Submission to the Financial System Inquiry

From Hydrargyros Pty Ltd

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This submission provides further detail in support of the remarks made by Mark Sheppard at the Academic Roundtable with Financial System Inquiry held at the Australian Centre for Financial Studies on 6th August 2014.

Contact: Mark Sheppard | mark.sheppard@hydragyros.com | +61 413 947 964

Hydrargyros Pty limited has an interest in a tradeable bank deposit product, but this is not applicable to Australia.

The submission follows the requests for comments within the FSI Interim Report July 2014.

Stability and the prudential framework

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Observation

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.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Increase the ability to impose losses on creditors of a financial institution in the event of its failure.
- Strengthen regulators' resolution powers for financial institutions, and invest more in pre-planning and pre-positioning for financial failure.
- Further increase capital requirements on the financial institutions considered to be systemically important domestically.
- Ring-fence critical bank functions, such as retail activities.

The Problem

It is a rational objective to minimise the risk to the Government and the moral hazard effects of the implied guarantee created by the perception that the major banks are Too Big To Fail (***TBTF***).

Improving the capital of the banks clearly reduces the risk of bank failure and the eventual loss post a failure however, a bank's capital resources are only "one leg of the financial strength stool". For the risk of failure and the requirement for the de facto support from the Government to be actually minimised, the other legs, general supervision (e.g. Pillar 2 and 3 measures), and the stability of the well over ninety percent of the funding of banks that is provided by deposits and other debt also need to be in good condition.

In the case of the Australian banks, the general supervision from APRA is widely regarded as very effective and the capital position is at least average.

Capital is an ideal buffer for credit losses owing to the loss absorbing properties of instruments like ordinary shares and hybrid capital. A major cause of bank failures is however, bank runs, which may be triggered by credit losses, but the effects of these extend far beyond those initial credit losses. To prevent these, a stable funding base is required, which cannot easily run-off when a bank or the banking system is perceived, whether actually or not, to be in trouble. This stable funding could consist of a very large amount of additional capital, which would be very difficult and expensive, or more practically, a more stable debt funding base.

Regarding the stability of debt-funding, Australian banks have implemented the Liquidity Coverage Ratio (***LCR***) earlier and more completely than other jurisdictions. This ratio is however only concerned with funding stability for 30 days and it gives little indication of the stability of funding over a longer period. Information to enable the stability of the debt funding of banks over a longer period to be determined is not readily available, as it cannot be determined from public financial reports. The indications that are available for the Australian major banks are however much less positive than for the other abovementioned legs. Indications of this weakness are as follows:

- The credit rating reports of the major Australian banks by the major agencies have noted, for many years, the relatively heavy reliance of the major Australian Banks on short term wholesale funding from offshore capital markets. Despite recent reductions in this reliance (FSI Interim report Chart 3.7, somewhat less than 30% pre-crisis, now somewhat less than 20%), this is still given as the reason for not rating them more highly than they would have been without this vulnerability.
- The primary Basel III regulation to be implemented in 2018 to ensure longer stable funding is the Net Stable Funding Ratio (***NSFR***). In June 2014, the IMF produced a report http://www.imf.org/external/pubs/ft/wp/2014/wp14106.pdf on the current status of the top 100 banks globally against this metric. In this report, the Australian banks rate, along with those of France Italy, Greece, Russia and Sweden as failing to meet the standard. On average, banks in all the other major economies; the US, UK, Germany, Canada and in all the major Asian economies are reported to currently meet this standard. In particular, of the Australian majors, only Westpac currently meets the standard. It is important to note that this report, being based only on publicly available data, which does not include sufficient breakdown of the term and sources of funding, has been subject to criticism as inaccurate. The criticism is however that the report is generally overly positive.
- Early in the financial crisis the Australian Government instituted a guarantee of the Australian bank capital market issues in offshore markets "in order to prevent any possibility of a run" (Wayne Swan 19 August 2014 http://www.abc.net.au/radionational/programs/breakfast/the-good-fight-swans-years-as-treasurer/5680192). This shows that when stressed, this particular vulnerability of the banks was important enough that the implied TBTF guarantee needed to be immediately made explicit.

The FSI report states that satisfaction of NSFR may be achieved by way of the RBA's Committed Liquidity Facility (***CLF***) under APS 210. , Depending on the final form of the NSFR (it is yet to be finalised), this is possible, but only by a convoluted route. Banks would need to:

- Securitise substantial amounts of their assets (principally mortgages)
- Sell these securitised assets to other banks
- Buy other bank's securitised assets (self-securitised assets are not eligible, under APS 210)

This is already underway in order for banks to have sufficient assets to apply to the CLF to meet the LCR standard.

Under APS 210, securitised assets from other banks held against the CLF then attract only a 10% Required Stable Funding (***RSF***) weighting instead of the 65% required for mortgages thereby improving that bank's NSFR.

