supervision frameworks and that, whilst there have been reforms since the financial crisis, improvements in regulatory and supervisory frameworks are essential for bank stability and efficiency.

While the literature does tend to reflect on the regulatory and supervisory roles in the context of stability post the financial crisis, there are a few scholars and financial advisors who also examine the role of supervisors in competition policy. For example, Ahrend, Murtin and Arnold (2009), and the OECD (2010a) report, highlight through empirical evidence, that strong supervisors enhance not only stability, but also competition. They note that the evidence shows that when supervisors are not very strong, capital requirements appear to hamper

competition, as the system can be abused, resulting in an uneven playing field. This also applies to entry and ownership regulations that can impede competition when the institutions are weak as the rules may be exploited. They also note that, when supervisory institutions use their enforcement powers fully, abuses of the regulations are less likely and this is beneficial for competition. It is for these reasons that they support a stronger and more independent competition law regime for the banking sector. The OECD (2010c, 2011) reports also advocate stronger independent competition authorities. It also notes that many countries were also strengthening their supervisory agencies following the Basel II framework. In terms of the current strength of supervisory and regulatory frameworks, Lyons (2009) compares the EU with the World Trade Organization (WTO), arguing that the EU as a supervisory and regulatory force is a powerful tool to enhance competition policy. It is backed by law and is a good model of effective regulatory implementation. This contrasts with the WTO, whose role is to reduce impediments to international trade. The WTO has a reporting role surrounding national trade policies but has fewer enforcement powers and a limited mandate (Lyons 2009: 20).

Thus, the literature highlights the need for supervisory and regulatory frameworks that are independent and have the strength to ensure that regulations are implemented and enforced, which serve for most notably stability, but also competition.

2.5.2 Competition and consumer policies

One of the current discussions is that competition and consumer policy share a common goal and purpose, that is, the maximisation of consumer welfare. For example, the OECD (2010a) argues for competition and consumer authorities to be more integrated to prevent anticompetitive restrictions. It also investigates the issue of integrating consumer and competition policy into one single agency (as in the case of the ACCC in Australia) and notes that there are both benefits and disadvantages in this approach. The report identifies benefits such as:

- (a) it ensures there is a more holistic approach when imposing policies;
- (b) both require similar expertise which means that when expertise is limited, they could provide information to both, making the agency more efficient; and
- (c) as consumer policy is seen by the public as a more positive institution than competition, combining the two could facilitate a more favourable view of competition policy.

The OECD (2009: 52) suggests that it may be beneficial for competition policy to be extended past consumer welfare to economic and systemic stability, or otherwise for competition authorities to focus on consumer welfare, while another institution looks at the importance of consumer welfare against other concerns. It refers to countries that already have this system in place, such as Canada, the Netherlands, Switzerland and in the European framework. For example, in Austria, concentration is permitted if it allows for international competitiveness and if it is sound in terms of macro-economic stability (OECD 2009: 52). In Australia, mergers that are likely to substantially lessen competition, yet are to the public benefit, can be authorised. The OECD (2007) report also acknowledges that competition authorities and economists generally agree that the main objective of competition authorities is consumer welfare.

As is evidenced by the literature, there is a question as to what role consumer and competition policies have in the financial sector. There is also a push for tighter co-ordination between the two policy areas.

Another important issue in the literature is that of the ability of consumers to make sound decisions when choosing financial products and, in particular, when switching from one financial institution to another. The OECD (2009: 12) report demonstrates through a recent OFT paper and sector inquiry report by DG Competition that retail customer switching is low. The importance of a customer's ability to switch is underlined in the OECD (2011, 2009) reports, which emphasise that consumer policies are a necessary element of competition. The ability of customers to easily switch is crucial for competition as consumers are then able to choose the best options for themselves, creating competition and forcing competitors to keep costs to a minimum thereby enforcing efficiency. For this to occur, it is necessary to have an appropriate regulatory and competitive framework in the financial sector. The report urges increased consumer education, and greater financial literacy about alternatives and transparency. It also urges consideration of the practicalities of implementing account number portability schemes to make it easier for consumers to switch and thereby promote competition between the financial institutions.

Lumpkin (2010) specifically investigates the role of consumer policies and finds that for competition, the ability of customers to switch is necessary. Without this component, financial businesses will have fewer incentives to compete. Lumpkin (2010: 128-133) also notes that retail financial consumers rarely switch to new service providers and finds that there are essentially three reasons for this: first, switching costs are too high, secondly, there are high search costs

and, thirdly, from the perspective of the providers of financial services, there is an adverse selection problem. The search costs dilemma is that financial products tend to be very complex with cryptic information and prices. Switching costs, such as financial information, high up-front fees and charges, mean that there are less incentives for customers to switch. In terms of the adverse selection problem, Lumpkin (2010: 129) notes that when a customer switches, the new institution does not have all of the information attained from the last provider, meaning that the new provider may have lower quality customers and potentially unfavourable terms. To counter the impediments to switching and for customers to make proper informed consumer choices, Lumpkin (2010: 134) argues for specific rules by regulators to prevent unfair and deceptive practices that exacerbate information asymmetry. The article highlights the importance of consumer access to information on prices, quality and the range of products available through improved disclosure, financial education and liberalisation of trade in financial services or the removal of other barriers to entry to allow for more choices and switching opportunities (Lumpkin 2010: 136).

Neal (2011: 2) investigates the ability of switching in the financial sector in Australia and the perception that switching banks is difficult and that there is no point as 'banks are all the same'. The article takes the view that competition increases when consumers can easily switch providers, but finds through quantitative research, that their ability to do so is limited. The article refers to ANZ's submission to the Senate Inquiry, which found that research by consumer advocacy group Choice discovered that 78.5 per cent of customers had not considered switching, whilst 7.6 per cent had switched and 11.8 per cent had considered switching but had not done so. Importantly, the reason given by the half who had not switched was the effort required (Neal 2011: 19). The article also refers to the commission of a poll in 2010 by the Association of Building Societies and Credit Unions, which found that:

40 per cent of respondents had considered changing their banks in the previous two years but two-thirds of this group hadn't because: 41 per cent said it was too difficult; 23 per cent said there were fees and charges attached to shifting; and 28 per cent said there was no point as all banks were the same.' (Neal 2011: 19)

In light of this data, the article explores the issue of exit fees impeding customers from switching financial institutions. It refers to the government's ban on mortgage exit fees that was to come into effect from 1 July 2011 and raises the issue of the effect of this on regional banks and mortgage originators that rely on exit fees to compete against major banks (Neal 2011: 19).

The article also cites the argument of Phil Naylor, the head of the Mortgage and Finance Association of Australia, in a complaint to the Senate Inquiry:

the banning of exit fees will have the reverse effect of increasing competition by causing non-bank lenders to lose their most effective weapon in competition with banks

He concludes that the new legislation will mean higher upfront costs, higher ongoing fees, or higher interests rates (Neal 2011: 19). As a final possible solution, the article briefly highlights the possibility of the implementation of full account portability making switching easier, but notes the technical and financial difficulty in changing the current Bank, State and Branch (BSB) account numbering system, as surmised by the ANZ and Westpac submissions to the Senate Inquiry (Neal 2011: 29).

Minor (2012) also gives insight into consumer policy in the EU by highlighting the research by the consumer enforcement authorities and financial services authorities of 500 financial providers in the EU that found over 70% of financial providers appeared to breach the rules such as failing to display the annual percentage rate of charge directly. This demonstrates that, similarly to Australia, information provided to the consumer by the financial institutions is opaque and that switching, which benefits consumers by encouraging competition, is far from easy (Minor 2012: 167).

The literature on consumer choices in the US follows the same trend as the literature on other OECD countries. For example, Lusardi and Tufano (2009) analysed a national sample in the US and found that debt literacy is low, which correlates with high-cost borrowing. In other words, financial illiteracy is related to indebtedness. Their work corresponds with other research studies, such as Hilgert, Hogarth and Beverly (2003), Moore (2003), and National Council on Economic Education (NCEE) (2005), (as cited in Lusardi and Tufano 2009), each pointing to the same conclusion on the low levels of financial literacy among US consumers. Research of Campbell et al. (2011) also points to a lack of financial information being provided to consumers. The article however, asserts that the US has taken an important step in addressing this issue by enacting the Wall Street Reform and Consumer Protection Act of 2010 that authorised the Consumer Financial Protection Bureau (CFPB) to 'safeguard consumer interest in many financial markets' (Campbell et al. 2011: 106). Part of the CFPB's role is to provide the necessary information for consumers to make informed decisions. Whilst the article is in favour of regulation for the benefit of consumers and competition, it warns that the CFPB must

encourage financial innovation, whilst not imposing ‘one size fits all’ solutions, and be aware of the economics of consumer financial markets (Campbell et al. 2011: 107-108).

Williams (2007), in the wake of a State push for statutory mandates to improve consumer financial literacy, questions this empowerment of consumers through financial literacy to make financially educated choices and to advance competition. The article contends that regulatory encouragement of financial literacy among consumers is a form of the government enforcing ‘responsibilization’ on individual ‘entrepreneurship of the self’ rather than protecting its citizens (Williams 2007: 233). Responsibility to regulate is thus shifted from regulators to consumers as they are expected to be self-reliant, while regulators only need to ensure that consumers are financially literate. The consumer is further expected to force the exit of firms that are ‘dishonest, incompetent, or indifferent’ to consumer interests and to promote competition by making the right choices according to their needs (Williams 2007: 233). The article questions this perception of consumers as regulators, noting that consumer access to financial information may be difficult to achieve if firms try to exploit consumers by providing complex information and advertising in ways that manipulate consumer behaviour. It refers to recent behavioural studies that suggest that the rationality of consumer decision-making may be flawed due to reasoning biases (Williams 2007: 245). The article concludes by suggesting further research is required to improve regulatory management, and that this should focus on:

- (a) how regulators interpret financial education mandates; and
- (b) the role of financial firms in providing financial literacy mandates.

The literature therefore points to a trend in many OECD countries that policies designed to benefit consumers are not sufficiently addressing switching costs, financial literacy education and transparency in the financial sector. Not least, the complexity of finance in the modern globalised world leads to information asymmetry risk, which in turn hinders the ability of consumers to stimulate competition. For this reason, the dominant view in the literature is that competition authorities and consumer protection laws are required to help increase consumers’ ability to make informed decisions, and to be able to switch and thereby increase competition.

2.5.3 Barriers to entry and exit

This section underlines the particular barriers to entry and exiting and possible responses. It is divided into three sections. First, it investigates barriers to entry, followed by a particular focus on foreign entry, and then exit issues. Lastly, it explores cases in Australia, Europe and the US.

2.5.3.1 Barriers to entry

Most of the literature points towards the need to reduce barriers so that firms are able to enter the financial system, thereby improving efficiency and optimising competition. This is especially important as a response to the financial crisis and to help remedy the ‘too big to fail’ dilemma and high concentration levels in the financial sector (for example, De Serres 2006; Neal 2011; OECD 2009, 2011). A common source used in the literature is from Barth, Caprio’s et al. (2004, 2008) analysis’ from the World Bank’s Regulation and Supervision Survey, which showed that restrictions on the entry of banks are detrimental to the performance of the banking system. This correlates with the view that contestability is a measurement for determining the level of competition in the financial sector, and that bank entry can be used as an indicator as it is a necessary element of competition. For example, Beck (2008a), and Cetorelli and Strahan (2006), highlight this issue, and link reducing barriers to entry to a reduction in the negative repercussions of high levels of concentration (such as the ability for banks to exploit their market power).

The OECD reports offer some insights into how to promote new firms entering the market. For example, the OECD (2010c) report, whilst concurring that entry barriers to new firms inhibit productivity, provides policies that have already been implemented in OECD countries to ease the entry of new firms. Some of these policies include (OECD 2010c: 38):

simplifying business start-up procedures, speeding up of administrative procedures and adaptation of bankruptcy procedures to facilitate rapid restructuring

Similarly, the OECD (2009: 14) report suggests that, as a response to increased concentration, reducing regulatory barriers that inhibit new entry should be encouraged by competition authorities, allowing for the entry process to be as ‘easy and inexpensive as possible’.

2.5.3.2 Barriers to foreign entry

A particular concern in the literature is that of barriers on foreign entry. The literature predominately uses empirical evidence from studies such as Claessens, Demirgüç-Kunt and Huizinga (2001) and Claessens and Laeven (2004), which found that foreign bank participation and reduced barriers to bank entry are necessary for effective competition. The OECD (2011), whilst agreeing that bank entry encourages competition, notes that foreign bank entry also reduces concentration, which means there is less chance of financial crises. This assumes that foreign entry is more likely than domestic entry. Further, Claessens (2009: 97) points to

the fact that foreign entry into local markets not only stimulates competition, but also improves the quality of regulation and supervision, and thus argues for foreign entry to be promoted in all countries, including those that have not become fully institutionalised.

Whilst it is clear that there are key benefits for allowing foreign entry in the financial sector, Amel et al. (2004: 2512) highlight the numerous barriers to foreign entry. These include not only rules against foreign competitors, but also adverse selection problems. These include different regulatory or supervisory structures, and language and cultural barriers that require local expertise, which often means a loss of competitive advantage. The OECD (2011: 116) report however, notes that problems such as not having access to ‘soft’ information, which is required for lending to small firms, may be mitigated by improving communication and ‘information processing technology’.

2.5.3.3 Barriers to exit

Exiting policies to enhance competition have become a focal point within the literature especially as a result of the financial crisis. This strand of literature focuses on the benefits of exit as an essential tool to make room for new firms to enter and avoid systemic crises. It is also linked to reducing concentration as it allows financial firms to leave rather than merge with a stronger financial institution. For example, academic literature such as De Serres (2006) and Lyons (2009) draw on empirical evidence suggesting that financial businesses that are the least efficient will leave first, which allows for the most efficient and innovative firms to dominate the market leading to a more competitive financial sector. Demirgüç-Kunt and Servén (2010: 95) also emphasise the importance of the endorsement of exit policies to promote efficiency and competition instead of ‘providing liquidity support’ that can often protract crises.

The OECD (2009) report outlines the necessity for financial corporations to have the capacity to fail and for competition authorities to have a role in the design and implementation of regulations that ease exit to enhance competition, and encourage new businesses to enter. Ahrend, Murin and Arnold (2009), using data provided by the World Bank, find that tougher exit and disciplining rules, such as a credible risk of exiting, allow for inadequately capitalised banks to exit, whilst remaining banks are pressured to hold larger capital to remain in the industry.

2.5.3.4 Case in Australia

The Deloitte Access Economics (2014b: 31) report provides an insight into the key barriers in Australia for bank entry and exit, which are: costs with licensing, regulatory obstacles,

compliance costs, increasing standards set by institutions such as the capital requirements set by Basel III, and the need for ‘approval from the Treasurer for ownership in excess of 15%’. The report further notes that the same rules apply for exit. This is because, if it is difficult to exit, the risk of joining the market increases and will act as a disincentive to enter in the first place. The report notes that, whilst concentration in the retail-banking sector remains high in Australia and higher than in most European countries, foreign financial entry in Australia is increasing and there are still new banking licences being issued. It argues that the financial market is contestable and that barriers to entry and exiting are not particularly high. It provides examples such as the *Australian Financial Review 2013* which found that Asian bank lending to non-financial corporations in Australia has recently exceeded that of European banks (Deloitte Access Economics 2014b: 46). The report further points to services such as Google that are offering financial products such as the Google Wallet, which it argues will create more of a competitive edge in the Australian financial market.

Although writing three years before the Deloitte Access Economics Report, Neal (2011: 21) provides some insight into the entry of foreign banks in Australia. Using data collected by APRA (2014) she notes that, after the financial crisis, Australia experienced a decline in foreign banks from 19.1 per cent in the September 2007 quarter to 12.9 per cent in the September 2010 quarter. The article highlights particular policies that could allow foreign banks to re-enter Australia such as those provided by submissions to the Senate Inquiry that advocate the abolition of interest withholding tax. Neal (2011) concurs with this view suggesting that this would promote competition between foreign and domestic banks in Australia.

2.5.3.5 Case in Europe

The literature on barriers to entry and exit focuses on the high level of cross-border services especially within the EU. For example, the Bank of England (2009) report notes that through single market rules imposed by the EU, it has allowed for banks headquartered in the EU to open branches in other member states or other forms of cross-border services. Similarly, the De Larosière (2009: 71) report finds that:

EU banks have become more international than ever, expanding into foreign markets both in Europe and beyond. Currently around 70% of EU banking assets is in the hands of 43 banking groups with substantial cross-border activities. Especially in the Central and Eastern European countries, the banking sectors are dominated by foreign (mostly Western European) financial groups.

Carletti and Vives (2008: 38-39) add that institutions such as the Committee of European Banking Supervisors have helped in allowing cross-border activities prosper in the EU as they set 'common standards, guidelines and interpretative recommendations'. Moreover, the article shows that the EU regulation 2560/2001 has permitted consumers to be charged the same for cross-border transfers as for domestic transfers, which evens the playing field between domestic and foreign firms. Despite this however, the article argues that there are still regulatory differences that make it more difficult for cross-border financial institutions.

2.5.3.6 Case in the US

The literature on the subject of entry and exit is mostly constrained to interstate banking. Academic writers such as Morgan and Strahan (2003) and Cetorelli and Strahan (2006) note that, in the US, the barrier to entry for banks operating in other states of the US was a challenge as they were also considered foreign. This barrier to state entry of banks was in force until 1994 when the Reigle-Neal Act was implemented, making it illegal for states to block entry. Morgan and Strahan (2003) and Cetorelli and Strahan (2006) further note that, with restrictions dismantled, entry barriers were reduced, proving beneficial as it allowed for more competition in the US. Stiroh and Strahan (2003) concur, finding that, after interstate banking restrictions were dismantled, the number of banks that exited increased by 3.6% per year. The work further illustrates that after deregulation, weak banks experienced increased pressure as they were forced to compete against more profitable banks from other states, and were either acquired or forced to exit. The article argues for exit policies to be eased. In other words, deregulation should continue in order to promote competition and thereby ensure that only efficient banks remain in the market.

As set out in this section, entry and exit strategies are ways to promote competition. The financial crisis has underlined this view. The solution offered by the literature is to ease barriers to entry and exit of financial institutions so that, instead of mergers and acquisitions being the only option, firms can more easily leave the industry, making room for new firms to enter, thus creating a more competitive industry.

2.6 Conclusion

This chapter has provided an overview of issues in financial regulation and competition in OECD countries. The review was divided into the approach before and after the financial crisis. This has meant that a serious factor in the narrative has been that of ensuring stability while still promoting competition. With the financial crisis still a predominant factor in the literature, some key issues are worth noting. These include:

- (a) an increased focus on macroprudential regulation;
- (b) a focus on regulations that respond to the globalisation of the financial market; and
- (c) the introduction of anti-competitive policies such as government intervention and consolidation after the financial crisis.

OECD reports and other academic sources have offered key policies to promote competition, which include the independence and strength of regulators, consumer policies such as the facilitation of switching, financial literacy, and easing entry and exit restrictions.

3 THE NATURE OF COMPETITION IN FINANCIAL SERVICES

3.1 Introduction

3.1.1 Life after the financial crisis

Australia emerged from the financial crisis not unscathed, but certainly with fewer scars than most in the short term. Australia was buoyed by the mining boom (for an estimate of the impact of the mining boom see Downes, Hanslow and Tulip 2014), and, as shown by Brown (2010) in her post-financial crisis comparison of the USA, the UK and Australia:

- general conditions saw economic growth slow, but not to recession levels, meaning that there was a marginal increase, rather than a step function, in the risk of impaired loan assets; and
- housing markets were unsettled, but apparently without a ‘bubble’ waiting to burst.

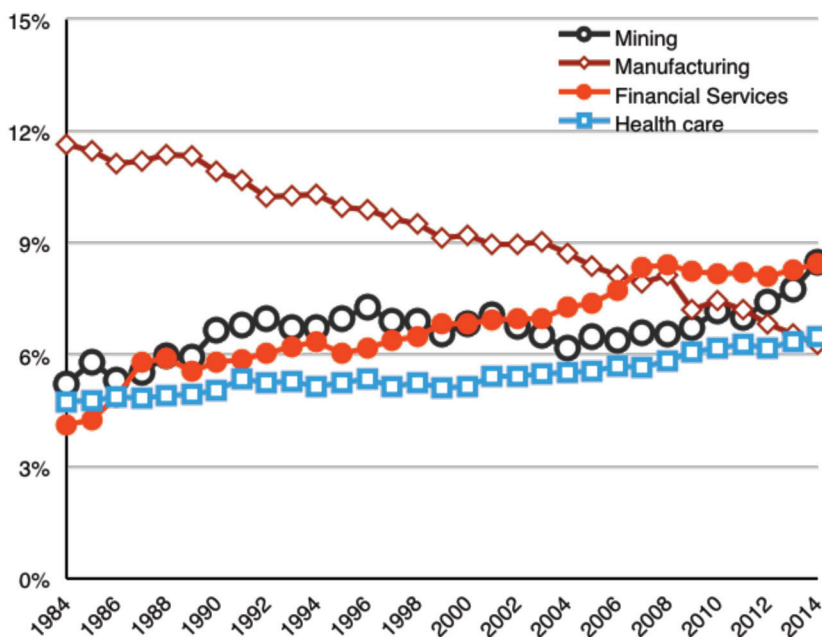
This illustrates the fundamental differences in the manner and means of housing finance in Australia. They include the combination of an Australia-wide comprehensive and generally well-enforced consumer protection regime, balanced against a universal practice of mortgages being full-recourse loans (entrenching the motivation to make repayments even in times of financial distress and/or bankruptcy).

As Brown also shows, return on equity for Australian banks remained solid, and while realisation of nonperforming loans increased, the rise was quite modest and not above manageable levels. Rather than being pressed to respond to imminent or actual bank or financial institution failures, the Australian Government’s bank deposit guarantee was instead a (well-timed) confidence-building gesture for the industry generally (for example, Laing 2011; OECD 2011; Perlich 2009; Rajapakse and Gardner 2014; Yates 2014).

The ongoing strong profit performance of Australian banks was confirmed in the annual report of the BIS for the year ended 31 March 2014. In examining the profitability of the world’s major banks, BIS compared the pre-tax profits of banks in 15 countries, which comprised 11 advanced economies (including the USA, the UK and Australia) and the four BRIC (Brazil, Russia, India and China) economies. Aggregated in three periods spanning before, during and after the financial crisis (being 2000-2007, 2008-2012 and 2013 respectively), Australia clearly led the advanced economies. The BRICs show more mixed, less stable results, although in some periods, specific results were better (Bank for International Settlements 2014).

Medium-term to longer-term, though, the picture is more debatable. As depicted in Figure 1 below, financial services are now equivalent to mining in terms of gross value added to the Australian economy, making them the top two industries on this measure. Figure 1 also illustrates the changing positions of the top four industries over the last three decades, reflecting a trend towards service industries in common with other advanced economies. The observable trends re-shaping the Australian economy take the debate beyond financial crisis-driven concerns over systemically important banks (SIBs) or financial institutions (SIFIs), to engage with the industry’s fundamental economic strength in supporting enduring prosperity for Australia.

FIGURE 1: Long term structural change in GDP composition in Australia (industry share of GDP by gross value added, chain volume measures)



Derived from Australian Bureau of Statistics (2014), Table 6 Gross Value Added by Industry, Chain volume measures. Financial services include insurance; health care includes social assistance services.

Palmer and Jeyaratnam (2014) find that household debt now comprises two thirds of banks’ collective loan assets using data from APRA (2014) and excluding lending to government and financial corporations. Just four banks hold nearly 85% of \$A1.3 trillion which is the nation’s collective household debt. Despite the lack of a housing bubble noted above, an unprecedented

run of economic growth in Australia has deflected attention from the fact that circumstances such as an economic downturn are always a possible threat to the general capacity of householders to service their mortgages. That aside, more serious questions remain about whether the financial industry really is healthy and structurally sound when it is so exposed to house price fluctuations and that risk is concentrated in so few hands.

Put another way, if both mining and banking were to become troubled, how would Australia manage and how well placed are policy makers to respond? Did the mining boom just mask deeper problems from a 'two speed economy' with undetected recession risk, where the 'resource states' of Western Australia and Queensland register stronger growth than 'non-resource States' of New South Wales and Victoria? (for example, Perlich 2009, 2013/2014). The wind down from the mining boom has led to the RBA having a policy to reduce the value of the Australian dollar. This is to avoid 'Dutch disease', where the currency trades at (prejudicially) high levels under pressure from the inflow of cash from mining exports (Critchlow and Curran 2012).

During 2014, two studies were conducted at the behest of the Australian Government. Echoing the regulatory approach to financial services in Australia, the FSI (Murray et al. 2014a) had a narrow industry focus with the option of a wide lens on policy issues. The Competition Policy Review (CPR, panel chaired by Ian Harper) (Harper et al. 2015) had a specific policy focus on competition, but with the discretion to range widely over various industries (not excluding financial services). The specific remits for these studies intersect in relation to identifying the health of financial markets and their soundness from a policy perspective.

Against the backdrop of such projects in the post-financial crisis climate, the character of financial markets in Australia is a pervasive consideration, including whether they are reasonably regarded as efficient, effective, innovative or competitive. Such considerations materially impact the selection and prioritisation of potential policy responses over time, not only in the light of lessons learned from the (most recent) financial crisis. Moreover, how financial markets measure up on these dimensions has ramifications for the challenges ahead in implementing policy recommendations that may be taken up from the FSI and the CPR.

General concerns over being efficient, effective, innovative and/or competitive beg specific questions, not least:

- the risks and costs of bank interconnectedness, whether within one country or around the world; and/or

- the risks surrounding innovation:
 - too much, leading to manipulation, such as the manipulation of currency mechanisms (The Economist 2012), or circumvention of, for example, prudential regulation and supervision (Brown 2010); or
 - too little, where customer needs remain unanswered, as discussed later in this chapter.

As well, there are post-financial crisis debates in Australia, such as the latest iteration of the perennial dilemma of balancing private enterprise benefits, garnered in good times, against the cost of support expected from the public purse in bad. This time around, the form of that support also raised the question of whether the bank deposit guarantee made conditions more fertile for moral hazard.

In this context, it is as well to keep in mind the inevitability of some other financial/banking crisis in the future, noting that they have been fairly common in the past. Beck points to this reality in drawing on the pre-financial crisis work of Honohan and Laeven:

[According to their stated crisis parameters, they] found 116 systemic banking crises in 113 countries over the period 1974 to 2002, which illustrates how widespread financial crises have become across the globe [noting that the] 1980s and 1990s have been characterized by a relatively large number of banking crises. During this period, at least 20 countries were in a systemic crisis at the same time; ranging from such diverse countries as Japan and US to Argentina and West Africa. In addition to systemic crises, there were numerous non systemic banking crises, which disturbed the normal functioning of bank business (Beck 2008a: 4).

Australia has not been immune to these, but more importantly, took the opportunity to learn from its share of non-systemic crises in financial services. Significantly, consequent reforms were in place before 2008 and no doubt assisted in weathering that particular storm. Not least, earlier crises highlighted need for reform of:

- Government involvement in market operations: for example, when ‘in the 1990s several state-owned banks foundered and others were taken over’ (The Economist 2011), noting that two of today’s four major banks also had significant problems at that time. This is also noted by Wu (2008: 143): ‘In the early 1990s, mergers involving virtually insolvent State banks have been conducted as a solution to bankruptcy, consistent with [other observations that] bank mergers are a substitute for bank failures.’

- Good governance and independent regulation: for example, when Pyramid Building Society collapsed in 1990, involving around 200,000 depositors who collectively stood to lose \$1.3 billion (which would still be significant now, but was all the more so 25 years ago in the economy and purchasing power of the day, and in an Australian population then of just around 17 million). That collapse came after intrusion by government ministers who became directly involved in decisions to allow exemptions under relevant regulations and providing public backing to Pyramid, which later saw them implicated in the collapse, albeit for bad judgment rather than corruption (The Economist 1990).
- The effectiveness of regulation and/or supervision: especially after the 2001 collapse of HIH Insurance with a deficiency estimated at up to \$5.3 billion, which, in particular, highlighted to industry regulators ‘the importance of using their full regulatory powers’ (Yates 2014: 375). Importantly, this is consistent with the points made by Brown (2010) about industry capture and presumptions about what level of supervision is required for larger or smaller industry players. HIH’s collapse was of epic proportions in the Australian economy, but was also credited as ‘the first of several events [in 2001] (September 11 was another) that triggered a rise in global reinsurance premiums’ (The Economist 2002). It is a tale that spawned a public enquiry that ran for nearly two years (namely the HIH Royal Commission), but also ‘a rather pathetic tale in which, to the great cost of thousands of ordinary Australians, the unwary followed the inept further and further toward predictable demise’ (Allan 2006: 137).

Not unrelated to the earlier of these events was the emergence of the so-called ‘four pillars’ policy, which arguably has determined the shape of the financial services sector as it stands in Australia today, and the role that its signature tune of banking plays in the overall economy.

3.2 The Shape of Financial Services in Australia

Turning first to the superstructure within which financial services are conducted, in common with other advanced economies, Australia is experiencing the relentless shift away from manufacturing of goods to the manufacturing of services. Financial services are thus unsurprisingly one of the two largest contributors of gross value added to GDP (as shown in Figure 1 above). Divergences from other advanced economies creating idiosyncrasies in the Australian context are threefold. First, the mining sector matches the financial services for scale. Second is the concentration of the sellers of financial service and third is the degree to which

the ‘real economy’ (the buyers of financial services) are intertwined with the sellers through financialisation.

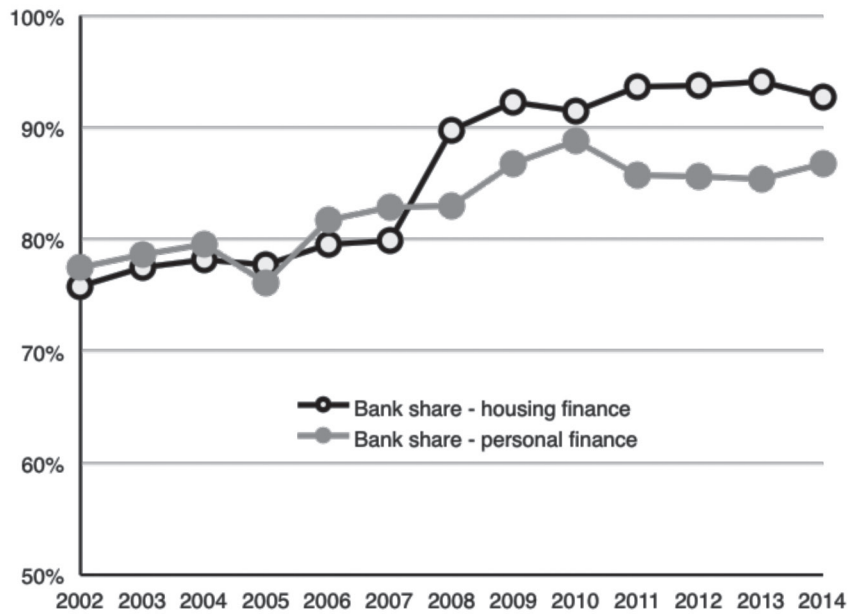
As it turns out, the nature of institutions providing debt to households is crucial because of the weight that this carries as the definitive portion of financial services. ‘Authorised Deposit-taking Institutions’ (ADIs) in Australia encompasses banks, building societies and credit unions, which are corporations and which become duly authorised institutions under the *Banking Act 1959* (Cth). Both ADIs and other lenders provide a variety of debt funding for non-business consumers. Data collected by the Australian Bureau of Statistics, for example, aggregates household and personal financial commitments held by banks, permanent building societies, credit unions/cooperative credit societies, life or general insurance companies, general government enterprises, superannuation funds, Registered Financial Corporations (RFCs) and securitisers of mortgage assets (wholesale lenders) which provide funds to borrowers through a retail intermediary (e.g. mortgage originators).

