me Bank
BANK FAIRER.

27 August 2014

Mr David Murray AO
Chair, Financial System Inquiry
Email: fsi@fsi.gov.au

Dear Mr Murray

I am writing in response to the Financial System Inquiry Interim Report released in July of this year.

ME Bank is passionate about our commitment to providing our customers with access to 'fairer banking'. We firmly believe in the advantages of a diverse, multi-tier banking system providing a different perspective, innovation, and competing vigorously to ensure consumers' best interests are served. ME Bank has consistently demonstrated superior customer service and, in conjunction with other regional banks, brings an essential competitive tension to the market.

These objectives of diversity, choice, innovation and competition can only be assured if there is a level playing field and the Panel's Interim Report identifies a number of areas where competitive neutrality is absent. Our submission seeks to provide a constructive insight into those issues that impede competition and proposes options that would encourage fairer competition.

Background

ME Bank wrote to you on 27 March 2014 outlining the Bank's background, our current business priorities and identified core issues that we believe should be addressed by the Inquiry. These included:

- the disparity between the amount of capital required to support assets under the Basel capital adequacy framework that delivers a significant advantage to banks accredited under the advanced approach;
- significant funding and cost advantage available to banks deemed systemically important;
- the higher costs for regional banks in relative terms in the constant flow of new regulatory and prudential requirements; and
- the increasing vertical and horizontal integration of the major banks in the broader financial services market.

We commend the Inquiry Panel for the thorough and thoughtful report that it has produced and appreciate the opportunity to provide a further response.

Submission

Consistent with our earlier submission our response comprises a number of elements:

- this letter to the Inquiry Panel;
- a joint submission from the regional banks (Suncorp, Bendigo & Adelaide Bank, Bank of Queensland and ME Bank) prepared by Pegasus Economics;
- the Australian Banker's Association (ABA) submission; and
- the submission by Industry Super Australia (Growth and Wealth –The return of workplace pensions).

Of particular interest to ME Bank are the following two key observations made in the Interim Report:

- the banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral; and
- 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.

In reference to the first observation we believe that a healthy multi-tiered banking system is essential to provide consumers and businesses with stronger access to diverse and competitively priced financial products.

Critical to this objective is a regulatory and prudential regime that is based on a clear principle of competitive neutrality. The current capital regime permits major banks to hold significantly reduced amounts of capital relative to the regional banks against low risk housing loans. This directly inhibits smaller banks such as ME Bank from competing in this market on price.

Regarding the second observation we endorse the Panel's concerns about the moral hazard associated with financial institutions being considered Too Big To Fail (TBTF). Of greater significance to ME Bank however is the threat to market competition posed by TBTF due to the funding advantage extended to those Australian Banks deemed to be domestically systemically important. The major banks receive a two notch rating upgrade due to the implicit Government guarantee, resulting in a significant funding cost advantage estimated to be in the order of 25 basis points.

The Panel has identified a variety of possible policy responses as having the potential to address the perception that some institutions are TBTF. The various options have advantages and disadvantages and we are unable to recommend a particular initiative. ME Bank submits however that a critical priority, in the interests of competitive neutrality, is to address the funding cost advantage extended to the major banks via the implicit guarantee.

The Interim Report also suggests the possibility of changes to the Financial Claims Scheme. We would strongly argue in support of retaining the current scheme particularly to the extent that TBTF remains unresolved. Any diminution of the current scheme would only risk exacerbating the current funding gap with the major banks.

Regional Banks Submission

The four regional banks, concerned that our issues have not been adequately covered by the ABA, have agreed on a collective perspective driven by a shared commitment to policy reform that promotes a competitive, efficient and sustainable banking system - reforms that 'level the playing field'.

Our key observation is that the very large gap between the profitability of the major banks and other deposit taking institutions is a visible indication of the lack of competitive equality in the banking system.

Consistent with our original submission, our response to the Inquiry's Interim Report focuses on the issues of the risk weighting of housing assets and the anti-competitive impact of TBTF.

