CUSTOMER OWNED BANKING ASSOCIATION

# Second round submission to the Financial System Inquiry

August 2014

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***Who is COBA?***

The Customer Owned Banking Association is the industry advocate for Australia's customer owned banking sector. It is owned by its 96 member institutions: 79 credit unions, 6 building societies, 10 mutual banks and 1 other; and represents 10 of Australia's 12 friendly societies though the Friendly Societies of Australia and a number of affiliate members.

COBA provides representation and advocacy on behalf of its members, along with expert advisory and support services, such as compliance, research and fraud prevention services.

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# 1 Executive Summary

COBA's objective with this submission is to propose positive and constructive changes to strengthen Australia's financial system and deliver sustainable competition for the benefit of consumers.

We want to see a strong banking system become even stronger, to witness a genuine commitment to promoting competition, and see a reduction in distortions and taxpayer risk created by the growing dominance of systemically important banks.

As recognised in the inquiry's Interim Report, the major banks have 'market power across a range of markets'. This means that the major banks have the ability to insulate themselves from competition and can use their market power against challengers and different business models such as the customer owned model.

The legislative and regulatory framework underpinning the sector does not support competition and is not competitively neutral.

The long list of parliamentary inquiries and independent reviews over the years since the completion of the Wallis inquiry demonstrates ongoing concern about the capacity of the banking system to deliver outcomes in the best interests of consumers.

This apparently endless series of inquiries looking at the banking sector would not be needed if the regulators were clearly directed to give consideration to competition, competitive neutrality and consumer outcomes.

The failure to appropriately balance competition and competitive neutrality against other priorities has resulted in particularly poor outcomes in three main areas:

- The unfair and distortionary funding cost advantage delivered to the major banks due to an implicit guarantee;
- An anti-competitive regulatory capital framework giving some banks a huge advantage in risk-weighting of home loans; and
- A disclosure regime which is failing consumers.

If a greater focus was placed on competition in the design and operation of legislative and regulatory frameworks, the anti-competitive imbalances in the system would never have been allowed to build up to the extent they have.

While regulators acknowledge that the current frameworks are not competitively neutral, and not supportive of competition, they are either unable or unwilling to act. This stands in stark contrast to many other countries where regulators have taken a much more active approach to ensuring that competition is not artificially constrained.

COBA believes that one of the critical outcomes of this inquiry should be to recommend changes to the legislative mandates of the key financial system regulators – APRA and ASIC – which would ensure that competition is given due regard. Without embedding this important principle, any other reforms flowing from the Inquiry will be addressing symptoms rather than the underlying cause.

### Too Big to Fail

Whether the government intends it or not, the reality is that the major banks enjoy an implicit government guarantee which reduces their cost of funds and provides them with a significant competitive advantage.

This distortion is getting worse as it feeds on itself and big banks get bigger and *more* systemically important.

The Interim Report acknowledges the detrimental impacts of the implicit government guarantee, and the need to find a policy solution, but this is a problem that governments around the world have been grappling with for some time and there is no easy fix:

- While an increased D-SIB capital surcharge will help, it will not fully address the issue; and
- Bail-in arrangements, while elegant and effective in theory have proved elusive to implement in practice.

While COBA strongly supports steps like these, we accept that the issue of too big to fail is unlikely to be resolved in the near term.

We therefore note that an effective interim measure could be for the Australian government to follow the lead of many European countries and introduce a modest temporary levy on systemically-important banks which would partially address the funding cost advantage until a permanent solution can be put in place.

## Risk Weighted Assets

Major banks accredited to use IRB modeling are able to significantly reduce the amount of regulatory capital they have to hold against assets such as mortgages. Mortgage risk weights for the major banks average 18 per cent, less than half the 39 per cent held on average by smaller ADIs.

Given the default rates for customer owned ADIs have been half the level of the major banks for decades, there is no case to require them to hold twice the regulatory capital against the same loans. While the regulator has acknowledged that the current arrangement does not provide competitive neutrality, this is dismissed as a "residual competition issue."

The gap is clearly too wide, and a number of other countries have been more proactive in increasing minimum capital obligations under the IRB, a policy response which simultaneously improves financial stability *and* competition.

Alternatively, risk weights under the standardised approach could be reduced, for either all low risk loans, or a subset of very low risk loans.

While COBA also supports changes which would see a greater number of ADIs achieving IRB accreditation, it's likely most ADIs will continue to rely on the standardised approach, and until the gap in risk weights for large and smaller ADIs is narrowed, the imbalance that currently exists will remain an impediment to competition.

## Disclosure

The current disclosure framework is not delivering outcomes in the best interests of customers.

Whether it is debenture issuers or other 'shadow' banking institutions posing as regulated banks, or a major bank using a sub-brand to pose as a regional bank, it is clear that consumers feel that they are being misled.

Consumers are entitled to simple and clear information which allows them to make informed decisions. If people wish to do business with a non-ADI or with a major bank, obviously they are welcome to do so, but it is important that in doing so they are making a 'confident and informed' decision.

The current rules are not delivering on this and need to be changed in the interests of consumer protection and competitive markets.

## The need to act

The FSI Interim Report clearly identified many problems; it is now time to agree on solutions and to act.

Failure to move decisively on these issues will see the major banks use their market power to further increase market share, reducing consumer choice, undermining competition, and further entrenching the systemic risk that these institutions represent.

Changing the system to provide greater support for competition does not necessitate undermining financial stability. Indeed, many of the problems identified in the interim report can be addressed in ways which will improve both competition and financial stability. These matters should be addressed without delay.

Complacency is not an option.

# 2 Summary of Recommendations

| | |
|---|---|
| *Too big to fail* | **That policy-makers address the Too big to fail implicit subsidy enjoyed by the major banks through a combination of:**<br><br>**1. Setting the D-SIB capital surcharge at a level that more appropriately recognises the systemic importance of these institutions; and**<br>**2. The development and implementation of a credible bail-in regime for D-SIBs.**<br><br>**Recognising that these measures will take time to implement, that the Government consider a temporary levy on D-SIB institutions as an interim measure.**<br><br>**That ring fencing not be adopted in Australia at this time.** |
| *Risk weighted assets* | **That the competitive advantage – enjoyed by ADIs able to use the IRB approach – be reduced by:**<br><br>**1. Lowering the standardised rate; and/or**<br>**2. Introducing appropriate floors on IRB modelling; and/or**<br>**3. Introducing a tiered approach which reduces the standardised rate applied to low risk residential mortgage lending.**<br><br>**That ADIs be allowed to gradually move to IRB accreditation – for example – by introducing the IRB approach for one risk class at a time.** |
| *Regulator Culture* | **That the legislative mandates of APRA and ASIC be amended to ensure competition and competitive neutrality are appropriately balanced against other objectives.**<br><br>**That further measures be introduced to improve APRA's accountability and transparency in line with those suggested in the FSI Interim Report, along with:**<br><br>**1. The establishment of a non-executive board to oversee decision making; and**<br>**2. The appointment of a senior executive to APRA with responsibility for competition who would review rule changes prior to enactment.**<br><br>**That greater transparency around, and industry involvement in, the development of APRA's budget each year be considered as an alternative to the continuation of the efficiency dividend.** |
| *Disclosure* | **That changes be made to the current disclosure regime to ensure that consumers can easily tell the difference:**<br><br>**1. Between an independent competitor and a major bank sub-brand; and** |

2. **Between an ADI and a non-ADI.**

**That APRA withdraw its proposal to restrict customer owned ADI use of the term banking, recognising that they are subject to the same prudential regulation as listed ADIs.**

**That the term 'Authorised Deposit-Taking Institution' be replaced with 'Authorised Banking Institution.'**

***Other recommendations***

**That mandatory CCR not be introduced at this stage.**

**That post-funding be retained for the FCS, but that if pre-funding is introduced, a tiered levy be adopted.**

# 3 Competition: chronically handicapped

The FSI interim report's finding that the banking sector is "competitive, albeit concentrated" is a recipe for complacency.

Sustainable competition in banking is chronically handicapped by anti-competitive regulatory settings (e.g. regulatory capital risk weights), the "entrenched" 'too big to fail' problem, and major bank market power.

The interim report observes that: "On balance, the Inquiry considers the banking sector is competitive, reflecting a number of indicators." However, this interpretation of these indicators - net interest margins, customer satisfaction and fee income – is open to question.

Major bank net interest margins may be historically low, not due to competition, but as a reflection of changes in industry structure[1]:

- The banking sector's share of Australian financial institution assets has grown from 50 per cent in the late 1990s to 60 per cent now;
- The share of banks' loans for housing has increased from 47 per cent in 1997 to 66 per cent now;
- The major banks have consistently achieved double-digit returns on equity, even through the financial crisis (when the profitability of other Australian-owned banks declined considerably); and
- Material changes in bank funding, with the share of funding from domestic deposits increasing from 40 per cent in 2007 to nearly 60 per cent in December 2013.

In commenting on stability, the FSI interim report observes that the unusually low share of Australian bank balance sheets used for investment banking activities "could reflect a lack of retail competition that makes 'plain vanilla' banking profitable without the need to take on riskier business."[2]

The reduction in the gap in customer satisfaction between major banks and their smaller competitors reflects a range of factors, including a sustained period of low interest rates.

The reduction in fee income is partly explained by regulatory interventions to reduce or ban certain fees.

Certainly consumers do not believe the sector is competitive. A poll of more than 1000 Australians conducted by Essential Research on behalf of COBA found that 54 per cent of Australians believe there needs to be more competition in the banking market.

Regulatory settings should be designed to promote competition and choice to allow consumers to have confidence and trust in the financial system, and to expect fair treatment. However, the customer owned business model, the model that best aligns the interests of the consumer with the interests of the business, is not appropriately accommodated in the regulatory framework.

The regulatory framework is biased towards the large, listed bank model and this is the model that has delivered the conduct uncovered by the recent long-running Senate Economics Committee Inquiry. The Committee found that "between 2002 and 2010, some financial advisers, brokers and

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[1] APRA, *Financial System Inquiry submission,* March 2014
[2] Financial System Inquiry, *Interim Report,* July 2014, p. 3-19

lenders systematically targeted more vulnerable members of the community, especially older Australians with assets but without high levels of financial literacy."[3]

## 3.1 Market power

The FSI interim report finds that:

> "The major banks have market power across a range of markets. However, it is not clear they are abusing this power. The ACCC has taken relatively little action against the major banks in recent years."

That the major banks *have* market power is an immediate concern, given the ACCC's definition of market power as "the ability of a business to insulate itself from competition", but more concerning is the ACCC's view that its current regulatory toolkit is inadequate to respond to the misuse of market power. The ACCC has advised the Competition Policy Review that the existing misuse of market power prohibition is of limited utility in prohibiting anti-competitive conduct by firms with substantial market power.[4]

The mortgage market is currently highly competitive, but as outlined in the sections below on the 'too big to fail' problem and risk weight settings, it is not fair and sustainable competition.

The nature of competition *between* the major banks has been a matter of concern for many years, exemplified by the 2008 Parliamentary Committee finding that:

> "While there is no doubt that the big four aggressively compete with the other players in the market, including foreign-owned banks, the credit unions, building societies and the non-banking sector, there is some uncertainty as to whether the big four are actively competing with each other."

As noted in our first-round submission, banking is the only sector of the Australian economy that is subject to anti-price signalling laws. The Explanatory Memorandum for the 2011 laws refers specifically to "major banks" and says anti-competitive price signalling and other information exchanges:

> "…most typically arise and have the greatest detriment in markets which exhibit oligopolistic features and can be as harmful to competition and consumers as explicit cartel behaviour. In an oligopolistic market businesses are not 'price takers', as they have a degree of market power and impact on market outcomes and the decisions of competitors. Accordingly, oligopolists are able to take advantage of increased transparency as it enables them to better predict or anticipate the conduct of their competitors and thus align themselves to it, to the detriment of consumers and the economy."