This is depicted in Figure 2 below, which shows that households in Australia source financing largely from banks. This is not a new development. The trend was well in place in 2002, which was the start of the time for which consistent data is available on the activities of banks. This start date is used for the majority of this chapter to ensure comparability of data sources. At this date, banks (rather than other retail credit providers) were the source of the significant majority of housing finance (then almost 76% and now over 90% by value) and personal finance (then over 77% and now over 85% by value).

On the other hand, the effect of this increased concentration of financial services providers as sellers, is that there is a tendency to domesticate risk in the supply of financial services. That is, lenders are oriented towards:

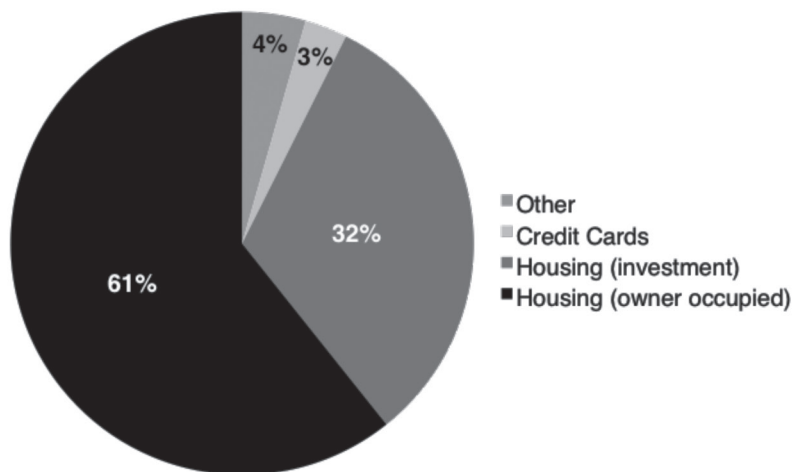
- lending to households: as noted earlier, household debt has long been the majority of banks’ collective loan assets, and now sits above two thirds (excluding lending to government and to financial corporations); and
- housing mortgages: lending to householders across the industry is dominated by mortgages for owner-occupied and investment properties, as shown in Figure 2 and Figure 3 below.

FIGURE 2: Household & personal finance commitments



Derived from Australian Bureau of Statistics (2015), Table 2 Housing and Personal Finance Commitments by Lender

FIGURE 3: All banks, loans to households as at June 2014



Derived from APRA (2014), banking statistics.

This self-perpetuating two-way homogeneity, of households principally seeking funds from banks, and banks being reliant on households for the majority of their profit-making business, adds a distinctive dimension of risk to policy making. Of immediate interest, not least is the

contagion risk that could transmit rapidly through the industry in the event of a relevant crisis (whether the result of housing price fluctuation or some systemic challenge to householders' capacity to service their debt). As well, over time the systemic lack of diversification on the supply side entrenches demand side behaviour in households as the majority customers, with important implications for barriers to entry and exit (discussed further below). But perhaps most importantly, the potentially negative implications for the overall economy are of concern, since as noted by Cetorelli, there is 'robust empirical evidence that broader, deeper financial markets are strongly associated, causally, with better prospects for future economic growth' (Cetorelli and Strahan 2006: 437).

The overall picture outlined above flows from the 'four pillars' policy, the long-standing policy on banking in Australia, arising not from legislation but from executive decisions by the (Australian Government) Treasurer and perpetuated by subsequent Treasurers of both political hues.

Articulated formally in 1990, it was 'a reversal of a long standing policy whereby the Reserve Bank of Australia had consistently waved through mergers and encouraged consolidation in the financial sector' (Maddock 2014). Then-Treasurer Paul Keating famously blocked a merger proposed between the Australia and New Zealand Banking Group and the National Mutual Life Association on the basis that it would reduce the effectiveness of competition (Keating 1990). Thus, the 'pillars' policy was first aimed at maintaining separation of the six most significant financial services institutions in Australia, at that time being the four largest banks and two largest life insurance providers. Importantly, as noted later by the Wallis Inquiry (the last systemic inquiry into financial services before the FSI), as well as likely receiving support from the Reserve Bank 'the merger would almost certainly have been approved by the then Trade Practices Commission (now the ACCC) (Australian Government 1997: 425).

In 1997, the 'pillars' policy was maintained contrary to the Wallis Inquiry recommendations (Australian Government 1997: 429). The abolition recommendation also had the unanimous support from the 'six pillars' at the time, although unions and consumer groups were against it (Wu 2008: 143). The government of the day did modify the policy, to focus on preventing mergers between the four largest banks, namely Westpac Banking Corporation (Westpac), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Australia New Zealand Banking Group (ANZ).

Since then, successive governments on both sides of the political spectrum have maintained the policy and the status of the 'four pillars'. No specific merger proposals however, have

arisen to test the policy, i.e. concerning two or more of the four pillars rather than other banks or financial services players, perhaps due to such bi-partisan consistency. This position has been maintained even against explicit urgings from the ‘four pillars’ and, implicitly, the wider financial industry. The opinions from the ‘four pillars are much quoted, for example Hepworth (2014) notes that ‘Australian bank chiefs have long urged the abolition of the Four Pillars policy on the basis that it prevented them from competing more effectively on the global stage’ and Durie and Gluvas (2009) express similar views. Williams (2008) states that Keating ‘believed this would ensure a competitive banking market. But the policy soon became a favoured party piñata for bank CEOs, who have argued ever since that it restricts their growth and prevents them from becoming true global players’. In context of the intersecting reviews in 2014, their views were consistent with a notable exception of CBA. As for the wider financial industry, maintaining the four pillars is often implicitly equated with a government guarantee only for these four banks and has an impact on bank credit ratings and so on (for example, Customer Owned Banking Association 2014). This has created an incumbency value for the ‘four pillars’ that is hard to over-estimate, and entrenches their position as, for all practical purposes, defining the nature of financial services in Australia.

3.3 The Regulatory Environment

Beyond any powers of the Treasurer that may be exercised from time to time, an important element of the context for this chapter is Australia’s regulatory framework for the financial services industry (OECD 2010b: 69). The principal agencies involved are three specific to financial services and one with a broad remit on competition (elsewhere, also known as ‘antitrust’). The entities within this governance structure are all national and independent, and have specified roles, responsibilities and relationships to other agencies (including the State and Federal Governments). The agencies are:

- The RBA is Australia’s central bank and its responsibilities include contributing to the stability of the currency, setting the cash rate to meet an agreed medium-term inflation target, issuing banknotes, managing Australia's gold and foreign exchange reserves and various banking services for the Australian Government.
- ASIC is the industry regulator which, among other things, regulates financial dealing and advising (on investments, superannuation, insurance, deposit taking and credit, including related licensing and ensuring that licensees meet relevant standards). It supervises

trading on Australia's domestic licensed equity, derivatives and futures markets (since 2010), and assesses how effectively authorised financial markets are complying with their legal obligations (including advising government on authorising new markets). and more recently, implements the National Financial Literacy Strategy (see the *National Consumer Credit Protection Act 2009* (Cth)).

- APRA is the prudential regulator of banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most of the superannuation industry.
- The ACCC is the competition regulator and has primary responsibility across all industries to ensure compliance with Australian competition, fair trading, and consumer protection laws, along with related regulation such as in relation to national infrastructure services (in particular the *Competition and Consumer Act 2010* (Cth)).

3.4 Purpose and Approach

In light of the discussion so far, key features of financial services in Australia suggest that at least three overarching considerations should inform policy objectives that may arise in the wake of the intersecting reviews in 2014. These would include a nuanced understanding of the role played by banks in the ongoing economic prosperity of Australia, an independent, facts-based appreciation of the causal role of competition, and an evidence-based assessment of potential risk from policies that preference stability over competition.

Accordingly, the purpose of this chapter is to unpack a section of issues in relation to 'retail' banking, selected because of its signal importance in the structure of financial services in Australia. For clarity, this puts commercial, merchant and industry financial services for financial and non-financial corporations (excluding SMEs where identifiable), collectively being business-to-business banking sometimes termed 'wholesale' banking, outside its scope. Retail banking here includes:

- for households/individuals: loans, credit cards, transaction accounts, deposits and term savings products and wealth management services. It excludes superannuation and recognises, as noted later in the chapter, that definitive data on wealth management is particularly problematic); and

- for small-sized and medium-sized enterprises (SMEs): similarly, loans, credit cards, transaction accounts, deposits and term savings products, plus business banking products and services where identifiable, such as business loans and overdrafts (SME agribusiness is grouped with SMEs, and larger scale agribusiness conducted by corporations is left with wholesale banking and outside the scope of this discussion).

The approach taken in this chapter is to:

- define markets consistent with the prevailing policy and practice of the competition regulator, being the ACCC as noted above;
- characterise markets in terms of market participants and certain market conditions such as barriers to entry and exit; and
- look at evidence of market metrics as the basis for discussion of key issues arising in relation to competition policy generally or financial system policy specifically.

3.5 Market Definition

To depict retail banking markets in Australia, the purpose of this section is to define markets consistent with the prevailing policy and practice of the ACCC as Australia's competition regulator.

As articulated in 2008, while necessarily always purposive, that is: 'the definition of a relevant market cannot be separated from the particular merger under investigation' (ACCC 2008b: 16), the core approach of the ACCC is that a 'market is the product and geographic space in which rivalry and competition take place'. That is, substitution is key to market definitions (ACCC 2008b: 15). Accordingly, to the extent that relevant behaviour evolves, so do market definitions, and in common with other advanced economies, over the last two decades Australia has seen substantive change in how markets for financial services operate. Not least are the consequences of the internet emerging as a distribution channel, first for market information and then for transactions, along with various iterations of card chip technology.

This is reflected in ACCC practice. In 1995, when reviewing the merger proposed between Westpac Banking Corporation (one of the four major Australian banks) and Challenge Bank (State-based, in Western Australia), the Trade Practices Commission (the predecessor to the ACCC) adopted the following view. It said that that 'the banking market was best examined as a cluster of banking services which were delivered by banks to their customers as a bundle'

(Jones, Nielsen and Trayler 2002: 25). In 1997, however, the ACCC (1997: 4) moved to a product-led approach which had regard to geographical and temporal considerations, finding that most retail banking was reliant on branches and therefore was State-based (including, for example, deposit and personal loan products). This is consistent with the last major inquiry into the financial markets, the Australian Government’s Wallis Inquiry (Australian Government 1997).

At that time, a recognised exception was the market for home loans, which was already operating on a national basis. By 2000, the ACCC further acknowledged that ‘providers of personal loans can also distribute their product through non-branch means’ and that ‘the geographic market for credit card issuing is likely to be approaching national’ although deposits and transaction account markets were still viewed as State-based (ACCC 2000: 4 and 6).

That market view was reiterated regularly in relation to proposed mergers relating to financial services (including in ACCC 2008d, 2008c, 2009, 2013, 2008a). There was an underpinning view that in ‘transaction accounts, SME and agribusiness banking [the] presence of a branch in a convenient location and the extent of the ATM network [are key considerations] in choosing between financial institutions for these products’ (ACCC 2008c: 7).

The trend to finding national markets culminated in more recent ACCC decisions being based on the view that national markets in retail banking are the norm. In 2010, the ACCC used Table 2.

TABLE 2: Retail banking markets

PRODUCT DIMENSION	GEOGRAPHIC DIMENSION
Personal banking markets	
Transaction accounts	Local but price competition is national
Deposit/term products	National
Credit cards	National
Home loans	National
Personal loans	National
Hybrid personal loans (margin loans)	National
Business banking markets	
Small to medium enterprise banking	Local but price competition is national
Equipment finance	National
Agribusiness banking	Local but price competition is national

Extracted from ACCC public competition assessment (ACCC 2010: 16).

Analysing banking markets on a national basis is supported by the implications of results from large scale commercial research, for example that undertaken by Roy Morgan Research Ltd. The majority of statistics quoted herein are from the company's publicly available materials that draw on its 'single source' omnibus survey of 50,000 people per annum, and/or their business research using about 12,000 business decision makers per annum. Highlighting the 'national' pattern of market behaviour, the shift to non-branch channels in retail banking is seen in the market behaviour of the majority of Australian consumers, as reported late in 2014:

The internet has become the channel most frequently used by [consumers] over the last few years to deal with their bank, largely replacing the branch. In an average four-week period nearly 60% of bank customers deal with their bank via the internet compared to only around one third visiting a branch (Roy Morgan Research Ltd 2014b: 2).

PricewaterhouseCoopers (2012: 5) has similarly reported customer preference for convenience over branch locations, including that 'more than 60% of new home loans are already sold through mobile channels (brokers and mobile bankers)'. In other words, branch banking is no longer a majority norm, and trends to non-site-specific channels reinforce the 'non-local' nature of consumer banking choices by Australians.

There remains a portion of banking where physical presence cannot be avoided, even if the customer would wish it. In Australia, this is required occasionally for personal banking activities, such as when making any arrangement that requires identity to be proven, and similarly, for the broad run of SMEs, on occasions such as when making arrangements for business finance in loans, overdrafts etc. Branch attendance remains routine for SMEs in certain industries, for example where depositing cash takings is a regular requirement.

Of course, there are also still customers who conduct their banking business face-to-face in a branch by preference. On the available evidence, though, such consumers appear to be in a shrinking minority fairly considered to be tied to a locality in retail banking (rather than part of a national market). While their banking behaviour may differ from the majority it does not seem plausible that, for competition generally or this industry specifically, considering such differences would reveal widespread or fundamental departures relevant to policy formulation.

Accordingly, in keeping with ACCC general practice and practical market considerations, this report proceeds by viewing all retail banking markets as effectively national. Markets for both deposits and loans are relevant, but information asymmetries in retail banking are at their

greatest in lending and, in turn, inadequacies of financial services policy or competition policy are more likely to be revealed in that context.

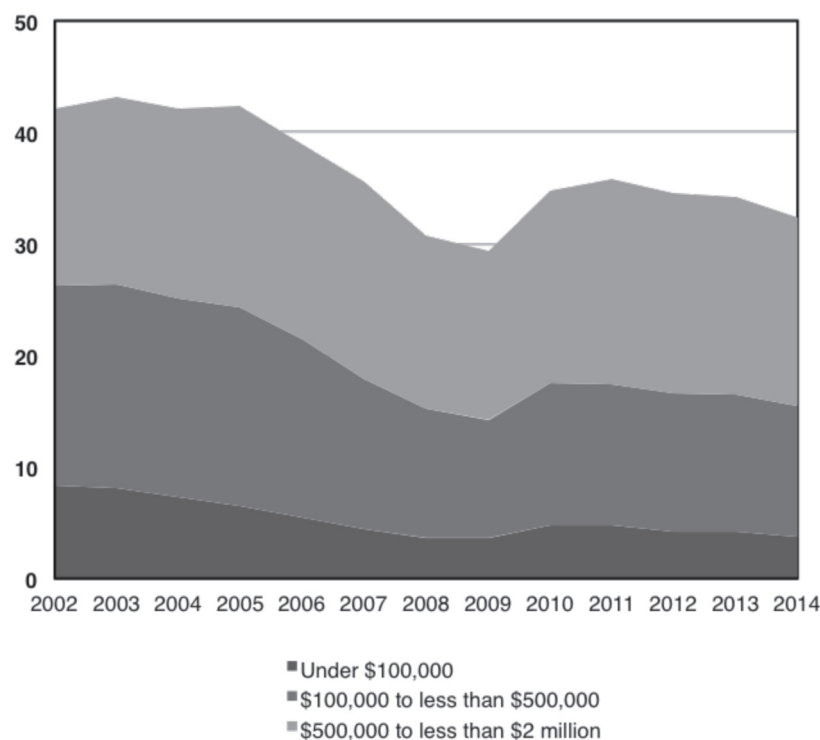
Based on available data sources, details on numbers of accounts (in aggregate or by lender) are not readily published on a consistent basis. Accordingly, analysis herein is generally limited to using the value of loan accounts as a proxy for the number of accounts (as it was for Figure 1 above).

As noted earlier, loans to government and financial corporations have been set aside, leaving loans to non-financial corporations as the measure for business loans. To exclude wholesale banking, the first issue would be to circumscribe what may be considered 'small to medium' sized business (and thus a retail banking client), a well-known definitional problem for analysts, statisticians, researchers and others alike (in relation to the finance industry, see: Beck 2013b, 2013a). Connolly, Norman and West (2012) provide an informative survey of the issues for the financial services industry in Australia. They show where contrasting definitions are used for widely applicable employment law, in general-use government statistical collections, and by the Australian Tax Office, as well as specifically in financial services where there are variations between APRA, ASIC and the RBA, and of course, lending institutions, which each have their own approach.

That said, since it 'is not possible to directly identify loans to small businesses from available data' (Reserve Bank of Australia 2010: 1), the most practical approach is to follow the RBA since their collections provide the most consistent source of relevant data. There is no method to filter out 'large entities' seeking modest loan principal amounts. In any case, they are likely to be exceptional. An appropriate method would be to use the loan principal amount as an indicator of the SME loan sector.

For all 'business' loans, the RBA reports in four size classes of loan principal amounts, based on data collected by APRA. The RBA usually categorises loans as being 'small business' loans if the loan principal is under \$2 million, meaning the sum of three size classes will encompass their classification of 'small business'. A borrowing business that is unincorporated may also be relevant, but has no discernible impact on the data used herein. Figure 4 below shows a time series analysis of the three size classes covering small businesses using the RBA approach, and including all 'businesses' whether incorporated or not.

FIGURE 4: Loans to business, credit outstanding by size of debt, % of credit balances as at 30 June each year



Derived from RBA reporting which uses APRA banking statistics (APRA 2014).

As shown in Figure 4, for over a decade, less than half of all business loans by value have been under \$2 million and there is a long-term downward trend in loans of this magnitude made by banks. While this is not definitive, it provides some sense of the market for loans to SMEs in Australia although it does not, *per se*, suggest whether or not there is an undue restriction of credit to SMEs. This decline is significant if small business lacks access to debt finance, and across various industries fails to thrive as a result.

Available data does not, however, provide further insight into this issue. Accordingly, the balance of this chapter uses consistent information from two APRA data streams, being the banking statistics for:

- loans to households (all forms), which potentially includes some debt that in reality provides working capital for SMEs, in particular small/micro businesses; and
- loans to non-financial corporations, which certainly includes SMEs, but which, in the absence of specific data collection on a reasonably consistent basis, is the necessary proxy for assessing the state of lending to SMEs.

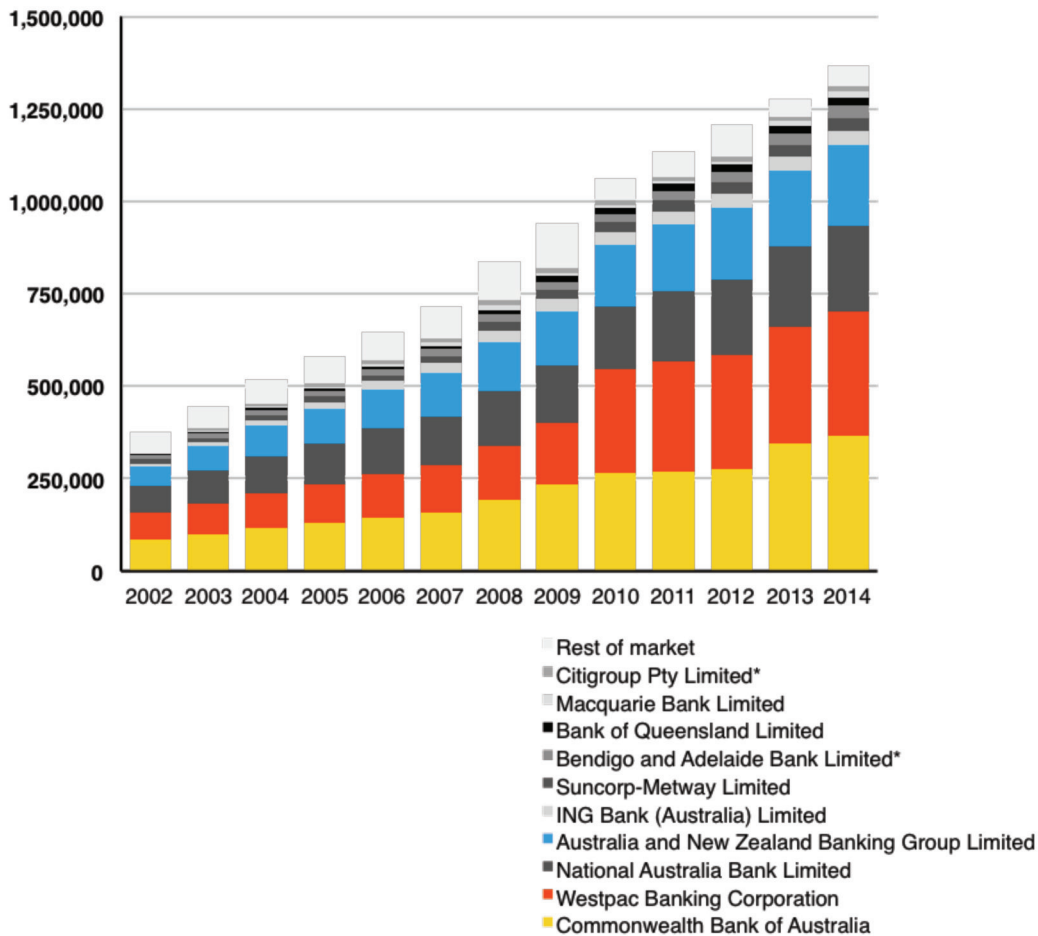
3.6 Market Characteristics

The core purpose of this section is to characterise Australian retail banking markets, primarily by reflecting on market participation over time and commenting on certain market conditions impacting participant behaviour.

3.6.1 Players

To identify the current players in retail banking, beginning with lending to households, Figure 5 below looks back over the period for which consistent data is available. This graph charts the progress of the 10 largest surviving banks in 2014, by volume of loans to households.

FIGURE 5: Loans to Households, market size (\$millions, as at 30 June each year)



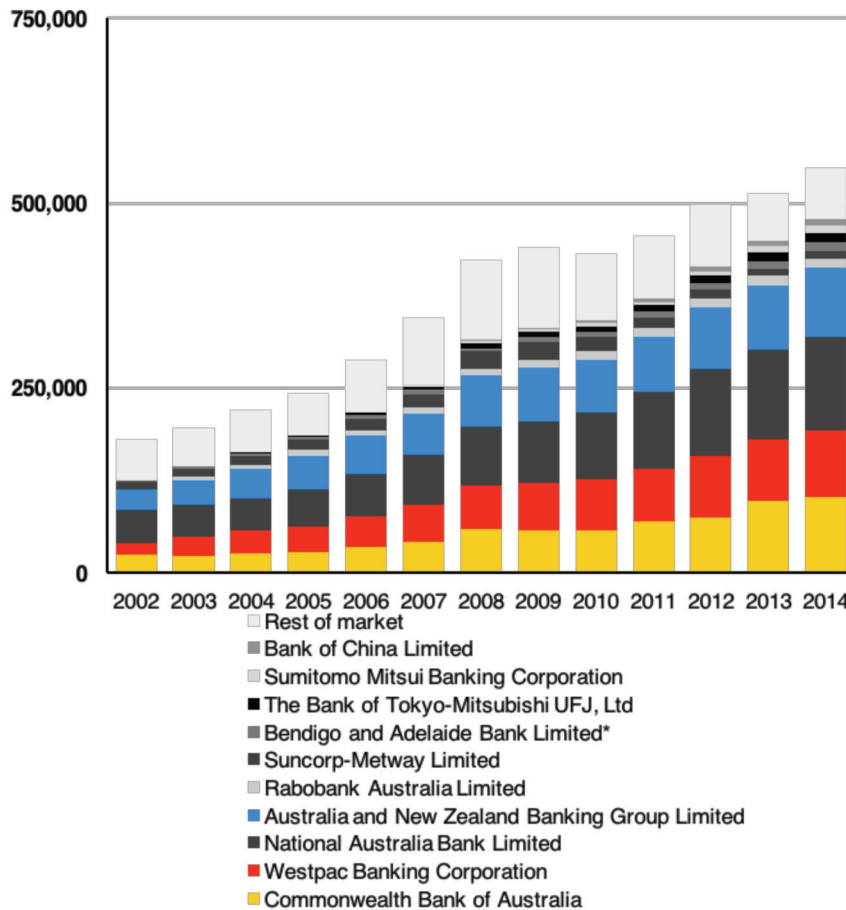
Derived from APRA banking statistics (APRA 2014).

A quarter of a century after the Australian Government's 'pillars' policy was first articulated, CBA, Westpac, NAB and ANZ (that is, the 'four pillars') are very obviously the mainstays of the market and continue to provide the bulk of loans to households. As is also obvious from this data, growth in the market for bank loans to households has been quite significant. In fact, it has far exceeded growth in the Consumer Price Index (CPI). Since 2002, the market for loans to households has expanded more than five-fold as shown in Figure 6, while the CPI has risen by around one third (Australian Bureau of Statistics 2015). Growth on this scale offers contestable space that would readily accommodate other competitors.

In 2014, the next tier of six banks providing loans to households included four which are locally owned (Suncorp-Metway, Bendigo and Adelaide Bank, Bank of Queensland and Macquarie Bank) and two internationally owned (ING and Citigroup), each of which varies in the extent to which it is present in specific product and/or non-national geographic portions of the market. Cumulatively, this tier has held of the order of a 10% share nationally in recent years. In very broad terms, this tier has been the source of merger and takeover targets (including intra-tier, such as the merger of Bendigo Bank and Adelaide Bank in 2007), so its membership has not been as stable. Those shown in the graph reflect the six largest survivors as at November 2014, when the data was collated.

Taking a similar approach to the business lending market, available statistics on loans to non-financial corporations provides a gross measure of lending to business for productive purposes, including loans to corporations of a size otherwise termed SMEs. With that qualification in mind, Figure 6 below shows that the market is, in any case, very similar in make up to that for household lending. It is noteworthy that the volume of loans started smaller and has seen slower expansion than the household market, although growth could still be regarded as quite healthy with the market being now three times its 2002 volume (again, compared to CPI growth of one third).

FIGURE 6: Loans to non-financial corporations, market size (\$millions, as at 30 June each year)

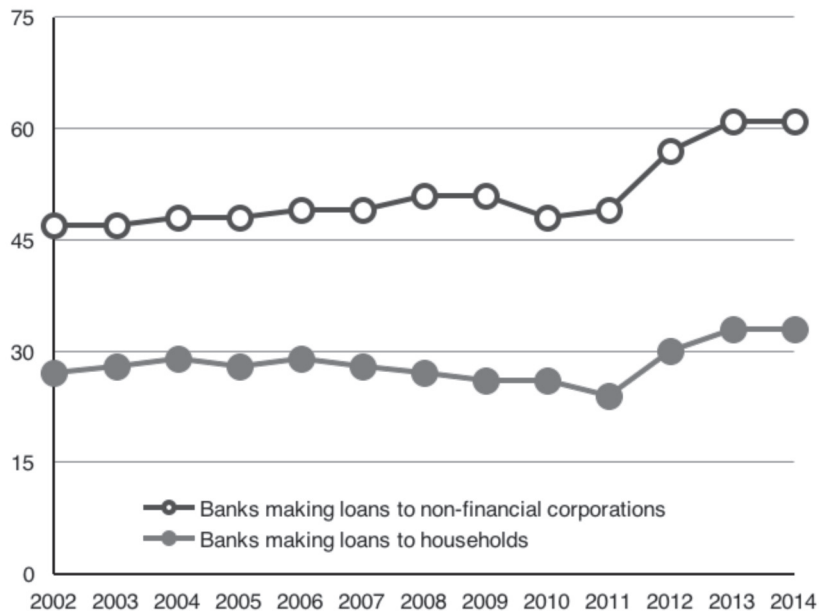


Derived from APRA banking statistics (APRA 2014).

The six non-major banks in this market in 2014 included two locally-owned (Bendigo and Adelaide, and Suncorp-Metway, both of whom also compete in loans to households), and four others (Bank of China which also competes in loans to households, plus Sumitomo-Mitsui, Tokyo-Mitsubishi and Rabobank which do not).

The total number of banks providing loans in either market is also interesting as an indicator of the state of the market. As shown in Figure 7 below, the number of competitors has grown in both markets over more recent years, but in a larger and more rapidly growing market place. Banks making loans to households started at half the number of those providing loans to non-financial corporations, and continues to be of the same order. Moreover, in both markets, the greater number of banks active in 2014 has not had an impact on the combined share of the ‘four pillars’. In fact, the opposite is observable in Figure 6 and Figure 7 and is discussed in more detail in the later section on market metrics.

FIGURE 7: Number of banks making loans to households and non-financial corporations (including SMEs)



Derived from APRA banking statistics (APRA 2014).

If competitiveness is limited, a lack of innovation may also impair consumer welfare. This effect can be exacerbated if policy focus on innovation is narrowed to ‘technology led’ innovation. Such a viewpoint tends to seek value solely in cost reduction and ignores the benefits of innovation which creates new value as perceived by a customer. This is consistent with reports on Australian business thinking (Deloitte Access Economics 2014a).

3.7 Market Metrics

This section reviews the state of retail banking in terms of internationally recognized market metrics.

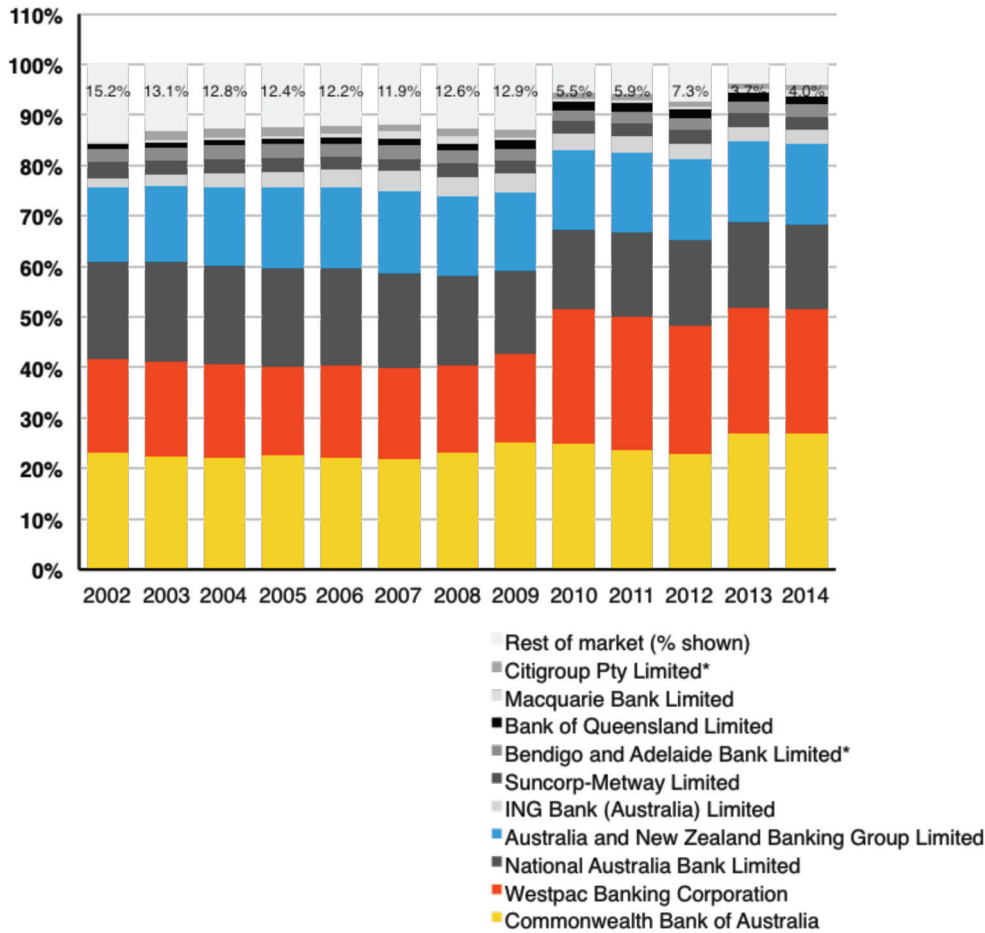
3.7.1 Indicators

3.7.1.1 Supply side: market share

As shown in Figure 7 above, the number of banks competing to make loans to households has grown since 2002. However, the extent to which they have gained a foothold in the market, shown in a meaningful market share, is quite a different matter.

