5 June 2014

Professor Ian Harper

Chairman
Competition Policy Review Secretariat
The Treasury Langton Crescent
PARKES ACT 2600

Dear Professor Harper

Thank you for the opportunity to make a submission to this Review. This submission is made on behalf of Bank of Queensland, Bendigo and Adelaide Bank, ME Bank and Suncorp Bank. These four banks have recently made a comprehensive submission[1] to the Government's Financial System Inquiry (FSI) which covers many aspects of competition in retail banking.

The purpose of this submission is to highlight key issues in our FSI Submission that are also relevant to the Competition Policy Review.

Our objective in making recommendations is to build a healthy, multi-tiered banking system. We believe that consumers and the wider economy will be the primary beneficiaries of an industry comprised of vibrant competitors of differing size and business approaches, competing on a level playing field.

Efficiency and competition issues in retail banking

The Regional Banks believe that while Australia's financial system has proven robust through the GFC, there are opportunities to strengthen competition. Up until the GFC, a relatively level playing field existed for large banks, regional banks, foreign-owned banks, credit unions, building societies and non-ADIs. However post GFC, regulation has tilted the playing field materially in favour of the large banks by lowering their capital costs, and relative funding and compliance costs.

As a result, there is evidence of efficiency and competition problems in financial services and retail banking. This evidence includes the following:

- Around 9% of total national income or GDP in Australia is spent on financial services. This is high by international standards.
- A high proportion of credit is being channeled into domestic housing. Small and medium size enterprises (SMEs) seeking to innovate, cite a lack of access to funds as a significant barrier to economic growth. Concerns do exist, therefore, that there has been some problems in terms of allocative efficiency.

[1] http://fsi.gov.au/files/2014/04/Regional_Banks.pdf

- The four largest domestic banks continue to increase their market share and are very profitable by international standards. Market concentration is significant in most markets and return on equity (ROE) is high for the larger banks, despite the heavy asset weighting towards low-risk domestic housing assets.

Principle of competitive neutrality

The Regional Banks believe now is the time to identify, acknowledge and discuss these issues in a constructive way with a view to improving the system for the future. The best means of mitigating the trend towards further concentration is to refocus banking regulation. Competitive neutrality is about ensuring all service providers compete on an equal footing and that regulatory arrangements do not favour some service providers over others. A small number of regulatory changes are needed to preserve customer value and choice to allow regional banks and other providers to compete more broadly for the benefit of consumers and the economy.

Prudential regulation and regulatory capital

A priority issue for Regional Banks is for imbalances created by the regulatory capital regime to be addressed. As detailed in Chapter 4 of our FSI Submission, the capital adequacy regime is currently causing a significant competitive distortion between large and smaller banks.

Under the current system, there are two approaches for determining regulatory capital levels. The larger banks and Macquarie are deemed as 'advanced' risk managers which affords them the right to estimate their own risk weights against their balance sheet exposures. These risk weights are then used as inputs to determine overall regulatory capital.

All the Regional Banks and other ADI's use the alternative 'standardized' approach. Under this method, risk weights are prescribed by APRA's prudential standard which, in turn, is largely based upon the Basel Committee framework.

The dual system of setting regulatory capital has resulted in very substantial differences in required capital levels, particularly in relation to housing loans. Regional Banks are required to hold between 2-3 times more capital against housing loans than are the major banks (See Table 1 below). Whilst the regional banks acknowledge that there should be some benefit to those institutions who have achieved advanced accreditation, there is no risk based justification for the size of the current differential on residential housing loans in particular.

Credit rating agency Standard & Poor's has developed a methodology for comparing bank capital levels on a risk-adjusted basis. Figure 4.3 of our FSI Submission, shows when using the Standard & Poor's methodology, Regional Banks hold materially higher capital levels than do the major banks.

