



Submission to the Financial System Inquiry

Response to the Interim Report – Banking Competition

Capital, Management Information Systems and Funding

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Competition - Banking Sector

Summary

Australian banking has become dominated by a handful of Australian ADI's which has created a landscape which is no longer competitively neutral and one which risks becoming more concentrated in time if the situation is not addressed.

This is not to say that the Majors should be penalised for what is a fact of history but Morgij believes that there are ways of addressing this situation which do not seek to drag the Majors down or penalise them for their size but rather these measures would seek that the majors recognise their systemic importance and thus seek to better capitalise themselves in order to protect the financial system, economy and Australian tax-payer from potential systemic problems arising from a too-big-too-fail institution falling upon hard times.

We also show how non-internal ratings based (IRB) ADI's can gain advanced accreditation utilising technology currently available in the Australian market.

But capital relief is only part of the solution in ensuring that the Australian financial system can be as competitively neutral as possible. Smaller ADI's also need access to a marginal and average cost of funds that can at least approximate that of the Majors.

In this way Australia can have a more diverse financial ecosystem which is more stable, more competitive and offers borrowers and investors the best possible financial solutions the Australian economy can bear.

Australian Banking - Competition

Australian banking is competitive as the FSI highlights in its interim report. But that competition would most likely be characterised as oligopolistic in nature meaning that the power is concentrated in the hands of a few institutions.

Some would say that in this fashion banking is no different to other industries within the Australian economy such as airlines and telecommunications.

However, whereas there is enough competition between smaller rivals in telecommunications and between the two big players in the airline business to serve the consumer the nature of banking has meant that in focussing on credit and asset growth since the Wallis Inquiry the concentration of banking services within the Majors has led to a landscape which is not as efficient as it could be, has built institutions which are too-big-to-fail and which have shown a desire to seek returns on equity close to 20%.

Indeed the Commonwealth Bank in their Full Year 2013-14 results release August 2014 showed a full year ROE of 18.7%. This in an economy with inflation anchored within the RBA's 2-3% band and in an economy where a diversified industrial and retail company such as Wesfarmers achieves a return on capital closer to 10% with its annual results for financial year 2013-14 released August 2014 showing an ROE of 9.4% once non-trading entities were excluded.

This chase for return sees the IRB institutions focus on lending which attracts lower capital weighting such as home loans (including investment loans which are seen as retail loans) at the expense of business or other



lending which will build the stock of the Australian economy. Indeed in their annual report the Commonwealth Bank reported they had a market share of home loan lending of 25.3% and 28.6% of Household deposits making that institution certainly too-big-too-fail in the Australian economy and financial landscape.

When the other three Majors are added in this type of market presence appears inconsistent with stability and competitive neutrality.

This focus on returns, credit, and asset growth, while understandable in terms of maximising shareholder returns, in turn favours management and shareholders of these institutions in the short term while placing a burden on competition. It has also led to a concentration of risk within 4 large institutions which in turn transfers a risk to the public purse, in the event of a crisis, via a too-big-too-fail status and potential need for resolution.

As a result the current system is not competitively neutral in a way that it could be as the ability to use IRB status gives ADI's holding advanced accreditation for an IRB assessment of capital an ability to hold less than half the capital on average to support a similar class of assets – mortgages – than ADI's not holding IRB status.

Indeed the interim report of the inquiry showed that the IRB accredited banks carry less than half the capital (18%) against their mortgage books that other ADI's (39%) hold against their mortgage books.

More tellingly though the [Pillar III disclosure](#) of the Commonwealth Bank for the period ending June 2014 shows that even though the bank increased its on balance sheet holding of residential mortgages by \$27.75 billion over the course of the 2013-15 financial year to \$391.727 billion its calculation for risk weighted assets over that period only increased by just \$2.1 billion.

This had the impact of lowering the ratio of capital held against the residential mortgage book from 17.55% in June 2013 to 16.84% in June 2014. This could only have happened with a recalibration in the "risk" of the mortgage book under an IRB approach.

The ability to of IRB accredited banks, Macquarie and the Majors, to self-calculate the risk weightings and thus capital they hold against their mortgage loan assets means that for any given level of capital those institutions holding IRB can either lend more at a certain price or, as may be the case, they can discount loans for the same borrower as a non-IRB ADI and still return the same or greater returns on capital as the non-IRB lender.

Thus IRB accredited institutions can seek out high returns on equity through what is effectively a regulatory capital arbitrage not available to their competitors.

This skews the competitive balance in favour of IRB accredited institutions and can, and has, led to a concentration of lending within the Major banks and lead to systemic risk via too-big-too-fail.

Morgij believes that a two pronged approach needs to be looked at in making the competitive playing field more neutral.