The implication of this however, from a stable funding perspective, is that, in the event of a run, the affected bank(s), the banks will repo these assets to the RBA under the CLF. This is an unconditional pre-committed form of the traditional lender of last resort facility normally provided by central banks and actually makes the implied TBTF guarantee quite explicit. In this circumstance the RBA also assumes the credit risk of the repoed assets and would need to raise very large amounts of funding very quickly – most likely offshore. This would almost certainly be at time of market stress and therefore very costly and very dependent on the view of Australia's credit standing then prevailing.

This mechanism does not provide an increase in a source of funded stable debt to eliminate liquidity risk as envisaged by the BIS when the Basel III was instituted. It merely transfers the liquidity risk from the banks directly to the RBA, which it may, or may not, be able to bear at that time. This is also provided for the very low facility fee of only 15BP p.a. whereas the market premium for bank term issuance is around 80-100 BP p.a.

APRA has done some stress testing of banks but unlike the US or UK, has not instituted a regular program of these.

Comparative Actions by Some Other Regulators

US

The US has instituted regular and systematic stress testing of its major banks. There have been regular statements from the Federal Reserve (including in speeches by Janet Yellen and Daniel Tarullo) that they intend to impose further limitations on the major banks reliance on short-term wholesale funding see http://www.federalreserve.gov/newsevents/speech/yellen20140415a.htm.

A very good summary of their position was published a few days ago:

http://www.ny.frb.org/newsevents/speeches/2014/dud140813.html. This view and these planned responses are supported by a very influential group of economists including Douglas Diamond, Philip Dybvig, HS Shin (soon be a chief economist at the BIS), Markus Brunnermeier, and more radically, John Cochrane and Anat Admati.

This is well summarised here:

http://www.chicagobooth.edu/capideas/video/2013/summer_are-we-prepared?cat=business&src=Video

It would seem from the Federal Reserve announcements that they are considering implementing stronger measures than the Basel III NSFR to limit the use of short term wholesale funding especially by large systemically important banks to improve their debt funding stability. They have also expressed frustration with the slow progress of international measures generally and may institute their own measures earlier.

UK

Despite the very slow introduction of measures in this area by the EU banking regulators (possibly in recognition of the inability of many of their banks to be able to meet them) the Bank of England PRA has instituted a regime of stress testing which has in practical terms managed the stability of the funding of their banks. This is good summary of their views:

http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130302.pdf

Canada

Despite the strength of the Canadian banking sector, which most closely resembles Australia's, except in its very low reliance on wholesale funding having a much larger deposit base, the Canadian Office of the Superintendent of Financial Institutions (***OSFI***) has instituted its own regulatory framework for ensuring funding stability, the Net Cumulative Cash flow (***NCCF***). This is in addition to Basel III NSFR and is already entering implementation. Being cashflow rather than balance sheet based, this standard has been described by some experts as being a very rigorous and effective standard that is likely to be replicated by other jurisdictions.

Recommendation

That along with the review of any additional capital that may be considered appropriate for the major Australian banks to hold in order to reduce the risk borne by the Government though the implied TBTF guarantee, that APRA consider early implementation of standards such as the Canadian NCCF.

This will strongly incentivise the Australian banks to also improve the stability of their debt funding either by the issuance of more long-term capital market issues or by raising more stable retail deposits. While this would reduce their profitability somewhat, it would also ensure earlier satisfaction of the Basel III NSFR standard (required anyway by 2018), improve the banks' likely credit ratings and general market perception leading to lower costs of funds.

Stability and the prudential framework

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Observation

Australia has implemented some aspects of global prudential frameworks earlier than a number of jurisdictions. It has also used national discretion in defining capital ratios. When combined with other aspects of the prudential framework and calculated on a consistent basis, Australian banks' capital ratios (common equity tier 1) are around the middle of the range relative to other countries. However, differences such as those in definitions of capital do limit international comparability.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Maintain the current calibration of Australia's prudential framework.
- Calibrate Australia's prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative.
- Develop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.
- Adopt an approach to calculating prudential ratios with a minimum of national discretion and calibrate system safety through the setting of headline requirements.

There is More to a Bank's Financial Strength than its Capital Ratio

There are clear advantages for the Australian banking system, especially as Australia is a capital importing economy, to be seen as conservatively managed with very strong regulation. As has pointed by APRA on numerous occasions, the prima facie cost of this is heavily mitigated by the consequent improved market perception and lower market funding costs.

As explained in the above submission on the TBTF guarantee, achievement of this conservative stance requires that all of "the legs of the financial strength stool" to be strong, not just capital. At present and for many years past the most vulnerable leg for the major Australian banks is the stability of their deposit and other debt funding given their relatively heavy reliance on short-term wholesale debt issuance in offshore capital markets.

Recommendation

Ensure that Australian bank regulation is conservative in all important respects i.e. general supervision, capital and the stability of the sources of debt funding. The collection of the required information to assess the stability of funding is a challenge, given it does not appear in public financial reporting however it is available to APRA and probably also to the credit rating agencies to some extent. Given the importance of this financial metric to the health of the particular bank there is also a good argument that this information, in some summary form, should be included in financial reporting.

