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Submission to the Australian Government's Financial System Inquiry

Ensuring a rich biodiversity of 2nd and 3rd tier players in the Australian Financial System via ensuring equity in funding costs throughout the system

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Bios available on www.Morgij.com.au
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Abstract

Australia's financial system has become heavily concentrated over the past 20 years with the Domestic Systemically Important Banks ("D-SIBs"), as recently defined by APRA, and their subsidiaries now dominating the landscape for deposits, loans and wealth management.

Even as new modes of lending and financial interaction have developed with technology this domination and concentration thrives with Westpac recently purchasing a stake in Australian based peer to peer company SocietyOne.

This submission accepts that the shape of the financial landscape in Australia is as it is and does not seek to implement any strategies, taxes or imposts which would seek to limit competition or tax the D-SIBs for their dominant position in the Financial System.

Rather this submission recognises that there is an ecosystem apart from the D-SIBs competing for the light that can form the basis of maintaining innovation, competition and systemic strength in finance across the entire Australian economy.

To this end we recommend a funding vehicle which is aimed at providing a mechanism which will go some way to ensuring a rich and diverse financial ecosystem is maintained in Australia by addressing the funding price mismatch between players of different sizes and scale owing to the large subsidies enjoyed by the D-SIBs (see separate submission by Morgij Analytics) thanks to their too-big-too-fail status.

We will show that this status has economic costs for the economy as a whole if the concentration continues unabated and the economic biodiversity shrinks further. We will argue that in empowering those financial system players on the second and third tier in terms of size to create and fund Australian assets and businesses this will help deliver consumers and the Australian economy a more innovative, competitive and healthy financial system.

Our submission deals primarily with the pricing disadvantage that smaller players in the Australian Financial system have against the D-SIBs. We will provide the back ground to and reason for a funding vehicle which will help equalise competition within the $1.5 trillion residential mortgage market underpinning Australia's $5 trillion in residential property investments.

Importantly this structure can also serve as a template for all types of borrowing and lending for markets where security is taken over an asset in receipt for a loan of funds.

Background

Since the float of the dollar in 1983 and the freeing up of restrictions between savings and trading banks, on the interest rates and business lines that banks can offer which eventually followed in Australia's Big Bang the trend toward concentration within the Australian financial system has occurred in all facets of the system.

The ANZ, Commonwealth, NAB and Westpac banks (D-SIBs) now dominate the market for borrowing and lending and more recently wealth management in a way that has intensified with each takeover and merger within the industry.

Looking back to 1983 the financial system was certainly less sophisticated cloisted behind the wall of a fixed/managed exchange rate, interest rate caps and business line limits but there existed within the financial system a vast number of financial institutions making for a rich diversity of trading banks, savings, banks, building societies, credit unions, finance companies and merchant banks.

No one institution was too big to fail.

Companies thrived and members and customers alike borrowed in an environment of choice.

But over the years competitors like Advance Bank, St George, Bank of South Australia and Bank of Melbourne have been subsumed by Westpac. The Commonwealth Bank took the other big state based regionals in the State Bank of Victoria, The Rural Bank of New South Wales which became Colonial and the GFC delivered them Bankwest via Bank of Scotland's failure.

But while deregulation has delivered 4 large, strong and profitable D-SIBs it has failed consumers and competition by increasingly concentrating market power in the hands of these 4 institutions.