In considering the Panel's discussion of housing risk weights, we canvass in some detail the various options. We recommend a simple change to the current risk weights by the addition of a further 20% category for low risk loans where the actual risk of loss justifies a lower capital treatment than the current 35% minimum.

In the case of TBTF, we are anxious that the Panel in its final determination ensures that the funding advantage conferred upon the major banks by the benefit of an implicit Government guarantee is addressed.

The submission also addresses a range of other issues of importance to the regional banks including comprehensive credit reporting and mortgage broker disclosure.

Australian Banker's Association Submission

ME Bank is a member of the ABA and has been involved in the preparation of the ABA's submission.

While we support the submission, we believe the ABA has failed to adequately address key structural issues in the sector that impede competition.

In particular we are concerned with issues of market concentration, the funding advantages afforded by the major bank's status as being 'Too Big To Fail' and the differential treatment of risk weighted capital between major and regional banks.

We do welcome the ABA statement acknowledging the need to examine the risk weighting gap and the view by some banks that materially reducing this gap would restore competitive neutrality.

Industry Super Australia Submission
ISA is the policy think tank founded by a number of ME Bank's shareholders. We generally support ISA's submission, with some limited exceptions. In particular, we endorse the ISA commentary regarding the role of Industry SuperFunds as major stakeholders in the domestic financial system focussed on investing to generate superior returns for beneficiaries and supporting sustainable growth necessary to 'support dignity in retirement'.

We support the ISA commentary regarding key measures to improve superannuation performance, eliminate value leakages, increase tax efficiency and create measures to encourage long term investment in productive capital.

The Bank, given its ownership by Industry SuperFunds, is acutely aware of the need for policy settings to comprehend the intersection of banking, superannuation and advice within financial services.

Additional Recommendations
In the interests of clarity and emphasis we would like to expand on three issues addressed in the Interim Report which we believe further demonstrate the lack of competitive neutrality in the banking system – interchange fee reform , mortgage broker disclosure and comprehensive credit reporting . These recommendations can be found in the appendix to this letter.

Conclusion
ME Bank, as a small bank with a unique business model due to its connection with Industry Superfunds, is heavily dependent upon policy settings that promote competitive neutrality. While our submission covers a range of issues, our principal concerns relate to the competitive advantages extended to the major banks due to the differential risk weighting of mortgages and the impact of the implicit guarantee extended to systemically important banks.

We also submit that as the work of this Inquiry is critical to the financial system's stability and competitiveness, and the economy's productive performance, it is important that the resulting recommendations are supported by clear direction as to priority and time frames for implementation.

We again appreciate the work of the Panel and the opportunity to further contribute.

Yours sincerely

Jamie McPhee

Jamie McPhee
Chief Executive Officer

Appendix

Recommendations on Interchange Fee Reform, Mortgage Broker Disclosure and Comprehensive Credit Reporting

Interchange fee reform

ME Bank agrees with the FSI Interim Report observation that the regulation of payment systems in Australia may not be competitively neutral. Our particular concern relates to the regulation of interchange fees in the credit card system. We recommend that interchange fee caps be removed as we believe this is the simplest means of achieving competitive neutrality between the competing payment instrument providers.

Currently, the regulatory system is discriminatory against open payment systems, like Visa and MasterCard. The open network schemes are subjected to interchange fee caps, yet competitor products such as American Express, Diners Club, CUP, and JCB are not.

While it is argued that these schemes are structured in such a way that interchange fees are not explicitly charged, there is still an ‘implicit’ interchange that operates between the merchant acquiring and the card issuing side of the businesses. A regulatory mechanism could be developed to ensure economically consistent regulation but this introduces complexity and compliance burdens. By not regulating however, the three-party schemes benefit from having comparatively more commercial freedom in how to allocate system costs between card users and merchants.

Large merchants argue that removing interchange fee caps will lead to higher merchant service fees (MSFs), but there is a trade-off in that if MSFs increase, then card issuers receive more revenue in which to provide additional card benefits, such as loyalty points or lower annual card fees. Interchange fees simply allocate system costs between merchants and card users. When an interchange fee is moved, it changes the allocation of costs. In any case, even if deregulation of interchange fees led to an increase in MSFs, there are no restrictions in merchants passing these costs onto either card users directly through ‘surcharges’, or to consumers in general through higher product prices.

