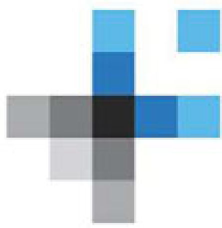

LAMINAR CAPITAL

Laminar Capital
info@laminarcapital.com.au
www.laminarcapital.com.au

Melbourne
Level 46 Rialto South
525 Collins Street
Melbourne VIC 3000
+61 3 9001 6990
+61 3 9001 6933

Sydney
Level 42, Gateway
1 Macquarie Place
Sydney NSW 2000
+61 2 8094 1230
+61 2 8094 1233

Brisbane
Level 18
123 Eagle Street
Brisbane QLD 4000
+61 7 3123 5370
+61 7 3123 5371

25 May 2018

Rosalyn Bell
Competition in the Australian Financial System
Productivity Commission
GPO Box 1428
Canberra ACT 2601
By email financial.system@pc.gov.au

Competition in the Australian Financial System Productivity Commission - Draft report

Dear Rosalyn,

Thank you for the opportunity to comment on the Competition in the Australian Financial System.

Productivity Commission Draft Report. Laminar Capital is a leading advisor to the mutual Authorised Deposit-taking Institution (ADI) sector. Our expertise has been sought by many mutual ADIs due to our deep understanding of the capital markets, our unique insights into factors effecting funding and capital, and our expertise in structuring solutions.

We have been engaged by the largest ADIs in the sector to establish wholesale funding programs, provide outsourced treasury solutions to smaller ADIs that don't have the expertise in house and provide specialist services and advice with structuring and managing securitisation vehicles. We currently manage approximate $2 billion of treasury portfolios and act as a trust manager for mutual ADI self-securitisations totalling in-excess of $1 billion

Our constant interaction with the sector coupled with our market penetration and presence gives us unique insights into the challenges facing the mutual ADI sector.

We are pleased to put forward our comments on the draft Productivity Commission Report. In addition to providing our insights on the mutual ADI sector, our submission includes an alternative funding structure that we believe will have a meaningful impact on the cost of funds of the mutual ADI sector and are seeking government support for the initiative.

Should you wish to discuss any comments made in this submission, please do not hesitate to contact me via email or phone.

Yours sincerely

Cameron Rae
Managing Director

Laminar Capital Pty Ltd
ACN 134 784 740
AFSL 476686

Funding Markets for Mutual ADIs

The draft report and various submission highlight the difference of funding costs between the major banks and smaller institutions. Laminar's daily interaction with the mutual ADIs regarding their funding requirements gives us unique insights to the sector as a whole, which has prompted us to provide comment on the regulatory attempts to level the playing field and suggest an alternative course of action.

> *Further policy reform is needed to reduce the artificial funding cost advantages enjoyed by the major banks.* (MyState Financial)
>
> *One of the major issues on the agenda of the Council of Financial Regulators that will affect competition is tackling the 'too big to fail' problem that gives the major banks an unfair funding cost advantage over their smaller competitors.* (COBA)

The draft report dedicates Chapter 5 to funding models and their effect on competition. Draft finding 5.1 covers the funding advantages that the larger banks have and suggests that raising their costs of funds in an attempt to level the playing field does not improve competition.

> DRAFT FINDING 5.1 COST OF FUNDS FOR DIFFERENT SIZE BANKS
>
> Larger authorised deposit-taking institutions (ADIs) benefit from lower costs of funding, compared with smaller institutions, as they can access funding markets overseas more easily and have higher credit ratings, which in part reflect an expectation of government support.
>
> In addition, larger institutions gain a cost advantage from being allowed to use risk weights that are lower than the Australian Prudential Regulation Authority's standard requirements.
>
> These lower costs of funds are not fully passed on to borrowers in the form of lower interest rates.
>
> Attempts to artificially raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and harm consumers.

Our submission discusses some areas of the capital markets not focussed on in the report and how these markets directly effect the cost of funds of the smaller ADIs.

A key point raised by the report identifies "*The cost at which banks and non-bank financial institutions source their funds has a substantial influence on their competitive position — those that benefit from lower cost of funds can offer customers loans at lower interest rates or boost their returns to shareholders*" (chapter5).