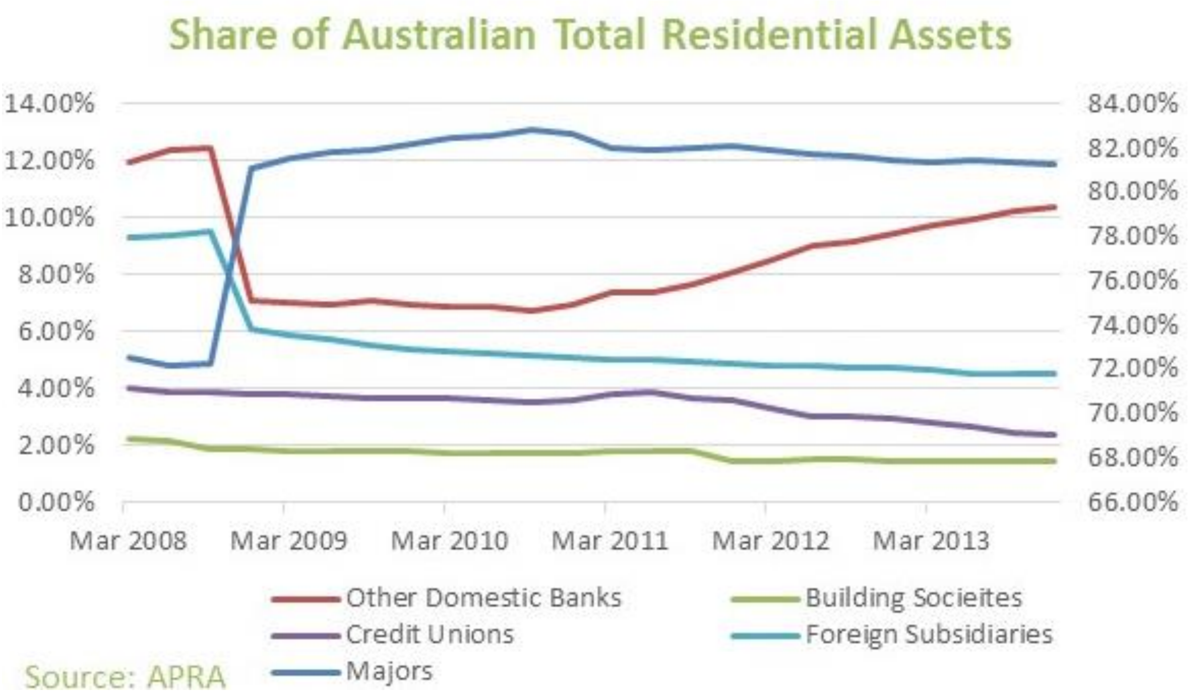
Concentration of competition is unhealthy for a financial system and the economy it serves

Our concern and clearly something that underpins the very existence of this inquiry is that there is a point where the economies of scale in banking that accrue to an economy as the size and sophistication of the banks in its financial system grow ultimately give way to diseconomies and systemic risk when the bank, or banks, become too-big-to-fail and thus earn themselves an implied government guarantee.

As a result of this "guarantee" recent studies[1] show that this leads to additional risk taking by the D-SIBs and the smaller competitors trying to keep up. Equally the too-big-too-fail banks gain a cost differential in terms of their ability to fund which is anti-competitive but which reinforces the risk to the economy and the Government and taxpayer balance sheet in a negative feedback loop where the implied guarantee begets more risk begets a stronger implied guarantee.

[1] Federal Reserve Bank of New York, Economic Policy Review Special Issue: Large and Complex Banks, Forthcoming Version of Do "Too-Big-to-Fail" Banks Take On More Risk?, Gara Afonso, João Santos, and James Traina March 2014. http://www.ny.frb.org/research/epr/2014/1403afon.html

In the Australian context in 2014 even the largest of the non-majors, Suncorp, has only 15% of the total Australian assets of the smallest majors. Bendigo Adelaide has around 10%, while the Mutual sector number around 100 ADI's has around $90 billion in assets.



The GFC has only reinforced this trend toward the domination of the D-SIBs and concentration in the Australian Financial System particularly the home loan market as data from the RBA and APRA shows. There was a clear and distinct step change in residential asset concentration from March 2008 when Bear Stearns collapsed and the GFC intensified.

We are not seeking to drag the D-SIBs down in any way and this submission is not aimed at that. Rather we believe a healthy competitive ecosystem in Australia is now beyond the grasp of the Australian economy because of the push toward concentration without a fresh injection of private cash and public backing.

