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29 August 2014

Mr David Murray
Chairman
Financial System Inquiry
GPO Box 89
Sydney NSW 2001
Email: fsi@fsi.gov.au

Dear Sir,

Response to Financial System Inquiry (Interim Report)

Coles and GE Capital (GE) welcome the opportunity to respond jointly to the Interim Report of the Government's Financial System Inquiry (the Inquiry).

On 15 July 2014, Coles announced its intention to enter into a joint venture (JV) business with GE. Subject to obtaining the relevant regulatory approvals, the JV will commence operations in the first half of 2015, extending the financial services offering in Australia with a range of credit cards and personal loan products, including new payment technologies such as the Coles Mobile Wallet.

Coles made a first round submission to the Inquiry on 31 March 2014 that outlined, among other things, the range of potential financial services offered by retailers, as well as recent international experience of retailers in increasing competition among financial service providers. As a new entrant into the financial services market, Coles is keen to engage with regulators and other stakeholders, as Coles offers a different perspective that can further inform future changes to the financial services industry.

Firstly, we believe our experience as a new entrant offers fresh insights into barriers to entry. Secondly, as the strategy of Coles and the JV will be focussed on providing innovative technology-based solutions to enhance the overall customer shopping experience, Coles can help illustrate how innovation can improve consumer experiences and where specific regulatory frameworks might need adjustment to leverage new technologies and enhance competition.

This letter also references issues raised in the Interim Report where the combined experience of Coles and GE, especially in preparation for the JV, may be of particular interest to the Inquiry. In particular, we would submit that:

- The proposed abolishment of the SCCI is essential to restoring the balance between competition and regulation in the credit card market. By lowering the barriers to entry, it provides opportunities for additional new entrants into the credit card market, creating greater competition, while still ensuring that participants meet adequate eligibility criteria;

- The regulation of credit card and debit card payment schemes improves competition and leads to more efficient outcomes for consumers. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral;

- There is opportunity to improve the effectiveness of the disclosure regime by using mechanisms to enhance consumer understanding, including layered disclosure, better information presentation, risk profile disclosure, online comparators, and removing disclosure requirements where they have proven ineffective, duplicative or confusing. The regime should facilitate new ways of providing information to consumers via technology and electronic delivery – and remain technology-neutral so it can keep up with the ever-changing technologies;

- Coles is acutely aware of the concerns of customers about the prospect of their personal data being sold. Whilst Coles does not sell personal customer information, Coles is of the view that there is capacity for further rigour to be introduced into the Privacy Act to require businesses to expressly disclose whether this is their practice. We believe this would further empower consumers to make informed decisions about to whom they're prepared to entrust their personal information.

Coles wishes to reinforce to the Inquiry our belief that a strong financial services offering from non-traditional sources such as retailers, might reduce the levels of concentration in the banking sector. We would note that the creation and announcement of the JV builds on almost two decades of experience by Coles in providing (via an agreement with GE) financial services products.

Coles, under its Coles Financial Services brand, began offering car and home insurance in 2010. Since then, Coles has progressively expanded its range of financial services products to now provide consumers with Coles Life Insurance and a range of credit cards, including the Coles 'No Annual Fee' MasterCard and the Coles Rewards MasterCard. We believe that consumers are positive about the Coles brand and our intuitive understanding of new technologies with simple features and how they can improve the overall consumer experience.

With more than 350,000 insurance policies and 400,000 credit card accounts, Coles has been recognised by the industry with numerous awards, including the Australian Banking and Finance 'General Insurance Product of the Year' award, and Money Magazine's Best Transaction Credit Card (Non-Bank, 2014). In addition, the Mozo People's Choice Awards voted Coles Insurance Australia's Best Value for Money Car Insurer (2013). More recently, the Coles Mobile Wallet was also awarded 'Australian Mobile & App Design Award 2014 - Financial Information & Tools'.