To analyse this further as an indicator of the competitive state of the market, of those banks still standing in 2014, the largest ten have been tracked back over the period for which consistent data is available. The overall results are depicted in Figure 8 below.

FIGURE 8: Loans to Households, market share (as at 30 June each year)

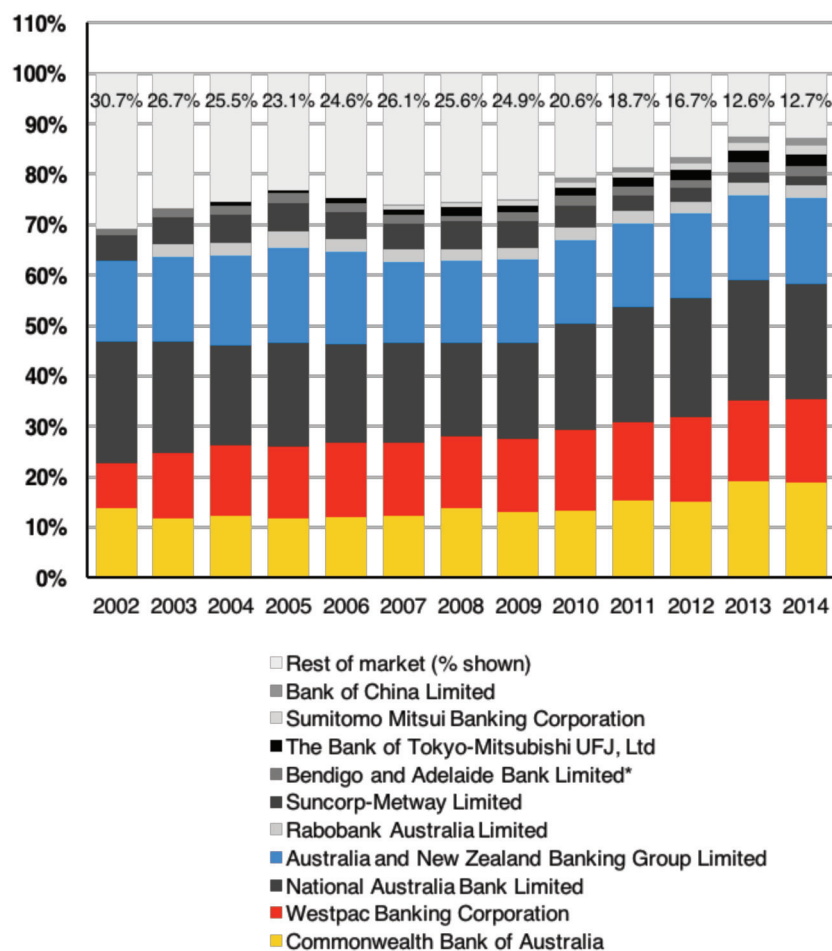


Derived from APRA banking statistics (APRA 2014).

This highlights that the ‘four pillars’ have long made up the lion’s share of the market for loans to households. From being steady at around 70-75%, the acquisition of St George (a substantial regional competitor) by Westpac constituted a step change to the level of around 80-85% since. This was effective in 2009, following an ACCC decision not to oppose the move (ACCC 2008e). No major adjustments to market share have otherwise been observed, despite the contestable space created by significant expansion of the market (as described earlier, well beyond inflation).

In fact, Figure 7 demonstrates that the contestable segment of the market has shrunk, to the effect of the quantum previously held by St George, rather than contestation resulting in wins for other lenders sufficient to see them expand into the space created. Mergers have also impacted the next tier through the merger of Bendigo Bank and Adelaide Bank to form the Bendigo and Adelaide Bank Limited, noting that, in Figure 8 above, their share is shown combined throughout the graph to better depict the impact of their presence as a competitive force. Similarly, in Figure 9, loans to non-financial corporations show a similar pattern, with a more marked tendency for the ‘pillars’ to crowd out smaller competitors over time. The ‘pillars’ have expanded from about two thirds to three quarters of the sector over a decade.

FIGURE 9: Loans to non-financial corporations, market share (as at 30 June each year)

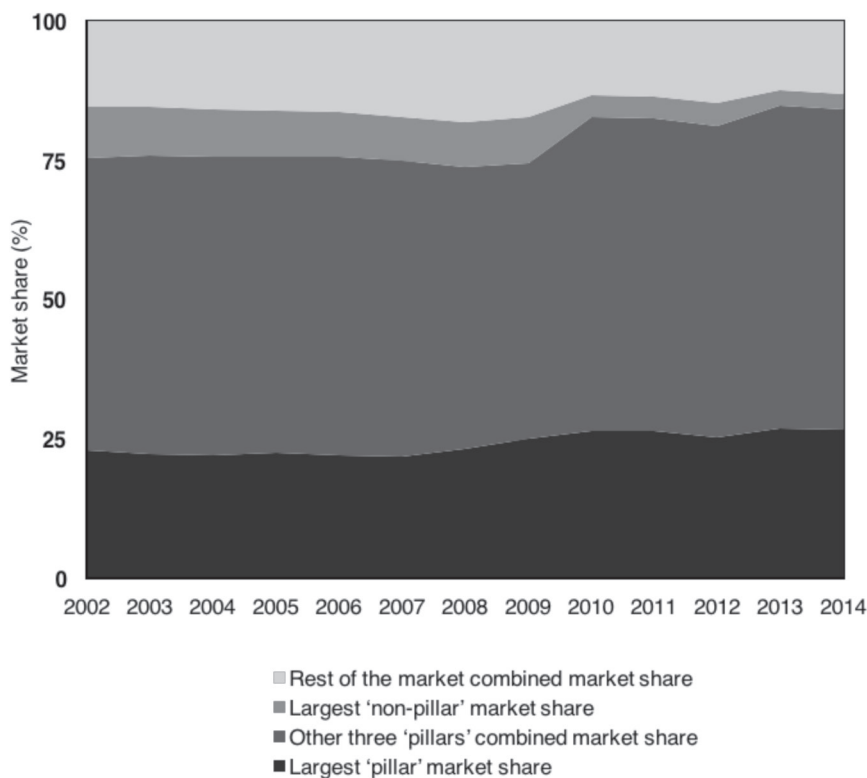


Derived from APRA banking statistics (APRA 2014).

If contestability of markets by smaller players is an indicator of healthy competition, revisiting the disaggregated data in each year from a different perspective more readily illustrates that contestable market space. It does so in terms of the smaller players' collective impact on the state of the market, rather than in terms of the success or otherwise of specific players.

First, by calculating individual firms' market shares, and then ranking them in order from largest to smallest, it is possible to produce the analysis of the household loans market shown in Figure 10 below. The individual firm market shares have been accumulated, beginning with the largest of the 'four pillars' as the base, followed by the aggregate of the other three 'pillars', then the largest 'non-pillar' competitor before the remainder of the market.

FIGURE 10: Market share, bank loans to households (all forms)



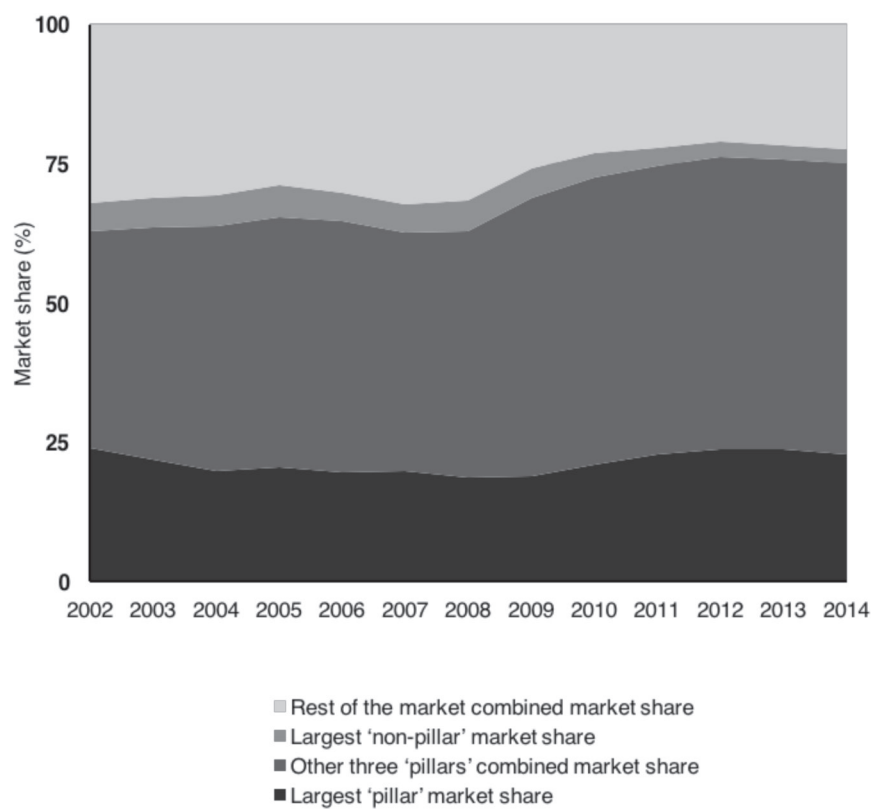
Derived from APRA banking statistics (APRA 2014)

It is clear from this that the retail banking sector has become more concentrated over the last decade. The '5th' competitor (largest after the 'pillars') has significantly diminished in footprint and new firms have been marginalised in a shrinking contested space. This is a direct result of the largest competitors outside the pillars being merger targets. By 2014, the 'rest of the market' was comprised of 24 other banks amounting to just a 4% share between them. Of the

new entrants that have developed a presence within the contestable margin, perhaps the most successful is Citigroup, which was not making loans to households in 2002, but which now has around 1% of this market.

For business, the picture is not dissimilar, as depicted using the same methodology in Figure 11 below.

FIGURE 11: Market share, bank loans to non-financial corporations



Derived from APRA banking statistics (APRA 2014)

There is clearly more space for contestation, and perhaps this partly explains the systematic presence of a higher number of competitors (shown earlier in Figure 7). But the fact remains that most are tiny by comparison to the 'pillars', and even the largest of their number has a more marginal position than a decade ago.

Returning to households illustrates the point raised in the previous section in relation to inertia in customer switching. The 'rest of the market' group includes four banks that are interesting for having more than a token presence, being Members Equity Bank Limited, HSBC Bank Australia

Limited, AMP Bank Limited and Heritage Bank Limited. Their market shares together amount to just around 2.5% in 2014. Two of these are long-standing Australian organisations well-known in their previously established orbit as non-bank competitors against banks:

- Members Equity Bank (ME Bank): now a national bank, was originally ‘Super Member Home Loans’ and has been operating since 1994 to provide home loans to members of industry superannuation funds in Australia. The entity became Members Equity Bank in 1999 and received a banking license in 2001, to provide a wider range of banking products to clients. The parent company group now comprises 30 industry superannuation funds.
- Heritage Bank: now a regional bank operating across South-East Queensland. This was previously Heritage Building Society, which was formed in 1981 by the merger of two very long standing building societies. The name was changed to Heritage Bank in 2011.

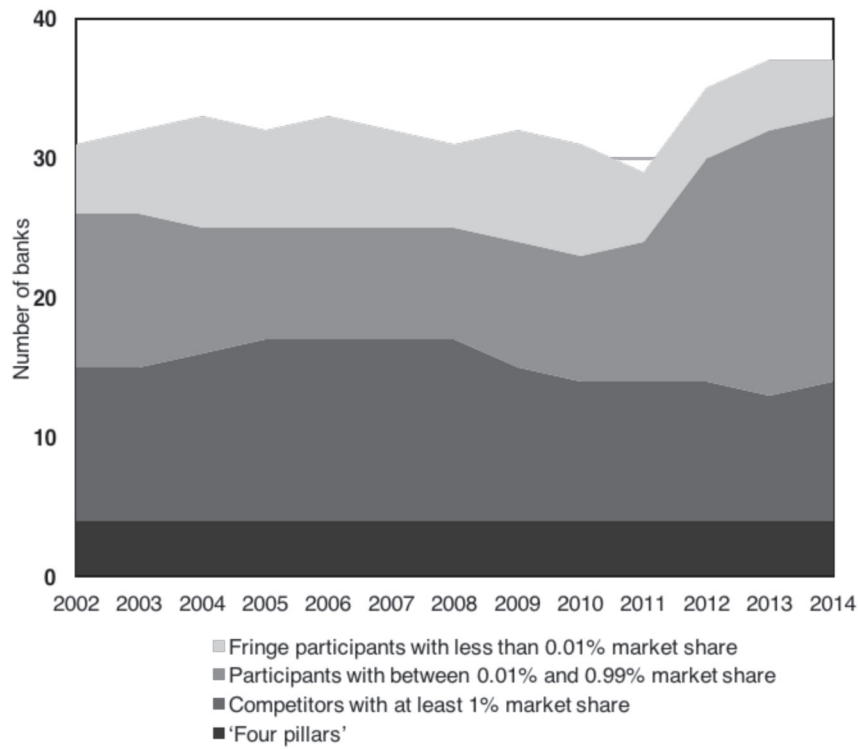
Setting aside any barriers to entry from regulatory requirements etc., both should have had little to do in terms of gaining share when compared with a start up with no reputational stock to draw on. Similarly, although HSBC is not as well known in Australia it is by no means a start-up. More importantly, before it obtained a banking licence AMP was a megalith of insurance services in Australia and should have been very well placed to compete effectively and make inroads into household loans. Looking at the graph above, it is clear that these organisations have gained little traction as retail banks in Australia, raising questions about barriers to switching by consumers.

Seeking a lens on the scale differences between competitors in terms of their presence in the lending market again calls for revisiting the year by year market shares of each competitor. In this case, specific market shares in each year for every competitor were classified by the order of magnitude. The four pillars now having a combined share of around 85% of this market, other firms were divided in to three groups based on the order of magnitude of their market presence, as follows:

- ‘competitors’ were defined as those banks having at least 1% market share;
- ‘participants’ were defined as those having at least 0.01% (but less than 1%); and
- ‘fringe participants’, being the remaining banks on the edges of the market with less than 0.01% share each.

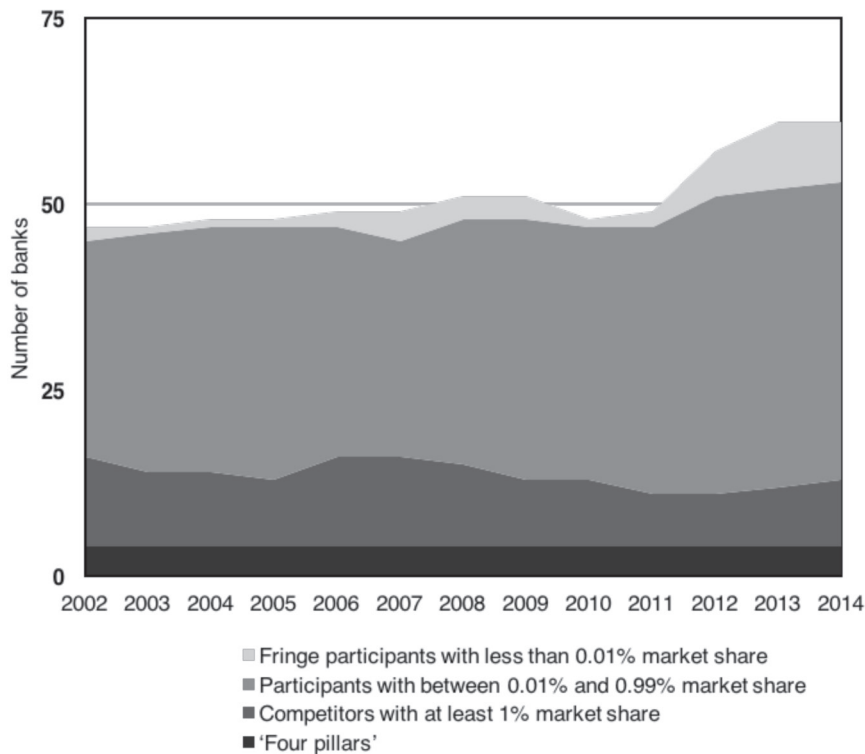
Re-aggregating these groups produces a stratified picture of the competitors in each market, depicted below in Figure 12 for loans to households and in Figure 13 following for loans to non-financial corporations (as before, including SMEs).

FIGURE 12: Banks making loans to households



Derived from APRA banking statistics (APRA 2014)

FIGURE 13: Banks making loans to non-financial corporations



Derived from APRA banking statistics (APRA 2014)

These graphs demonstrate that, on the whole, loans to non-financial corporations appear much more contestable than loans to households, but it has not stopped the ‘pillars’ from coming to dominate the market. Despite the non-trivial number of players meeting all regulatory and other statutory requirements for entry into either market:

- It is hard to find evidence of effective competition from a good majority of the firms in either market, particularly third and fourth tier banks, or ‘participants’ and ‘fringe participants’. In 2014 there were 23 banks lending to households, and almost 50 banks lending to non-financial corporations, which are so far unable to gain a market share toehold of at least 1%. Given the diversity of firms and business models involved, this is more likely indicative of the value of incumbency and other barriers to switching than any competitive inadequacy of firms, which would presumably be replicated across all those banks. It is certainly not plausible to suggest that high satisfaction rates make customers loyal. This is introduced in the first section and discussed further in the next section.

- There is a second tier of six banks, seen as ‘competitors’, which may have gained a firmer footing. However, it remains that the largest of these has only gained a market share of 2.5% in household lending, or 2.8% in lending to non-financial corporations, and the same comments about their competitive performance apply.

The lack of progress by competitors is crucial in terms of the extent to which any, or all as a group, could step up to the challenge of assisting to ‘resolve’ a banking crisis. In such an exigency involving a larger institution that is one of the ‘four pillars’, their capacity to absorb the shock and assist in replacing that institution must be considered very much an open question. This is an important perspective in terms of the capacity of the market to respond to shocks, including ‘resolving’ a non-systemic banking crisis by absorbing the business of a larger competitor. Ceterolli’s (2002) analysis of entry and concentration in thousands of local markets in the USA serves to highlight a crucial point. That is, the importance of new entrants not only for competition *per se*, but as a buffer of alternative service providers to step in should one provider fail. Looking at this series of graphs gives pause on that score, given the lack of sizeable competitors for the ‘pillars’. Moreover, as discussed below, there is a significant observable similarity of their business models and, in many cases, a deal of any significance will involve two or more of the ‘four pillars’.

3.7.2 Stability: Assessment by the International Monetary Fund

While not an indicator in the sense of being an index or other measurement able to be replicated independently, the International Monetary Fund (IMF) Financial Sector Assessment Program (FSAP) is internationally recognised as an assessment protocol. In advanced economies such as Australia, the IMF team uses a systematic approach to consider a synthesis of data and observations, designed to assess systemic conditions in a country’s financial system. In developing economies, the responsibility is jointly held with the World Bank.

Post-financial crisis FSAP stability assessments consider vulnerabilities and resilience of the financial system, regulatory and supervisory frameworks, and financial safety nets, and the resulting report includes a Risk Assessment Matrix (International Monetary Fund 2014). In late 2012, the relevant risk assessment of Australia found that, overall (International Monetary Fund 2012b: 1):

Australia’s financial system is sound, resilient, and well-managed. Major banks are conservatively run, well capitalized and profitable, and they are likely to withstand severe shocks.

Importantly though, the assessment took note of the highly concentrated and interconnected banking system and also found that a medium probability of contagion risk from bank concentration would, if it eventuated, be likely to have a high (negative) impact on financial stability.

Comments included in the matrix observed that:

Dominated by four major banks, the Australian banking system is one of the most concentrated in the world. The four banks have similar business models, and such similarities may be a source of contagion risk.

The similarities in the big four banks' lending and funding operations mean that stress in one bank could be quickly transmitted to others. A deposit guarantee from the Australian Government 'seems inadequate to address such a contagion risk, meaning that other resolution options would be needed' (International Monetary Fund 2012a).

This independent expert view about the business models of the 'pillars' is crucial. In the absence of demonstrated collusion or other anti-competitive behaviour, concentration is of less concern given resilience from diversity. However, the combination of concentration and homogeneity is of great concern, quite separately from the potential to dilute or limit the benefits to consumers from competition.

3.8 Evidence from Observation

As covered by extensive scholarship, the overall conditions prevailing in a market are an important basic indicator of the climate in which competition thrives or otherwise. Even if regulatory barriers to entry are well managed by competent firms, incumbency may become a sovereign barrier to new firm expansion if inconvenience is a significant barrier to customer switching. In turn, this creates highly concentrated markets. Ultimately (CMA and FCA 2014: 9):

There is no simple relationship between concentration and competition. However, more concentrated markets are in some cases less competitive. This is more likely to be the case where barriers to entry and expansion are significant.

That is, observation of the actions of competitors often forms a central feature of considerations about whether and when to exercise regulatory power. As one example, which is particularly on point, the UK's CMA, under the Enterprise Act 2002, has relevant powers to make a 'market investigation reference' and, in 2014, to such ends undertook a preliminary market study of

personal current accounts (PCAs) and SME banking services (conducted jointly in respect of SME banking services, CMA and FCA 2014). In late 2014, the preliminary decision to go forward with a full investigation was confirmed (CMA 2014a: 62). In so doing, the CMA report noted:

- The PCA market in terms of active accounts remains relatively concentrated, with the top four banks having a combined market share of over 77%.
- Other than the impact from mergers and acquisitions, market shares have been stable over time, suggesting that growth and expansion are difficult in the PCA market.
- In terms of relevant harms from concentration, some evidence was found of poorer service but not of higher prices.
- Low levels of switching despite evidence of poorer service, meaning that providers with higher customer satisfaction ratings have nonetheless not been able to gain significant market share, ‘which is not what one would expect in a well-functioning market’ (CMA 2014b: 8).

By the same token, parallel evidence from observation of prevailing market conditions provides a starting point in relation to markets in Australia:

- The retail banking market in Australia appears relatively concentrated, with the four major banks now having a combined market share of 80-85% in household lending and 70-75% in lending to non-financial corporations.
- More than just being stable, in both parts of retail banking this share is well up on a decade ago, largely due to the consequences of mergers and acquisitions.
- In terms of harms from concentration, such as higher prices or lower service, commercial market research suggests that customers of other banks are markedly more satisfied than the customers of the ‘pillars’.

Despite markedly lower consumer satisfaction, there is little evidence of customer switching away from the ‘pillars’, leaving observers to wonder whether these are well-functioning markets.

These comparisons are stark in their similarity and worthy of attention in the context of the intersecting reviews in 2014. Based on this cue from the UK CMA, policy considerations include:

- Independent research on consumer banking satisfaction shows that ‘four pillars’ customers are noticeably less satisfied than those of other banks, and that this is not

new. That overall result has hardly changed over the last four years (Aquilina 2015). As well, in a 2014 climate of very low home loan interest rates, home loan customers of the four major banks reported lower satisfaction levels than non-home loan customers (Roy Morgan Research Ltd 2014b: 4).

- The ten banks with the highest reported customer satisfaction ratings over years include five out of the six non-major banks identified in Figure 5 and Figure 6 above but, none of the ‘four pillar’ banks (Roy Morgan Research Ltd 2014a: 2).
- Commercial research noted a particular problem for the ‘pillars’, with ‘small business customers, who rate satisfaction with banks overall at only 67.5% compared to 82.3% for personal customers’ (Roy Morgan Research Ltd 2014a: 3). This suggests that customer outcomes are particularly poor in the SME market at a time when concentration has increased for several years in a row.
- As illustrated earlier in Figure 8 and Figure 9, non-major banks have not been able to gain market share while the major banks have preserved their combined share and grown it (albeit largely through mergers/acquisitions), despite the relative performances on customer satisfaction.
- While reforms were initiated in 2010 to facilitate customer switching, akin to reforms to facilitate mobile number portability in telephony a decade ago, arguably these reforms were lost in the last change of federal government and their home in ASIC is by no means a usual or familiar source of information for households.

In more detail on retail customer satisfaction, Roy Morgan Research Ltd recently found that the top ten performers for customer satisfaction in consumer banking ‘were well above the level of the best performer among the big four’ (Roy Morgan Research Ltd 2014b: 2). This was satisfaction for banks of any size, that is, the ‘four pillars’ did not rate in the top ten on customer satisfaction. In the six months to August 2014, the top ten performers ranged from 85.7% to 89.9% of customers giving a rating of ‘very satisfied’ or ‘fairly satisfied’, while the best result for any of the four major banks was 81%. Note that all customer satisfaction results in this section are calculated on this basis. While average satisfaction with consumer banking has been improving such that ‘the satisfaction level of the personal customers of banks reached an eighteen-year record high of 82.8%’ in November 2014, up from 81.3% 12 months earlier, all four major banks remained below that average (Roy Morgan Research Ltd 2014b: 1).

It must also be noted that ‘fairly satisfied’ is hardly a ringing endorsement of the service provider, and the best customer satisfaction performance among the ‘four pillars’ had at least one in five customers not even ‘fairly satisfied’. Such ratings would be more consistent with shifts in market share, rather than static or increasing market share. From an effectiveness of competition and consumer benefit perspective, this makes the growing concentration of markets even more concerning.

The performance of subsidiaries is also worth noting, even though these are not analysed separately here in terms of market share. In this particular commercial research, the ten largest banks are measured according to personal banking customer numbers and this includes:

- (a) St George Bank, a subsidiary of Westpac since the ACCC decided not to oppose that acquisition in 2008 (ACCC 2008e); and
- (b) Bank of Western Australia Ltd (BankWest), a subsidiary of the CBA since the ACCC decided not to oppose that acquisition also in 2008 (ACCC 2008c).

St George was ranked fifth at 84.1%, while its parent was ranked eighth at 81.2%. Similarly, BankWest was rated sixth with customer satisfaction of 83.8%, while its parent was rated seventh with 81.8%. As reported by the researchers, these are non-trivial differences and speak volumes about customer preferences.

In an interesting insight on the distinctiveness of banks other than the ‘four pillars’, the researchers also commented that (Roy Morgan Research Ltd 2014a: 3):

1.3% points now separate [the four major banks] compared to 12.6% points in 2005. This competition is good for customers but shows that it is difficult for the major banks to create and maintain a clear positioning advantage ... other competitors, including the smaller banks, building societies and credit unions ... remain well ahead of the big four for customer satisfaction and are seen as outperforming them ... on fees and charges, interest rates and treatment of customers.

So outside the ‘pillars’ group, banks and other financial institutions are creating distinctive positioning and service propositions which are met with customer approval shown in high levels of customer satisfaction ratings. Among the ‘pillars’, the same simply cannot be said, suggesting that customer outcomes are of a lower standard even if there is little price differential to find in these sectors.

3.9 Informing Policy Options

Evidence from around the world, not least as to how each country responded to and emerged from the most recent financial crisis, shows that there are many ways to succeed and fail in the regulation of financial services. As with many complex policy matters though, the issue is not only the means but the end. That is, the choice of policy should depend on the objective that government has in mind based on that society's needs. So for Australia at this time, it is not just a matter of 'four pillars' or some alternative, nor a simple question of the level of trust policymakers may be willing to place in the good governance of private enterprise (colloquially, 'if they were not hit by the financial crisis, they must be sound'). The fundamental issue is being quite specific about the broader economic purposes to be served, and to what extent any such policy will serve them.

In that vein, there seems little doubt that the intersecting reviews in 2014 raised expectations among both policy makers and the public, not least through what was a highly engaged public consultation process. Whatever policy recommendations may come forward from this significant investment in inquiry, those expectations may well be disappointed without a coherent basis on which to evaluate options, including against policy objectives that are expatiated and agreed as such.

Accordingly, returning to the overarching issues identified earlier as essential bases for policy formulation, in this section the following considerations are explored in relation to current scholarship:

- a nuanced understanding of the role played by banks in the ongoing economic prosperity of Australia. This occurs directly in ongoing growth of the financial services industry (which may be prejudiced by 'financialisation' of the industry), and indirectly as the enabler of productive activity in the wider economy (which may be unwittingly restrained by the business models of banks). In either case, it is with the concomitant capacity to unilaterally destroy significant economic value through private enterprise decisions and actions;
- an independent, fact-based appreciation of the causal role of competition which, given the direct impact on outcomes for consumers and the indirect impact for the economy in terms of productivity outcomes, brings into consideration possible or actual implications of concentration arising from entrenched incumbency by the 'four pillars'; and

- an evidence-based assessment of potential risk from policies that continue to preference stability over competition, given the contemporary scholarship and empirical analyses, and that this particular policy horse may have already bolted in terms of options other than continuing with the ‘four pillars’.

3.10 Enabling Economic Prosperity

The provision of financial services plays a crucial role in the economic strength of Australia today. This is both directly by way of a contribution to national economic activity and indirectly by enabling productive business enterprise. The critical qualification is that markets be competitive in keeping with overseas research findings, for example from Cetorelli (2014: 320):

Empirical studies have documented that more competition in credit markets enhances entry in non financial sectors. This evidence has been recognized for its importance in supporting theories claiming that finance matters for real economic activity.

In an economy where SMEs play a central role in production of goods and services, and related employment, the potential impact of retail banking’s enabling role is hard to overestimate. In this, Cetorelli (2004b: 556) earlier identified the generic policy concern in relation to financial services, where her research showed ‘regulation that directly affects the market structure of the banking industry will also have effects, perhaps undesirable, down the line in non financial product markets’.

It is also worth noting that ‘credit availability to enterprises, but especially to SMEs, depends on the infrastructure that supports financial transactions, including the legal system and the information environment’ (Beck, Demirgüç-Kunt and Maksimovic 2006: 2939). In this, Australia is generally very well served, as noted in international comparisons by Brown (2010).

Elsewhere in the world, ‘numerous studies have provided empirical evidence that supports a positive relation between financial development and growth’ (Koetter and Widow 2010: 1529). As an example from another advanced economy, in their study of ‘Germany’s fragmented three-pillar system of private and government-owned banks’, Koetter and Widow (2010: 1530) considered whether the quality, rather than the volume, of financial intermediation would be of significance in promoting growth. They found that, ‘in Germany’s fairly mature economy, the availability of credit alone is not the main bottleneck to economic growth’ (Koetter and Widow 2010: 1540), rather that their measure of quality showed a quality effect, i.e. that there is ‘a

significantly positive effect on growth' (Koetter and Widow 2010: 1540).

In contributing to economic prosperity, it is obviously important that banks themselves be efficient. In a study of 17 bank mergers in Australia (1983 to 2001), Wu (2008: 154) provided an important insight into the wider economic significance of bank mergers:

[T]he acquiring banks are larger, more aggressive and less efficient than the target banks [and] the major source of inefficiency is scale inefficiency, [with regression analysis confirming] a potential negative efficiency impact of a merger between any two of the major banks [meaning that whether] the abolition of the four pillars policy is socially beneficial depends on the evolution of competitiveness and contestability in the market.

In fact, beyond the lack of contestability that seems to prevail, and the scale diseconomies at play in such results, other findings show that using mergers to 'resolve' bank failure has a further hidden cost (Wu 2008: 153):

It appears that the larger and more profitable the target bank relative to the acquiring bank, the more efficiently the consolidated bank will operate. This contradicts the relative size effect hypothesis, which predicts that mergers between a large acquiring bank and a small target bank tend to achieve higher efficiency improvement.

