FINANCIAL SYSTEM INQUIRY RECOMMENDATIONS

Submission to Government

Regional Banks
31 March 2015

CONTENTS

1 INTRODUCTION

The regional banks welcome the opportunity to make a further submission to Treasury on the recommendations of the final report of the Financial System Inquiry (FSI). The FSI has made a number of significant and welcome recommendations aimed at promoting efficiency, resilience and fairness of the financial system and to increase competition in the banking sector.

In previous submissions to the FSI, the regional banks advocated for principles, regulations, and a prudential framework for the banking sector based on competitive neutrality that builds confidence in Australia's financial system and delivers improved long-term competitive outcomes for consumers, small business, and the economy. The regional banks contend that the financial system will benefit from a competitive multi-tiered banking system.

The final report of the FSI acknowledged the need to level the playing field in banking. The major banks currently receive significant funding and capital advantages under the existing prudential framework and by virtue of being deemed to be systemically important to the domestic economy. The advantages became more pronounced during the global financial crisis. Competition and competitive neutrality must be given greater prominence in the regulation of the Australian banking system.

The regional banks particularly welcome the recommendations of the FSI to reduce the gap in risk-weightings of residential mortgages, to strengthen the capital requirements for systemically important banks and banks reliant on global financial and capital markets, and increased disclosure of the ownership structures of mortgage brokers. The regional banks urge the Government to implement the key recommendations of the FSI without delay.

The key priorities of the regional banks are the recommendations of the FSI that address the competitive anomalies in the banking system. Implementation of the recommendations will not in any way detract from the strength or stability of the system. A levelling of the playing field will increase competition across the whole banking system and deliver improved outcomes for consumers, small business, and the economy. Continued concentration of market power is inconsistent with the fundamental principles of stability, competition and efficiency.

The recommendations of specific interest to the regional banks are:

- Recommendation 1 – raise the capital requirements for ADI's, in particular ADI's that pose systemic risks or are reliant on global financial and capital markets;
- Recommendation 2 – adjust the requirements for calculating risk weights for housing loans to narrow the gap between average IRB and standardised risk weights;
- Recommendation 3 – implement a framework for minimum loss absorbing and recapitalisation capacity to facilitate the orderly resolution of Australian ADI's and reduce the perception that some banks are subject to an implicit Government guarantee and taxpayer support;

- Recommendation 6 – maintaining the ex post funding structure of the Financial Claims Scheme. We are concerned that a pre-funded 'deposit tax' scheme will disproportionately impact smaller banks, who rely more heavily on deposits for funding than larger banks; and
- Recommendation 40 – increased disclosure of the ownership structure of mortgage brokers.

The regional banks also support the observation of the Inquiry that the process to achieve IRB accreditation be streamlined and decoupled to promote incentives for ADI's to develop IRB capacity.

The specific recommendations are discussed in more detail later in this submission when the individual recommendations are addressed.

In summary, the regional banks believe that if these recommendations are delivered in full, the competitive landscape in Australia would be improved. Over time, the regional banks and other smaller banks (such as customer owned banks, building societies and mutuals) will be able to truly challenge the entrenched positions of the major banks. In turn, Australian consumers will benefit from a healthier, multi-tiered banking system.

2 IMPLEMENTATION TIME-FRAME AND RISK OF EXCESSIVE DELAY

As a group, the regional banks harbour concerns that even if the Government endorses the recommendations of the Inquiry, their ultimate implementation will be excessively delayed in subsequent policy and implementation processes.

On the 22 December 2014, shortly after the release of the final report of the FSI, the Basel Committee on Banking Supervision (BCBS) issued two consultation papers proposing alterations to the 'standardised' and 'advanced' approach to setting regulatory capital. The proposed changes are a part of the wider policy review by the Basel Committee to reduce the variability in risk-weights across banks.

The changes proposed by Basel partly overlap the recommendations in the final report of the FSI that relate to the capital and risk weightings of banks. The changes to the standardised approach are subject to a quantitative impact study and the proposed introduction of a regulatory capital 'floor' under the advanced approach is still at an embryonic stage. The regional banks are concerned that the Basel consultation and review process may be used to justify delaying implementation of Government-endorsed recommendations of the FSI. A key plank of the recommendations of the FSI was the need to level the playing field in banking and address the competitive capital and funding advantages available to the major banks under the prudential capital framework.

It is generally recognised that it may take up to two years before the Basel Committee determines the final form of the revised approaches. There will be a further transitional period before the reforms are implemented. There is a strong case for acting now on the introduction of risk weights on residential mortgages for IRB banks.

The Inquiry had quite a different objective – its terms of reference were aimed at advancing Australia's interests through setting regulatory rules that will enhance Australia's specific interests.

While the Inquiry's report stresses the need for Australia's regulatory system to be consistent with international standards, it is quite specific when it formally aligns recommendations with international rules.