Further evidence about the true nature of competition between the major banks has been put on the record by a former director of a major bank.[5] This board-room perspective from John Dahlsen is significant because Mr Dahlsen served as an ANZ director for 20 years (1985-2005).

According to Mr Dahlsen:

> "Banks compete through engaging in parallel behaviour and colluding with each other to the disadvantage of the consumer."

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[3] Senate Economics References Committee, *Performance of ASIC*, June 2014
[4] ACCC, *Reinvigorating Australia's Competition Policy – Submission to the Competition Policy Review,* June 2014.
[5] *Murray financial report 'abject failure', says ex-ANZ boad man* , Australian Financial Review 18 August 2014

In COBA's view there is a strong case for action to promote genuine and sustainable competition in the Australian banking market. The market is increasingly concentrated and the major players have market power and benefit from anti-competitive regulatory settings and an unfair funding cost advantage.

## 3.2 Timing

The current policy settings in the banking sector are having a significant detrimental effect on competition, and as such COBA believes it is important that these concerns are addressed with some urgency. The Interim Report was clear in its identification of the issues, it is now important that effective recommendations are put forward and that these are implemented by the Government in a timely fashion.

That said, it is probable that recommendations put forward by the Inquiry will need to be implemented over an extended timeframe – certainly this was the case with the Wallis Inquiry. As such, it would be useful if the Inquiry could give some thought to the prioritisation of recommendations, and suggested timeframes for implementation. Providing this context would no doubt assist the Government in their considerations of the Inquiry's final recommendations. Indicative timeframes would also provide some impetus for the Government to act promptly on the recommendations.

We note that the Wallis report dedicated significant attention to the practical issue of implementation, and included a chapter which identified those recommendations which would benefit the most from early adoption, along with a suggested approach and implementation timeline for the remaining recommendations.

We would recommend that a similar approach be taken with the current financial system inquiry.

## 3.3 Customer owned banking

We are concerned that the Inquiry may not fully appreciate the safety and stability of the customer owned banking sector in Australia. In discussing the sector, the FSI Interim Report states that:

> "The aggregate regulatory capital requirements of an ADI should reflect its overall risk profile. Although small ADIs may benefit from detailed knowledge of their customers, they also have relatively concentrated loan books and, in the case of credit unions and building societies, limited capacity to raise new equity. They also tend to have less sophisticated risk management systems, albeit with less complex risks. These factors suggest smaller ADIs may need higher regulatory capital buffers than their larger competitors."[6]

COBA agrees that some small ADIs have "relatively concentrated loan books." However, when considering customer owned ADIs, this concentration needs to be considered in the context of business model differences between these institutions and listed ADIs. The annex to our previous submission included details of successive studies and performance data from the Global Financial Crisis (GFC) which demonstrated the superior stability of the mutual model abroad.

COBA acknowledges that customer owned banking institutions have "limited capacity to raise equity." While APRA has recently made some accommodation for capital issuance by our sector under Basel III, customer owned ADIs remain unable to directly issue CET 1 capital, despite having this flexibility under Basel II, and despite other jurisdictions providing this flexibility for their customer owned banking sectors. COBA agrees that this is a problem, but the solution is to provide our sector with this flexibility, not to burden it with additional regulatory capital obligations.

[6] Financial System Inquiry, *Interim Report,* July 2014, p. 2-10

While some customer owned ADIs have "less sophisticated risk management systems," we would argue that this approach is entirely justified given the less complex risks being managed by these institutions. With a 20 year track record of demonstrating significantly lower levels of impaired loans than other ADIs, it would appear that the risk management systems currently in place for customer owned ADIs are entirely appropriate and working well.

COBA agrees that "the aggregate regulatory capital requirements of an ADI should reflect its overall risk profile." However, over the last twenty years, impaired loans in customer owned ADIs have averaged 0.3 per cent of total loans compared to 0.8 per cent for major banks. Customer owned ADIs are also far less reliant on wholesale funding for their loans than the major banks.

It is therefore not clear how the conclusion is drawn that "smaller ADIs may need higher regulatory capital buffers than their larger competitors." COBA finds it particularly astonishing that customer owned ADIs which have a more stable business model, decades of lower impaired loans and an industry-run liquidity support system are somehow considered to be a greater risk to the Australian economy than the systemically important major banks.

# 4 Too big to fail

## 4.1 The problem

Most stakeholders appreciate that "Too Big To Fail" (TBTF) is a real issue in Australia's banking sector and that the current approach is leading to undesirable outcomes. As the FSI Interim Report acknowledged, actions taken by the Government in Australia during the GFC have "entrenched perceptions that some institutions are too big to fail."[7]

It is broadly accepted that this perception exists:

- APRA has said that "…the ratings agencies are quite explicit about how much of a ratings gap there is due to perceived support, which tends to be about two notches. So there is a material perception benefit of these very large institutions."[8]
- Treasury agrees that "Australia's major banks are commonly considered to benefit from an implicit government guarantee of their financial viability reflecting the perception of investors, rating agencies and analysts that they are 'too big to fail'."[9]
- The RBA notes that it is "very difficult to quantify the extent to which the too big to fail issue exacerbates systemic risk in Australia."[10]
- The IMF's April 2014 Global Stability Report says the "subsidies" enjoyed by systemically important banks are "large", amounting to hundreds of billions of dollars across the globe.[11]

While some have suggested that TBTF is not a problem in the Australian context, this assertion does not stand up to any objective assessment. Some of the major banks have argued that they do not benefit from an implicit government guarantee:

- ANZ "rejects the view that its ability to access capital more cheaply than smaller banks is because of a perceived government guarantee," stating that "While some have continued to argue that major banks are too big to fail and therefore gain a competitive advantage, this was clearly rejected [by APRA]."[12] But at the same time, ANZ non-executive director Ian Macfarlane is of the view that "It is just not credible for a government or regulator to promise not to step in and prevent large scale bank failure in a financial crisis. The public know they will, and no amount of words will dispel this expectation."[13]
- The Commonwealth Bank has said that it "does not believe that there is an implicit guarantee for the major banks but that there is general government support for the whole banking system,"[14] but at the same time accepts that the major banks receive a rating uplift "because S&P considers that [they] are systemically important and therefore likely to receive additional or extraordinary' government support in a crisis situation."[15]

In addition to creating a range of moral hazard problems, the implicit government guarantee provides the major banks with a significant cost of funds advantage which undermines competitive neutrality in the sector. As the FSI interim report observes, "lower funding costs might allow the institutions to become larger and more systemically important. The overall system can therefore

[7] Financial System Inquiry, *Interim Report,* July 2014, p. 3-9
[8] House of Representatives Standing Committee on Economics, *Transcript,* 18 July 2014.
[9] The Treasury, *Submission to the Financial System Inquiry,* April 2014, p. 38.
[10] Reserve Bank of Australia, *Submission to the Financial System Inquiry,* March 2014, pp. 78-79.
[11] IMF, *Global Financial Stability Report*, April 2014
[12] ANZ, *Submission to the Financial System Inquiry,* March 2014, p. 20.
[13] Ian Macfarlane AC, *Submission to the Financial System Inquiry,* 2014.
[14] Commonwealth Bank, *Wellbeing, Resilience and Prosperity for Australia,* March 2014, p. 49.
[15] ibid., p. 48.

become larger than is economically efficient, exacerbating the size of the potential cost of a crisis and therefore the size of the perceived guarantee."[16]

The IMF's April 2014 Global Financial Stability Report[17], provides new estimates of the implicit funding subsidy received by systemically important banks.

> "The estimated subsidies are large. In terms of the funding cost advantage in 2013, these subsidies are at least 15 or so basis points in the United States, 25–60 basis points in Japan, 20–60 basis points in the United Kingdom, and 60–90 basis points in the euro area. In dollar terms, if applied to banks' total liabilities (net of equity), the implicit subsidies given just to G-SIBs in 2011–12 represent around $15–$70 billion in the United States, $25–$110 billion in Japan, $20–$110 billion in the United Kingdom, and up to $90–$300 billion in the euro area."

In determining the detrimental impact of the guarantee in the Australian market it is useful to assess the magnitude of the subsidy.

COBA commissioned economics modelling firm *Macroeconomics* to provide such an estimate, with the result that the annual average value of the subsidy to the four major banks provided by the perception that they are TBTF is between $2.9 billion and $4.5 billion (see attachment).This is based on findings that the implicit guarantee provides a funding cost benefit of between 22 and 34 basis points to the major banks.

Major banks already have a significant cost of funding advantage over smaller competitors due to factors such as their size, asset base and risk-management capacity. The additional funding cost advantage of an implicit guarantee provided at no cost by Australian taxpayers gives the major banks an even more powerful market position.

***Table 1: Summary of implicit subsidy calculation***

| Institution | Uninsured Liabilities | Credit Rating Discount | | | Implied Subsidy | | |
|---|---|---|---|---|---|---|---|
| | $ billion | bps | | | $ billion | | |
| | | Low | Average | High | Low | Average | High |
| **ANZ** | $311 | 22 bps | 28 bps | 34 bps | $0.7 | $0.9 | $1.1 |
| **CBA** | $340 | 22 bps | 28 bps | 34 bps | $0.7 | $0.9 | $1.1 |
| **NAB** | $348 | 22 bps | 28 bps | 34 bps | $0.8 | $1.0 | $1.2 |
| **WBC** | $340 | 22 bps | 28 bps | 34 bps | $0.7 | $0.9 | $1.1 |
| **Total** | **$1,339** | | | | **$2.9** | **$3.7** | **$4.5** |

**Sources:** Macroeconomics, APRA, Annual Reports (2013), IMF 2014, Moodys 2014 and Soussa 2000.

## 4.2 Policy options

The FSI Interim Report flagged the following policy options as possible ways to address the moral hazard issues created by some banks being TBTF:

- "Increase the ability to impose losses on creditors of a financial institution in the event of its failure." (i.e. 'bail in')
- "Strengthen regulators' resolution powers for financial institutions."

[16] Financial System Inquiry, *Interim Report,* July 2014, p. 3-8
[17] http://www.imf.org/external/pubs/FT/GFSR/2014/01/index.htm

- "Invest more in pre-planning and pre-positioning for financial failure."
- "Further increase capital requirements on financial institutions considered to be systemically important domestically."
- "Ring-fence critical bank functions, such as retail activities."[18]

All of these options appear valid, with a bail-in regime likely to be the most effective but also the most challenging to implement. Increasing regulatory capital requirements on domestic systemically important banks (D-SIBs) is less challenging to implement.

APRA has already announced a D-SIB capital surcharge of one per cent, to be met in full by Common Equity Tier 1 capital from 1 January 2016.

> "APRA emphasises that the designation of a bank as a D-SIB does not make it immune from failure, and shareholders and investors should draw no inferences about public sector support for a D-SIB in the event of distress. Rather, the designation is intended to ensure that banks perceived to be 'too big to fail' are subject to more intense supervisory oversight and have greater capacity to absorb losses, to increase their resilience to failure."[19]

## 4.3 D-SIB levy

COBA's first-round submission recommended a levy on D-SIBs to at least partly capture the benefit they receive from the implicit government guarantee reflected in the credit ratings uplift provided to major banks.

We note the FSI interim report grouped this option – "explicitly charging the major banks to ameliorate the funding cost advantage" – with the option of explicitly guaranteeing all ADIs, and stated that the inquiry "does not consider that there is a case for options of this nature."

COBA does not advocate explicitly guaranteeing all ADIs and we accept the FSI's view that a levy is not a satisfactory permanent solution because it "may strengthen the perception of Government support" for the major banks.