This sits at odds with the unitary test being whether the merger will substantially lessen competition. This research suggests that creeping market concentration through a series of takeovers, none of which would fail the substantial lessening of competition test, nevertheless has a hidden negative impact on system productivity. While essentially a commercial problem for the merger partners, this consideration may still weigh in the balance against any further concentration of the industry.

3.10.1 Managing inherent risk

All commercial endeavour involves risk, but the operating risk of a bank is typically cast as distinctive due to the ramifications for the wider economy in which that bank operates. Moreover, there are specific risks of 'financialisation' of the financial services industry, which creates a growing distance between financial transactions in the wholesale sector and the productive activity that underpins those trades. As put by ASIC Chairman Greg Medcraft (2014):

At their core, markets assist in funding the real economy and in doing so help fuel economic growth. Markets do not simply exist to feed on themselves. The financialisation of markets –

for example, through high-frequency trading, dark liquidity and speculative trading – creates new risks for market resilience. Financialisation has the potential for parasitic outcomes that can destroy confidence and potentially stall economic growth.

An understanding of how financial services enable economic prosperity would not be complete without considering the overall risk management of financial services sellers, including beyond retail banking. Given this role in the economy, it is also crucial to consider that the decisions and actions of private enterprise entities or their agents (such as individual employees) may destroy economic value. This is a lesson from the LIBOR scandal, a seemingly ‘parochial affair involving Barclays, a 300-year-old British bank, rigging an obscure number’ (The Economist 2012) that proved to be globally significant (The Economist 2013). The lesson similarly applies closer to home, in probes by ASIC into the bank bill swap rate (McConnell 2015), and by the New Zealand Commerce Commission into misleading conduct in marketing of interest rate swaps in New Zealand (Fletcher 2014; ComCom 2014).

It is clear that financial services have considerable inherent risk, and certainly no less than other commercial enterprises on a similar scale. However, rather than making them a special case for crisis support from the public purse, or for ever more detailed regulation in an attempt to prevent such crises, the post-financial crisis assessment of Blundell-Wignall, Atkinson and Roulet (2012: R41) puts into perspective the particular character of risks. Specifically, this perspective shows that the interests of sellers and buyers of financial products are potentially in conflict:

The main way to deal with conflicts of interest is to reduce the opportunity set of conflicts and to improve corporate governance [including by stopping] TBTF cross-subsidisation, which is a massive temptation for bonus-hungry businesses to make easy profits in ‘normal’ periods prior to crises - using other people’s (cheap) money while claiming there is somehow some skill in this. The OECD [recommended reforms include] implementation of the NOHC structure with ring-fencing for bank business models in the world of counterpart risk.

The ‘NOHC’ referred to is a non-operating holding company. ‘Ring-fencing’ is a policy solution that has a variety of specific forms, but in general is designed to regulate by forcing risk matching between the part of the portfolio providing funds and the part using those funds. For example, segregating household deposits to be used for household lending from wholesale sources of funds for wholesale lending. By which ever means it is implemented, ring-fencing works only as well as the actual risk profiles involved will let it, and even if the policy segregates ‘retail banking’ from ‘commercial lending’, the effectiveness of that policy is limited by the

validity and completeness of reporting and supervision. In that context, it is worth recalling Brown's (2010) analysis of significant and consequential lapses in both the underpinning logic and the application of that approach where policy makers effectively aided and abetted financial institutions (whether knowingly or not). The effectiveness of ring-fencing is, of course, determined by the quality of the loans funded. If mortgages are not of the quality assumed in the arrangement, as in large swathes of the mortgage belt in the USA during the subprime crisis, a generic ring fence won't help.

Interestingly, as pointed out by Blundell-Wignall, Atkinson and Roulet (2012), Macquarie Bank is the sole implementer of the NOHC approach in Australia, a voluntary step in self-regulation that seems particularly well advised amid the variety of wholesale finance scandals currently in the media (including those noted above). The RBA's supplementary submission to the FSI provided the view that:

such structures are more relevant to business models that combine commercial banking with substantial non-banking business or activities in capital markets; these are not applicable to the vast majority of ADIs in Australia

3.11 Summary

There are three characteristics of retail banking in Australia. First and critically important, the stability of the sector is sound and retail banking had a relatively soft landing in the aftermath of the financial crisis. Second, there is limited competitiveness and this is reflected in the static state of market share between the four major banks and very slow and marginal improvements gained even by strong second tier competitors. Further evidence for this claim is provided in the next chapter. Third, product and service innovation is limited.

There are two important implications that flow from these issues. First, the absence of vigorous rivalry, whilst providing stability, is likely to mean that the welfare of retail banking consumers is not maximised. Second, the level of innovation may not be as high as is feasible, and barriers, including prudential regulatory barriers to entry or expansion, mean that the extent of rivalry is unlikely to change without some form of promotion of competition.

The next chapter examines some of the approaches to these two implications.

4 FACILITATING COMPETITION IN FINANCIAL SERVICES

4.1 Introduction

Consumers are potentially key to vibrant competition in a market. However, in order to exercise that power, they need to be able to use the latent threat of switching. Ideally, they should have a low-cost switching option. Consumers ‘not only benefit from competition, they activate it, and one of the purposes of consumer protection law is to ensure they are in a position to do so’ (Ron Bannerman quoted in Sylvan 2006: 3). But while consumer protection in Australia is highly evolved and highly effective, switching remains low in retail banking. This is discussed in this chapter.

In 2010, the Australian Government announced banking reforms (Australian Government 2010). The purpose, among other things, was to facilitate consumers switching between banks and to better inform that possibility of switching through greater financial literacy across the Australian community. These reforms are now administered by ASIC.

The initiative to facilitate switching was to reduce the switching costs inherent in changing banking accounts. The main changes in 2010 related to switching within the residential mortgage sector. However, there is general support for reducing consumer switching costs. For example, Bell and Eisingerich tested a range of relevant hypotheses, including propositions that (Bell and Eisingerich 2007: 470-472):

- (a) technical service quality will be positively related to customer loyalty (H1);
- (b) functional service quality will be positively related to customer loyalty (H2);
- (c) customer education will be positively related to customer loyalty (H3); and
- (d) customer expertise will be negatively related to customer loyalty (H5).

Of these, as might have been anticipated, data supported hypotheses 1, 2 and 3. Customer loyalty was found to be positively and significantly related to technical service quality, functional service quality and customer education. As well, but contrary to expectations, customer expertise was *not* negatively related to customer loyalty, meaning that hypothesis 5 was not supported. This suggests that banking reforms that facilitate customer switching do not necessarily reduce loyalty, unless there is a significant benefit in switching. Put simply, facilitating switching does not adversely affect strong providers of services. Importantly, and counter-

intuitively in some views, increased financial literacy is generally a good thing and does not adversely affect customer loyalty.

However, the momentum to switch must be sufficient to overcome the inertia in bank customers that has been identified in empirical research (Colgate and Lang 2001). Mere financial literacy and unpublicised system changes are unlikely to provide the momentum required to overcome the level of inertia created by low levels of rivalry between competing suppliers.

4.2 The contribution of competition to financial services

4.2.1 The importance of a competitive retail banking sector

The issue of banking sector competitiveness is critical to consumer welfare. Each of the FCA and the CMA has considered competition in the UK financial services sector. The Bank of England (2014) has recently published a discussion document that examines fair and effective markets in one of the critical wholesale sectors of the financial services sector. This illustrates the importance of competition law and policy as the driver of intervention in all types of markets without excluding markets for financial services.

The CMA has expressed a number of concerns that appear to apply in Australia (CMA 2014b). Retail banking competitiveness in the UK is greater than it is in the US, but lower than in Australia, based on the evidence presented in this chapter.

4.2.2 Consumer position

The consumer protection regime and legal structures around lending are significant, if invisible, contributors to the effectiveness of competition by improving the quality of loans made and diluting the potential for unresolved impairment. To illustrate, non-performing housing loans saw a peak in 2010, post the financial crisis, which was a 20-year high. However, the quantum was still less than 1%, and low by international standards (Reserve Bank of Australia 2009: 21). Lending practices of banks certainly play a part in this picture, but should be understood in context of the distinguishing features of Australia's legal framework. In particular, the legal environment creates 'a stronger obligation on lenders to make responsible lending decisions than is the case in the United States', but equally, all mortgages are 'full recourse' following a court repossession action, and households generally understand that they cannot just hand in the key to the lender extinguishing the debt' (Reserve Bank of Australia 2009: 21). Arguably, then, the strong social norm of paying the mortgage even when distressed financially has been

created by a long history of full recourse mortgages as the legal norm, which is balanced by a supportive net of effective consumer protection law. The prevalence of Lenders' Mortgage Insurance, taken for the lender's benefit at the borrower's expense, for loans where the loan to valuation ratio exceeds 80% is also an important factor.

Beck and Demirgüç-Kunt (2006) highlight the importance of consumer protection and other legal structures in their review of the evidence from across country studies of the impact on SMEs of access to finance. They also point to the importance of innovative financing instruments and processes, as well as the importance of the interdependence of financial and legal institutions in an overall environment conducive to business growth, including the presence of well-defined property rights and effective contract enforcement.

4.2.3 The position of SMEs

The provision of financial services is an essential input for businesses. For example, Cetorelli (2004b: 544):

The theoretical conjecture that financial markets should matter for economic growth is hardly recent, tracing back at least to Schumpeter [in 1912]

One of the post-financial-crisis issues in some countries, particularly the US, is whether the retail banking system lends at the levels that are required to stimulate the SME sector, taking into account the risks of that sector. Some empirical work suggests that it does, even though the theoretical perspective is less clear. For example, (Cetorelli 2004b: 546), states that the:

effect of bank concentration on industry market structure [is] theoretically ambiguous. Empirical evidence [indicates] that in fact higher bank concentration and more banking market power are associated with higher industry concentration [including] that bank concentration leads to larger average firm size in non financial sectors [and] higher bank concentration and market power have an impact on the entire distribution of firm size

Later work goes further (Cetorelli and Strahan 2006: 459):

While theory does not paint a clear picture about how competition in banking ought to affect the firm-size distribution, the empirical work does. Our empirical evidence is consistent with the idea that banks with market power erect an important financial barrier to entry, to the detriment of the entrepreneurial sector of the economy [and] that bank competition has a significant impact on important structural characteristics of sectors of production. Moreover,

it indicates that such impact is not uniform across firms, but rather that, depending on the degree of bank competition, some firms may benefit while others may lose [contrary to] the conventional wisdom that bank competition is either good or bad overall.

Work done by the World Bank before the global financial crisis came to a similar view. However, this analysis did have a developing country focus (Beck, Demirgüç-Kunt and Maksimovic 2006: 2935):

Both in the developing and developed world small firms have been found to have less access to external finance and to be more constrained in their operation and growth.

4.2.4 Innovation

Schumpeter proposed that an inverted U-shaped function could be used to describe the relationship between the number of competitors in a sector and the level of innovation (Bos, Kolri and Lamoen 2013). The principle is that a monopoly has little incentive to innovate and the sector is likely to have commodity characteristics if there are many participants. In this model, the pivotal question is how many participants are required to hit the turning point on the curve? If the size and concentration of the industry puts it past the apex, then more competitors lead to less innovation, whereas on the upward part of the inverted U, more competitors lead to more innovation. Policy decisions, such as the four pillars policy, make significant assumptions as to whether consumers will reap the maximum benefits from innovation associated with vibrant competition. Aghion et al. (2005) confirm the presence of an inverted U across a range of industries, although not specifically finance or banking.

In a speech in 2001, then-Commissioner of the ACCC, Ross Jones, observed that regional banks ‘have been an important source of competition to the big four major banks. They have also been important drivers of innovation in the Australian financial sector.’ He noted that the Wallis Report similarly pointed out that these banks had led the way in service and innovation (Jones 2001: 4):

Small businesses are an important source of innovation in the economy. While ABS data indicate that small businesses are less likely to engage in innovative activity than larger businesses and account for a relatively small share of research and development expenditure, almost 90 per cent of the businesses engaging in innovative activity are small businesses.

While that naturally incorporates the reality that small businesses in Australia are much more

numerous than large ones, it provides reason to pause for sober reflection on what impact a SME credit crunch would do to Australia's prosperity (Connolly, Norman and West 2012: 3).

In a study of the productivity and performance of the 'four pillars' between deregulation in 1983 and the financial crisis 2008, Abbott, Wu and Wang (2013: 122) found that 'the productivity performance of the Australian banks tended to improve considerably in those periods of strongest economic growth'. Perhaps more importantly, their results showed that it 'is apparent that the main driver of the productivity change is the improvement in technological change rather than improvements in pure technical efficiency or scale efficiency' (Abbott, Wu and Wang 2013: 132).

In line with many other industries, benefits to banking from innovation need not be limited to those conceived by and for the supply side, such as technical improvement to behind-the-scenes systems, designed for and/or by banks for their purposes. There is empirical evidence to show that innovation comes largely from consumers, not sellers, and that this holds true in banking as much as in other industries (Baldwin, Hienert and Hippel 2006; Consoli 2005, 2008; Oliveira and Hippel 2011). In fact, Roberts and Amit (2003: 107) showed, in their study of retail banking over 1981 to 1995, that 'the vast majority of observed innovative activity was based on ideas sourced from outside the focal firm, and that innovations diffused very quickly across competing banks.' For policy makers, this is a crucial consideration in evaluating policy options.

4.3 Concentration

4.3.1 Concentration: Herfindahl–Hirschman Index

As set out in section 2.4.6 above, the HHI is an internationally recognised indicator of market concentration, typically used as a proxy for estimating the extent of competition. Calculated as the sum of the squares of the market shares of the 50 largest participating firms, or of all firms if there are less than 50, this approach effectively 'upweights' the impact of the largest competitors. Using whole number market shares (for example, 17%), the HHI will produce a result in the range up to 10,000 (that is, 100 x 100 if a single firm has 100% share).

Calculated in this way, HHI of up to 1,500 is commonly viewed as indicative of an acceptably concentrated market (that is, unlikely to impede competition), while HHI around 2,000 or more is generally viewed as problematic. For example, if five firms have equal market shares, the HHI will be 2000: each firm has 20%, single firm contribution to HHI calculation is $20 \times 20 = 400$, this is summed over five firms: $400 + 400 + 400 + 400 + 400 = 2000$. A practice example from the UK Competition and Markets Authority is that (CMA and FCA 2014: 44):

any market with a post-merger HHI exceeding 1,000 may be regarded as concentrated and any market with a post-merger HHI exceeding 2,000 may be regarded as highly concentrated

Of course, in the UK and even more so in the US, any industry may involve multiple sub-national markets that are comparable to the entire market in Australia, giving proposed mergers/acquisitions a different complexion when considered by the ACCC.

For a reference point in context of the Australian economy, the market for domestic air travel provides a useful example. For a decade, Qantas and Ansett effectively shared the market in a now defunct 'cosy duopoly', before Ansett was placed under administration in 2001 and subsequently wound up. For much of that decade, the HHI for the domestic air travel market was in the range 5,000 to 5,500, peaking at over 7,000 immediately after the demise of Ansett (see Kain and Webb 2003). Had no other trunk airline been in operation to absorb the traffic dropped by Ansett's demise, it is highly doubtful Qantas could have taken up the slack sufficient (in speed and/or quantum) to avoid serious ramifications for the economy. More than a decade and a half on, what is worth recalling is that fundamental disaster for the economy was averted not because of any specific policy or government action, but because Virgin Blue (now Virgin Australia) happened to have commenced operations as a challenger in late 2000. As such, they then took the commercial opportunity to ramp up their activities apace to become the second major airline domestically, very much ahead of their schedule, and in effect allowed the economy to recover by avoiding the backwash from firm failure in a highly concentrated market.

Valid calculation of the HHI relies on an appropriate market definition including consideration of substitutes. Bank concentration in Australia could be assessed based on assets, deposits or loans, as distinct market aspects of bank operations. From a policy perspective concerned with end results for consumers, there is clear merit in considering deposits or loans. If pricing is impacted by monopoly behaviour, or prejudicial pricing is otherwise the result of undue market power though, it is more likely to be in evidence in loan markets where banks are the sellers of loans. Therefore, loan markets are the basis for analysis here.

For the present purpose, it could also be relevant to consider how households substitute products within a market in some fashion (for example, credit card and mortgage debt where both are provided by banks). Alternatively, how one set of suppliers (for example, banks providing home loans) may compete for business with another set in a substitute product market (for example, non-bank financial institutions such as credit unions/cooperatives providing home loans). Similarly, it may be relevant to consider the extent to which SME operators may substitute

their own household debt for SME debt in the current environment where banks seek security over property, rather than a fixed and floating charge over the business.

However, unless the significant majority SMEs have household accounts at different banks to their relevant business accounts, it would not change the markets' concentrations. Similarly, the outcome in household banking may be impacted in the unlikely event that significant numbers of households over time substitute one type of debt held at one institution for a different type held at another.

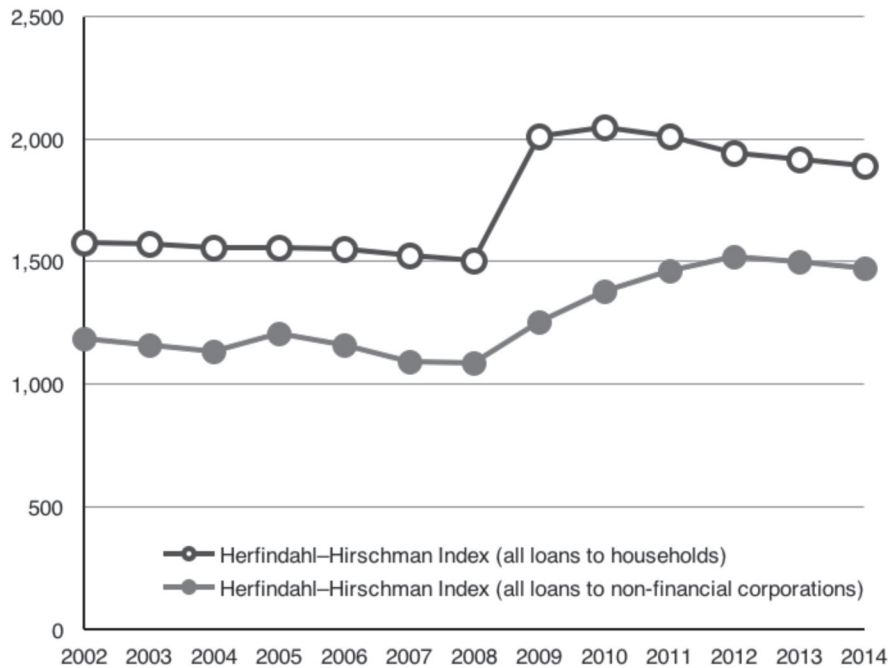
Thus, market definition for the purposes of calculating an HHI, is in two elements, the national market for all forms of bank loans to households, and the national market for bank loans to non-financial corporations (which includes SMEs). This is based on:

- The ACCC view of the market for home loans over two decades (as discussed earlier) is that it is a national market.
- The vast majority of household debt is in the form of home loans from banks, whether for owner-occupied or investment properties.
- There is an unknown relationship between the forms of credit used by households, noting that the credit card and 'other' segments are a small minority in terms of dollar value. However, the proposition that such accounts are distributed among banks to an extent that is sufficiently different to the distribution of home loans so as to reverse the indications from an overall measure is not plausible. This is so even if the aggregate for credit cards comprise a very large number of accounts each having modest balances due and distributed among suppliers in some way fundamentally different to mortgages).
- Non-bank providers of loans, especially credit cards, are present in Australia, and are fairly seen as a growing consideration in market dynamics. However, even in a highly disaggregated data set (for example, a very specific geographical market for one loan product) they would not provide a plausible proposition for fundamentally changing the HHI outcome.
- Permeability of the boundary between household loans and SME business loans is quite probably an issue, but one which ebbs and flows in the face of a very large number of unknowable variables. Noting that any influence will be mitigated by the extent to which both sets of accounts are with the same bank, a co-incidence of provider of 60% was

found in the UK (see CMA and FCA 2014: 9). Although no specific data is available for Australia, that permeability is highly unlikely to materially impact the HHI outcome.

For retail banking in Australia since 2002, the period over which consistent data is available, in any given year less than 50 banks were providing loans to households (whether housing for owner-occupied houses, housing for investment properties, credit cards or other loans). Similarly, although a growing number of banks provide loans to non-financial corporations including SMEs, the high water mark so far is around 60 in recent years. Accordingly, for both parts of the retail market, calculations have been based on all participating banks.

FIGURE 14: Industry concentration



Derived from APRA banking statistics (APRA 2014).

Figure 14 above shows the HHIs calculated for the years 2002 to 2014 for the two elements taken as indicating the retail banking market. In 2014, the HHI for loans to households was 1,893, which indicates a moderately to highly concentrated market by international standards. Although below the peak of 2,013 in 2009, this is a material increase over the earlier prevailing level around 1,500. The peak came in the wake of the 2008 acquisition of St George by Westpac and was reinforced by some financial crisis-related exits that have not been (and may never be) directly offset by new entrants gaining market comparable share.

In comparison, the HHI for loans to non-financial corporations is only now reaching the pre-financial crisis level of concentration in the household market. Just prior to the effects of the

financial crisis, that measure reached a low of 1,089 before the ‘pillars’ began expanding to create a more concentrated business market, including through mergers as noted earlier.

4.4 Competition in banking

4.4.1 Measurements other than HHI

The literature on banking competition suggests that concentration alone does not provide a good indicator of competitiveness in the banking sector. Indeed, there can be vibrant competition in highly concentrated sectors based on innovative products and pricing.

This becomes critical in the context of the application of a substantial lessening of competition test. The blunt tools offered by either the HHI or simple margin analysis cannot provide the level of information required to determine the degree and intensity of rivalry that is occurring in the financial services sector.

On the other hand, if market concentration is high, there is a risk of oligopoly behaviour. In the banking sector, this would be expressed as a Cournot model. One issue with reliance on margins as an indicator of banking competitiveness is that the same outcome would flow from a Cournot model.

Historical competitive analysis in the financial services sector has used market concentration or margin levels as an indication of competitive intensity. However, there are a number of alternative indicators of banking competitiveness.

The Panzar-Rosse H-statistic captures the elasticity of bank interest revenues to input prices. It is calculated in two steps:

- (a) running a regression of the log of gross total revenues (or the log of interest revenues) on log measures of banks’ input prices; and
- (b) adding the estimated coefficients for each input price, including deposits, staff, equipment and fixed capital (for example, Bikker and Haaf 2002).

Higher values of the H-statistic are associated with more competitive banking systems. In a monopoly, the demand curve is downward sloping and an increase in input prices results in a rise in marginal costs, a fall in output, and a decline in revenues. This leads to an H-statistic less than or equal to 0. Under perfect competition, an increase in input prices raises both marginal costs and total revenues by the same amount and the H-statistic will equal 1.

The Lerner Index is defined as the difference between output prices and marginal costs (relative to prices). Prices are calculated as total bank revenue over assets, and marginal costs are obtained from an estimated translog cost function with respect to output. Higher values of the Lerner index signal less bank competition. After describing and using this method, Maudos and Fernández de Guevara (2004) concluded that the European reduction in interest margins was driven by cost reduction in the sector.

A third and more recent approach is the Boone Indicator (Boone 2008b, 2008a). It measures the effect of efficiency on performance in terms of profits on the basis that more efficient banks achieve higher profits. It is calculated as the elasticity of profits to marginal costs. This elasticity is calculated by regressing the log of a measure of profits (such as return on assets) against a log measure of marginal costs. The elasticity is captured by the coefficient on log marginal costs. The more negative the Boone indicator, the higher the level of competition is in the market.

The advantage of using indicators of competitiveness such as the Lerner Index and the Boone Indicator is that they can be applied in a concentrated sector in order to determine the level of competitiveness.

4.5 Indicators of competition in Australian banking

4.5.1 Overview

This section examines the four pillar banks at a group level in respect of competitiveness and efficiency. This work has used data envelopment analysis, Lerner Index, H-Statistic and Boone Indicator, using data from reputable but independent sources. Specifically, the data set is from the World Bank, and has been used extensively by the Federal Reserve system in the US as well as in Europe. The section on data envelopment analysis uses public data provided by the four major Australian banks as part of their half-yearly reporting.

4.5.2 H-Statistic

The H-Statistic for the banking sector for a number of countries, and globally, is available in the World Bank Global Financial Development (2015). The data subset, known as GFDD.OI.03, contains the H-Statistic. There is limited Australian data, but there are results for 2010. These are set out in Table 3.

TABLE 3: H-Statistic for banking in selected geographic areas

REGION	H-STATISTIC
Australia	0.651
Euro Area	0.651
United Kingdom	0.642
United States	0.689
World	0.65

Based on the H-Statistic for 2010, it could reasonably be concluded that the US has a more competitive banking sector than the UK and that Australian banking competitiveness lies between the UK and the US at a level that is comparable with the Euro Area and the world as a whole.

4.5.3 Lerner Index

The Lerner Index for the banking sector for a number of countries and globally, is available in the World Bank Global Financial Development (2015) Database. The data subset, known as GFDD. OI.04, contains the Lerner Index. Australian data is available from 1999 to 2010. This is set out in Figure 15.

FIGURE 15: Lerner Index for banking over time for selected geographic areas

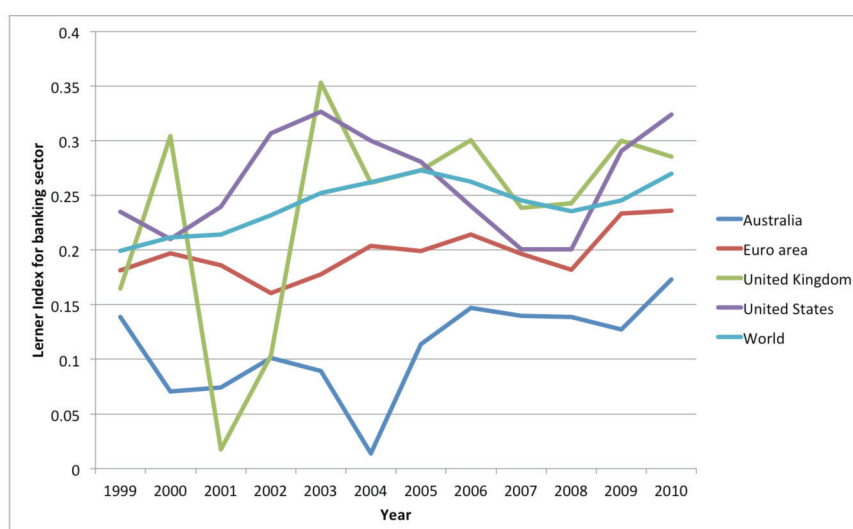


Figure 15 indicates that Australia’s banking sector is more competitive than the other geographic areas, that the UK reached the highest level of competitiveness in 2001, and that Australian banking competitiveness peaked in 2004.

4.5.4 Boone Indicator

The Boone Indicator for the banking sector for a number of countries, and globally, is available in the World Bank Global Financial Development (2015) Database. The data subset, known as GFDD.OI.05, contains the Boone Indicator. Australian data is available from 1999 to 2011. This is set out in Figure 16.

FIGURE 16: Boone Indicator for banking over time for selected geographic areas

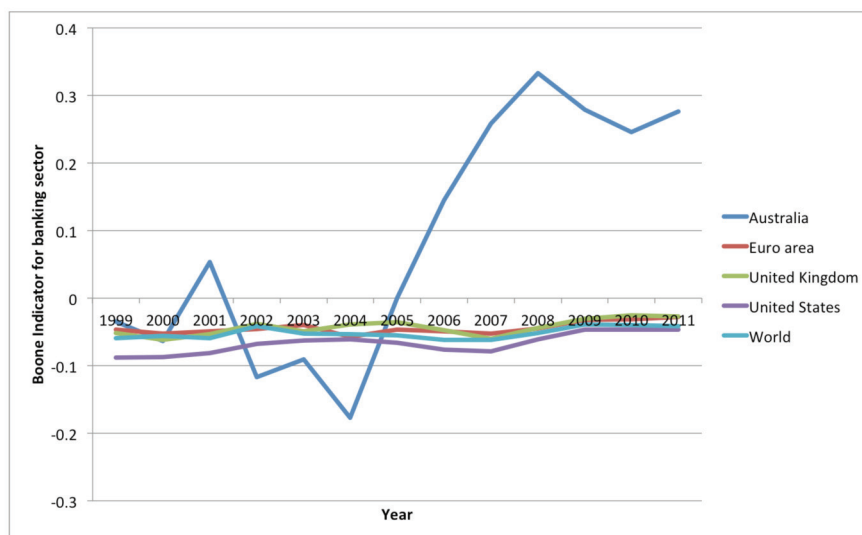


Figure 16 indicates that Australia’s banking sector is less competitive than the other geographic areas. The volatility and extreme nature of the Australian results makes the World Bank data questionable. The data indicates such a lack of competitiveness, compared to the other measures set out above, that it may be unreliable. However, correspondence with the World Bank has not led to a revision in its published data.

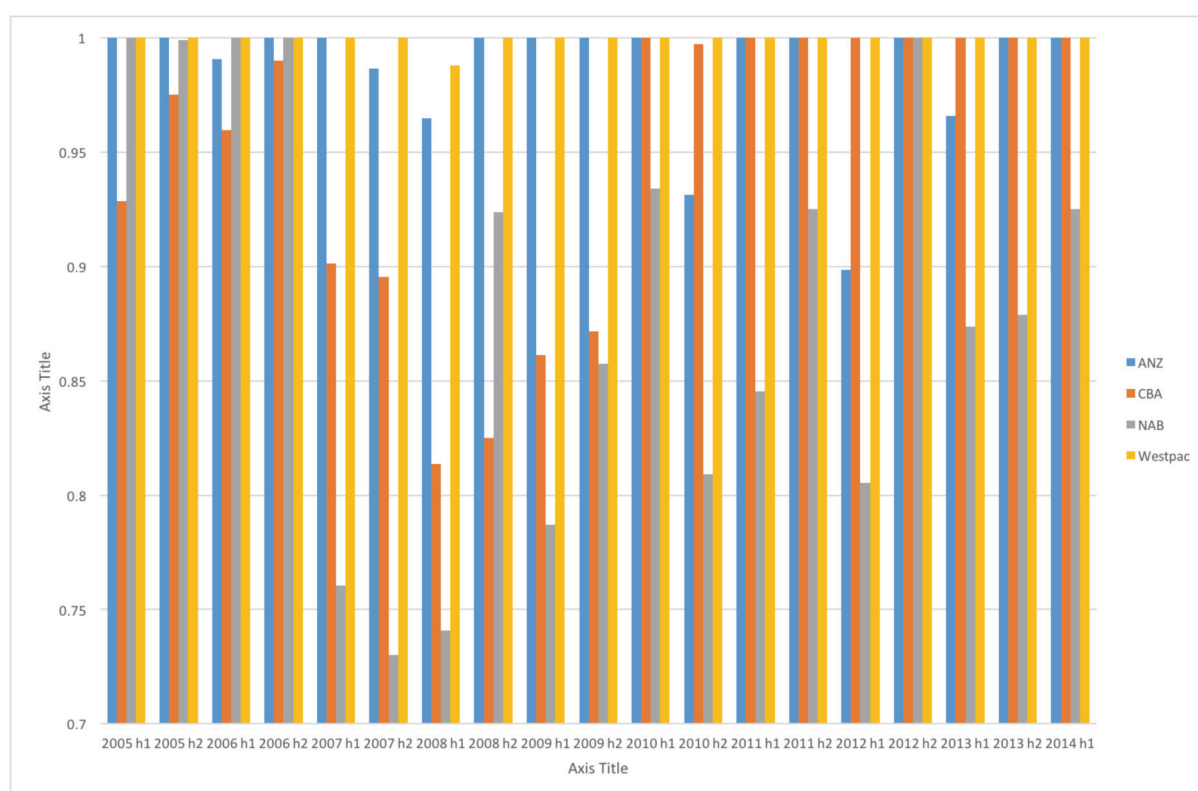
4.5.5 Data envelopment analysis

Another method that can be applied to the analysis of the retail banking sector is Data Envelopment Analysis (DEA). This is a non-parametric method, in which the efficiency of dissimilar enterprises can be estimated using a common set of inputs and outputs (Barros, Barroso and Borges 2005) (Wei 2001) (Cooper, Seiford and Zhu 2004).