For example, FSI recommendation 3 argues that Australia's domestically significant banks (D-SIBs) should have higher loss absorbing and recapitalisation capacity to facilitate the orderly resolution of Australian ADI's and minimise taxpayer support. The Inquiry does not suggest that Australia should go it alone, but instead ties this recommendation to the international process involved in establishing a 'bail in' mechanism.

In contrast, the Inquiry does not link the timing of implementing recommendations 1 and 2 to international policy processes.

FSI recommendation 1 is designed to put Australian banks ahead of banks in other jurisdictions in terms of their attractiveness in international financial and capital markets. By benchmarking Australian bank capital levels to the top quartile of international peer banks, the Inquiry is attempting to ensure our banks remain strong. The Inquiry's recommendation aims to ensure Australian banks will remain competitive in capital markets through times of stress.

While we accept that a final calibration of this benchmark will be dependent on the successful implementation of internationally comparable reporting by Australian ADIs, this does not mean that no action should be taken to address the current imbalance in the interim. Given that the major banks are among the lowest capital adequacy levels of the Australian ADIs, it would be sensible to consider a temporary additional capital buffer for systemically important banks as an interim measure.

For example, In March 2015, Hong Kong's Monetary Authority announced that five banks had been designated as D-SIBs, with only one of the five given the minimum additional capital surcharge of 1 per cent. Three of the banks were given a capital surcharge of 1.5 per cent and one bank was given a surcharge of 2.5 per cent, to be phased in by January 2019.[1]

Importantly, FSI recommendation 1 is not dependent upon a final Basel position. It is an enhancement to the Basel 'minimum' framework. Hence, it can be implemented without any reference to Basel processes.

Similarly, FSI recommendation 2 which aims to restore some competitive neutrality to housing loan risk-weights without reference to the Basel consultation processes and outcomes. There are several cases where countries, including Sweden and Norway, have moved outside the Basel timeline and process.

The Basel Committee is currently proposing a capital floor for advanced banks. The introduction of average risk weight floors on housing loans under the advanced approach is consistent with the concept of capital floors proposed by Basel.

Regional banks expect to see arguments mounted to maintain the status quo. The Return on Equity (ROE) gap between major banks and all other banks has widened since the introduction of Basel II in 2008 and the major banks now have 80%+ share of the housing loan market.

APRA has signalled that it will be considering the FSI recommendations in the context of the current Basel consultations discussed above. The regional banks would like to see the bi-partisan support from all sides of Government to give APRA clear guidance on implementation time-frames. We see no policy or operational reasons why the FSI recommendations 2 cannot be implemented as soon as possible, with appropriate transitional arrangements if deemed necessary. The Shadow Treasurer has confirmed publicly that, if the Government and APRA chose to move forward on recommendation 2 in advance of the Basel process, they would do so with the bi-partisan support of the Opposition.

Changing the system to provide greater support for competition does not necessitate undermining financial stability. We see a timely implementation as consistent with APRA's mandate to promote financial stability and give due consideration to competition in the exercise of its powers.

The Regional Banks recommend that the Government in responding to the FSI final recommendations does not make FSI implementation contingent on international policy processes, such as the Basel Committee, unless the FSI recommendations have already included a linkage.

[1] Hong Kong Monetary Authority, *Designation of Domestic Systemically Important Authorized Institutions,* March 2015.

The regional banks recommend the Government provide a timetable for the implementation of the FSI recommendations, particularly those recommendations aimed at enhancing competition, such as recommendation 2.

3 FSI RECOMMENDATIONS 1: CAPITAL BENCHMARK

FSI recommendation 1: *'Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.'*

The Inquiry recommended that Australian banks maintain capital ratios in the top quartile of internationally active banks. This is a dynamic benchmark that will change in line with movements in the levels of capital held by domestic and international banks.

It was unclear from the final report whether the recommendation was to apply to all Australian banks as the primary focus of the discussion supporting higher levels of capital was directed at domestic systemically important banks (D-SIB's) and banks with a high degree of reliance on foreign sourced funding.

In relation to D-SIB's, the Inquiry was seeking to significantly reduce the implied support and, therefore, the contingent liability of Government and taxpayers during periods of financial stress. The two notch uplift in the ratings of D-DIB's in Australia by international credit rating agencies is tangible evidence of the implied support.

Prior to the release of the final report, APRA designated the four major banks and Macquarie Bank as D-SIB's and proposed that they hold an additional 1% of capital due to the significant importance of these banks to the domestic economy and payments systems. Subsequent to the determination by APRA, regulators in other global jurisdictions have, in some cases, proposed larger uplifts in capital for systemically important banks.

A further objective of the Inquiry was to increase the strength of banks that rely on funding from global capital and financial markets. Both the larger Australian banks and domestic economy are, and will continue to be, reliant on foreign sourced funding. The Inquiry observed that it was particularly important that banks that source funding in international markets are perceived to be unquestionably strong and more resilient to shocks. The Inquiry was concerned that factors prevailing in Australian economy that assisted banks during the GFC may not exist during the next crisis. The Inquiry proposed that banks reliant on foreign sourced funding maintain higher capital ratios to be more resilient to shocks, improve ongoing access to foreign sourced funding during periods of financial stress, and to reduce the risk to Government and the broader economy.