The report also identifies that the banking system has increased its reliance on deposits, in part as a result of the global financial crisis and the ensuing regulatory changes.

The deposit market is a vital source of funding for mutual ADIs, and in fact, is the only source of funding for many of the customer-owned institutions. While table 5.1 of the draft report examines funding sources available to mutual banks and Credit Unions and Building Societies (CUBS) as set out below, we feel the table needs further explanation.

Table 5.1 **Sources of funding for lenders**

Source of funding	*External factors that affect the price institutions pay*	*Which type of institution can use this funding source?*				
		Major banks	**Other domestic banks**	**Mutual banks and CUBS**	**Non-ADIs**	**Foreign banks**
Deposits	Price affected by cash rate	✓	✓	✓	×	✓ Retail deposits only for foreign bank subsidiaries
Short term wholesale debt	On domestic markets — price driven by cash rate, and influenced by the institution's credit rating. On foreign markets — price determined by supply and demand in foreign markets and influenced by institution's credit rating	✓	✓	✓	✓	
Long term wholesale debt		✓	✓	✓	✓	Funds are usually raised in the bank's country of origin – using any of these sources
New equity issuance	Determined by a range of market factors at the time of issuance	✓	✓	Only limited types of equity can be issued	✓	
Securitisation	Determined by a range of market factors at the time of issuance	✓	✓	✓	✓	

The are 75 customer owned institutions including 22 mutual banks which collectively hold $111 billion in assets and service 4 million customers[1]. However only 19 of these ADIs have a credit rating issued by one or more of the large credit rating agencies. This effectively precludes the remaining 56 ADIs from accessing other sources of funding and makes them entirely reliant on the deposit markets. The 19 rated intuitions have limited access to alternate funding sources which we will cover briefly below.

Wholesale Negotiable Certificates of Deposit (NCDs) are a short-term wholesale debt instrument issued by the banks to raise wholesale funds. It is an extremely important

[1] COBA

funding source with $140 billion outstanding and on average over $1 billion in NCDs are issued each day[2]

This market is only open to 19 rated mutual ADIs and there are virtually no institutional buyers of mutual ADI NCDs.[3] 98% of mutual ADI issued NCDs are being issued to other mutual ADIs - leading to significant systemic risk. APRA have identified this and have implemented an 80:20 rule which is imposed on mutual ADIs and sits outside the actual published liquidity regulations. The 80:20 rule states that only 20% of a mutual ADI liquidity book can be invested in securities issued by ADIs with a credit rating below A-. This essentially puts a cap on this type of funding for the larger mutual ADIs.

Likewise, long term wholesale debt is only open to the 19 rated mutual ADIs and is an expensive source of funds compared to the cost paid by the major banks. On average the mutual ADIs are paying approximately 50 basis points more for long term wholesale debt due to ratings differential. This ratings differential is exacerbated by the implied government support. This has been clearly identified in the draft report.

"The 'too big to fail' perception affects the cost of wholesale funding — as credit ratings agencies and investors see such institutions as safer due to the prospect of government support, and therefore ascribe higher credit ratings to them and, in turn, lend them money at lower rates or on less strict terms (chapter 5 discusses this issue in detail). The RBA estimated the size of this subsidy for Australia's four major banks at $1.9 billion a year. This BANKS' RESPONSES TO PERVASIVE REGULATION DRAFT REPORT 177 represents the amount of interest major banks saved due their lower funding rates." (chapter 6)

Securitisation – Smaller institutions that rely on securitisation incur higher costs when raising funds, partly because they use "warehouse funding" provided by the major banks. The regulatory changes associated with Basel III reforms now make warehouse provision prohibitively expensive for smaller institutions. The average cost of a bank provided warehouse is 120-150 basis points over the bank bill rate on a drawn basis however, it is the undrawn line fees that make warehouse funding non-viable for smaller ADIs who originate smaller volumes of loans. The undrawn portion of the facility attracts expensive fees further adding to the overall cost of funds. Those that do use bank provided warehouse facilities become beholden to the bank and must pay significant capital market fees when the bank elects to "term out" the warehouse by selling securitised notes into the capital markets. In many cases the smaller ADI is not permitted to use an independent lead manager to arrange the transaction, instead paying significant additional fees to the warehouse provider. This stifles competition and keeps mutual ADI funding cost high.

