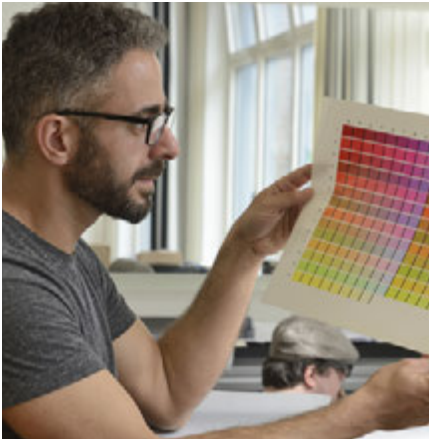


REGIONAL BANKS
MARCH 2018
COMPETITION



LEVELLING THE PLAYING FIELD IN RETAIL BANKING

SUBMISSION TO THE PRODUCTIVITY COMMISSION

SECOND SUBMISSION





Mr Peter Harris AO
Chairman
Productivity Commission
Delivery via e-mail: financial.system@pc.gov.au

23 March 2018

Dear Peter

Regional Banks - Submission to the Productivity Commission

We congratulate the Productivity Commission, Commissioners and Secretariat staff for the Draft Report of their inquiry into *Competition in the Australian Financial System*, released in January 2018. At 628 pages, it is one of the most comprehensive investigations of competition into our industry.

As you know, the Regional Banks have focussed on making recommendations to level the playing field in retail banking. By ensuring competitive neutrality, the supply-side of the market will be best positioned to serve the interests of household and business customers - the ultimate goal.

The impediments to competitive neutrality outlined in our submission have been well canvassed in the Draft Report. As such, we support the recommendations as a comprehensive package. In this, our second submission, we encourage the PC to prioritise the reform agenda on the supply-side, and we contribute a further 11 points for consideration.

Your inquiry is occurring at a critical time. We are facing increased community and political scrutiny after many examples of poor banking conduct. This is reflected in countless Government inquiries, a Royal Commission, and more intensive regulatory interventions, most recently the *Banking Executive Accountability Regime (BEAR)*.

The community is increasingly looking to the Government to solve identified problems and restore trust in the sector. Confidence in the ability of competition to deliver the best customer outcomes appears to be waning. This began with the Global Financial Crisis (GFC), which undermined confidence in financial institutions, however, there is no doubt recent concerns around culture and conduct, in some sections of the banking sector, has intensified negative sentiment.

In response to this, regulators and government have placed additional obligations on all ADIs – and in doing so, have threatened innovation, failed to appreciate the disproportionate burden this places on smaller ADIs, and exacerbated the unlevel playing field, further dampening competition. Collectively, this in turn leads to further impacts on customer outcomes.

The optimal solution is to ensure the supply-side of the market is working as effectively as possible, based on the principle of a level playing field. Only then, will the benefits of initiatives to strengthen the demand-side be fully realised.

We believe there is a real risk that government and regulators will focus policy attention on measures that will have limited impact on competitive outcomes and fail to address issues that, while perhaps more difficult, would ultimately deliver greater consumer benefits.

Fintech's are mainly collaborating

The Regional Banks agree with the PC's finding that fintech companies are not currently providing competition to the major banks, rather, they are collaborating.

We acknowledge that fintechs are able to deliver value to customers faster using technology, platforms and data insights which result in better customer experiences. The momentum and value created by fintech companies can assist smaller banks, and indeed, a number of Regional Banks have already developed fruitful partnerships. However, we do have a concern the Government may be placing too much importance on the capacity of fintechs to single-handedly provide a disruptive competitive force in retail banking.

The reality is that a fintech's value is maximised when sold to a major bank which has a large customer base and low funding costs. A sound fintech business model is to develop a technology that potentially disrupts a component of a product supply chain, then sell the assets to a major bank.

Foreign banks have had limited success in retail banking

The PC's Draft Report notes that foreign owned subsidiaries have had limited success in competing in Australian retail banking and have instead specialised in niche advisory and market segments. There is little reason to believe this situation will change in the foreseeable future.

The trend in regulation since the GFC is to encourage international banks to reduce their size and geographic footprint, not expand. Globally systemic banks (G-SIBs) are subjected to higher capital charges and domestic regulators are wary of the taxpayer implications of allowing these banks to expand outside their home jurisdiction. Many countries are discouraging growth with taxes on total liabilities.

Another relevant factor is that very few notable foreign banks benefit from an implicit subsidy to the extent of Australia's four largest banks. Standard and Poor's (S&P) provides a three-notch rating uplift to the major Australian banks, due to its assessment that our Government is "Highly Supportive".

There are no North American or European banks that have this level of Government support. The closest is Canadian banks where S&P regard the Government as "Supportive", one category down from "Highly Supportive".

Without a comparable implicit subsidy, international banks will face similar difficulties in competing in Australia that Regional Banks currently confront.

Open banking useful, but no substitute for competitive neutrality reforms

In December 2017, the Government released a report setting out a blueprint for introducing an Open Banking regime in Australia (Farrell, 2017). The banking proposal is the first stage of a wider initiative - the Consumer Data Right in Australia.

Open Banking is being marketed as a scheme that will provide competition in banking as it will make it easier for consumers to understand and compare products and services, leading to better choices while reducing switching costs.

The Regional Banks fully support the concept of giving consumers more control of their data, subject to appropriate safeguards on privacy and a scheme with minimal compliance costs. However, until more critical reforms that level the competitive playing field are delivered, smaller banks will not be able to fully take advantage of the opportunities that Open Banking presents, and therefore the consumer benefits will be muted.

Level playing field provides the best way forward

For these reasons, we believe it is important that your final report prioritises the reform agenda and focusses on the supply-side.

In this respect, our key recommendations are as follows:

1. Addressing the 'too big to fail' implicit subsidy which affords the major banks a 'three-notch' credit rating advantage on wholesale debt;
2. Reducing the regulatory burden that falls more heavily on institutions with smaller customer bases;
3. Reducing the risk weight differences between IRB and standardised ADIs, without eliminating the incentive for smaller ADIs to seek advanced accreditation;

4. Requiring proper disclosure of mortgage broker ownership, including publication of the proportion of business that goes to the broker's owners; and
5. Removing the macro prudential restrictions that have the effect of locking in the market share 'status quo'.

If you have any further questions, please do not hesitate to contact one of us below.

Yours sincerely

Sally Bruce	Mike Hirst	Jon Sutton	Jamie McPhee	David Carter	Melos Sulicich
Group Executive AMP Bank	Managing Director Bendigo Bank	MD & CEO BOQ	CEO ME Bank	CEO, Banking Suncorp	MD & CEO MyState

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Summary

The Regional Banks¹ welcome the opportunity to provide a second submission to the Productivity Commission's (PC's) inquiry into *Competition in the Australian Financial System*². The Regional Banks congratulate the PC on its Draft Report (2018) which is comprehensive, includes insightful findings, and outlines sound draft policy recommendations.