Public statements by the Chairman of the FSI, David Murray, following the release of the final report reinforced that the recommendation for banks to hold more capital was directed at systemically important banks and banks reliant on foreign sourced funding. The clear inference was that banks in each category should hold a higher level of capital to mitigate the specific risks.

Regional banks do not fall into either category. They were not designated as D-SIB's by APRA and foreign sourced funding only represents a minor portion of their funding bases. Regional banks are predominantly funded by retail deposits.

There is currently no way of comparing the prudential capital ratios of banks across the various global jurisdictions or between standardised and IRB banks in Australia. The standardised approach is far more conservative as more capital is held against the assessed risk.

A recent survey of banks in the Asian region by international credit rating agency, Standard & Poors, revealed that, on a risk-adjusted basis, regional banks in Australia are amongst the highest capitalised banks in the region. The Standard & Poors risk methodology provides a consistent comparison of capital adequacy across all banks including standardised and IRB.

If the FSI recommendation is to apply to regional banks, the determination of appropriate levels of capital should be made based on a relevant peer group comparison. Standardised banks already hold higher levels of capital than IRB banks in relative terms due to the far more conservative risk-weights applied under the standardised approach compared to the IRB banks.

Implicit in the FSI recommendation is the need to define a relevant peer group from which to establish the top quartile capital benchmark. Given the focus of the recommendation is on ensuring a capacity to import capital by Australia's D-SIBs, the peer group should comprise international banks that are actively engaged in competing for international capital and be themselves systemically important. The globally systemically important banks (G-SIB's) identified by the Basel Committee and Financial Stability Board provide a relevant peer group comparison for Australian D-SIB's. Further uplifts in capital should be applied to banks in the categories that present a higher degree of systemic risk including banks reliant on international capital and financial markets. In other jurisdictions, a higher loss absorbency capital charge of up to 3.5% may be applied against G-SIB's.

The Inquiry concluded that the cost to customers flowing from banks holding higher levels of capital was marginal. Banks have a range of options other than simply increasing interest rates on loans to manage the impact of maintaining higher capital. There is also the prospect that the cost of both domestically and globally sourced funding may reduce.

The Regional banks support recommendation 1 on the basis that it be applied to the categories of banks identified by the Inquiry that present systemic risk and/or create a dependency on foreign sourced funding.

The regional banks accept that Australian banks should be perceived as unquestionably strong but believe that adopting a dynamic benchmark based on maintaining capital ratios in the top quartile of internationally active banks will present many practical problems. Capital levels maintained by banks in different jurisdictions may be influenced by factors not directly linked to stability or strength. Banks will be compelled to adjust their capital ratios on an ongoing basis even if they are already perceived by the market and regulators to be unquestionably strong. The preferred approach is to determine a preferred level of capital that may be adjusted periodically by regulators.

The Regional banks recommend that target capital ratios be prescribed for each relevant peer group and reviewed periodically.

4 FSI RECOMMENDATION 2: MORTGAGE RISK-WEIGHTS

FSI recommendation 2: *'Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.'*

Of most concern to the regional banks is the system of setting regulatory capital for bank housing loan exposures. Under the current 'dual' regulatory approach, minimum capital for the 'advanced' banks is significantly lower than for 'standardised' banks and other smaller institutions, a differential that is not justified on the basis of risk. As the Inquiry notes, "The gap between average IRB and standardised mortgage risk weights … translates into a funding cost advantage."[2]

Currently, the average risk weight of housing loans of the major banks is around 18% (including Macquarie Bank) compared to 39% for regional banks. (Under the IRB approach accredited banks can determine their own risk weights consistent with their internal models, while all other 'standardised' banks must calculate risk weights using a mandated set approach).

The Inquiry explicitly addressed this issue in recommendation 2 where it recommended an average 'advanced' housing risk-weight for mortgages of between 25% and 30%.

Regional banks believe this is the single most important recommendation to help restore the competitive position of smaller banks as was the case prior to the introduction of Basel II.

If the recommendation of the Inquiry were adopted, the major banks will retain a significant capital advantage as the difference between the average risk weights on housing loans for advanced banks will be between 9% and 14% below the average risk weights for standardised banks. That is, they would still hold onto a competitive advantage by virtue of being advanced.

Regional banks fully accept the principle that banks should receive a capital incentive for improvements in identifying and managing risk, implying that accredited IRB banks should maintain lower levels of capital for any given risk.

The question is whether the current disparities between advanced and standardised can be justified on a risk management basis. Our assessment is that the current disparities are too great, particularly in relation to very low risk mortgages; those with low loan-to-value ratios (LVR's) and a highly credit worthy borrower.