The recently announced JV will extend our consumer offering to a range of credit cards and personal loans under the Coles brand. Initially, this may not appear significant, given that there are already two Coles branded credit cards on the market. Developing a product manufacturing capability for credit cards and personal loans via the JV, however, will allow Coles and GE to build the capabilities required to provide more competitive stimulus to the credit card and personal loan categories.

It should not be surprising that a large retailer like Coles would seek to expand its financial service offerings by leveraging its customer base and extensive distribution networks. This reflects the trends in offshore markets, particularly the experience of retailers in the UK, France and Canada. Although a relatively small proportion of the broader financial services industry, their contribution to the sector as a whole has been important in driving innovation, competition and greater consumer choice – and ultimately improving the affordability of financial services to consumers.

Australian retailers have lagged behind large retailers internationally which have expanded their financial services businesses to cater for a greater range of financial products that have traditionally been offered only by licensed banks.

Allowing retailers to expand easily but safely so that they may compete with financial institutions in personal financial services, brings several potential benefits to consumers including increased consumer choice and convenience, as well as further innovations.

Coles has already positioned itself as a potential leader in financial service technologies with products such as the Coles Mobile Wallet, which incorporates the Coles Pay Tag and Mobile App. We believe the convenience these new technologies will bring to the Australian consumer experience is substantial, and over time, has the potential to transform both the banking and retail sectors, as consumers demand increasing simplicity and transparency in their transactions.

Competition

Coles' first submission to the Inquiry described the regulatory burdens on new entrants and identified specific instances where the Inquiry might look to remove unintended barriers to innovation and new entrants. In providing an alternative to traditional financial institutions, Coles' strategy is heavily focussed on new technologies. This reflects our belief that innovative products have the potential to deliver real value, in terms of both price and convenience. As a retailer, and an innovative user of technology, Coles is particularly supportive of the Interim

Report's observations about competition and the need to support access by new entrants and new platforms.

Coles and GE agree with the Interim Report's initial assessment that "competition is important because of its ability to lower prices and improve [the] quality of financial products, services and markets" and that "the threat of new entrants can exert competitive pressure on incumbents". Retail group offerings in personal financial services in offshore markets have demonstrated its importance in driving innovation, competition and greater consumer choice.

While we remain of the view that the current regulatory framework in Australia is broadly appropriate, we continue to emphasise the need for the framework to encourage competition and avoid unnecessary barriers to entry. Based on Coles' recent experience in attempting to enter the market and expand our financial services, we would agree with the Inquiry's observation that "Australia's larger banks have a number of commercial competitive advantages over their smaller domestic rivals, including scale of operations, funding costs, product breadth and brand recognition".

Competitive advantage is not in itself a concern. Coles' own strategy is based on a belief in our competitive advantages – e.g. our understanding of the potential for technology to improve consumer experience and outcomes. It is only when a competitive advantage becomes an impediment to contestability that the advantage itself forms a barrier to entry for new players.

Competition in the payments sector

The Interim Report notes that there are separate standards or access regimes for the various payment system operators and that some "are subject to relatively intensive regulation, while others are less heavily regulated". In principle, we agree that there should be more consistency in the way different schemes are regulated.

With respect to interchange fees, Coles and GE are of the view that the current regulatory framework is appropriate and provides the right balance among all participants in the card segment of the payments system. The standards relating to interchange fees have assisted in driving technological innovations which, in turn, have greatly benefited consumers. In our view it is critical that the standards on interchange fees continue to encourage innovation and competition in the payments system.

Despite the significant advances that have been made to date under the current regulatory arrangements, we believe there is potential to enhance certain elements of the regulatory framework, particularly where there may be issues around competitive neutrality, efficiency or incentives to innovate.

Coles and GE support the view of competitive neutrality in interchange fees between payments of similar economic substance.[1] Expanding the scope of interchange fee caps to non-regulated schemes will allow schemes to compete on a more level playing field. We believe that this will ultimately drive greater efficiencies, system performance and increased innovation across the payment systems.

