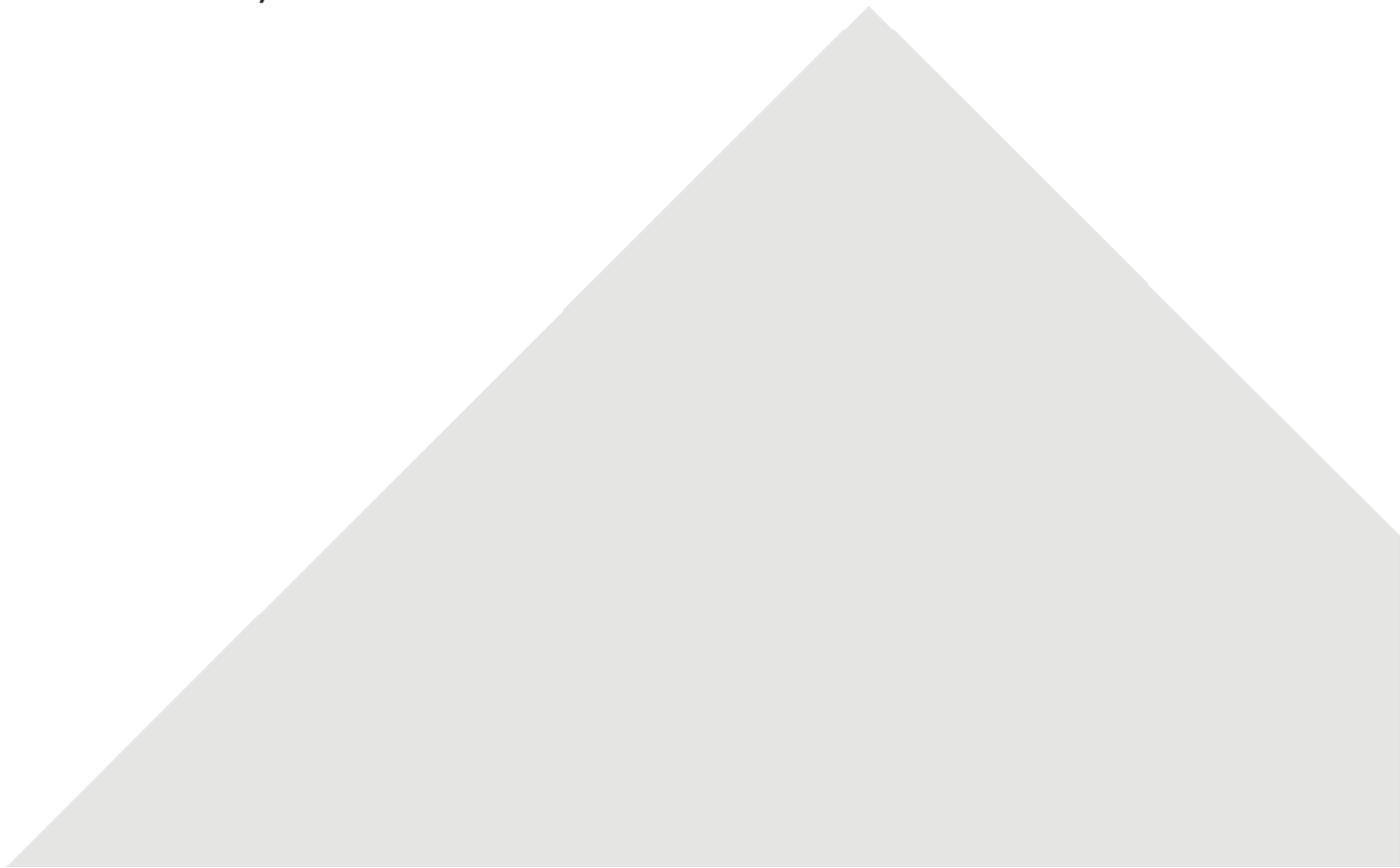


Commonwealth  
Bank

# Review into Small and Medium-sized Banks

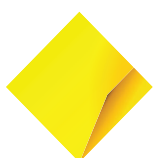
*Submission to Council of Financial Regulators  
Consultation*

7 February 2025



# Contents

1.	Executive summary	3
2.	Proportionality in regulation	5
3.	Funding	10
4.	Entry, scale, and exit	11



# 1. Executive summary

CBA welcomes the opportunity to provide some perspectives to the Council of Financial Regulators' Review into Small and Medium-sized Banks.