4.1 IMPORTANCE OF THE RECOMMENDATION

Housing mortgages is a major area of business for Australian banks, representing around 65% of total banking assets. This concentration is unusually high from an international perspective and also an historic perspective. In the early 1990s, the major banks had around 65% of their lending in commercial assets and that has diminished to less than 40% today. Currently, the major banks have over 80% of the residential mortgage market, incentivised by the regulatory regime.

[2] Murray, *FSI Final Report*, November 2014, p. 61.

Given the concentration in mortgage finance, regulatory capital rules relating to housing finance have a significant adverse impact on competition.

This imbalance is having a detrimental impact on the Australian banking sector. As the Inquiry notes:

> *"Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of small ADIs will harm competition in the long run."*[3] *And that "In some cases, these ADIs contend that, without change, they will be forced out of the market – materially lessening competition."*[4]

Similarly, FSI Panel member Kevin Davis noted that:

> *"Significant distortions in competitive ability have occurred, particularly in domestic housing mortgage markets. This is a paradoxical outcome, given that the IRB approach was premised on levelling the playing field for large banks operating in international markets, but has had the largest impact on risk weights on purely domestic activities and adverse consequences for smaller domestic banks."*[5]

Since the introduction of Basel II and the use of Internal Ratings Based (IRB) approach to setting regulatory capital in 2008, the Australian IRB banks have increased their exposure to residential mortgages and, due to the use of their internal models in estimating risk weights, significantly reduced their overall capital (increased leverage) held against this asset class.

Prior to the introduction of Basel II, the return on equity (ROE) for Australian banks was relatively similar across all retail banks. However, since 2008, the IRB banks are now producing ROE's results around twice that of the average of regional banks (See Chart C in APPENDIX A)

In addition to competitive neutrality, a recent stress test by APRA concluded that the amount of capital maintained against mortgage assets of the major banks (IRB banks) was insufficient:

> *"…the stress test results can also give us a perspective on the relative levels of capital required by different regulatory approaches. This was not the purpose of the test, but it is topical given the FSI's focus on the issue. The loss rates on residential mortgages in the scenarios did demonstrate that banks using the IRB approach tended to generate, on average, lower loss rates than banks using the Standardised approach. However, regulatory capital for housing held by Standardised banks was (just) sufficient to cover the losses incurred during the stress period; that was not the case for IRB banks…"*

In addition to improving stability and creating a more level playing field, increasing IRB risk weights will result in other positive outcomes. For example, placing an average floor on residential mortgage risk weights should improve the relative attractiveness of other forms of lending, and encourage major banks to redirect a greater proportion of their lending to

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[3] ibid., p. 61.
[4] ibid., p. 63.
[5] Australian Centre for Financial Studies, *Basel 3++: Buttons, Belts and Braces,* January 2015, p. 4.

other activities. This would help to reinforce the current activities of the RBA and APRA which are directed at ensuring growth in residential mortgage lending does not become unsustainable. It would improve the relative attractiveness of SME lending to the major banks and encourage them to conduct more business in this area.

4.1.1 Competitive neutrality in segments of the mortgage finance market

While the average risk weights for mortgages between IRB and standardised banks in Australia is significant (18% versus 39%) - the average results mask some important competitive issues relating to both the risker and safer ends of the mortgage finance market.

Included in the Pillar 3 disclosures of the IRB banks, average risk weights are disclosed along probability of default (PD) bands. These correlate to very safe mortgage loans (e.g. to borrowers with stable PAYE employment and with equity greater than 20% of the house's value). It can be seen from the data included in APPENDIX B that in the low PD bands, average risk weights of the IRB banks are very low relative to the 35% minimum risk weight applying to standardised banks.

For example, in the PD band of 0-0.1%, one IRB bank records an average risk weight of just 2.9% - considerably lower than the 35% that would apply to standardised banks with the same portfolio. A 2.9% risk weight equates to a debt/equity leverage of around 270, assuming a capital target of 8%.

Importantly, the 2.9% risk weight applies to nearly <u>one third</u> of this IRB bank's total residential mortgage portfolio. These numbers are similar for other IRB banks.

With such low risk weights applying to large portions of the IRB banks mortgage portfolios, this translates into very low regulatory capital ratios. Low capital requirements allow IRB banks to maintain very small interest rate margins on loans to exceed their return on equity (ROE) targets.

Clearly, with such a pricing advantage due to the freedom of IRB banks to estimate low risk weights for large portions of their lending book, they are afforded a significant competitive advantage. The advantage is compounded by the fact that IRB banks are deemed as systemically important (D-SIBs) and enjoy a two-notch uplift in their credit ratings which lowers their wholesale funding costs relative to non-systemically important banks.

4.2 BASEL COMMITTEE CONSULTATION ON THE STANDARDISED APPROACH

FSI recommendation 2 can be implemented independent of the Basel Committee processes to revise the standardised approach to credit risk and impose a capital floor on advanced banks. Implementing the average risk weight for housing loans as recommended by the Inquiry is broadly consistent with the Basel Committee's concept of a proposed capital floor. APRA may implement the recommendation without compromising the Basel process.