The Regional Banks fully endorse the PC's finding that:

Competition and stability are both important to the Australian financial system. In order to preserve both principles, a genuine debate is essential before every material regulatory intervention. (Productivity Commission, 2018, p. 31).

The Regional Banks' earlier submission to the PC outlined key policy areas that need to be addressed as a matter of priority to help level the playing field in retail banking. This second submission responds to the Productivity Commission's Draft Report and complements the separate broader submission being prepared by the Australian Banking Association (ABA) on behalf of the banking sector more generally.

In responding to the PC's Draft Report, the Regional Banks have focussed on 11 key issues of particular relevance to smaller banks.

The Regional Banks are strongly supportive of the PC's findings that highlight the importance of competition. In particular, the Regional Banks welcome the PC's finding that competition and stability must co-exist (see section 1), and its recommendation to designate a regulator as "competition champion" would help ensure that banking regulations are developed with due regard to competition considerations (section 9).

While all of the PC's recommendations are well intentioned, and Regional Banks are generally supportive of the majority, there are a small number of areas where there are concerns that the proposed reform will not deliver the desired outcome. In particular, the draft recommendation regarding a loan interest rate comparator is unlikely to improve consumer outcomes (section 10). The Regional Banks would also challenge the suggestion that smaller banks simply increase margins in response to improved regulatory settings (section 6), and note that the gap between the profitability of large and small banks remains wide by historical standards (section 11).

The Regional Banks are strongly of the view that the most effective way to deliver improved customer outcomes is through reforms targeting the supply side of the market. This is in line with the recommendations made in the Regional Banks' submission last September (section 2). In this regard, the Regional Banks welcome the positive findings made by the PC in relation to risk weights (section 3), macroprudential caps (section 7), and mortgage brokers (section 8). The Regional Banks also commend the PC's findings regarding funding costs differences, though acknowledge that finding a solution to this problem is challenging (sections 4 and 5).

The Regional Banks therefore ask the PC to consider these matters, and look forward to the final report due to the Government in July 2018.

¹ AMP Bank, BOQ, Bendigo & Adelaide Bank, ME Bank; Suncorp; MyState.

² The inquiry was commissioned by Treasurer Scott Morrison on 8 May 2017 for a commencement date of 1 July 2017. The specified date for the final report was 12 months from commencement, which is 1 July 2018.

Key points responding to the PC Draft Report

1. Both stability and competition policy principles must coexist

The Regional Banks strongly endorse the PC's findings that:

First, the benefits of competition to the individuals and businesses for whom the financial system exists are being reduced in the quest for stability. Regulators have focused almost exclusively on prudential stability since the Global Financial Crisis, promoting the concept of an unquestionably strong financial system. (Productivity Commission, 2018, p. 2)

With the default regulatory position having been almost exclusively focussed on safety and stability for nearly a decade, it is unsurprising that this has contributed to the emergence and maintenance of an oligopolistic market structure in retail banking. Given the current situation, there is a critical need to adjust regulatory settings to better balance the needs of both stability and competition.

The Australian banking sector has a very long record of safety, and in fact, no depositor has lost money through the demise of an Australian bank since the 1890s. Given the outstanding strength of the Australian banking sector, which stands in stark contrast to a number of other OECD countries, there is certainly scope to rebalance towards competitive outcomes.

Some have argued that there is no trade-off between stability and competition, on the basis that the stronger an individual bank's balance sheet, the stronger a competitor will be. However, such an argument assumes all institutions have similar business models, objectives and cost bases, and ultimately higher costs due to a regulatory intervention impacting equally across all competitors. This homogeneity is clearly not the case in Australia's banking sector, which is made up of a diverse range of almost 150 institutions.

In fact, the conflict between stability and competition arises often when it comes to prudential regulation, with regulatory settings typically trading away competition in the name of stability. A stark example of this was APRA's 2014 response to suggestions from some parts of the industry that risk weights should be reduced for standardised banks to allow them to more fairly compete with Internal Ratings Based (IRB) ADIs. Despite the fact that, at the time, risk weights for standardised ADIs were roughly twice as high as those for IRB ADIs, APRA's view was that there was no merit in reducing standardised risk weights to address what they characterised as a "residual competition issue." (APRA, March 2014, p. 76)





2. Level playing field should be the priority in reforms

The Regional Banks support competition in retail banking. As part of the ‘supply-side’ of the market, the Regional Banks’ reform priority is to ensure a level playing field, where all banking institutions can compete fairly for customers and market share. While Regional Banks also support initiatives to strengthen the consumer’s capacity to make informed decisions and to put pressure on prices, the Regional Banks see this as being optimised if the supply-side of the market is ready to respond to that pressure on an equal footing.

Prioritising reforms to deliver a level playing field will ensure that the effectiveness of other pro-competitive initiatives, (such as open data, disclosure, switching, broker reform, and lowering entry barriers) are maximised. In the current environment, existing regulatory and prudential distortions limit the capacity of smaller banks to take advantage of the opportunities these reforms present. As such, some of these broader consumer focused reforms, while well intentioned, could potentially lead to further consolidation and ultimately less competitive outcomes for consumers.

As argued in their first submission, the Regional Banks highlight the following key areas where regulatory and prudential settings continue to distort the playing field in favour of the major banks:

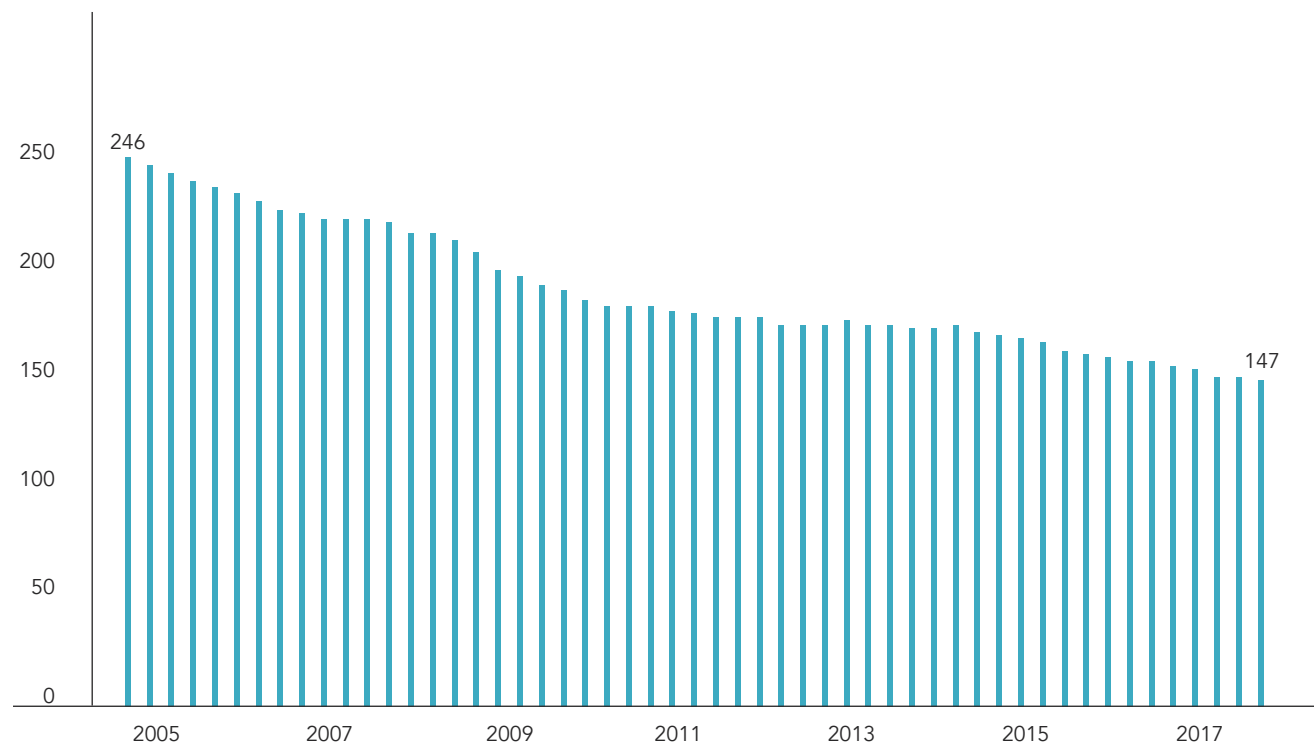
1. The 'too big to fail' implicit subsidy which affords the major banks a 'three-notch' credit rating advantage on wholesale debt;
2. The increasing regulatory burden that falls more heavily on institutions with smaller customer bases;
3. Material differences in mortgage risk weights, both on average and in relation to low-risk mortgage loans;
4. The lack of transparency around ownership of mortgage broker aggregators and networks; and
5. The imposition of macro prudential restrictions that have the effect of locking in the market share 'status quo'.³

While there have been some positive developments in recent years, and these have been welcomed, properly addressing the ongoing imbalances will require further reforms before a true level playing field can be delivered. In this regard, the Regional Banks are encouraged that the PC's Draft Report has acknowledged most of these issues, and in several areas has proposed sensible solutions.

The Regional Banks further recommend that the PC prioritise the issues outlined above, in order to maximise the positive long-term impact of other 'demand-side' reforms. A more competitively neutral system may also help stem the current trend towards consolidation in the banking sector. As can be seen from Figure 1, the number of Authorised Deposit-taking Institutions (ADIs) has declined from 246 in 2004, to 147 today.

FIGURE 1

TOTAL ADI NUMBERS



Source: Underlying data from APRA QADIPS, September 2017. Calculations and presentation by Benchmark Analytics.

³ APRA Chairman Wayne Byres recently suggested that the 10 per cent restriction in residential mortgage investor loan growth is probably past its use by date (Byres, 2018).



3. Impact of APRA's recent risk weights proposals is unclear

The Regional Banks support the PC's Draft Reports finding that larger institutions enjoy a funding cost advantage through lower risk weights compared to smaller banks (Finding, 5.1).

The Regional Banks acknowledge the PC's Draft Recommendation (Rec 16.1) for APRA to commence and complete a review of APS 112 by June 2020, with a view to finely calibrating the risk weights to better reflect the risk inherent in individual mortgages.

Since the PC's Draft Report was released, APRA has published a discussion paper, *Revisions to the capital framework for authorised deposit-taking institutions* (APRA, 2018), setting out a number of proposed changes to the treatment of risk weights for standardised and IRB ADIs.

APRA's proposed revisions to the capital framework have three main purposes. The first is to reflect the final recommendations of the Basel Committee on Basel III (Basel Committee on Banking Supervision, 2017). The second is to deliver on the Murray Inquiry's recommendation that Australian ADIs should have "unquestionably strong" capital levels. The third is to address the Australian ADIs' structural concentration in residential mortgages.

The Regional Banks will engage closely with APRA on this consultation, both as individual banks and as a group. One of the key concerns for smaller banks will be to understand how the newly proposed risk weights will impact on the competitive position of standardised banks versus IRB banks. Ensuring that the gap between the two approaches is set at a sensible level forms a key part of delivering a level playing field. These concerns are particularly acute in relation to residential mortgages and Small and Medium Enterprise (SME) lending, given the significant proportion of lending these represent for most small banks.



While it is too early to fully assess the impact of APRA's proposed changes on competitive neutrality between standardised and IRB methods, the Regional Banks would make the following initial high-level comments:

1. APRA is proposing to reduce standardised risk weights for certain portfolios in the corporate book, with some key categories to be subject to risk weights of less than 100 per cent. This is a positive step as it will both support SME lending by standardised banks, and also assist in encouraging SME lending relative to mortgages.
2. APRA has reduced the minimum mortgage risk weight from 35 per cent to 20 per cent. This will improve competitive neutrality by reducing the risk weight disadvantage for standardised banks competing for lower risk mortgage loans. Having said that, the Regional Banks note that APRA has proposed simultaneously increasing risk weights on most other standardised loan categories.
3. APRA has not yet specified its proposed approach to risk weights for loans with LVRs above 80 per cent that do not have Lenders Mortgage Insurance (LMI). Nor is there specification on how APRA will treat LMI in the IRB framework. At a minimum, the Regional Banks strongly encourage APRA to publish a risk weight schedule for standardised banks.
4. In regard to IRB, APRA is proposing to reduce the minimum Loss Given Default (LGD) parameter from 20 per cent to 10 per cent. It is unclear how much of an impact this will have on actual risk weights faced by IRB ADIs, but this will be an important element in assessing the relative position of the two approaches (IRB and standardised) under the new framework. In theory, halving the LGD parameter will almost halve the capital calculation for lower risk loans. While overall capital level outcomes will ultimately be determined through a system of calibration to ensure "unquestionable" capital strength alongside the application of Basel Risk Weighted Asset (RWA) 'floors', the LGD change is likely to undermine the capacity of smaller banks to compete on price for lower risk loans.

In summary, there are many moving parts to APRA's capital proposals, and there is simply insufficient clarity at this stage to provide an overall assessment as to whether the new proposals – if implemented – would help level the playing field between the standardised and IRB approaches. Going forward, the Regional Banks will share further feedback with the PC on this important issue as work progresses.