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[2] https://www.rba.gov.au/speeches/2016/sp-ag-2016-02-22.html

[3] Post GFC, the major banks pushed heavily into the term deposit markets. Institutional super funds have shifted from buying bank issued NCDs to investing in term deposits because of the higher rate the banks are paying for deposit funding. This was originally driven by regulatory change incentivising banks to hold a larger percentage of their funding in deposits and a decade later, the major banks are still dominating the wholesale deposit market with aggressive pricing crowding out the smaller ADIs from both the NCD and deposit markets.

The combined costs together with the fact that the smallest securitisation deal that the market will absorb is $250 million per transaction makes securitisation in its current form a non-viable option for all but the very largest mutual ADIs that can absorb the sudden excess liquidity that undertaking a market securitisation transaction creates.

This brings us back to the term deposit market and why it is such an important source of funding for mutual ADIs.

The term deposit market can be broken up into two main categories. Retail and wholesale.

The draft report discusses in some detail (chapter 6) how regulatory changes have driven up the cost of deposit funding however it makes comments that need further explanation.

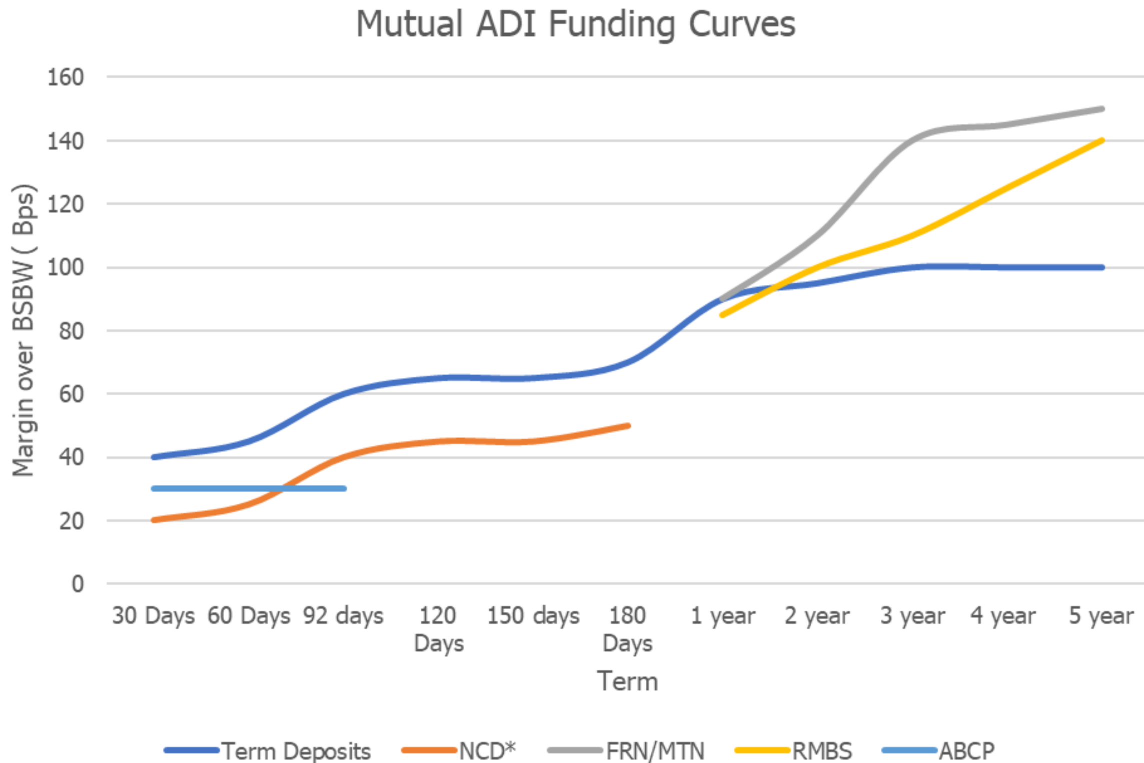
Further, as funding markets have recovered from the GFC, banks no longer needed to compete as strongly for deposits, as they could access alternative sources of funding — therefore interest rates offered to consumers have been relatively stable, or declining (chapter 6) is a statement that is misleading when it comes to the wholesale term deposit markets.