1. APRA should impose a lower bound on the discount on risk weights for residential mortgages allowed to IRB approved banks in order to ensure that an appropriate level of capital is held by these institutions.
2. Non-IRB rated institutions should be allowed to use 3rd party software, where applicable, to increase the level of measuring, monitoring, reporting and stress testing on their mortgage book so as to allow



these institutions to approach a level of capital holding closer to APRA's lower bound of capital measurement as articulated in 1 above.

In doing so the regulatory capital arbitrage available to the IRB banks which has so concentrated pricing power in their hands can be addressed in favour of competitive neutrality. Indeed it limits contestability by those ADI's that need to hold more capital and allows the IRB authorised banks to effectively discretely price for risk in a way that other ADI's cannot.

How could Morgij two-pronged approach work?

Morgij believes that the regulatory intention to have IRB accreditation was to reward institutions that invested in better MIS for the measurement, monitoring, reporting and managing of credit risk in lending. But as the example above shows the reward for an investment in such MIS has opened up a significant regulatory arbitrage in favour of the institutions which have the financial and human capital resources to make such an investment.

At present that is 5 institutions among an Australian banking ecosystem of more than 100 ADI's – this has created an unequal competitive landscape.

Morgij believes that a "hard floor" between 70-80% of the standardised risk weights would be an appropriate reward for the investment in such MIS and go some way to levelling the playing field without substantially effecting the 5 institutions using IRB models.

However this ability to hold lower capital still favours the larger institutions already benefitting from a too-big-too-fail funding advantage so Morgij suggests that third party vendors with appropriate MIS be directly pre-qualified by APRA to enable non-IRB ADI's to seek capital relief should they wish to make the investment in such systems. APRA should issue criteria by which a vendor could qualify to supply the appropriate MIS to ADIs. As an example, the European Central Bank has criteria for vendors to qualify to supply Credit Rating Tools to banks including tools that assess the risk of mortgages.

This would enable Australian ADIs without the financial or human capital resources on an individual basis to effectively pool resources and purchase off the shelf or bespoke MIS.

Once an MIS or methodology is accredited APRA could designate an **Advanced Standardised Approach** and in doing so reward these institutions with a discount on the 35% standard risk weighting for mortgages (and other assets) to the pre-determined hard floor depending on the granularity and quality of the MIS and its outputs.

This would fit with the current draft requirements as put forward under APRA's CPG 223 which is part of its CPS 220 and a standard to which all ADI's will be expected to adhere.

In this sense the market would move toward competitive neutrality in lending.

Benefits of enhanced technological infrastructure

In order for non-IRB's to on board external credit management skills and a MIS which would allow them to reach the "advanced standardised approach" they would need to fully integrate such a system within their suite of banking risk management processes.

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Longer term this would allow a significant upgrade of institutional capabilities by building a culture of risk monitoring and management throughout the ADI from the point of origination – where a “score” could be generated using enhanced metrics, such as the inputs for the RBA’s RMBS warehouse, to give an expected loss at the time the loan was written and originated.

This loan, and the pool of loans on an ADI’s balance sheet, in its internal securitisation, or in any on market issues, could then be tracked and mapped according to the metrics of the underlying collateral and borrower characteristics from the point of origination, through the mortgage life cycle to eventual repayment or default as may be the case.

Morgij Analytics has an Australian owned, built and domiciled MIS which is capable of being of use to Australian ADI’s in this manner.

Funding?

But capital floors and capital relief is only part way to competitive neutrality. Notwithstanding the recent material improvement in the price of issuing RMBS and unsecured bonds into the market for Australia’s second and third tier of ADI’s there exists still a large cohort of ADI’s who because of size or geographic concentration are locked out of the wholesale markets.

APRA’s APS 210 – Liquidity – specifically calls for all ADI’s to better manage their liquidity, on both sides of the balance sheet, such that where possible they are able to withstand either an idiosyncratic or systemic crisis.

The inquiry’s suggestion of provision of direct government support to the RMBS market would go a long way to both ensure a more competitively neutral banking sector – as more ADI’s are able to access the cheaper cost of funds as the Majors do by virtue of their too-big-too-fail status and also provide a vehicle for accessing wholesale markets for smaller institutions when they otherwise could not. This will materially increase market contestability across all 100+ ADI’s in Australia who could if they so desire access a marginal cost of funds approaching levels achieved by larger ADI’s holding the quasi-government guarantee.

Already APRA and the RBA have recognised that an emergency facility is required in seeking to have all Australian ADI’s including Australia’s second and third tier ADI’s establish internal securitisations for repo with the RBA in times of trouble.

Such a scheme however continues to put the onus on the Australian taxpayer and Morgij firmly believes that a government backstopped RMBS facility for all ADI’s would help facilitate the establishment of RMBS as a tradeable asset class thus reducing the risk to the RBA and as a consequence the Australian government balance sheet. It would also offer ongoing support to smaller ADI’s in managing their cost of funds during business as usual times.