4. 'Too big to fail' funding advantage needs addressing

The Regional Banks welcome the PC's Draft Finding in 5.1 that larger ADIs benefit from lower costs of funding compared to smaller institutions, in part reflecting an expectation of government support.

This remains a key issue for the Regional Banks, since the cost of funding is the major competitive distortion between small and large banks.

Having said that, the Regional Banks acknowledge the difficulty in finding a solution and note that at this stage, the PC has not made any explicit draft recommendations to directly address the issue.

It was because of this funding cost advantage that the Regional Banks were broadly supportive of the Government's recently introduced major bank levy.

The Regional Banks recognise that the PC has formed a view that the levy does not improve competitive outcomes as it does not reduce the funding costs of smaller banks. However, the Regional Banks would challenge this perspective, and believe it is pro-competitive because it partly offsets an existing funding cost subsidy enjoyed by the major banks⁴.

While the Regional Banks are not advocating for an increase in the bank levy, they do believe it could be better designed to more directly target the funding cost subsidy. The Regional Banks also believe that broader options could be considered by the PC which would help to reduce the funding cost disparity between large and small banks without increasing major banks' funding costs. Several suggestions in these regards are outlined below:

1. Improving the design of the bank levy

There is scope to adjust the levy to be more cleanly linked to the implicit guarantee enjoyed by the major banks. The purpose of this change is not to increase the amount of revenue raised by the levy, but rather to better match it to the implicit guarantee subsidy.

As a practical way forward, the Council of Financial Regulators (COFR) could be required to estimate the value of the guarantee annually as a regular part of the Commonwealth Government's Budget process. The level of the bank levy could then be adjusted to recoup a set proportion of the estimate calculated by COFR.

Such an approach could operate alongside other measures aimed at reducing the impact of the implicit subsidy. Importantly, under such an arrangement, if COFR formed the view that implicit government support was no longer providing any benefit, the "value" of the benefit would effectively be zero, and no levy would be paid.

⁴ As noted by the PC in the Draft Report, a further competitive distortion occurred during the Global Financial Crisis (GFC) when the Commonwealth Government used credit ratings to determine the fee schedule for accessing the Commonwealth Government Guarantee, even though these credit ratings reflected implicit support for the major banks.

2. Potential for greater role of covered bonds

Another potential policy change to assist in addressing the 'too big to fail' funding advantage would be to allow non-major banks to issue a greater amount of covered bonds. A covered bond is a debt security whereby investors have protection from both the name of the issuing institution and also a specified pool of ring-fenced assets, typically residential mortgages.

Currently under APRA's prudential standards (APRA, 2012), an ADI is able to issue covered bonds up to a value of 8 per cent of the bank's domestic assets. This issuance level could be lifted for smaller banks, assisting them to enhance the credit rating of their liabilities, similar in economic effect to the implicit government support enjoyed by the major banks.

Some may argue that lifting the issuance of covered bonds and ring-fencing a higher proportion of residential assets would increase the risk to retail deposits, which are protected by the Government under the Financial Claims Scheme (FCS)⁵. In the event the FCS is activated to make a payment, it has legislative backing to recoup this from the asset pool of the failed entity.

However, the liabilities of the FCS are not liabilities of the taxpayer, rather the FCS is an industry-funded scheme, albeit a post-event funded one. This is in contrast to the implicit guarantee which is, in effect, a taxpayer subsidy because the wholesale debt which benefits from the three-notch credit rating uplift is not covered by the FCS.

3. Let smaller banks pay for a guarantee

The Regional Banks made the following recommendation to the Murray Financial System Inquiry:

As part of the APS 210 liquidity standard, the RBA will provide a Committed Liquidity Facility (CLF) to banks to effectively wrap eligible liquid assets that do not fall within the APRA defined Tier 1 asset class (effectively government and semi-government bonds).

The banks pay 15 basis points for access to this facility. Eligible securities for the CLF include RMBS, as well as internal RMBS repo structures.

A potential alternative model to address funding distortion between TBTF and non-TBTF banks would be for non-TBTF banks to have access to a government guarantee provided by the RBA on AAA rated RMBS. The access to the government guarantee is in effect what is implicitly provided to the D-SIBs for no fee.

This guarantee could, for example, be available for up to a certain percentage of any AAA rated RMBS tranche, say for example, 75%. This would ensure a meaningful component of each deal (e.g. 25%), would be priced subject to market pricing disciplines as to pool origination characteristics, collections practices and experience, rating agency tranching and previous pool performance.

Guaranteed RMBS could be placed as a Level 1 Basel III liquid asset, increasing the pool of eligible Level 1 assets and reducing the amount of liquid assets for which the RBA will need to provide its liquidity facility and receive its 15 basis points fee. The fee on the guaranteed portion could be simply the difference between the pricing on the unguaranteed portion and the pricing the issuer achieves on the guaranteed tranche, potentially adjusted to cover issuing costs or enhance wider market competition. (Regional Banks, 2014, p. 67)

⁵ The FCS guarantees retail deposits of up to \$250,000 per bank per customer – see <http://www.apra.gov.au/CrossIndustry/FCS/Pages/default.aspx>



5. Unwinding subsidies may increase costs, but it promotes competition

As part of Draft Finding 5.1, the PC's Draft Report concludes that 'attempts to artificially raise the costs of funds to larger institutions to offset their cost advantages do not improve competition and harm consumers'.

The Regional Banks do not support initiatives that artificially increase major bank funding costs, however do advocate for the removal of existing distortions that artificially lower them.

The major banks enjoy a 'too big to fail' perception that gives them a three-notch credit rating funding advantage. The Regional Banks accept that the size and scale of the major banks will naturally provide them with higher ratings than smaller banks, but the implicit guarantee provides a further uplift beyond this. This is an artificial benefit due to size, interconnectedness, substitutability and complexity, as noted by APRA's media release of December 2013:

The Basel Committee's framework responds to the strongly held view of the G20 Leaders, including Australia, that no financial firm should be 'too-big-to-fail' and that taxpayers should not bear the cost of resolution...

APRA's assessment methodology has regard to the Basel Committee's four key indicators of systemic importance: size, interconnectedness, substitutability and complexity. Based on its assessment of these indicators, APRA has determined that the following authorised deposit-taking institutions are D-SIBs:

Australia and New Zealand Banking Corporation

Commonwealth Bank of Australia

National Australia Bank

Westpac Banking Corporation. (APRA, 2013)

As part of its framework to deal with the D-SIBs, APRA imposes an additional Common Equity Tier 1 (CET 1) capital charge of 1 per cent on these institutions. In relation to this capital charge, the Regional Banks note two points:

- 1 per cent is low by international standards (Reserve Bank of Australia, March 2014, p. 56); and
- The impact of the additional 1 per cent is offset to some degree by the fact that it lowers the D-SIB's risk profile which will be partly reflected in an associated reduction in funding costs.