Under the current arrangements, the non-regulated schemes have competed more on benefits (such as shopping vouchers, frequent flyer points and travel insurance) and less on innovation (e.g. mobile wallets and other payment innovations). Arguably, this price-agnostic competition delivers benefits to consumers where merchants (such as Coles) absorb the higher acceptance costs of non-regulated schemes (i.e. where a customer surcharge is not applied). The use of non-regulated card schemes has significantly increased over the last 16 years, making the current model increasingly unsustainable for both merchants and consumers.[2] This is further exacerbated by the increasing use of surcharging by some merchants to recover the higher acceptance costs of non-regulated schemes, resulting in a poor experience for both the consumer and the merchant at point of sale.

By comparison, the introduction of interchange fee caps for regulated schemes (i.e. four-party) has been associated with benefits, including better system performance and reduced merchant service fees. The caps have also assisted large merchants to attract investment and innovation to the payment sector, thus enhancing the customer experience. In particular, Coles has developed new payment innovations such as FastPay (Box 1) and, together with GE, the Coles Mobile Wallet (Box 2).

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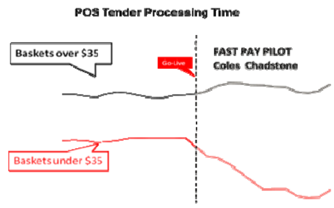
[1] Coles and GE notes that there are three party schemes which function as four party schemes in a "companion card" scenario, these should be regulated on a similar basis as four party schemes to promote competitive neutrality.

[2] The impact of regulation being contained to four-party payment schemes has seen an increase in the share of non-regulated products, across all credit cards within the Coles Switch, from 9% in FY04 to 24% in FY14 (a 10 year CAGR of 10%). This compares to the RBA data showing growth from 15% in FY04 to 19% in FY14 (a 10 year CAGR of 2%). Had the share of non-regulated products remained stable at 9%, then on an underlying basis Coles' acceptance costs increased by 21% in FY14 due to the growth of the share on non-regulated products.

Box 1 – FastPay

Introduced in June 2011, FastPay is a payment capability that allows customers to pay for purchases under $35, without the need for a signature or PIN. This payment system is limited to cards from Visa, MasterCard and Amex schemes. Similar to the introduction of other contactless payment technologies, FastPay has delivered greater convenience to customers and significantly reduced POS processing time, by as much as 45 per cent. This has contributed to the rapid growth in contactless payments in Australia, with Australia now being the number 1 market in the world in terms of contactless usage.



Box 2 – Coles Mobile Wallet

Coles has taken contactless payment technology further by adapting it for use in mobile phones. In July 2014, Coles and GE launched the Coles Mobile Wallet, enabling customers to make contactless payments – using the Coles Pay Tag attached to their mobile phones.

The Coles Mobile Wallet can be operated using an iOS or Android app by the customer and has the additional function of turning the Pay Tag on and off, providing the customer with enhanced control and a greater sense of security.

These innovations have delivered greater convenience to customers, whilst substantially reducing the point-of-sale (POS) processing time. More importantly, the growth in adoption of these types of payment innovations, demonstrates the demand by consumers for products that simplify and streamline purchases and help them to manage their finances.

Regulatory architecture

Currently, Banking Regulation 4 and the RBA's access regimes (which are applied to eftpos, Visa and MasterCard) require entities that engage in 'credit card issuing' and 'credit card acquiring' to be licensed as an Authorised Deposit-taking Institution (ADI) by APRA (either as a fully-licensed ADI or as a Specialist Credit Card Institution (SCCI)). Prudential regulation by APRA involves a significant undertaking and creates considerable barriers to entry for entities wishing to provide credit card services. It is also arguable that the regime did not achieve its intended objective of increasing competition.

On 7 March 2014, the RBA announced that it has decided in principle to vary the Visa and MasterCard access regimes and to seek removal of the SCCI framework (including repeal of Banking Regulation 4). The RBA concluded that the current access regime may be unduly restricting access, and proposed a framework that would allow Visa and MasterCard to expand membership beyond existing participants. The schemes will be required to have in place transparent eligibility and assessment criteria for accepting participants, and must report information about membership and applications to the RBA. It was expected that the variations to the access regimes and the repeal of Banking Regulation 4 would become effective by the end of 2014.

