SUNCORP BANK

Suncorp Bank
Level 18, Suncorp Centre,
36 Wickham Tce,
Brisbane, QLD, 4000
Ph: 07 3836 1110
Fax: 07 3835 5988

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Mr David Murray AO
Financial System Inquiry
GPO Box 89
Sydney NSW 2001
By email: fsi@fsi.gov.au

Dear Mr Murray

Financial System Inquiry Interim Report – supplementary submission

Thank you for the opportunity to make a second submission to the Inquiry. I'd like to congratulate your team on compiling a comprehensive summary of the financial system and key issues to be further examined. I am encouraged by the fact that our arguments have been acknowledged in the report. Competitive neutrality is a critical and growing issue for the industry and consumers. As a priority, the existing regulatory settings should be reviewed to ensure that the non-major banking sector remains strong, competitive and continues to provide benefits for consumers and businesses.

As the leading regional bank, Suncorp Bank is the natural proponent to facilitate competition and deliver innovative products and financial solutions to Australians. With more than one million customers, the Bank has a strong presence in the market and is committed to remaining a viable and competitive option for consumers.

I believe it is in the best interests of the community and our economy for a robust multi-tiered banking system to exist. Entrenched distortions in the way different tiers are able to fund themselves and the capital they have to hold restricts the ability of regionals and non-major banks to create necessary competitive tension.

Our enclosed submission focuses on the observations and policy options in the Interim Report that have the potential to address competitive anomalies in the market while maintaining the integrity of the system.

Suncorp Bank's recommendations for the Panel's consideration include:

- *Application of a flat 20% risk weighting of assets across standardised and advanced banks for loans up to 80% LVR or, at very least, a reduction to 20% for standardised banks on loans up to 80% LVR;*
- *Greater transparency of the ownership structures in mortgage broking and aggregation;*
- *Further consideration of methods to address too big to fail. The objective should be to address the funding costs gap between major and non-major banks while maintaining system stability and consumer and investor confidence;*
- *A range of measures to support bank funding including a stable mortgage securitisation market and an increased cap on covered bonds; and*
- *A regulatory environment which supports competition and is more coordinated across the regulatory bodies.*

While I agree with many of the observations in the report and some policy options hold promise, I am concerned that the critical consideration of timing has been overlooked.

The Australian banking system needs rebalancing now. Given the rate of consolidation and concentration in banking since 2008, I believe there is some urgency in establishing competitively neutral settings. While I appreciate the challenges in implementing reform, I would ask the Panel to consider prioritising relevant matters as recommendations are developed.

Specifically, it is imperative that improvements to the system of risk-weighting housing loans be achieved by mid-2015, greater transparency around broker and adviser ownership and incentives are introduced early and steps to address 'Too Big to Fail' (TBTF) are agreed by mid 2016.

I have been working closely with my colleagues from Bendigo and Adelaide Bank, ME Bank and Bank of Queensland and I fully support the positions presented in our joint submission to the Interim Report.

As the Interim Report has not outlined draft recommendations, it is important that dialogue between stakeholders and the Financial Systems Inquiry (FSI) Secretariat/Panel continue up until the final publication of the report. If possible, it would be useful for interested stakeholders to see and comment on a draft version of the Final Report.

I would welcome the opportunity to contribute further to the development of initiatives which support and deliver a more competitive, stable and efficient Australian financial services sector.

Yours sincerely

John Nesbitt
Chief Executive Officer
Suncorp Bank

Financial System Inquiry: Interim Report

Suncorp Bank Submission
26 August 2014

Executive summary

Suncorp Bank welcomes the opportunity to provide a second submission to the Financial System Inquiry (FSI) Interim Report.

Suncorp agrees that the financial system has generally performed well in meeting the financial needs of Australians and facilitating productivity and economic growth. Equally, we agree there is no room for complacency and that the Inquiry must be forward-looking when making recommendations.

The Interim Report observed that the banking sector is competitive, albeit concentrated. It observed further that some aspects of the banking sector are not competitively neutral and identified components of the banking system that limit the capacity of smaller banks to compete on a level playing field. While Suncorp supports these observations, we feel that the extent of competition in banking is overstated and further consideration is needed to ensure there is a robust future state of competition to provide maximum benefit to consumers and businesses.

Suncorp contends that a healthy, multi-tiered banking system is essential to guarantee Australian consumers and businesses will be able to access innovative and better value financial products and services well into the future. This is not guaranteed unless the prudential and regulatory framework incorporates the principle of competitive neutrality.

The specific issues Suncorp seeks to address in this response to the Interim Report are:

Competitive neutrality: a more risk-reflective system of setting regulatory capital for housing loan assets

Suncorp welcomes the FSI Interim Report observation that the current system is not competitively neutral and believes a relatively small change to the current approach can deliver material benefits in terms of competition.

Suncorp recommends that the system of setting regulatory capital to be modified to better reflect fundamental risk in the system and promote competitive neutrality. Suncorp recommends the Panel give serious consideration to a 20% risk weight on housing lending up to and including 80% Loan to Value Ratio (LVR) across the industry.