We recognise that these views are offered from the Commonwealth Bank's perspective, informed often only by publicly available information.

Supporting small and medium banks is important for Australia. These institutions provide competition in often under-served communities. Their viability is important, given no recent or new entrants to financial services seek to serve regional communities or offer cash or in-person services.

The Issues Paper provides a thoughtful examination of the banking industry. The paper highlights how structural shifts, largely driven by technology, have challenged the business model of small and medium banks.

Our overarching perspective is that the prudential framework, as it applies to small and medium banks, is appropriate. There is a negligible difference in the cost of required regulatory capital between standardised and Internal Ratings Based (IRB) banks. Diluting the capital framework further is likely to have negligible competitive benefit for smaller banks but may be detrimental to their long-term viability, system stability, and broader confidence in Australia's financial system.

We also believe that the limits of regulatory proportionality have largely been reached in areas where there is high interconnectedness between industry participants, and where the system is only as strong as its weakest link. In these complex risk types, such as financial crime, cyber and scams, large banks should be expected to provide support to smaller banks where possible.

The Commonwealth Bank makes some of its anti-scam technology and intelligence available to other market participants. It is used by two medium sized banks today, with another bank affiliated fintech expected to be live soon. We are exploring whether any of the cyber investments we are making could be made available to smaller institutions.

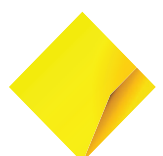
Further, we suggest three areas where small and medium banks may benefit from further relief:

- providing further regulatory relief on areas that are not critical to system stability or customer safety, for example compliance with Open Banking and New Payments Platform roadmaps.
- creating a mechanism for small and medium banks to work together on shared technology, operations, or compliance activity to benefit from scale opportunities.
- implementing a suitable mechanism to share across the industry some of the cost of providing critical but not commercially viable shared services like cash and regional in-person services.

Smaller banks have also been impacted by a significant change in the competitive landscape and associated structural decline in industry profitability. This is somewhat masked at this point in the cycle by the extremely benign credit environment.

The Issues Paper highlights this erosion in profitability over time and relative to other international jurisdictions. This has occurred despite a period of higher interest rates, low credit losses and robust lending growth. It has largely been driven by a collapse in home loan profitability where many smaller banks have concentrated exposure.

Greater competition placing pressure on profitability is not a problem per se. Lower prices are good for customers. In this case, however, the customer benefit mostly flows to wealthy, digitally active, metro customers who are being 'cherry picked' at scale.

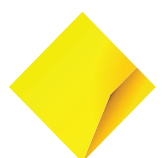


Further, the economics for the entire industry have been shifted. This disproportionately challenges the business models of smaller banks. It will continue to drive service degradation in regional areas and for face-to-face services.

As a result, the industry is less resilient to a deterioration in economic conditions. International experience has demonstrated that banks unable to generate capital organically are unlikely to be supported by debt or equity markets when economic conditions inevitably deteriorate.

These perspectives are addressed in this submission in response to selected consultation questions.

We would be happy to engage further on any of these topics, should that be of assistance.



## 2. Proportionality in regulation

1. *Do the regulatory and supervisory frameworks strike an appropriate balance between safety, stability, and competition? Please provide examples.*
2. *Are regulators' approaches to regulation and supervision (including tiering and implementation approaches) suitably proportionate, efficient and effective, having regard to the size, complexity and risks associated with different segments of the banking sector?*
3. *Are regulators' data collections and reporting requirements proportionate? If not, please provide specific examples of requirements that could be adjusted (e.g. frequency) or removed.*
17. *Are there private sector led initiatives that could address some of the issues being faced by the small and medium banking sector? Please provide examples.*
19. *What regulatory or supervisory changes and/or initiatives could be made to assist small and medium banks in gaining benefits from scale?*
21. *Is there a minimum scale of bank necessary to compete effectively whilst meeting customer expectations with respect to a safe, "always on", efficient digital environment (e.g. minimum downtime, effective scam mitigation, cyber risk mitigation, AML protections etc.)?*

### *Prudential Regulation*

The Issues Paper notes that APRA "seeks to adopt a risk-based and outcomes-focused approach with proportionality embedded." CBA believes that a proportionate approach is appropriate.