In this way the smaller players in the market whether non-bank lenders such as Resimac or Yellow Brick Road, Second tier lenders such as the regional and foreign banks, Macquarie bank and the 100+ Mutual sector of Credit Unions, Building Societies and Mutual banks can gain access to a cost of funds that is in line with the D-SIBs and in doing so redress some of the cost advantage that these D-SIBs hold over other players in the Australian financial landscape due simply to their size and implied government guarantee.

Equally we will show how the structure that we are proposing can deliver a lower cost of funds, more competition and more choice for users of the financial system and help spread risk more evenly throughout the Australian economy thus helping to mitigate the inherent riskiness associated with the D-SIBs.

The Funding Cost Playing Field – mismatched because of an implied guarantee

Credit Rating Agencies (CRAs) such as Moodys, Fitch and Standard and Poors are on the record in saying that banks they deem to be systemically important attract a rating uplift of between one and two notches.

That is because they assume that in the interest of the "greater good" of the economy the supra-national, national or regional government will step in with support to ensure the institution in question does not collapse.

The impact of this on the financial system in any jurisdiction are at least two-fold. Taking the Australian example:

1. The D-SIBs have their credit rating increased to AA- which is 2 notches above the stand alone rating that these too-big-too-fail banks would enjoy on their own; and,

2. CRAs not only do not uplift smaller players deemed less systemically important but they tend to mark smaller players in the financial landscape down for a lack of diversification – regardless of credit and operational performance.

This has a tendency to make the ratings gap wider than the performance of the organisation or its assets would suggest and makes the rating mismatch doubly bad for the smaller players in favour of the D-SIBs.

The rating uplift hurts competition because investors tend to price the implied government guarantee when D-SIBs issue debt.

A recent study[2] by Joao Santos released by the Federal Reserve Bank of New York showed that,

"the largest banks have a cost advantage vis-à-vis their smaller peers…this difference is consistent with the hypothesis that investors believe the largest banks are "too to fail""

This study found that in the United States up till 2009 the cost advantage is around 41 basis points over their smaller rivals.

[2] Economic Policy Review, Special Issue: Large and Complex Banks, Forthcoming Version of Evidence from the Bond Market on Banks' "Too-Big-to-Fail" Subsidy, João Santos. March 2014 http://www.ny.frb.org/research/epr/2014/1403sant.html

The IMF conducted similar studies since that time finding in 2012 that larger banks enjoyed a cost advantage of around 80 basis points.

Morgij Analytics own research, the subject of a separate submission, reveals that Australia's D-SIBS enjoy an annual subsidy in the order of $10Bn which includes the benefit of the credit rating increase.

Whichever way you cut it the subsidy is material and while Santos argues it may not all be as a result of the too-big-too-fail dividend that accrues to the big banks the competitive advantage that they enjoy as a result of an implied Government Guarantee is substantial enough to give them a large competitive advantage in raising funds.