Alternatively, and at the very least, Suncorp recommends that the current 'standardised' system of risk weight tiers should be extended to include an additional 20% tier for loans up to and including 80% LVR.

Suncorp considers 20% to be at a level which is more closely aligned to where the advanced banks are currently estimating – but still higher than that calculated under International Ratings-Based (IRB) models.

Suncorp does not consider a change for loans beyond 80% LVR is required. At this higher-risk end of the market, it would be expected that capital holdings would remain lower for banks with more sophisticated risk management systems.

With these changes, the system can become more competitively neutral without additional risk. The benefits of this policy initiative will be to foster genuine competition in the low-risk housing finance market with a long-term benefit of increased pricing tension and better value for customers. Similarly, with a lower capital requirement, standardised banks will have more capital to lend to the SME market or invest in innovation and product development across all portfolios.

Assistance for standardised banks to achieve advanced accreditation

Suncorp supports the Interim Report option of assisting standardised ADIs to use IRB models in attaining accreditation. Suncorp Bank is in the process of seeking advanced accreditation but the process has proven protracted and inefficient. Suncorp recommends that the Australian Prudential Regulation Authority (APRA) engage more fully during the process.

APRA could establish a dedicated team to work with the regional banks to support them through the accreditation process, in a similar way that the major banks were supported during their accreditation. As part of this, it would be beneficial for major banks to provide data to regionals – via APRA – to support the move toward advanced e.g. market and operational risk data. Market and operational risk data would be particularly beneficial as the larger banks have much bigger data sets to model. Suncorp has a number of risks we encounter relatively infrequently, so modelling to a high enough standard to achieve advanced accreditation is likely to continue to be challenging and time consuming for us. This process should lead to the overall system being enhanced and strengthened.

APRA could also assist regional banks in achieving advanced status by implementing a staged approach, to enable standardised banks to achieve accreditation progressively across their respective portfolios and operations, i.e. decoupling market, operational and credit risk models to support standardised banks to achieve advanced would be a practical and sensible solution. This is not out of step with international precedent. The logical place to start with this staged approach is housing loans as it is a core business of regional banks and the risk is well understood.

Addressing the funding cost advantage for banks deemed 'Too Big to Fail' (TBTF)

Suncorp sees promise and risks associated with most of the options outlined in the Interim Report to address TBTF. Further modelling and work is needed to understand the implications for the market, investors and customers. On this basis, Suncorp is not strongly recommending any particular initiative to address TBTF, though we have provided comments on the various policy options.

The primary issue for smaller banks is that banks deemed systemically important receive a significant funding and pricing advantage from an implied government support. Finding a clean solution to this problem has proven difficult, but a strong case remains to continue efforts to do so.

Whatever the inevitable solution, for Suncorp Bank, a key agreed objective should be to address the funding cost gap between major and non-major banks while maintaining system stability and consumer and investor confidence. Suncorp suggests that TBTF is a market failure and it must be addressed directly with a determination to ensure that the funding cost disparity between TBTF and non-TBTF institutions is eliminated.

Improving the disclosure arrangement for mortgage brokers to ensure customers of brokers are fully aware of a broker's ownership structure and potential conflicts of interest

Suncorp recommends that greater transparency is needed and that better pre-sale disclosure be introduced to ensure consumers understand the level of independence or otherwise. Repaying a housing loan is probably the largest financial commitment a household will ever make, and any compromise in terms of the most suitable loan has financial implications.

The premise of a mortgage broker is that a consumer can receive an objective and independent assessment of what is the best housing loan available for their needs. It should be recognised that consumers utilise mortgage brokers in order to receive personal, independent advice and as such, brokering advice should be clear and transparent as to incentive structures and product and adviser salesforce ownership.

A national funding strategy that recognises the need for robust, stable and efficient funding sources for all ADIs

Experience through the GFC has proven the value of diverse and stable funding sources. It is imperative, particularly for stability, efficiency and competition that banks have access to as wide a funding base as possible, by both product and jurisdiction.

Australia needs a robust, diverse and good quality range of funding sources that are able to carry the industry through any kind of stress. Having important players dip in and out of the market does not enhance long-term confidence in the system as a whole.

A holistic approach to the funding needs of the economy that fully supports economic growth would be best achieved through the agreement of a national funding strategy that brings all the challenges of Australia's funding needs together in a considered, comprehensive and co-ordinated manner.

Products such as securitisation and covered bonds offer a very practical means of managing Australia's exposure to housing finance, particularly when bonds are placed offshore. These funding sources are particularly important for regional banks, and steps should be taken to ensure that these funding sources remain stable and resilient.

Suncorp recommends that there should be support for the development of a strong and liquid secondary RMBS market. Suncorp also recommends that the 8% limit on assets funded from covered bonds does not provide sufficient headroom to fund growth, or hold contingent funding capacity that could be used in times of market stress. The cap should be amended to allow banks to be able to issue up to 8% and still hold sufficient capacity for times of stress.