There are currently four tiers used in Australia's prudential framework:

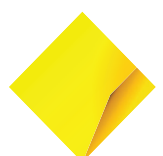
- i) Domestic systemically important banks (D-SIBs, e.g., CBA, WBC);
- ii) Other Internal risk-based (IRB) banks (e.g., ING, Macquarie);
- iii) Other Significant Financial Institutions (SFIs, e.g. Bendigo, BOQ); and
- iv) Non-SFIs (e.g. Qudos, Teachers Mutual).

These tiers provide sufficient granularity to apply a proportionate approach.

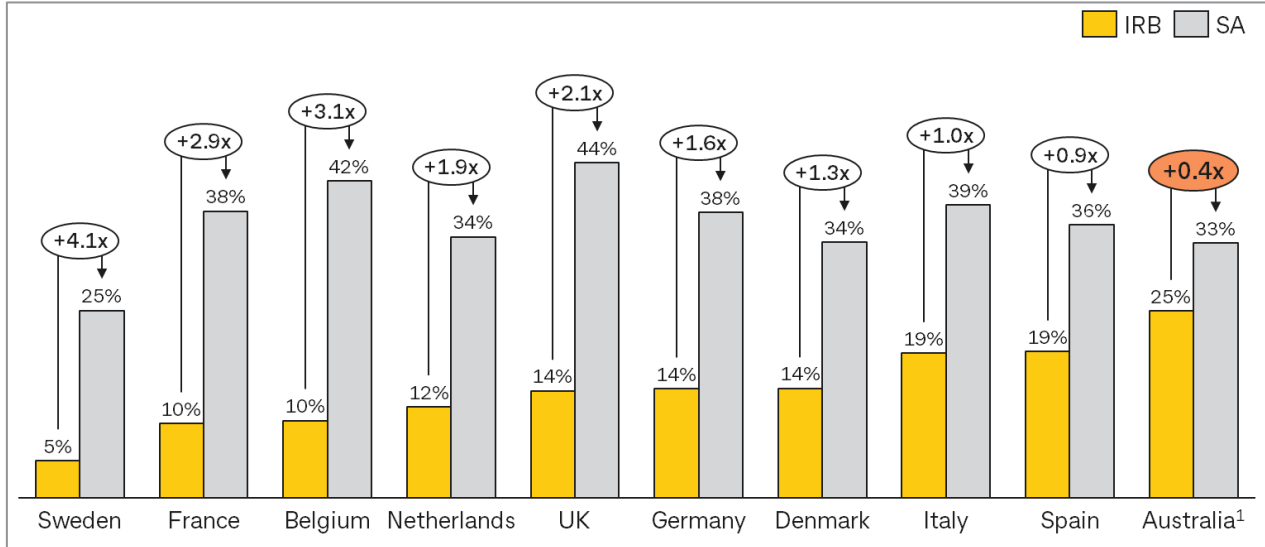
We believe that prudential requirements are appropriate for banking activities across these tiers. Diluting the capital framework further is likely to have negligible competitive benefit for smaller banks but it may be detrimental to their long-term viability, system stability, and broader confidence in Australia's financial system.

Publicly available data indicates that prudential requirements are not the binding capital constraint for small and medium banks. Instead, external credit ratings and/or internal risk appetite appears to be the binding constraint. The Issues Paper (Graph 15) shows that these banks have reported similar or higher CET1 ratios than major banks for the past 10 years, despite having lower capital requirements. This means that even if regulatory requirements were lowered, it is unclear that this would change the actual capital balances of smaller banks.

Compared globally, Australia's prudential framework has driven one of the smallest differences between standardised (SA) and IRB approaches (Chart 1). The Basel Committee would prefer other countries had a similarly small gap: the new Basel framework introduced a floor to limit the capital advantage that IRB banks can have relative to standardised banks. While the adoption of this floor in Australia had a negligible impact, it is expected to result in a material capital increase in other developed economies.