Wholesale term deposit markets are an important alternative source of funding for mutual ADIs that cannot access other forms of wholesale funding. Many smaller ADIs that have a limited catchment for retail term deposits (through either operating in a specific geographic region or have members tied to a particular sector, ie police, teachers, defence) can access additional funding through the vitally important "middle market".

The wholesale market itself is split into different segments including institutional investors (retail and industry-based super funds) and the broader market known as the middle market. This market consists of local councils, charitable organisations, universities, corporates and smaller super funds, all of which have significant portfolios of investment funds held in term deposits. The middle market enables the smaller ADIs to access funding without a credit rating, from customers nationwide.

However, the major banks are also highly active in this market and have for the past decade driven the cost of funding for the smaller institutions higher. Given their cost of funds advantage in other markets the major banks can afford to pay higher rates than the smaller institutions and dominate the deposits raised from this sector. They are effectively using their market dominance to stifle competition and shut out the smaller ADI from the only viable wholesale market that they have. A survey conducted by Laminar Capital of 20 ADIs (May 2018) regularly showed major banks having the highest deposit rates in the middle market with National Australia Bank, Bankwest and Westpac particularly active showing rates equating to 80 basis points over bank bill rate. This forces the smaller ADI to pay close to 100 basis points over bank bill to attract deposits making term deposits an expensive form of funding and heavily impacting their cost of funds, profitability and competitiveness.

The table below shows the different funding cost available to the mutual ADIs



A Viable Wholesale Funding Option

Draft fining 5.1 identifies the *"Attempts to artificially raise the cost of funds for larger institutions to offset their cost advantages do not improve competition and harm consumers."*

Rather than attempting to raise the cost of funds for the larger institutions (these costs usually end up being borne by the consumer), consideration should be given to measures that reduce the cost of funds for the smaller ADIs.

While term securitisation can be viewed as an expensive form of funding, secured instruments are the only form of funding that places large and small institutions on a level playing field. This is because the pool of assets securing the instrument (be it a term bond or short-dated commercial paper) are largely homogenous. A relatively small amount of credit support enables both large and small institutions to issue highly rated securities which are priced similarly in the market and can be bought by true institutional wholesale investors.

The cheapest form of securitised funding is asset backed commercial paper (ABCP).

ABCP is a form of highly rated short-term borrowing. It is created by an ADI selling or assigning home loans into a trust. Credit support is given to the trust through the issue of notes that rank subordinate to the short-term notes issued by the trust. The trust issues commercial paper (CP) to raise the funds required to purchase the loans. Because the trust

is issuing short-term liabilities is purchase long-term assets, the trust has a level of liquidity risk that it must manage. Short-term CP (usually 30 to 90 days) must be continually rolled over to match the longer term of the home loans that have been acquired by the trust. To enable a high credit rating to be assigned, the rating agent will require a highly rated entity within the structure to provide liquidity support. Historically this role was played by the major banks. The liquidity provider agrees to buy the CP onto their balance sheet in the event that there is no market bid. The ABCP market had outstandings of $65 billion prior to the GFC and was an important source of funding for many smaller ADI and non-bank lenders. Post GFC, regulatory changes meant the cost of providing liquidity to ABCP structures essentially broke the economics.

There are still some non-bank lenders who have active ABCP programs. A1+ rated CP is currently trading in the market at approximately 30 basis points over BBSW.

Laminar Capital has developed a structure which we believe can deliver cost effective funding to the mutual ADI sector through the establishment of a new asset backed commercial paper program. The missing link to this structure is a highly rated liquidity provider that can support the program in the event that market participation is eroded in the event of a crisis. We believe that the Australian Office of Financial Management (AOFM) could fulfil this role enabling the mutual ADIs to raise funding at much lower levels in the wholesale market. This would help reduce their cost of funds which will enable better price competition.