In most businesses, raising the cost of business inputs will – all things being equal – increase prices for consumers. However, this analysis is complicated in the case of banks given their nature as intermediaries, and the role they play as a channel for monetary policy.

The Regional Banks understand the need to keep costs low. However, there are additional complexities around funding costs that need to be considered. Changes to funding costs impact on banking institutions in a more complex manner than more traditional business costs, such as salaries.

The following factors demonstrate why higher funding costs will not necessarily disadvantage consumers:

1. Banks are intermediaries between savers and borrowers, and a funding cost increase may disadvantage borrowers, but simultaneously advantage savers.
The real cost is actually the margin, so the extent of consumer detriment is best analysed through an assessment of how regulatory interventions impact this.
2. Interest rates are just one component of consumer cost. The total amount a borrower pays is determined by both the interest rate and the loan amount.
For new loans, there is typically a negative correlation between the variables. When interest rates decline, borrowing capacity increases and borrowers can apply for larger loans (although the ultimate loan size is also subject to compliance with a bank's credit policy, responsible lending obligations, and applicable prudential rules).
Even though bank interest rates are at record lows, average households' debt repayments as a proportion of income are currently higher than the historical average.
3. While a range of factors impact on interest rate decisions made by individual banks, at an aggregate level retail interest rates in the market are influenced by monetary policy⁶. For example, if funding cost increases lead to banks moving retail interest rates outside the level deemed appropriate for monetary policy, the RBA will work to counter this with an adjustment to the overnight cash rate⁷. This was evident during the Global Financial Crisis (GFC); when banks' overseas funding costs spiked, the RBA offset the pressure on retail rates by dramatically lowering the overnight cash rate.

For these reasons, the Regional Banks suggest that initiatives to increase major banks' funding costs can be pro-competitive, and cannot be automatically assumed to be anti-competitive or detrimental to consumers. This is particularly true where a measure is simply unwinding an existing subsidy, as opposed to introducing an additional distortion.

⁶ During the GFC and years following, the historical relationship between the overnight cash rate (OCR) and retail rates broke down as a result of increased demand for retail deposits and spikes in the cost of funds from overseas.

⁷ Current RBA Governor Phil Lowe (then Deputy Governor) noted this linkage in a speech in 2012: *"...this increase in interest rates relative to the cash rate has been offset by the Bank setting a lower cash rate than would otherwise have been the case. While it is difficult to be too precise, the cash rate today is in the order of 1½ percentage points lower than it would have been in the absence of these developments."* (Lowe, 11 July 2012)

6. Regional Banks' shareholders bore the brunt of GFC impacts, not customers

The Regional Banks note the PC's suggestion that when the major banks repriced loans due to an increase in mortgage risk weights to a minimum average of 25 per cent, the Regional Banks did not take the opportunity to increase market share, but rather improved margins.

The Regional Banks are concerned about this finding as it suggests they have prioritised shareholders ahead of customers. This is damaging to the Regional Banks as it is through securing the trust of consumers and delivering superior customer service that smaller banks can overcome the major banks' scale and other size advantages.

The Regional Banks would challenge the PC's perspective on this issue, and believe that an objective assessment of the data suggests that it has been the Regional Banks' shareholders (not customers) which have borne the brunt of costs imposed in the post-GFC period.

In 2008, three factors combined to materially undermine the competitive position of smaller banks:

- The introduction of Basel II created a significant gap in mortgage risk weights between the major banks and other banking institutions;
- The near closure of the securitisation market had a disproportionate impact on smaller banks given its greater importance to these institutions; and
- Pricing of the Government's wholesale funding guarantee unfairly benefited the major banks thanks to their implicitly guaranteed status.

In responding to these events, the data shows it was the Regional Banks' shareholders that were most disadvantaged. Evidence for this can be seen in analysis of the net interest margin (NIM) and return on equity (ROE) figures for the sector.

Net interest margin is the price of intermediation in banking. It is the difference between interest paid to depositors and interest received from borrowers. A lower margin indicates a lower price and a benefit to consumers.

ROE estimates the benefit that shareholders receive from bank operations. It measures after tax profits as a proportion of total equity. A decrease in ROE represents a declining benefit to shareholders.

FIGURE 2

RETURN ON EQUITY AND NET INTEREST MARGIN

	INSTITUTIONS TYPE	PRE-GFC	GFC AND POST GFC	RECENT
Avg. Net interest income to assets	Major banks	1.9%	1.8%	1.7%
	Other domestic banks	1.7%	1.4%	1.6%
Avg. Return on equity (after tax)	Major banks	16.0%	14.6%	11.1%
	Other domestic banks	17.9%	7.8%	9.3%

Source: Underlying data from APRA QADIPS, September 2017. Calculations and presentation by Benchmark Analytics.

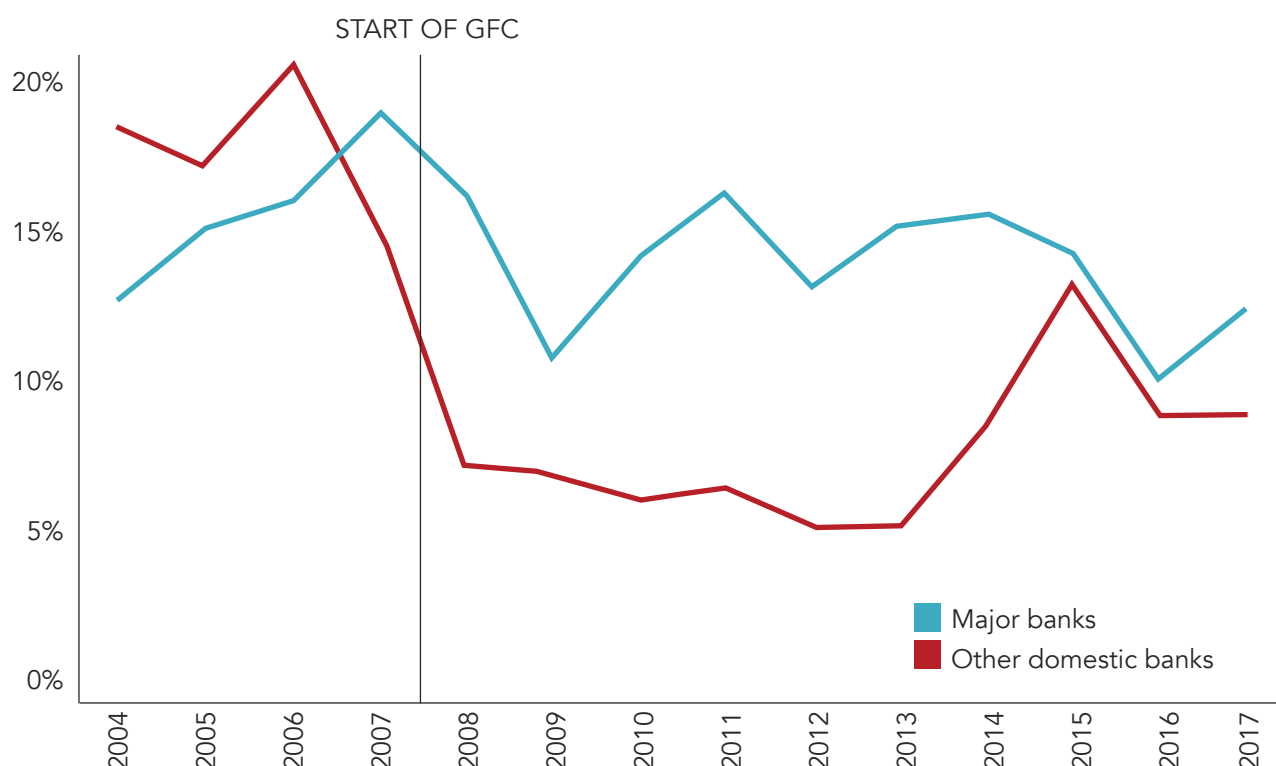
Notes: Pre-GFC is period June 2004 to December 2007; GFC and Post GFC is March 2008 to December 2015; Recent is March 2016 to June 2017.