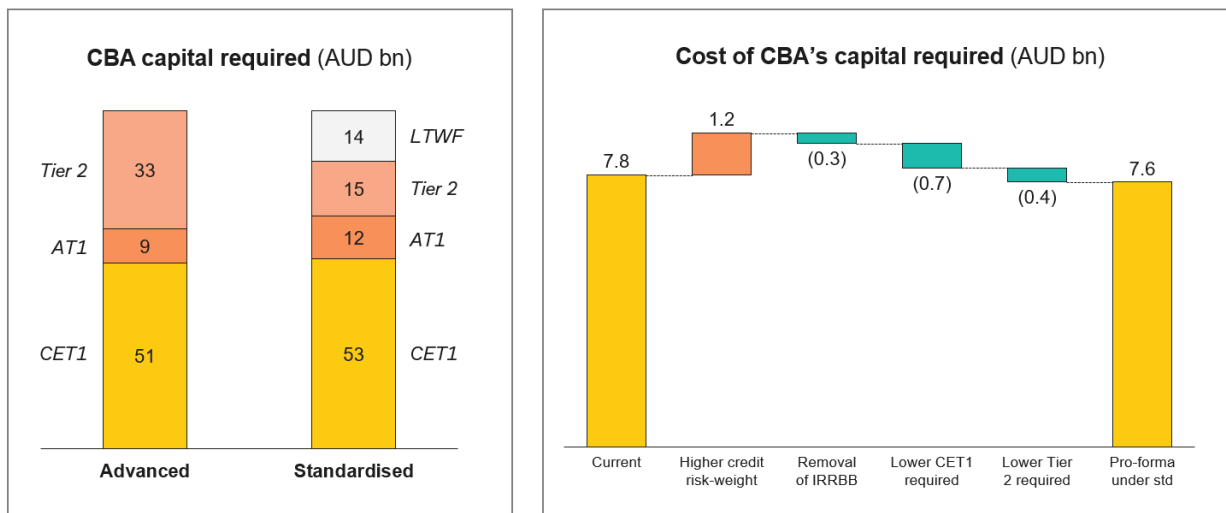
**Chart 1: Home loans risk-weights in Australia<sup>1</sup> vs largest European countries (by exposure)**



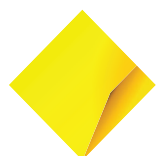
Home loan risk weights are just one of several factors that contribute to a bank’s overall capital requirements. For IRB banks, risk weights vary by the risk characteristics of each loan type, while for standardised banks, a single risk weight applies. When applied in aggregate across an entire bank, risk weights tend to be higher for standardised banks. This is offset by standardised banks not needing to hold capital for Interest Rate Risk in the Banking Book (IRRBB), and by lower CET1 and Tier 2 capital requirements.

We estimate that CBA’s total cost of funding would actually be ~\$200 million lower if calculated on a standardised basis (see Chart 2). Given the systemic importance of banks like CBA, we believe this is appropriate. However, it illustrates the narrow gap between the frameworks in Australia, despite the higher risk management standards expected of IRB banks.

