REGIONAL BANK RESPONSE TO THE FSI INTERIM REPORT

Levelling the playing field – policy options

August 2014

Final

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2 Background and Executive Summary

This submission is made on behalf of four Australian-owned Regional Banks: Bendigo and Adelaide Bank, BOQ, ME Bank and Suncorp Bank.

The Regional Banks commend the approach adopted by the Panel and welcome the opportunity to respond to the observations and policy options detailed in the Interim Report of the Financial System Inquiry (FSI).

The Regional Banks agree 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 Inquiry observed that the banking sector is competitive, albeit concentrated. It observed further that some aspects of the banking sector are not competitively neutral. The Regional Banks contend 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 into the future. This is not guaranteed unless the prudential and regulatory framework incorporates the principle of competitive neutrality.

Balancing domestic policy objectives within a global framework is particularly challenging. The Interim Report identified components of the banking system that limit the capacity of Regional Banks to compete on a level playing field. The specific issues the Regional Banks seek to address in this response to the Interim Report are:

1. In contrast to previous financial system inquiries, the Regional Banks request the FSI not only identify a list of policy changes and principles but additionally include guidance on priorities and optimal implementation time-frames.
2. A more risk-reflective system of setting regulatory capital for housing loan assets. We welcome the FSI Interim Report observation that the current system is not competitively neutral and believe a relatively small change to the current approach can deliver material benefits in terms of competition;
3. Establish a more efficient and staged process to assist Regional Banks to achieve accreditation under the ‘advanced’ capital framework, particularly in relation to housing;
4. Addressing the funding cost advantage for banks deemed ‘too big to fail’ (TBTF);
5. 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;
6. Lowering information asymmetries through an improved system of collecting important financial data relating to credit histories of bank customers (known as Comprehensive Credit Reporting); and

The common theme of the above is to promote competitive neutrality in Australian banking and meet the overall objective of fostering a healthy, multi-tiered banking system.

2.1.1 Regulatory capital

A major recommendation of this submission is for the system of setting regulatory capital to be modified slightly to better reflect fundamental risk in the system and promote competitive neutrality. Currently, the Major Banks are able to hold relatively lower amounts of capital against low-risk housing loans. This is inhibiting smaller banks in competing for customers at the same price in low-risk housing categories and, as a consequence, is a source of risk to competition.

By extending the current 'standardised' system of risk weight tiers to include one additional 20% tier, 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. Lower risk weights would lead to better pricing for risk and greater access for those requiring credit.

The Regional Banks also support the option of assisting ADIs in attaining accreditation. A number of Regional Banks are in the process of seeking advanced accreditation but the process has proven protracted and inefficient. It is recommended that the Australian Prudential Regulation Authority (APRA) engage more fully to accelerate the process.

Access to APRA's various risk units along the path to accreditation provides a more efficient process rather than reviewing the risk framework in its entirety when an application is submitted. The purpose is to ensure questions by banks are promptly answered and that information on best-practice methods is shared. The Regional Banks plan to approach APRA with a formal proposal for how such an approach could work.

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 is housing loans as it is a core business of regional banks and the risk is well understood by them. Additionally, as a result of the analytics that major banks apply to 85% of the market, regional bank models can be easily validated.

2.1.2 Too big to fail

The Regional Banks see both advantages and costs associated with most of the options outlined in the Interim Report to address TBTF. On this basis, we are not recommending any particular initiative to address TBTF. The primary issue for Regional Banks is that banks deemed systemically important receive a significant funding and pricing advantage from the implied Government guarantee. TBTF is a clear market failure which has real consequences for competitive neutrality and taxpayers.

The large banks receive a two notch rating upgrade due to implicit Government support which gives them a funding and cost advantage. The IMF estimate the on-going funding cost advantage to be in the order of 25 basis points. Using this estimate, the implicit taxpayer subsidy to the Major Bank's – just on their rated debt programs - is in the order of $2 billion per year. Finding a clean solution to this problem has proven difficult, but a strong case remains to continue efforts to do so.

The Regional Banks believe the international framework, including through the G20, provides a possible approach to addressing the TBTF problem for Australia's D-SIBs (Domestic Systemically Important Banks). The benefit of applying this framework is that it will be in international alignment.

The Regional Banks submit that TBTF is a market failure and that the market failure must be addressed directly with a determination to ensure that the funding cost disparity between TBTF and non-TBTF institutions is eliminated and non-TBTFs do not bear higher costs as a consequence.

2.1.3 Mortgage broker disclosure

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. 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 Regional Banks recommend more transparency and that better disclosure be introduced to ensure consumers understand the level of independence of mortgage brokers. 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.

2.1.4 'Competitive, albeit concentrated'

While an observation in the Interim Report was that the banking system is 'competitive, albeit concentrated', the Regional Banks believe this statement does not give enough consideration to the likely future state of competition given the current inequalities that exist in the market. The large gap that exists between the profitability of the Major Banks and all other deposit-taking institutions most visibly represents the lack of competitive equality in the banking system today. The Regional Banks believe there is some urgency required in implementing the above mentioned policy changes to materially reduce this gap.

With sensible policy changes flowing from the FSI, the Regional Banks are confident the future for customers will be positive. A healthy, multi-tiered banking system will ensure consumers retain choice and providers will continue to innovate and serve their communities.

2.1.5 Policy principles & policy assessment framework

The Regional Banks understand the nature of a major financial system inquiry must ultimately result in a series of proposed policy 'principles' rather than a list of specific regulatory changes. Policy principles have the virtue of remaining relevant as the environment changes, such as technology improvements, changing consumer choices and changes to the system's structure.

BACKGROUND AND EXECUTIVE SUMMARY

Appendix A of this submission details a set of policy principles could be used to guide policy makers in choosing solutions to identified problems. These are:

- International integration and regulatory alignment, with appropriate local adjustments
- Competitive neutrality
- Financial stability
- Macro-economic growth
- Dynamic efficiency and innovation

The core message of the Regional Bank submission is the promotion of the principle of competitive neutrality. Australia's long history of financial stability enables a greater focus on ensuring the system remains dynamic long term with consumers benefiting from a healthy, multi-tiered system.

The recommendations in this submission can be grouped under this key principle:

- Competitive neutrality must be given greater prominence in the regulation of Australian banking, including through changes to prudential regulation (particularly risk-weighting), removal of implicit support for certain categories of institution, disclosure of financial products, information dissemination to the market, and payment systems.

3 Timing and process issues

The Regional Banks recommend that the Inquiry's final recommendations include clear guidance on priority issues and also outline time frames in which policy recommendations should be introduced. The Regional Banks are concerned that any FSI recommendations to improve the financial system, particularly in relation to competition, may be undermined through a protracted implementation process. This risk is even greater today than in previous inquiries given the increasing internationalization of regulatory rules.

Previous inquiries reveal the very long time-frames in which endorsed recommendations can often take to implement. For example, the 1979 Campbell Report recommended the entry of foreign banks in Australia to provide additional competition to domestic banks. It took six years before the Government implemented this policy, with the first foreign bank commencing operations in late 1985.

In March 1997, the Wallis Report recommended a single licensing and disclosure regime for financial market participants. This was not achieved until seven years later (March 2004), when the FSRA regime became fully operational (Segal, 2002).

Given the rate of consolidation and concentration that has arisen in banking since 2008, the Regional Banks believe there is some urgency in establishing competitively neutral regulations. It is recommended that improvements to the system of risk-weighting housing loans be achieved by mid-2015.

By identifying priority reform areas and maximum implementation time-frames, the FSI will give the Government some target dates and increase accountability for the costs of failing to implement key reforms.

4 Risk-weighting of housing assets

The Regional Banks fully endorse the Interim Report's observation that the system of setting regulatory capital[1] in Australia is not competitively neutral.

The FSI Interim Report offered six options to address the problem:

a. No change;
b. Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation;
c. Increase minimum IRB risk-weights;
d. Introduce a tiered system of standardised risk-weights for mortgages;
e. Lower standardised risk-weights for mortgages;
f. Allowing smaller ADIs to adopt IRB modelling for mortgages only;

The Regional Banks recommend a combination of options to address the lack of competitive neutrality. We note these options are not mutually exclusive, but the focus of this submission is on options (b) and (d).

A primary recommendation of the Regional Banks is to extend the existing system of tiered standardised risk-weights for mortgages. In the standardised approach, the current risk-weight tiers are: 35% (minimum), 50%, 75% and 100%, the applicable risk-weight depends upon various loan characteristics and use of lenders mortgage insurance (LMI).

The Regional Banks recommend a simple change to the current structure by adding a further 20% 'tier' for low risk loans where the risk of actual loss justifies a lower capital treatment than the current 35% minimum. Low risk housing loans are defined as those loans where the loan-to-value ratio (LVR) is below 80%, the borrower has a pay as you go (PAYG) income stream, and the loan is a standard principal and interest loan. It is in this low-risk end of the market where the differences in capital treatment between 'advanced' and 'standardised' approaches is unsustainably large and creating a lack of competitive neutrality.

On average, the Major Banks through their advanced accreditation status are able to generate risk-weights of 18%, compared to Regional Banks where the average risk weight is 39%. This is a significant difference resulting in the Major Banks having a significant advantage in pricing housing loans. But the average comparison masks some very large disparities in risk-weighting at the low-risk end of the housing finance market. A simple example illustrates why a lower risk-weight tier in the standardised approach is needed.