The case for deregulation of interchange fee caps strengthens when a wider perspective on the competitive market is considered. Visa and MasterCard also compete against in-store cards, such as the David Jones Card. This store card is not subject to interchange fee regulation, so the issuer has more commercial freedom in which to price the consumer payment offering. In-store cards can offer generous consumer loyalty benefits, such as discounts on the price of goods and services.

This is a relevant consideration because smaller merchants and businesses often do not have the scale to offer their customers a David Jones style payment card. Smaller merchants are relatively more reliant upon Visa and MasterCard to provide their customers with payment convenience, so the extent to which interchange fees inhibit consumer payment benefits in Visa and MasterCard is, at the margin, a relative disadvantage to smaller merchants.

The original argument supporting interchange regulation was based on the idea that regulation was necessary to change the relative consumer price between using credit cards and the more ‘efficient’ debit card. Interchange regulation was aimed at and had the effect of diluting the value of credit card loyalty points and, therefore, encouraged consumers to use EFTPOS debit cards which were considered to be a more efficient payment method.

However, by eroding the value of Visa and MasterCard as a payment instrument, the regulation may have inadvertently slowed the rate of which credit cards replaced cash and cheques – both of which are more costly than credit cards when all costs are taken into consideration.

Lastly, the interchange fee regulatory regime should promote universal acceptance of cards and maximize choice for customers. Having a two-tier interchange regime undermines this goal by allowing some schemes to price significantly above the ‘averaged’ cap and ultimately this undermines consumer choice.

Mortgage Broker Disclosure

Integration and competition in the banking sector

Vertical integration in the banking sector is a cause for competition concern. The major banks have over 80% market share in the core domestic banking market, deposits, housing loans and SME lending. This dominance is supported by implicit Government support that enables the large banks to raise cheaper wholesale funding and a capital adequacy regime that enables high leverage in low-risk housing loans.

Having established a strong market position in banking, the large banks have moved into other markets. Superannuation and wealth management has been a significant focus. The large banks have also aggressively moved into financial planning. It is estimated that 70% of financial planners are either owned or affiliated with large banks. A similar trend is now occurring in the mortgage broking industry.

The mortgage broker channel drove much of the competition and innovation in the lending market in the period leading up to the GFC. The broking industry emerged in the 1990s partly in response to the widespread closure of bank branches. It assisted smaller banks in achieving a nation-wide footprint and was instrumental in driving mortgage finance competition and innovation. We are concerned that as this sector becomes integrated into the dominant banks its role in driving competition, innovation and consumer welfare will be significantly diminished.

Vertical integration and distortions in mortgage broking

While we do not have firm evidence that vertical integration is distorting the way in which mortgage brokers direct borrowers to lenders, we share an increasingly common view that distortions have occurred and may worsen. We certainly believe that there are emerging characteristics within the industry that give rise to serious concern.

First, an increasing number of broker networks are now owned (or partly owned) by the major banks and Macquarie. The top four mortgage aggregators in the market (AFG, Aussie Home Loans, and Choice Home Loans) have an estimated 70-80% of the market. All are either fully owned or have significant ownership by the banks. It is likely that as part of the strategic objective in making investments in these networks, the banks have factored in the potential to increase deal flow and/or source lower risk borrowers.

Second, the major banks and Macquarie have a regulatory capital regime (IRB) that enables them to hold significantly less equity against housing loans than do all other banks and mutuals. This gives them considerable market pricing power relative to other banks, and it also means that housing finance is a relatively more profitable line of business (on an ROE basis) than it is for smaller banks. A strong financial incentive exists for these banks to increase market share, particularly in the low-risk end of the market. It is expected that banks would use whatever leverage they have to increase market share.

Third, while all commissions to brokers will no doubt be disclosed to customers, ownership opens up other opportunities to influence broker decisions and exercise inside influence.

Fourth, there may be some means of increasing a broker's remuneration without having to disclose it to mortgage customers. For example, where a broker has to pay a fee for utilising aggregator platform infrastructure, such as a computer system, this fee could be reduced if the broker originated a loan supplied by the broker's bank owner. This fee discount would not need to be disclosed to the mortgage loan customer, but stands as a clear conflict.