**Chart 2: Financial cost difference between D-SIB and standardised framework for CBA**

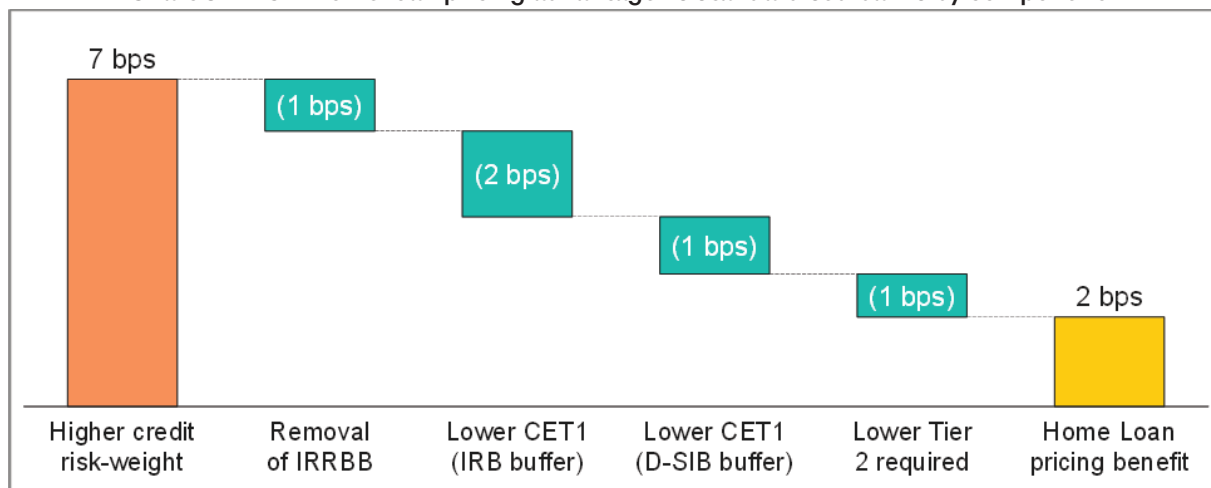


<sup>1</sup> Includes undrawn commitments and non-standard home loans that are required to be treated as standardised by Australian IRB banks.



We agree with the Issues Paper that the divergence in capital treatment between standardised and IRB banks leads to an immaterial competitive impact. As Chart 3 shows, we estimate that the pricing difference for home loans is only ~2 bps<sup>2</sup>. This would be even smaller if the incremental operational costs of attaining and maintaining advanced accreditation were considered.

Chart 3: D-SIB home loan pricing advantage vs standardised banks by component



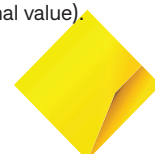
In summary, we do not believe that prudential requirements for banking activities are the root cause of the challenges currently faced by some small and medium banks. A lowering of prudential requirements for small and medium banks may be detrimental to their long-term viability, system stability, and broader confidence in Australia’s financial system. A lowering of prudential requirements led to the 2023 US Banking Crisis where Silicon Valley, Silvergate and Signature Banks all failed.

We also believe that the limits of regulatory proportionality have largely been reached in areas where there is high interconnectedness between industry participants and the system is only as strong as its weakest link. In these complex risk types, such as financial crime, cyber and scams, large banks should be expected to provide support to smaller banks where possible.

Noting this, the Commonwealth Bank makes some of its anti-scams technology and intelligence available to other market participants. It is used by one medium-sized bank today, with one smaller bank and one fintech expected to be live soon. The relevant tool, NameCheck, has been used 80 million times and prevented more than \$650 million mistaken and scam payments since July 2023. (Note these figures reflect the use of NameCheck by CBA customers, not the total number). We are exploring whether any of the cyber investments we are making could be made available to smaller institutions. We are committed to exploring further initiatives to lower compliance costs for smaller banks and strengthen the overall system.

To support small and medium banks, greater flexibility could be considered on some regulatory obligations that are not critical to customer or system safety. For example, compliance with Open Banking and New Payments Platform roadmaps. Waivers for product design and distribution obligations for simple, low risk non-lending products could also be considered.

<sup>2</sup> CBA’s estimate differs from the Issues Paper on: includes loans required to be treated as standardised by IRB banks; cost of debt of 5.35% (CBA’s term funding cost); includes Tier 2 requirements for D-SIB; includes management buffers (+1.0% for CET1 and +0.5% for Tier 2); includes the new proposed capital framework; and includes value of franking credits (70% of their nominal value).



Permitting regional banks to work together on shared technology, operations, or compliance-type utilities to lower the cost of back-office services is also worthy of exploration. The pooling of payment capability serving many smaller banks through CUSCAL provides a helpful case study. Scale economies are particularly important in certain parts of the value chain, and there could be benefit in smaller banks being more easily able to pool these activities.