While we acknowledge that the Basel Committee is currently considering possible changes to standardised risk weights, this is no reason to delay implementation of this recommendation. At this stage, the proposals are only proposals, and there is no guarantee that any changes in this space will eventually be agreed to by the Basel Committee. Even if changes are adopted, it will be a number of years before the work of the Committee is finalised and implemented in Australia. The competition imbalances which result from the current regulatory settings are real, and are leading to undesirable outcomes.

Regional banks strongly support implementing recommendation 2 as a matter of urgency.

There is no basis to combine consideration of the recommendation with the Basel consultation process.

4.3 ADVANCED ACCREDITATION

While not a formal recommendation of the Inquiry, it observed that APRA could consider how to make the accreditation process less resource intensive to promote incentives for banks to develop IRB capacity. It noted that APRA had already indicated it was willing to explore decoupling operational risk from credit and market risk accreditation in the 'advanced' accreditation process.

The regional banks recognise the benefits of accreditation and accept the prudential distinction between the standardised and advanced approaches. Regional banks are moving down that path but the current process is inefficient and creates significant delays in the process.

The regional banks support any proposal for APRA to accelerate the advanced accreditation process.

The regional banks would also support consideration of de-linking accreditation of credit and market risk from operational risk.

5 Other FSI recommendations

FSI 3: Loss absorbing and recapitalisation capacity

'Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.'

This recommendation will encourage APRA to apply the G20's work around 'total loss-absorbing capacity' (TLAC) to Australia's IRB Banks – this currently only applies to global systemically important banks (GSIBs).

As the Inquiry notes, one of the objectives of this recommendation is to: "Reduce perceptions that some banks are subject to an implicit Government guarantee…" This is a particularly important recommendation for the regional banks, as it should reduce the funding cost advantage the major banks enjoy by virtue of a credit rating uplift based on an implicit government guarantee.

While it is likely to be a number of years before this change takes effect, this recommendation has the capacity to reduce the unfair funding cost advantage the banks deemed to be systemically important.

While important, this is also one of the more challenging and complex recommendations of the Inquiry, and we support the approach of implementing the recommendation in line with emerging international practice.

Regional banks support the recommendation and the guiding principles recommended by the Inquiry.

FSI 4: Transparent reporting

'Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.'

There is the perception in some quarters that Australian banks are lightly capitalised. Part of the reason is that regulatory capital ratios are dependent upon the various prudential rules and definitions applied in different jurisdictions.

Difficulties around international capital comparisons mean that it is difficult to tell how far IRB banks currently fall short of the "top quartile" benchmark in Recommendation 1. In this regard, the Inquiry has also recommended that APRA should "Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework."[6]

Regional banks support FSI recommendation 4.

[6] Murray, *FSI Final Report*, November 2014, p. 76.

FSI 5: CRISIS MANAGEMENT TOOLKIT

‘Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.’

The regional banks support the resumption of consultation on the crisis management toolkit commenced by Treasury and APRA in 2012, and we look forward to commenting further on the specific proposals when further detail is released.

Regional banks support FSI recommendation 5.

FSI 6: FINANCIAL CLAIMS SCHEME

‘Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.’

With a strong focus in the FSI report on bolstering competition in banking, the regional banks are disheartened by proposals to ignore the FSI recommendation.

The Federal Government indicated at the last MYEFO statement[7] that its next step with regard to financing the Financial Stability Fund would depend upon the outcome of the FSI.

David Murray has made an explicit recommendation against “pre-funding” the Financial Claims Scheme[8]. The Inquiry has instead recommended that the Government “Maintain the ex-post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.”[9]

We also believe that the Financial Stability Fund should not be established on competitive neutrality grounds. The Labor Government’s proposed method of raising the funds was more favourable to the major banks. It proposed that the levy be calculated by multiplying a bank’s insurable deposit base by a fixed percentage levy (e.g. 5 – 15 basis points).

Because smaller banks raise a higher proportion of their funding through deposits, they would contribute a proportionally larger amount to the balance in the Financial Stability Fund. This status elevates their credit rating and artificially reduces the interest rate they borrow at in capital markets.

We also see no fiscal advantage to the Government in imposing the levy on banks. Under Labor’s proposal, the levy was solely designed to build balances in the Financial Stability Fund. As such, the money raised has no impact on Government consolidated revenue.

We ask the Government to consider the consumer and competitive impacts of this new tax proposal.

Regional banks support FSI recommendation 6 on competitive neutrality grounds.

FSI 7: LEVERAGE RATIO

‘Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions’ risk-weighted capital positions.’

Bank leverage ratios are primarily designed to control overall leverage in financial systems and the associated financial instability in times of stress.

[7] http://www.budget.gov.au/2014-15/content/bp1/html/bp1_bst8-05.htm
[8] Murray, *FSI Final Report*, November 2014, p. 82
[9] Ibid.

Regional banks support FSI recommendation 7 as a backstop.

FSI 21: STRENGTHENING PRODUCT ISSUER AND DISTRIBUTION ACCOUNTABILITY

'Introduce a targeted and principles-based product design and distribution obligation.'