The Commonwealth Bank's[2] Pillar III report shows that 29% of its $341 billion housing mortgage portfolio is risk-weighted at just 2.9%. This risk-weight translates into a requirement that the bank holds only

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[1] Regulatory capital is the minimum amount of loss absorbing liabilities required by the Australian Prudential Regulatory Authority (APRA). There are two approaches available to estimate this minimum level, one known as 'standardised' and the other is 'advanced'. If accredited, the 'advanced' approach enables banks (currently the Major Banks + Macquarie) to estimate key portfolio risk variables and use those to feed into the minimum capital calculation. For all other banks, the standardised approach is used which is a regulator prescribed approach.

around 26 cents in equity against every $100 in loans. In contrast, a Regional Bank with exactly the same loan portfolio, would have to hold around $3.15 per $100 of loans.

In other words, the Major Banks are able to achieve much higher leverage on their low-risk housing loan assets. In this example, the Commonwealth Bank's leverage is in the order of 380% compared to a Regional Bank's maximum leverage of 31%. This disparity in leverage is at the core of the competitive inequality because it affords the Major Banks strong market pricing power. While margins on housing loans across the industry are broadly comparable, this translates to a significant higher return on equity (ROE) for banks accredited under the advanced approach given the same risk.

To see this, it is necessary to understand how banks price their loans. At a minimum, the interest rate charged to borrowers must cover the costs of supplying that loan. This will include the costs of securing deposits or other debt funding, the cost of provisioning for any expected losses, the cost of processing the loan documentation, and the costs of origination such as marketing and broker commissions.

All banks must cover these costs. On top of these costs, a bank will apply an additional interest rate margin to cover the cost of equity capital – to generate shareholder returns. This margin is typically calculated to achieve a targeted level of profit, most commonly return on equity (ROE). ROE is defined as net profit after tax (NPAT) divided by equity.

Given this disparity in profitability for low-risk mortgages, it is very difficult for a Regional Bank to compete at the same price. To compete on price, Regional Banks need to accept a lower ROE, which in some cases would fall well short of shareholder expectations.

The inclusion of a 20% risk-weight tier in the standardised approach is aimed at addressing this significant gap and improving the risk sensitivity of regulatory capital more generally. The 20% tier is the precise risk weight advocated by APRA in 2001 to the Basel Committee, although APRA's recommended 20% minimum risk weight was to apply to <u>all</u> standardised loans, not just the loans under 80% LVR as advocated by the Regional Banks in this submission. In this sense, the Regional Banks are advocating a more conservative position than what APRA held 2001.

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 choice and better value for customers.

The simple change to the tiered structure of the current standardised approach is represented in the Figure 4.1 below with red bracketed numbers.

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[2] The example is based on Commonwealth Bank's Pillar III reported numbers, but the general result is consistent across all the four Major Banks.

RISK-WEIGHTING OF HOUSING ASSETS

FIGURE 4.1 MORTGAGE RISK-WEIGHTS – STANDARDISED APPROACH WITH 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

Further information and discussion is included in Appendix B.

4.1.1 Argument that introducing a 20% tier will fuel house prices

One argument against an additional lower 'tier' in the standardized approach is that it might encourage more lending into housing and fuel house prices.

We estimate that including a 20% tier in the standardised approach would only impact marginally given that 80% of loans are held by the Major Banks and 5% are securitized. Also, the Regional Bank proposal is that a 20% risk-weight should only apply to low-risk loans, not any loans above 80% LVR. This further reduces the proportion of loans to which it would apply.

Reducing the capital gap between 'standardised' and 'advanced' banks will improve competition in this market, potentially reduce margins, and lead to a greater incentive for Major Banks to invest in business lending. Although not possible to prove that a future scenario will play out, the Regional Banks believe a closing in the capital gap will improve incentives for the supply of SME finance. Regional Banks will have some capital freed up and the Major Banks profit incentives in housing will decline, which is positive for alternative asset classes.

4.1.2 Alternative is to increase the risk-weighting of AIRB

An alternative approach to restore competitive neutrality is for the risk-weights estimated by the Major Banks (AIRB banks) to be increased through the use of a minimum 'floor' or some tweaking of the model input parameters. The Regional Banks have not analysed the robustness of the AIRB approach, the primary concern of the Regional Banks is the unsustainable gap between risk-weights and associated capital outcomes.

We note, however, there is considerable international concern with the advanced approach to setting capital and the Basel Committee is undertaking a comprehensive review. Given the long time-frames and uncertain outcomes involved in making rule changes at the international level, the Regional Banks believe a closing of the risk-weighting gap through changes to international rules is unlikely to happen within an appropriate time-frame.

4.1.3 Assist ADIs to attain IRB accreditation

The Regional Banks also support the option of assisting ADIs that are not accredited to attain accreditation. A number of Regional Banks are in the process of seeking advanced accreditation but the process has proven protracted and inefficient. It is recommended that the Australian Prudential Regulation Authority (APRA) engage more fully during the process. Access to the various risk units along the path to accreditation provides a more efficient process rather than reviewing the risk framework in its entirety when an application is submitted. The purpose is to ensure questions by banks are promptly answered and that there is sharing of information on best-practice methods. The Regional Banks plan to approach APRA with a formal proposal for how such an approach could work.

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 is housing loans as it is a core business of regional banks and the risk is well understood.

5 Too big to fail

Regional Banks agree strongly with the Interim Report identification of a funding cost advantage for TBTF institutions and endorse the observation in the FSI Interim Report that significant Government actions in a number of countries, in response to the GFC, including Australia, entrenched perceptions that some institutions are too-big-to-fail (TBTF). The Regional Banks also agree that these perceptions can be reduced by making it more credible to resolve these institutions without recourse to Government/ taxpayer support.

The FSI Interim Report offered seven potential options:

a. No change to existing approach;
a. Increase the ability to impose losses on creditors of a financial institution in the event of its failure;
b. Strengthen the regulators' resolution power for financial institutions;
c. Invest more in pre-planning and pre-positioning for financial failure;
d. Further increase capital requirements on financial institutions considered to be systemically important domestically;
e. Modify the Financial Claims Scheme (FCS), possibly including simplification, lowering the insured threshold, or introducing an ex ante fee; and
f. Ring-fencing critical bank functions, such as retail activities.

The Regional Banks see both advantages and costs associated with each one the options outlined above. On this basis, we are not recommending any particular initiative to address TBTF. The primary issue for Regional Banks is that banks deemed systemically important receive a significant funding and pricing advantage from the implied Government guarantee.

The large banks receive a two notch rating upgrade due to implicit Government support which gives them a funding and cost advantage. The IMF estimate the on-going funding cost advantage to be in the order of 25 basis points. Using this estimate, the implicit taxpayer subsidy to the Major Bank's – just on their rated debt programs - is in the order of $2 billion per year. Finding a clean solution to this problem has proven difficult, but a strong case remains to continue efforts to do so.

In the interests of competitive neutrality, the funding cost advantage to Major Banks needs to be addressed. Aside from the proposed changes to the FCS, the options outlined in the Interim Report to address TBTF have the potential to help address the funding cost differential between the D-SIBs and those that do not enjoy implied support.

Increasing capital charges on D-SIBs is a more direct means of addressing the funding cost gap. Currently APRA has imposed a 1% higher loss absorbency (HLA) on D-SIBs to reduce the probability of failure further and, therefore, make it less likely that taxpayer's will be called on to bail out a large bank. If the HLA is increased, this may have some impact on closing the gap as it may increase the average level of major bank funding costs.

The D-SIB levy should be set at a level that eliminates the funding advantage brought about by the 2 notch upgrade.

The FSI Interim Report also raises the potential of changing the Financial Claims Scheme (FCS) to help address TBTF. The Regional Banks support the insurance coverage limit of $250k and the current funding model. The foreshadowed changes will not reduce the funding gap between TBTF and other banks. While TBTF exists, the scheme should remain as currently structured. If the scheme is to be modified, the Regional Banks support the Treasury model whereby a tiered approach to setting the levy whereby only institutions with assets above a specified minimum[3] would be required to pay the fee. This approach could promote competition and would likely offset the tendency of either a flat and risk-based approach to disproportionally impact smaller banks.

Similarly, pre-funding the scheme will relatively disadvantage smaller players that have a higher proportion of liabilities in the form of retail deposits. If the scheme is to be pre-funded with risk-based premiums, the Regional Banks submit that premiums should <u>not</u> be based on credit agency ratings[4] as these artificially inflate those institutions that have implicit taxpayer support. Any benchmark used must take into consideration the higher Regional Bank and Mutuals risk-adjusted capital levels.

[3] Assumed to apply to D-SIBs only.

[4] As was the case with the Government's wholesale debt and large deposit guarantee introduced in 2008.

6 Mortgage broker disclosure

The FSI has not outlined options to address concerns over ownership of mortgage brokers by the Major Banks. Instead, the FSI Interim Report seeks additional information via the following questions:

a. Is integration in the banking sector causing competition issues?

b. Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?

c. If so, what would be the best way to limit the adverse impacts?

6.1.1 Is integration in the banking sector causing competition issues?

Integration in the banking sector is a cause for concerns over competition. Economic theory establishes that while vertical integration can generate efficiencies, it may also enable firms to leverage oligopolistic powers from one market to another. This may be a factor in Australian banking. 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 have moved into other markets. Superannuation and wealth management has been a significant focus. The FSI Interim Report found that fees in that market appear high by international standards.

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 a key player in the period of mortgage finance competition and innovation. The extent to which this industry is now becoming captured by large product providers will undermine its potential role in driving competition, innovation and consumer welfare.

FIGURE 6.1 LAST 10 YEARS – CONSOLIDATION (BOURIS, MARCH 2014)

6.1.2 Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?