We also note that the removal of the SCCI framework will require revisions to the Bulk Electronic Clearing Systems (BECS) rules governed by the Australian Payments Clearing Association. While Coles and GE are not aware of any specific issues that would delay the removal of the SCCI framework, we stress the importance of maintaining progress towards implementation. The removal of the SCCI framework (by the end of 2014) is a critical step in facilitating the JV's proposed commencement in April 2015.

These reforms will, in effect, allow non-ADIs (including the Coles and GE JV) to directly acquire and issue credit cards should they meet the scheme's criteria. And as the RBA acknowledged in its submission to the Inquiry, the (credit card) access regime, which currently excludes non-ADIs, may no longer strike the balance between competition and regulation "given the change in the ownership structures of the schemes (from member associations to listed companies) and the interest shown by some niche players, which might not warrant full prudential regulation, in seeking access to the card systems."

Opening the credit card market to additional new entrants, with lower barriers to entry, should promote greater competition in the credit card market, while still ensuring that participants meet adequate eligibility criteria. In turn, increased competition from non-traditional players will inevitably increase the differentiated product offerings in market, creating increased consumer choice.

In addition to the credit card access regimes, Coles explored the regulation of Non Cash Payments (NCPs) and other forms of payment facilities (such as PPFs) in its first submission. It noted that the existing regulations affecting non-cash payments and other forms of payment facilities are complex and layered by multiple requirements that are administered by ASIC, RBA and APRA. This complexity may prevent new participants from developing innovative payment facilities for the benefit of consumers. New participants wishing to enter the market with an innovative product offering face an effective barrier to entry due to the lack of clarity in regulations that apply, and the costs that may be involved if they were to become subject to prudential supervision. Coles suggested a review of the regulatory framework associated with NCP, PPFs and related payment facilities.

The Inquiry's Interim Report addresses these concerns by noting the RBA's views that "imposing regulation equivalent to ADIs on these players could be onerous, and a graduated framework may be more appropriate." We support the Inquiry's views that the framework could be "tiered with clear thresholds for when an activity or participant becomes regulated". This graduated framework should take into account the risks posed by participants, the costs associated with imposing prudential regulatory requirements, and the potential negative effects on innovation and competition. Coles supports the proposed approach to streamline the current regulatory framework for NCP, PPFs (including stored value payment systems) by imposing a graduated framework.

Consumer outcomes – Disclosure within the context of technology neutrality

Coles and GE support the policy options in the Interim Report to improve the effectiveness of disclosure by using mechanisms to enhance consumer understanding, including layered disclosure, better information presentation, risk profile disclosure, online comparators, and removing disclosure requirements where they have proven ineffective or duplicative.

The Interim Report notes that the disclosure-based regime implemented following the Wallis Inquiry was intended to be principles-based "to allow maximum flexibility for product issuers." Yet, in practice the regime has:

> … subsequently been driven by an industry culture of legal compliance, rather than a focus on how best to inform consumers. This has resulted in lengthy and complex documents, rather than short, targeted documents that highlight product features, risks and rewards.[3]

We support the need for providing disclosure to consumers to enable them to make informed decisions. However, we believe the current regime is not effective in enabling consumers to make truly informed decisions and consistently purchase financial products and services that meet their needs. Behavioural economics is providing regulators with new understandings about decision making processes and heuristics which we would like to see reflected in disclosure requirements.