A regulatory environment which supports competition and is more coordinated across regulatory bodies

Suncorp believes that the Government and regulators need to take more account of the potential implications of regulatory change on competitive neutrality. This applies to both the design of regulation and the volume of regulatory change to which industry segments are subject.

Our Regulator mandates require refinement in terms of scope and breadth to ensure regulatory settings do not materially disadvantage some segments over others. The market design that best provides for stability, competition and choice for consumers should be the goal of regulatory policy.

Additionally, there needs to be a shared understanding of the financial sector's regulatory landscape, between regulators and relevant departments, to reduce overlaps and conflicts, improve effectiveness, reduce regulatory burden and improve sequencing of regulation and regulatory change. The industry needs appropriate, scalable regulation and there is a need for greater coordination among regulators. Considering this, the establishment of a Director-General of Regulation, as explored by the FSI, may provide a more suitable coordination body.

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Competition and contestability

Interim Report Policy Observation: Risk weights for mortgage lending

Competition (Interim Report Section 2-9)
"The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. 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."

Suncorp Response

The regulatory settings stemming from Basel II capital adequacy rules have created an entrenched disadvantage for regional and mutual banks and a significant cost advantage for major banks. As a regional bank, Suncorp Bank is required to hold up to three times the level of capital of the major banks against equivalent portfolios with the same underlying risk. This makes clear the competitive differential driven by the regulatory settings. It also highlights the barriers to entry in banking created by the onerous capital and regulatory environment for non-major banks.

The major banks are making strong and growing returns from the low-risk, middle Australia housing market by virtue of the regulatory settings in their favour. The advanced banks achieve significant Return on Equity (ROE) as a result of the application of advanced capital models to their lower risk LVR residential mortgage books.

Across mortgages with the same level of risk, the major banks can significantly discount interest rates and still achieve a ROE of 20%, as shown in the table below. By maintaining higher interest rates and booking the capital advantages of their favourable regulatory settings, they are making ROE of up to 35% plus.

To achieve a ROE of 20%, the standard variable interest rate charged by a major bank in the current regulatory environment could be 4.35% versus 4.95% for a non-major bank. There is a high premium to be paid for <u>not</u> being an advanced accredited institution.

Table 1: Interest rates to achieve a 20% ROE under the differing regulatory capital settings

20% ROE	Majors	Non-Major
Standard Variable Rate	4.35%	4.95%
3 year fixed	4.47%	5.07%
5 year fixed	5.02%	5.62%

The average risk-weighting ratios for the residential mortgage asset class for the four major Australian Banks is around 18% whereas these ratios are around 39% for Regional Banks (APRA, July 2014, p. 74). The difference in risk-weighting ratios translates to a pricing differential of around 32bps (after tax) to achieve a Return on Regulatory Capital (RoRC) of 12%. Regional Banks' RoRC reduces to less than 6% if they were to fully absorb the cost differential by offering the same market price as Advanced IRB (IRB) banks.

Suncorp is actively pursuing the requirements to attain the IRB approach. It is a complex and lengthy process.

The current risk-weight framework for residential mortgages has a range of unintended consequences. It provides greater incentive for banks on the advanced approach to lend to low risk mortgages holders relative to other types of lending, like Small and Medium Enterprises (SME). It also reduces genuine competition in the low-risk housing market and enables high margins to be earned by major banks. This further encourages major bank lending into this asset class at a time when property affordability and investment in housing has been flagged as a macro-prudential issue – and noted as a concern in the Interim Report.

One of the benefits of having large, diversified institutions with sufficient resources to build sophisticated risk-management capability is that they can more appropriately provide credit to SMEs and entrepreneurs. These borrowers are key to driving innovation and productivity for the economy.

The current method of determining risk-weighted assets gives the major banks the most incentive to invest in homogenous housing loans which, while an important product, has less benefit to long-term growth prospects or employment than SME/commercial lending.

Preferred Policy Option and Recommendation

It is vital that this competitive anomaly is addressed.

Suncorp Bank has a 'vanilla' book with no offshore business, no syndicated or complex lending and 80% of the business is mortgages. Additionally, much work has been done to improve the Bank's risk management capabilities under the program to achieve Advanced Accreditation.

Encouragingly, the report suggests that it *"may be possible to develop a tiered system of standardised risk weights that incorporates some components of IRB models. Such a system could potentially be more accurate than standardised risk weights, while less burdensome than IRB modelling".*

There are many variations to this model, but the basic feature is that capital should be more closely aligned to the level of risk under the standardised model.

Suncorp recommends the Panel give serious consideration to a 20% risk weight on housing lending up to and including 80% LVR across the industry.

Alternatively, Suncorp considers that the introduction of a new tier of risk-weights for the standardised approach which is more reflective of actual risk would go some way to addressing the competitive anomaly and would still promote appropriate incentives for risk management and capital allocation.