However, given that the major banks have already been officially designated as D-SIBs, the concept of a temporary levy to ameliorate their unfair and harmful funding cost advantage, should not be dismissed, at least until a permanent solution is implemented.

The IMF's April 2014 Global Stability Report says bank levies can be collected to explicitly or implicitly fund bank resolution and also, if linked to liabilities, to lower banks' incentives to become too large.

> "Given the difficulty of completely ruling out bailouts in practice, some level of government protection, and thus some positive subsidy, may be unavoidable. Bank levies can allow governments to recoup part of it. Levies may also help reduce the incentives for banks to seek TITF status and lower the negative externality associated with it, especially if they are progressive – for example, if they increase with asset size or liabilities."[20]

***Box 1 - Bank levies in the EU:***

Since 2011, 14 European countries have imposed levies on their banks – Austria, Belgium, Cyprus, France, Germany, Hungary, Latvia, Portugal, Romania, Slovakia, Slovenia, Sweden, Netherlands,

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[18] Financial System Inquiry, *Interim Report,* July 2014, pp. 3-12 to 3-20
[19] APRA, *Domestic Systemically Important Banks in Australia*, December 2013
[20] IMF, *Global Financial Stability Report*, April 2014

and the UK. A December 2013 Oxford University paper, *Can taxes tame the banks? Evidence from European bank levies*[21], says: "In the wake of the financial crisis, the IMF promoted levies on the risky part of bank funding as a tool to increase revenue collection from the financial sector while at the same time contributing to financial stability by incentivizing banks to adopt less risky capital structures. Bank levies of some form have been adopted in a number of countries and are still under consideration in many others. The most common levy design adopted by 11 countries taxes some measure of bank liabilities."

The FSI Interim Report notes that it is difficult to estimate the size of any possible funding cost advantage that the perception of being TBTF provides large banks and that estimates vary depending on the methodology used.

We agree with the FSI Interim Report observation that:

> "Any advantage is also likely to fluctuate over time, and could be transient if Government policies effectively reduce the systemic risks posed by large banks."

As noted above, it is estimated the TBTF subsidy enjoyed by Australia's major banks is currently between $2.9 billion and $4.5 billion.

Although ending TBTF through 'bail-in' is a high priority for the Brisbane G20 Leaders Summit in November, design and implementation of the agreed solution will take considerable time and is initially targeted at global SIBs, meaning a D-SIB solution will take even longer.

Australia's G20 Finance Deputy Barry Sterland has commented that ending TBTF is the "largest challenge" for financial system reform of the G20 and there will be a "necessarily long period" for implementation.[22]

This point is underlined in the RBA's first-round FSI submission setting out arguments against bail-in and observing that while these arguments don't preclude the inclusion of bail-in in the suite of resolution tools…

> "…they do suggest that implementation needs to be carefully considered and should proceed cautiously in order to avoid unintended adverse consequences. The arguments for conservatism in the implementation of bail-in are further supported by the observation that there are few, if any, examples of banks which have successfully been resolved as going concerns through the use of bail-in powers alone."

The option of a D-SIB levy should also be considered in the context of support by the Council of Financial Regulators for a levy on Financial Claims Scheme (FCS) protected deposits to to create a Financial Stability Fund (FSF).

As argued in our first-round submission, imposing a levy on certain D-SIB liabilities rather than ADI deposits would still deliver a FSF but without imposing a tax on Australian consumer deposits and without the anti-competitive impacts of a deposit levy.

Treasury's Options Stage Regulation Impact Statement (RIS) for the Financial Stability Fund says the FSF is a response to two problems:

- the Government does not have a dedicated and readily accessible pool of assets that could be used to fund resolution activities; and

[21] Devereux, Johannesen and Vella, *Can taxes tame the banks? Evidence from European bank levies*, Dec 2013
[22] Barry Sterland PSM, *Speech to the Melbourne Institute: Social and Economic Outlook 2014*, July 2014

- ADIs do not currently pay for the right to offer explicitly guaranteed deposit accounts under the FCS.

The RIS says:

> "The Government is not compensated for the insurance it provides through the FCS. In addition, systemically important ADIs do not pay for the benefits they derive from the market-perceived implicit government support which, as the IMF noted in its report on Australia's 2012 Finance Sector Assess Program, include lower funding costs than their competitors."

The fact the FCS is currently post-funded rather than pre-funded is arguably a "subsidy" for all ADIs compared to non-ADIs but it is competitively neutral within the ADI sector and the FCS "subsidy" to all ADIs is dwarfed by the much larger and grossly distortionary subsidy provided by the implicit guarantee applying only to D-SIBs.

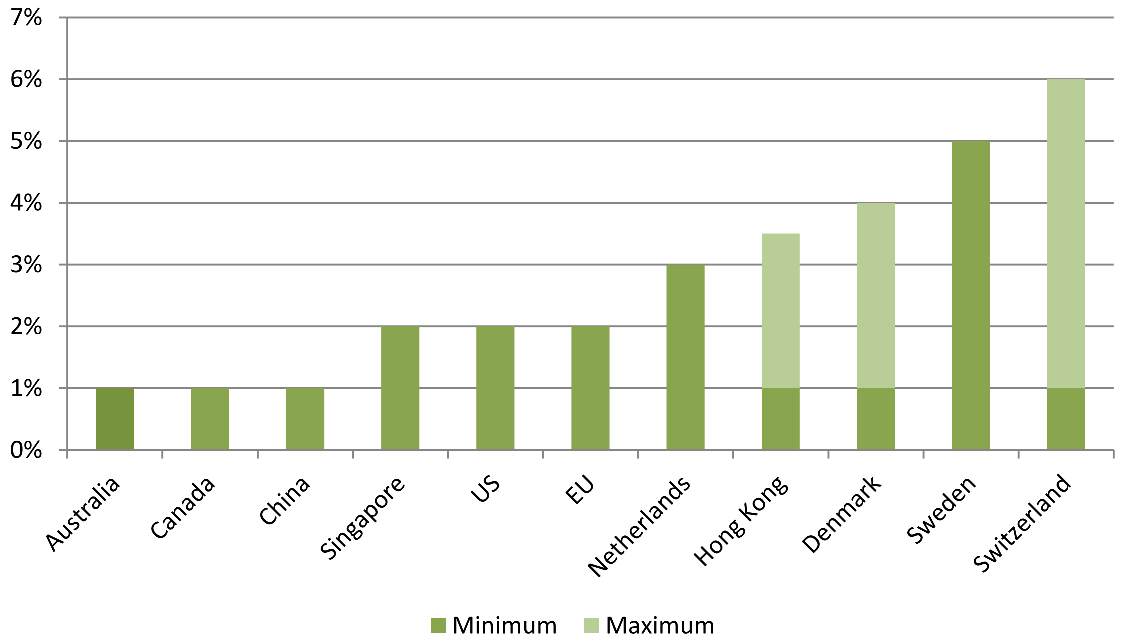
A D-SIB levy is a temporary solution to ameliorate the unfair funding cost advantage of the major banks and is also a potential means to create a FSF.

However, if a D-SIB levy is ruled out, a levy on FCS protected deposits should also be ruled out on the same basis, i.e. that if D-SIBs are not required to pay for their TBTF funding subsidy, then there is no case to impose a deposit guarantee levy that disproportionately affects smaller ADIs.

## 4.4 D-SIB capital requirements

The FSI Interim Report acknowledges that "Australia's [D-SIB capital surcharge] is at the low end of the international spectrum, which ranges from 1 percentage point to around 6 percentage points for the largest banks in Switzerland."[23]

### *Chart 1 – D-SIB responses in other countries*[24]




[23] Financial System Inquiry, *Interim Report,* July 2014, p. 3-15
[24] FSI, APRA

APRA's former chairman John Laker canvassed this point recently in an appearance[25] before the Senate Economics Committee:

> **Dr Laker:** Recently, the Dutch looked at their banking system and said, 'Here is a banking system that is highly concentrated and it is heavily exposed to housing lending.'
>
> **Senator MARK BISHOP:** Theirs or ours?
>
> **Dr Laker:** Theirs. You can see the parallels: heavily exposed to housing lending, dependent on wholesale funding and at risk of losing deposits to their pension schemes, their superannuation industry. They said, 'This puts our major banks at risk,' so they have put a D-SIB surcharge on their top three banks of **three per cent**. I am reluctant to get into a kind of arm-wrestle about who is toughest. We take a judgement about what is appropriate for Australian circumstances, given the long history of a conservative approach to measuring capital. But I can bring out examples of jurisdictions that have got larger numbers in the system than we have. We think our numbers are right.

APRA has also subsequently emphasised that it did not set the D-SIB level with the intent of addressing the competitive imbalance created by TBTF.

> "…we did not impose a DSIB surcharge to level the playing field; we imposed it because of a systemic risk of the major banks. It was a systemic risk calculation, not a competitive calculation. It certainly does not make the big banks more competitive, but that was not the main point of the exercise."[26]

APRA's 1 per cent buffer is likely to be even lower in practice, as APRA has said that it "considers it reasonable if D-SIBs choose to operate with a relatively lower management capital buffer from 1 January 2016 given the nature and size of the extended capital conservation buffer."[27]

In considering the appropriate D-SIB requirement in Australia, the IMF has indicated that "If the goal were to achieve a 99.95 per cent probability of no default, additional Tier 1 capital ranging from **1.4 to 5.2 per cent** of RWA would be necessary."[28]

In arguing against higher D-SIB capital requirements, the major banks have complained that they're already holding more capital than global peers. However, The FSI Interim Report found that when "…calculated on a consistent basis, Australian banks' capital ratios … are around the middle of the range relative to other countries."[29] In fact, Chart 5.3 in the Report, which relies on the BCBS's most recent international comparison of capital levels, finds that Australia's major banks are below the median in terms of CET1 holdings, and in the bottom 25 per cent in terms of total capital holdings.[30]

APRA has noted that "…there are peer jurisdictions that have gone further and/or faster in implementing the reforms than APRA," and "…the claim that APRA is way out in front of the rest of the world on its own is, in our view, incorrect."[31]

Requiring D-SIBs to hold more regulatory capital strengthens the system overall and further protects taxpayers. In addition, it may also stimulate competition and provide competitive opportunities as D-SIBs respond by adjusting their return on equity or their pricing.

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[25] Senate Estimates Committee hearing, *Transcript,* 3 June 2014
[26] House of Representatives Standing Committee on Economics, *Transcript,* 18 July 2014.
[27] APRA, *Domestic Systemically Important Banks in Australia*, December 2013
[28] IMF, *Global Financial Stability Report*, April 2014, p. 126.
[29] Financial System Inquiry, *Interim Report,* July 2014, p. 3-34
[30] ibid., p.3-36
[31] House of Representatives Standing Committee on Economics, *Transcript,* 18 July 2014.

If major banks attempt to increase prices, consumers can protect themselves by taking advantage of the competitive response from smaller players – customer owned banking institutions, regional banks, foreign banks and non-ADI lenders. Major banks will lose market share if they try to force their customers to pay for higher regulatory capital requirements.

We note that higher regulatory capital does not automatically mean higher funding costs. It is argued that because increasing regulatory capital makes an institution safer, the institution’s overall cost of funding including debt funding should fall.

APRA says the Modigliani-Miller theorem on capital structure gives one basis to consider the potential reduction in cost of equity and in funding costs.

> “Without reprising the empirical research on Modigliani-Miller, it is worth simply noting that there is a reasonable consensus that safer institutions can borrow and raise capital more cheaply than less safe institutions. Depending upon the assumptions used, this effect can partially, fully, or even more than fully offset the cost of any increased equity requirement.”[32]

RBA Governor Glenn Stevens recently addressed this point in responding to the claim that pressing major banks to hold more capital will impair economic growth.