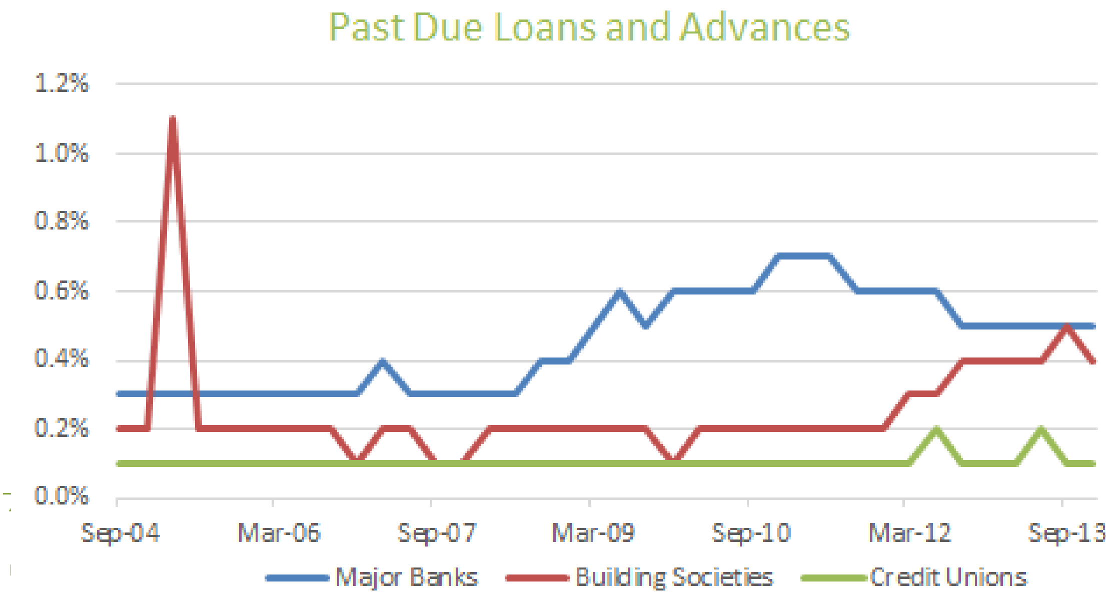
Certainly during the GFC the Australian Government charged a fee in wholesale markets for the explicit guarantee that it provided to allow Australian banks to continue to issue in local and global wholesale markets. But as markets have reverted toward normal there is no such charge presently for what is likely perceived as a very strong implicit guarantee on Australia's D-SIBs.

That is not to say that we believe it should charge a fee for the implicit guarantee but rather it would aid competition and financial system resilience by providing a guarantee to the funding vehicle we propose to level the playing field.

The lower risk taken by smaller players in the Australian Mortgage Market is not rewarded with lower funding costs

Leaving aside the CRA mismatch on ratings and the impact that this has on the cost of funds for smaller players in the Australian financial system the better asset performance of smaller players in Australia with regard to long term credit experience of assets on and off balance sheet in Australia is neither reflected in their rating or their ability to raise funds in wholesale markets.

APRA banking data shows the folly in this on a credit basis alone if we compare the performance of the D-SIBs versus the Mutual Sector – as a readily available subset in its data base since 2004 with regard past due loans.

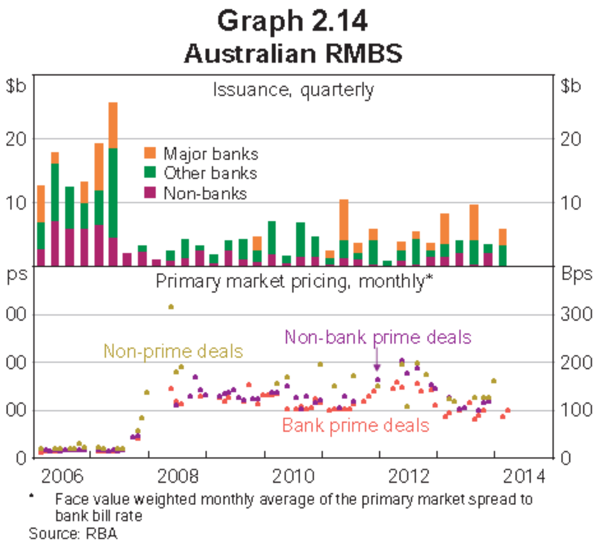


Source: APRA, Morgij Analytics

By international standards the Australian banking system is well performing when it comes to assets. The performance during of the system during the GFC was amongst the best in the world with only Canada experiencing similar results.