Under this approach, mortgages under with an LVR less than 80%, would attract a risk weight of 20%. Suncorp considers 20% to be at a level which is more closely aligned to where the advanced banks are currently estimating – but still higher than calculations under IRB models. Housing loans with LVRs of under 80% are lower risk and homogenous across the industry and do not require 'advanced' modelling.

Suncorp does not consider a change for loans above 80% LVR is required. At this higher-risk end of the market, it would be expected that capital holdings would remain lower for banks with more sophisticated risk management systems.

A reduction in capital for the 0-60% LVR and 60-80% LVR bands would align risk modelling capability to appropriate/comparable risk levels (standardised banks to less risky lending and IRB banks to SME/commercial).

This approach would achieve competitive neutrality in the residential lending market where loans are homogenous and risks equivalent. The settings would maintain an advantage for lenders with more sophisticated risk management systems and retain an incentive to achieve advanced accreditation.

Table 2: Mortgage risk-weights – Standardised approach with proposed new 20% tier

LVR (%)	Standard eligible mortgages		Non-standard eligible mortgages	
	Risk-weight (no mortgage insurance)	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI)	Risk-weight (no mortgage insurance)	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI)
	%	%	%	%
0 - 60	35 [20]*	35 (20)*	50	35
60.01 - 80	35 [20]*	35 (20)*	75	50
80.01 - 90	50	35	100	75
90.01 - 100	75	50	100	75
➢ 100.01	100	75	100	100

***proposed 20% tier**

The Interim Report notes that it may be possible for the Government or APRA to work with smaller ADIs to help them attain IRB accreditation. While clearer steps and tighter transition arrangements to achieve accreditation would be appreciated, there are concerns that this option, absent of expedient change to standardised risk weights, would prove protracted and that momentum would stall at the conclusion of the Inquiry. Suncorp would welcome a clear and stepped approach to advanced accreditation.

There are two key areas in which APRA could support regional banks to achieve IRB accreditation quicker, and help to enhance the risk management capability within the broader system.

The first is implementing a staged approach, to enable standardised banks to achieve accreditation progressively across their respective portfolios and operations.

Decoupling market, operational and credit risk models to support standardised banks achieve advanced accreditation would be a practical and sensible solution. This is not out of step with international precedent. Enabling advanced accreditation for credit risk on residential mortgage portfolios as an initial step – allowing regional banks to model risk and allocate capital accordingly on this portfolio only – would go a long way towards levelling the playing field in what is recognised as a more homogeneous, lower risk asset category. This approach is also not uncommon in other jurisdictions.

There is also merit in decoupling residential lending versus business lending – where there are already Australian advanced banks who use a mix of IRB and standardised approaches today.

The second area of support would be for APRA to establish a dedicated team to work with the regional banks to support them through the accreditation process, in a similar way that the major banks were supported during their accreditation. As part of this, it would be beneficial for major banks to provide data for regionals – via APRA – to support the move toward advanced. Market and operational risk data would be particularly beneficial for standardised banks as the larger banks have a much bigger data set to model. Suncorp has a number of risks we encounter relatively infrequently, so modelling to a high enough standard to achieve advanced accreditation is likely to continue to be challenging and time consuming for us.

The Interim Report proposes that it may be possible to increase the risk weights for IRB banks. This could involve setting a minimum risk weight for mortgages determined by IRB models, or indirectly determined by setting or increasing floors for key parameters in IRB models. Increasing the minimum risk weights for mortgages under IRB models could increase stability and competition, and incentivise more lending away from housing. If pursued, any increase in IRB minimum floors should be made in combination with a new tier of standardised risk weighting according to LVR bands – as covered above. Or preferably, a flat 20% risk weighting of assets across the industry on lending up to 80% LVR. Together these changes would reduce the competitive anomalies in the market and maintain risk-based pricing.

The Interim Report notes that a number of submissions proposed that APRA should lower standardised risk weights for mortgages. While this can be achieved in number of ways, the Report states that this would have several drawbacks, remarking that it could lower the incentive to improve risk management models and further incentivise non-IRB ADIs to undertake mortgage lending, rather than business or personal lending. The Report notes that this option could also increase risk, which could increase funding costs. There will also be counterarguments by those with greater market power that this move will be out of step with international precedent.

Suncorp considers that these fears are unfounded and misdirected. The major banks control 80% or more of the mortgage market, so if there are concerns around overheated mortgage lending, restricting the smallest players is neither fair nor appropriate to addressing the issue. Importantly, the system is regulated by very capable and powerful regulators who supervise systemic risks such as property exposure. There are many tools available to the regulators to control activity in the market.

Suncorp would consider it particularly inconsistent to see arguments against a new tier of 20% on the basis that this would be unaligned with international approaches, when those arguing this will also be strongly stating that we shouldn't be blindly follow international regulations without taking account of the unique features of the Australian market (in response to other Interim Report observations and options).