While we support a principles-based approach to ensuring a range of factors are taken into consideration with the distribution of financial products and recognise that this obligation aims to reduce the number of consumers buying products that do not match their needs, we are concerned that any movement in this direction needs to be targeted at the problem.

The problem the recommendation seeks to address is primarily a result of large scale financial investment failures, and poor advice, associated with complex, 'Tier 1' financial products.

The Final Report identifies the difference in risk of consumer detriment between complex and simple products, and states "simple low-risk products such as basic banking products would not require extensive consideration, and may be treated as a class with a standard approach to their design and distribution."[10]

The regionals are unaware of any incidence of significant consumer detriment associated with the design or distribution of basic banking products. [11]

Regional banks would like to see further consultation on this recommendation to ensure that simple banking products are not treated in the same way as complex products.

FSI 22: INTRODUCE PRODUCT INTERVENTION POWER

'Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.'

As with the above recommendation, regional Banks are concerned that if extended to the simple banking products; this power may lead to excessive legal conservatism and effectively constrain product innovation. An intervention power, if progressed, should be directed at those products that are seen to create issues for customers.

Regional banks would like to see further consultation on this recommendation.

FSI 27: REGULATOR ACCOUNTABILITY

'Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.

Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.'

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[10] Ibid., p. 199.

[11] Basic banking products are defined under section 961F of the *Corporations Act 2001* and include basic deposit products (such as transaction accounts), non-cash payment facilities, and travellers cheque facilities.

Recommendation 27 encompasses several different elements, with the overall objective of improving the regulator accountability framework. The regional banks support this objective, and the proposals put forward by the Inquiry to achieve this outcome.

We support ASIC having a competition mandate and while APRA's legislative mandate already requires it to balance a broad range of objectives, specifically financial safety, efficiency, competition, contestability, competitive neutrality and financial system stability[12] the legislation does not explicitly state how these often competing objectives should be prioritised.

The language used in the Government's Statement Of Expectations is that it would like to see APRA be an agency "…that balances the objectives of financial stability and efficiency, competition, contestability, and competitive neutrality…"[13].

Regional banks support this recommendation. This recommendation will help ensure that competitive neutrality concerns can be raised in a systematic, objective way on a regular basis.

FSI 30: Strengthen the focus on competition in the financial system

'Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.'

A primary objective of the Regional Banks in participating as a group through the Financial System Inquiry was to improve competitive neutrality of the system. This is the best means of protecting a multi-tier and healthy industry into the future. While Regional Banks can understand why safety and stability issues can dominate policy making at various times, there remains an obligation to properly consider competition. On-going reporting by regulators on competition matters will assist in this endeavour.

Regular competition reviews may ensure that a strong focus on competition in the banking sector is maintained going forward, and will make it more likely that emerging issues in the sector will be addressed in a timely fashion.

The Inquiry correctly notes that without this change, "…there is a risk that regulators and policy makers will not place sufficient emphasis on competition when making decisions…"[14] Holding the reviews every three years is a sensible suggestion.

We also support the Inquiry's recommendation that, prior to the completion of the first review, "…regulators should examine their rules and procedures to assess whether those that create inappropriate barriers to competition can be modified or removed, or whether alternative and more pro-competitive approaches can be identified."[15]

Regional banks support this recommendation on competitive neutrality grounds and would welcome further opportunities to contribute to this change.

[12] *Australian Prudential Regulation Authority Act 1998*, Section 8(2)
[13] Treasurer, *Statement of Expectations – APRA,* 2014, p. 4.
[14] Murray, *FSI Final Report*, November 2014, p. 256.
[15] ibid., p. 254.

FSI 31: Compliance costs and policy processes

'Increase the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently.'

By definition, smaller banks have less capacity to absorb regulatory costs than do major banks. Regulatory costs are often fixed in nature and the smaller is your customer base, the less accounts there are to spread costs. Consideration of competitive impacts of reform and allowing sufficient time to implement change are means of diffusing this relative cost burden, at least to some extent.

Regional banks strongly support this recommendation on competitive neutrality grounds.

FSI 40: Provision of financial advice and mortgage broking

'Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.'

We acknowledge that general advice is not widely understood to be "financial advice" by consumers. Therefore, we believe there is merit in giving further consideration to different and more appropriate terminology and labels which more closely reflect the true nature of information that is termed "general advice" under the law.

Additionally, we support clearer and more effective disclosure of ownership structures across the financial services industry. Specifically, the regional banks support enhanced disclosure in the financial advice and mortgage broking industries. In submissions made to the Inquiry, the regional banks argued strongly that consumers would be more informed if mortgage brokers disclosed their corporate ownership structure.

With major banks now owning a significant portion of the mortgage broking market, the industry's own integrity will depend upon consumer confidence and this will only be achieved with full disclosure. Ownership structure can influence decision making and consumers need to be aware.

Regional banks support this recommendation.