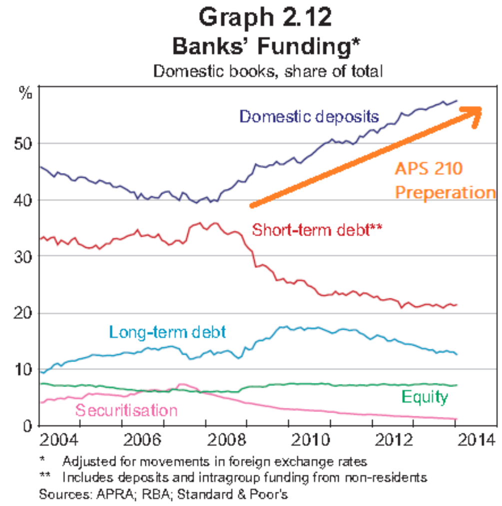
But whether Australia's performance was an accident of history, Australian law, the Federal Government guarantee on all deposits, wholesale and retail, the federal government stimulus, aggressive Reserve Bank rate cutting or simply a result of the floating Australian dollar taking the shock falling to a low of 0.5960 against the US dollar at the depths of the GFC is up for debate.

Regardless of the cause Australia has retained a very low level of past due loans by international standards with building Societies and Credit Unions even lower than the D-SIBs, a strength not recognised by investors or reflected in the borrowing costs on wholesale markets nor indeed even on AAA rated RMBS issues as the chart below highlights.

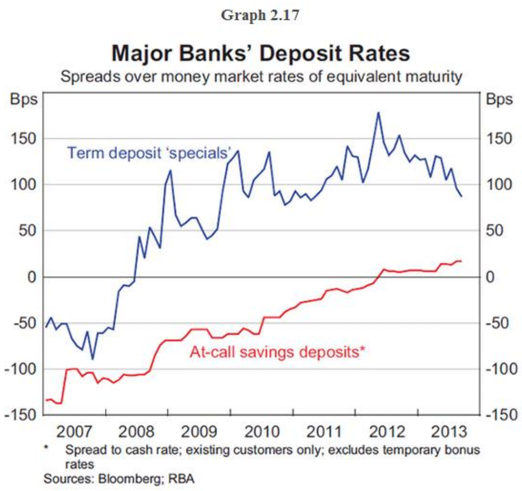


The difference in pricing between the D-SIBs and other lenders of the same credit type (ie prime) is clearly not the 41 or 80 basis points of the Santos or IMF studies as shown in the above graph. But the D-SIBs retain a clear funding advantage over other large issuers into the RMBS markets.

Importantly however due to scale and size many non-D-SIB lenders, indeed the vast majority, are currently cut-off from funding in the RMBS market due to cost of funding. These smaller ADI's have and remain primarily deposit funded.



This is extremely important because under APRA's APS 210 implementation of the Basel III rules on liquidity the Majors are explicitly being forced to chase more "stable" deposit funding even though they can raise money often more cheaply on a marginal cost basis in wholesale markets or offshore.



While we applaud APRA's efforts to redress the poor deposit funding exhibited by the majors prior to the GFC we also recognise the competitive pressure this has placed on smaller players who are more reliant on term deposits for funding are now under pressure from D-SIB TD Specials.

This is tending to drive their cost of funds higher without any mitigants available in wholesale markets which either are closed to them because of size or discriminate against them due to size and lack of too-big-too-fail status and thus an implied government guarantee.

Indeed APS 210 calls explicitly calls for all ADI's to seek to diversify their funding models which pushes smaller ADI's toward the increased cost of wholesale funds at the same time their retail customer base has also become more expensive.

Ensuring a diverse Financial System that is competitive and innovative

Notwithstanding all of the above the Australian financial system has not gone to or beyond the point of no return in terms of a rich biodiversity below the D-SIBs.

Smaller ADI's and non-bank lenders and funders might be endangered, particularly if their market is for Prime product only, from increased funding costs, margin pressure, cost of doing business disadvantages[3] and increased cost of regulatory compliance. But the diversity that exists among Regional Banks, Macquarie, the Mutual Sector and non-bank continues to provide the basis for sustainable competition.

We recognise that innovation and technology is likely to empower disrupters to change the shape of the Financial system in the decades ahead but this recognition and Westpac's recent investment in SocietyOne further reinforces to us the need for the diversity to thrive so that it is not only a small select few companies who benefit from such.