We should be flexible enough to clearly demonstrate the rationale for any deviations from the international framework that are appropriate for the Australian context. For example, the legal framework which supports lenders recourse over residential mortgages is much more favourable than most other countries. This should be taken into account when assessing regulatory requirements for the Australian residential mortgage market.

Similarly, maintaining the current risk weights under standardised for loans over 80% LVR and non-housing loans maintains an incentive to achieve A-IRB. This runs counter to arguments that dropping the standardised risk weights to 20% would run the risk of there being insufficient difference between advanced and standardised approaches, removing the incentive to invest in risk management improvements to achieve A-IRB.

The Report also suggests that a final option would be to allow smaller ADIs to adopt IRB models for residential mortgages only, rather than for all asset classes. This approach has merit but Suncorp's preferred option is to have a flat 20% for mortgages at or below 80% or to see a change to the standardised approach with the addition of a new risk weighting 'tier' of 20% for mortgages where the LVR is 80% or less. These are low risk, homogenous housing loans that do not require advanced modelling**.**

Interim Report Observation: SME lending

Competition (Interim Report section 2-17)

"During the GFC, the spreads between lending rates and the cash rate increased for all loans. However, spreads for SME and personal lending increased by more than spreads for mortgages and corporate loans, which largely increased in line with banks' funding costs. Terms of lending also tightened. This has generated concerns about the strength of competition in the SME and personal lending sectors."

Funding (Interim Report section 2-61)

"There are structural impediments for small and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation."

Suncorp Response

Small and Medium Enterprises (SMEs) are the engine room of the economy, yet the existing risk weighting rules under Basel II implicitly encourage banks to favour residential mortgage lending over business lending.

Since the introduction of Basel II and the GFC there has been a lending bias towards the household sector. While there are policies that encourage mortgage lending such as the first home owners grant scheme, Basel II may have contributed to the redirection of 'advanced' bank capital into the very high return/lower risk retail banking market for home lending and away from business lending.

Under Basel II, residential mortgages attract a lower capital charge under both standardised and advanced accreditation frameworks. This is logical given the higher risk associated with SME and commercial lending, but it does mean that banks can do on average three to four times more in residential mortgage lending relative to business lending in terms of capital management. Consequently, the proportion of major banks' mortgage lending has grown from about 60% to 83% between 2007 and 2013, at the expense of SME and commercial lending.

Preferred Policy Option and Recommendation

The Interim Report proposes to address the issues of information asymmetry - either by expanding Comprehensive Credit Reporting (CCR) by making it mandatory, adding new fields and/or extending it to SME lending.

These options have merit. CCR can assist with meeting responsible lending responsibilities and international experience shows CCR can help with financial literacy as consumers get to understand how their actions can impact of credit ratings.

However, we think the most significant improvements to SME lending across the economy could be achieved by addressing the risk weights for mortgage lending as covered in the previous section.

If CCR is pursued, long transition times are needed to minimise compliance costs.

Interim Report Policy Observation: Increased concentration and integration

Competition *(Interim Report section 2-21)*
"The major banks have increased concentration and integration in the banking sector through acquiring other banks and integrating with mortgage brokers. Mortgage brokers enable consumers to compare the value of different banking products better, including mortgages, personal loans and term deposits. The major banks have also integrated horizontally and vertically into other sectors of the financial system, including wealth management and insurance."

Consumer Outcomes (Interim Report section 3-72)
"The current framework does not require personal advice to be independent. It simply limits who can call themselves independent. Some submissions argue it can be difficult for consumers to know whether an adviser is aligned or independent, and that consumers may not fully appreciate the potential implications for the range of products they are offered. The United Kingdom has recently gone further than Australia in dealing with conflicts by labelling these advisers as 'restricted' rather than 'independent', although restricted advisers are subject to the same professional standards as their independent counterparts."

Suncorp Response

Integration in the banking sector is causing competition issues. Vertical integration is distorting the way in which mortgage brokers direct borrowers to lenders.

A key factor in the current and future competitive landscape is the concentration of ownership in the manufacturing and distribution of banking products. At question is the transparency of the ownership structures behind the products, mortgage broking networks and aggregator platforms and the incentive schemes driving sales. More than 47% of Australia's mortgage customers seek impartial advice on the best product for them from aggregator groups.

In the past six years the major banks have acquired regional bank brands and are increasingly taking control of the broker-originated home loan market through their acquisition of aggregator businesses. While there are plenty of brands in the market, the ownership of those brands is becomingly increasingly concentrated in the hands of a few. Customers must have a clear and transparent view of products promoted by these consolidated broker networks and aggregators.

Of great concern is the fact that customers view brokers as independent but the major banks have growing influence over these channels which they now predominantly own, and coupled with generous incentive schemes, are able to direct business to their products. For example, with some of the aggregator platforms, aggregator fees are being waived for brokers when they sell a product of the major bank which owns the aggregator site. These fees, or the absence of them, can quickly add up and at the very least influence behaviour.