There is a precedent of the AOFM providing market support with the success of the residential mortgage backed buying program post the GFC. This has been recognised in the draft report where *"a range of other measures, such as the Australian Government's purchase program for residential mortgage backed securities (chapter 16). These measures were put in place to shore up depositors' confidence in ADIs, and enable the institutions to continue to use capital markets. On both counts, the RBA and APRA (2009) consider that the interventions have been successful."* (Chapter6)

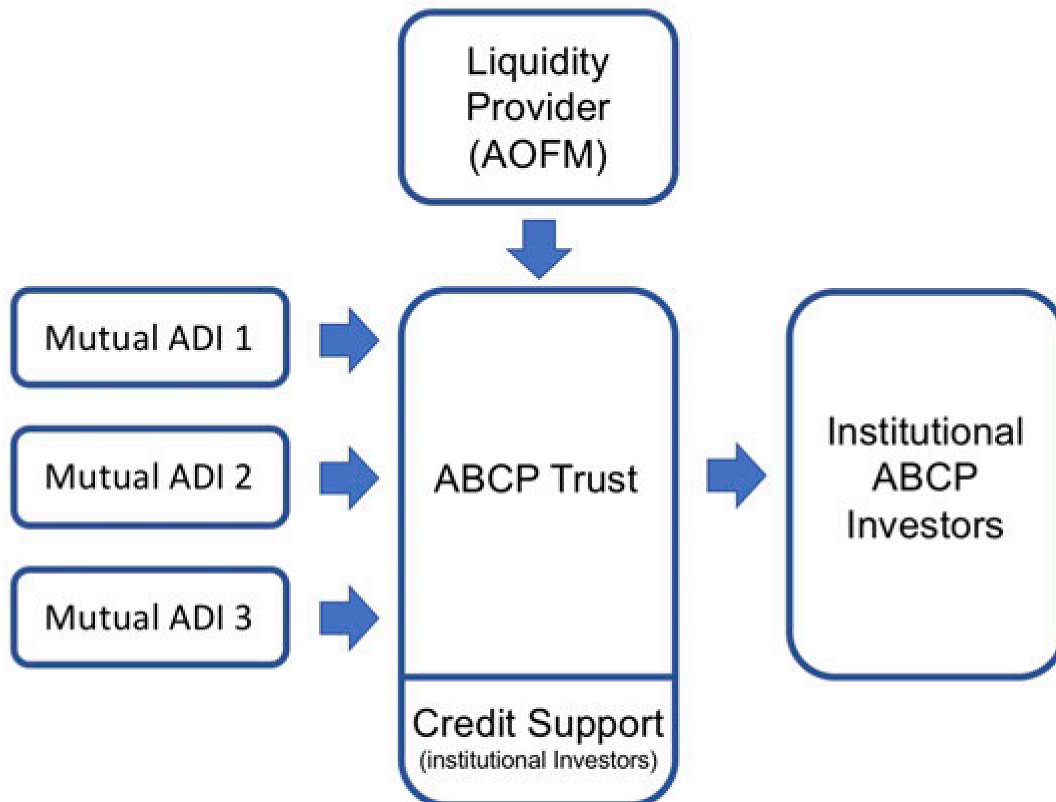
The report also identified that *"regulatory measures should seek to reduce costs. If relative risk weights are wrong, lowering them for smaller authorised deposit-taking institutions (ADIs) is more desirable than lifting them for others."* (chapter 16)

While this comment relates to the specific risk weight of mortgages we believe that AOFM involvement as a liquidity provider is an alternate measure that could significantly reduce the cost of funding for the mutual ADI sector.

Acting as a liquidity provider could result in the ABCP coming onto the public balance sheet in the event that the market bid evaporates. The credit risk associated with taking these types of assets on balance sheet can be mitigated by ensuring the required amount of credit support is provided to the trust. This is achieved by selling a note to institutional investors that take first loss. The credit support will be prescribed by the ratings agents and be sufficient to ensure the ABCP is A1+ rated and therefore repo eligible with the RBA. Australian ADIs had a history of generating quality asset backed securities with no ADI

originated securities ever failing their repayment obligations, even at the height of the global financial crisis.

The diagram below gives a brief outline of the structure.



Access to Capital

Much has been made of the revised prudential standard APS111 which came in to effect 1 January 2018 which facilitates the ability of mutually owned ADIs to directly issue CET1 instruments. This was the first recommendation of the recent Independent Facilitator Review (Hammond Review) into the mutual ADI sector[4].