Table 1: Housing loan risk weight comparison – as of March 2014

BANK	RISK-WEIGHTING APPROACH	RISK-WEIGHT (%)
ANZ	Advanced	17.9
CBA	Advanced	17.6
NAB	Advanced	19.94
MACQUARIE	Advanced-FIRB	22.9
BOQ	Standardised	44.10
BENDIGO AND ADELAIDE BANK	Standardised	39.0
ME BANK	Standardised	38.4
SUNCORP BANK	Standardised	39.6

Source: Regional Bank FSI Submission[2]; Me Bank

Housing loans are a major component of Australian bank lending and, therefore, material differences in capital requirements will have real competitive impacts. In countries where housing finance is a smaller component of bank lending, the impacts would be less.

A further issue outlined in the Regional Bank's FSI Submission addresses APRA's requirements for authorizing 'advanced' status. Before authorizing a bank to be an 'advanced' risk manager, APRA requires the bank to demonstrate an advanced capability in three risk categories: credit, operational and market risk. This is not a Basel Committee requirement and, as far as we know, is not adopted in any other countries.

APRA's response

In addressing the housing risk weight issue in its FSI submission[3], APRA wrote that it sees no case for changing its current approach to deal with 'residual competition' issues:

APRA does not see any compelling reasons to depart from the Basel II capital framework, now well-established globally, to seek to deal with residual competition issues in housing lending. Comparing the specific risk-weight for a particular loan under the two approaches will give a misleading impression of the competitive impact of Basel II. As noted earlier, there is a clear, risk-based logic in applying higher risk-weights on housing lending to standardize ADIs, which generally have more concentrated balance sheets.

Moreover, in current circumstances of emerging housing price pressures, there would be no case to reduce standardized housing loan risk-weights on macroprudential grounds. The IRB approach is risk-sensitive and is available to ADIs that have the resources, data and capabilities needed to adopt it; in contrast, the standardized approach lacks that risk sensitivity and is, in effect, the default methodology for determining an ADI's capital adequacy.

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[2] P58, Regional Bank FSI Submission

[3] Page76, APRA FSI submission. http://fsi.gov.au/files/2014/04/APRA_2014.pdf

The Regional Banks strongly disagree with APRA's position. APRA's own submission to the Basel Committee in 2002 warned of the negative competitive impacts of the standardized risk weight for housing being 35% and recommended a weighting of 20%. The Regional Banks believe the standardized risk weight should be reduced to 20%, consistent with what APRA wrote in 2002.

APRA's opposition to lower housing risk weights for standardized banks is also based on a macroprudential argument. While APRA does not give details on this, it suggests APRA is worried that reducing housing risk weights for standardized banks will encourage excessive housing credit growth.

Once again, the Regional Bank disagree with this argument. The advanced banks in Australia account for around 85% of housing loans, so macroprudential concerns over the level of credit growth should really focus on the major lenders and not the smaller market participants. APRA's submission also does not consider the allocative efficiency issue of credit being channeled into domestic housing as opposed to small business. If the regional banks and other lenders were able to compete in the housing loan market on a more level playing field, it would encourage the advanced banks to allocate more capital into other areas such as small business lending, which would become relatively more attractive to them on a Return on Equity basis.

Recommendation: The Competition Policy Review Panel examine the extent to which the risk weighting of housing finance is impacting competitive neutrality. The Regional Banks recommend a 20% risk weight as a transition while smaller ADIs seek advanced accreditation (See FSI submission).

Recommendation: The Competition Review Panel assess whether APRA's requirements regarding 'advanced' accreditation are consistent with promoting competition.

Too big to fail

Another key issue for the Regional Banks is the funding cost advantage enjoyed by institutions deemed by Government and, therefore, credit rating agencies and investors as 'too big to fail'.

Since the GFC and the widespread taxpayer support for large institutions in other countries, there is now a good appreciation of the taxpayer risks associated with too big to fail banks.

However, from a Regional Bank perspective, the real issue with too big to fail is the impact it has on competitive neutrality. Credit rating agencies like Moody's and Fitch, give the major Australian banks a 'two-notch' rating upgrade due to their too big to fail status. This is in effect a taxpayer subsidy.