Further, even if a broker is impartial as to the volume of loans directed to competing banks, the broker can reward their owner bank by directing a higher proportion of quality loans, i.e. those with LVRs less than 80%.

These models have implications for consumers seeking independent information on the best mortgage for them. Customers may be unaware that advice and commission structures are tied to specific providers and there is also little transparency about the product provider relationship in many cases

It should be recognised that consumers utilise mortgage brokers in order to receive personal, independent advice and as such, brokering advice should be clear and transparent as to incentive structures and product and adviser salesforce ownership.

Preferred Policy Option and Recommendation

Customers using mortgage brokers should have the following disclosures made available:

- The mortgage brokers' ownership structure;
- The range of issuers and products offered by the mortgage broker; and
- The proportion of loans brokered that go to their owners (if applicable) and basic risk information about the loans, such as average LVRs and serviceability standards (this disclosure would be aimed at identifying whether brokers are sending the best credit risk to their owners). Note – this would be an aggregator requirement, not an obligation on individual brokers.

Funding Australia's economic activity

Interim Report Policy Observation: Funding Credit Growth

Funding (Interim Report section 2-79)

".. the Inquiry acknowledges that the composition and stability of the funding for ADIs are important. A more stable funding composition enhances the ability of ADIs to fund long-term loans. The Inquiry recognises the need for some adjustments, particularly to tax, to ensure a more efficient allocation of funding in the economy."

Suncorp Response

Suncorp Bank relies on credit and capital markets – both domestic and offshore – to fund the business and as a source of liquidity. In recent years, global credit and capital markets have experienced significant volatility, with such markets demonstrating periods of reduced liquidity, widened credit spreads and decreased price transparency. Disruptions, uncertainty or volatility in domestic or global financial markets increases funding costs, limits access to funding and reduces financial flexibility.

Domestically, as with the other banks, Suncorp Bank has responded to the volatility with a marked shift towards higher deposit funding and lowering risk through the runoff of a portfolio of corporate and property loans and Suncorp Bank's exit from these markets.

While Suncorp Bank has taken steps to strengthen its funding position, if current sources of funding prove to be insufficient, banks including Suncorp, may be forced to seek alternative financing and/or reduce their level of lending. For example, a significant change to consumer saving patterns, a taxation policy change on superannuation and/or a dramatic increase in credit flows would require a change in funding needs. These are real, potential risks.

Preferred Policy Option and Recommendation

Experience through the GFC has proven the value of diverse and stable funding sources. It is imperative, particularly for stability, efficiency and competition that banks have access to as wide a funding base as possible, by both product and jurisdiction.

Australia needs a robust, diverse and good quality range of funding sources that are able to carry the industry through any kind of stress. Having important players dip in and out of the market does not enhance long-term confidence in the system as a whole.

Suncorp agrees with industry representations[1] that what is missing in the Interim Report is a holistic approach to the funding needs of the economy that fully supports economic growth. The Australian Bankers' Association, of which Suncorp Bank is a member, proposes that this would be best achieved through the agreement of a national funding strategy that brings all the challenges of Australia's funding needs together in a considered, comprehensive and co-ordinated manner.

Products such as securitisation and covered bonds offer a very practical means of managing Australia's exposure to housing finance, particularly when bonds are placed offshore. These funding sources are particularly important for regional banks, and steps should be taken to ensure that these funding sources remain stable and resilient.

In Suncorp Bank's earlier submission to the Inquiry, we recommended that there should be support for the development of a strong and liquid secondary RMBS market.

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[1] ABA FSI Submission, March 2014, http://www.bankers.asn.au/FSI/ABA-submissions

Suncorp also argued that the 8% limit on assets funded from covered bonds does not provide sufficient headroom to fund growth and that a change was needed to allow banks to reach the 8% either through an increased overall cap, or flexibility to buffer the 8% cap. In Suncorp's case, this would allow an increase of $2 billion in covered bond issuance which would materially enhance the Bank's ability to lift mortgage competition.

It was noted in the earlier submission that another possibility to consider would be for the regulator to impose a cap on total covered bond and securitisation issuance in the vicinity of 20% to 25%.

Suncorp Bank stands by those recommendations, and would appreciate consideration for these changes.

Stability and the prudential framework

Interim Report Policy Observation: Too Big to Fail and moral hazard

Stability (Interim report section 3-9)
"During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support."

Suncorp Response

The existence of Too Big to Fail (TBTF) banks raises a number of public policy concerns.

Firstly, with an implicit government subsidy, there is the potential for the beneficiaries of that subsidy to grow larger than what is optimal. In banking, with assets being loans, the subsidy may have the effect of increasing the amount of credit in the economy to an inappropriate level, or a sub-optimal level in a particular sector, such as housing.

A second concern is the moral hazard effect; being the increase in risk taking due to the fact that the costs of lending risks will, in part, be covered by taxpayers, whereas the benefits of risk will return to the bank's stakeholders, primarily shareholders and staff. Australia is recognised as having a financial system that is large by international standards.