For each of the four pillar banks, the half-year reports between 2005 and the first half of 2014 were reviewed, and a value obtained for two outputs and three inputs. The outputs were the loan book and non-loan outputs, and the inputs were shareholders' funds, deposits plus other borrowings and operating expenses. The DEA for each period will have one or more banks on the edge of the envelope (expressed as a relative efficiency of 1) and the other banks at a lower efficiency, which is expressed as a fraction. Computations were performed in the program R (R Core Team 2015) using functionalities included in package called 'nonparaeff' (Oh and Suh 2013).

The results of the DEA are set out in Figure 17. They include a shift in the efficiency of NAB over the period, the lead in efficiency held by Westpac, and the striking effect of the financial crisis in the first half of 2008.

FIGURE 17: Data Envelopment Analysis



The Malmquist index measures how much a firm has improved from one period to the next. The change can be decomposed into the general technological progress that affects all players, and the specific approach of a firm that changes its performance relative to that of the other firms (Bogetoft and Otto 2011). We can express these as the technical change (TC) and the efficiency

change (EC). The latter is a ‘catch up’ measure. These are set out in Figure 18 and Figure 19. The notable issue in the technical change is the high level of change before the financial crisis, the focus on other things during that crisis, and the relatively poor recovery in technical change since then. In Figure 19, a feature which is consistent with Figure 17 is that there is no catch up from Westpac as it leads in efficiency.

FIGURE 18: Decomposed Malmquist Index – technical change

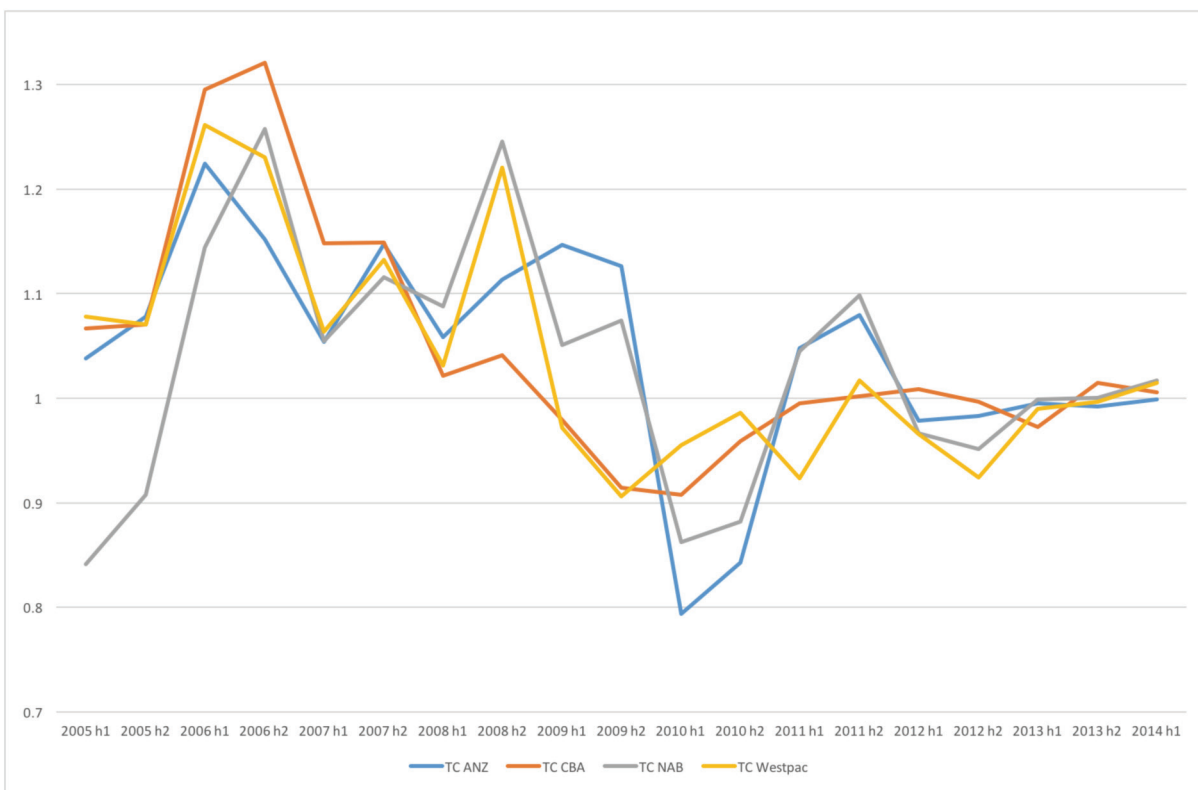
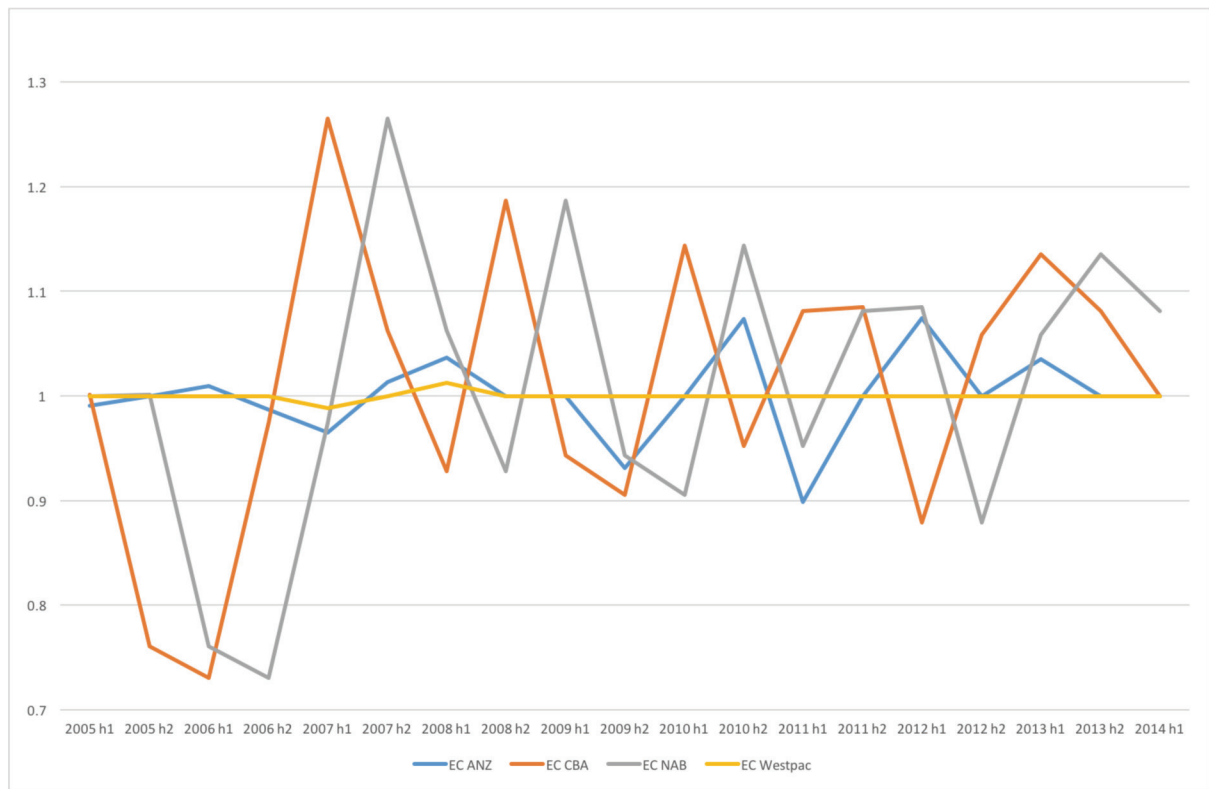


FIGURE 19: Decomposed Malmquist Index – efficiency change



4.5.6 Return on assets

One approach that demonstrates the extent to which the four pillar banks have similar business models is the way that the return on assets has changed over time. A time series analysis of the return on assets for the four pillar banks was calculated using Net Assets and Net Profit After Tax, as reported by the profit and loss and balance sheet statements provided by each bank's Interim Financial Report.

Comparison of Financial Statements did not yield a noticeable difference in methodology for reporting net assets across the firms, although:

- CBA provided a more comprehensive breakdown of asset/liability components.
- NAB Net Assets in 2004 excluded the net assets of an affiliated bank, Northern Bank Ltd and National Irish Bank Limited, because these were disposed of.

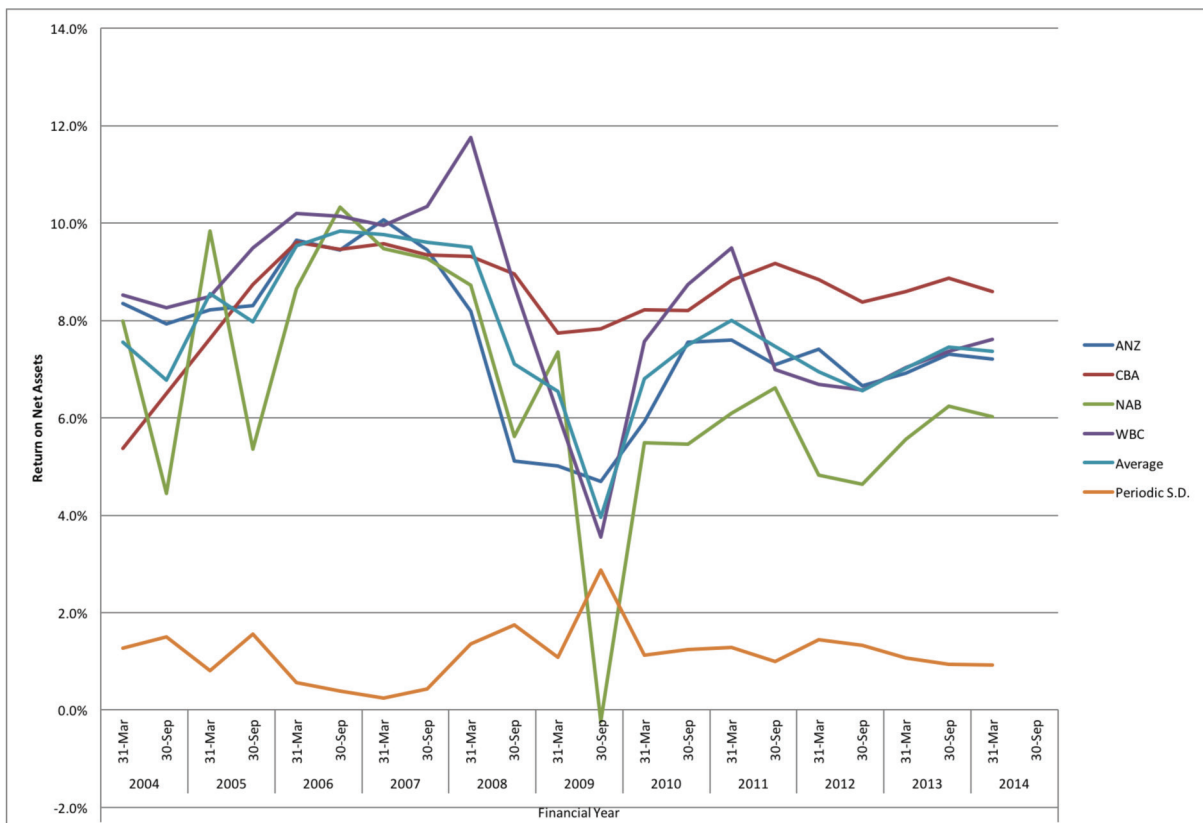
To maintain consistency with other firms, the Net Profit After Tax (cash basis) was used for CBA.

In the absence of quarterly financial statements, the figures for CBA were adjusted by taking an average of the reported figures for each half-yearly reporting period. That is, a March figure was derived by taking an average of the December and June month ends. It may be that an average ‘midpoint’ between consecutive periods is not the best approximation. For example, there may be cyclical tendencies for performance to be greater in the September period than in the March period. Although recognised, no trend analysis was done to further investigate.

Where there were two or more reported figures for Net Assets, the latest financial release was used. This best reflects management’s compliance with the most recent accounting standards. It appears the most common cause of variation is a conversion of liquid assets to cash, increased issuance of net loans and advances, and increases in deposits and other borrowings.

The result is shown in Figure 20.

FIGURE 20: Return on assets, 2004 – 2014



4.6 Applying competition law in the banking sector

4.6.1 Coordinated conduct – difficulties in cartel action

It may be difficult for the ACCC to take an action against a financial institution that has engaged in cartel conduct in relation to manipulation of financial benchmarks such as:

- (a) inter-bank offered rate;
- (b) foreign exchange rates; or
- (c) bid/ask spreads.

The issue is that the manipulation is likely to have occurred in a different jurisdiction. This problem is magnified by the Federal Court decision in *Australian Competition and Consumer Commission v Air New Zealand Limited* [2014] FCA 1157 on the international airfreight cartel (LeClair 2012). Although the *Competition and Consumer Act 2010* (Cth) has been amended to clarify jurisdictional issues since the airfreight cartel conduct and the case is likely to be appealed, it is difficult to demonstrate the nexus between the manipulation and the jurisdiction (Niels 2013). In any case, whereas there is some indication that the locally set benchmarks (such as the bank bill swap rate – BBSW), have been manipulated, there has been no public ACCC cartel conduct action. This is in contrast to the New Zealand Commerce Commission's announcement that it had provided an immunity marker to at least one financial institution (ComCom 2014).

The European Union has followed the path of using cartel conduct to deal with financial benchmark manipulation (Nicholls and O'Brien 2014). The twin announcements of further cartel settlements in October 2014 and the retiring Commissioner Almunia's speech on the passing of the antitrust litigation directive suggest that there is scope for competition law to provide consumers of financial services with courses of action in the EU and such courses are already available in Australia (Nicholls 2014).

4.6.2 Mergers and acquisitions

One of the fundamental approaches in the CPR (Harper et al. 2015) is the need for Governments at all levels in Australia to avoid unnecessary intervention that impacts competition either directly or indirectly. There is good reason to consider that the 'four pillars' policy, described in 3.2 above, is a policy that should be removed.

The FSI (Murray et al. 2014a) recommended that the ‘four pillars’ policy should be retained. It did so on the basis that it was required to prevent mergers between the four major Australian retail banks. However, the removal of the four pillars policy is not likely to result in mergers between the ‘four pillars’. It is not unreasonable to assume that the operation of section 50 of the *Competition and Consumer Act 2010* means that the analysis of any such potential merger would lead to the ACCC finding that the merger would lead to a substantial lessening of competition in a market.

Competition and contestability arise when there are reasonably low barriers to entry and exit from the sector. It is not clear that low barriers to entry exist in Australia and evidence to support this view comes from the failure of international banks to gain a significant toehold in the retail banking sector in Australia.

The four pillars policy creates a barrier to exit for each of ANZ, CBA, NAB and Westpac, except by way of a trade sale to an international bank and subject to approval by APRA and the Foreign Investment Review Board. Low interest margins in banking, used as evidence of competitiveness in the Interim Report of the Financial System Inquiry (Murray et al. 2014b), are potentially a barrier to entry. The final report of the Financial System Inquiry did not repeat this analysis (Murray et al. 2014a). The effect may be that competitive entry is only by industry disruptors (for example, Adner 2002).

The four pillars policy has led to a degree of vertical integration in the sector, particularly in the sale of mortgage products. There was a contraction in the proportion of loans provided by banks other than the ‘four pillars’, and by the non-bank mortgage sector, associated with the global financial crisis (Australian Bureau of Statistics 2015). Since then, there has been a contraction in the diversity of mortgage intermediaries, with CBA acquiring 80% of Aussie Home Loans and Westpac acquiring RAMS’ brand and distribution business.

Within the constraints of the pillars policy, there have been recent acquisitions by the ‘four pillars’ banks, with Westpac acquiring St George and CBA acquiring BankWest. There has also been a significant amount of horizontal integration in the sector, particularly within the areas of wealth management, insurance and specialised finance.

There are major issues that flow from horizontal and vertical integration in the banking sector. The primary one is that systemic risk becomes more domesticated and in so doing crosses multiple elements of the Australian financial system. For example, NAB provides banking, wealth management, insurance (through MLC) and a range of wholesale superannuation products and

services. The bank has the potential to be ‘too big to fail’ not from its banking operations, but due to its impact in the superannuation sector (for example, Donald and Nicholls 2015).

The problem with the four pillars policy arises from the regulatory culture that it creates. APRA’s finding (APRA 2013) that only the ‘four pillars’ are Domestically-Systemically Important Banks (D-SIB or local ‘too big to fail’ banks) compounds the issue.

The institutionalisation of these banks has the potential for both a lessening of intensity of competition and the creation of a regulatory blind spot in respect of digital disruption.

The lessening of intensity of competition effect comes from the barriers to entry raised around these banks. Although the regulatory regime might permit new entry, the regulatory focus is on the ‘four pillars’, on the basis that they are critical to stability. The entry or exit of a potential competitor is not the highest regulatory priority.

The blind spot comes from the same regulatory focus. The potential transformative effects of peer-to-peer lending and from PayPal providing working capital loans to SMEs are examples of the types of digital disruption that the regulatory regime is destined, even designed, to ignore. These types of structural changes that arise from the innovation that is expected from a competitive environment are recognised by the smaller players, but are sometimes regarded as unimportant by the too-big-to-fail entities.

In order to address these blind spots, we offer two very specific proposals, which have the potential to increase competition in the retail banking sector without significant regulatory intervention.

4.7 Increasing competition – account number portability

4.7.1 Introduction

One of the issues which deters consumers from changing suppliers is the associated switching cost (Fuentelsaz, Maicas and Polo 2012; Colgate and Lang 2001). The Financial Conduct Authority (FCA), a UK financial regulatory body that is independent of the UK government, released a report in March 2015 that highlights the benefits of account number portability (bank account number portability) in encouraging consumers to switch. The report predominately concentrates on Current Account Switching Service (CASS), a service provided in the UK to allow for customers to switch more easily by automatically switching all direct debits, standing orders and bill payments within seven working days and providing a redirection service for up

to 13 months. The report also provides important insights into the workings of bank account number portability. These can be used to understand how this mechanism can be introduced into Australia as an effective tool to make switching easier and simpler, which is a necessary component in the financial system for vibrant competition.

4.7.2 Benefits of bank account number portability

The FCA report finds that bank account number portability would encourage more customers to switch. Based on recent quantitative consumer research, the report revealed that 35% of consumers and 40% of businesses ‘would be much more likely or more likely to switch if they had portable account details’ (Financial Conduct Authority 2015: 53). The research signalled that customers view bank account number portability as having ‘less risk and is more seamless as a process than CASS’, as there is no requirement to change details or to notify consumers of any changes (Financial Conduct Authority 2015: 53). Further quantitative research shows that, for small and medium-sized enterprises (SMEs) and charities, bank account number portability is viewed as a more convenient mechanism. This is because ‘they would not have to notify their customers of changing details, worry about transferring certain payments, make changes to stationery, or be concerned about what the change in account details may signal to their customers’ (Financial Conduct Authority 2015: 53). Moreover, bank account number portability is seen by customers as reducing the chances of encountering problems such as incoming payments going astray. Thus, the main benefits for incorporating bank account number portability are that switching is made easier and quicker for customers by allowing existing direct debits and credits linked to the account to be automatically transferred to the new institution, meaning that the risk of error for payments going amiss would diminish.

4.7.3 Possible implementation of bank account number portability

The FCA report provides technical advice on what measures are required for bank account number portability to be implemented. This includes the following prerequisites: payments, as well as the existing balance, would need to be transferred from the old to the new account, and a record of both the payments to be transferred and the current and any previous account numbers would also be required. Essentially, for bank account number portability to be effective, the customer’s details and payments would need to be accessible by the old and new institution.

According to the FCA report, these requirements could be dealt with via two different methods.

The first potential method is based on the existing market structure, but would incorporate bank account number portability by building additional infrastructure that includes the prerequisites, as previously referred to, such as retaining information on payments and account information, and routing payments and balances. This additional infrastructure would be run centrally, but providers would still work under their own existing systems. The second concept is a ‘central utility model’ based on a ‘central shared banking platform’. The ‘utility’ model could include features such as a ‘Know-Your-Customer’ (KYC) database (which stores the customer’s details for identification) and a ‘payment mandates database’ for all payments to be transferred through a common payment infrastructure that would identify which institution the account is linked to (Financial Conduct Authority 2015: 54). The idea is for providers to retain their different products and services, interest rates, internet banking sites, or mobile banking applications to continue offering competing products to customers, whilst using a common infrastructure system. Unfortunately, the FCA does not delve into the specifics of how bank account number portability would be implemented, but rather provides a framework to be further examined.

4.7.4 Portability implementation in Australia

Implementing account number portability in Australia would require compliance with the relevant regulatory safeguards, especially in the context of anti-money laundering and counter-terrorism, that have been constructed over the years. Consequently, an Australian model would need to include a ‘Know Your Customer’ database and a ‘payment mandates database’. Currently, the Australian payment system is based on the direct entry system, which essentially is a series of bilateral networks between financial institutions to facilitate the transactions of direct credits and debits. In other words, an electronic payment system to transfer money. For this to occur, each customer has a customer account number to identify the specific account, and a bank, state, branch (BSB) number to indicate which financial institution, state and branch the customer’s account number is linked to. To switch in Australia, customers are required to change their BSB, customer account number and redirect incoming or outgoing transactions to the new account details.

The Fraser (2011: 8) report, commissioned by the Australian government, developed a similar idea to the FCA report on bank account number portability. The report conceptualized an alternative numbering system with a central account registry to store the details of the customer’s account, including that of the customer’s institution, which would be updated each time a switch occurs, as well as, a ‘central hub’ or clearing house whereby all direct payments

would be transferred. The existing BSB number and account number system would thus be replaced with a unique customer account number with the clearing house and central registry acting as a mechanism for rerouting payments. The report alternatively describes the possibility of a de-centralized approach whereby institutions would be held responsible to reroute payments and retain their own account registry of switched account numbers which would be available to other financial institutions (Fraser 2011: 8). The report however, concludes by arguing that the costs involved in building the infrastructure necessary for bank account number portability and for it to function, outweighs the benefits.

Of interesting note however, the Fraser (2011) report does not provide a reason for why the current BSB and account number could not be merged to form a unique customer account number rather than having to develop a completely new one. Furthermore, the report does not examine whether a current banking institution, such as one of the four big banks could manage the centralized payments system, which could be checked by the remaining big banking institutions and would avoid the costs of establishing a new institution. Perhaps a simpler alternative however, could be to merge the current BSB and account number in order to form a unique customer account number rather than having to develop a completely new one. This parallels the mobile numbering approach where two digits after '04' previously indicated the network operator and now only do so for non-ported numbers.

4.7.5 Additional detailed option for bank account number portability

There is also a report by Jain and Kudidhi (2010) from the Infosys Institute that envisages a similar but much more detailed idea of how bank account number portability could be implemented, compared to the Fraser (2011) and Financial Conduct Authority (2015) report. The authors propose a method that entails a local database for each institution to initiate switching requests, as well as a central database with all customer account numbers that would be accessible to all banking institutions. A clearing house agency would be given the responsibility to manage this database by updating the requests made by the new serving bank and informing the old serving bank of the customer's request to switch. The old serving bank would be responsible for undertaking closure procedures including cancellations of ATM/Debit cards and transferring to the new bank the customer's details whilst informing the clearing agency of this process. Finally, the new bank would perform a KYC process requirement and make switching requests via its local database that is connected to the central database. The report however, does not provide any assessment of the costs involved in this bank account number portability

initiative. A centralised database system is also important and is sometimes regarded as a high cost item. However, a process could be established where one of the four big banks manages the database, which is then checked by the remaining big banking institutions. This would avoid the costs of establishing a new institution. In the telecommunications sector, Telstra runs the equivalent data repository known as the Integrated Public Number Database.

4.7.6 Summary

Introducing bank account number portability is an important step towards implementing a measure that would make switching quicker, easier and less risky, and which would, in turn, increase customer confidence and willingness to switch, a necessary component for vibrant competition.

4.8 Returning customer data

4.8.1 Introduction

For large corporations with access to consumer data, the challenge is to ensure that big data is used for helpful purposes, facilitating positive customer outcomes without being overbearing or intrusive. In usual parlance, this means that big data mustn't be creepy. In banking, it would be feasible for consumers to use their own data to find the best retail products between the banks, rather than within their current bank.

4.8.2 The data

Consumers create a rich data trail that is used by businesses to improve their product and service offerings. Banks, along with utility providers and telecommunications operators, collect detailed sets of information to tailor their best offerings. Currently, this data belongs to the service provider, rather than the consumer. However, it would be feasible to use that data to find the best offering from a range of providers, not just the one that is currently used. In the UK, there is a service available called 'midata' that allows consumers to download the data trail that they have left and which each of the service providers has collected. Applications program developers have been encouraged to start offering software that allows people to use their own data to find the best product offering for them across the sector. This UK service has been deployed on a mainly voluntary basis and is still in its early stages. In combination with consumer-friendly switching regulations, such as bank account number portability, midata offers consumers a way of using their own data to make product and service choices.

4.8.3 Australian perspective

This approach has been taken up in the CPR process (Harper et al. 2015). In their submissions to the Harper review panel, CHOICE argued that such a scheme would support ‘robust demand-side competition by enabling consumers to make better informed decisions’ and would encourage innovation. The ACCC put the case that ‘initiatives to allow consumers to effectively use their information ... have the potential to assist consumers to make better choices and drive competition’. Harper et al. (2015) also noted that the UK government believes that ‘being able to base decisions on their previous behaviour will mean individuals can choose products and services which better reflect their needs and offer them the best value’ and that this would also encourage innovation.

The report references the submissions of both CHOICE and the ACCC in coming to the view that:

- Markets work best when consumers are engaged, empowering them to make informed decisions.
- The Panel sees scope for Australian consumers to improve their access to data to better inform their decisions.

This led to a recommendation on informed choice that governments (at all levels) should ‘allow consumers to access information in an efficient format to improve informed consumer choice’. The CPR recommended that a working group should be set up to implement the recommendation. It then went further. It recommended ‘governments ... should draw on lessons from behavioural economics to present information and choices in ways that allow consumers to access, assess and act on them’.

4.8.4 Next steps

The consumer group peak body, the consumer law regulator and the competition policy review all agree that consumers’ access to their own data should proceed. The data formatting needs to be agreed in order to make the system useful. The midata approach and similar systems in the US can provide a model, but this needs to be standardised in Australia. In order for the approach to work, the Australian Bankers’ Association would need to take a lead in standardisation.

5 THE RISE OF CROWD EQUITY FUNDING: WHERE TO NOW?

5.1 Introduction

Over the centuries, a range of projects have been funded by small contributions from members of the public.¹ A notable example is the completion of the Statue of Liberty in the US. The construction of this iconic statue was almost derailed as it faced a range of financial challenges, which were overcome at a later stage as a result of donations made by the French and American public.² In fact, the pedestal of the Statue of Liberty was partially funded by a \$US102,000 donation campaign where 80% of the money came from donors who invested less than a dollar each.³

Today, the development of the internet and the rise of social media have created a new frontier for raising money to fund projects from the 'crowd' through crowdfunding.⁴ This form of finance is the result of the convergence of two concepts:⁵ crowdsourcing and microfinance. Crowdfunding relies on online web-based platforms to allow individuals, businesses and/or not-for-profit organisations to raise small amounts of money from a large number of people in order to fund a particular project, business venture or even personal loan.⁶ Crowdfunding has had a phenomenal growth since it gained traction in 2003.⁷ For example, in 2013, the capital raised from crowdfunding worldwide was just under \$US6.1 billion, a major jump from \$US2.7 billion in 2012.⁸ Further, the amount of funds sourced from crowdfunding is set to grow over the next

1 See for example, William Baumol and Hilda Baumol, 'On the Economics of Musical Composition in Mozart's Vienna' (1994) 18 *Journal of Cultural Economics* 171, 175-6; Carlos Gomes, Daniel Scheider, Katia Moraes and Jano de Souza, 'Crowdsourcing for Music: Survey and Taxonomy' (Paper presented at IEEE International Conference on System, Man and Cybernetics, Seoul, Korea, 14-17 October 2012), 1: For instance, Mozart financed some of his concerts and musical publications through advance subscriptions from the general public.

2 A thorough history of the funding of the Statue of Liberty can be found in: Yasmin Sabina Khan, *Enlightening the World: The Creation of the Statue of Liberty* (Cornell University Press, 2010) Chapter 11.

3 Enrico Wieck, Ulrich Brestschneider and Jan Marco Leimeister, 'Funding from the Crowd: An Internet-Based Crowdfunding Platform to Support Business Set-Ups From Universities' (2013) 22(3) *International Journal of Cooperative Information Systems* 1340007-1, 1340007-4.

4 Haichao Zheng, Dahui Li, Jing Wu and Yun Xu, 'The Role of Multidimensional Social Capital in Crowdfunding: A Comparative Study in China and US' (2014) 51 *Information Management* 488; Miguel Cavajal, Jose A Garcia-Aviles and Jose L Gonzalez, 'Crowdfunding and Non-Profit Media: The Emergence of New Models for Public Interest Journalism' (2012) 6 *Journalism Practice* 638.

5 Devashis Mitra, 'The Role of Crowdfunding in Entrepreneurial Finance' (2012) 13(2) *Delhi Business Review* 67, 68.

6 Eleanor Kirby and Shane Worner, *Crowd-Funding: an Infant Industry Growing Fast* (Staff Working Paper of the International Organisation of Securities Commissions Research Department, SWP3/2014, 2014), 4.

7 David Freedman and Matthew Nutting, 'A Brief History of Crowdfunding: Including Rewards, Donation, Debts, and Equity Platforms in the US' (22 June 2015) <<http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf>>; However, the term crowdfunding only appeared in 2006: Richard Harrison, 'Crowdfunding and the Revitalisation of the Early Stage Risk Capital Market: Catalyst or Chimera?' (2013) 15(4) *An International Journal of Entrepreneurial Finance* 283, 285.

8 Massolution Crowd Power business, 2015CF *The Crowdfunding Industry Report* (Massolution, 2015) 8.

decade, especially as a range of countries have started to amend their legislation to facilitate the development of this form of finance.⁹

There are different types of crowdfunding: donation crowdfunding, reward crowdfunding, peer to peer lending (P2P lending) and crowd equity funding (CEF).¹⁰ The first two types are community-focused, where the funders are not aiming to generate a financial return from their contribution to a particular cause or project.¹¹ In reward crowdfunding, the funders may receive a reward for their contribution.¹² This type of fundraising is especially popular for art projects such as the creation of movies and music videos, where the names of contributors may be added to the credits for the project and/or the contributors may receive a copy of the product when completed.¹³ This type of finance has also been relied on by companies looking to pitch their ideas. For example, Pebble used Kickstarter, an online platform, to test its idea for an e-paper watch – the Pebble watch – which could be customised to feature apps such as calendar notifications and emails. The organisation outlined its idea and noted that it needed to raise \$US100,000 to complete the Pebble watch. Different donation amounts had different rewards attached to them. A donation of \$US99 would allow the contributor to receive a watch when the product was manufactured. By the time the campaign was over, Pebble had raised \$US10,266,845, or 100 times the initial amount they wanted to raise.¹⁴ In 2014, \$US1.33 billion was raised through reward-based crowdfunding.¹⁵ Donation-based crowdfunding, which focuses on funding charitable or social causes and is strictly philanthropic, is also popular, having raised 1.94 billion worldwide during the same year.¹⁶

Unlike donation and reward crowdfunding, P2P lending and CEF focus on the generation of financial returns to investors. P2P lending forms the bulk of crowdfunding with \$US11.08 billion

9 See for example, Decreto-Legge 18 Ottobre 2012 n 179 ('decreto crescita-bis') for Italy, *Jumpstart Our Business Startups Act* for the US, *Financial Markets Conduct Regulation* in New Zealand.