The way forward

We believe that there is a fairly straight forward answer to the complex question of ensuring competition within at least the Australian mortgage market.

This would require the establishment of a funding vehicle, which we will refer to as

"AUSMortgage".

This funding vehicle would require the establishment of a special purpose vehicle for the purchase of qualifying loans and issuance of residential mortgage backed securities in to the domestic Australia and international capital markets.

This structure would require private capital to establish and to take any losses but also require explicit government support to establish the vehicle and to provide a senior guarantee. This would

[3] Federal Reserve Bank of New York, Economic Policy Review Special Issue: Large and Complex Banks, Volume 20 Number 2, Forthcoming Version of Do Big Banks Have Lower Operating Costs? Anna Kovner, James Vickery, and Lily Zhou, March 2014 http://www.ny.frb.org/research/epr/2014/1403kovn.html

be similar to the French Government support at the beginning of the French covered bond market.

Writing in September 2013[4] Standard and Poors said of the French Covered Bond Market and in particular to the CRH Bonds we refer,

"Caisse de Refinancement de l'Habitat (CRH) bonds. Caisse de Refinancement de l'Habitat (CRH), a type of credit institution that is governed by a specific law, was the first entity to issue covered bonds in the current format. It was founded in 1985 exclusively to refinance banks' housing loans. Originally backed by an explicit state guarantee, CRH is now a private corporation."

There have been some iterations and new structures over the years in France but the key in an Australian context is that after initially being supported by the government this and other iterations within the French Financial System have been able to develop a funding function without a Government Guarantee.

We believe in the Australian context that the provision of private capital at the bottom of the structures that would support AUSMortgage issues would only require the Australian Government to sponsor the initial set up of AUSMortgage and guarantee its senior debt obligations until such time as RMBS could be issued at competitive pricing without a guarantee.

Likewise in the United States as a result of the structure of the mortgage lenders Fannie Mae and Freddie Mac and lessons learnt as a result of loans and practices prior to the GFC the US Government is planning (although legislation has not passed the senate) on restructuring these two companies such that private capital will provide equity into the structure with the US government limited to providing explicit support to the senior RMBS

Key to the changes in a behavioural, cultural and practical sense is the requirement for private capital as we suggest above. In addition under the AUSMortgage structure lenders who sell loans into the structure will at all times be required to maintain servicing rights. This is different to Fannie Mae and Freddie Mac prior to the GFC and is a second line skin in the game over and above the provision of financial capital as it requires lenders who sell loans into AUSMortgage pools to own the customer and maintain a workforce, and costs associated with same, to service these loans through the lifecycle including any arrears or collections.

Importantly in our discussions with 2nd and 3rd tier players in the Australian Financial landscape the preferred option of these smaller companies, who see themselves strongly as owner and custodians of the customer relationship, is to retain the servicing of their customers. Equally they see access to this RMBS structure as primarily a vehicle to access a better cost of funds so that they can pass the benefits onto their customers or members in the case of the Mutual sector.

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[4] Standard and Poors, Ratings Direct, The French Covered Bond Market Explained, September 5 2013. http://twitdoc.com/upload/lisa_nugent/french-covered-bond-market-explained.pdf

The specifics of the AUSMortgage funding vehicle

Our proposal would be as follows.

1. Establish a privately owned but not for profit, securitisation vehicle – "AUSMortgage (AM)" that issues residential mortgage backed securities. These securities due to volume of issuance and diversity of sellers into the pool will encourage standardisation of structure and price across the system and improve primary and secondary market liquidity;

2. All ADI's and non-banks with qualifying mortgages, except D-SIBs, can access AUSMortgage equally. This vehicle into which all parts of the financial system sell qualifying mortgages to securitise will, in time, provide a liquid secondary market for RMBS which will aid APRA and RBA desire for liquid high quality securities;