The Regional Banks do not have firm evidence that vertical integration is distorting the way in which mortgage brokers direct borrowers to lenders, although based only on anecdotes, there is common view that distortions have occurred and are set to worsen.

At the very least, the Regional Banks believe that pre-conditions and emerging characteristics about the industry give cause for concern.

Firstly, an increasing number of broker networks are now owned by the Major Banks and Macquarie, or at least partly owned. The top four mortgage aggregators in the market (AFG, Aussie Home Loans, Mortgage

Choice and Advantage group (Choice Home Loans and FAST) have an estimated 70-80% of the non-bank originated market. With the exception of AFG[5], all are either fully owned or have significant ownership stakes by 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.

Secondly, 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. As described in the section on housing risk-weighting, 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.

Thirdly, 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.

Fourthly, 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, or the aggregator retains part of the commission for utilising aggregator platform infrastructure, such as a computer system, this fee could be reduced or the full commission passed through to the broker 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.

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. 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.

Confusion over ownership is reinforced by the different branding. This point was drawn out by a recent Roy Morgan research study into financial planning released on 4 August 2014:

> *This latest research shows that considerable confusion remains among the users of financial planners regarding the extent to which the planner is perceived to be independent. These are the latest findings from the Roy Morgan Research Single Source survey.*
>
> *The main area of confusion regarding the independence of financial planners occurs when the planner is branded differently to the major fund manager that owns the planning group.*

[5] Macquarie Bank holds a 10% stake in AFG.

> *For example, 55% of the clients using Financial Wisdom (owned by the Commonwealth Bank) consider it to be independent, which is well ahead of the 14% who consider Commonwealth Bank branded planners to be independent.*
>
> *The planners belonging to all the Major Banks and labelled as such are generally understood to be 'tied' rather than 'independent'. Only 11% of Westpac financial planners' customers considered them to be independent, compared to 12% for the NAB, 13% for the ANZ and 14% for the Commonwealth Bank.*
>
> *On the other hand, three of the Major Banks' own financial planning groups are largely perceived as independent by their clients. These include Godfrey Pembroke owned by NAB (considered by 50% of clients to be independent); RetireInvest owned by ANZ (37% considering it to be independent) and Count Wealth (42% considered independent) owned by CBA. AMP Group own Charter (48% considered independent) and Hillross (44% considered independent).*

Six, 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%.

Seven, 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 such as returning these white label products ranked as the first products presented in the list of suitable products ahead of the hundreds of other bank products.

6.1.3 If so, what would be the best way to limit the adverse impacts?

The Regional Banks recommend more transparency and that better disclosure be introduced to ensure consumers understand the level of independence.

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. This latter point is particularly important given the multi-brand/white label trend.

6.1.4 Recommendation

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;
- 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.

7 Comprehensive credit reporting

The Regional Banks endorse the FSI Interim Report's discussion of comprehensive credit reporting (CCR) and agree it is a potential means of strengthening competition and competitive neutrality. At the heart of CCR is better information in order to make more informed decisions.

The FSI Interim Report outlines two policy options relating to expanding comprehensive credit reporting (CCR):

a. No change to current arrangements
b. Expand CCR by making it mandatory, adding new fields and/or extending it to SME lending.

Properly pricing risk is at the core of a well-functioning financial system. Credit risk, the losses associated with a borrower defaulting, is the primary risk faced by financial intermediaries, like banks. The extent to which credit risk can be managed has implications for institutions themselves and also for the wider financial system and economy.

Credit risk exposure of any specific loan is determined by the estimation of two variable – (a) probability of default (PD), and (b) loss given default (LGD). Probability of default is the likelihood that a borrower will fail to meet contractual obligations under the loan contract. This likelihood is determined by a range of factors, such as the fundamental commitment of a borrower to make the repayments and the general state of the economy which may influence the borrower's capacity to generate income (e.g. risk of unemployment).

Information regarding the credit history and current debt obligations of a prospective borrower assists banks in estimating PD and also LGD associated with each prospective borrower. As such, additional information is generally helpful to risk management across the system and is widely seen as having a 'public benefit'.

Access to information also has a competition perspective. Those institutions that have access to better information will have a competitive advantage in that they more accurately estimate PDs and LGDs (i.e. credit risk). For any given level of risk tolerance, more information allows lenders to lend more and with more risk-reflective pricing.

For customers, the implications are diverse. For some borrowers, credit may become more accessible. For others, it may become less accessible. Some borrowers may end up paying more for credit, while others may pay less. The essential point is that more and better quality information will result in better risk-reflective outcomes and improve the credit distribution system and, in turn, capital allocation across the economy as a whole.

7.1.1 The Major Banks must be a part of the system

An improvement in the infrastructure for sharing credit information was made in March 2014 when legislation was enacted to enable credit institutions to voluntarily contribute positive credit information to a Credit Reporting Body. Previously, only negative credit information was collected, such as default events. The scheme has had limited take up at this point, particularly amongst banks.[6]

There is a public benefit in having credit institutions share customer credit information. Numerous submissions to the Australian Law Reform Commission[7] (including those from Major Banks) pointed to the national interest in having a comprehensive credit reporting system and noted that Australia is one of the few developed countries still operating a negative reporting environment.

The move in March 2014 to start the collation of positive credit information shows there is some momentum for a market-based solution to CCR.

The consumer/customer benefits of CCR are also significant. For example, international experience shows that have a credit rating score assists with financial literacy as consumers get a better understanding of how repayment actions can impact on credit standing. Further, CCR improves the capacity of banks to meet responsible lending obligations as the consumer's financial obligations are better understood.

7.1.2 Recommendation

On balance, the Regional Banks support the FSI Interim proposed changes (option (b) as per above), but note that adequate transition periods are needed to minimise compliance costs.

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[6] The UK experience provides insight into the evolution of participation in credit reporting schemes. When the UK system commenced, there was significant reluctance of banks to participate for concern over giving away a competitive advantage. However, as the benefits of participation and access to wider information became better understood, participation increased markedly.

[7] http://www.alrc.gov.au/publications/55.%20More%20Comprehensive%20Credit%20Reporting/models-more-comprehensive-credit-reporting

APPENDIX A: FRAMEWORK FOR ASSESSING POLICY OPTIONS

8 Appendix A: Framework for assessing policy options

8.1 A FRAMEWORK TO ASSESS POLICY OPTIONS

8.1.1 Need for a policy framework[8]

Sound policy development requires in the first instance an articulation of the philosophical foundation of how the economy and financial system operate. In Australia, there is widespread support for a market-based economy and financial system where suppliers of products and services compete for customers. The FSI Interim Report supports this general approach. With that agreed, the general approach to regulation is to confine regulation to only those instances where markets have failed to work effectively, perhaps through the emergence of market power.

Identifying problems and recommending solutions inevitably requires a framework to ensure any remedies to problems do not create unintended consequences. The financial system is unique to other industries in that significant contagion effects exist which creates systemic risk. Policy development must take these contagion risks into consideration. There are five policy principles that should be considered when developing policies for the financial sector. There are outlined below.

8.1.2 International Integration & Regulatory Alignment, with appropriate local adjustments

Ensuring that Australia's regulatory regime is consistent with international regulatory frameworks and/or best practice emerging trends. Without regulatory alignment, Australia will pay a risk premium on borrowed money because investors will have greater uncertainty as to the risk implications of solely domestic regulation. This should not mean, however, that we blindly follow international regulations without taking account of the unique features of the Australian market. 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.

8.1.3 Competitive Neutrality – Similar risks, Similar functions & Same regulations

Financial regulation should be applied in a consistent, 'functionally equivalent' manner (i.e., neutral from a product, institutional, sectoral, and market perspective so that similar risks are treated equivalently by regulation).

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[8] For a detailed discussion of the high level set of principles for a financial policy framework developed by the OECD and endorsed by the Financial Stability Board, see the OECD (2009), "Policy Framework for Effective and Efficient Financial Regulation" - http://www.oecd.org/dataoecd/28/49/44362818.pdf

APPENDIX A: FRAMEWORK FOR ASSESSING POLICY OPTIONS

8.1.4 Financial Stability – Confidence, Safety & Soundness

Promoting confidence in the financial system and addressing systemic risks - be it in terms of financial groups, sectors, systems, or markets. Financial stability is essential to ensure people can get on with their lives and not have to worry about the safety of their deposit or the reliability of the payments system

8.1.5 Macroeconomic Growth – Strong & Stable/Sustained

Financial policies to foster and support macroeconomic growth – the focus being the extent those policies affect allocative efficiency and, in turn, macroeconomic activity (the real economy). This principle also encompasses real shocks to economic activity and can also be a source of financial instability.

8.1.6 Dynamic Efficiency & Innovation…Sound Incentives

Financial regulation should seek to encourage businesses to seek new ways of doing things, improve productivity and create better products. Proper incentives are important as is a general competitive environment. The concept applies to financial firms, but also to real businesses that rely on banks to provide finance and payment service. For example, the financial system should find ways to support entrepreneurs that have innovative business plans.

8.2 ROLE OF COST-BENEFIT ANALYSIS IN FRAMEWORK

These policy principles provide a general framework from which to assess the consequences of regulatory actions and policy options. Under each policy principle, costs and benefits of regulatory actions need to be identified and considered before making a general conclusion.

Ticks, crosses and question markets are used to visually highlight the Regional Bank's considered view on how policy proposals stack up in relation to the fame work principles. The process is somewhat arbitrary, but where possible, hard data and facts are identified.