During the GFC and post-GFC period, the Regional Banks reduced their average NIM by more than the major banks. Compared to the pre-GFC period, the Regional Banks' NIM fell from 1.7 per cent to 1.4 per cent. This stands in contrast to the major banks, who reduced average NIM from 1.9 per cent to 1.8 per cent over the same period.

This reduction in NIM flowed through to a very significant reduction in relative profitability between the major banks and the Regional Banks. Pre GFC, the Regional Banks recorded higher ROE than the major banks. However, during the GFC and post-GFC period, the Regional Banks' ROE averaged half that of major banks, 7.8 per cent versus 14.6 per cent.

FIGURE 3

RETURN ON EQUITY



Source: Underlying data from APRA QADIPS, September 2017. Calculations and presentation by Benchmark Analytics.

Only since the Murray Inquiry recommendations were implemented have Regional Banks been able to rebalance towards shareholder benefit.

Banks that are listed on the ASX face daily scrutiny of their financial performance. The large ROE gap which arose between the Regional Banks and the major banks in the GFC and post-GFC period was unsustainable and a force for consolidation. In recent years, the major banks' ROE has declined, due in part to increased capital requirements from APRA.

It should be noted that most consolidation has occurred in the credit union sector. As mutuals, there is less market scrutiny on shareholder/owner returns. Mutuals are typically smaller, have higher cost bases and focus on returns being shared with members through a different level of community involvement and other activities, rather than being distributed to shareholders as dividends.



7. Macro prudential rules are increasingly redundant

The Regional Banks agree with the PC's finding that both the 30 per cent cap on interest only loans as a percentage of new loans, and the 10 per cent investment loan growth rate cap are blunt policy instruments, and have had adverse consumer impacts.

While the Regional Banks agree with, and understand the broader economic objectives, the policy concern is that these restrictions have 'locked in' current market shares. The caps have effectively rationed these types of loans and, therefore, made it harder for customers to refinance.

Limiting borrowers' ability to refinance with a competitor bank, increased the risk that lenders would respond to the cap by raising interest rates – consistent with the theory of rationing. Indeed, as the PC has found, the major banks did lead the market re-price of investment loans, including their back books, and a number of banks made clear that this repricing was necessary to ensure that their lending levels did not exceed the cap.

The caps have also presented an opportunity for banks to increase interest rates in markets where competition is restricted (interest-only and investor lending), offsetting the costs of reducing interest rates in markets where competition is stronger (owner occupier mortgage lending). In this way, the Regional Banks have seen the competition distorting aspects of the macroprudential caps flow beyond investor and interest only lending, to impact on residential mortgage lending more generally.

Those banks with proportionally larger investment and interest-only loans have been the primary beneficiaries of the caps, as they have precipitated repricing over a higher proportion of their mortgage portfolio. In this way, the caps have contributed to a further distortion of the playing field – in favour of banks with mortgage portfolios weighted more heavily towards investment and interest-only loans.

In recent weeks, there has been speculation that, with heat coming out of the housing market, APRA may remove the restrictions, particularly the investment loan cap, which has been in place since 2014.

APRA Chairman, Wayne Byres, said in evidence at Senate Estimates on 1 March 2018 (Byres, 2018) that the 10 per cent limit on investor loans has probably passed its useful life due to investor credit growth averaging around 5 per cent in recent years and lending standards having improved.

In relation to the 30 per cent limit on interest-only loans, Mr Byres noted that the limit had only recently been introduced and that APRA wants to get a clearer picture on how industry is responding to the limit before considering its withdrawal. While this is reasonable, the regulator could assist banks by providing clarity around the benchmarks necessary to trigger removal of the caps, and indicative timings. Banks can then plan strategies with greater certainty, by better understanding the future likely regulatory settings.

In this regard, the Regional Banks support and note the increased transparency incorporated in the PC's Draft Report recommendation that APRA:

"...should conduct and publish annually quantitative post-implementation evaluations of its macroprudential policies, including costs and benefits to market participants and the effects on competition." (Productivity Commission, 2018, p. 49)

Similarly, Regional Banks support the PC's position where it states that it:

"...sees merit in introducing a more formal, transparent review process into the CFR deliberations, which would enable the financial regulators to assess the market effects of regulations proposed by their peers before they are implemented." (Productivity Commission, 2018, p. 477)

And Regional Banks support the PC's position that the COFR

"...should provide the forum for regulators to discuss the competition effects of systemically relevant macroprudential interventions..." (Productivity Commission, 2018, p. 474)

The Regional Banks would support giving COFR a more explicit role in the development and ongoing calibration of macroprudential initiatives, to ensure that a broader range of relevant considerations are taken into account in determining interventions.





APRA's proposed revisions to the capital framework & macro prudential

APRA's recently announced proposed capital changes provide a further reason to withdraw the macro prudential restrictions (APRA, 2018), although full implementation of these changes remains some years away.

APRA has proposed introducing new categories of loan segmentation that will increase risk weights on investment and interest-only (IO) loans, relative to their owner occupier (OO) principal and interest (P&I) loan equivalents. Under APRA's proposal, this differential would apply to both standardised and IRB banks.

Increasing relative risk weights will encourage differential pricing of investment and IO loans, which is the same outcome delivered by the current macro prudential rules. As such, the implementation of these risk weight revisions will make APRA's existing 10 per cent investment and 30 per cent interest-only restrictions redundant.

However, as previously noted, APRA's revisions will not take effect for a number of years, meaning an interim solution is still needed to address the competitive imbalances already created by the macro prudential caps.