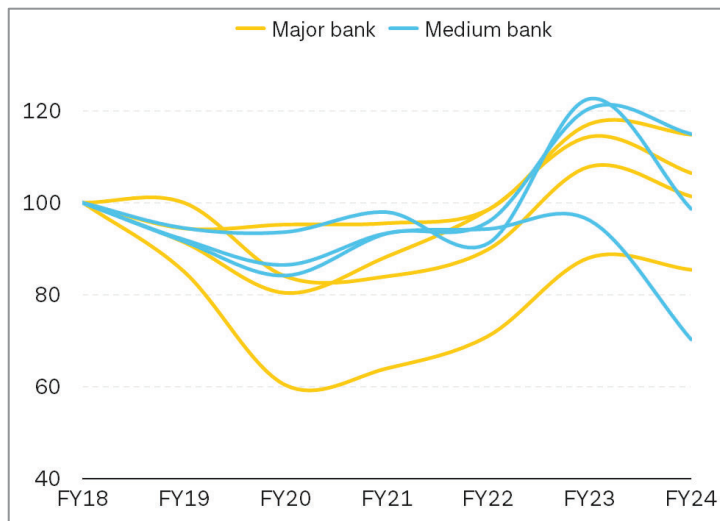
There has also been a suggestion made to lower the home loan serviceability buffer. The 3% home loan serviceability buffer is an important and appropriate macroprudential tool. It does not apply to non-banking financial institutions. While this is not a problem for the major banks, small and medium-sized banks are caught somewhere in between. Further consideration should be given to whether it is appropriate for NBFIs to operate without any buffer.

Finally, the Issues Paper (Graph 19) shows that there has not been a significant change in the profitability gap between the majors and small and medium banks compared to pre-COVID levels. This is consistent with the bank-by-bank performance shown in Chart 4 below.

Chart 4 also shows that overall industry earnings growth has been weak: close to nil for the majors and negative for the medium banks in the chart. It also shows that some medium banks have experienced a sharper decline in profitability in FY24. This is despite an extremely benign credit environment.

We believe this is largely driven by the structural change in competitive dynamics of the Australian banking industry. This has already started to challenge the viability of business models with higher home loan concentration and weaker organic capital generation. This includes some small and medium banks, along with banking services for regional Australia.

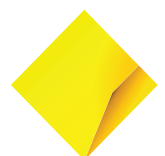
**Chart 4: Cumulative change in operating profit<sup>3</sup> (indexed to 100 in FY18)**



**4. Are current financial system protections for consumers appropriate? Are there any steps that could be taken to improve consumer outcomes?**

Customers of banks are generally well protected by Australia’s regulatory system.

<sup>3</sup> Compounded annual change in cash operating profit as reported by each ADI (four majors plus three non-IRB SFIs that report bank operational performance on a standalone basis).



Australia has an enviable record of leading the world in consumer protection legislation and regulations that help the community. Banks operate against this costly but necessary backdrop and the challenge of providing services to a small population spread around a giant land mass.

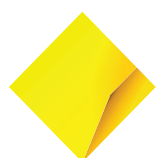
CBA welcomes the Scams Prevention Framework Bill before Parliament, which would legislate an ecosystems approach to scams prevention and detection. An ecosystem approach is required because most scams originate outside the banking industry. A concerted effort to address scams is required across banks, telcos and digital platforms to prevent, detect and respond to scams. Over the past two years, CBA has reduced customer scams losses by just over 70% but there is more to be done.

We also welcome the Payments Systems Regulation Act reform Bill before Parliament that would also move to establish greater customer protection by establishing a framework to regulate payment service providers.

Finally, recent reforms to Buy Now Pay Later and payday lending will help protect customers from predatory practices.

***5. Are there changes that could be made to resolution tools (including the FCS) that would enhance the balance between safety, stability and competition in the overall regulatory framework?***

Australia is well served by current settings including the current design of the Financial Claims Scheme. Notwithstanding the international moves to an ex-ante funding model, CBA believes the regulatory and prudential system as a whole provides strong protection for Australian depositors.



### 3. Funding

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

The recommendations set in the 2014 Financial System Inquiry have successfully achieved its first objective: an efficient and resilient funding of Australia's economic growth. Supported by "unquestionably" strong capital levels, major banks are among the best rated by foreign and domestic investors, leading to a low cost to import capital to Australia. In 2024, we saw Australian banks' subordinated debt in the US trading at a lower cost than national champions such as JP Morgan or Bank of America.

This ability to import capital ultimately benefits borrowers than can access cheaper funding. It also benefits the overall economy: as noted by the RBA, Australia's net foreign liabilities have fallen sharply in recent years to the lowest level since the mid-1980s. This is partly driven by major banks, which represent a significant proportion of Australia's foreign debt liabilities<sup>4</sup>. Major banks understand their role in representing Australia's national interest beyond their own institution when engaging with foreign investors.