9 Appendix B: Risk-weighting of housing – policy options discussion

9.1 CORE PROBLEM NEEDING TO BE ADDRESSED

The four Major Banks in Australia have been accredited to use the Advanced IRB (AIRB) Approach to calculate Risk-weighted Assets (RWA). Most other ADI's in Australia (including Regional Banks) use the Standardised Approach (SA).

Average risk-weighting ratios for 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 23bps[9] to achieve a Return on Regulatory Capital of 15%.

Regional Banks face considerable challenges in meeting the requirements to attain the Advanced IRB Approach because of their size/scale, data availability (depth and breadth) and risk management status.

Due to the differences in how risk-weighing applies under the prudential framework, the current risk-weight framework for residential mortgages appears to have the following unintended consequences:

- Encourages ADIs on the Standardised Approach to engage in higher risk lending in order to achieve returns demanded by their investors (they are inhibited from competing more effectively in the lower-risk end of the market);

- Provides greater incentive for Banks on the Advanced Approach to lend to low risk mortgages holders relative to other types of lending, like SME; and

- Reduces genuine competition in the low-risk housing market and, therefore, enables high margins to be earned, further encouraging lending into this asset class.

These are poor outcomes in terms of incentives. One of the benefits in having large, diversified institutions with sufficient resources to build sophisticated risk-management capability, is that they can more prudently 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 (RWAs) 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 and employment – there is a problem with efficient allocation of capital across the economy.

[9] This does not reflect tax or imputation credit effects.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

The FSI Interim Report offered six options to address problems created through the imbalance of risk-weighing for housing lending.

a. No change;
b. Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation;
c. Increase minimum IRB risk-weights;
d. Introduce a tiered system of standardised risk-weights for mortgages;
e. Lower standardised risk-weights for mortgages;
f. Allowing smaller ADIs to adopt IRB modelling for mortgages only;

While the focus of the housing risk-weighting in the FSI Interim Report is on ADI's, any change needs to consider the broader housing market including non-ADI's; RMBS issuers as well as arbitrage between on-balance sheet and off-balance sheet options for ADIs.

9.2 OPTION 1: NO CHANGE

There is broad agreement, both in Australia and overseas, that calculation of risk-weighting for residential mortgages needs to be reassessed. APRA's newly appointed Chairman recently addressed CEDA to discuss APRA's perspective on the FSI. His dot point presentation (Byres, 2014, p. 7) noted:

> *Risk-weights from internal models subject of considerable international scrutiny*
>
> *Loss of credibility – status quo not a viable option*
>
> *Options: modelling constraints; tougher validation; floors and benchmarks; greater disclosures*
>
> *Gap between modelled and standardised risk-weights to be narrowed*

In Australia, Major Banks challenge the 20% Loss Given Default (LGD) floor[10] on residential mortgages as being arbitrary and distorting the principles of using internal risk models. Both banks and mortgages insurers challenge the lack of capital relief for mortgage insurance on residential mortgages for banks (QBE Lenders' Mortgage Insurance Limited, March 2014) on the Advanced Approach.

Regional Banks and Mutuals[11] point to the imbalance between risk-weightings for banks on the Advanced Approach against ADI's on the Standardised Approach. In its submission, APRA calculated the average risk-weighting for Standardised ADI's was 39% against Advanced IRB Banks at 18%. APRA calculated the housing loan pricing differential is 23bps to which we concur. APRA stated that there is no discernible change in market share of standardised ADIs due to the implementation of Basel II' to which we also

[10] APRA imposes a 20% floor on LGD estimates for AIRB banks. This is justified on the basis that there is insufficient experience in Australia of a protracted housing 'downturn' to ensure the LGD estimate reflects sufficient potential 'downturn'.

[11] Credit unions, building societies, and mutual banks.

concur. However, in order to compete on price, ADIs on the Standardised Approach are forced to accept lower Return on Equity than banks on the Advanced Approach.

A structurally lower ROE due to regulatory capital differentials creates an incentive in the market for greater consolidation and concentration towards those institutions that have favourable regulatory capital treatment.

In overseas markets, many regulators continue to adjust their approach to risk-weights for residential mortgages with various limits, floors and overlays. As noted by APRA in its submission (APRA, July 2014, p. 77):

> *Regulators in some jurisdictions have recently made adjustments to IRB risk-weights for housing lending, reflecting concerns that modelling practices may not capture the full range of risks inherent within housing markets.*
>
> *The Basel Committee is currently reviewing the risk-weighted asset measurements under the advanced approaches in response to studies showing that the variability in such measurements was much greater than could be explained by differences in actual risks. The Basel Committee's objective is to reinforce - but not replace - the risk-based Basel II framework by developing a set of simplifications and safeguards (through the use of floors and benchmarks) that will help limit variability but still provide for appropriate risk-sensitivity in risk-weighted asset measures. This review is now extending to retail portfolios (including housing lending), with an APRA expert involved, but conclusions are some time away.*

9.2.1 Conclusion

Clearly there are concerns with the current Basel II framework. Evidence demonstrates that 'no change' is not an option as the Basel Committee and APRA have both openly stated that they wish to review the RWA measurements under advanced approaches. Further, the Major Banks have also expressed concerns over the 20% floor applied to loss given default (LGD) and LMI's have expressed concerns about lack of capital relief for mortgage insurance in the IRB approach

No change would retain the misallocation of capital and continue to erode competition.

9.3 OPTION 2: ASSIST ADIS TO ATTAIN IRB ACCREDITATION

To be accredited by APRA to use advanced approaches in estimating risk weighted assets, there are three key aspects that Regional Banks would need to address:

1. Development of predictive models for probability of default (PD) and, to a lesser extent because of the 20% floor, LGD.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

For PD estimation, it is required that there is a capacity to estimate 'through the cycle'. In terms of LGD, the requirement is for a capacity to produce a 'downturn' LGD, meaning how much is likely to be lost in an adverse scenario (both tasks made more difficult by Australia's long history of house price resilience resulting in low default rates and loss rates relative to experience in other jurisdictions such as US and Europe.).

2. Creation of underlying databases for management and monitoring of models – including clear definition of default, exposure at default and detailed loss history.

3. Capability to manage and monitor the results from the models, take appropriate and informed actions and be able to use the models in business decisions.

Under close APRA supervision, the Major Banks invested heavily in the infrastructure required to meet these three areas required for advanced accreditation. While difficult to isolate the costs related to development for the residential mortgage portfolio, an estimate of $20m per bank is reasonable.

Continuation of the 20% floor for LGD indicates that despite the breadth of data and modelling capabilities of the Major Banks, APRA remains concerned about their ability to develop robust LGD models.

FIGURE 9.1 SHARE OF HOUSING LENDING – BANKS ONLY

	Market Share (%)
Commonwealth Bank of Australia	27.2%
Westpac Banking Corporation	25.0%
National Australia Bank Limited	16.8%
Australia and New Zealand Banking Group Limited	15.3%
ING Bank (Australia) Limited	3.0%
Suncorp-Metway Limited	2.8%
Bendigo and Adelaide Bank Limited	2.3%
Bank of Queensland Limited	1.8%
Macquarie Bank Limited	1.1%
Members Equity Bank Limited	0.9%

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

FIGURE 9.2 SUMMARY OF WHAT REGIONAL BANKS NEED TO SECURE ADVANCED ACCREDITATION

What is needed for IRB accreditation?	Which organisations will provide this?	Who will pay the cost?	What is the time frame?	What assurance mechanisms is there that the time frame will be met?
Risk-management framework & processes - documentation	Big 4 professional services, some niche consulting firms	Circa $5M not unreasonable	A number of Regional Banks have been working for 3-4 years. A shared project could be delivered in a couple of years, includes model build and validation, system integration and database build	Needs a private + regulator steering committee – something like PEXA and MAMBO maybe
Modelling software & documentation	Shared service maybe, SAS/Experian etc	Leverage operational scoring systems, still circa $2M although will get operational benefits as well	Per above, at least a year, maybe two	Per above
Data	Shared service, credit bureau option		Assuming most data is available, consolidation may take a year or two	Per above
Other requirements - Model build	Rhino Risk example of industry LGD model			

There are a number of Regional Banks that are keen to complete applications for advanced accreditation.

9.3.1 Offer of assistance via the ABA

Industry discussions regarding the FSI Interim Report have demonstrated a degree of goodwill on behalf of some Major Banks to assist Regional Banks with securing advanced accreditation.

9.3.2 Importance of APRA

Clearly advanced accreditation must involve a high level of interaction with APRA. When the Major Banks were seeking accreditation in the lead up to Basel II implementation, APRA constituted a dedicated working group to help facilitate accreditation. The Regional Banks request a similar approach be taken now so that Regional Banks can get timely feedback on the various issues that arise in relation to accreditation.

9.3.3 Link between operational, market and credit risk

The Regional Banks also request that APRA change its policy regarding the need for accredited banks to be advanced in all three aspects of risk modellings, operational, market and credit. This is not a Basel Committee requirement and may act as an unnecessary barrier to more timely implementation of advanced credit risk modelling.

9.3.4 Conclusion

The prospect of a greater number of banks becoming accredited to use advanced modelling to estimate RWA is consistent with improving competitive neutrality. However, it must be said that it is not an approach that has much visibility internationally and compliance costs need to be considered.