10 Kirby and Worner, above n 6, 8-9.

11 Ibid 9.

12 Paul Belleflamme, Thomas Lambert and Armin Schwienbacher, 'Individual Crowdfunding Practices' (2013) 15(4) *Venture Capital: An International Journal of Entrepreneurial Finance* 313, 318.

13 Arts Law Centre of Australia, 'Crowdfunding: Information sheet' (2015) 3 <http://www.artslaw.com.au/images/uploads/Crowdsourcing_funding_info_sheet_19_01_15.pdf>; In October 2003, ArtistShare became the first online platform to promote reward crowdfunding where musicians seek contributions from their fans to produce their music. This platform has since raised funds for movies as well as photography projects. ArtistShare, 'About Us' <<http://www.artistshare.com/v4/About>>; Steve Gordon, *The Future of the Music Business: How to Succeed with the New Digital Technologies – A Guide for Artists and Entrepreneurs* (Backbeat Books, 2005) 234.

14 Kickstarter, 'Pebble: E-Paper Watch for iPhone and Android' <<https://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android/description>>.

15 Massolution Crowd Power business, above n 8, 14.

16 Ibid.

raised worldwide through this form of finance in 2014.¹⁷ P2P lending matches online lenders/ investors with borrowers in order to provide them with unsecured loans to fund a particular venture.¹⁸ The investors will receive interest as well as repayment of their loans at the end of the agreement.

While it is not as popular as P2P lending with only \$US1.1 billion raised worldwide in 2014,¹⁹ CEF allows companies to obtain seed or other capital through small equity investments from a large range of investors via an online portal. Investors receive shares in the company in return for their investment.²⁰ The biggest challenge for the growth of this type of crowdfunding is the fact that existing fundraising legislation in many countries has played a role in blocking or limiting the development of this form of finance since the legislation is skewed towards the protection of investors.²¹ For instance, in Australia, legislation requires a public company to issue costly disclosure documents to the general public before it is able to raise any equity funds from the market.²² However, a number of countries have been considering or have already implemented changes to their fundraising legislation that would allow CEF to flourish.²³

As Australia is one country currently considering the introduction of such a change,²⁴ this chapter will focus on the proposed Australian reforms regarding CEF. It will further draw on the international experience to discuss possible amendments in this area. Before doing so, however, it is important to understand the motivations behind such a change, as these should guide the proposals put forward to introduce CEF. Consequently, Part II of the paper will first consider the reasons behind the rise of CEF on government agendas around the world. Part III of the paper will focus on the Australian setting, by highlighting the different proposals that have been put forward to introduce legislation friendlier to CEF. The paper will then assess the best possible alternatives in view of international experience. The aim is to guide policy on crowdfunding to achieve the right balance between investor protection and entrepreneurship.

17 Massolution Crowd Power business, above n 8, 14.

18 Kirby and Worner, above n 6, 9.

19 Massolution Crowd Power business, above n 8, 14.

20 Corporations and Markets Advisory Committee (CAMAC), *Crowd Sourced Equity Funding – Report* (May 2014) 5.

21 See for example, Joseph Borg, 'Protecting Inventors and the Integrity of Capital Markets' (2007) 8(2) *Journal of Investment Compliance* 49

22 See for example, *Corporations Act 2001* (Cth), ss 606, 627.

23 For a summary of different initiatives, see CAMAC, above n 20.

24 Ibid; Australian Government, *Crowd-Sourced Equity Funding – Discussion Paper* (December 2014) <<http://treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Crowd%20Sourced%20Equity%20Funding/Downloads/PDF/CSEF%20Discussion%20Paper.ashx>>.

5.2 The rise of crowd equity funding

Since the global financial crisis took place in 2007, CEF has risen to the top of government reform agendas around the world, with a number of countries such as the US, New Zealand and Italy implementing law reforms to promote this type of finance while providing the necessary protection to investors.²⁵ While the legislative amendments adopted vary from one country to another, law reform initiatives, which usually take decades to come to fruition²⁶ have been fast-forwarded as a result of the opening of a window of opportunity that has allowed governments to implement changes to their fundraising legislation. According to Kingdon, this window for change was the result of a convergence of three independent streams which affect the public policy development process.²⁷ While Kingdon's work is focused on the US political system and has been subject to criticism,²⁸ in a 2001 survey of public policy scholars, it was classified as the top public policy paper of all time²⁹ and has been applied by Zahariadis in a variety of international contexts such as the European Union, Britain, Germany, France and Greece.³⁰ Kingdon's model provides a good illustration of the way CEF reforms have come to the forefront of government agendas.

5.2.1 A Kingdon model

Kingdon has developed a multiple-streams framework to explain the policy development process. In doing so, he rejected the assumption that policy development processes are always rational and logical. In fact, he notes that the setting of government agendas may involve 'considerable doses of messiness, accidents, fortuitous coupling and dumb luck'.³¹ Kingdon advocates that the policy development process is composed of three independent streams:

25 Decreto-Legge 18 Ottobre 2012 n 179 ('decreto crescita-bis') for Italy, *Jumpstart Our Business Startups Act* for the US, *Financial Markets Conduct Regulation* in New Zealand.

26 See generally John W Kingdon, *Agendas, Alternatives, and Public Policies* (HarperCollins, 2nd ed, 1995) 116.

27 Ibid 165–8.

28 See for example, Paul Sabatier (ed), *Theories of the Policy Process* (1999, 1st ed, Westview Press); Jonathan Bendor, Terry M Moe and Kenneth W Shott, 'Recycling the Garbage Can: An Assessment of the Research Program' (2001) 95 *American Political Science Review* 169; Scott Robinson and Warren Eiler, 'Participation in Policy Streams: Testing the Separation of Problems and Solutions in Subnational Policy Systems' (2010) 38(2) *The Policy Studies Journal* 199.

29 Brian Shoup, 'Policy Section Members Vote for the Most Important Works in Public Policy' (2001) 11(2) *Policy Currents* 14, 14.

30 Nikolaos Zahariadis, *Markets, States and Public Policies: Privatization in Britain and France* (University of Michigan Press, 1995); Nikolaos Zahariadis, *Ambiguity and Choice in Public Policy: Political Decision Making in Modern Democracies* (Georgetown University Press, 2003); Nikolaos Zahariadis, *Essence of Political Manipulation: Emotion, Institutions, and Greek Foreign Policy* (Peter Lang, 2005); Nikolaos Zahariadis, 'Ambiguity and Choice in European Public Policy' (2008) 15(4) *Journal of European Public Policy* 514.

31 Kingdon, above n 26, 206.

a problem stream, a policy stream and a political stream. It is the combination of these streams that allows for the opening of a policy window that may lead to reforms.

5.2.1.1 Problem Stream

While individuals may only attend to one problem at a time, the division of labour in governments allows them to deal with a number of issues at the same time.³² As such, at any one time policymakers and members of the public may be applying themselves to remedying a range of problems, such as government budget deficits, inflation, environmental disasters and overstretched medical systems. These problems come to the attention of the relevant authorities as a result of indicators, focusing events and feedback.³³

Indicators may be generated from the routine monitoring of various activities and events by relevant authorities. They can also be deduced from studies conducted on a particular issue by the government, non-government agencies or academics. It is important to note that indicators, while powerful, are flawed and have serious deficiencies.³⁴ As such, the method that leads to the gathering and interpretation of indicators may be subjective and may attract criticism.³⁵ Additionally, indicators by themselves are not self-evident of a problem. To get the attention of a government, they may need a nudge. This nudge is sometimes provided as a result of a focusing event such as a crisis or disaster that makes the problem more prominent. This then allows the government to focus on the problem. As one of Kingdon's respondents noted:³⁶

The whole [reform] process is crisis. This system responds to crisis. It's the only thing that it does respond to [Y]ou have to get hit on the side of the head before you do something.

However, it is rare for a crisis by itself to carry a subject to the top of the government agenda. A pre-existing perception that there is a problem may need to have existed in people's minds. In certain instances, the crisis may be viewed as a warning that requires investigation. A repeat of the crisis may redefine the problem.³⁷ Lastly, feedback about the operation of certain programs

32 Nikolaos Zahariadis, 'Ambiguity and Multiple Streams' in Paul Sabatier and Christopher Weible (eds), *Theories of the Policy Process* (Westview Press, 3rd ed, 2007) 28-9.

33 Kingdon, above n 26, 90.

34 Ibid 94.

35 Ibid 90-4.

36 Ibid 95.

37 Ibid 94-100.

may further highlight existing problems. Ultimately, recognition of the problem/s may bring the subject to a prominent place in the government's agenda.

5.2.1.2 Policy Stream

The policy stream is characterised by Kingdon as a 'policy primeval soup' of ideas that compete against each other to win acceptance by policy makers.³⁸ At any one time, communities of specialists ('policy communities') will be putting forward different ideas/solutions to various problems. These policy communities may be formed by specialists in a particular area and may include bureaucrats, politicians and their staff, academics, think tanks, interest groups and not-for-profit organisations. One of the unique features of such a community is that it 'hums along on its own, independent of such political events as changes of administration and pressure from legislators' constituencies'.³⁹

While a large amount of ideas/solutions will be put forward by policy communities, only a few will attract attention. These ideas are generated, debated, redrafted and accepted for consideration as genuine alternatives to the existing system.⁴⁰ The process of amendment and reconsideration of ideas may be incremental and may depend on the nature of the policy communities. If such communities are fragmented, it will be harder and so take longer to achieve a consensus.⁴¹ The consensus reached will, in the end, be the result of both persuasion and diffusion.⁴² Further, the solutions put forward are context dependent and will reflect the 'dominant thinking of the day'.⁴³ If viable solutions to a problem are available for adoption by the government, the chances the problem will be placed on the government's agenda are increased, since sufficient information on the problem and ways to remedy it will be able to be provided to decision-makers.

5.2.1.3 Political Stream

The political stream has its own dynamics and rules and is independent of the problem and policy streams discussed above. Its composition is made up of a range of factors such as the

38 Ibid 116.

39 Ibid 117.

40 Ibid 122.

41 Ibid,119-20.

42 Ibid 139-40.

43 Catherine Althaus, Peter Bridgman and Glyn Davis, *The Australian Policy Handbook* (Allen & Unwin, 5th ed, 2013) 35.

national mood, administrative or legislative election results, and pressure group campaigns.⁴⁴ For example, the national mood may influence government agendas as it reflects the way a large number of people are thinking regarding a particular problem. Similarly, if organised pressure groups lobby in relation to a particular issue, the government may view such support as a consensus to implement change.⁴⁵ Consequently, changes in the national mood and the consensus of pressure groups may lead to the promotion of certain items to the government's agenda or to their removal from it.⁴⁶

Additionally, administrative and/or legislative changes in government have a big impact on a government's policy agenda as they may result in a new political ideology and/or new priorities taking effect. While in the policy stream consensus is built through persuasion, consensus in the political stream is very differently achieved as it focuses on compromise and bargaining between political parties. Here, consensus is created as a result of the granting of concessions in return for support of a particular cause.⁴⁷ Finally, the combination of and commonality between all the factors discussed in the political stream have a powerful impact on the government agenda as they may result in some subjects being dropped from the government agenda or may lead to the promotion of certain issues to the top of the agenda.⁴⁸

5.2.1.4 Policy Window

The opening of a policy window provides an opportunity for advocates of a particular proposal to shape government agendas by bringing attention to a particular problem and championing their favourite solution. This window is usually opened as a result of a compelling problem that becomes prominent or due to political ideology. The solutions put forward to deal with the issues raised emerge from the consensus on this particular topic within the policy stream.⁴⁹ The window is most widely open when the three streams converge, as only then is there clear policy guidance/consensus on how a problem may be dealt with by the government.

44 Kingdon, above n 26, 87, 145-164.

45 Ibid 163.

46 Ibid 146, 150.

47 Ibid 159.

48 Ibid 164.

49 Ibid 173.

5.2.2 Application of the Model to CEF

Over the last five years, the topic of CEF has become prominent in a range of government agendas around the world. As noted previously, this prominence may be explained by applying Kingdon's model.

5.2.2.1 Problem Stream

Small and medium enterprises (SMEs)⁵⁰ are no longer viewed as mere stepping stones to big businesses but are recognised as key contributors to employment and economic growth⁵¹ in both national economies and the global economy.⁵² For example, in 2014, small businesses accounted for 48% of private sector employment in the United Kingdom (UK). Further, 33% of turnover in the private sector was generated by these firms.⁵³ Similarly, 2013 data indicates that SMEs are major employers in the Australian economy as they hire almost 70% of the workforce and are considered a major source of innovation.⁵⁴ The situation is similar in the US with the US Small Business Administration noting that '[small] businesses continue to be incubators for innovation and employment growth'.⁵⁵ The downturn in the global economy has in fact highlighted the vital role healthy small businesses play in revitalising the US economy.⁵⁶ In the European Union, SMEs are also viewed as the 'backbone of the European economy, providing a potential source of jobs and economic growth'.⁵⁷

While this may be the case, a range of indicators have illustrated that there is a shortfall in the finance of SMEs.⁵⁸ Traditionally, these firms cannot access public capital and raise funds from the market. As such, they may need access to external private financing.⁵⁹ However, information

50 The definition of small and medium enterprises includes start-ups.

51 Malcolm Harper, *Profit for the Poor: Cases in Micro-Finance* (London Intermediate Technology Publications, 1998) 17.

52 Meghana Ayyagari, Thorsten Beck and Asli Demircuc-Kunt, 'Small and Medium Enterprises Across the Globe' (2007) 29 *Small Business Economics* 415, 415; Javed Hussain, Cindy Millman and Harry Matlay, 'SME Financing in the UK and in China: A Comparative Perspective' (2006) 13(4) *Journal of Small Business and Enterprise Development* 584, 584; Francesca Pissarides, 'Is Lack of Funds the Main Obstacle to Growth? EBRD's Experience with Small - and Medium- sized Businesses in Central and Eastern Europe' (1999) 14 *Journal of Business Venturing* 519, 520.

53 Department for Business Innovation and Skills, 'Statistical Release – Business Population Estimates for the UK and Regions 2014' (26 November 2014, UK) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/377934/bpe_2014_statistical_release.pdf>.

54 Commonwealth of Australia, *Financial System Inquiry – Interim Report* (July 2014) 1-15.

55 Kathryn Kobe for Small Business Administration, *Small Business GDP: Update 2002-2010* (Report n 390, January 2012) 1.

56 Small Business and Entrepreneurship Council, 'Small Business Facts and Data – A Rundown on Key Facts, Numbers and Trends Regarding Entrepreneurship and Small Business' <<http://www.sbecouncil.org/about-us/facts-and-data/>>.

57 European Commission, 'Eurostat: Small Business Statistics – Small and Medium-Sized Enterprises (SMEs)' <<http://ec.europa.eu/eurostat/web/structural-business-statistics/structural-business-statistics/sme>>.

58 Jay Ebben and Alec Johnson, 'Bootstrapping in Small Firms: An Empirical Analysis of Change Over Time' (2006) 21 *Journal of Business Venturing* 851, 851.

59 Allen Berger and Gregory Udell, 'Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure' (2002) 112 *The Economic Journal* F32, F32.

asymmetry resulting from the opacity of the management and finances of these businesses, and the higher risk that may attach to them, has led to credit rationing by lenders⁶⁰ and has made it more expensive for small businesses to raise external funds from banks and investors. The situation is compounded for start-ups, as financial institutions cannot observe a start-up's track record for quality purposes and this makes lending to these ventures riskier and more unlikely.⁶¹

This reality has meant that SMEs as well as start-ups have been relying on personal wealth, family support and internal finance to fund their businesses.⁶² However, once a business has exceeded the internal financial resources available to it, its growth becomes dependent on external financing⁶³ which may be unavailable due to asymmetry of information and transactional cost. The shortfall in financing then creates an obstacle to the growth of the business.⁶⁴ In view of the key role these businesses play in the economy, this may have a negative impact on the productivity of the nation, the efficiency of markets and the rate of employment.⁶⁵ Further, it may prevent innovative businesses from becoming established. As noted by one Canadian researcher, 93% of inventive projects fail to reach the market because they are not viewed as commercial enough and as such are faced with the challenge of accessing funds from lenders and investors.⁶⁶ In fact, Craig et al noted that '[if] small businesses face credit rationing, the next Google, Microsoft, or Starbucks might wither on the vine for want of funding'.⁶⁷

It is important to note that the indicators attached to the problem of a shortage of finance for SMEs, as well as start-up businesses, may be flawed. For example, Oakey noted that 'overall the United Kingdom capital market for [SMEs] functions adequately [...], but] there persists a

60 Joseph Stiglitz and Andrew Weiss, 'Credit Rationing in Markets with Imperfect Information' (1981) 71(3) *The American Economic Review* 393; Frederick Scherr, Timothy Sugrue and Janice Ward, 'Financing the Small Firm Start-Up: Determinants of Debt Use' (1993) 3(1) *The Journal of Entrepreneurial Finance* 17, 18-19.

61 Gavin Cassar, 'The Financing of Business Start-ups' (2004) 19 *Journal of Business Venturing* 261, 265.

62 See for example, Douglas Holts-Eakin, David Joulfaian and Harvey Rosen, 'Entrepreneurial Decisions and Liquidity Constraints' (1994) 25(2) *The RAND Journal of Economics* 334; Clement Kong-Wing Chow and Michael Ka Yiu Fung, 'Small Businesses and Liquidity Constraints in Financing Business Investment: Evidence from Shanghai's Manufacturing Sector' (2000) 15 *Journal of Business Venturing* 363, 364; Hussain, Millman and Matlay, above n 52, 586, 592-3.

63 Allen Berger and Gregory Udell, 'The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle' (1998) 22 *Journal of Banking & Finance* 613, 627.

64 Mike Wright and Paul Westhead, 'Introduction' in Mike Wright and Paul Westhead (eds), *Advances in Entrepreneurship* (Volume 1, Edward Elgar Publishing, 2000), 1; Pissarides, above n 52, 534; Mirjam Schiffer and Beatrice Weder, *Firm Size and the Business Environment: Worldwide Survey Results* (International Finance Corporation, Discussion Paper Number 43, 2001).

65 Jurgen Egelin, Georg Licht and Fabian Steil, 'Firm Foundations and the Role of Financial Constraints' (1997) 9 *Small Business Economics* 137, 137.

66 Thomas Astebro, 'The Return to Independent Invention: Evidence of Unrealistic Optimism, Risk Seeking or Skewness Loving' (2003) 113 *The Economic Journal* 226, 227.

67 Ben Craig, William Jackson III and James Thomson, 'Credit Market Failure Intervention: Do Government Sponsored Small Business Credit Programs Enrich Poorer Areas?' (2008) 30 *Small Business Economics* 345, 346.

sentiment that particular niches of the demand side of this market are not operating efficiently (for example, early stage start-ups and high technology firms showing only moderate actual or potential growth)⁶⁸. As such, the problem may not be as widespread as believed. However, the conventional wisdom remains that the shortage of supply of finance from financial institutions and investors is the root of the inadequacy of the financing of SMEs.⁶⁹

This perceived problem relating to a shortfall in external funding for small businesses has become more prominent as a consequence of the global financial crisis. The resulting shock to the banking system had a negative effect on the supply of credit to these businesses as the cost of corporate and banking borrowing rose, leading to a fall in the lending volume of financial institutions.⁷⁰ There is now an even bigger shortfall of funding for SMEs as a result of the tightening of lending practices. These lending practices are especially influenced by the poor economic prospects for small businesses, stagnation of inter-bank lending and the increase of capital cost.⁷¹

Lastly, changes to regulatory regimes significantly impact on the lending practices of banks. For example, the decline in lending may be the result of the implementation of risk-based capital standards under the Basel Accord.⁷² Concerns have been raised that the adoption of Basel III may run the risk of limiting the availability of credit, raising the cost of lending and reducing the economic activity of nations.⁷³ For instance, the Organisation for Economic Co-operation and Development has noted that the implementation of Basel III requirements may lead to a reduction in the growth of lending to SMEs.⁷⁴ All these factors have emphasised the problem

68 Ray Oakey, 'A Commentary on Gaps in Funding for Moderate 'Non-Stellar' Growth Small Businesses in the United Kingdom' (2007) 9(3) *Venture Capital* 223, 224. See also Ed Vos, Andi Jia-Yuh Yeh, Sara Carter and Stephen Tagg, 'The Happy Story of Small Business Financing' (2007) 31 *Journal of Banking and Finance* 2648.

69 Augusto de la Torre, Maria Soledad Marinex Peria and Sergio Schmukler, 'Bank Involvement with SMEs: Beyond Relationship Lending' (2010) 34 *Journal of Banking and Finance* 2280, 2280.

70 Harrison, above n 7, 283; Victoria Ivashina and David Scharfstein, 'Bank Lending During the Financial Crisis of 2008' (2010) 97 *Journal of Financial Economics* 319, 319, 320; However, the decline in lending by banks may also be due to a decline in demand for such finance: businesses may postpone their expansion due to global uncertainty resulting from the crisis and the lowering of consumer demand for goods and supplies. See for example, Giovanni Dell'Ariccia, Enrica Detragiache and Raghuram Rajan, 'The Real Effect of Banking Crises' (2008) 17 *Journal of Financial Intermediation* 89, 90.

71 Organisation for Economic Co-operation and Development, 'The Impact of Global Crisis on SME and Entrepreneurship Financing and Policy Responses' (2009) 6 <<http://www.oecd.org/cfe/smes/43183090.pdf>>.

72 Berger and Udell, above n 59, F44.

73 Bill Allen, Ka Kei Chan, Alistair Milne and Steve Thomas, 'Basel III: Is the Cure Worse than the Disease?' (2012) 25 *International Review of Financial Analysis* 159, 159.

74 Organisation for Economic Co-operation and Development, 'Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard – Final Report' (2013) 32, <<http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME%282012%2912/FINAL&docLanguage=En>>; see also NSW Business Chamber, 'Small Business Access to Finance', 14 <http://www.nswbusinesschamber.com.au/NSWBC/media/Misc/Policy%20Documents/Local%20govt/Thinking%20Business/FINAL-Thinking-Business-Access-to-Finance_web.pdf>.

of the shortfall in finance for SMEs and have made this issue more prominent than was previously the case.

5.2.2.2 Policy Stream

As a consequence of the key role SMEs play in the economy, a range of options and ideas to help finance these ventures—such as bootstrapping, venture capital funding and government sponsored credit programs—has been put forward over the decades.⁷⁵ From the early 1990s, microfinance has been adopted by a range of countries as a means of combating social exclusion: this form of finance may provide an opportunity for people who come from disadvantaged backgrounds to establish small businesses through the availability of small loans.⁷⁶

The development of the internet, social media and crowdsourcing has allowed microfinance to be repackaged and launched in an online environment in a new format: crowdfunding (especially P2P lending).⁷⁷ This has led policy communities to view crowdfunding in general as a type of funding that could provide the necessary capital for both charitable and business ventures.⁷⁸ However, community-focused types of crowdfunding, especially reward crowdfunding, have their limitations as they do not allow investors to receive a financial return for their investment. A business wishing to raise only a small amount of capital may prefer reward crowdfunding, but if the capital required is more substantial, the business might consider profit-sharing types of crowdfunding.⁷⁹

75 Egel, Licht and Steil, above n 65; Joakim Winborg and Hans Landstrom, 'Financial Bootstrapping in Small Businesses: Examining Small Business Managers' Resource Acquisition Behaviors' (2001) 16(3) *Journal of Business Venturing* 235; Craig, Jackson III and Thomson, above n 67; Leslie Jeng and Philippe Wells, 'The Determinants of Venture Capital Funding: Evidence Across Countries' (2000) 6 *Journal of Corporate Finance* 241; Thorsten Beck and Asli Demircug-Kunt, 'Small and Medium-Size Enterprises: Access to Finance as a Growth Constraint' (2006) 30 *Journal of Banking and Finance* 2931.

76 For benefits and criticisms of microfinance see for example, Ben Rogaly and Thomas Fisher (eds), *Poverty, Social Exclusion and Microfinance in Britain* (Oxfam Publication, 1999); Naila Kabeer, 'Is Microfinance a 'Magic Bullet' for Women's Empowerment? Analysis of Findings from South Asia' (2005) 40(44/45) *Economic and Political Weekly* 4709; Nitin Bhatt and Shui-Yan Tang, 'Delivering Microfinance in Developing Countries: Controversies and Policy Perspectives' (2001) 29(2) *Policy Studies Journal* 319; Jonathan Tucker and Jonathan Lean, 'Small Firm Finance and Public Policy' (2003) 10(1) *Journal of Small Business and Enterprise Development* 50, 51.

77 See for example, MaryAnne Globble, 'Everyone is a Venture Capitalist: The New Age of Crowdfunding' (2012) 55.4 *Research Technology Management* 4, 5; Thomas Allison, Blackey Davis, Jeremy Short and Justin Webb, 'Crowdfunding in Prosocial Microlending Environment: Examining the Role of Intrinsic Versus Extrinsic Cues' (2015) 39(1) *Entrepreneurship Theory and Practice* 53, 55.

78 See for example, Commonwealth of Australia, *Financial System Inquiry – Final Report* (November 2014) 178; The Board of the International Organization of Securities Commissions, *SME Financing Through Capital Markets – Final Report* (July 2015) 31; European Commission, *Crowdfunding in the EU – Exploring the Added Value of EU Action* (Consultation Paper, October 2013) 6-9; Armin Schwienbacher and Benjamin Larraide, 'Alternative Types of Entrepreneurial Finance' in Douglas Cumming (ed), *The Oxford Handbook of Entrepreneurial Finance* (Oxford Press, 2012) 369; Paul Belleflamme, Thomas Lambert and Armin Schwienbacher, 'Crowdfunding: Tapping the Right Crowd' (2014) 29(5) *Journal of Business Venturing* 585.

79 Alexandra Sharp, 'Crowdfunding Success Factors' (2014) 5(7) *International Research Journal of Applied Finance* 822, 822-3.

As such, the model of P2P lending became more appealing. As noted previously, \$US11.08 billion was raised worldwide in 2014 through this form of finance.⁸⁰ However, P2P lending may not be attractive to businesses due to the costs it involves since, in addition to the setting up cost, the business has to repay the loan with interest to its investors irrespective of whether the business is profitable or not.⁸¹ Additionally, P2P lending may not be popular in certain countries. For example, Egypt does not have a P2P lending market for cultural reasons, as charging interest for loans is forbidden under Islam.⁸² This highlights how certain solutions may work for some countries but not others. Further, P2P lending does not provide investors with equity in the business: the investors can only be lenders, and this limits the choices and rights that they may have. Investors may also be attracted to having a stake in the business.⁸³ This is especially apparent in the US where ‘more than \$15 million in funding has been waiting on the sidelines [to] be invested in over 1,000 companies now that this bill [the *Jumpstart Our Business Startups Act (JOBS Act)*] has become law’.⁸⁴

Policy communities seem to have come together around the idea that CEF may provide a solution to dealing with the shortfall of finance available for small businesses.⁸⁵ The challenge then faced by the policy communities is that, in most countries, this type of finance is illegal and so requires a change in legislation.⁸⁶ A review of the different proposals put forward in countries such as the US, the UK, Italy, New Zealand and Australia has highlighted a consensus that the law needs to be amended to allow CEF to take place and prosper. The policy communities were united in putting forward proposals that focus on the establishment of three types of safeguards for investors. These safeguards target the regulation of businesses, intermediaries and investors, and they vary from one country to the next.⁸⁷ Accordingly, while there is a consensus that CEF may provide additional financial support to SMEs, the proposals put forward to

80 Massolution Crowd Power business, above n 8, 14.

81 Seth Freedman and Ginger Zhe Jin, ‘Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence from Prosper.com’ (November 2008, The Networks, Electronic Commerce, and Telecommunications Institute) 3, <<http://www.microfinancegateway.org/library/do-social-networks-solve-information-problems-peer-peer-lending-evidence-prospercom>>.

82 Kirby and Worner, above n 6, 53.

83 Jorge Pesok, ‘Crowdfunding: A New Form of Investing Requires a New form of Investor Protection’ (2014) 12 *The Dartmouth Law Journal* 146, 148.

84 The *JOBS Act* creates an exemption in the US that allows CEF to be conducted by companies as long as a range of safeguards are in place: Ben Popper, ‘JOBS Act Becomes Law, but Questions Linger about Potential for Fraud’ VB News (5 April 2012) <<http://venturebeat.com/2012/04/05/crowdfunding-bill-becomes-law-but-questions-linger-about-potential-for-fraud/>>.

85 See summary of development of CEF in CAMAC, above n 20.

86 Schwienbacher and Larralde, above n 78, 379.

87 See summary of different CEF initiatives around the world in CAMAC, above n 20.

introduce it into the legislation of different countries have varied and the final solution to be adopted has depended on the local context and political agenda.

5.2.2.3 Political Stream

Most government philosophies and ideologies support proposals that promote employment, innovation and the cutting of red tape for SMEs.⁸⁸ The occurrence of the global financial crisis has pushed governments around the world to think of new ways to broaden the funding opportunities for these businesses to counteract the economic downturn, as this would have negative impact on the national mood.⁸⁹ For example, in the US, the White House noted the importance of allowing small businesses to raise funds from investors efficiently with President Obama observing SMEs are key drivers for the recovery of the economy.⁹⁰ In Italy, the Italian Minister of Economy and Development requested a taskforce put forward proposals to encourage and enhance the establishment and development of innovative start-ups.⁹¹ Similarly in Australia, the 2015-16 Budget supported initiatives that ‘will help small businesses invest more, grow more, and employ more [people]’.⁹² Further, the Australian Department of Broadband, Communication and Digital Economy highlighted the importance of relying on technology to attract finance and recommended a review of CEF due to its popularity as a finance model in different countries.⁹³ Accordingly, governments around the world are considering different options to enhance the flow of capital to SMEs.

5.2.2.4 Opening of a Window

The perceived shortfall of funding for SMEs, combined with the global financial crisis and the resulting drying up of funding for these businesses, brought this problem to the attention of a number of governments around the world. As there seems to be an acceptance in the

88 See for example, European Commission, ‘Council Recommendation on the Implementation of the Broad Guidelines for the Economic Policies of the Member States Whose Currency is the Euro’ (2015) 2 <http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_euroarea_en.pdf>; European Commission, ‘Council Recommendation on Italy’s 2012 National Reform Programme and Delivering a Council Opinion on Italy’s Stability Programme for 2012-2015’ (2012) 6, recommendation 3 and 6 <http://ec.europa.eu/europe2020/pdf/nd/csr2012_italy_en.pdf>.

89 Ross Weinstein, ‘Crowdfunding in the US and Abroad: What to Expect When Expecting’ (2013) 46 *Cornell International Law Journal* 427, 427.

90 White House, ‘President Obama to Sign Jumpstart Our Business Startups (JOBS Act)’ (Press release, 5 April 2012) <<https://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act>>.

91 Taskforce on Startups Established by the Minister of Economic Development, ‘Restart Italia: Why We Have to Restart from the Youth, Innovation and Startups’ (2012, transl by Dana Candek) 3.

92 Commonwealth of Australia, *Budget 2015 – Growing Jobs and Small Business* (2015) 2 <http://www.budget.gov.au/2015-16/content/glossy/sml_bus/download/Growing_Jobs_and_Small_Business.pdf>.