We believe that importing capital predominantly through unquestionably strong entities is in Australia's national interest. Small and medium banks are subject to lower prudential requirements, have lower scale and diversification, and less comprehensive funding programs. This makes them less efficient at raising funds from sophisticated investors. In most economies, small and medium banks have a higher proportion of deposit funding. For example, European large banks have a loan-to-deposit ratio of ~110%, compared to ~95% for medium banks and ~80% for small banks<sup>5</sup>.

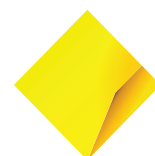
Small and medium banks can still access competitive forms of secured funding to grow in periods of high lending but weak deposit growth. Also, we believe that lower access to wholesale funding markets does not represent a material headwind to their profitability. As noted in the Issues Paper (Chart 12), large, medium and small banks have reported a similar cost of funds in the past decade, with medium banks currently enjoying a lower funding cost than large banks.

We do not have concerns regarding an increase of small and medium banks covered bonds capacity, although we believe the impact is likely immaterial. This is because only eight banks (including the majors) have issued covered bonds, using on average around a third of their limit – as noted in the Issues Paper.

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<sup>4</sup> The Extraordinary Decline in Australia's Net Foreign Liabilities (RBA, October 2023).

<sup>5</sup> European Banking Authority Risk Dashboard (Q3, 2024)



## 4. Entry, scale, and exit

### **9. *What is the role and impact of the small and medium banks in providing competition? How does this benefit consumers?***

Small banks often target different niches in the competitive fringe for the most part, including underserved communities including regional communities. As the ACCC has noted, it is important Australia has a market structure that enables a competitive fringe of second-tier firms to participate and deliver good consumer outcomes.

We note that recent developments in the lending market where some lenders have moved to target only wealthy, digital, metro customers and have actively chosen to offer no cash or branch services or contribution to shared infrastructure.

Unless we have strong and viable small and medium banks, customer choice will reduce. We note that no recent or future entrants to financial services will likely seek to serve regional communities, vulnerable customers, or offer cash or in-person services.

As a country, if we decide that it is important to serve regional Australia, provide cash services, and serve more vulnerable communities and individuals, then there is a role for a public policy response.

CBA supports implementing a suitable mechanism to share across the industry some of the cost of providing critical but not commercially viable shared services like cash and regional in-person services. This will help many small and medium-sized banks to continue to play an important role in the market.

### **10. *How does the nature and extent of competition differ across different banking products and market segments (e.g. mortgages, credit cards, small business lending)? Please provide examples.***

### **11. *How has consolidation in the banking sector impacted competition?***

### **12. *What are the regulatory, consumer and market trends affecting small and medium banks' competitiveness?***

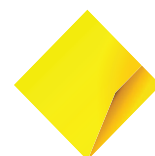
### **14. *What would be the characteristics of high levels of competition in the banking sector?***

The effects of intense competition in home lending over the past few years have been masked by a benign macroeconomic backdrop for banking: higher interest rates, low arrears and credit losses, low unemployment, and robust credit growth. We believe that competition has structurally disrupted the industry, making banks less resilient to a deterioration in economic conditions.

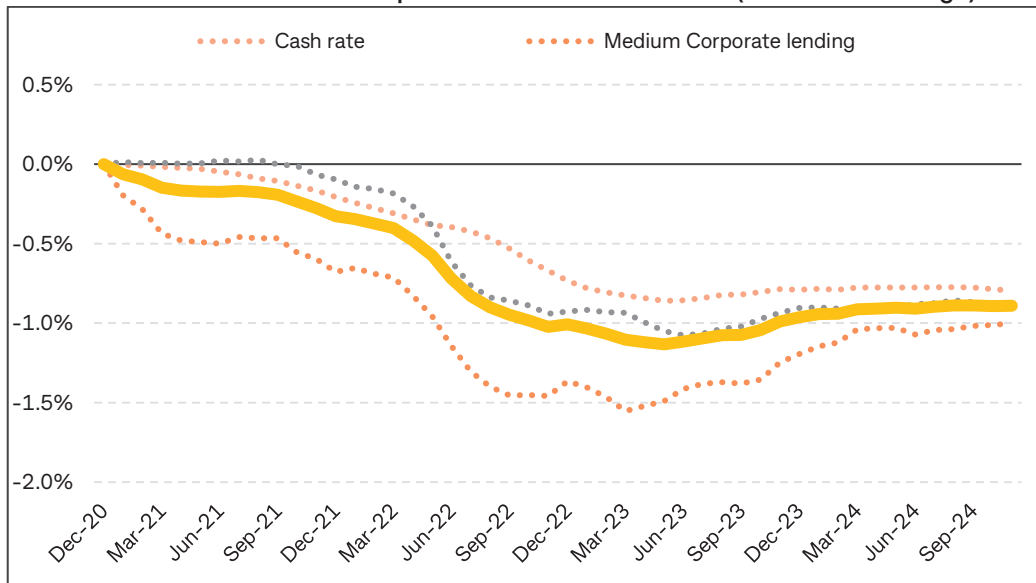
Industry economics have declined over the past decade. Over this time, Australian bank Return on Equity (ROE) has fallen from above to below average by international standards<sup>6</sup>. In particular, home loan rates have fallen 0.9% pts relative to alternative investment assets such as business lending or cash (see Chart 5).