9.4 OPTION 3: INCREASE MINIMUM IRB RISK-WEIGHTS

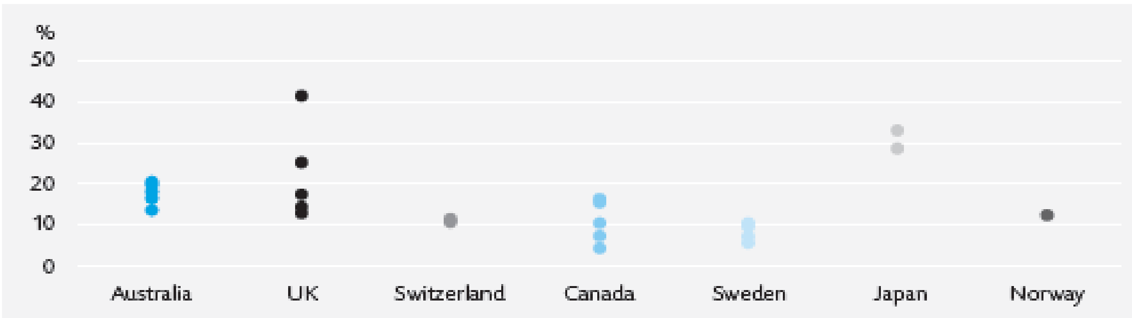
In order to address the RWA gap between standardised banks and IRB banks, the IRB risk-weights would need to be almost doubled[12]. Within the IRB capital formula, this could be done be either increasing the LGD floor from 20% to 40%, placing a floor on PD, increasing the long run calibration of PD, increasing the asset correlation value or decreasing the confidence level.

There is some precedent for departing from international principles in tailoring the AIRB approach in Australia. APRA uses a 20% LGD floor and doesn't allow lenders' mortgage insurance (LMI) to provide capital relief for AIRB banks. Additionally, Australia's 20% LGD floor corresponds with a 90 day definition of default for mortgages whereas most other jurisdictions have a 180 day definition of default.

Altering floors or caps on risk measures across the entire mortgage portfolio may hide the relative risk issues within the portfolio. If these regulatory tools are to be used, they are probably more usefully applied at a segment level. For example, a loan approved with an LVR of less than 60% (which comprise 25% of Major Banks approvals) has a 20% LGD floor which is the same as for a loan with an LVR of 90% that is not mortgage insured.

[12] Although a variation might be to have the higher risk-weights apply only to new loans.

FIGURE 9.3 INTERNATIONAL COMPARISON OF IRB RISK-WEIGHTS – APRA FSI SUBMISSION



The advantage with increasing minimum IRB risk-weights is that it would assist in closing the gap between Standardizes and Advanced approaches while simultaneously addressing prudential concerns over risks in the housing market. If this policy approach is to be adopted, it is recommended that average AIRB risk weights are increased from around 18% to 30% to improve competitive neutrality.

9.4.1 Conclusion

The differences between regulators across jurisdictions is becoming more diverse and driving more concerns about global consistency. While an argument can be mounted for increasing the asset correlation value or decreasing the confidence level, these types of changes would probably require alignment across global regulators which would be difficult to realize. In its submission to the FSI, APRA showed that Australian IRB risk-weights are comparable to overseas jurisdictions.

9.5 OPTION 4: INTRODUCE A TIERED SYSTEM OF STANDARDISED RISK-WEIGHTS FOR MORTGAGES

The existing standardised approach is a tiered system of risk-weights with weights varying depending on three factors:

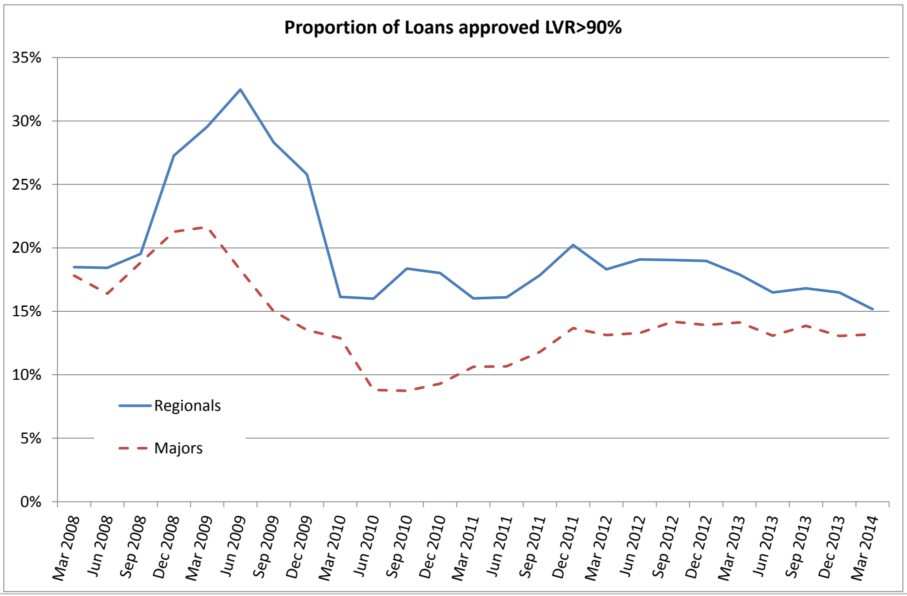
- Standard or non-standard mortgages (low docs);
- LVR; and
- Mortgage insurance (LMI).

However, the system of risk-weighting may not capture all the key risks in mortgage portfolios. For example, data from one of the Regional Banks shows that non-PAYG mortgages are twice as risky as PAYG borrowers. Data from another lender shows line of credit products are riskier than amortising mortgages. Data from Bank of England shows (Bank of England, June 2014, pp. 56-62) that loan-to-income multiples are an indicator of risk in mortgages.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

In regard to a residential mortgage principle and interest loan amortising over 25 years at an 80% LVR to individual on a high PAYG income, the standardised risk-weight would be 35% and the advanced internally modelled rate 11%.

FIGURE 9.4 PROPORTION OF LOANS APPROVED >90% - REGIONALS VS MAJORS



While the current setting of risk-weights encourage the standardised banks to seek higher risk loans, the opposite is true for the advanced banks – they have a capital incentive to invest in the safer end of the risk spectrum. This is an anomaly because it is the larger, more diversified banks with greater capacity for sophisticated risk-management that should be incentivized to meet the demand in the riskier end of the mortgage market, not the smaller banks.

9.5.1 20% risk-weight for standardised <80% LVR loans

One means of helping address this incentive problem is by reducing the standardised risk weight to 20%, but only for loans that are characterized by an LVR<80% and a PAYG borrower(or 80-90% LVR covered with LMI). Loans of this nature are a well understood, homogenized product. They do not require sophisticated internal modelling to control risk. Hence, the 20% will result in a better risk-reflective alignment of capital, albeit still above the advanced internal estimates.

Adding this additional tier to the current standardised approach would help achieve more competitive neutrality, increase competition in the safe end of the market, and yet not raise prudential concerns given the relative low-risk nature of a mortgage loan with an LVR less than 80%, and the relatively small share of the market held by standardised banks.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

Regional Bank analysis shows that the 20% risk-weight is still higher than that estimated by advanced internal models and, therefore, an incentive remains for smaller banks to invest in risk-management capability. The proposed 20% also aligns with the advice APRA provided to the Basel Committee in 2001 albeit with one key difference – APRA advised that the minimum risk-weight should apply to all mortgage loans, whereas the Regional Banks are confining the 20% risk weight to only those loans with an LVR less than 80%. Further, 80% is the cutoff for lower capital in the absence of mortgage insurance.

The Figure 9.5 below shows how the proposed change would impact the current set of standardised risk weights under APRA's framework – new values depicted in red.

FIGURE 9.5 MORTGAGE RISK-WEIGHTS – STANDARDISED APPROACH

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

9.5.2 Conclusion

Including a new 20% 'tier' in the current standardizes framework would be a simple change that would reduce the capital anomaly and increase competition in the safe end of the mortgage lending market. There would be no discernible impact on financial stability or macroeconomic stability given the relatively small portion of the market held by the standardized banks and the fact the 20% is confined to the safer loans.

With greater competition in the homogenized market, margins would decline and the Major Banks would have a greater incentive to move up the risk curve and allocate a higher proportion of lending to SME. As such, the policy will deliver important productivity benefits.

9.6 OPTION 5: LOWER STANDARDISED RISK-WEIGHTS FOR MORTGAGES

While APRA have stated in their first round FSI submission that '*Basel II resulted in overall reductions of capital for advanced ADI's of between zero and 10 per cent, and around five per cent on average for standardised ADI's*' (APRA, July 2014, p. 74) the reduction is not specific to mortgages.

Regional Banks estimate that the reduction for standardised banks to be around 28%, whereas the reduction for advanced banks is considerably higher.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

FIGURE 9.6 COMPARISON OF RISK-WEIGHTS & CAPITAL UNDER BASEL I AND BASEL II

Approach	Average Risk-weight	Average Capital
Basel I	54%	4.3%
Basel II Standardised	39%	3.1%
Basel II Advanced	18%	1.4%

APRA also state that because *'of emerging house price pressure, there would be no case to reduce standarised housing loan risk-weights on macroprudential grounds'* (APRA, July 2014, p. 76). We concur that overall capital in the system for mortgages needs to be cognisant of the forward-looking risks inherent in a heating housing market.

However, the apportionment of the overall capital between IRB banks and Standardised ADI's needs to reflect relative risk. It should also be noted that Major Banks are doing the majority of mortgage lending given the regulatory settings incentivise them to do so. A change to the risk weightings used by non-Major Banks is unlikely to have macro-prudential impacts, particularly if the changed settings promote Major Banks into the SME/commercial lending they are best-placed to undertake.