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APPENDIX A. Excerpt from OECD Economic Surveys Australia – December 2014

Prudential oversight is focusing on the housing market

Strong prudential regulation and oversight undoubtedly helped Australia weather the global financial crisis. Various rules dissuading high-risk lending played a key role. In particular, conservative capital adequacy rules and reduced leverage protected the system and encouraged banks to focus portfolios on domestic and low-risk credit. Indicators show that the banking sector is currently in a strong prudential position; return on equity remains high as do capital adequacy ratios and there remains relatively little problematic debt (Figure 7).

Given the recent rapid increase in house prices, the Australian Prudential Regulation Authority's (APRA's) circulation of new draft guidelines on residential mortgage lending in May 2014 (APRA, 2014a) has been a sound move. For instance, the guidance outlines prudent practices in addressing housing credit risk for deposit taking institution's (ADI's), such as guidance on loan origination criteria, security valuation methods, the management of hardship loans and stress-testing. These guidelines are in addition to a review in 2013 on the loan serviceability standards. Also micro-prudential scrutiny (i.e. scrutiny on an institution-by-institution basis) has intensified, its effectiveness helped by the fact that the four major banks represent the bulk of the banking sector. This said, macro-prudential measures may become appropriate if a general slowing in lending is needed, and as a means of signalling concern and willingness to act to stabilise the financial system as a whole (i.e. announcement effects). Accordingly, the Council of Financial Regulators is continuing to monitor developments in the housing market (particularly in relation to investment housing) and is actively considering additional steps in order to reinforce appropriate lending practices.

Banks are strong, but the degree of concentration raises issues

Australia's financial sector is in good health from a prudential perspective but there are concerns, particularly relating to the degree of concentration in banking. The global financial crisis strengthened the already dominant position of the four main banks, as two of them took over smaller banks over this period (Figure 7). Nevertheless, according to

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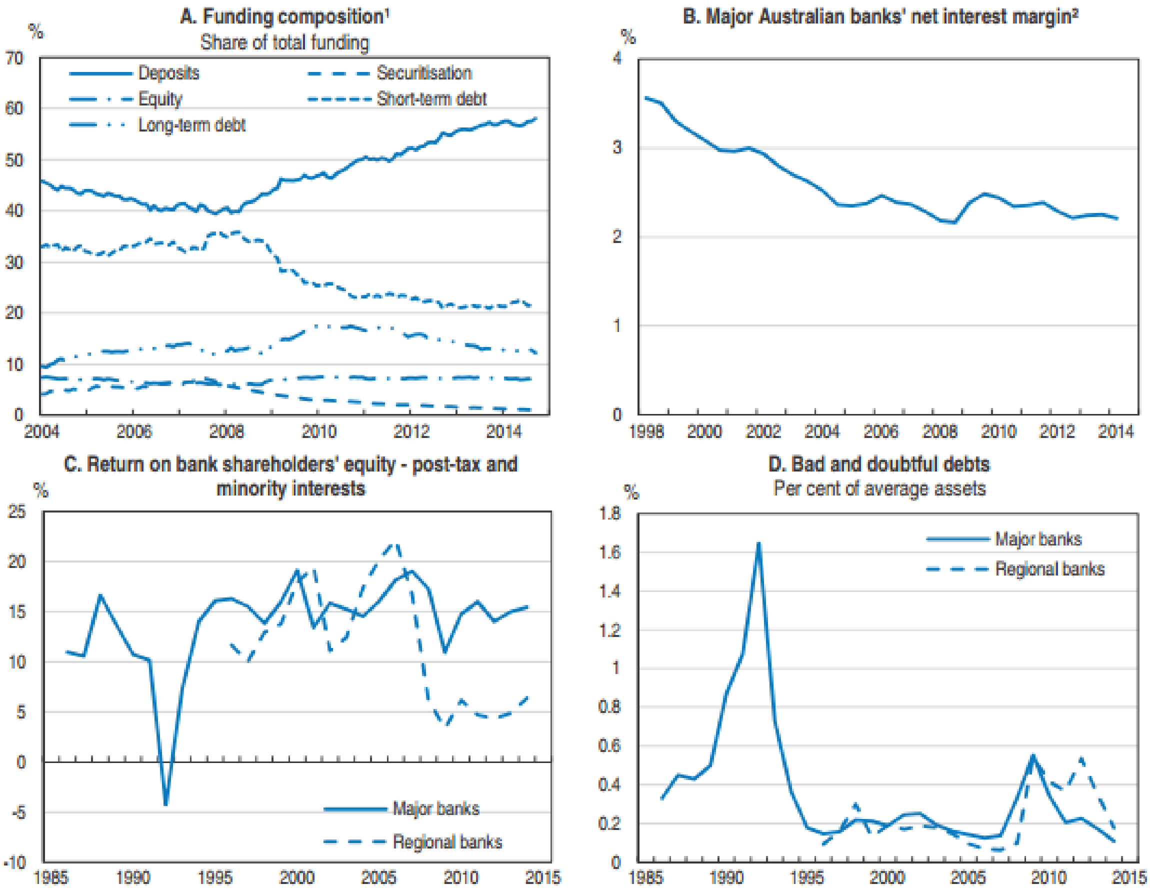
Figure 7. **Banking sector indicators**



1. Short-term debt and long-term debt are adjusted for movements in foreign exchange rates. Short-term debt includes deposits and intragroup funding from non-residents.
2. The data refer to the major banks' public reports on net interest margins, excluding St. George Bank and Bankwest prior to the first half of 2009.

