ADDITIONAL RESEARCH, TABLES AND REFERENCES

FINANCIAL SYSTEM INQUIRY 2014

Response to the Financial Services Inquiry Interim Report

2nd September 2014

The references, table and additional commentary contained herein support the information contained in Financial Institutions and Markets Advisory's (FIMA) submission to the Financial Services Inquiry titled "Response to the Financial Services Inquiry Interim Report" and dated 26 August 2014. It should be read in conjunction with that document.

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Introduction

Financial Institutions and Markets Advisory (***FIMA***) submitted its formal response to the Interim Report on July 26, inclusive pf principles and recommendations. Owing to time limitations, specific references for works utilised or cited in that paper were not included. These are now covered below.

We understand the Inquiry is open to follow-up submissions incorporating additional research, tables and references, which we have also detailed below.

A) Overview

The FIMA stance is that the represented robustness of the Australian Regulatory regime prior to the onset of the GFC is overstated. The Big 4 banks' benign credit risk profiles, a consequence of excess returns from a cartel focus on domestic markets, were the main bank related factor; with capital and funding and liquidity profiles less robust than peers , such as the Canadian banks, and the amount of subsequent catch up a confirmation.

References

BIS – "Options for Liquidity assurance" – 27 9 2010

Vox- "Why foreign exchange transactions did not freeze up during the financial crisis – the role of the CLS Bank" – 10 7 2009 – Richard Levich - NYU

Kevin Davis and Christine Brown – "Australia's Experience in the Global Financial Crisis" -2009

Wharton University – Insights from Six Financial Regulatory Committees from around the world – 2011

Tables

Refer Table 1 of BIS – "Options for Liquidity assurance" – 27 9 2010

B) **Unambitious and Evolutionary**

The FIMA stance is that the Inquiry Interim Report, within an initiative that is exercised every 10-15 years, is not forward-looking, ambitious and revolutionary, effectively diluting its strategic relevance and focus.

References

Wiley – "Virtual Banking – A guide to Innovation and Partnering"– Dan Schatt

Accenture – "Future of Banking"– 13 8 2014

Finextra – FCA presentation to Bloomberg Conference, London- May 2014

BBA - Digital Banking initiative - May 2014

ABA – Digital Banking Summit – 2-4 6 2014

C) Policy Themes and Interim Conclusions

Concentrated, albeit competitive

The FIMA stance is that the banking services market, due to the Big 4 banks' oligopoly position, is not competitive, with external barriers to entry currently in place to preclude a counter e.g. offshore banks. We find the initial public policy stakeholders' position, that competitive equilibrium is alive and well, ingenuous; and unsupported on many levels.

The Australian manufacturing sector is feeling the full force of an overvalued A$, high labour costs and a poor productivity record, with tariffs limited effectively to the automotive and wine sectors; the financial services sector has impenetrable barriers to entry, resulting in excessive remuneration packages compared to offshore service providers, with Australia's circa 16-18m customers having an impost in excess of c $2,500 pre tax profit pa for Big 4 bank customers alone in their pursuit of 14-18% post tax ROE returns .

International comparisons of efficiencies across banks are notoriously difficult. However, any assessment of the Big 4 banks' cost metrics has to factor in the 2-4 % excess ROE that boosts the revenue denominator, a negligible default and provisioning history, balance sheet leverage that a 60% + secured residential mortgage portfolio enables, a low if concentrated risk profile and an almost wholly domestic focus.

Although not specifically referenced in the earlier submission, and potentially difficult to legislate and enforce, banking practice for customers is to follow a front book/ back book customer strategy, where they offer discount deals to new customers only via mortgage brokers to maintain volumes, while retaining profitable margins on back book customers who are excluded from such offers. This is an aberration of risk based pricing that is not followed in other financial services sectors ; a public policy stance that all offers must be open to customers , regardless of existing or new, if accompanied by enhanced mobility of banking relationships , would also assist switching and constrain mortgage broking practices, although it might be an intrusion too far.

References

IOD London – "On being the right size" – A Haldane, B of E, 25 10 2012

BIS – Working Papers 331 – "Central Banks and Competition Authorities – Institutional Comparisons and New Concerns" – John Vickers – November 2010

BBA – "Competition, the pressure for returns and stability " Paul Tucker -17 10 2012