We accept that smaller ADIs do not have the degree of diversification in terms of geography and product. However the current standardised approach is lopsided. The current Basel risk-weight is 35%. In order to account for riskier loans, APRA has introduced a set of tiers that increase the risk-weight as the riskiness of the loan characteristic change, such as higher LVR and LMI coverage. Yet, there is no tiering at the safer end of the spectrum, i.e. under the standardised approach, a loan with a 40% LVR receives the same capital treatment as a loan with an 80% LVR, yet clearly there is a difference in risk.

While the Regional Banks are satisfied that the current 35% remains the internationally-agreed benchmark risk-weight for standardised, we recommend that an additional tier of 20% is used for mortgage loans where the LVR is less than 80% and the borrower is PAYG.

We believe that lower risk-weights are appropriate for homogeneous housing loans with low risk characteristics such as:

- Standard principle and interest repayments over a 25 year term (i.e. excluding line of credit and interest only products);
- Loan-to-value of less than 80%;
- PAYG borrowers (i.e. excluding self-employed borrowers); and
- Low debt-to-income ratios.

The Regional Banks note that in its submission to Basel Committee in 2001 (APRA, May 2001, p. 7), APRA suggested lowering the proposed standardised housing risk-weight to 20%.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

According to APRA Quarterly ADI Property Exposures Statistics[13], the volume of housing loans in this homogeneous low risk category is around 60% of all loans approved. A risk-weighting of 10%-15% for these types of exposure would even the gap between IRB banks and Standardised Bank. It would therefore encourage Standardised Bank to focus more on lower risk homogeneous housing lending.

Because of the disproportional amount of mortgage volume held by IRB banks, it is unlikely that decreasing Standardised RWA's will materially impact the overall capital held in the system to support mortgages.

9.6.1 Conclusion

The Regional Banks believe a 20% risk weight is more appropriate for low risk homogeneous mortgages and that the 35% standardised risk weight is appropriate benchmark for loans that do meet the homogeneous category.

9.7 OPTION 6: ALLOWING SMALLER ADIS TO ADOPT IRB MODELLING FOR MORTGAGES ONLY

The Regional Banks view this as a version of Option 2 and would support this option in addition to Option 2.

[13] http://www.apra.gov.au/adi/Publications/Pages/Quarterly-ADI-Property-Exposures-statistics.aspx

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

9.8 CONCLUSION AND RECOMMENDATION

Differences between the Advanced IRB and Standardised Approaches to measurement of risk-weights for residential mortgages has created unintended consequences that are inconsistent with the principles of the Basel II Accord and competitive neutrality generally.

The Regional Banks advocate that the system of risk-weighting become more risk reflective and, therefore, competitively neutral. There are three pathways to achieve competitive neutrality.

a. Changes to the 'standardised' approach;
b. Changes to the AIRB approach; or
c. A combination of (a) and (c).

The recommended initiative to change standardised approach is a simple addition of a new risk weighting 'tier' of 20% for PAYG mortgage loans where the LVR is 80% or less. These are low risk, homogenous housing loans that do not require advanced modelling. This approach is outlined in (Option 4).

An alternative approach is to use a 'floor' or modelling parameter change to increase the average risk-weight under AIRB. At this stage, the recommended increase would see the average risk weight go from 18% to around 30%.

An assessment of the policy options against key policy criteria is outlined in Figure 9.7 below.

APPENDIX B: RISK-WEIGHTING OF HOUSING – POLICY OPTIONS DISCUSSION

FIGURE 9.7 SUMMARY OF POLICY OPTIONS & ASSESSMENTS: RISK-WEIGHTING OF HOUSING

Policy options	Consistent with International integration & Regulatory Alignment[14]	Competitive neutrality	Consistent with Financial System Stability	Consistent with Macro-economic stability	Consistent with dynamic efficiency & innovation
Option 1: No change	×	×	×	×	×
Option 2: Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation	✓	✓	✓	✓	✓
Option 3: Increase minimum IRB risk-weights	?	✓	✓	?	✓
Option 4: Introduce a tiered system of standardised risk-weights for mortgages	✓	✓	✓	✓	✓
Option 5: Lower standardised risk-weights for mortgages	✓	✓	✓	✓	✓
Option 6: Allowing smaller ADIs to adopt IRB modelling for mortgages only	✓	✓	✓	✓	✓

[14] Note – that this principle encompasses the practice of tailoring regulatory rules to domestic conditions, as argued previously in this submission.

APPENDIX C: BANKING IS COMPETITIVE, ALBEIT CONCENTRATED - ASSESSMENT

10 Appendix C: Banking is competitive, albeit concentrated - assessment

The Interim Report makes the observation that the banking system is 'competitive, albeit concentrated'. This observation is based on three primary indicators: net interest margin, customer satisfaction, and reductions in bank fees. The Regional Banks maintain that the state of competition is less healthy than that implied by the FSI Interim Report observation, and also think that it is critical that the Inquiry take a forward looking view towards what the competitive landscape may look like in 10-15 years if the current settings and trends persist.

As discussed earlier in this submission, financial regulation (in particular, the barriers faced by smaller ADIs in the capital framework and TBTF) have had a major impact on the risk appetite of market participants and competitive forces in some market segments – especially housing and SME loans.

10.1 CRITIQUE OF EVIDENCE USED TO SUPPORT FSI OBSERVATION

10.1.1 Net interest margin decline since late 1980s

The Interim Report quotes the Reserve Bank of Australia (RBA) submission to state that *'net interest margins of the Major Banks are around historic lows…'.* The RBA's finding reflects the time series data presented in Graph 2.12 on page 27 of its FSI submission. The chart shows a steady decline in the major's NIM from the late 1980s to about 2004. It has been broadly stable since then.

The period of NIM stability since 2004 is also revealed in APRA's quarterly performance statistics that present performance and balance sheet data since 2004. In APRA's series, the Major Bank's NIM has been notably stable at around 1.9% of average assets.

There are reasons as to why the decline in the NIM may not indicate strong competition. Firstly, the NIM decline was not associated with any structural decline in Major Bank profits. Economic theory finds that in a perfectly competitive market, firms compete with one another by cutting prices until above normal profits are eliminated.

While margins compressed from early 1990s to 2004, the implied reduction in profit was offset through higher lending volume and cost efficiencies. Major Bank asset growth was particularly strong in this period.

Second, the balance sheets of the Major Banks look quite different today than they did in the early 1990s, with Major Banks now allocating a much higher proportion of credit to households, mainly in the form of housing loans. The shift in portfolio weight towards household lending was driven by a determination of Major Banks to 'de-risk' their balance sheets after the commercial property problems of the early 1990s recession and again post the GFC. It is expected that as a bank's lending portfolio becomes less risky (i.e. increasing lending into Australia's housing market), that this relative conservatism is reflected in lower net interest margins. At least to some extent, the reduction in NIM can be explained by changes in portfolio composition.

Third, the ability of the Major Banks to maintain profits through cost-cutting is also a sign that they face little competitive constraint in relation to service standards. While personal customer satisfactions ratings of the Major Banks is currently high (partly reflecting the low-interest rate environment and the popularity of Internet banking), satisfaction amongst business customers is much lower. Business customers are more reliant on relationship management and may be more vulnerable to price exploitation due to the bundled nature of their banking product needs.

Fourth, and more generally, lack of contestability and product substitutes, informational comparison problems and switching costs associated with SME banking, are structural impediments supporting higher margins and a lack of price competition amongst Major Banks.

In summary, the fact that the Major Banks did not suffer any decline in profitability as a result of margin decline is an indication they have exercised market power to the benefit of shareholder, rather than an indication of competition.

10.1.2 Net interest margins of the Major Banks are mid-range internationally

The Interim Report references the World Bank's Financial Development and Structure Data set to state that Australia's Major Banks' net interest margins are mid-range by world standards. While the notes to the data are not conclusive, it appears this survey samples a wider range of banks than just large commercial banks.

A more instructive, albeit with a smaller country sample, is the annual profitability data (BIS, 2014) released by the Bank of International Settlements (BIS). This data compares only large banks and it shows that Australia's major four have NIMs considerably higher than the international average for industrialised countries. The same data set also compares countries on the profitability measure of after-tax return on assets (ROA). Comparing industrialised countries on ROA shows Australia's Major Banks are the most profitable in the world, including that of Canada – a country often seen as comparable given its similar banking structure and similar GFC performance.

APPENDIX C: BANKING IS COMPETITIVE, ALBEIT CONCENTRATED - ASSESSMENT

FIGURE 10.1 PROFITABILITY OF MAJOR BANKS – AS % OF TOTAL ASSETS – BIS DATA

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.

APPENDIX C: BANKING IS COMPETITIVE, ALBEIT CONCENTRATED - ASSESSMENT

Australia's Major Banks are outliers in terms of asset structure in that they have a higher proportion of lower-risk housing lending than large banks in most other countries and a lower proportion of income from higher risk investment banking activities. A lower risk profile suggests Australian Major Bank NIMs should also be relatively lower, but the BIS data suggests they are high when viewed against comparable countries with well-developed financial systems.