Recent findings from the field of behavioural economics show how 'volume and detail' in disclosure regimes perversely increase information asymmetries. The UK Financial Conduct Authority (FCA) has undertaken research that has found:

> Consumers often focus on a few headline rates and ignore the additional information about features or charges that is provided to them. Information disclosure requirements that do not take into account how consumers' process information are likely to be ineffective or even counterproductive.[4]

[3] Financial System Inquiry Interim Report, page 3-54
[4] FCA, Occasional Paper No.1, Applying behavioural economics at the Financial Conduct Authority, April 2013. Page 25

The FCA notes further that, if information is provided "in lengthy legal terms that make it excessively costly to access and assess, then poor consumer choices are also likely."[5]

Coles and GE believe that there is an opportunity for the disclosure regime to be simplified and targeted in order to be more meaningful to consumers

ASIC has provided a set of 'Good Disclosure Principles' to help in preparing Product Disclosure Statements in the Financial Services regime[6]. These Principles are that disclosure should:

- be timely;
- be relevant and complete;
- promote product understanding;
- promote product comparison;
- highlight important information; and
- have regard to consumers' needs.

Although this guidance does not apply to the credit regime, we believe that this type of 'principles-based' guidance should be the starting point for disclosure of all products.

We also strongly support moves to facilitate new ways of providing information to consumers, including using technology and electronic delivery. The delivery mechanism itself – such as a digital platform – does not form a barrier to the provision of quality information. Thus, disclosure requirements should be technology-neutral to allow service providers to arm consumers with information that is relevant, informative and facilitates informed choice.

Technology neutrality should also extend to product promotion where regulations on advertising – particularly digital and online advertising – need to stay on pace with developments in social media and upcoming digital delivery methods.

Overall, the emphasis needs to be in ensuring that we empower consumers to make the right choices when selecting credit and financial services products. We believe that technology is key to enhancing this process, as it enables consumers to receive information from the channels that are familiar to them.

Data Privacy

Coles takes the confidence and security of the personal information it manages seriously. Coles approach to managing privacy is to do what is right for customers, not just what is required under the law.

Coles only shares data internally within the Wesfarmers Group, GE (for the purposes of operating the Coles MasterCard products), flybuys partners and service providers (such as printers and mailing houses) that work with Coles to deliver a high standard of customer service. Coles carefully selects its services providers and only works with trusted partners who share the same values as Coles. Importantly, Coles does not sell the personal information of its customers.

The latest changes to the *Privacy Act 1988* (Cth) commenced only recently on 12 March 2014. Coles agrees with the Inquiry's proposal to review and assess the new privacy requirements two years after implementation. This will allow consumers, the industry and the regulator to understand the impact of those reforms which directly go to the management of personal and credit information. In particular, Coles notes that the efficacy of the framework for comprehensive credit reporting has yet to be tested. An opportunity to observe the Privacy Act in practice will also give stakeholders the opportunity to assess the impact reforms such as Australian Privacy Principle 11 have on cross-border information flows and any opportunities for mutual recognition of the data protection laws of Australia's trading partners. With significant inconsistency in the management of personal information across different jurisdictions, Coles believes that Australia, with its robust regulatory regime, is well positioned to lead international discussions aimed at raising the standards, and would encourage the Government to do so for the benefit of Australian consumers and business.

[5] FCA, Occasional Paper No.1, Applying behavioural economics at the Financial Conduct Authority, April 2013. Page 24
[6] ASIC Regulatory Guide 168, Disclosure: Product Disclosure Statements (and other disclosure obligations), October 2011

The Inquiry has invited further information on the options for improving the ability of consumers to make more informed decisions. Coles is acutely aware of the concerns of customers about the prospect of their personal information being sold. While Coles does not sell personal information, Coles is of the view that there is capacity for further rigour to be introduced into the Privacy Act to require businesses to expressly disclose whether this is their practice. We believe this would further empower consumers to make informed decisions about to whom they're prepared to entrust their personal information.

We would be more than happy to meet with the Inquiry and explore any of the points outlined in this letter. If the Inquiry wishes to do so, please contact Chris Mara from the Coles Corporate Affairs team on 03 9829 4141. Fundamentally, we believe that a vibrant financial system requires competition. This provides better outcomes for Australian consumers, and the broader industry. This includes creating a system that encourages continued competition in the market through innovations that keep up with the ever changing landscape of the Australian market.

Yours sincerely,

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