> “Can banks with more capital support growth as well as those with less capital? Equity is more expensive than debt for banks, and so a financial structure with more equity does mean, other things equal, that the cost of intermediation to the community is higher. Even without appealing to propositions of a Modigliani-Miller kind, which would dispute this assumption, the question is whether this apparently higher cost is a serious impediment to growth. Bankers often claim it is. The empirical estimates published by the FSB and BCBS suggest the effect is small, particularly when compared with the costs of large financial crises.”[33]

## 4.5 Bail-in

The effectiveness of ‘bail-in’ as a response to the TBTF problem is demonstrated by the ratings agencies’ response to the Canadian Government’s announcement of plans to implement a ‘bail-in’ regime.

Moody’s announced in June 2014 that it had changed the outlook to negative from stable on the supported senior debt and uninsured deposit ratings of the seven largest Canadian banks.

> “Moody's very high systemic support assumptions remain unchanged for now. However, Moody's decision to assign a negative rating outlook reflects the possibility it may reduce its systemic support assumptions in the future. Moody's negative outlook was assigned today based on its expectation that within the next 12-18 months, more details on the resolution policy for Canadian banks will be made available by Canadian regulators. Once details of the government's bail-in regime are announced, Moody's will evaluate the feasibility of implementing a bail-in of senior creditors while at the same time achieving the government's other goals, including financial stability and limiting potential effects on the broader economy.”.[34]

Moody’s announcement was followed by a similar announcement by Standard & Poor’s in August.

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[32] APRA, *Insight*, Issue Two - 2012
[33] Glenn Stevens, *Speech – Financial Regulation: Some Observations,* June 2014
[34] Moody’s, *Moody's changes outlook to negative on Canadian banks' supported ratings,* June 2014.

COBA agrees with Treasury that "In theory, a credible bail-in regime would directly address the moral hazard and efficiency issues caused by too big to fail."[35]

However, implementing an effective bail-in regime presents significant challenges. As Treasury correctly notes "The credibility of a government's commitment to bail-in would be critical to its effectiveness in removing the pricing advantage brought about by the implicit guarantee."[36] This is particularly challenging, as demonstrated by the recent experiences of many other countries during the global financial crisis, where it became apparent that in such situations "…there is considerable pressure on government to minimise the losses to shareholders and bondholders to prevent a shock to the broader financial system and economy."[37]

Given the difficulty of identifying and being able to count on a class of creditors in what could be a period where all investment capital is scarce and the difficulty of forecasting behavioural effects, the alternative approach of increasing regulatory capital requirements, where the instruments (CET1, AT1 & T2) have clear and explicit loss-absorbency features, may be more achievable and prudent.

Bail-in is clearly not a near-term solution and until a solution is implemented Australia's D-SIBs are able to exploit their TBTF status to become larger and even more systemically important.

## 4.6 Ring fencing

COBA has not formed a view on whether there is a strong case to introduce ring-fencing in Australia.

Other options to reduce systemic risk, such as increasing the D-SIB capital surcharge, appear more compelling.

We note the FSI Interim Report's view that "there is no one way to implement ring-fencing, with approaches differing by country" and that ring fencing is likely to be the "most burdensome" measure under discussion.

Answering the question of 'how high should any ring fence be?' depends on whether the bank is systemically important. APRA takes the view in its recently published conglomerates framework[38] that 'operational separation' of groups within a systemically important bank would not be enough to address contagion risk.

> "APRA considers that there is a serious risk that financial markets will expect an ADI that dominates its group to cover losses sustained by group members, even if the affected members are operationally separated or separable from the ADI. If this market expectation is not met, markets could form the view that the ADI is unable rather than unwilling to cover these losses. This loss in market confidence could adversely affect the ADI's liquidity position and, ultimately, its viability."

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35 The Treasury, *Submission to the Financial System Inquiry,* p. 39.
36 ibid.
37 ibid.
38 APRA, *Media release: APRA releases framework for supervising conglomerates but defers implementation,* Aug 2014.

## 4.7 Recommendations

**COBA recommends:**

1. **That policy-makers address the Too big to fail implicit subsidy enjoyed by the major banks through a combination of:**
    a. **Setting the D-SIB capital surcharge at a level that more appropriately recognises the systemic importance of these institutions; and**
    b. **The development and implementation of a credible bail-in regime for D-SIBs.**

2. **Recognising that these measures will take time to implement, that the Government consider a temporary levy on D-SIB institutions as an interim measure.**

3. **That ring fencing not be adopted in Australia at this time.**

# 5 Risk Weighted Assets

COBA welcomes the FSI's acknowledgement that "the application of capital requirements is not competitively neutral," and that "Banks that use IRB risk weights have lower risk weights for mortgage lending than smaller ADIs that use standardised risk weights, giving the IRB banks a cost advantage."[39]

While this is an important acknowledgement, COBA urges the FSI to make effective recommendations to address this problem.

## 5.1 The problem

It is commonly accepted that the IRB model provides ADIs with a significant cost advantage when compared to ADIs using the standardised model.

- APRA says that, "…for a typical housing loan portfolio, an ADI using the IRB approach will clearly hold less capital than a standardised ADI. This difference in capital requirements will have an impact on the relative profitability and return on equity for housing lending by standardised ADIs, which are generally price-takers in the housing market."[40]
- Treasury agrees that "…the risk weights generated by the internal approach tend to be lower than those set by APRA under the standardised approach. This effectively lowers the funding costs of those banks using the internal ratings based approach, boosting their scale advantage and putting them at a competitive advantage over other banks."[41]

In announcing transitional guidance around the introduction of Basel II in 2003, APRA's media release stressed "…that a level playing field needed to be maintained in the Australian financial services industry," and stated that it:

> "…does not expect the different approaches in Basel II to produce markedly different competitive effects compared to the current rules."[42]

However, it is clear that the introduction of the IRB approach has led to a significant disparity between those using this and the standardised approach. Indeed the average residential mortgage risk weight under the standardised approach is more than twice as high as the IRB figure, with APRA noting that as of early 2014, "the weighted-average risk-weight for housing lending under the standardised approach is 39 per cent; the comparable figure under the advanced approach varies by institution with the average around 18 per cent."[43] It should also be noted that the 18 per cent figure is an average across the portfolio, and for low risk residential mortgages the risk weights applied by IRB ADIs can be well below this. The minimum risk weight applicable under the standardised model is fixed at 35 per cent.

This differential provides IRB ADIs with a significant pricing advantage. Again, by APRA's own estimates, "Some simple figuring on reasonable assumptions… suggests that the difference in risk-weights translates to around 23 basis points."[44] APRA goes on to acknowledge that one interpretation of this would be that "…assuming the same cost of capital, standardised ADIs are operating with a 23 basis point pricing disadvantage due to not using the IRB approach."[45]

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[39] Financial System Inquiry, *Interim Report,* p. 2-9
[40] APRA, *Financial System Inquiry Submission,* March 2014, p. 75.
[41] The Treasury, *Submission to the Financial System Inquiry,* pp. 41-42.
[42] APRA, *Media Release: APRA issues transition guidelines for Basel II implementation,* June 2003
[43] APRA, *Financial System Inquiry Submission,* March 2014, p. 74.
[44] ibid. p. 75.
[45] ibid.

The inequity between the residential mortgage risk weights under the standardised and IRB approaches has a more significant impact on small Australian ADIs than it does on smaller banking institutions in other jurisdictions, given the relative size of lending in this area when compared to other jurisdictions. As APRA's submission notes, residential mortgages makes up around 60 per cent of banks loans in Australia, compared to ranging from less than 20 per cent to 40 per cent in countries including the UK, Germany, Italy, the Netherlands, Spain, Finland, the US, Sweden and Canada.[46]

Under the current risk weights, IRB ADIs enjoy the most significant pricing advantage on low risk residential loans. This effectively means that the prudential framework provides the largest ADIs with a financial incentive to focus on lower risk loans, while the framework encourages standardised ADIs to seek relatively higher risk loans. While loan default data demonstrates that in practice, customer owned ADIs are not shifting to higher risk loans, the aggressive marketing of low risk products by the major banks would suggest that the majors are particularly active in targeting this sector. Perversely, the sophisticated risk management frameworks put in place to achieve IRB accreditation encourage the major banks to excessively skew their lending towards residential mortgages at the expense of other alternatives such as small business lending.

In their individual submissions, the major banks defended the current arrangements:

- ANZ has said that "APRA's AIRB accreditation would reduce risk weighted capital requirements for institutions presently claiming to be disadvantaged by their use of the Standard rating approach. It is reasonable that where ADIs invest to manage risk better, they should be able to benefit from commensurate reductions in capital requirements."[47]
- Westpac notes that "While it is correct that these credit risk capital rules impact the level of capital that accredited and non-accredited banks are required to hold against specific assets, this is a logical distinction arising from different risk assessment methodologies."[48]

It is unsurprising that the institutions which gain the most from the current regulatory framework are its strongest champions. With virtually all other stakeholders acknowledging the challenges that the current arrangements create, the major banks appear to be the only institutions which believe the current system does not distort the market.

We are disappointed that APRA does not consider this disparity as an issue worth addressing, with the regulator's submission stating that it "…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."[49] COBA sees this as further evidence of APRA failing to give adequate weight to the importance of competition and competitive neutrality when implementing its legislative mandate. This issue is discussed further in Chapter 6.

## 5.2 Policy options

The FSI has put forward the following policy options for further consideration:[50]

- Lower standardised risk weights for mortgages;
- Increase minimum IRB risk weights;
- Introduce a tiered system of standardised risk weights;
- Allow smaller ADIs to adopt IRB modelling for mortgages only; and
- Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation.

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[46] APRA, *Financial System Inquiry Submission,* March 2014, p. 89.
[47] ANZ, *Submission to the Financial System Inquiry,* March 2014, p. 20.
[48] Westpac, *Initial Submission to the Financial System Inquiry,* March 2014, p. 28.
[49] APRA, *Financial System Inquiry Submission,* March 2014, p. 76.
[50] Financial System Inquiry, *Interim Report,* July 2014, p. 2-11

COBA's view is that whatever recommendations or principles the FSI puts forward to address this issue, one of the underlying objectives must be to significantly narrow the gap between the capital requirements under the standardised and IRB approaches. The chasm that currently exists between the two approaches is clearly far too wide.

Allowing the current system to continue would see sustainable competition put at further risk, and would allow the largest ADIs to continue increasing their market share. As such, we think failing to recommend a policy change in this space is not an option.

## 5.3 Reducing the standardised rate

Under the Standardised Approach as set out in APS 112, "Risk weights are based on credit rating grades or fixed weights broadly aligned with the likelihood of counterparty default."[51] As such, risk weights under the standardised approach are designed to be a reflection of the riskiness of the underlying assets. A long period of loan data in the Australian context has clearly demonstrated that in our market, residential mortgages represent a very low risk.

This is particularly true in the case of customer owned ADIs, which have demonstrated a long history of very low rates of default. Over the past two decades, impaired loans in customer owned ADIs have been less than half the level experienced by the major banks (0.3 per cent for customer owned ADIs compared to 0.8 per cent for the major banks).[52]

Further, we would note that the riskiness of a residential loan remains unchanged whether it is held by a standardised or IRB ADI. Indeed, COBA would argue that the riskiness of a residential mortgage held by a customer owned ADI is typically lower given our prudent culture and detailed knowledge of our customer base. Historic loan default rates for our sector when compared to the major banks would suggest that this is not an unreasonable assertion.