93 Australian Government, Department of Broadband, Communications and the Digital Economy, *Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy* (2013) 33 <<http://apo.org.au/files/Resource/Advancing-Australia-as-a-Digital-Economy-BOOK-WEB.pdf>>.

general community that the development of technology would allow crowdfunding to prosper and enhance the national as well as the global economy, partisan support was easier to establish in relation to this matter due to the national mood being supportive of crowdfunding. Further, the popularity of crowdfunding in general made it feasible for policy communities to reach a consensus that CEF may provide an opportunity to remedy the perceived problem. Consequently, the convergence of the three streams meant that CEF rose to the top of government agendas. A window of opportunity arose to implement change to support this new form of finance. In fact, a range of countries such as New Zealand, Italy and the US are implementing new amendments to promote the use of CEF.⁹⁴ In Australia, changes in this area are also currently being considered, with the government putting forward different models that may promote CEF.⁹⁵ The government has further noted that '[removing] obstacles to crowdsourced equity funding will help promote small businesses' access to finance by increasing the availability of innovative sources of funding'.⁹⁶

5.3 Australia's position – what alternatives to adopt?

While CEF may provide one solution to the perceived shortfall of funding for SMEs, the current Australian legislation does not promote this type of funding. As such, legislative reforms are being contemplated by the government. Part III of this chapter considers the current Australian position to assess the need for a change in the legislation. It then evaluates the proposals put forward by the government and compares them to approaches adopted in other countries. Do the reforms proposed achieve a balance between consumer protection and the promotion of business, thus ensuring compatibility with the reasons that have pushed this item to the top of the government agenda?

5.3.1 The Status Quo

Fundraising legislation in Australia has been significantly reformed by the enactment of the *Corporate Law Economic Reform Program Act 1999* (Cth) (CLERP), the *Financial Services Reform Act 2001* (Cth) and the *Corporations Legislation Amendment (Simpler Regulatory System)*

⁹⁴ Decreto-Legge 18 Ottobre 2012 n 179 ('decreto crescita-bis') for Italy, *Jumpstart Our Business Startups Act* for the US, *Financial Markets Conduct Regulation* in New Zealand.

⁹⁵ Australian Government, above n 24.

⁹⁶ Commonwealth of Australia, above n 92, 15.

Act 2007 (Cth). These reforms were driven by the following policy and political philosophies:⁹⁷

- promoting market confidence, stability and liquidity;
- assisting with the expansion of the economy, particularly growth in the small business sector;
- creating new employment opportunities;
- bringing innovative products and services to the market.

As such, the motivations behind the proposed introduction of CEF are familiar and compatible with the reasons behind the introduction of the fundraising regime. Consequently, reforms in this area may be complimentary to the current legislation.

5.3.2 Law on Fundraising

The fundraising laws in Australia embody a philosophy of *investor protection through disclosure*.⁹⁸ Under the current Australian regime, public companies⁹⁹ are the only companies that are allowed to issue securities¹⁰⁰ to the public if they comply with the disclosure requirements set out in the legislation.¹⁰¹ Such a company will have to issue a prospectus¹⁰² to advise potential investors of any information a reasonable person needs to know to be able to make an informed decision about whether to invest in the company or not.¹⁰³ However, this disclosure document can be costly. Consequently, other alternatives to prospectuses have been put forward to increase the efficiency of fundraising rules and reduce the cost to businesses. For example, depending on the situation, companies may use short form prospectuses¹⁰⁴ or an offer

97 Commonwealth of Australia, Fundraising: Capital Raising Initiatives to Build Enterprise and Employment (Corporate Law Economic Reform Program, Proposal for Reform: Paper No 2, 1997) 10 <<http://lowpollutionfuture.treasury.gov.au/documents/282/PDF/full.pdf>>.

98 ASIC v Axis International Management Pty Ltd (No 5) (2011) 81 ACSR 631, [203]; Re Golden Gate Petroleum Ltd [2010] FCA 40, [24].

99 A public company is defined under the *Corporations Act 2001* (Cth) as a company other than a proprietary company: see s 9 of the *Corporations Act 2001* (Cth). A proprietary company may be defined as a company that cannot issue securities on the market and cannot have more than 50 non-employee members: s 113 of the *Corporations Act 2001* (Cth).

100 The definition of securities is contained in ss 700(1) and 761A of the *Corporations Act 2001* (Cth). A security can be a share or a debenture in a company.

101 *Corporations Act 2001* (Cth), ss 706, 727.

102 The prospectus may be issued in electronic form: see Commonwealth of Australia, Corporate Law Economic Reform Program: Policy Reforms (AusInfo, Canberra, 1998) 1.

103 *Corporations Act 2001* (Cth), s 710.

104 Companies may send short form prospectuses to retail investors with technical information contained in separate documents which will be available on request: see ss 705 and 709 of the *Corporations Act 2001* (Cth).

information statement.¹⁰⁵

The legislation further allows companies to raise capital without the issue of a disclosure document if certain criteria are met.¹⁰⁶ The main offers of securities that are exempted from the disclosure regime under the *Corporations Act 2001* (Cth) are:¹⁰⁷

- Small scale personal offers: personal offers in a company do not need disclosure to investors if the offer is made to no more than 20 investors and the offer does not exceed \$2 million during a period of 12 months.¹⁰⁸
- Sophisticated investors: A person may be classified as a sophisticated investor and does not need to receive a disclosure document if they fulfil one of the following criteria:
 - the minimum investment made to purchase the securities is at least \$500,000;¹⁰⁹ or
 - the person to whom the offer of securities is made has net assets of at least \$2.5 million, or has a gross income for each of the last two financial years of at least \$250,000 per annum, as determined from a certificate given by a qualified accountant no more than six months before the offer is made;¹¹⁰ or
 - the offers are made through a financial services licensee to experienced investors where the licensee believes on reasonable grounds that the investors have previous experience in investing in securities and can assess the merits of the offer.¹¹¹
- Professional investors: Disclosure documents are not required in a case where the issue of securities is aimed at professional investors.¹¹² The definition of a professional investor can be found in section 9 of the *Corporations Act 2001* (Cth) and includes:
 - financial services licensees acting on their own behalf;

105 An offer information statement has lower disclosure requirements than a prospectus (see s 715 of the *Corporations Act 2001* (Cth)). This disclosure document allows small and medium enterprises to raise up to \$10 million (before the changes made by the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (Cth) the amount was \$5 million) without subjecting them to the cost of a prospectus. Companies who seek to raise larger amounts would be expected to be capable of bearing the cost of prospectus preparation.

106 *Corporations Act 2001* (Cth), ss 708, 708AA and 708A.

107 The company issuing the securities has the onus of proving that they fall under the exceptions of s 708: *ASIC v Great Northern Developments Pty Ltd* (2010) 79 ACSR 684, [44]; For a discussion covering all the exemptions under the *Corporations Act 2001* (Cth), see Robert Austin, Ian Ramsay, *Principles of Corporations Law* (LexisNexis, 16th ed, 2015), 1311-1325.

108 *Corporations Act 2001* (Cth), ss 708(2), (3) and (4); *ASIC v Cyclone Magnetic Engines Inc. & Ors* [2009] QSC 58, [26].

109 *Corporations Act 2001* (Cth), s 708(8)(a) and (b).

110 *Corporations Act 2001* (Cth), s 708(8)(c); *Corporations Regulation* (Cth), reg 6D.2.03.

111 *Corporations Act 2001* (Cth), s 708(10).

112 *Corporations Act 2001* (Cth), s 708(11).

- trustees of superannuation funds which have net assets of at least \$10 million; and
- persons who control at least \$10 million.

Additionally, if an offer, or intended offer, of securities requires a disclosure document, a person (not just the securities issuer) must not advertise the offer, or intended offer, or publish a statement referring to the offer or be reasonably likely to induce people to purchase the securities.¹¹³ This general restriction on advertisement and publicity is aimed at ensuring that the disclosure documents remain the main source of information for investors.

5.3.3 Australian Small Scale Offering Board

Policy communities have been considering the issue of financing SMEs for decades. For example, in 1997, the Australian Industry Commission issued an Information Paper that noted the importance of allowing SMEs to trade their shares in new markets.¹¹⁴ This influenced the ASIC to issue exemptions that then allowed the Australian Small Scale Offering Board (ASSOB) to be established.¹¹⁵ This online platform allows public unlisted companies to issue shares in their companies to the public without the need for a disclosure document.¹¹⁶ This has been viewed by a range of authors as a form of CEF.

However, such classification may be misleading. ASSOB has been able to go around the fundraising rules through its reliance on the small scale personal offers exception in the *Corporations Act 2001* (Cth).¹¹⁷ Further, this platform has received an exemption from the advertisement restrictions imposed by fundraising legislation.¹¹⁸ Accordingly, while raising funds through this platform is targeting the public, investments in the company are limited to 20 investors (the ceiling for small scale personal offers). This has been an issue in the past for SMEs as the amounts invested cannot be characterised as small amounts of money. For instance, if a company sought to raise \$1 million through this platform, certain investors would have to invest a minimum of \$50,000. In fact, the average investment through ASSOB is \$30,000.¹¹⁹ This would

113 *Corporations Act 2001* (Cth), s 734.

114 Industry Commission, *Informal Equity Investment – Small Business Research Program* (Information Paper, 1997).

115 Matt Vitins, 'Crowdfunding and Securities Laws: What the Americans Are Doing and the Case for an Australian Crowdfunding Exemption' (2013) 22(2) *Journal of Law, Information and Science* 92, 109-110.

116 Australian Small Scale Offering Board, 'About ASSOB' <<https://www.assob.com.au/about.asp?page=1>>.

117 *Corporations Act 2001* (Cth), ss 708(2), (3) and (4); ASIC, Class Order 02/0273.

118 ASIC, Class Order 02/0273.

119 Australian Small Scale Offering Board, *Crowd Sourced Funding – Submission to the Corporations and Markets Advisory Committee* (2013), 1.

put ASSOBS at the high end of the scale for crowdfunding.

Accordingly, even though ASSOBS has helped raise over \$143,518,923 since its establishment,¹²⁰ it has been lobbying for the removal of the 20 investors ceiling, as this is considered to be hindering certain businesses from achieving their targets.¹²¹ Consequently, the ASSOBS format is not the answer to achieving the policy objectives behind CEF. Specific reforms to the fundraising system are needed.

5.3.4 What Level of Regulation is Required?

As noted previously, proposals in relation to the regulation of CEF should attract three key safeguards: the regulation of businesses, the regulation of intermediaries and the regulation of investors. However, a review of these safeguards indicates that different countries have adopted or championed different levels of scrutiny and protection, with some legislative changes becoming a hindrance to CEF.

5.3.4.1 Need for Protection

Although CEF may provide a financial solution for businesses looking for extra capital to expand their ventures or transform their ideas into reality, the deregulation of fundraising provisions comes at a risk as investors attracted to crowdfunding in general are not your 'standard, experienced' investors. They are more likely to view crowdfunding as a social phenomenon.¹²² Even in instances where CEF provides the necessary funds for a business and the business does in fact prosper, the investors may not realise at the time they are investing that there will be few options available to them to subsequently sell their shares as there is no, or a very limited, secondary market for the trading of such shares.¹²³

Further, the allure of possible easy riches may attract a range of investors to invest in companies without assessing the likelihood of success of the venture. This is especially the case as CEF is being endorsed by prominent leaders such as US President Obama.¹²⁴ This would accentuate a range of pitfalls attached to investments in general. For instance, CEF raises the risk of

120 Australian Small Scale Offering Board, above n 116 .

121 Ibid.

122 Paul Belleflamme and Thomas Lambert, 'Crowdfunding: Some Empirical Findings and Microeconomic Underpinnings' (2014) 4 *Revue Bancaire et Financiere* 288, 290.

123 Karima Bouaiss, Isabelle Maque and Jerome Meric, 'More than Three's a Crowd ... in the Best Interest of Company! Crowdfunding as Zeitgeist or Ideology?' (2015) 10(1) *Society and Business Review* 23, 23-24.

124 Michael Dorff, 'The Siren Call of Equity Crowdfunding' (2014) 39 *The Journal of Corporation Law* 493, 498.

fraudulent activities. While fraud is a common problem in business,¹²⁵ this may be accentuated in an online environment. Since raising money can be quicker online, a fraudster may raise capital quickly and then abscond with it before anyone realises that a fraud has been committed.¹²⁶ Consumer protection advocates have noted that CEF may pose a danger for older investors who are already the target of securities fraud. AARP Senior Vice President Joyce Rogers notes that crowdfunding online platforms (the intermediaries) ‘could become the new turbo-charged pump-and-dump boiler room operations of the Internet age’.¹²⁷ Each of the different types of crowdfunding has already been the subject of fraudulent activities. Kickstarter, a popular US crowdfunding intermediary, has promoted a range of projects that were fraudulent.¹²⁸ For instance, one project called the ‘Kobe Red’ was all about producing the first 100% Japanese Kobe Beef Jerky made from beer-fed cattle. The project raised \$US120,309 from 3,252 backers. The amount raised was in fact 50 times more the campaign’s original goal. However, it was soon discovered that the project was a scam.¹²⁹ Despite the relatively small losses of investors, such scams have led the attorney general in Washington State and more recently the Federal Trade Commission to send a message to fraudsters by taking action to protect and compensate consumers from fraudulent Kickstarter campaigns.¹³⁰

Additionally, it is important to remember that equity investment in small business is risky in any event, as small businesses have well-documented high rates of failure.¹³¹ Start-ups are even riskier. In Australia and the US, the rate of failure of these businesses is 95% and 90% respectively.¹³² In the UK, over 50% of start-ups fail by their fifth year of operation.¹³³ Further, with

125 See for example, George Robb, *White-Collar Crime in Modern England: Financial Fraud and Business Morality 1845-1929* (Cambridge, 1992).

126 Gmeleen Faye B Tomboc, ‘The Lemons Problem in Crowdfunding’ (2013) 30 *Journal of Information Technology and Privacy Law* 253, 266.

127 As cited in Joe Eaton, ‘Using Crowdfunding to Start Your Business’ (AARP The Magazine, October/November 2013) <<http://www.aarp.org/money/investing/info-10-2013/crowdfund-investing-in-small-business.2.html>>.

128 See for example, Michael Numez, ‘Kickstarter Crooks: The Biggest Frauds in Crowdfunding’ (19 February 2014) <<http://www.supercompressor.com/gear/kickstarter-frauds-worst-crooks-in-crowdfunding>>.

129 Ibid; Magnus Fun Inc, ‘Kobe Red – 100% Japanese Beer Fed Kobe Beef Jerky’ Kickstarter <<https://www.kickstarter.com/projects/kobered/kobe-red-100-japanese-beer-fed-kobe-beef-jerky/description>>.

130 ‘US Authorities Target Crowdfunding Fraud on Kickstarter’ *BRW* (02 May 2014) <http://www.brw.com.au/p/business/us_authorities_target_crowdfunding_UFUKuSxPQ1pcXdsUNa66uM?>; Amy Schatz, ‘FTC Takes First Action Against a Fraudulent Kickstarter Campaign’ (11 June 2015) <<http://recode.net/2015/06/11/ftc-takes-first-action-against-a-fraudulent-kickstarter-campaign/>>.

131 See for example, Sharp, above n 79, 825.

132 Evan Schwaten, ‘The Grim Reality of Start-ups: 95 Per Cent Fail’ *Sydney Morning Herald* (Online, 20 March 2015), <<http://www.smh.com.au/business/the-grim-reality-of-startups-95-per-cent-fail-20150320-1m3wtb.html>>; Max Marmer and Ertan Dogrultan, *Startup Genome Report Extra on Premature Scaling: A Deep Dive Into Why Most High Growth Startups Fail* (Report Vol 1, 2012) 4, <https://s3.amazonaws.com/startupcompass-public/StartupGenomeReport2_Why_Startups_Fail_v2.pdf>.

133 Elizabeth Anderson, ‘Half of the UK Start-ups Fail within Five years’ *The Telegraph* (Online, 21 October 2014) <<http://www.telegraph.co.uk/finance/businessclub/11174584/Half-of-UK-start-ups-fail-within-five-years.html>>.

P2P lending, for example, rates of default on repayment to investors have been so high they may even ‘rival or exceed those of credit-card borrowers at big banks’.¹³⁴

With the promotion of CEF, business failure may become more pronounced, as it is important to remember that merely attracting the funds sought is not a guarantee of a business’s success. Businesses still need to convert their pitch into reality and this can be challenging, as many businesses are start-ups and do not have the necessary know-how or experience to achieve their objectives. One key problem that emerges from the review of crowdfunding projects in general is that they may be underfunded, since entrepreneurs may have concerns about asking for too much money from investors. They may also underestimate the costs involved in their project.¹³⁵ Further, even well-funded projects may have trouble achieving their aims as a result of interdependencies that are involved in product development.¹³⁶

5.3.5 Getting the Balance Right

In view of the benefits and risks attached to CEF, it becomes vital to provide a legislative exemption that protects consumers while allowing CEF to thrive. Achieving such a balance has its challenges. On the one hand, having laws that deregulate the system for the purpose of promoting competition to the detriment of consumer protection may enhance entrepreneurship, but may also negatively affect the stability of the financial system as fraud and business failure may become more prominent. On the other hand, having exemptions so targeted at the protection of consumers that they fail to promote businesses defeats the purpose of including a CEF exemption in the legislation, since very few businesses will then be able to raise capital via this form of finance. Further, such an exemption would not be supported by the policy communities which are currently lobbying for the establishment of a balanced approach to the regulation of CEF.

In short, it is easy to skew the balance towards one side or the other. This challenge was summarised by US Senator Mary Landrieu in discussing the possible introduction of a crowdfunding exemption in the US setting:

134 Eric Chaffe and Geoffrey C Rapp, ‘Regulating Online Peer to Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry’ (2012) 69(2) *Washington and Lee Law Review* 485, 507.

135 Symposium Panel II, ‘Crowdfunding’ (2013) 16 *SMU Science and Technology Law Review* 59, 66-7.

136 Ethan Mollick, ‘The Dynamics of Crowdfunding: An Exploratory Study’ (2014) 29 *Journal of Business Venturing* 1, 11.

*This isn't about a conservative-liberal fight. This is about the right regulations that are necessary before we take a good idea and mess it up. Crowdfunding is a good idea. It is an exciting idea. There are great entrepreneurs out there. The Internet could be a very powerful tool. But everyone knows if you enter into new territory without caution and care, you can fall off a cliff that you didn't even know was there.*¹³⁷

A perfect example of an unbalanced system can be found in Italy, which in 2012 became the first country in Europe to enact CEF laws.¹³⁸ The Italian CEF exemption to fundraising laws is based on providing protection to consumers through the regulation of businesses, intermediaries and investors:

- Business regulation: Italian law permits a business to raise a maximum of €5 million through CEF. This amount is substantial and does provide businesses with a large amount of capital to achieve their aims without needing to rely on a disclosure document. However, CEF is only available to certain types of businesses classified as 'innovative start-ups'. Very strict rules apply to this classification: the definition requires a business to have been in existence for no more than 48 months and be recognised as 'innovative' by the Chamber of Commerce, a concession that has to be updated every six months.¹³⁹ A business may be viewed as innovative if its purpose, for example, is 'the development and commercialisation of high-tech value products or services'.¹⁴⁰ The strict classification excludes a number of businesses including many start-ups, which goes against the reason for having introduced the legislation in the first place.¹⁴¹ Consequently, since the introduction of the exemption, less than 20 projects have been able to rely on CEF to raise the capital necessary for them to get off the ground. Further, the total amount raised through the CEF exemption has been less than €1.5 million.¹⁴²

137 158 Congressional Record S1,717 (daily ed 15 March 2012) (Statement of Senator Mary Landrieu).

138 European Crowdfunding Network, *Regulation of Crowdfunding in Germany, the UK, Spain and Italy and the Impact of the European Single Market* (Report, June 2013) 6 <http://www.osborneclarke.com/media/filer_public/51/b3/51b3007b-73aa-4b9a-a19d-380fc1d6ff35/regulation_of_crowdfunding_ecn_oc.pdf>.

139 Decreto-Legge 18 Ottobre 2012 n 179 ('decreto crescita-bis'), article 25.

140 CAMAC, above n 20, 226; for further discussion see Ministero Dello Sviluppo Economico, 'Executive Summary of the New Italian Legislation on Startups' (November 2012) 2-3.

141 Taskforce on Startups Established by the Minister of Economic Development, above n 91, 16-17.

142 Moody's Investors Service, 'Italian SME ABS – The Extension of Equity Crowdfunding to Innovative SMEs is Only Mildly Positive for Italian ABS SME Securitisations' (Sector Comment, 8 April 2015) <http://bebeez.it/wp-content/blogs.dir/5825/files/2015/04/Moodys_Innovative-SME_Crowdfunding_Full-Report.pdf>.

- For this reason, in 2015, the Italian Government expanded the eligibility criteria from ‘innovative start-ups’ to ‘innovative SMEs’. However, even the expanded criteria is viewed as narrow and restrictive as it still excludes the majority of businesses from applying for funding. According to Moody, ‘in 2012, only 10% of Italian manufacturing companies qualified as being high technology-intensive. High technology-intensive SMEs, as per the decree, would need to have above-average research and development expenditures and value added activities’¹⁴³ to be able to access this form of finance.
- Intermediaries: CEF online platforms must follow specific rules to ensure that they comply with anti-laundering laws and the EU Markets in Financial Instruments Directive (MiFID), and they must be classified as ‘permitted managers’. Further, they are responsible for verifying that the businesses advertising on their platforms have satisfied all the requirements necessary to enable them to access finance through crowdfunding.¹⁴⁴ They are also required to match investors’ profiles with investment risk.¹⁴⁵
- Investors: Investors are required to complete a questionnaire to ensure that they fully understand the risks attached to crowdfunding.¹⁴⁶

The Italian law additionally requires professional investors, banks or start-up incubators to play a role in the process of CEF as they must own at least 5% of the equity of a crowdfunded firm after the crowdfunding exercise takes place. If such an investment does not eventuate, the fundraising would be invalid.¹⁴⁷ While the aim behind all these safeguards is to protect investors from business failure and fraud, the Italian regulation fails to provide a solution for the motivations and problems that led to the introduction of the CEF exemptions to the system: the existing laws make it difficult for all types of businesses (including innovative businesses) to raise funds through CEF. These protections defeat the purpose behind the introduction of the reforms that were supposed to facilitate CEF. As a result, a more balanced approach is needed.

143 Global Credit Research, ‘Italian Decree to Give Innovative SMEs Crowdfunding Access is Only Mildly Positive for ABS SME Securitisations’ (Moody’s Investors Service Announcement, 8 April 2015) <https://www.moody.com/research/Moodys-Italian-decree-to-give-innovative-SMEs-crowdfunding-access-is--PR_322486?WT.mc_id=AM--WWFob29fRmluYW5jZV9TQl9SYXRpbmcgTmV3c19BbGxfRW5n~20150408_PR_322486>.

144 Commissione Nazionale Per Le Società E La Borsa (CONSOB), Regolamento Consob n. 18592 sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line, articles 14, 18.

145 Commissione Nazionale Per Le Società E La Borsa (CONSOB), Regolamento Consob n. 18592 sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line, article 17; Exemptions do exist for such a requirement. See CAMAC, above n 20, 226-7.

146 Commissione Nazionale Per Le Società E La Borsa (CONSOB), Regolamento Consob n. 18592 sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line, article 15.

147 Commissione Nazionale Per Le Società E La Borsa (CONSOB), Regolamento Consob n. 18592 sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line, article 24.

5.3.6 Proposals and Alternatives

Australia is currently considering two different proposals that may permit CEF to be exempt from its fundraising provisions. One proposal, referred to in this chapter as the CAMAC model, has been put forward by the Corporations and Markets Advisory Committee.¹⁴⁸ The other proposal—referred to in this chapter as the NZ model—is based on the New Zealand law reforms in this area.¹⁴⁹ While both proposals have adopted the policy communities’ consensus proposal regarding focusing regulation on the three safeguards referred to previously, the level of consumer protection adopted by each model varies. The paper compares the proposals to highlight their similarities and differences, and then proposes the adoption of a new exemption to allow CEF to prosper while providing the necessary protection for consumers.

5.3.6.1 Business Regulation

One of the safeguards proposed in Australia is the imposition of certain regulations on businesses who are trying to raise capital from the public. This is an important safeguard because, as noted previously, there is a risk of fraud and business failure attached to crowdfunding. Both the CAMAC and the NZ models impose a cap on investments through CEF. The proposed cap under both models is \$2 million in any 12-month period limited to one class of shares – ordinary fully paid shares.¹⁵⁰ This cap is appropriate for the following reasons:

- Around the world, the average amount raised by different types of crowdfunding to date is less than \$2 million. For example, in 2014, the average amount that a business raised from P2P lending was \$US103,618. In the case of CEF, the average amount varied from region to region, with averages ranging from \$US175,000 in North America to an average of \$US342,260 in Asia.¹⁵¹
- The \$2 million cap is consistent with the seed capital requirement that the majority of start-ups may need.¹⁵²

148 CAMAC was established in 1989 to provide the responsible Minister with an independent source of advice on the amendment of the corporations legislation, the operation and administration of that legislation, and the enhancement of financial services laws to ensure their efficiency: <www.camac.gov.au>. Despite the central role CAMAC has played in implementing reforms that have cut red tape and enhanced business efficiency, the Australian government is planning to abolish CAMAC: Australian Securities and Investments Commission Amendment (Corporations and Markets Advisory Committee Abolition) Bill 2014.

149 Australian Government, above n 24, 7.

150 This cap excludes funds raised under existing prospectus exemptions for wholesale investors. See Australian Government, above n 24, 9.

151 Massolution Crowd Power business, above n 8, 15.

152 CAMAC, above n 20, 58.

In addition, the NZ model allows all types of companies to raise capital through CEF. This approach is simple and allows companies of all sizes to benefit from this form of finance. However, to apply such a system in Australia is difficult, due to the cap imposed on proprietary companies:¹⁵³ such companies may not have more than 50 non-employee members.¹⁵⁴ The existence of this cap goes against the spirit of CEF, which is trying to raise small amounts of money from large numbers of people. Accordingly, CAMAC started by proposing that only public companies would be able to rely on CEF to raise funds from the market. Such a limitation is problematic, since it would exclude small businesses, who are most likely to be proprietary companies, from raising capital through this form of finance. It does not provide a solution to the problem that led the policy communities to reach consensus on this form of finance: the shortfall of capital for SMEs.

It can be argued that proprietary companies may convert to public companies, and this would allow them to raise funds through CEF. However, this suggestion does not take into account the reality that, even if a company becomes a public company, it may not have the necessary resources or funds needed to comply with the legislative requirements attached to public companies.¹⁵⁵ For this reason, CAMAC put forward a proposal for the establishment of a new type of company: the exempt public company. Such a company would be exempt from following the compliance requirements imposed on public companies by the *Corporations Act 2001* (Cth) for a period of up to three to five years.¹⁵⁶ At the end of that period, the company would revert to being a public company and would have to comply with the compliance requirements set out in the legislation.

Although this proposal deals with the shareholders limitation imposed on proprietary companies and the regulatory costs faced by a public company, the nature of the exemption is temporary. There is an assumption that at the end of the specified period, a business that attracted crowdfunding as an exempt public company will have the necessary resources to be able to comply with the legislative requirements attached to a public company. However, this may not be the case and, consequently, compulsory conversion to a public company may negatively

153 98.9% of companies are in fact proprietary companies: Robert Austin and Ian Ramsay, *Ford, Austin and Ramsay's Principles of Corporations Law* (LexisNexis, 2015) 169.

154 *Corporations Act 2001* (Cth), s 113.

155 Terence Wong, 'Crowd funding: Regulating the New Phenomenon' (2013) 31 *Company and Securities Law Journal* 89, 98.

156 *Ibid* 52-53; Australian Government, above n 24, 9.

impact the affairs of the business. Accordingly, it is crucial to get the timing of when such a conversion occurs correct.

In determining what length of time is appropriate before requiring a business to convert from being an exempt public company to being a public company, it is important to consider a range of factors. First, the life cycle of a business has seven stages: seed stage, start-up stage, growth stage, established stage, expansion stage, mature stage and exit stage.¹⁵⁷ As CEF is aimed at encouraging and promoting innovation as well as providing funding to small businesses, a number of businesses may be testing their ideas through crowdfunding and may still be at a seed stage. The biggest hurdle then is to convert their business idea into a successful commercial venture, and this could take years to achieve.¹⁵⁸ Further, if the venture involves the development of a new product, the product development cycle has to be considered, as this involves different stages, which include project strategy, development process, organisational and firm characteristics.¹⁵⁹ According to empirical research conducted in this area, newer and more complex projects are associated with longer development times.¹⁶⁰ In the case of crowdfunding, many start-ups may not have the necessary tools, knowledge or infrastructure required to be able to complete their project in a short period of time.¹⁶¹ As such, a majority of start-ups take longer than expected to produce their product.¹⁶²

Further, research has shown that the average development cycle for a product is 27 months. However, the development of a product does not ensure its success.¹⁶³ Commercialisation of the product is still necessary and is essential for the success of the business.¹⁶⁴ This process would then take an average of 4.5 months in the case of an organised and experienced person.¹⁶⁵ This

157 Thierry Janssen, 'The Seven Stages of Business Life Cycle' (white paper, Just in Time Management Group, 2013) <<http://www.justintimemanagement.com/sites/default/files/WP-The-7-stages-of-business-life-cycle-Thierry-Janssen.pdf>>.

158 Karish Manchanda and Pushkala Muralidharan, 'Crowdfunding: A New Paradigm in Start-Up Financing' (2014) (1) *Global Conference on Business and Finance Proceedings* 369, 369.

159 Abbie Griffin, 'Modeling and Measuring Product Development Cycle Time Across Industries' (1997) 14(1) *Journal of Engineering and Technology Management* 1.

160 Abbie Griffin, 'The Effect of Project and Process Characteristics on Product Development Cycle Time' (1997) 34(1) *Journal of Marketing Research* 24, 24-25; Malte Brettel, Rene Mauer, Andreas Engelen and Daniel Kupper, 'Corporate Effectuation: Entrepreneurial Action and Its Impact on R&D Project Performance' (2012) 27 *Journal of Business Venturing* 167, 171.

161 Sramana Mitra, 'Can Crowdfunding Solve the Startup Capital Gap' *Harvard Business Review* (Online, 24 July 2013) <<https://hbr.org/2013/07/can-crowdfunding-solve-the-sta>>.

162 Mollick, above n 137, 11-13; Ethan Mollick and Venkat Kuppaswamy, 'After the Campaign: Outcomes of Crowdfunding' (UNC Kenan-Flagler Research Paper No. 2376997, January 2014) 5-6, <http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2376997>.

163 Abbie Griffin, 'Product Development Cycle Time for Business-to-Business Products' (2002) 31 *Industrial Marketing Management* 291, 296.

164 Griffin, above n 160, 1.

165 Griffin, above n 164, 296.

would mean that a company developing a new product may not start generating profit until at least three years after it had become an exempt public company. As such, it is recommended that the time for conversion should not be less than five years. This is especially the case as, by the fifth year, more than half of the businesses would have failed. Accordingly, by this time, it is most likely that the exempt public companies remaining are the ones that have a good chance of succeeding in their businesses. However, as the product development cycle may vary from one case to the next, ASIC¹⁶⁶ should be given the power to allow exempt public companies to apply for an extension of the five-year exemption period if needed. This will ensure the flexibility of the system and enhance businesses' chances of success.

5.3.6.2 *Intermediaries Regulation*

The second safeguard proposed relates to the regulation of intermediaries. Such regulation is especially important due to the key role intermediary online platforms play in bringing together businesses and investors.¹⁶⁷ The intermediary controls which projects go on its platform and which investment opportunities are available to investors. As these platforms play the role of gatekeepers, it is in their best interests to limit fraud and attract successful ventures, since poor quality projects would negatively impact their profitability. If an intermediary can develop a reputation as being trustworthy, this would raise investor confidence in the platform and would attract more investors to it as they would trust the platform to promote viable projects.¹⁶⁸

Although there are intrinsic and extrinsic motivations for an intermediary to closely monitor the projects it promotes, it is important to regulate these online platforms to safeguard investors. A close look at existing platforms reveals a lack of transparency in relation to failed ventures: instead, intermediaries only promote their successful projects. This may be misleading to the average investor.