10.1.3 Major Bank return on equity (ROE) pre and post GFC

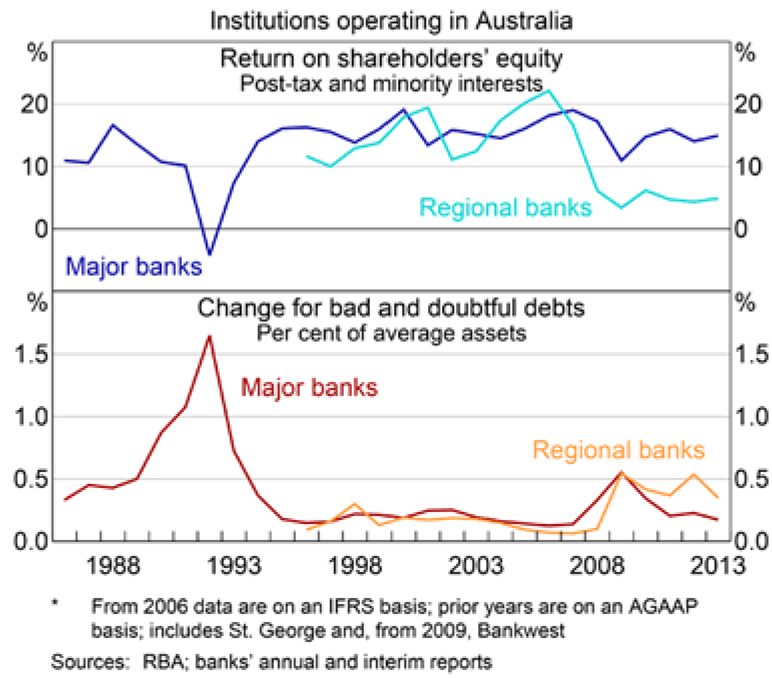
The Interim Report cites pre and post-GFC profits as an indicator of competition, specifically that average return on equity (ROE) of the Major Banks post GFC has been 14% post-crisis compared to 16% from 2004 to 2007[15].

The Regional Banks question whether this is evidence of greater competition. The operating environment for banks generally since the GFC has been quite different, characterized by subdued credit growth and higher funding costs. Further, the Major Banks have improved profitability compared to the pre-GFC period if assessed in a relative sense, i.e. compared to domestic Regional Banks and against large banks in other countries. While absolute ROEs might be down marginally on average, they are higher in a relative sense.

[15] This shows a 2% average difference, although if the data (which comes from APRA's performance survey) is not rounded, the gap is closer to a 1.5% difference.

APPENDIX C: BANKING IS COMPETITIVE, ALBEIT CONCENTRATED - ASSESSMENT

FIGURE 10.2 BANK PROFITABILITY – ROE – INSTITUTIONS OPERATING IN AUSTRALIA



10.1.4 ROE comparison with other large Australian corporates

A comparison of Major Bank profits and those of other large Australian corporates was cited by the Interim Report as an indicator that Major Bank profits are not reflective of market power. This is a useful comparison in the sense that it accounts for population size. A number of submissions to the FSI identify Australia's population size as one explanation for Australia's relatively concentrated banking system.

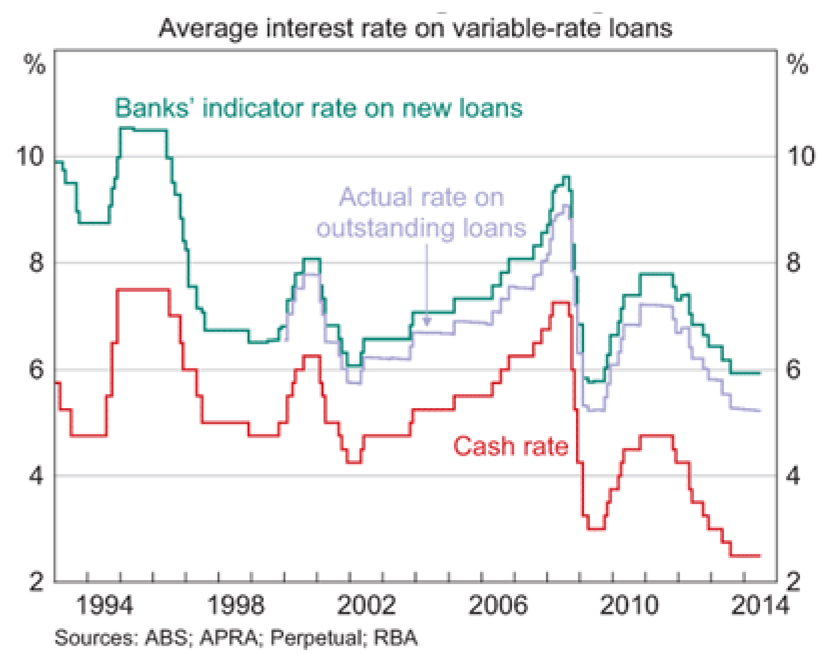
The main challenge in the cross-sector comparison of financial versus non-financial corporations is in adjusting for differences in risk between large corporates. Australia's four largest banks all have AA credit ratings which are assisted by a 'two notch' credit rating uplift due to implicit Government support. No other large Australian corporates are AA rated, or have this implicit support, so comparing profitability is problematic. For example, BHP is A+ and Telstra is A-rated. The risk/return principle in finance suggests the Major Banks' profits should only be compared against other large corporates that have a AA rating. The risk/return principle also suggests that lower returns should be expected when there is lower risk, but this does not seem to be borne out in the major banks' profitability.

Rating agencies typically give Major Banks credit ratings higher than utility-type businesses, this makes sense given the Major Banks not only have implicit support but they also have a prudential regulator that imposes a capital requirement whereby the chance of failure is one in one thousand years (99.9%). Yet, the high returns (14-18% post tax ROE) are indicative of businesses with considerably more risk.

10.2 CUSTOMER SATISFACTION

An improvements in bank customer satisfaction can reflect competition between banks for customers[16], but it is difficult to disentangle this influence from other factors. The low interest rate environment due to the historically low RBA overnight cash rate will also benefit a Major Bank's reputation.

FIGURE 10.3 AUSTRALIAN HOUSING LENDING RATES – RBA DATA



Internet banking is another factor assisting reputation. This channel has high penetration and is widely viewed as increasing banking convenience, functionality and is low cost. There are two drivers for technology improvements, competition for customers and that of cost efficiency.

10.2.1 Divergence between personal and business customer satisfaction

One noteworthy aspect of customer satisfaction data is the difference between personal customers and business customers. Surveys show that business customers record higher dissatisfaction levels than

[16] In the case of Regional Banks, the long history of customer satisfaction reflects their need to provide a higher level of service to customers and communities, in part to overcome the scale and regulatory benefits afforded to Major Banks.

personal customers. In commenting on this issue, a spokesperson for Roy Morgan noted (Roy Morgan Research, 2014):

> *Satisfaction among banks' personal customers is at record high levels and is obviously the result of a concerted effort since 2001 when they were at their lowest point. Although this improvement has been seen consistently over a long period, more recent improvements have had a lot to do with low interest rates on home loans and high satisfaction levels and preference for internet banking. For a number of years it appears that banks have had a preference for the relative safety of personal customers and as a result their business customers are being left behind as evidenced by the wide gap in customer satisfaction ratings.*
>
> *'Recent moves by the Major Banks to show an increased focus on the business customers obviously stems from a realisation that something needs to be done to attract and retain them to compensate for the reduced prospects for growth in the personal market. Banks currently appear to lack empathy with their business customers who require more attention and understanding. This is evidenced by the fact that these customers rate their banks very poorly on 'maintaining regular contact', 'following developments in the industry' and having a 'good understanding of their business'. Banks recognise the need for personal contact with their business customers, and use business managers to manage the relationship with their clients, but at this stage the satisfaction level with these managers is less than seventy percent for each of the four Major Banks. This is an area that obviously needs some improvement if overall satisfaction is to increase.*
>
> *'The relatively low satisfaction among business customers is likely to be impacting negatively on personal customer satisfaction as there is a strong link between the bank used for business and the personal bank for Australia's two million micro and small business owners.*
>
> *'The current Financial System Inquiry will need to consider how well the needs of business are being met by the banks in order to ensure that they remain viable and contribute to economic growth. At the present time it appears that there is room for improvement.*[17]*'*

It is arguable as to whether customer satisfaction results in Australia reflect strong price competition between banks. An explanation for why personal customers are more satisfied is that they are more influenced by the historically low level of loan rates and benefits of Internet banking, and less concerned about relationship banking given the greater ease in unbundling products and switching provider for personal customers, compared to business customers (especially SME).

[17] http://www.roymorgan.com/findings/5606-consumer-satisfaction-with-banks-at-record-high-but-business-customers-lagging-behind-201405280120

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10.2.2 Product range

The Interim Report notes that *‘consumers also have access to an extensive range of products and providers. For example, there are more than 500 standard variable mortgage products from more than 100 providers available, and more than 1,500 term deposit products from over 80 providers. That said, there are only about 35 small business loan products from around 20 providers.’*

Product choice can be indicative of non-price competition. There are some qualifications to the extent to which product choice is a sign of competition. These include:

- The large range of products in banking is in-part related to the number of legacy products.
- Products can be differentiated by very small costless changes to product features. For example, a term deposit of 3 months versus 6 months.
- The number of products is not a sign of a diversified market, banking concentration in Australia is amongst the highest in the world.
- The large supermarket providers in Australia are noted for carrying wider product choice than competitors, but there are still competition concerns in that market.

10.3 BANK FEES

The Interim Report cites bank fee reductions as evidence of banking competition. There are a number of challenges to interpreting changes in bank fee revenue as indicating competition. Changes in bank fee revenue may be partly related to competition, but may also be influenced by industry reputation and regulatory factors. The following are examples of reputation and regulatory factors impacting on fee revenue:

- In 2001, the banking industry announced a major reputation initiative which included minimum standards for basic bank accounts. This initiative sought to provide the community with guarantee that free or low-cost bank accounts would be made available to low income customers, many banks made these accounts generally accessible.
- In 2002, the Payments Systems Board (PSB) regulated credit card interchange fees that had the effect of reducing merchant service fee revenue (MSFs) by around $1 billion annually.
- In 2011, the Government passed legislation to ban home loan exit fees from mortgage accounts.
- In response to legal and reputation challenges, banks have also reduced or abolished a range of ‘exception fee’ – fees for overdrawing or making late payments on transaction and credit card accounts.