TBTF also affords the major banks credit rating and funding advantage. There are two components to the funding cost advantages. The first is fair, which is the 'normal' difference between big and small found in most industries. The second is not fair, which is the implicit benefit of TBTF.

The objective should be to find the policy option (or options), that will best address the funding costs gap between major and non-major banks while maintaining system stability and consumer and investor confidence. Ensuring access to markets is fundamental. Conceptually, this can be achieved either by (i) increasing the funding costs of TBTF banks, (ii) decreasing the funding costs of smaller banks, or (iii) a combination of both.

The Interim Report considers a range of options including heightened regulator powers, stronger pre-planning and pre-positioning testing, and ring fencing, however, these will not address the funding anomaly (at least not directly).

Accordingly, three general policy areas have been identified as potentially capable of closing the funding cost gap between major banks and regional banks. These are:

- *'Bail in' models.*
- *Higher capital models*
- *The capacity for smaller banks to pay for a government guarantee*

Bail in
In Australia we have traditionally had a robust system in the face of crises. This is particularly relevant given the large size of the financial system relative to GDP, and the enormity of banking assets concentrated on the four major banks' balance sheets.

A 'bail in' scheme targeted at the domestically significant banks (D-SIBs) has merit but will face challenges in terms of design and implementation. Many argue that unsettling bondholders is bad for the system. This may be the case. Unfortunately, despite moves in Europe and Canada to 'bail-in' and support from the G20, there is currently a lack of modelling on 'bail-in' mechanisms to refer to.

Our preliminary view is that for a 'bail-in' mechanism to solve for the TBTF risk to the taxpayer, address the competitive funding anomaly, and not inflict higher risk across the system, it would need to:

- Clearly define the terms of when it is applied, to who it is applicable to and to what products and instruments it can be applied to;
- Be designed to ensure non-TBTF institutions do not bear higher costs as a consequence. TBTF is an existing market failure and it must be addressed directly where it is occurring;
- Recognise that Australia relies on off-shore funding markets, and that investors must have confidence. Following the GFC, Australia was one of the first jurisdictions to regain access to global funding markets. Any bail-in regime must ensure that this confidence is not put at risk;
- Be designed as an optional mechanism for authorities to resolve failed banks, in addition to current liquidation or bail out options and not be automatic. Essentially, 'bail in' would be an intermediate option between liquidation and public recapitalisation, where the entity continues to trade as a "gone concern" and is wound up in an orderly fashion;
- Be applied to company specific failures rather than systemic collapse. Investors would need to know that the government stands behind the banking system it regulates, particularly in event of a crisis; and
- Emphasise the benefits to system stability in terms of reducing contagion to the rest of the banking system, government and real economy.

It is clear that more work is needed on the merits and detail of the range of 'bail-in' mechanisms.

Higher Capital models

There appears sufficient international precedent to conclude that APRA's 1% Higher Loss Absorbency (HLA) for D-SIBs is on the light side of international experience and IMF estimates, especially given D-SIBs have been allowed to offset the HLA with a lower capital buffer.

A substantive increase in the HLA as a solution to TBTF seems a credible option. An increase in the HLA would impact D-SIBs' return on equity and help to even the competitive landscape – especially for home lending.

Introduce a graduated fee schedule for larger Committed Liquidity Facilities (CLFs)

As part of the implementation of the Basel III liquidity framework, the RBA will offer ~$300 billion[2] of Committed Liquidity Facilities (CLF) to Australian ADIs from 1 January 2015. The CLFs will be used to satisfy the individual banks' Liquidity Coverage Ratio (LCR) in lieu of holding government securities or cash. Notionally, this is due to the lack of sufficient Commonwealth Government Securities (CGS) on issue in Australia to cover D-SIBs' LCR requirements.

In practice, this could lead to an automatic bail out of failing institutions that are automatically permitted to pledge assets of lower quality than CGS, such as RMBS, to the RBA for cash. In the event of a bank failure, the RBA could be left holding these lower quality assets, while being owed a larger face value by the failing bank, creating a potentially large contingent liability for the Australian Government. An example of a situation when this could eventuate is in a US-style housing crash.

Under the CLF arrangements, Australian banks are automatically allowed to pledge RMBS to the RBA, even while the market value of the underlying securities are falling, as would be the case if default rates on mortgages increased significantly. As such, the CLF is supporting the TBTF Institutions that rely on the facility, who in its absence would need to raise funding in the market by selling high quality liquid assets.

Suncorp believes that this could be remedied by introducing a graduating CLF fee that charges a higher rate for larger CLF facilities. This could reduce TBTF risk by providing an incentive for large institutions to stand on their own two feet in a liquidity crunch and provide some competitive neutrality to bank funding markets to compensate for the TBTF subsidy currently received by Australian D-SIBs.