A CET1 instrument by definition must be perpetual, the most subordinated claim in liquidation, not redeemable without APRA's approval and have distributions that are not obligatory, cumulative or subject to a contractual cap that may suggest payment is obligatory

[4] https://treasury.gov.au/publication/p2017-t235882/

While the adopted changes give a regulatory avenue for mutually owned ADIs to access CET1, we believe the practical implications are not so straight forward and distribution of such instruments needs to be undertaken with some caution. These instruments will be unlisted, largely illiquid and the target investors will be the mutual ADI members who may not be fully informed investors.

An informed investor will always look at the next best alternative when making investment decisions. At the time of writing the dividend yield of the listed regional ADIs was as follows.

ADI	Cash Yield (%)	Gross Yield (%)
Bendigo Adelaide Bank	6.35	9.08
Bank of Queensland	8.18	11.68
MyState Limited	5.96	8.52
Auswide Bank	6.03	8.62

Investors should ask themselves what premium they should expect or demand for investing in an illiquid, perpetual security with the income stream not obligatory or cumulative. In fact, in the event of a crisis, investors could end up holding a perpetual zero coupon instrument with no market to exit or crystallise losses.

Given the alternative is to invest in listed ADI shares with gross yields of greater than 8.5%, one could argue that the cost of CET1 capital for a mutual ADI should be in the order of 10% as a minimum. This should be viewed against the current ROE of the sector which has averaged 4.69% over the last 2 years[5]. It makes little economic sense for a mutual to raise CET1 at significantly higher rates than their current ROE given its impact on earnings. The more capital the ADI raises via these types of securities the greater the negative impact on equity which can end up with the ADI in a negative earnings position.

Their alternative is to raise equity from potentially less informed members. Every mutual ADI will have members that would view CET1 instruments as an alternative to term deposits and possibly be attracted to returns at 2% over the prevailing term deposit rates. Selling perpetual equity investments to members could provide mutual ADIs with a significant moral hazard risk particularly in the event of a crisis where members may request to "redeem" their investments.

We don't believe regulatory changes that allow mutual ADIs to issues CET1 in the form of a mutual equity interest will have any meaningful impact on their ability to compete or drive down cost of funds but it will serve as an important source of capital for mutual ADIs who require CET1 rather than other forms of readily available capital such a subordinated debt.

[5] https://home.kpmg.com/content/dam/kpmg/au/pdf/2017/mutuals-industry-review-2017-data.pdf

Conclusion

Having access to a cheaper cost of funds can lead to lower loan rates, and/or greater net interest margin which drives profitability and therefore retained earnings and CET1 levels. Well run profitable mutual ADIs should be capable of generating strong levels of organic capital given they are free from shareholder demands of ever having to pay dividends.

We believe a healthy mutual sector is vital in providing competition as they have a key point of difference as member-owned organisations. The royal commission has shown that banks are putting profits and shareholder returns above the interest of customers.

Customer owned banking institutions have a built-in advantage on their listed competitors in complying with consumer protection regulation because customers are the number-one stakeholder. They are not trying to maximise returns to shareholders by squeezing customers and cutting regulatory corners.[6]

We have provided this submission to raise the awareness regarding the current state of the funding market and to draw attention to an initiative that we believe would offer an important alternative source of lower cost funding.

The draft report acknowledges that *"History suggests that even where Australia's smaller ADIs are given a regulatory advantage over the major banks, they do not noticeably take advantage ……..*

An exception may be the mutual ADIs, which do not face the same shareholder pressures as other ADIs. The Customer Owned Banking Association reports its members' standard variable rate on home loans average 0.4 to 0.8% points lower than the major banks' rates. However, their scope to lower lending rates further is probably even more limited than other ADIs simply due to narrower sources of funding. (page10)

Government support through The Treasury and its mandating of the AOFM to act as a liquidity support provider to a securitisation vehicle specifically for the mutual ADI sector would allow smaller institutions to use securitisation as a viable source of funding. Our commentary and findings presented in this submission have also been shared with The Treasury.

We would welcome any further dialogue you would like to have on the content of this submission.

[6] http://www.customerownedbanking.asn.au/media-a-resources/media-release-alerts/1281-coba-op-ed-on-royal-commission