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<sup>6</sup> See CBA 1H24 Results presentation ([link](#)), page 10.



**Chart 5: Home loan rates spread to other asset classes (cumulative change)**



The impact of competition is most acutely felt by smaller banks with a less diversified asset mix. Home loans represent 82% of medium<sup>7</sup> banks’ domestic lending portfolios, compared to 64% for major banks. Given this concentration, some of these banks have more acutely felt the decline in home loan profitability.

While the impact of extreme competition has already been felt by some banks with a more concentrated home loan exposure, the entire industry is more vulnerable to external shocks given its lower organic capital generation. International experience has demonstrated that banks unable to generate capital organically are unlikely to be supported by debt or equity markets when economic conditions inevitably deteriorate.

**15. What competitive pressures from sectors outside, or adjacent to, the banking sector are impacting the competitiveness of small and medium banks (e.g. mortgage brokers, nonbank financial institutions, payment providers, expansion of major tech companies and platforms in payment services and financial services)?**

The banking sector is also facing competitive pressures from non-bank financial institutions, payment providers, mortgage brokers, and major tech companies expanding into financial services.

These entities often offer innovative and convenient solutions that can attract customers away from traditional banks and often benefit from regulatory arbitrage.

Globally, the scale and pace of change in the provision of financial services is also relevant to any assessment of the competitive landscape. Several fintech companies have experienced rapid growth in offshore markets and increasingly, big technology companies are now offering a range of retail financial services including savings accounts.

In response to this competition, CBA continues to focus on driving innovation. For example, in our home lending offering we continue to focus on the delivery of distinct and differentiated customer experiences.

<sup>7</sup> Bank of Queensland, Bendigo and Adelaide Bank, ING Bank, Norfina, HSBC Bank, AMP Bank and Heritage and People's Choice.  
12 Commonwealth Bank of Australia | 7 February 2025



CBA is focused on delivering distinct product innovations (e.g, CBA App, Yello, our digital home loan) and also responds to pricing pressures in the market to provide more value for customers.

We continue to support customers who prefer a face-to-face experience via our network of CommBank lenders and mortgage brokers. CBA proudly maintains Australia's largest branch network and bank-owned ATM network, providing customers across the country with a wide range of flexible banking options and locations.

***16. Are there barriers to entry (including inefficiencies in licensing frameworks), expansion, and exit? If so, what are these barriers and how could they be removed?***

In CBA's view, the barriers to entry and expansion have significantly reduced. For example, barriers to new entrants seeking to supply retail deposit products to Australians have declined because of developments in technology and the introduction by APRA of the Restricted ADI licence.

Continuing to foster a supportive ecosystem for fintech collaborations and providing access to funding and mentorship programs can help further reduce these barriers.

***18. How can the risks and benefits of utilising third-party providers be appropriately balanced when being used to achieve scale?***

Using third-party providers can help small and medium banks achieve scale by accessing advanced technology and services without significant upfront investment. However, it is essential to balance the risks, such as data security and dependency on external providers, by implementing robust risk management frameworks and ensuring compliance with regulatory standards. It is CBA's view that CPS230 provides a strong regulatory oversight framework.