More generally, the Regional Banks are yet to form a collective view on whether APRA's proposed changes to investor and IO risk weights will benefit competitive neutrality.

As an overarching principle, the Basel Committee has configured the capital adequacy framework to match bank capital levels to the inherent risks of various exposures, with higher levels of capital to be held against exposures that present greater risks. Whether the new risk weight segmentation proposed by APRA is genuinely reflective of underlying risks is an important consideration in determining whether or not their introduction will result in undesirable distortions. Unless the calibration of the new investor and IO risk weights is based on historical data, there is a concern that the settings may be overly arbitrary.

APRA has stated that its revised risk weights are being configured, at least in part, to address the concentration of residential housing assets within the banking sector. It may be that risk weights are not the best way to address this concern, and that concentration risk may be better tackled through the supervisory review process under Pillar II of the framework.

This is an issue that Regional Banks will give further consideration to as part of their submission in response to APRA's consultation paper.



8. Disclosure of mortgage broker ownership is a priority

The Regional Banks note the PC's findings regarding mortgage brokers, including concerns over trailing commissions and the absence of a customer 'best interest' duty on brokers.

As noted in the Draft Report, smaller banks are dependent on the broking industry to overcome the scale and geographical advantages of the major banks.

With broker-originated loans now accounting for 56 per cent of new loans, the Regional Banks see this growth as positive evidence that brokers are providing a valued service. The Regional Banks also note the PC's finding that, on average, mortgage broker-originated loans have lower interest rates. Given the size and duration of the average residential mortgage, even a small interest rate reduction can yield a considerable saving over the life of a loan.

However, ASIC has found that ownership relationships have an influence on competition:

Finding 9: Competition in the home loan market is affected by ownership and the limited ability of some lenders to access and remunerate brokers

Our review identified that competition in the home loan market is affected by ownership relationships between lenders and aggregators and the inability of smaller lenders to access or remunerate brokers in the same way as larger lenders. (ASIC, March 2017, p. 17)

The Regional Banks therefore believe it is important to ensure that the customers of mortgage brokers know the identity of the broker's owner, so they can factor this information into their decision-making process.

In addition to ownership disclosure, the Regional Banks recommend that broker networks and aggregators publish information showing the amount of business directed towards their owners or associated companies, relative to the proportion directed elsewhere. This information would serve as a prudent check to ensure any systemic problems with ownership are identified early.

More broadly, the Regional Banks note the PC intends making a recommendation to the Government on the merits of trailing commissions. The Regional Banks recognise that the prospect of a higher trailing commission may bias a mortgage broker towards recommending that loan. However, the extent to which this is a material problem in practice is unclear.

The Regional Banks make the obvious point that brokers need to be remunerated, and that consumers have a strong tendency to resist paying explicitly for services. Brokers also relieve banks of having to employ full-time staff and incur other operating costs. A significant disruption to the economic viability of the broker industry would be a material competitive neutrality issue for smaller banks.

On the question of 'best interest' duty, the views of Regional Banks are reflected in the broader submission being made on behalf of the industry by the Australian Banking Association (ABA).

9. Having the ACCC or ASIC champion competition would be good for banking policy

As previously noted, Regional Banks strongly believe that the best way for Government to improve consumer outcomes in the banking sector is through the implementation of reforms that help to level the playing field. The Regional Banks believe that any reform which helps give greater weight to competition considerations when developing new banking regulations will support this overarching objective. The Regional Banks therefore endorse the PC's draft recommendation that the ACCC or ASIC be designated as the "competition champion," and that COFR meetings be used as the forum to engage in discussions on banking competition.

There are many areas where such a regulatory body could promote banking reforms which would improve competition through the delivery of a level playing field. In this regard, the Regional Banks believe the agency selected as the "competition champion," should be well placed to address our key concerns around:

- (a) the 'too big to fail' funding cost advantage;
- (b) excessive regulatory burdens;
- (c) unjustified differences in risk weights on mortgages;
- (d) macro prudential restrictions that undermine competition; and
- (e) mortgage broker ownership disclosure.

To achieve further progress on these issues, the Regional Banks see the selection of a regulatory champion as being aligned with some key principles, namely that the regulator will:

- Strongly push a focus on competition in banking policy deliberations;
- Support greater transparency around banking policy deliberations and decisions;
- Initiate more thorough and genuine consultation before decisions are finalised; and
- Push for greater clarity around regulatory mandates.

Applying these principles, the Regional Banks believe the ACCC is preferable than ASIC, mainly because its mandate is more purely focussed on promoting competition. In contrast, ASIC has wider responsibilities. Both agencies could be relied upon to be transparent and consultative, so it is the singularity of the ACCC's competition mandate that is particularly appealing. To perform this role effectively, the ACCC will need to be a member of COFR⁸.

The Regional Banks also support the PC's recommendation that Statements of Expectations and Statements of Intent be used to clarify regulatory priorities.

However, the Regional Banks are not convinced that disclosure of the minutes of COFR meetings is necessarily in the public interest.

While Regional Banks are keen to ensure greater weight is given to competition when developing policy initiatives, the Regional Banks also recognise that COFR discussions around stability and safety may not lend themselves to regular public disclosure. For example, COFR would be the obvious regulatory body to discuss issues around resolving a failing financial institution. Public disclosure obligations may complicate such discussions.

Further, unlike the RBA Board (which publishes its minutes), COFR is an advisory body, and as such it does not have any statutory powers or responsibilities itself. Given this, mandatory disclosure of minutes could highlight situations where the views of the Government differ from those of COFR. While this may have merit in some circumstances, it could also have stability implications and may politicise the body to some degree.

⁸ <https://www.rba.gov.au/fin-stability/reg-framework/cfr.html>



10. Loan interest rate comparisons – unintended consequences

The Regional Banks note the PC's Draft Recommendations 8.3 regarding collection of home loan interest rate and fee data by APRA, and Draft Recommendation 8.4 which recommends that ASIC use this data to develop an online tool that improves pricing transparency for consumers.

The PC has recommended that the online tool enable a consumer to select different combinations of loan and borrower characteristics and that the tool would then report median interest rates issued in the previous month with those characteristics, broken down by lender. In addition, fees and charges associated with that loan would be detailed.

While this has the potential to improve competitive pressure from the demand-side of the market, it may also involve considerable practical difficulties. More importantly, it may mislead customers as to the true cost of a product. The main problem with such tools is that they have a tendency to lead to 'gaming', whereby suppliers develop products that rate well on the tool, but have shortcomings in other areas.

For example, comparison tools have difficulty capturing the full benefits of a 'bundle' of services offered by a financial institution. They also provide an incentive for suppliers to increase costs for services outside the scope of required disclosures. For example, in the case of mortgages, suppliers could shift costs to account closing or switching fees.