Tables

Country[2]	Pre-tax profits			Net interest margin			Loan loss provisions			Operating costs[3]		
	2000–07	2008–12	2013	2000–07	2008–12	2013	2000–07	2008–12	2013	2000–07	2008–12	2013
Australia (4)	1.58	1.09	1.28	1.96	1.81	1.79	0.19	0.30	0.17	1.99	1.20	1.11
Canada (6)	1.03	0.85	1.06	1.74	1.58	1.65	0.24	0.25	0.17	2.73	1.85	1.78
France (4)	0.66	0.27	0.32	0.81	0.95	0.92	0.13	0.24	0.21	1.60	1.09	1.16
Germany (4)	0.26	0.06	0.10	0.68	0.81	0.99	0.18	0.16	0.18	1.38	1.15	1.55
Italy (3)	0.83	–0.04	–1.22	1.69	1.82	1.58	0.40	0.67	1.43	2.27	1.79	1.84
Japan (5)	0.21	0.40	0.68	1.03	0.89	0.77	0.56	0.19	0.02	0.99[4]	0.73[4]	0.60[4]
Spain (3)	1.29	0.77	0.50	2.04	2.32	2.32	0.37	0.94	0.96	2.29	1.61	1.75
Sweden (4)	0.92	0.58	0.77	1.25	0.93	0.98	0.05	0.16	0.08	1.34	0.87	0.84
Switzerland (3)	0.52	–0.03	0.36	0.64	0.54	0.61	0.05	0.05	0.01	2.39	1.86	1.90
United Kingdom (6)	1.09	0.19	0.23	1.75	1.12	1.12	0.31	0.54	0.36	2.02	1.27	1.55
United States (9)	1.74	0.53	1.24	2.71	2.49	2.32	0.45	1.06	0.21	3.58	3.01	3.03
Brazil (3)	2.23	1.58	1.62	6.56	4.71	3.55	1.24	1.43	1.07	6.21	3.69	3.28
China (4)[5]	1.62	1.61	1.86	2.74	2.34	2.38	0.31	0.29	0.25	1.12	1.02	1.01
India (3)[6]	1.26	1.37	1.41	2.67	2.46	2.82	0.88	0.50	0.57	2.48	2.47	2.36
Russia (3)	3.03	1.64	2.04	4.86	4.56	4.15	0.87	1.59	0.80	4.95	2.73	2.68

[1] Values for multi-year periods are simple averages. [2] In parentheses, number of banks included in 2013. [3] Personnel and other operating costs. [4] Excludes personnel costs. [5] Data start in 2007. [6] Data start in 2002.

Sources: Bankscope; BIS calculations.

Too big to fail

FIMA views the Resolution and Recovery framework and the accompanying options as solely "mechanisms" that are only to be assessed and progressed, compared to subscription to key public policy principles, which deliver compelling outcomes and benefits. Any subscription in Australia not in accord with these principles would impair the targeted outcomes and benefits and would have to be evidenced as justified on an exception basis only

The current public policy stance is tentative and largely undisclosed; an assessment that "bail –in" remains to be proved and "ring fencing " is overkill represents an element of disclosure, but is not tenable in the context of the targeted principles and outcomes - i.e. is implicit government support to remain in place, causing competitive disequilibrium, and leaving the taxpayers presenting a 'free lunch' to bank management and shareholders?

The level of engagement and debate needs to be elevated to a level of "principles, outcomes and benefits", with transparent, informed, disclosure and engagement

In terms of the specific mechanisms, "bail-in" sends an unequivocal message to stakeholders as to non- recourse to government support, and, therefore, its non-adoption has to be evidenced in that context - i.e. will it send a message to the financial markets of indecision and uncertainty. "Ring fencing" merits further research, as the Australian financial system is "closed", banks' trading activity is limited and the reach is overwhelmingly Trans- Tasman

References

BIS Stability Report – April 2014 – "How big is the implicit subsidy for banks considered too big to fail"

FSB – "Overview of progress in the implementation of the G20 Recommendations for strengthening Financial Stability "- 19 6 2012

BCBS – "Core Principles for Effective Banking Supervision" - 2012

Moodys – "Bank Systemic Report Global Update " - - July 2014

B of E – Andrew Gracie – 17 7 2014-09-02

RBA – Glenn Stevens – Speech - 10 6 2014

Capital allocation and outcomes

FIMA understands that the Inquiry remit is to assess and conclude on the eligibility of the determinants of the capital base, adequacy of capital levels, the efficiency within which capital is allocated and the congruence of risk and capital settings across the system. Within that remit, and the leveraged concentration of residential mortgages on banks' balance sheets, it would legitimately undertake a "bottom up "assessment of capital settings across the banks' customer and product bases, specifically the financing of the residential property market.

As FIMA supports a systemic approach to capital adequacy, it will not comment on the specific credentials of RWAS and regulatory models, although it has completed extensive research in this area for other FSI responses, is a party to the severe inconsistencies and unintended consequences, and looks to play a role in progressing future initiatives in this area.

FIMA does support, with the assistance of the Big 4 banks and AORA, a commitment to elevate the risk governance, compliance and oversight systems of the banks outside the Big 4, to the benefit of systemic stability and competitive equilibrium.

Efficiency of the Superfund sector

FIMA's contention is that the Government, as underwriter to the system via the provision of State pensions, has been a bystander as the system through its adulthood, retains a series of intrinsic design flaws. We have restricted our comments in this area - i.e. entitlement rights are absent the requisite responsibilities and duties of care; the fund management sector is fragmented, unsophisticated and expensive to maintain; the complexity and proliferation of conflicted intermediaries exacerbates investment in property; and the regulatory regime may be constraining future super returns in the absence of a coherent public policy support stance.

References

Ontario Teachers' Pension Fund Annual Report 2013

Banking as a community and social service

Although the Inquiry incorporated a section on the consumer and customers, it is the FIMA stance that a major current theme, the continuing disenfranchising of the Australian customer base from recourse to banking services, remains substantively unaddressed. This is primarily a result of the unintended consequences of a wave of consumer credit legislation.

If this remains the case - i.e. legislation which is not fully thought through and free markets remain unfettered - the social and community impact may take access to Australian financial services back to a previous generation.

References

FINSIA Journal of Applied Finance– Issue 3, 2013 – "Consumer Lending – Implications of new comprehensive credit reporting" – S Johnson, FIMA

ME Bank Survey– "The financial psychology of Australian households" –Sixth Survey June 2014 – J Oughton, FIMA

Financial Institutions & Management Advisory

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