In addition, with nearly a decade of data under Basel II we are unaware of APRA or any independent party conducting a study comparing the *actual* loss rates on mortgages of a similar risk profile managed Australian ADIs using the IRB approach, versus customer owned ADIs using the standardised approach and thus proving that these additional "sophisticated" resources for modelling data are actually resulting in lower losses to justify a 2100 basis point difference[53] in capital held against residential mortgages. In fact, on overall loans portfolios customer owned ADI typically have had impaired loans at half the rate of the major ADIs. As such, the level of capital held against a given loan by each institution should be, if not the same, then at least very similar.

APRA states that "…smaller ADIs generally do not have a high degree of geographic or product diversification and tend to have relatively greater business/strategic and credit concentration risks than the larger, more diversified ADIs using the IRB approach,"[54] and that "there is a clear, risk-based logic in applying higher risk weights on housing lending to standardised ADIs which generally have more concentrated balance sheets."[55]

However, COBA notes that it is not the role of the RWA framework to address this issue. As was previously noted, the role of RWA is to reflect the riskiness of the individual assets, not the riskiness of the overall portfolio. COBA notes that the presence of any concentration risk is more properly dealt with – and is already dealt with – by APRA in setting the prudential capital ratios (PCRs) for individual ADIs. Pricing concentration risk into both the PCR and RWA would mean that smaller ADIs were effectively holding capital against the same risk twice.

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[51] APRA, *APS 112 – Capital Adequacy: Standardised Approach to Credit Risk,* Jan 2013, p. 1.
[52] APRA, *Quarterly ADI Performance*
[53] The weighted-average risk-weight for housing lending under the standardised approach is 39 per cent; the comparable figure under the advanced approach varies by institution with the average around 18 per cent.
[54] APRA, *Financial System Inquiry Submission,* March 2014, p. 75.
[55] ibid. p. 76.

The FSI Interim Report indicates that it sees this policy option as involving a trade-off between stability and competition. However, in COBA's view, this change would support financial stability rather than undermine it:

- Smaller ADIs would be able to better compete with IRB ADIs for low risk residential mortgages, and allow smaller ADIs to take some market share from the major banks in this area. This would reduce the overall riskiness of the small ADIs lending, and would also ensure that a higher amount of capital was held in the system than if these same loans were held by the major banks.
- In addition, addressing the current imbalance will help to push back against the major banks' ever increasing market share, and reduces the degree to which the systemic risk of these institutions increases.

APRA has raised several broader concerns around the suggestion to lower the standardised risk weight, and these are addressed below:

*Macroprudential and system capital concerns:* APRA states that "in current circumstances of emerging house price pressures, there would be no case to reduce standardised loan risk weights on macroprudential grounds."[56] We also understand that the FSI has concerns about the potential for a change of this kind to reduce the aggregate level of capital held in the banking sector against mortgage lending. While we acknowledge these concerns, they could be addressed by simultaneously introducing a risk floor on ADIs using the IRB approach.

*IRB equally available to all:* APRA argues that "The IRB approach is risk-sensitive and is available to ADIs that have the resources, data and capabilities needed to adopt it…"[57] While this is true, it is equally true that not all ADIs have, or could ever have, the "resources, data and capabilities" needed to adopt IRB. As such, there will always be some ADIs unable to access the concessional risk weights available under IRB, and for this reason, it is important that the impact of the current approach on competitive neutrality is addressed.

In rejecting a reduction in the standardised rate, APRA also notes that "The four major banks will also be subject to a higher loss absorbency requirement in the form of a one per cent CET1 D-SIB surcharge."[58] While this is true, the D-SIB buffer is intended to address the systemic risk that institutions of this size present, and is unrelated to the appropriate risk weights to be applied to an ADIs residential mortgages.

## 5.4 Increasing minimum IRB risk weights

Raising the IRB floor would be one way of reducing the competitive distortion that the current risk weighting approach creates. Raising the floor also presents a number of broader advantages to the banking sector in aggregate:

- The aggregate level of capital held in the banking system would be increased, which would improve the overall stability of the financial sector;
- It would be an appropriate response to the high proportion of residential mortgage lending in the Australian banking sector when compared to other forms of lending;
- It would make other forms of lending, and in particular small business lending, relatively more attractive to IRB ADIs; and
- It would be entirely consistent with Basel, in that Basel sets minimum capital requirements and national discretion is left to policy makers to add in additional capital requirements where domestic circumstances are warranted.

[56] APRA, *Financial System Inquiry Submission,* March 2014, p. 76.
[57] ibid.
[58] ibid. p. 75.

In considering the downsides of this proposal, the FSI Interim Report notes that it "could also increase costs for IRB banks and may therefore reduce efficiency." While the imposition of a risk floor will result in IRB ADIs generally needing to hold additional capital and thereby increase costs to some extent, there are several important offsetting factors:

- The introduction of a risk floor would reduce the riskiness of IRB ADIs which in theory should reduce their cost of capital unless their costs of capital are more a factor of the implicit taxpayer guarantee  than market forces; and
- The degree to which a risk floor has an impact on actual levels of capital holding over the full economic cycle is unclear at this point – while IRB modelling in Australia currently produce very low risk weights, this may not always be the case.

More generally, there are indications of other jurisdictions[59] (and Basel) already moving in this direction.

Basel has recently completed studies looking at international comparisons of IRB risk weights. In commenting on this work, APRA noted that "…the variations were alarmingly wide and quite uncomfortable. The Chairman of the Basel Committee has made clear that the status quo is clearly not acceptable and there will have to be changes made to the framework."[60] And that "The international direction of that work, I think, will be to, through various means, reduce the benefit that banks get from modelling."[61]

APRA acknowledges that the conclusions of this review "are some time away,"[62] and that many countries are prepared to act on the problem now rather than waiting on the final Basel position, "reflecting concerns that modelling practices may not capture the full range of risks inherent within housing markets."[63] APRA's FSI submission notes that Hong Kong, Sweden, Norway and New Zealand have all adjusted the rules around their IRB modelling to increase minimum risk weights.[64]

COBA acknowledges that the Basel Committee is already investigating this issue, and there is a real possibility that they may recommend changes in this space. However, that is no reason for Australia not to act now. Given the extended timeframes and considerable uncertainties associated with making changes to prudential frameworks at an international level, movement in this space is not expected any time soon. The current situation is placing smaller ADIs at a significant competitive disadvantage, and the issue is one which needs to be addressed with urgency. When, and if, Basel implements a policy change in this space, APRA can appropriate tailor and introduce similar obligations in Australia, but the fact that Basel is already looking at the issue should not be used by our prudential regulator as an excuse to take no action in the interim.

## 5.5 A tiered approach

Consideration could be given to reducing the risk weight to lower risk residential mortgages held by ADIs using the standardised approach. Under the current arrangement, a risk weight of 35 per cent is applied to all loans with an LVR of 80 per cent or below.[65] This is despite the fact that residential mortgages with very low LVRs are clearly less risky than loans with an LVR of 80 per cent.

There could be scope for APRA to introduce a tiered approach which applies a reduced risk weight to very low risk residential mortgages. As previously noted, this is the section of the market where advanced ADIs enjoy the most significant pricing advantage over standardised ADIs.

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[59] Hong Kong, Sweden, Norway, New Zealand.
[60] House of Representatives Standing Committee on Economics, *Transcript,* 18 July 2014.
[61] ibid.
[62] APRA, *Financial System Inquiry Submission,* March 2014, p. 77.
[63] ibid.
[64] ibid.
[65] APRA, *APS 112 – Capital Adequacy: Standardised Approach to Credit Risk,* Jan 2013, Attachment D – p. 29.

While this change would directly reduce the amount of capital held by smaller ADIs, to the extent that it allows lower risk residential mortgages to shift from the major ADIs to standardised ADIs, the aggregate level of capital held in the system could actually increase depending on where the risk weights are set.

One advantage of this approach is that it addresses the FSI's concern that "Standardised risk weights do not provide incentives for the ADIs that use them to reduce the riskiness of their lending, as this would not reduce their risk weights."[66] Reducing the risk weights of low risk mortgage lending would encourage smaller ADIs to focus more of their effort on this type of lending, reducing the overall riskiness of their lending portfolios.

The FSI Interim Report notes that one downside of this option is that it would "…be inconsistent with Australia's commitment to the Basel framework, and so may risk the international reputation of Australia's banking system."[67] In relation to this concern COBA notes that:

- The Basel framework is designed to be applied to internationally active banking institutions. As such, providing small ADIs that are not internationally active with a different risk treatment for very low risk assets would not be inconsistent with that broader commitment. This is how many jurisdictions[68] have implemented Basel, consistent with the intentions of the Basel Committee; and
- If there were genuine concerns about compliance with the Basel framework, an alternative approach would be to leave risk weights unchanged, but provide smaller ADIs with a capital offset of an equivalent size which could be applied to their PCR.

In response to concerns that this approach could reduce the total level of capital held against mortgages in the Australian banking system, we note:

- If an RWA floor was also introduced, the total level of capital could be held constant (or even increased) given the substantial proportion of the banking sector represented by IRB ADIs in Australia;
- In the absence of any change, the competitive advantages the major banks already enjoy will lead to them increasing their market share over time, which will similarly reduce the aggregate amount of capital held in the system (as more loans shift from standardised ADIs to IRB ADIs); and
- Under the current framework, IRB ADIs can price standardised ADIs out of the market for low-risk mortgages, forcing standardised ADIs to compete at the riskier end of the mortgage market.

If there are genuine concerns about the level of capital held in the system or the levels of lending in the residential mortgage sector then these issues should be tackled directly through policy interventions rather than indirectly by retaining a system which distorts competition.

## 5.6 Assisting with accreditation

Under the current arrangements, to gain approval to use the IRB approach, models must be built and approved for credit risk, operational risk and interest rate risk. An ADI is not accredited to use the IRB approach unless APRA has approved the ADIs models for all three of these risks.

Achieving IRB accreditation under this framework is obviously a substantial burden – both in terms of the time needed to collect and analyse data as well as the direct costs.

[66] Financial System Inquiry, *Interim Report,* July 2014, p. 2-10
[67] ibid., p. 2-11
[68] For example Canada, US, UK and Korea.

COBA believes there is merit in easing this requirement, and allowing an ADI to utilise the IRB approach for any one or more of credit risk, operational risk and interest rate risk, rather than requiring accreditation under all three.

In relation to the IRB approach for credit risk, processes could be further simplified if an ADI were able to apply the IRB approach to specific portfolios within its credit risk capital adequacy calculation.

This would allow ADIs operating under the standardised approach to gradually move towards the IRB approach over time, rather than need to simultaneously invest in modelling all three elements. Under this approach, an ADI would be able to adopt the IRB approach for credit risk while still retaining the standardised approach for operational and interest rate risk.

This would provide ADIs with the flexibility to manage their risks on a cost effective basis. For example, if the cost of developing IRB approaches for operational risk and interest rate risk in the banking book was not going to lead to any meaningful reduction in regulatory capital, then there would be no merit in pursuing their implementation.

For example, ADIs which operate a single line of business generally have a lower operational risk profile than ADIs which operate multiple lines of business. For these institutions, adoption of the IRB approach for the management of operational risk is less likely to make economic sense, and would arguably represent an unnecessary and inefficient waste of resources.

COBA notes that some of its members have already adopted modelling which goes beyond the requirements set out under the standardised approach. Providing smaller ADIs with partial IRB options would encourage more smaller ADIs to go further down this path, leading to a more sophisticated approach being taken to risk management on average across the system. As such, this approach would be supportive of both financial stability and competition.

More generally, we note that throughout Germany, France, the Netherlands, Austria and Quebec, individual cooperative banks are permitted under national discretion rules to utilise the IRB approach on a consolidated/group basis. In each of these instances, some mechanism is in place for mutuals to support each other with capital or liquidity, somewhat similar to CUFSS Ltd, the mutual banking industry's self-funded and operated emergency liquidity support scheme.