Source: Reserve Bank of Australia (2014), *Banks' Financial Reports*; Australian Prudential Regulation Authority (2014).

StatLink http://dx.doi.org/10.1787/888933176458

available indicators it would appear that competition is robust. Indeed, net interest margins are near thirty-year lows and measures of consumer satisfaction are near record highs. However, the concentrated structure of the banking sector leaves no room for complacency for the Australian authorities in ensuring prudence is maintained and that there is strong competition in financial markets. A recent interim report from an inquiry of the financial system contains welcome discussion of these issues alongside suggestions for reform (Murray Report, 2014). It elaborates on avenues to reduce the problem that the four major banks are perceived as too-big-to-fail and, linked to this, that they benefit from a substantial implicit guarantee. For instance, the interim report suggests increasing powers to impose losses on creditors in the event of bank failure. As regards retail markets, the interim report identifies banks as benefitting from differences in risk-weighing systems in mortgage lending and is critical of the degree of competition in superannuation (i.e. pension fund) administrative fees. As regards business financing, the report notably suggests the creation of a credit registry to facilitate lending to small and medium-sized

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enterprises, and proposes facilitating bond financing by making it easier for companies to raise money using vanilla (i.e. simple) bonds. Follow-up on these suggestions for reform will await the final recommendations of the inquiry (which are due in November 2014).

Recommendations on ensuring price and financial stability

- **Continue intensive monitoring of the housing market**; Maintain deep micro-prudential oversight and consider using macro-prudential tools to bolster credit safeguards and signal concern.
- **Examine credit and competition issues in the financial sector**; Consider reducing banks' implicit guarantees, tackling risk-weighting advantages in mortgage lending, improving credit databases.

APPENDIX B. Pillar 3 disclosures and leverage estimates

Bank Name

Risk weight uplift factor

$2.61B	0.89%	3.8%	4.8%	$0.01B	259	$0.38	0.06%
$191.29B	64.98%	6.4%	7.4%	$1.13B	168	$0.59	0.09%
$22.63B	7.68%	13.4%	14.4%	$0.26B	86	$1.15	0.17%
$62.46B	21.22%	30.3%	31.3%	$1.56B	39	$2.50	0.38%
$8.46B	2.87%	74.1%	75.1%	$0.51B	16	$6.01	0.90%
$5.22B	1.77%	107.7%	108.7%	$0.45B	10	$8.70	1.30%
$1.73B	0.59%	224.0%	225.0%	$0.31B	5	$18.00	2.70%
$141.60B	29.78%	2.9%	3.9%	$0.44B	320	$0.31	0.05%
$121.02B	25.45%	9.2%	10.2%	$0.99B	122	$0.82	0.12%
$82.89B	17.43%	14.4%	15.4%	$1.02B	80	$1.23	0.18%
$113.74B	23.92%	24.4%	25.4%	$2.31B	48	$2.03	0.30%
$4.88B	1.03%	74.0%	75.0%	$0.29B	16	$6.00	0.90%
$8.59B	1.81%	99.8%	100.8%	$0.69B	11	$8.06	1.21%
$2.81B	0.59%	183.2%	184.2%	$0.41B	6	$14.74	2.21%
$98.84B	31.14%	3.4%	4.4%	$0.35B	283	$0.35	0.05%
$110.22B	34.72%	10.4%	11.4%	$1.01B	109	$0.91	0.14%
$81.69B	25.74%	27.2%	28.2%	$1.84B	43	$2.26	0.34%
$15.79B	4.97%	55.5%	56.5%	$0.71B	21	$4.52	0.68%
$8.72B	2.75%	95.3%	96.3%	$0.67B	12	$7.70	1.16%
$2.14B	0.68%	196.0%	197.0%	$0.34B	5	$15.76	2.36%
$195.61B	51.15%	4.0%	5.0%	$0.78B	249	$0.40	0.06%
$20.17B	5.27%	8.0%	9.0%	$0.15B	138	$0.72	0.11%
$113.86B	29.78%	16.0%	17.0%	$1.55B	73	$1.36	0.20%
$33.94B	8.88%	35.0%	36.0%	$0.98B	34	$2.88	0.43%
$11.98B	3.13%	68.0%	69.0%	$0.66B	17	$5.52	0.83%
$4.82B	1.26%	108.0%	109.0%	$0.42B	10	$8.72	1.31%
$2.01B	0.53%	215.0%	216.0%	$0.35B	5	$17.28	2.59%