The higher a bank's credit rating, the lower its funding costs. This funding cost subsidy is estimated to be worth up to $6 billion[4] per year.

Regional Banks do not enjoy this 'two notch' rating upgrade and subsequently face a genuine competitive disadvantage. Access and cost of funding is the lifeblood of banking. Institutions that have better or cheaper access to funding have a material advantage.

In its FSI Submission[5], the Federal Treasury described the problems associated with this implicit support:

[4] Page 65, Regional Bank FSI Submission

The perception that the major banks are too big to fail has two major consequences for the efficiency and stability of the financial system:

- *moral hazard: the behaviour of the major banks and their investors, particularly their attitude to risk and its management, may be affected as some downside risk is perceived to be shifted to the government.*
- *allocative inefficiency: mispricing of risk will reduce the efficiency of the financial system as the price signals for the allocation of capital are distorted. All else being equal, major banks funding costs will be lower relative to competing financial institutions, such as smaller banks or corporate bonds.*

Addressing the too big to fail issue is not straightforward. Ideally, Government would bind itself against any form of taxpayer subsidy to large institutions. However, this is unrealistic given the potential economic damage a major bank failure could create. The Regional Bank FSI Submission details a number of options, including a discussion of APRA's approach to the issue.

The Regional Banks will be undertaking further work on how to address the too big to fail problem and we will keep the Competition Review Panel updated with any further work or recommendations on this issue.

Recommendation: The Competition Policy Review Panel assess the extent to which the too big to fail issue is causing competition problems and identify a first best solution to address it.

Major bank ownership of mortgage brokers

Mortgage brokers are intermediaries who match home loan borrowers with financiers. They can add economic value by reducing loan search costs, enhancing competition amongst lenders, particularly those suppliers without a branch network, and can assist consumers and financiers in finding the most suitable loan.

Many mortgage brokers are aligned to mortgage platforms or aggregators. These platforms provide affiliated brokers with infrastructure, such as technology systems and an established panel of wholesale loan providers. They typically share the fee revenue paid by the financier for whom they matched a borrower. It is estimated that around 40% of housing loans are sourced through mortgage brokers.

Together, brokers and aggregators have the potential to increase competition in housing finance. However, it is critical the industry remains free of conflicted incentives, or else the industry could quickly become a source of competitive distortion and consumer risk. The major banks have begun vertically integrating into the mortgage broking and aggregation business.

Given the major banks are also retailers of housing loans, the risk is the major banks will be able to use their ownership position as a means of reducing competitive tension in the market. The main concern of Regional Banks is that the major banks will be able to exercise influence over key mortgage broking businesses.

For example, a major bank owner could set up an incentive for its mortgage broker to direct only the best credit quality borrowers to them and, therefore, allocate the higher risk borrowers to competitor banks.

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[5] Page 38, http://fsi.gov.au/files/2014/04/Treasury.pdf

The Regional Bank's FSI submission recommends[6] some disclosure principles to address this problem. A key principle is to ensure potential home loan borrowers are aware of the mortgage broker's ownership structure before contracting for a loan.

Recommendation: The Regional Banks recommend the Panel endorse the disclosure principles as detailed on page 77 of the Regional Bank's FSI submission.

Other issues

The main issues impacting the competitive position of Regional Banks are capital adequacy requirements, too big to fail and vertical integration. Other issues identified in the Regional Bank FSI submission are: (a) the disproportional regulatory burden on smaller ADIs, and (b) the potential for confusion over the parent owners of various trading entities, such as RAMS, St.George, BankWest, Aussie Home Loans, and Wizard. The submission also recommends a focus on switching as part of the development of the New Payments Platform.

Further consultation

The Regional Banks believe the Competition Policy Review is a good opportunity to improve competition in retail banking. As discussed above, we believe the best way of delivering consumer benefits is by ensuring a level playing field in banking that will foster a healthy, multi-tiered system.

We are available for any follow-up questions or other consultation opportunities.

Regards,

Jamie McPhee

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[6] P77, Regional Bank FSI Submission.