Conceptually, this could be applied in Australia if there was greater consolidation and co-operation in the sector here. There is a clear precedent for this approach already being taken in several European markets where Basel III rules are applied to the cooperative banking sector. In their application of Basel III, the policymakers in these jurisdictions see these changes as being within the scope of the national discretion.

However, while there may be benefits to assisting smaller ADIs to gain IRB accreditation, we note that it can never fully address the problems created by the current arrangements. While changes could be introduced which make it easier for smaller ADIs to achieve some form of IRB accreditation, this will inevitably require the investment of considerable time and resources, and there will be some minimum size threshold below which moving to any form of advanced accreditation would not be feasible or economic.

As such, there will always be some smaller ADIs which use the standardised approach to calculate their risk weighted assets, and for these institutions, other steps need to be taken to ensure that the magnitude of the gap between the two approaches is reduced to an appropriate level.

## 5.7 Recommendations

**COBA recommends:**

1. **That the competitive advantage – enjoyed by ADIs able to use the IRB approach – be reduced by:**
    a. **Lowering the standardised rate; and/or**
    b. **Introducing appropriate floors on IRB modelling; and/or**
    c. **Introducing a tiered approach which reduces the standardised rate applied to low risk residential mortgage lending.**

2. **That ADIs be allowed to gradually move to IRB accreditation – for example – by introducing the IRB approach for one risk class at a time.**

# 6 Regulator mandates and accountability

## 6.1 The problem

Competition is an essential component of well-functioning markets, and without adequate competition consumer outcomes suffer. Irrespective of whether the FSI agrees that the banking sector is currently competitive, it is critical that the regulators operate in a manner which gives due regard to the impact of their operations on competition.

In this regard, the FSI Interim Report observes that "Regulators' mandates and powers are generally well defined and clear; however, more could be done to emphasise competition matters."[69]

COBA agrees that more needs to be done, and asserts that key regulators are not giving adequate consideration to competition and competitive neutrality in the performance of their functions.

We believe that a range of policy concerns raised in the FSI which are the responsibility of APRA and ASIC clearly demonstrate that competition is not being adequately balanced against other objectives. Examples include:

- APRA's approach to **risk weighted assets**, which it believes is only a "residual competition issue,"[70] despite acknowledging that this does not provide competitive neutrality.
- APRA is proposing changes to warehousing arrangements which could prevent many customer owned ADIs from making use of **securitisation**.
- APRA places unnecessary, confusing and anti-competitive restrictions on the use of the words 'bank' and **'banking'**, despite all ADIs being subject to the same framework of prudential regulation.
- In considering disclosure issues in relation to **major bank multi-branding** and shadow banking, ASIC has taken a cautious rather than activist approach.
- Restricted capacity by customer-owned banking institutions to issue **regulatory capital instruments.**

***Box 2 –CET1 capital instruments for mutuals***

APRA and ASIC have been slow to facilitate a model which accommodates the direct issuance of CET 1 capital by customer owned ADIs despite:

- the recognition of cooperative capital as CET1 if it meets certain covenants as laid out in Basel III; and
- precedents for this in Europe and part of Canada.

Listed ADIs regularly issue regulatory capital, and it is important that customer owned ADIs also have the capacity to do so. Under Basel II, customer owned ADIs were able to issue all forms of regulatory capital. Unfortunately, APRA's implementation of the Basel III capital framework does not allow issuance of mutual capital instruments that qualify as CET1 capital, which is the most important type of regulatory capital.

Customer owned ADIs have considerably less flexibility than they had prior to the Basel III reforms. In contrast, listed ADIs have been accommodated under the Basel III capital rules and are able to issue all forms of regulatory capital in Australia.

[69] Financial System Inquiry, *Interim Report,* July 2014, p. 3-121.
[70] APRA, *Financial System Inquiry Submission,* March 2014, p. 76.

It is essential that listed ADIs and customer owned ADIs receive equivalent treatment under the Basel III capital rules. Failure to provide customer owned ADIs with the capacity to issue organisationally equivalent forms of capital as listed ADIs will continue to harm competition, choice and diversity for no prudential benefit.

This is not a new issue, with a Senate Committee recommending in November 2012 that: "APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed."[71]

This is another example of a policy area where we believe that the regulators have not given due consideration to the impact of their policy decisions on competition and competitive neutrality.

COBA strongly urges the FSI to make recommendations that bring real reform and accountability to regulators to operate in a manner which better promotes competition and competitive neutrality.

## 6.2 Legislative mandates

While we welcome the FSI's acknowledgement that more could be done to ensure that regulators give greater weight to competition matters, we are disappointed at the apparent reluctance to adjust the regulators' legislative mandates.[72]

The Interim Report acknowledges that "…although the individual parts of Australia's regulatory mandates are clear, they are not entirely ambiguous," and that "Regulators are required to make judgements in balancing sometimes competing objectives."[73]

As argued in our first round FSI submission, we believe that the regulators are not getting the balance right between competition and other considerations, and that it is the regulators' interpretations of their legislative mandates that are causing the problem.

We believe that in order to properly ensure that appropriate consideration is given to competition by both APRA and ASIC, amendment of their legislative mandates will be required.

### *6.2.1 APRA*

In APRA's view "The promotion of financial system stability is the overarching objective in APRA's mandate."[74]

The reference to financial system stability was only added to APRA's mandate in 2006, prior to this there was not explicit reference to the issue. The explanatory memorandum which accompanied the Bill containing this amendment explained the Government's rationale for the change as follows:

> "Financial system stability is a high-level objective of financial sector regulation because of the potential implications of instability for the broader economy. The amendment to subsection 8(2) clarifies that one of the things APRA is required to do in performing and exercising its functions and powers is to promote financial system stability in Australia."[75]

[71] Senate Economics References Committee, *The post-GFC banking sector,* November 2012, p. xxv.
[72] Financial System Inquiry, *Interim Report,* July 2014, p. 3-121.
[73] ibid.
[74] APRA, *Financial System Inquiry Submission,* March 2014, p. 7.
[75] Explanatory Memorandum, Financial Sector Legislation Amendment (Trans-Tasman Banking Supervision) Bill 2006.

While the explanatory memorandum only suggests that financial system stability is "a high level objective" and "one of the things" APRA is required to do, APRA appears to have interpreted financial stability as "the sole objective" rather than "one objective." We do not believe that APRA's interpretation of section 8(2) is consistent with the intent of the amendment.

The interpretation of APRA's legislative mandate is supported by the Government's Statement of Expectations and APRA's Statement of Intent. These were initially issued in 2007, and updated in 2014.

In commenting on APRA's role, objectives and priorities, the Government's 2007 Statement of Expectations said: "It is important that the prudential regulation regime maintains a low incidence of failure of regulated entities while not… hindering competition." In response, APRA's Statement of Intent acknowledged this expectation and separately noted that "APRA has sought to achieve a high level of financial safety for beneficiaries without unduly impairing the Australian financial system's efficiency, competitiveness or contestability."

Interestingly, the Government's updated 2014 Statement of Expectations states the view that APRA should balance "…the objectives of financial stability and efficiency, competition, contestability and competitive neutrality…" implying once again that financial stability is one objective of many rather than being the main overarching goal. Given APRA's shortcomings in this area, we encourage FSI to make more explicit requirements for APRA to have a senior executive with responsibility for competition to review all APRA rules prior to enactment for their impact on the marketplace.

As COBA noted in its previous submission, clarifying the mandate to place competition and competitive neutrality on an equal footing with other considerations would see a return to the original Wallis vision that the prudential regulator's charter:

> "…should emphasise the need to approach prudential regulation in a way that balances the objectives of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality."[76]

While it is true that "APRA's policy making process demonstrates routine consideration of competition issues," and its "responses to submissions contain references to competition…" this does not mean that APRA is necessarily giving adequate weight to the issue. Despite competition concerns regularly being raised by stakeholders, and despite these concerns being acknowledged by APRA in their consultations, the outcomes of their deliberations demonstrate that competition is not something that rates highly in their consideration.

We believe that an amendment to APRA's legislative mandate would be an effective way to remove the residual uncertainty in the current drafting and ensure that competition considerations were given appropriate weight by the prudential regulator. While we also support many of the FSI's suggestions about other changes which could assist in emphasising competition, we believe that the effectiveness of those measures will be greatly diminished if the fundamental issue of the legislative mandate is not addressed.

### *6.2.2 ASIC*

COBA believes that a similarly strong focus on competition should be introduced into ASIC's legislative mandate.

ASIC notes that "An express competition mandate is not part of ASIC's statutory obligations under s2 of the ASIC Act. Nor do ASIC's existing statutory objectives provide a sufficient basis to pursue an

[76] Wallis, *Financial System Inquiry Final Report,* March 1997, p. 321.

implied competition mandate."[77] ASIC is well aware of the challenges that the current legislation presents, noting that "we are not specifically empowered to design regulatory responses that enhance competition."[78]

We agree with ASIC that a change to their legislative mandate to explicitly include a reference to competition is warranted. We are therefore disappointed that the FSI Interim Report indicates a reluctance to recommend changes to ASIC's legislative mandate, noting that "…ASIC's mandate with respect to competition is broadly similar to international peers…"[79] While this is correct, it is equally true that the UK's Financial Conduct Authority has the promotion of competition as one of its specific objectives.

We believe that supporting and promoting competition is integral to the delivery of quality outcomes for consumers, and agree with ASIC that amending their mandate "would drive a greater focus on the long-term benefits for the end users of the financial system."[80]

## 6.3 Accountability and transparency

The FSI Interim Report observes that "Australia generally has strong, well-regarded regulators but some areas of possible improvement have been identified to increase independence and accountability."[81]

A range of measures are outlined in the Interim Report, and COBA is generally supportive of most of these. However, as we previously emphasised, the capacity of these changes to actually alter the operation of the regulators in practice will be substantially undermined if their legislative mandates are not similarly adjusted to properly emphasise competition.

We note that some improvements in accountability have recently been introduced by the Government and COBA has been supportive of these initiatives. In particular:

- Having APRA formally appear before the House Economics Committee is a welcome addition to the current accountability and transparency recommendations;
- Refreshing the Statements of Expectation and Statements of Intent has provided a clearer understanding of how the regulators will be expected to operate under the current government; and
- Greater transparency around the calculation of APRA's levies has provided industry with greater confidence that the methodology is appropriate, and has already resulted in important adjustments to the calculation methodology being made.

Suggestions in the Interim Report around independent reviews of regulator performance, clarifying the metrics for assessing regulator performance, and improving the oversight process for regulators more generally,[82] are all welcomed, as are the suggestions that APRA's annual report include a section on competition and an additional APRA Member be appointed with a focus on competition.[83] We note that APRA "…fully supports the need for independent statutory authorities to meet high standards of accountability to the Parliament and the community."[84] In this regard, consideration should be given to whether APRA's performance would be improved by having a non-executive board overseeing management decision-making or at a minimum an advisory board comprised of persons from the financial sector and consumer advocates.

[77] ASIC, *FSI: Submission by ASIC,* April 2014, p. 120.
[78] ASIC, *FSI: Submission by ASIC,* April 2014, p. 18.
[79] Financial System Inquiry, *Interim Report,* July 2014, p. 3-122.
[80] ASIC, *FSI: Submission by ASIC,* April 2014, p. 18.
[81] Financial System Inquiry, *Interim Report,* July 2014, p. 3-108.
[82] ibid., p. 3-117
[83] ibid., p. 3-127
[84] APRA, *Financial System Inquiry Submission,* March 2014, p. 31.

While we support the need for the regulators to have appropriate levels of independence from government, it is equally important the proportionate levels of accountability are in place.