3. Single vehicle issuance for smaller players does not prohibit D-SIBs or any other lender from issuing in their own name but allows smaller players access to capital market investors in the vast pool of fixed interest funds in Australia and around the globe;

4. Ensure a minimum private sector involvement or skin in the game at the equity (first loss) piece;

5. Qualifying mortgage test established using a score on the collateral underlying each loan or pool of loans to be agreed and a level of loan data transparency consistent with the reporting required by the Reserve Bank of Australia under its Committed Liquidity Facility due to come into effect in January 2015[5];

6. The Australian Federal Government would provide an explicit guarantee on RMBS issued by AUSMortgage for a fee consistent with the cost of the RBA's CLF;

7. To discourage creating other D-SIBs or over exploitation of the government support of AUSMortgage, access to AUSMortgage would be limited to a percentage of a lenders assets (say 50%);

8. Provide clear standards for ADI servicers who qualify to take part in this funding structure;

9. This vehicle will lower the cost of funds for smaller lenders and thus ensure cost effective choice within the Australian Financial system for borrowers;

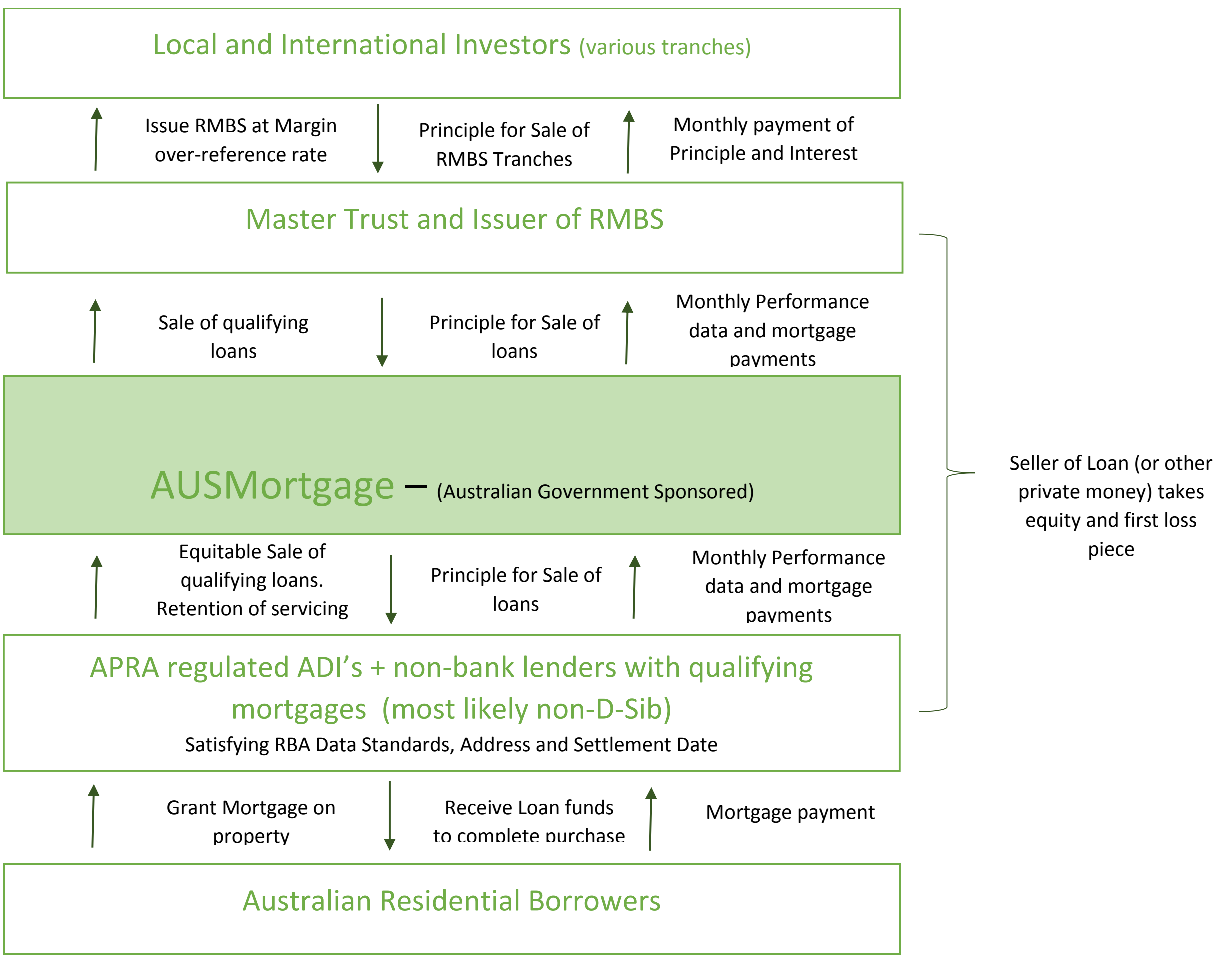
[5] While the success of the structure that this submission and proposal suggests does not rest on it use Morgij Analytics would recommend the use of its MARQ Score methodology and would be happy to discuss at a later stage in the Financial System Inquiry as required