Australia is not alone in reducing bank fees for reputational reasons. In the United Kingdom, banks have been prevented from charging account and ATM fee charges due to political and community backlash.

Lastly, changes in bank fee revenue cannot be viewed in isolation of bank profitability indicators. As with declining interest margins, the real issue from a competition perspective is whether margin or fee reductions are impacting on excessive shareholder returns. The fact that Major Banks have been able to maintain profitability in the face of fee and margin declines is testament to their wider capacity to exercise market power – notwithstanding some improved operational efficiency over the past decade.

10.4 PERCEPTIONS OF COMPETITION VERSUS REALITY

With low mortgage interest rates due to historically low RBA cash rates, the average consumer may view this as evidence of competition. This perception can be reinforced by Major Bank bank advertising and marketing initiatives. But the actual competitive dynamic that exists is quite different to that commonly understood.

Large banks have extremely stable market shares, their competitive decisions centre on trading off small basis point reductions in margins to achieve small basis point increases in product volume. Large banks do not live with the sorts of difficulties faced by most SME businesses where strategic mistakes can have real commercial consequences.

Further, there is a veneer of competition due to the competitive disadvantages that smaller banks and Mutuals face in competing against the large banks. Regulatory capital, too big to fail funding advantages, and vertical integration combines to make it more difficult to compete on price. These regulatory-related factors are on top of general advantaged of large players associated with economies of scale and scope.

The striving of smaller banks to compete with large banks appears to be characteristic of a thriving competitive market, but it is an unhealthy form of competition because there is not a level playing field and the competitive winners are not necessarily those with the best products and services.

10.5 NEED FOR A FORWARD LOOKING PERSPECTIVE ON COMPETITION

The FSI Interim Report concludes that the banking system is competitive, albeit concentrated. A key issue for the Regional Banks is the likely state of competition in the medium term. There are strong forces which indicate there will be further consolidation and concentration which will continue to undermine competitive outcomes.

Major financial sector inquiries occur in Australia about every 15 years, a time frame that will easily see further concentration and get to a point that mitigating the costs of negative consumer outcomes will be much higher than if pre-emptive actions are taken. Research undertaken for the Regional Bank's first round submission found high concentration scores (Herfindhal-Hirschman Indexes)) for most retail banking. The data showed that very small increases in concentration would create formal competition concerns across most banking markets.

From the Regional Banks perspective, competition in banking is at a tipping point where further concentration will lead to an even more dire competitive outlook. The FSI should recognise this situation and the potential for more serious concerns to arise in the medium term.

11 Appendix D: Regional Bank capital levels

The Interim Report finds that the capital levels of Australia's banks are in the middle of the pack internationally. It appears the FSI's assessment was mainly that of the Major Banks, but some statistics concerning Regional Banks's capital ratios are presented here. Three datasets are used:

1. S&P risk adjusted capital (RAC Ratio);
2. Pillar 3 data; and
3. APRA's data.

These statistical sources show the Regional Banks hold high levels of capital, both in an absolute terms and on a risk-adjusted basis.

11.1 S&P RISK ADJUSTED CAPITAL – COMPARISON WITH MAJOR BANKS

Standard & Poor's introduced a method of comparing capital on a risk-adjusted basis in 2009, called the Risk-adjusted Capital Ratio (RAC Ratio)[18]. The purpose of the RAC ratio is to better compare relative capital levels across banks and jurisdictions. The RAC Ratio aims to bring greater transparency to the ratings process and to overcome factors that can make capital comparisons difficult, such as the regulatory approach used to set minimum capital or the issuer-specific economic capital models used by banks.

As can be seen by Figure 11.1, the two Regional Bank's shown have materially higher risk-adjusted capital than the large Australian banks.

FIGURE 11.1 S&P RAC RATIO – DOMESTIC BANKS

Bank	S&P RAC ratio
Bank of Queensland	15.5%
Bendigo & Adelaide Bank	11.5%
ANZ	8.3%
CBA	8.2%
Westpac	8.2%
NAB	7.9%

Source: Regional Bank first round FSI submission

Similarly, as can be seen from Figure 11.2, Regional Banks score highly in terms of risk-adjusted capital when compared to other banks in the region. The Regional Banks are attempting to get updated data including comparisons for America and Europe.

[18] https://www.financialexecutives.org/eweb/upload/FEI/Standard%20and%20Poor's%20Risk-Adjusted%20Capital%20Framework%20For%20Financial%20Institutions_21-Apr-09.pdf

APPENDIX D: REGIONAL BANK CAPITAL LEVELS

FIGURE 11.2 ASIAN BANKS RANKED BY RAC RATIO

Country	Institution	RAC ratio	Rank
Australia	BOQ	15.5	1
Indonesia	PT Bank Danamon	12.6	2
Hong Kong	Bank of China (Hong Kong)	12.5	3
Australia	BEN	11.5	4
India	ICICI Bank	9.9	5
India	HDFC Bank	9.5	6
Singapore	OCBC	9.4	7
Australia	WBC	9.1	8
Hong Kong	HSBC	8.9	9
Indonesia	PT Bank Negara	8.8	10
Singapore	UOB	8.6	11
Australia	ANZ	8.4	12
Australia	CBA	8.3	13
Malaysia	Malayan	8.3	14
Singapore	DBS	8.2	15
Hong Kong	Hang Seng Bank	8.1	16
Malaysia	Public Bank	7.9	17
Indonesia	PT Bank Mandiri	7.9	18
Australia	NAB	7.8	19
Korea	Kookmin	7.5	20
China	ICBC	7.3	21
China	CCBC	7.2	22
Japan	Mitsubishi UFJ Financial Group	7.2	23
Japan	Resona Bank	7.2	24
China	Bank of China	7.1	25

Source: S&P

11.2 PILLAR 3 DATA

As part of banks' regulatory reporting, banks publish more detailed data on their risk-profile and capital levels than can typically be found in Annual Reports. The latest Pillar 3 reports show that the Major Banks and Regional Banks have similar capital levels as defined by the ratio of common equity tier 2 (CET1) to risk-weighted assets (RWA).

APPENDIX D: REGIONAL BANK CAPITAL LEVELS

The short-coming of this data as an indicator of capital strength is that, unlike the S&P RAC ratio, it does not look through the influence of regulatory capital approaches to estimating RWAs. As discussed through this submission, the Major Banks use an 'advanced' internal models based approach to estimate RWA (AIRB) and the Regional Banks use the 'standardised' approach.

The difference in approach distorts the true risk associated with portfolios. If RWA assets are adjusted to equate the RWAs between 'standardised' and 'advanced' banks, then the derived figures reveal the Regional Banks have much stronger capital positions. In Figure 11.3 the adjustment to the Regional Bank's RWA is through multiplying by credit exposures by the average risk-weight of the Major Banks for each credit exposure category.

FIGURE 11.3 PILLAR 3 DATA & ADJUSTED RWA RATIOS TO REMOVE INFLUENCE OF REGULATORY APPROACH

Bank	CET1 Ratio	CET1 Ratio with adjusted RWA to remove influence of regulatory capital model
ANZ	8.3%	8.3%
CBA	9.3%	9.3%
NAB	8.6%	8.6%
WBC	8.8%	8.8%
BOQ	8.8%	14.8%
SUNCORP	8.5%	14.6%
BENDIGO	7.9%	11.5%

Source: Based on Pillar 3 reports

11.3 APRA DATA

APRA's Quarterly Performance Statistics also include estimates of average capital ratios for banking groups, including Major Banks and the category of 'Other domestic banks'. This category includes Regional Banks and mutual banks.

Three key ratios are presented: (a) the capital adequacy ratio which is total tier 1 and tier 2 capital as a proportion of RWA; (b) Tier 1 capital as a proportion of RWA, and (c) core-equity tier 1 (CET1) as a proportion of RWA.

As with the Pillar 3 data, the estimates are undermined by the dual methodology for estimating RWAs. By adjusting RWAs of the 'Other domestic banks' by a factor that broadly equates RWAs, then a more risk-reflective set of ratios can be derived. The adjustment factor is a ratio of the average credit risk-weight of the major banks, divided by the average risk-weight of three Regional Banks:

(Adjustment factor = 33.5%/52.6%). These averages are derived from Pillar 3 reports. The APRA capital ratios, including the data with adjusted RWAs is presented in Figure 11.4

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FIGURE 11.4 CAPITAL ADEQUACY STATISTICS – APRA DATA SET WITH ADJUSTED RWA

BANK SECTOR	CAPITAL ADEQUACY RATIO	TIER 1 CAPITAL RATIO	CET 1 CAPITAL RATIO
Major Banks	11.9%	10.5%	8.6%
Other domestic banks	12.7%	10.5%	9.4%
Other domestic banks (with adjusted RWAs)	19.7%	16.3%	14.7%

Source: Statistics derived from APRA's Quarterly Performance Survey March 20.

11.4 CONCLUSION

The comparisons presented above show that Regional Banks are well capitalized in comparison to Major Banks and other banks in the Asian regional. When appropriate adjustments to RWA are made, the Pillar 3 and APRA data reveal similar results to that of S&Ps RAC ratio.

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