## 6.4 The role of the ACCC

The FSI Interim Report canvasses the possibility of broadening the membership of the Council of Financial Regulators (CFR) to include the ACCC.[85] The Interim Report acknowledges that broadening the membership of the CFR would "strengthen the Council's ability to perform its role as a coordination body on a whole-of-sector basis."[86]

COBA supports this suggestion, and agrees that including the ACCC as part of the CFR would help to ensure that competition issues are given more adequate attention by policy makers but that doing so would not be a suitable substitute to revising APRA and ASIC's legislative mandates to include competition.

We note that in considering the role of the ACCC, research commissioned by the Australian Centre for Financial Studies has recommended that "The ACCC should receive the competition mandates currently held (and generally ignored) by APRA and other regulators."[87]

While we agree that existing competition mandates held by financial sector regulators are both too weak and often ignored, we believe that this problem is more appropriately addressed by clarifying and strengthening the existing competition mandates rather than transferring them to the competition regulator. We would be concerned about the capacity of the ACCC to exert its influence on the policy decisions of APRA and ASIC if these two regulators had competition considerations explicitly removed from their focus.

## 6.5 The efficiency dividend and APRA's budget

COBA notes the concerns raised by APRA around the application of the efficiency dividend, and in particular their view that "Continued efficiency dividends will ultimately compromise financial safety but make no contribution to the Government's budgetary objectives."[88]

While it is true that applying the efficiency dividend to APRA does not deliver budget savings to the Government, it does deliver savings to industry. As noted in a research note produced by the Parliamentary Library, "The justification for the dividend is that ongoing increases in productivity make it possible to reduce funding … without compromising outputs."[89] COBA believes that this makes application of the efficiency dividend to APRA no less valid than its application to any other government department or agency.

It is important that all government bodies are incentivised to deliver their outputs in an efficient and cost effective manner, and the efficiency dividend recognises that the public sector does not face the same incentives as the private sector in this regard.

While meeting the budgetary constraints imposed by the efficiency dividend can be challenging, we note that APRA acknowledges that its "…financial arrangements have not to date materially affected its ability to conduct effective supervision."[90]

[85] Financial System Inquiry, *Interim Report,* July 2014, p. 3-120
[86] ibid.
[87] Australian Centre for Financial Studies, *Funding Australia's Future – Regulating the Australian Financial System,* 2014, p. 7.
[88] APRA, *Financial System Inquiry Submission,* March 2014, p. 6.
[89] Parliamentary Library, *Background Note – The Commonwealth efficiency dividend: an overview,* Dec 2012, p. 2.
[90] APRA, *Financial System Inquiry Submission,* March 2014, p. 30.

When considering the appropriate level of APRA funding more generally, we note that APRA's total funding envelope for each financial year is agreed by the Government in the lead up to the Budget. There is no formal engagement with industry stakeholders at this stage in the process, and as APRA's budget does not have any impact on the Government's deficit or surplus in any given year, Government has little incentive to exert strong oversight over this spending.

We therefore strongly back APRA's comment that it "…would support a transparent process of consultation on its funding needs with interested stakeholders as part of the normal pre-Budget submissions process, before Government approval of APRA's budget, rather than afterwards through the levies determination process."[91] If this were to prove an effective way for industry stakeholders to have confidence in the efficiency of APRA's expenditure then it could potentially lead to the efficiency dividend becoming redundant for this agency.

## 6.6 Recommendations

**COBA recommends:**

1. **That the legislative mandates of APRA and ASIC be amended to ensure competition and competitive neutrality are appropriately balanced against other objectives.**

2. **That further measures be introduced to improve APRA's accountability and transparency in line with those suggested in the FSI Interim Report, along with:**
    a. **The establishment of a non-executive board to oversee decision making; and**
    b. **The appointment of a senior executive to APRA with responsibility for competition who would review rule changes prior to enactment.**

3. **That greater transparency around, and industry involvement in, the development of APRA's Budget each year be considered as an alternative to the continuation of the efficiency dividend.**

[91] APRA, *Financial System Inquiry Submission,* March 2014, p. 55.

# 7 Disclosure

## 7.1 The problem

There is general agreement that the current disclosure regime is not delivering desired outcomes. Treasury noted that "Current disclosure requirements are not effective in helping consumers make informed decisions…"[92] and ASIC's submission observed that "…disclosure of certain information does not improve market outcomes, and may simply represent a cost for providers."[93]

We agree with these comments and the FSI's observation that "The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants."[94]

Customers are clearly unsatisfied with the current arrangements, as demonstrated by a wide range of consumer research pieces.

In a consumer survey of more than 1,500 people undertaken by People's Choice Credit Union:

- 84.3 per cent of respondents said that banks should disclose in their advertising when they are owned by another bank; and
- 64.6 per cent of respondents believe that allowing some banks to use multiple brands is intended to trick customers into thinking the bank is local.

These findings built on the results of an earlier consumer survey of the same size also conducted by People's Choice Credit Union, where:

- 70.4 per cent of respondents thought bank advertisements were 'confusing,' and 64.7 per cent believed they were 'misleading'; while
- Only 33.1 per cent thought they were 'honest' and 26.4 per cent said they were 'clear.'

A poll of more than 1000 Australians conducted by Essential Research on behalf of COBA found:

- 86 per cent of Australians think there needs a little or a lot more transparency and clarity regarding rates and fees, while only 7 per cent believe that current levels of transparency and clarity are appropriate.[95]

The current disclosure frameworks allow ADIs and non-ADIs to operate in ways which COBA believes are misleading, particularly when it comes to branding and ensuring that consumers understand who they are dealing with. At the same time, the regulators exert excessively tight control over the language that the customer owned banking sector can use to describe its own business, for no discernible consumer benefit.

We believe that changes to the current arrangements are warranted to address these issues.

## 7.2 Informed consumers

In a genuinely competitive market with real choice, consumers need to be able to easily understand the true identity and regulatory status of the entity they're dealing with.

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[92] The Treasury, *Submission to the Financial System Inquiry,* April 2014, p. 24.
[93] ASIC, *FSI: Submission by ASIC,* April 2014, p. 12.
[94] Financial System Inquiry, *Interim Report,* July 2014, p. 3-56.
[95] EMC, *Attitudes to banking Australia,* August 2014.

This does not always apply in the financial services market because:

- major banks hide behind sub-brands that look like regional banks or non-banks;
- non-ADIs pose as regulated banking institutions; and
- brokers may not be on the customer's side.

Competitive neutrality in retail banking depends on consumers understanding that major bank sub-brands are not separate institutions and that so-called 'shadow banks' are not regulated banking institutions. The current disclosure framework is not delivering this outcome.

***Box 3 – The loss of trust***

The capacity for consumers to know exactly who they are dealing with has become even more important because of the betrayal of consumer trust documented in the June 2014 report of the Senate Economics Committee into the performance of ASIC.[96]

When dealing with businesses motivated to maximise profits for shareholders at the expense of customers, customers rely on the integrity of the business and the performance of the regulator. The Senate Committee found failures in both these layers of protection. It's unlikely these problems will be solved by giving "financial advisers a crash course in ethics and professionalism" as flagged by AMP.[97]

The Senate committee found that between 2002 and 2010 some financial advisers, brokers and lenders systematically targeted more vulnerable members of the community, especially older Australians, with assets, but without high levels of financial literacy.

According to the Committee:

- CBA financial advisers and other staff deliberately neglected their duties and placed their personal interests far above the interests of their clients.
- assets of clients with conservative risk positions, such as retirees, were allocated into high-risk products without their knowledge to the financial benefit of the adviser, who received significant bonuses and recognition as a 'high performer'.
- There was forgery and dishonest concealment of material facts.
- Clients lost substantial amounts of their savings when the global financial crisis hit.

The Committee found that the conduct of a number of rogue advisers was unethical, dishonest, well below professional standards and a grievous breach of their duties—in particular the advisers targeted vulnerable, trusting people.

The committee found that CBA deliberately played down the seriousness and extent of problems in Commonwealth Financial Planning Limited in an attempt to avoid ASIC's scrutiny, contain adverse publicity and minimise compensation payments. "In effect, the **CBA managed, for some considerable time, to keep the committee, ASIC and its clients in the dark**," the Committee found.

The Committee also noted **'systemic failings of compliance'** and the 'poor compliance culture' of Macquarie Equities Limited trading as **Macquarie Private Wealth**. Macquarie Equities Limited is sending out **160,000 letters** to current and former clients about possible remediation for flawed financial advice. The letters are being sent to all people who have been clients at any time since Macquarie Equities Limited obtained its AFSL on 1 March 2004.

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[97] *A wealth of advice*, Herald Sun 22 Aug 2014

### 7.2.1 *Multibranding*

Major bank multi-brand strategies are intended to lure customers who don't want to bank with a major bank and/or to compete on price against genuinely independent competitors without providing any benefit to the bulk of the major bank's existing customers.

Westpac's sub-brands include St George, BankSA, Bank of Melbourne and RAMS. NAB has UBank and CBA has BankWest and Aussie Home Loans (AHL).

Consumers need more effective disclosure about the true identity of major bank sub-brands and subsidiaries.

Multibranding by the major banks also creates problems regarding the provision of financial advice, as banks tighten their grip on parts of the financial system outside retail banking. Research by Roy Morgan has found that consumers are more likely to believe that a major bank financial planner is independent when it is less clear that the adviser works for the major bank. As Roy Morgan noted:

> "The main area of confusion regarding the independence of financial planners occurs when the planner is branded differently to the major fund manager that owns the planning group. For example, 55% of the clients using Financial Wisdom (owned by the Commonwealth Bank) consider it to be independent, which is well ahead of the 14% who consider Commonwealth Bank branded planners to be independent."[98]

The research found similar levels of confusion existed in relationships with other major banks:

- Only 12 per cent of clients using NAB branded planners considered them to be independent, but this increased to 50 per cent when using Godfrey Pembroke (which is owned by NAB).
- Only 13 per cent of clients using ANZ branded planners considered them to be independent, which compared to 37 per cent when dealing with Retireinvest (owned by ANZ).

It is critical that customers understand whether or not they are dealing with a major bank. Independent polling commissioned on behalf of COBA found that 62 per cent of people have a little or no trust in the big four banks to give independent financial advice, while only 5 per cent of people place a lot of trust in the big four to provide independent financial advice.[99]

ASIC has taken the view that while it is good practice for entities to disclose in their advertising the relationship between parent entities and their subsidiaries or divisions where appropriate, there is no positive obligation on entities to disclose this information.

ASIC, rather than the ACCC, is responsible for ensuring that consumers are confident and informed in financial services. The ACCC's approach to a similar problem outside financial services appears to be more robust than the approach taken by ASIC.

One of the ACCC's current priority areas is "credence claims", i.e. representations, including marketing and labeling, that portray large manufacturers as small, niche business.

The ACCC says this type of behavior has the potential to mislead consumers, particularly those who prefer to support Australia's small business community and that this goes to the heart of market efficiency.

> "There is a competition side to credence claims as well - businesses should be able to compete on their merits. Misleading credence claims tilt the playing field away from suppliers

[98] Roy Morgan Research, *Confusion with Financial Planner independence continues,* August 2014.
[99] EMC, *Attitudes to banking Australia,* August 2014.

> who are doing the right thing. In other words, a supplier may lose its competitive advantage or unique selling point if others are making misleading claims."[100]

Given the ACCC's view that "unless we send some clear enforcement messages such behavior will only increase", COBA is disappointed that ASIC is apparently not sending such messages to the major banks.

Consumer research strongly suggests that major banks are getting away with portraying their sub-brands as independent competitors. The current legislative framework does not ensure that retail banking consumers who want to deal with a regional bank or a non-bank have the opportunity to make a fully-informed choice.