10. Aid Liquidity at an individual ADI or other lender level by allowing the issuance of RMBS which are self liquidating structures. Thus a transformation of liquidity risk occurs from the originator to the RMBS buyer and lowers the competition for deposits and access the vast pool of superannuation savings which is in keeping with current practice and mandates;

11. Provide all financial system participants with access to a vehicle which is open through all periods, including market stress, so as to lower individual or systemic risk during times of idiosyncratic or system wide stress;

12. AUSMortgage will underpin financial system stability by levelling the competitive playing field and reducing lending concentration. In doing so AUSMortgage will encourage product innovation and reduce costs to Australian mortgage borrowers.

The Functional Structure of AUSMortgage



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Benefits to the Australian Financial System of AUSMortgage

Borrowers and taxpayers

1. Allows cost effective choice of bank regardless of size;
2. Ensures system stability through lender diversification;
3. Encourages product innovation;
4. Transparent and known Government support;
5. Makes bankers more accountable for the risks they take and the support they receive from Government.

APRA, RBA and Australian Government

1. Ensures increased liquidity in RMBS market as size on issue grows assisting RBA with goals for the CLF program;
2. Exposures known, manageable and limited;
3. Eases Federal Government exposure to implied guarantee of D-Sibs which is unknown;
4. Full disclosure of performance of underlying collateral via RBA data requirements;
5. Private Sector provides first loss to shield government risk;
6. Provides a level playing field in funding for all players in the mortgage market providing strength and stability in the system;
7. Allows government to address sustainable affordability in lending.

Smaller players in the Australian Financial landscape

1. Provides a lower cost of funds;
2. Allows competition and relieves cost pressures from margin compression;
3. Recognises strength of underwriting practices;
4. Allows retention and ownership of customer/member;
5. Allows access to funds to grow balance sheet size;
6. Offers self liquidating structures to ensure liquidity remains high and in line with APS 210.

Capital Markets

1. Liquid, large RMBS market for institutions, fund managers and SMSF;
2. Simple diversified product;
3. Can invest through the capital structure
    a. Senior Government Guaranteed
    b. Mezzanine/Sub Debt
    c. Equity/first loss – capped but high yield
4. RMBS risk is isolated and understood;
5. Strong secondary market ensures liquidity maintained in a stressed situation.

Conclusion

We have shown that the Australian Financial System retains a vibrant level of biodiversity below the canopy of the D-SIBs and their subsidiary firms but that this biodiversity is being threatened by the market dominance of these firms and the concentration of market power in their hands.

With our proposal however we have shown a simple and easy structure which once established would function with a known and limited government guarantee and deliver to the 2nd and 3rd tier of financial institutions the ability to once again compete on a level playing field with their larger rivals.

In doing so we can be certain that the Australian Financial system will retain it stability, flexibility, innovation and quality in the decades ahead.