Further, the majority of intermediaries have not been generating any profit, which means that they are at risk of failure.¹⁶⁹ The collapse of an online platform may result in the loss of data or contracts entered into between investors and businesses, and may cause investors to lose their investments. For example, in 2011 P2P lending platform Quakle closed, leaving investors with

166 ASIC is the corporate and financial services regulator in Australia.

167 CAMAC, above n 20, 87.

168 Joan MacLeod Heminway, 'The New Intermediary on the Block: Funding Portals under the Crowdfund Act' (2013) 13 *UC Davis Business Law Journal* 177, 185-6.

169 Kirby and Worner, above n 6, 25-26; Chaffe and Rapp, above n 135, 506.

few remedies to recover their investments.¹⁷⁰ As such, it is important for an intermediary to have a data retention system that will continue to make all information available even if the platform fails. Further, clients' funding should go into a separate account. This would ensure that invested funds are protected if the platform collapses.

In view of the role that online platforms play in the process of CEF, both the CAMAC and the NZ models require intermediaries to be licensed.¹⁷¹ This would permit ASIC to monitor each online platform and ensure that the conditions of its licence are met. Due to the nature of the intermediary, there are two possible existing licences that might apply:

- an Australian financial services licence;¹⁷² and
- an Australian market licence.¹⁷³

It is most likely that the Australian financial services licence¹⁷⁴ would be adopted for intermediaries, as applying for this licence is both more straightforward and less costly than applying for an Australian market licence. An Australian financial services licence would also present fewer entry barriers to intermediaries since such a licence is issued by ASIC if the legislative requirements are met,¹⁷⁵ while an Australian market licence may only be issued at the discretion of the relevant Minister.¹⁷⁶ Further, an Australian financial services licence would provide investors with a range of protections,¹⁷⁷ including the establishment of compensation arrangements¹⁷⁸ and internal and external dispute resolution processes.¹⁷⁹

Additionally, under both the CAMAC and NZ models, the intermediary is required to conduct limited due diligence checks on businesses that are raising capital on its platform, and may not provide financial advice regarding any investment. Instead they are to provide a generic risk

170 Rupert Jones, 'Quakle Collapse Serves as Warning to Peer-to-Peer Investors' *The Guardian* (15 February 2014, Online) <<http://www.theguardian.com/money/2014/feb/15/quakle-collapse-warning-peer-to-peer-investors>>.

171 Australian Government, above n 24, 9.

172 An Australian financial services licence is required if a person is running a financial services business, *Corporations Act 2001* (Cth), s 911A.

173 An Australian market licence is needed if a person is operating a financial market, *Corporations Act 2001* (Cth), s 791A.

174 CAMAC, above n 20, 87, 93-94.

175 *Corporations Act 2001* (Cth), s 913A.

176 *Corporations Act 2001* (Cth), s 795B(1).

177 See *Corporations Act 2001* (Cth), s 912A.

178 *Corporations Act 2001* (Cth), s 912B.

179 *Corporations Act 2001* (Cth), s 912A.

warning to investors.¹⁸⁰ The due diligence requirement will help reduce the risk of fraud,¹⁸¹ while the generic risk warning requirement will highlight to investors the risks their investment may involve.

One of the key differences between the CAMAC and the NZ models relates to the fee structure that may be relied on by the intermediary. The CAMAC model prohibits any remuneration being paid to the intermediary based on the amount of securities issued or of funds raised by the business.¹⁸² The NZ model does not have such a limitation and only requires the disclosure of any fees paid by the business.¹⁸³ The NZ approach takes into account the fact that intermediaries around the world are already struggling to break even.¹⁸⁴ Similar observations can be made regarding the ASSOB platform in Australia.¹⁸⁵ The additional licensing requirement proposed on these platforms will add to their business cost and make them less viable. Consequently, intermediaries should be able to choose and adopt any fee structure that matches their business model, as long as the fees earned by the platform from businesses are flagged to investors. However, any other conflict of interest, such as the provision of investment advice to investors, should be prohibited for the protection of consumers.

5.3.6.3 Investors Regulation

The third safeguard proposed relates to imposing regulation on investors. A review of the different approaches adopted or lobbied for around the world indicates that the level of obligations imposed on investors varies, with some countries adopting very few limitations on investors while others have more restrictive rules that curtail investors' freedom. For instance, New Zealand allows investors to invest in CEF as long as they have signed a document acknowledging the risk that this form of finance involves.¹⁸⁶ Italy goes one step further by requiring investors to complete a questionnaire to ensure that they understand the risks

180 Australian Government, above n 24, 9.

181 Steven Bradford, 'Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others' (2014) 83 *University of Cincinnati Law Review* 371, 375.

182 CAMAC, above n 20, 113.

183 Australian Government, above n 24, 9.

184 Kirby and Worner, above n 6, 25-26; Chaffe and Rapp, above n 135, 506.

185 Australian Small Scale Offerings Board Limited and Controlled Entities, *Financial Report for the Year Ended 30 June 2014* (2014) 7.

186 Financial Markets Conduct Regulation (NZ), reg 197(1).

attached to CEF.¹⁸⁷ However, the most popular model, adopted in countries such as the US¹⁸⁸ and the UK,¹⁸⁹ is very restrictive as it imposes a cap on the CEF investments that a person can make in a period of 12 months.

In Australia, the CAMAC model would only allow a person to invest \$2,500 in any one business in a 12-month period, with a maximum of \$10,000 to be invested in CEF during that period.¹⁹⁰ This proposal is more rigid than the NZ model, which does not have any compulsory investment caps attached to it.¹⁹¹ Further, the total cap on investments in CEF proposed by the CAMAC model is much lower and less flexible than the caps adopted in countries such as the UK¹⁹² and the US.¹⁹³

The imposition of investment caps stems from the nudge theory. This theory seeks to enhance the understanding and management of heuristic influences on human behaviour, which affects the decision-making of individuals. With this understanding, it aims to reshape existing choices of individuals through choice architecture.¹⁹⁴ The investment caps recommended by the CAMAC model are designed to change behaviour by limiting the number of businesses individuals can invest in. The fact that there is a limitation is intended to stop a person from rushing into any particular investment and instead make them reflect on whether such an investment is possible or whether they should save their funds and invest in other, more promising businesses.¹⁹⁵ Curtailing investment choices through caps is a paternalistic approach to CEF and may go beyond the liberal paternalism promoted by the nudge.¹⁹⁶

However, applying such a paternalistic approach may be not only justified but warranted, as people's decision-making is not generally clever or logical and a herd mentality may apply.¹⁹⁷ These deficiencies are likely to be accentuated in an online environment where investors may

187 Commissione Nazionale Per Le Societa'E La Borsa (CONSOB), Regolamento Consob n. 18592 sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line, article 15.

188 *JOBS Act*, s 302.

189 Financial Conduct Authority, *Conduct of Business Sourcebook* (COBS) 4.7.7, 4.7.10.

190 CAMAC, above n 20, 146.

191 Australian Government, above n 24, 10.

192 See Financial Conduct Authority, *Conduct of Business Sourcebook* (COBS) 4.7.10: the investor should not invest more than 10% of their net assets in non-readily realisable securities in a period of 12 months.

193 See *JOBS Act*, s 302: the aggregate amount sold to an investor does not exceed the greater of \$2,000 or 5% of the annual income or net worth of the investor if their annual income or their net worth is less than \$100,000 or 10% of their annual income or net worth (to a maximum of \$100,000) if the annual income or the net worth of the investor is equal or more than \$100,000.

194 Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions About Health, Wealth and Happiness* (Penguin Group, 2009).

195 *Ibid* 53-56.

196 *Ibid* 13.

197 *Ibid* 66.

be trading more actively and speculatively.¹⁹⁸ With CEF and financial markets in general, history has demonstrated that there is a seemingly irresistible movement of the crowd toward bad investments, with investors being ‘sucked into the vortex of the market whirlpool’.¹⁹⁹ Some may even say that the crowd is destructive and impulsive, and will exhibit a new persona separate from its members as individual consciousness vanishes from the crowd.²⁰⁰ The crowd is then perceived as a single being and ‘is subjected to the law of the mental unity of the crowd’.²⁰¹ As a result of this, the crowd is viewed as irrational, and this characteristic would be dangerous in the case of CEF where fraud and business failure may become rife.

More recent research, however, suggests that the crowd may not be irrational.²⁰² For instance, the rush toward bad investments in the past may not have been conducted by an irrational crowd. The crowd may have had promising leads, motivations and reasons that guided them to particular investments.²⁰³ Additionally, a crowd may be wise.²⁰⁴ The aggregate judgment of the crowd is more accurate than the judgment of individuals.²⁰⁵ Aristotle, for instance, noted that when people come together, ‘they may surpass – collectively and as a body, although not individually – the quality of the few best ... When there are many who contribute to the process of deliberation, each can bring his share of goodness and moral prudence; ... some appreciate one part, some another, and all together appreciate all’.²⁰⁶ With crowdsourcing, for example, the crowd has been able to provide more original and superior problem-solving outcomes.²⁰⁷ Individuals involved in crowdsourcing are motivated by extrinsic and intrinsic factors to make a contribution to a particular project.²⁰⁸ The technology now allows for millions of independent

198 Brad Barber and Terrance Odean, ‘Online Investors: Do the Slow Die First?’ (2002) 15(2) *The Review of Financial Studies* 455, 456.

199 David Dreman, *Psychology and the Stock Market: Investment Strategy Beyond Random Walk* (Amacom, 1977) 99; for examples of corporate collapses resulting from the madness of crowds see Charles Mackay, *Extraordinary Popular Delusions and the Madness of the Crowd* (Wordsworth Reference, 1995, originally published in 1841).

200 Gustave Le Bon, *The Crowd: A Study of the Popular Mind* (trans. Digireads, 2008) 13, 18 [trans of: *Psychologie des Foules* (first published in 1895)].

201 Ibid 13.

202 Yochai Benkler, *The Wealth of Networks: How Social Production Transformed Markets and Freedom* (Yale University Press, 2006); Barry Libert and Jon Spector, *We are Smarter than Me: How to Unleash the Power of Crowds* (Prentice-Hall, 2007).

203 See for example, Eugene White, *Crashes and Panics: The Lessons from History* (Dow Jones-Irwin, 1988).

204 James Surowiecki, *The Wisdom of Crowds* (Anchor Books, 2005).

205 Francis Galton, ‘The Ballot-Box’ (1907) 75 *Nature* 509.

206 Aristotle, *Politics* (Oxford University Press, 1972) 123 [trans Ernest Barker].

207 Darren Bragham, ‘Crowdsourcing as a Model for Problem Solving: An Introduction and Cases’ (2008) 14(1) *Convergence: The International Journal of Research into New Media Technologies* 75.

208 Mark Wexler, ‘Reconfiguring the Sociology of the Crowd: Exploring Crowdsourcing’ (2011) 31(1/2) *International Journal of Sociology and Social Policy* 6, 12.

ideas to come together without the danger of too many compromises being made by individuals in the crowd.²⁰⁹

Further, with CEF, a range of people will be coming together from different backgrounds with different knowledge and experience and that may make the crowd wiser.²¹⁰ The more diverse a group is, the better it is at solving problems, as each member of the group will be bringing new information which will enhance its decision-making in the end.²¹¹ Homogeneous groups, on the other hand, are often victims of ‘group think’:²¹² their mental efficiency and moral judgment are influenced by in-group pressure which may lead to the deterioration of decision-making.²¹³ Accordingly, the diversity of people that will be attracted to CEF may result in better outcomes for investors.

Of course, this does not mean that people will always make good decisions when investing in SMEs through CEF, as there is always the danger that the crowd may become polarised and homogeneous.²¹⁴ Further, some investors may be investing as a result of a hyped-up project without considering the value of the project properly. As such, investor-targeted protections need to be in place. However, such protections do not need to adopt the paternalistic approach of the investment cap. The approach to investor regulation proposed by CAMAC is also problematic from an enforcement perspective: who will enforce the caps? To require the intermediary to ensure that investors on their platform are in compliance with the cap may be costly for the intermediary. Further, if this responsibility is placed on the intermediary and an investor breaches the cap, what penalties will then apply? The imposition of penalties may be a draconian approach to protecting investors. It may even go against the national mood that has been supportive of CEF. A different solution, that would provide protections to investors while promoting their interest in investments, may instead be needed.

It is suggested that CEF may be viewed as a social experiment to boost financial literacy.²¹⁵

209 Bragham, above n 208, 80.

210 Clinton Davis-Stober, David Budescu, Jason Dana and Stephen Broomell, ‘When is a Crowd Wise’ (2014) *Decision* 79, 80.

211 Scott Page, *Diversity and Complexity* (Princeton University Press, 2011); Lu Hong and Scott Page, ‘Groups of Diverse Problem Solvers Can Outperform Groups of High-Ability Problem Solvers’ (2004) 101(46) *Proceedings of National Academy of Sciences of the United States of America* 16385.

212 Irving Janis, *Groupthink: Psychological Studies of Policy Decisions and Fiascoes* (Cengage Learning, 2nd ed, 1982).

213 Ibid 9.

214 Tonis Vaga, ‘The Coherent Market Hypothesis’ (1990) 46(6) *Financial Analysts Journal* 36, 39.

215 Cody Friesz, ‘Crowdfunding and Investor Education: Empowering Investors to Mitigate Risk and Prevent Fraud’ (2015) 48 *Suffolk University Law Review* 131, 146.

Financial literacy is very important as it can develop and promote individuals' autonomy of choice: it will open the door for the average person investing in CEF to be treated as a free rational being, and would prevent the CEF exemption from sliding into overbearing paternalism.²¹⁶ People who are becoming interested in investment will be self-motivated to learn how to enhance their decision-making in this area. A culture that enables them to find out what they need to know will lead to better decision-making of the crowd. It is important to allow people to adopt the right norms and practices in their investments.²¹⁷ One key element that an education campaign to boost financial literacy should highlight to investors is the fact that there are a number of signals that ought to be considered when investing in CEF. These signals provide information regarding a project's viability and so may enhance the decision-making of investors.²¹⁸ In addition to the traditional signals referred to in the literature of crowdfunding,²¹⁹ it is suggested that regulation to protect investors could add one more signal which would lower the information asymmetry between a business and investors.²²⁰ Businesses attempting to raise more than \$100,000 in one go should only be able to do so if they raise the funds in stages. Each stage would be a milestone which, when reached, would allow the business to raise more money to achieve the next milestone in the project. This would provide additional information to investors regarding their initial investment: is the business meeting its milestones on time? If it is, it may attract more investors or encourage existing investors to increase their stake in the company. On the other hand, if milestones are not met, questions will be raised regarding the reasons behind the delay. Evidence of delays may deter new investors from investing in the business. Such milestones may limit fraudulent activities in the sphere of CEF and may also limit the losses of investors.

This education campaign to boost financial literacy could be conducted jointly by ASIC, as part of its financial literacy program, and the intermediaries in CEF, since they play a gatekeeper role between businesses and investors. In addition, an approach similar to the Italian system

216 Benkler, above n 203, 140.

217 Cass Sunstein and Reid Hastie, *Wiser: Getting Beyond Groupthink to Make Groups Smarter* (Harvard Business Review Press, 2015) 13.

218 Ahlers, Cumming, Gunther and Schweizer, above n 117; Todd Moss, Donald Neubaum and Moriah Meyskens, 'The Effect of Virtuous and Entrepreneurial Orientations on Microfinance Lending and Repayment: A Signaling Theory Perspective' (2015) 39(1) *Entrepreneurship Theory and Practice* 27; Sabin Wu, Bin Wang and Yuanqing Li, 'How to Attract the Crowd in Crowdfunding?' (2015) 24(3) *International Journal of Entrepreneurship and Small Business* 322.

219 Ibid; Fania Valeria Michelucci and Francesca Silvia Rota, 'The Success of Non-Profit Crowdfunding: First Evidences from the Italian Web-Platforms' (2014) Torino: DIGEP—Dipartimento di Ingegneria Gestionale e della Produzione, Politecnico di Torino 1, 5 <<http://www.dii.univpm.it/sites/www.dii.univpm.it/files/dii/allegati/MichelucciRota.pdf>>.

220 Haewon Yum, Byungtae Lee and Myungsin Chae, 'From the Wisdom of Crowds to my Own Judgment in Microfinance through Online Peer-To-Peer Lending Platforms' (2012) 11 *Electronic Commerce Research and Applications* 469.

might be adopted, so that investors are required to complete a questionnaire demonstrating their understanding of the risks and the factors to consider when investing in CEF. It is to be hoped this will raise investors' awareness of investments in general and so enhance financial literacy. This is important as it may also impact how investors perceive their superannuation.

Lastly, investors still need a regulatory policy that protects their interests. This is particularly important since CEF is relied on when SMEs wish to raise a small amount of money from a large pool of investors. In instances where misleading or fraudulent conduct by businesses or intermediaries occurs, investors have few resources available to them: it is unlikely that individual investors would have invested enough money in a project to justify bringing a legal action against the business or the intermediary. A class action may also be unlikely as the gains for lawyers running such a case are limited.²²¹ Consequently, ASIC must take an active role in monitoring and regulating CEF. Actions and initiatives similar to those of the Attorney General in Washington State and the US Federal Trade Commission may be necessary to send a message to businesses that they will be held accountable if they are involved in misleading or fraudulent conduct through CEF, irrespective of the fact that the losses to individual investors may be relatively small.

However, from the regulator's perspective this may be problematic, as ASIC has a limited budget. Accordingly, the full-scale audit of ASIC that is currently taking place²²² should consider improving the regulator's budget to enable it to achieve its objectives in protecting consumers, even in the CEF sphere. ASIC should additionally be equipped with administrative enforcement powers that would allow it to act quickly to stop a fraudulent scheme from taking place. To provide ASIC with intervention powers may also be desirable. Such powers would allow the regulator to stop the promotion of a particular product or business venture if ASIC believed there is a high risk of fraud or deception in the product.²²³ This power would allow ASIC to act to protect consumers without having to prove that a breach of the law has occurred.²²⁴

221 Pesok, above n 83, 149.

222 Sarah Thompson, Jonathan Shapiro and James Evers, 'Abbott puts ASIC under the Microscope in Funding and Operations Review' *Australian Financial Review* (Online, 24 July 2015) <<http://www.afr.com/business/banking-and-finance/abbott-puts-asic-under-the-microscope-in-funding-and-operations-review-20150723-gjj1t6>>.

223 The Financial System Inquiry conducted in 2014 recommended that ASIC should have product intervention orders at its disposal: see Commonwealth of Australia, above n 54, Recommendation 22, 206.

224 For a discussion on product intervention powers, see Dimity Kingsford Smith and Marina Nehme, 'Product Intervention Powers: A Legal, Comparative and Policy Analysis' (2015) <http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Financial%20System%20Inquiry%20Final%20Report/Submissions/PDF/Kingsford_Smith_Dimity_and_Nehme_Marina.ashx>.

5.4 Conclusions

There has been a convergence of the funds raising problem and an absence of a policy response and a political will for change. As a result the tide is turning in favour of CEF. As this form of finance is viewed as a way to revitalise economies and to further promote innovation, this has led to the promulgation of a number of initiatives around the world to facilitate the use of CEF by average people. To fulfil the needs that have driven this issue to the top of government agendas, legislators must introduce a balanced CEF exemption to the fundraising provisions that will allow CEF to prosper while providing the necessary protections to consumers.

CEF is a social phenomenon. Through its use of social media, it has attracted people who have previously never been interested in investing in companies. Instead of being feared, this interest should be nurtured through the promotion of investors' financial education. A questionnaire to test investors' understanding of the risks involved with CEF and the factors to consider when investing through CEF, such as signals to look for, would also be beneficial. To rely on caps on investors is too restrictive and may stunt the development of CEF in Australia. It is further problematic as such caps are not only paternalistic but go against the national mood, which is supportive of CEF. Issues regarding monitoring and enforcing the caps would also be raised.

To enhance the protection of investors, ASIC should take an active role in monitoring CEF and be willing to sue in case of fraudulent action. Further, if ASIC believes that a project should be withdrawn due to possible fraudulent activities attached to the venture, the regulator should be provided with tools that would allow it to stop CEF of the project from proceeding. Equipping the regulator with additional intervention powers may be a possibility.

As the gatekeeper between businesses and investors, the intermediary online platform should have a financial services licence with a limited duty of care. Conflicts of interest that may arise for the intermediary as a result of CEF should be banned. One exception can be made and it relates to the fee structure of the platform. The intermediary's fee structure should be disclosed to investors, to highlight any conflicts of interest that may exist.

For businesses, limiting the amount that may be raised through CEF to a cap of \$2 million in a 12-month period seems reasonable. However, businesses should only be allowed to raise amounts that are more than \$100,000 through stages to send a signal to the market about the viability and potential of the project. Including these limitations in the CEF exemption to the fundraising provisions will promote this form of finance and may actually make it a source of capital to SMEs while providing the necessary protection to investors.

6 ISSUES IN COMPETITION AND STABILITY IN FINANCIAL SERVICES

6.1 Introduction

This short chapter examines some of the issue that flow from arguments that the financial sector is distinct from other parts of the real economy and requires forms of protection from competition.

Competition in banking acts to increase social welfare in the same way that competition works in any other sector. The academic literature on the balance between competition and stability in the financial services sector follows two competing views (Beck 2008b; Beck, Demirgüç-Kunt and Maksimovic 2004; Berger et al. 2004; Berger, Klapper and Turk-Ariss 2009; Cetorelli 2004a):

- (a) the ‘competition-fragility’ view, in which competition lowers bank margins and encourages adverse risk taking; and
- (b) the ‘competition-stability’ view, in which market power in the provision of loans exacerbates moral hazard and adverse selection problems.

These simple contrasts are made more complicated with the more nuanced pair of competing views (Cetorelli and Peretto 2012):

- (a) the ‘more credit’ view, in which bank competition leads to more credit availability, more firm entry and more growth; and
- (b) the ‘less credit’ view, where credit availability may be higher in less competitive environments.

6.2 Examining banking sectors

Determining the vibrancy of competition in any of the financial services sectors is complex. Chapter 4 set out some measures. However, the conduct of the delivery of financial services, even at the relatively simple retail level, can be an opaque cocktail of conduct representing the interactions of buyers and sellers. The nature of the service, perceptions about alternatives or substitutes, power relationships connecting buyers to sellers make analysis difficult. In the current environment, interactions can be facilitated or impeded by technological innovation. However, more vibrant competition improves consumer outcomes, not least by the combination of engendering greater rivalry among sellers and shifting the balance of bargaining power towards buyers to some extent.

This view places policy problems at either end of the competition scale. Too little competition adversely affects consumers and results in higher prices or less value embodied in the service. Too much competition may lead to firm failures though pressure on prices and resultant lack of profitability. Firms that fail exit. In advanced economies such as Australia, the exit of a deposit taker means that the government will pay to make retail deposit holders whole.

As we have seen, there are arguments that competition is diametrically opposed to financial system stability. That is, less competition is somehow in the public interest, as banks need significant rents for stability and to play their part in enabling productive enterprise in the rest of the economy. Failure to provide those rents will lead to a capital call on the government. That is, the invisible costs of lesser competition, most likely in lower levels of service and less motivation for innovation, have been preferred to the more visible costs of bank failure. Despite this, there is a growing body of scholarship on banking in which '[it] turns out that the widely accepted trade-off between competition and stability does not generally hold' (Carletti and Hartmann 2002). This is worthy of serious consideration in formulating policy options.

At an OECD roundtable in 2010 (at which Australia was represented), the question was put in stark relief (OECD 2010b):

A controversial question has arisen in the context of the ongoing global financial crisis: Is financial stability enhanced or weakened by competition? [A] clear causal link between either competition or concentration and stability in the financial sector can be found neither in theory nor in the data.

Other work, in the immediate aftermath of the financial crisis found (Berger, Klapper and Turk-Ariss 2009: 100):

Under the traditional 'competition-fragility' view, more bank competition erodes market power, decreases profit margins, and results in reduced franchise value - the on-going concern or market value of the banks beyond their book value. ... [More recently, the 'competition-stability' view contends] that more market power in the loan market may result in higher bank risk as the higher interest rates charged to customers make it harder to repay loans and exacerbate moral hazard incentives of borrowers to shift to riskier projects [and] it is also possible that a highly concentrated banking market may lead to more risk taking if the institutions believe that they are too big to fail and more likely to be explicitly or implicitly protected by the government safety net

Berger et al. found that ‘more market power is associated with riskier loan portfolios and results are consistent across the three different proxies of market power’. The three proxies being the Lerner index, HHI-deposit index and HHI-loan index, described in the previous chapter. However, they also argue that ‘even if market power in banking results in riskier loan portfolios, the bank’s overall risk need not increase’ (Beck, Demirgüç-Kunt and Maksimovic 2006: 113), particularly if banking institutions hold significantly more equity capital.

Anginer, Demirgüç-Kunt and Zhu (2012: abstract) found that ‘greater competition encourages banks to take on more diversified risks, making the banking system less fragile to shocks.’ Examining the impact of the institutional and regulatory environment on systemic stability shows that banking systems are more fragile in countries with weak supervision and private monitoring, high government ownership of banks, and in countries with public policies that restrict competition. Furthermore, lack of competition has a greater adverse effect on systemic stability in countries with generous safety nets and weak supervision.’ Anginer, Demirgüç-Kunt and Zhu (2012: 2) summarise that ‘greater competition in the banking sector has no doubt led to greater innovation and efficiency, [but] there is still no academic consensus on whether this competition has also led to greater fragility, with conflicted theoretical predictions and mixed empirical results.’

6.3 Is there a money creation problem?

One of the issues that arises from disruptive entry is the extent to which the function of money creation will be affected (Kohler 2015). The mechanism by which money is created by banks has been described by the Bank of England (McLeay, Radia and Thomas 2014). The basic premise is that when a bank issues a loan, it places a matching amount in the borrower’s deposit account.

Elements of the paper’s overview are helpful:

The reality of how money is created today differs from the description found in some economics textbooks:

- *Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.*
- *In normal times, the central bank does not fix the amount of money in circulation, nor is central bank money ‘multiplied up’ into more loans and deposits.*

Although commercial banks create money through lending, they cannot do so freely without limit. Banks are limited in how much they can lend if they are to remain profitable in a competitive banking system. Prudential regulation also acts as a constraint on banks' activities in order to maintain the resilience of the financial system. And the households and companies who receive the money created by new lending may take actions that affect the stock of money – they could quickly 'destroy' money by using it to repay their existing debt, for instance.

The issue that Kohler raises is that many disruptive plays recycle money rather than create it. However, his assertion that 'Quantitative easing' (QE) is the modern name for central bank money creation' is dispelled by the Bank of England. (McLeay, Radia and Thomas 2014: 24) shows that the commercial banks are necessary intermediaries in the mechanism by which QE works.

This is a critical issue in the competition stability balance. If commercial banks are a necessary part of the creation of money, it becomes important that disruptive entry should, at some point, also become part of money creation. This leads to the question as to when entrants should be subject to prudential regulation. The answer from the Bank of England's perspective is that money creation must be subject to prudential regulation (Tucker, Hall and Pattani 2013; Farag, Harland and Nixon 2013).

7 CONCLUSIONS

This report has set out some of the findings from investigation of the research question for this project being ‘What are the optimal competition law and policy settings that should apply to the financial services sector?’

The report finds that there are high barriers to exit for the four pillar banks and regulatory barriers to entry associated with a differential prudential regime between the four major Australian retail banks and other participants in the sector. This means that the critical characteristic of a competitive sector – low barriers to entry and to exit – is absent in the retail banking sector, with little evidence to suggest that there is significantly more effective competition in the balance of the banking industry.

We have shown that international work from central banks, international financial institutions and academic sources in this field is still dominated by the effects of the financial crisis. There are three critical themes:

- (a) an increased focus on macroprudential regulation;
- (b) a focus on regulations that respond to the globalisation of the financial markets; and
- (c) the introduction of anti-competitive policies such as government intervention and consolidation after the financial crisis.

These sources have also offered key policies to promote competition, which include the independence and strength of regulators, consumer policies such as the facilitation of switching, financial literacy, and easing of entry and exit restrictions.

The work in this report has shown that there are three characteristics of retail banking in Australia:

- (a) the stability of the sector is sound and retail banking had a relatively soft landing in the aftermath of the financial crisis;
- (b) there is limited competitiveness and this is reflected in the static state of market share between the four major banks and very slow and marginal improvements gained even by strong second tier competitors; and
- (c) product and service innovation is limited.

This raises two important implications:

- (a) the absence of vigorous rivalry, whilst providing stability, is likely to mean that the welfare of retail banking consumers is not optimised; and
- (b) the level of innovation may not be as high as is feasible, and barriers, including prudential regulatory barriers to entry or expansion, mean that the extent of rivalry is unlikely to change without some form of promotion of competition.

As a result of these conclusions, we recommend the removal of the ‘four pillars’ policy for the following reasons:

- The four major banks are protected by an implicit government guarantee which impacts market operation to little observable benefit to consumers, and may be a source of consumer disutility.
- The four pillars policy has prompted increased vertical integration within the sector, particularly in the area of mortgage products.
- There are sufficient merger protections provided by Part IV of the *Competition and Consumer Act 2010* (Cth).
- Competition and contestability arise when there are reasonably low barriers to entry and exit from the sector. It is not clear that low barriers to entry exist in Australia and evidence to support this view comes from the failure of international banks to gain a significant toehold in the retail banking sector in Australia. One deterrent to entry is the regulatory focus on the four pillars.

The report draws a number of conclusions on crowd equity funding and these are repeated here. Crowd equity funding is viewed as a way to revitalise economies and to further promote innovation. This has led to the promulgation of a number of initiatives around the world to facilitate the use of crowd equity funding by average people. To fulfil the needs that have driven this issue to the top of government agendas, legislators must introduce a balanced crowd equity funding exemption to the fundraising provisions that will allow crowd equity funding to prosper while providing the necessary protections to consumers.

Crowd equity funding is a social phenomenon. Through its use of social media, it has attracted people who have previously never been interested in investing in companies. Instead of being feared, this interest should be nurtured through the promotion of investors’ financial education.

A questionnaire to test investors' understanding of the risks involved with crowd equity funding and the factors to consider when investing through crowd equity funding, such as signals to look for, would also be beneficial. To rely on caps on investors is too restrictive and may stunt the development of crowd equity funding in Australia. To enhance the protection of investors, ASIC should take an active role in monitoring crowd equity funding and be willing to sue in case of fraudulent action. Further, if ASIC believes that a project should be withdrawn due to possible fraudulent activities attached to the venture, the regulator should be provided with tools that would allow it to stop crowd equity funding of the project from proceeding. Equipping the regulator with additional intervention powers may be a possibility.

As the gatekeeper between businesses and investors, the intermediary online platform should have a financial services licence with a limited duty of care. The intermediary's fee structure should be disclosed to investors to highlight any conflicts of interest that may exist.

For businesses, we recommend limiting the amount that may be raised through crowd equity funding to a cap of \$2 million in a 12-month period. However, businesses should only be allowed to raise amounts that are more than \$100,000 through stages to send a signal to the market about the viability and potential of the project. Including these limitations in the crowd equity funding exemption to the fundraising provisions will promote this form of finance and may actually make it a source of capital to SMEs while providing the necessary protection to investors.

The report has demonstrated that the competitiveness of Australia's banking sector lies broadly between the US and the UK, and is comparable with the world overall. However, statistical measures indicate that competition in the domestic sector peaked in 2004.

We recommend two specific policies to promote competition in retail banking without the structural intervention that would otherwise be required to improve the intensity of competition in the retail banking sector:

- Introduce bank account number portability. This would use 'know your customer' and central database systems in a similar form to those that have been used for mobile number portability in Australia for the last decade and a half.
- Introduce customer access to data held by banks to allow third parties to compare bank offerings across all banks.

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