Fifth, there is currently no obligation on mortgage brokers working for an aggregator to disclose the ownership structure of the aggregator. This issue has become significant in the context of the financial advice industry where non-transparency of ownership misled consumers over the independence status of financial advisers.

Sixth, mortgage brokers can influence the competitive playing field in ways that are difficult to assess. 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%.

Seventh, a bank owner of a mortgage aggregator can set the terms of participation on the aggregators 'panel of lenders'. The terms can be tweaked to provide an advantage to the owner's own suite of products or set up in such a way to provide advantages to the bank's white label products.

Limiting adverse impacts
ME Bank, along with the other regional banks, recommend that better disclosure be introduced to ensure consumers understand the potential incentives that may exist for mortgage brokers to steer them towards loans provided by the mortgage broker's bank owner. Borrowers should know if their broker is owned by a product provider and arguably there should be a specific and additional pre-sale disclosure required in the product offered, particularly given the multi-brand, white label trend occurring in the market.

We endorse the recommendations outlined in the regional bank submission that customers using mortgage brokers should have the following disclosures made available:

- funder-owned brokers ensure that prospective customers are aware of the role of the funder in the ownership structure AND that it is clear to customers when they are being offered a product manufactured by that owner;
- the fees and commissions attached to each product offered by the mortgage broker, including any additional financial benefits such as increased pass through of commission or reduced aggregation fees; and
- the proportion of loans brokered that go to their owners (if applicable) and basic risk information about the loans, such as average Loan to Value Ratios (This disclosure would be aimed at identifying whether brokers are sending the best credit risk to their owners). Note – this is an aggregator requirement, not an obligation on individual brokers.

ME Bank also recommends two additional requirements which we believe will further minimise the adverse impacts of vertical integration:

- mortgage brokers should be required to put products from three different lenders forward to customers, and at least two of these lenders should not be associated with the owner of the broker aggregator group. This will ensure a minimum of two products from independent lenders are presented to customers;
- brokers should be required to make a specific and additional pre-sale disclosure of any product offered that lets mortgage customers know if their broker is owned by a product provider and of any financial benefits the broker may receive from the aggregator.

Comprehensive Credit Reporting
In further support of the Comprehensive Credit Reporting section in the Regional bank submission we make the following additional comments.

Mandatory v. Voluntary Scheme Participation
In order to ensure the ongoing commitment to a comprehensive credit reporting scheme from credit providers with large market share (that is, with a large customer base) we submit that participation in a comprehensive credit reporting scheme by those providers wanting to use the scheme should be mandatory. Moreover, consumers should not be permitted to "opt-out". A voluntary scheme that, by its nature, can provide only limited positive data (and where the limitations or gaps are not apparent to users) is significantly less powerful because the "full picture" is not available.

The U.K experience & commercial disincentives in voluntary schemes
As demonstrated in the U.K, when a voluntary system of credit reporting was introduced the banks did not participate. It seems they believed that they would be giving away the competitive advantage derived from the positive credit information profiles they maintained on their own large customer bases. Eventually, the banks did participate, but not until they believed that the benefit to be gained by using positive data available from sources other than their own profiles outweighed the "detriment" they perceived was inherent in sharing their positive credit information with other credit providers.

Current Australian data gaps
It is common knowledge in the financial services industry that some credit providers (even some of the major lenders) do not either note "inquires" on applicants credit files – nor do they record customer's defaults. Quite often, when customers come to us seeking relief from repayment obligations, their statements of financial position reveal debts that were not disclosed to us on the customer's application for credit. Moreover, nothing on the customer's credit bureau file would have indicated to us that the customer may have undisclosed debts.

Credit bureaux & credit provider bi-lateral agreements

Credit bureaux do not, for commercial reasons, “enforce” contribution or even require the same levels of contribution of data (or standards of data quality) from their users. It is not feasible to expect credit bureaux arrangements to achieve a de-facto “compulsory” scheme of any integrity or reliability.