[2] Debelle, G. (2013), The impact of Payment System and Prudential Reforms on the RBA's Provision of Liquidity, Sydney, 16 August 2013

The capacity for smaller banks to pay for a government guarantee
Government support should be considered to reduce funding costs for smaller ADIs and non-bank lenders include: introducing a new RMBS purchase program, or purchasing housing loans from small lenders and issuing RMBS; or establishing a joint public–private sector body to undertake this function along the lines of the Canadian approach or Fannie Mae and Freddie Mac in the United States. Suncorp would support moves to develop a strong and liquid secondary RMBS market as this is a particularly important source of funding for smaller ADIs.

Additional option
Another option that merits consideration is the introduction of Non-Operating Holding Company (NOHC) structures across TBTF institutions to provide a useful vehicle for banks to limit contagion. A NOHC can be used to individually capitalise a retail banking business apart from other businesses such as wealth management and insurance. The structure provides fungibility of capital across the group, while requiring individual operating companies to fund themselves. It also removes the incentive to use the TBTF subsidy to finance non-retail banking businesses.

Preferred Policy Option and Recommendation

'Bail in' powers could be included in the suite of tools available to regulators as part of resolution powers, however far more work analysis and modelling is required.

In theory, the presence of an alternative resolution mechanism should result in a stronger, more resilient system that provides much needed certainty in the event of a name specific crisis at a D-SIB. This would reduce the penalty currently in place in the bond markets between systemically important institutions and others, but should not increase the overall cost of debt funding across the system.

Suncorp Bank recommends further consideration of methods to address TBTF. Whatever the solution, the objective should be to address the funding costs gap between major and non-major banks while maintaining system stability and consumer and investor confidence.

Regulatory Architecture

Interim Report Policy Observation: Competitive Neutrality

Regulatory Architecture (Interim Report section 3-99)
"Regulators' mandates and powers are generally well defined and clear, though they could place more emphasis on competition matters."

Suncorp Response

Overall, Australia's financial services industry managed well through the GFC, with the support and oversight of the regulatory framework. However, in the past few years the roles, powers and jurisdictions of the various Australian regulators have become increasingly blurred and the burden of regulation has grown substantially. With so many regulators taking an interest in the banking industry, and a more activist approach being taken by policymakers on financial and regulatory issues, there has been substantial and costly regulatory change in recent years.

The resulting pace, volume and layers of reform have created complexity and duplication. There is a dire need for a robust framework through which regulators can share information, coordinate requests and better understand the impacts of regulation on banks, their customers and the economy.

Regulation has the consequence of placing a higher burden of compliance and increased relative costs on the smaller market participants. Smaller banking institutions typically have lower risk, more vanilla businesses and products yet they are subject to regulatory regimes similar to that of complex international financial institutions.

As noted in the Interim Report (3-96), although large institutions have faced the biggest absolute costs, their smaller competitors may face a higher relative burden, particularly where change imposes fixed implementation costs. Larger firms may also have more capacity to influence the direction of regulatory change.

The report also states that "*smaller firms do not generally want to be subject to different regulatory frameworks than their larger competitors if they consider this will change customer preferences or their access to funding. For this reason, concessional licensing regimes or frameworks can be problematic*" (3-96).

Preferred Policy Option and Recommendation

Suncorp believes that the Government and regulators need to take more account of the potential implications of regulatory change on competitive neutrality. This applies to both the design of regulation and the volume of regulatory change to which industry segments are subject. While Suncorp doesn't believe concessional licensing regimes are desirable, our Regulator mandates require refinement to ensure regulatory settings do not materially disadvantage some segments over others. The market design that best provides for stability, competition and choice for consumers should be the goal of regulatory policy.

While banks see competition as a key principle to balance against other considerations, the Regulators prioritise other factors. For example, APRA places greater emphasis on minimising risk and promoting stability, versus promoting competition and efficiency. Similarly, ASIC prioritises consumer protection, at the expense of innovation and efficiency. Australia needs a regulatory environment more conducive to competition and efficiency. Currently the regulatory framework has a disproportionately high impact on smaller institutions which struggle to deal with the cost and administrative burden.

Additionally, there needs to be a shared understanding of the financial sector's regulatory landscape, between regulators and relevant departments, to reduce overlaps and conflicts, improve effectiveness, reduce regulatory burden and improve sequencing of regulation and regulatory change. The industry needs appropriate, scalable regulation and there is a need for greater coordination among regulators.

Considering this, the establishment of a Director-General of Regulation, as explored by the FSI (and suggested by Uhrig[3]), may provide a more suitable coordination body. An independent body appointed to oversee our Regulators could be an option. Certainly, stronger mechanisms and incentives for sharing information would beneficial – for example, a clearing house and shared resource for regulators to avoid duplication and double handling would be beneficial.

Suncorp Bank commends the Government on their recent 'Statements of Expectations' to our Regulators and strongly supports the Government's focus on reducing the regulatory burden on business and the community.

[3] Uhrig J, 2003, Review of Corporate Governance of Statutory Authorities & Office Holders