This can be corrected by requiring that major bank sub-brands and subsidiaries clearly and prominently disclose in all advertising and all customer-facing material that they are owned by a major bank.

### *7.2.2 Shadow banking*

Shadow banking institutions, such as debenture issuers, have marketed themselves as offering deposits, savings products and at-call accounts. Treasury's submission to the FSI notes that "The distinction between those entities that are prudentially regulated and those that are not is a source of confusion among investors and invites regulatory arbitrage."[101]

The occasional high-profile collapse of one of these entities prompts calls for a regulatory crackdown on non-ADIs presenting themselves as regulated banking institutions. Treasury has suggested "…exploring the scope for improving the capacity of investors to distinguish between entities that are prudentially regulated and those that are not."[102]

Unfortunately, proposals to ban these 'shadow banks' from using terms such as 'deposit' and 'savings account' and from offering at-call investment products have been repeatedly delayed.

In the interests of competitive neutrality, and consumer protection, a better informed market is needed about the real identity of various entities in the banking market. The regulatory system needs to ensure that consumers understand that there is a bright line between regulated banking institutions and shadow banking institutions.

### *7.2.3 Mortgage broking*

CBA's takeover of AHL means that one of the leading mortgage brokers in the market is subject to the interests of the largest lender in the market. Consolidation of the mortgage distribution services market in recent years includes NAB's acquisition of the PLAN, Choice and FAST brokerages, trading under the Advantage brand name. Westpac owns the RAMS Home Loans network. CBA, in addition to its major stake in AHL, has a significant stake in Mortgage Choice through its ownership of Count Financial.

In their submission to the Financial System Inquiry, the regional banks warn about the risks to borrowers of major bank ownership of mortgage brokers.

> "Despite the benefits that mortgage brokers bring, there is the potential for the exploitation of borrowers. Bank ownership of mortgage broking platforms is potentially a competitive

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[100] Sarah Court – ACCC, Speech: Enforcement priorities at the ACCC, Sep 2013.
[101] The Treasury, *Submission to the Financial System Inquiry,* p. 30.
[102] ibid. p. 31.

> distortion and has consumer protection implications. One reason prospective borrowers seek a loan from brokers is to receive an impartial offering of housing loan products, yet this is potentially compromised if the broker owner is also a housing loan issuer. Ownership may exert pressure on brokers to allocate high credit quality customers to the owner, while sending lower quality customers to competitors. Even if pressure is not applied, the relationship between owner and broker may give the owner greater opportunity to tailor products to secure better customers."[103]

Borrowers need to understand whether a mortgage broker is genuinely independent, whether the broker is offering products from a narrow or broad range of lenders, and whether some lenders are 'preferred' by the broker.

## 7.3 Use of term 'banking'

It is important that the customer owned banking sector is afforded flexibility around the words used to describe its business and the products it offers, subject of course to that language not being misleading.

In this context, APRA should withdraw its current proposal to restrict credit unions and building societies from using the term 'banking' as part of a registered corporate, business or trading name, or as part of an internet domain name.

This proposed new restriction is at odds with APRA's – entirely appropriate - stance of allowing credit unions and building societies to use the term 'banking' in marketing and branding material. Banking is the business of credit unions and building societies.

COBA has strongly objected to APRA's draft proposal but at this stage APRA has not indicated any willingness to withdraw the proposal. In our view, the proposal represents a significant policy shift by APRA, and the change will impact on a large number of our members.

***Box 4 – 'Authorised Banking Institutions'***

'Banking business' is defined in the Banking Act 1959 as both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money.

While this is what all Authorised Deposit-taking Institutions (ADIs) do, APRA restricts use of the terms 'bank' to a minority of ADIs and is even proposing to reduce the capacity of credit unions and building societies to use the term 'banking'.

ADIs must have at least $50 million in Tier 1 capital to apply for permission to call themselves banks. This hurdle has been in place since 1992 and is a carry-over from the days before the ADI concept existed when the RBA had responsibility for banking regulation and was concerned about dubious new entrants to the banking market.

All ADIs – both customer owned banking institutions and listed banks – are subject to the same strong prudential regulatory regime, with the same set of strict, legally-enforceable prudential standards covering capital, liquidity, risk management and governance.

Allowing only a minority of regulated banking institutions unrestricted use of the terms 'bank' and 'banking' is anti-competitive.

[103] Regional banks, *Submission to the FSI - Levelling the Playing Field*, March 2014

Credit unions and mutual building societies, as customer owned institutions, obviously value their distinct identity from banks but the reality is the terms 'bank' and 'banking' are well understood in the community, whereas the term 'ADI' is not.

A simple step to improving market awareness of the prudential standing of all regulated banking institutions – and therefore contestability, competition and choice – would be to replace the term 'Authorised Deposit-taking Institution' with 'Authorised Banking Institution.'

This change would be a simple tool to allow credit unions and building societies the opportunity to more effectively promote their prudential standing to the market.

Such a change would not be merely cosmetic. This change would increase the capacity of smaller banking institutions to deliver simple, cut-through messages to respond to consumer perceptions about risk, security and prudential standing.

## 7.4 Recommendations

**COBA recommends:**

1. **That changes be made to the current disclosure regime to ensure that consumers can easily tell the difference:**
    a. **Between an independent competitor and a major bank sub-brand; and**
    b. **Between an ADI and a non-ADI.**

2. **That APRA withdraw its proposal to restrict customer owned ADI use of the term banking, recognising that they are subject to the same prudential regulation as listed ADIs.**

3. **That the term 'Authorised Deposit-Taking Institution' be replaced with 'Authorised Banking Institution.'**

# 8 Other issues

In addition to the main themes raised above, COBA would like to briefly address the following issues.

## 8.1 Comprehensive Credit Reporting

The FSI Interim Report notes recent changes to the consumer credit reporting regime which allow credit providers and credit reporting bodies to exchange 'positive' data. COBA wishes to outline the following in response to the concept of a mandatory comprehensive credit reporting (CCR) regime:

- Credit providers are vastly different in their size and nature. The benefits of CCR will not be the same for all lenders or their customers.
- While credit providers have been permitted under the law to exchange positive data for the past five months, very few have done so. This is because the rules for exchange of the data – the Principles of Data Exchange and Reciprocity – are yet to be finalised (this is expected to be complete first quarter 2015). There are currently few participants for this reason and not necessarily because of unwillingness to participate. It is too early to determine the level of participation we will see in CCR.
- At this point the costs of participating in CCR are unclear.
- It is unclear how mandatory CCR would work in an environment with multiple credit reporting bodies (CRBs); Australia has three CRBs amongst which the data will be distributed. It appears the CRB market would have to be restructured to some extent for a mandatory CCR system to be feasible.
- Credit reporting has always been an option to help lenders meet their responsible lending obligations under *National Consumer Credit Protection Act 2009* but it is not mandatory under the credit regime and it should remain up to credit licensees to decide how to meet their responsible lending obligations.

Overall, while we acknowledge that CCR will bring benefits to some lenders and some borrowers, these benefits, the costs, and further impacts are unknown at this early stage. The current regime should be allowed some time to mature before recommendations are made about a mandatory CCR regime.

**COBA recommends: That mandatory CCR not be introduced at this stage.**

## 8.2 FCS levy

As argued in our first-round submission to the FSI, COBA supports the continuation of the FCS guarantee at the current level of $250,000 but does not support the introduction of an up-front levy, given that the current post-funded framework is working well.

In considering the issue of pre-funding, the FSI Interim Report notes that while this "would satisfy a 'user pays' principle for the deposit insurance provided," it would also "impose a cost on the financial sector… that would likely be passed on, at least in part, to depositors…"[104]

In supporting the continuation of the current post-funding arrangements, COBA again emphasises that:

- Given Australia's prudential framework, a pre-funded scheme is unnecessary and will be costly to administer;

[104] Financial System Inquiry, *Interim Report,* July 2014, p. 3-17.

- A flat rate levy on guaranteed deposits would impact smaller ADIs more heavily given their higher reliance on deposits as a source of funding; and
- A new tax on deposits further disadvantages these savings relative to other investments (such as equities and property), and is in complete contradiction to the Henry Review's recommendation that the tax burden on deposits be reduced.

In addition, we note that while the Government provides a deposit guarantee under the FCS, it does not provide any funding. The Government's commitment to pay deposit holders in an FCS event is analogous to the promise of a temporary loan to industry. The FCS is effectively a form of industry self-insurance, whereby if an ADI was ever unable to pay out all protected deposit holders, the rest of the ADI sector would be levied to make up the difference. Given that it is always industry that will ultimately be responsible for any funding shortfall under the FCS, it only makes sense to collect that shortfall when and if it ever materialises.

While we acknowledge that a number of other countries have introduced pre-funded deposit insurance schemes, the prudential frameworks in those countries make it far more likely that deposit insurance will be triggered. As our first-round FSI submission noted:

> "Of the 21 Financial Stability Board (FSB) members with a deposit insurance scheme in place in 2012, 16 countries had used their schemes a total of 1,000 times over the past decade, while Australia was one of only 5 countries to have not used their scheme over this period."[105]

However, should the FSI not support this view and instead recommend the introduction of a deposit levy, it is critical that it be designed in a manner that promotes competition rather than undermines it. As Treasury notes, "…careful design is required since smaller banks are more reliant on deposits than the major banks and can be disproportionately impacted."[106]

While the FSI Interim Report briefly discusses the pros and cons of moving to a pre-funding model for the FCS, it does not discuss the different approaches that could be taken in allocating the levy to industry. In general terms, there are three broad approaches that the levy could take:

- A flat rate, where the same levy is applied to all FCS guaranteed deposits in all ADIs;
- A risk-based approach, whereby ADIs determined to be higher risk would pay a higher levy; or
- A tiered approach, whereby only ADIs with assets above a certain level would be required to pay the levy.

While COBA does not support the introduction of an FCS levy, if one is to be introduced, we believe that the tiered approach should be adopted. We have previously argued that a tiered approach would produce a pro-competitive outcome, and we have been encouraged by Treasury's support for this view. Treasury has noted that "The tiered approach would be beneficial for competition and would offset the tendency of either the flat and risk-based approaches to disproportionately affect smaller banks that are more reliant than larger banks on deposit funding."[107]

Similarly, COBA would be very concerned about the introduction of a risk-based levy. As Treasury correctly observes, such an approach would be complicated to administer, would lessen competition, and could impact negatively on financial stability by sending adverse signals to the market about the stability of individual ADIs.[108]

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105 COBA, *Submission to the Financial System Inquiry, March 2014,* p. 36.
106 The Treasury, *Submission to the Financial System Inquiry,* p. 37.
107 ibid., p. 38.
108 ibid.

On the operation of the FCS more generally, COBA also believes there is scope for the Government to streamline the practical implementation requirements imposed on ADIs. APRA is currently administering the legislation and has developed a Prudential Standard (APS 910) which outlines ADI obligations. In contrast to APRA's more general approach to prudential regulation, APS 910 is highly prescriptive and imposes significant compliance burdens on all ADIs. Changes could be made which would significantly reduce the compliance burden imposed without undermining the consumer protections that this deposit insurance provides.

**COBA recommends: That post-funding be retained for the FCS, but that if pre-funding is introduced, a tiered levy be adopted.**

## 8.3 Franking credits and tax on deposits

COBA's March submission to the FSI raised issues around the tax treatment of deposits and the anti-competitive impact of the dividend imputation regime on the customer owned model. We welcome the FSI's acknowledgement of these issues as legitimate concerns, and support the FSI's recommendations that these issues "…should be considered as part of the Tax White Paper process…"[109]

COBA looks forward to raising these issues as part of that process in due course.

For questions or further information about any aspect of this submission, please contact:

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[109] Financial System Inquiry, *Interim Report,* July 2014, p. A2-1.

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