Further, some financial institutions may respond by choosing not to offer services outside what the tool requires, and consumers could end up with products that fall short of expectations. Such an approach could see suppliers in a race to the bottom, offering only the most basic and feature free products in order to present the most attractive median interest rates to the comparison tool. This would then inevitably result in additional regulatory interventions as Governments attempt to patch over the shortcomings of the tool.

Furthermore, the online tool would, in some respects, compete with the broker channel, particularly given the proposal is for the comparison tool to have the authority of a government agency standing behind it. Such an approach could potentially undermine the broker industry and eventually favour the banks with larger bricks and mortar networks.

11. Major bank profitability remains high

In response to a finding in the Draft Report that major bank profits are high, there have been suggestions that major bank return on equity (ROE) has fallen in recent years and is low by comparison to other companies listed on the ASX⁹.

However, comparing major bank profits to that of other listed companies is only truly meaningful if the returns are risk adjusted, given that ROE is not a risk adjusted metric.

The four major banks are AA rated institutions. With such strong credit ratings, this implies investing in banks is very low risk. A key principle in finance is the risk/reward trade-off, whereby low risk implies low returns.

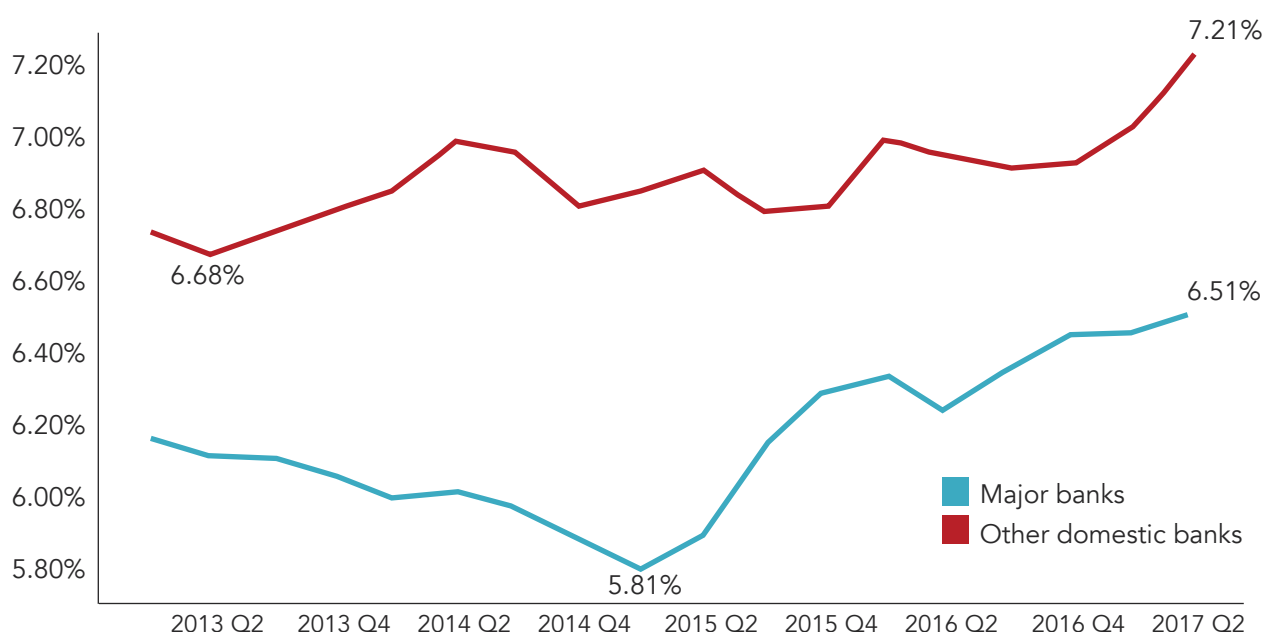
The major banks' returns cannot be directly compared to institutions with lower credit ratings, especially those from other industries. The four major banks are the only AA rated private institutions listed on the ASX. By way of comparison, BHP is A+.

In recent years, it is true that the major banks' average ROE has marginally declined. However, it is also true that this decline is at least in part due to APRA's capital reforms which have increased the minimum level of required 'equity'. For any given level of after-tax returns, additional amounts of 'equity' will reduce the estimated ROE. A benefit of higher equity is that it reduces risk for investors. The Regional Banks do not believe that recent declines in ROE are reflective of an improvement in the competitive dynamics of the sector.

The effect of APRA's increased capital requirements can be seen in Fig 4 below. Between 2015 and 2017, the average shareholder equity to average total asset ratio for the major banks increased from 5.81 per cent to 6.51 per cent, representing a significant change in the amount of leverage. The chart also highlights the considerable difference in leverage between major banks and other ADIs.

FIGURE 4

RATIO OF SHAREHOLDER'S EQUITY TO TOTAL ASSETS



Source: Underlying data from APRA QADIPS, September 2017. Calculations and presentation by Benchmark Analytics.

⁹ <https://www.smh.com.au/business/banking-and-finance/big-banks-really-aren-t-that-profitable-westpac-finance-chief-says-20180228-p4z247.html>



The Bank of International Settlements (BIS) has published data on major banks' returns across a range of comparable countries. The metric used is that of return on total assets, which accounts for differences in minimum capital requirements between domestic prudential regulators. This data shows that Australian banks have consistently outperformed major banks in comparable countries (Regional Banks, 2017). Further, this data arguably underestimates the Australian banks' profit performance as it is not adjusted for risk¹⁰. Compared to large banks in many other countries, Australia's major banks have much higher asset weightings towards relatively low risk residential housing loans.

¹⁰ Regional Banks are unaware of any publicly available comparisons across countries of profitability that adjust for risk, such as return on risk weighted assets (RoRWA)

Conclusion

The Regional Banks welcome the PC's progress in its competition inquiry, and congratulate the PC on the work completed so far.

The Regional Banks fully endorse the PC's finding that:

competition and stability are both important to the Australian financial system. In order to preserve both principles, a genuine debate is essential before every material regulatory intervention. (Productivity Commission, 2018, p. 31).

The key recommendation is that the PC should prioritise reforms aimed at restoring a level playing field on the supply-side of the retail banking system by:

1. Addressing the 'too big to fail' implicit subsidy which affords the major banks a 'three-notch' credit rating advantage on wholesale debt;
2. Reducing the regulatory burden that falls more heavily on institutions with smaller customer bases;
3. Reducing the risk weight differences between IRB and standardised ADIs, without eliminating the incentive for smaller ADIs to seek advanced accreditation;
4. Requiring proper disclosure of mortgage broker ownership, including publication of the proportion of business that goes to the broker's owners; and
5. Removing the macro prudential restrictions that have the effect of locking in the market share 'status quo'.



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