Regulatory architecture

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Observation -

Australia generally has strong, well-regarded regulators, but some areas of possible improvement have been identified to increase independence and accountability.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Move Australian Securities and Investments Commission (ASIC) and Australian Prudential Regulatory Authority (APRA) to a more autonomous budget and funding process.
- Conduct periodic, legislated independent reviews of the performance and capability of regulators.
- Clarify the metrics for assessing regulatory performance.
- Enhance the role of Statements of Expectations and Statements of Intent.
- Replace the efficiency dividend with tailored budget accountability mechanisms.
- Improve the oversight processes of regulators.

Examples of Incompatibility Between the Different Objectives of the Regulators

ASIC's focus is very much on investor/consumer protection. While laudable, this can be taken to disproportionate level when the requirements of financial system stability are not also considered.

Under the Australian Corporations Law, bank deposits which can be sold by tellers without special training are called Basic Deposits. A requirement of Basic Deposits is that they must be redeemable for their full Australian dollar capital value at will (interest may be deducted). For term deposits, this requirement is contrary to finance theory, uncommercial and well out of line with the other markets. It also significantly undermines the stability of bank funding. APRA have made representations for this to be changed for a considerable time but ASIC has so far resisted this. It is not unreasonable for term depositors to be charged, or be paid, the proper economic break cost, if they change their mind and decide to redeem early.

Another example of a laudable measure, which is good for customers, but which may undermine bank funding stability is the bank account mobility "tick and flick" legislation. Basel III recognises retail deposits as 'sticky" largely because of the well-known reluctance of depositors to change banks for transaction accounts due to the time and effort required to set up new accounts and automatic payments. Once well established these tick and flick rules may well reduce this "stickiness" when tested again in future, which may lead to lower weightings for retail and operational deposits.

Recommendation

Include banking system stability in the list of considerations when weighing the costs and benefits of legislation and regulations managed by ASIC, as bank runs are very unfavourable, even from a strictly consumer protection viewpoint.

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Residential mortgage-backed securities

Some submissions argue that the Government should support the RMBS market to reduce funding costs for smaller ADIs and non-bank lenders, and to promote competition. The options include:

- Introducing a new RMBS purchase program, which could potentially focus on purchasing lower-rated tranches
- 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

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements
- Provide direct Government support to the RMBS market
- Allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio

RMBS are Already Very Well Treated

RMBS are already in effect treated as HQLA with the RBS's support. This is done, by a circuitous route, where RMBS may be sold to other banks (self-securitised assets do not count) which may use them as collateral for the RBA's Committed Liquidity Facility (***CLF***). Assets held against the CLF count as liquid assets (as do HQLA) for the Basel III LCR requirement. These assets also have a 10% RSF under APS 210 (0-5% RSF for most HQLA) improving the bank's NSFR position. This is already a form of Government support of the RMBS market and at the very low facility fee of 15 BP p.a.

The liquidity of standalone RMBS under stressed conditions is however questionable as many declined significantly in price during the crisis.

Recommendation

Do not include RMBS as HQLA.

Consider increasing the pricing of the CLF to market rates equal to the current market premium for term issuance of 80-100 BP p.a.

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The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements and review the effectiveness of the MySuper regime in due course.
- Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.
- Replace the three-day portability rule:
  - With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress.
  - By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.

Recommendation

The portability of superannuation investments should be aligned to the particular class of investment.

For investments in cash, the three-day portability rule may be too long. For listed liquid equities, three days is probably reasonable. For unlisted infrastructure investments much longer portability periods possibly even twelve months should be instituted, but with the fund having the option to settle earlier if alternative investors become available. Similarly, for venture capital investments which are either unlisted, or listed but illiquid, longer periods should be instituted. Investors would have a clear choice of liquidity versus return, which they could assess when choosing their fund allocations. The same choice currently operates without problems in the Self-Managed Super Fund environment for example with direct property investments.

Liquidity risk affects all financial intermediaries, including superannuation funds, in a similar way to banks and they should therefore have the same quantum and quality of liquid resources, as a bank, with respect to the same assets and liabilities. Superannuation funds do not however have explicit recourse to the RBA when under stress. Consequently, they need to reduce portability and apply redemption gates to achieve the same level of protection.

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Capital requirements

In December 2013, APRA identified the four major banks as domestic systemically important institutions and increased their capital requirements, from 2016, by 1 percentage point. Increased capital requirements for systemically important banks are in line with international practice. Most jurisdictions adopting the Basel framework have introduced, or will introduce, similar measures. Australia's requirement 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 (Chart 5.1). In their submission, the regional banks suggested that a higher capital add-on for systemically important banks could be warranted.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- No change to current arrangements.
- Further increase capital requirements on financial institutions considered to be systemically important domestically.

Recommendation

As for the above submission on the Too Big To Fail implied guarantee, further capital may well be warranted for the systemically important institutions, however it is at least as important that the systemically important banks have very stable debt funding. As detailed in the above submission, in this respect, current indications (which are not readily available) are that the systemically important banks (the four majors) are below international standards. As a result, this vulnerability should also be addressed with at least equal urgency. This is a clear priority in the US, the UK and Canada, all of which have banks which are reported to have more stable funding bases.