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APRA

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Mr John Hawkins
Secretary
Senate Economics References Committee

By email: john.hawkins@aph.gov.au

Dear Mr Hawkins,

I refer to your email of 29 December 2010 seeking responses to the additional questions posed by the Senate Economics References Committee as part of its *Inquiry into competition within the Australian banking sector*. APRA's responses are attached (in italics).

Please contact Michael Horton on 02 9210 3258 or by email to michael.horton@apra.gov.au should you have any further questions.

Yours sincerely

(...)

Thea Rosenbaum
Secretary
Corporate Services Division
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1. Charts in the Reserve Bank's submission show bank interest margins gradually narrowing after deregulation but widening somewhat in recent times. Do you regard the recent widening as just some noise in the data or does it reflect reduced competition since the GFC?

The widening of spreads reflects a combination of factors and it is difficult to attribute any portion of this widening to a specific factor. Importantly, however, it is generally agreed that risk was not being adequately priced in the global banking system in the lead-up to the global financial crisis so some repricing of assets (and hence widening of margins) was to be expected and was prudent.

2. To what extent has the longer term narrowing in interest margins been offset by increases in bank fees? Does this differ between household and corporate customers?

APRA does not have detailed data on the fees charged by authorised deposit-taking institutions (ADIs). However, there has undoubtedly been some substitution of fees for margins over time, as ADIs have sought to reduce cross-subsidisation of products and customers.

3. (a) How do bank fees in Australia compare to those overseas?

APRA does not have these data.

(b) To what extent would a lack of competitive pressures allow banks to pay their executives excessive remuneration?

Remuneration levels for executives are determined by a range of factors, but an important driver will be the overall performance and profitability (measured in various ways) of the bank concerned. The impact of a lack of competitive pressures on remuneration levels is difficult to measure and can cut both ways. To the extent that lower levels of competition allow ADIs to derive higher levels of profitability than they might otherwise do, there is likely to be an impact on remuneration levels. However, it is also arguable that less competitive industries need not pay their executives as much as companies in highly competitive industries.

(c) How does the remuneration of Australian bank executives compare to that of executives of comparable banks overseas?

APRA does not collect these data but the Committee might find helpful a comparison undertaken by Reuters in 2009: http://graphics.thomsonreuters.com/099/GLB_EXCMP0909.gif

There is an international market for executive talent that will influence global remuneration levels. However, domestic factors can make direct comparisons difficult. Further, remuneration levels may include a range of non-salary components (such as share options) that may not always be realised. This also affects global comparisons of remuneration levels.

(d) Do some remuneration packages encourage CEOs to take a more short-term or risky approach?

APRA's prudential requirements on remuneration are designed to ensure that the incentive structures adopted within APRA-regulated institutions promote sound risk-taking decisions and generally support the firm's risk management policies. They do this by requiring:

- *boards of directors to have in place appropriate policies on remuneration and oversight arrangements to vet remuneration outcomes;*

- *adequate risk-based measures to be used in determining remuneration awards; and*
- *a significant proportion of variable remuneration awards to be deferred and subject to performance assessment before vesting.*

These requirements, which were introduced in April 2010, are still being bedded down, recognising the need to change institutions' employment policies and, in some cases, individual employment contracts.

4. Would bank account number portability increase competition? Would it cause any practical or prudential problems?

All else being equal, account number portability can be expected to assist competition. From a prudential perspective, portability would expose ADIs to greater liquidity management pressures and would be likely to require them to hold higher levels of liquid assets to compensate for increased customer movement.

5. Do you think exit fees are an impediment to competition? Would you have any prudential concerns if they were limited or eliminated?

The removal of exit fees does not in itself raise prudential concerns. However, it is important that ADIs are able to cover and/or recoup their legitimate costs involved in originating, managing and closing out a mortgage.

6. What proportion of home loans are at fixed rather than variable rates? Are these typically only fixed for a few years? Why are Australian home loans predominantly at variable rates whereas in many comparable countries fixed rates are more common? Would you have prudential concerns if banks offered home loans with interest rates fixed for longer periods than are their term deposits?

A table showing the proportion of fixed- and variable-rate home loans between December 2008 and September 2010 is at Table 1.

Most fixed-rate home loans extend for a period of up to five years, which allows ADIs to fairly readily match the term of the loan with the term of the borrowings needed to fund it. ADIs in Australia have offered variable and fixed-rate loans for many years; the dominance of variable-rate loans appears to be largely a matter of consumer choice. While ADIs could offer longer-term fixed-rate loans, they would need to manage the associated funding and interest rate risk; all else being equal, this would require higher holdings of liquidity and capital to compensate.

APRA notes that very long-term fixed-rate loans, such as the American model of 30-year fixed-rate home loans with optional and free prepayments by the borrower, have been associated with substantial prudential problems that can exacerbate bank failure rates. This risk is not a current feature in the Australian market.

7. Given that there appears a widespread belief that home loan rates are tied to the cash rate but this is not the case, would it be more transparent for banks to offer an additional home loan product where the interest rate was explicitly tied to the cash rate? Would you have any prudential concerns with this?

In APRA's view, there is a substantial implicit interest rate risk in such a product, when ADI funding costs increase more than the reference rate. This problem was notable, among other examples, with United Kingdom 'tracker' loans during the global financial crisis. If home loan rates were to be tied to the cash rate or other rates not controlled by the lending institution, the ADI may be required to hold additional capital against the extra risks.

8. Conceptually, in a competitive banking market, would you expect bank lending variable interest rates to follow movements in the banks' *average* or *marginal* cost of funds?

APRA agrees with the Reserve Bank of Australia's response to this question. That is, the use of average or marginal funding costs as a basis for loan pricing will depend on how the loan is repriced.

9. Does APRA require funds borrowed offshore to be either borrowed in Australian dollars, or hedged so as to be effectively in Australian dollars? Is the cost of short-term offshore funds then close to the RBA cash rate?

APRA has no prudential requirements as to the currency in which offshore borrowing by an ADI is undertaken. The larger part of offshore borrowing is denominated in foreign currency with the foreign currency risk being hedged. It is possible for ADIs to mis-match their borrowing and lending currencies but, as a practical matter and facilitated by APRA's prudential requirements on foreign currency risk, such mismatching is minimal in the context of any ADI's total balance sheet.

10. Has APRA encouraged banks to raise more retail deposits? If so, has this bid up the interest rates on them?

APRA has been encouraging ADIs to raise more <u>stable</u> funding. In simple terms, this means ADIs being less reliant on short-term wholesale funding (particularly from offshore markets) and making greater use of domestic deposits and long-term wholesale funding. To the extent ADIs are competing for a relatively fixed pool of domestic deposit funding, it would be expected that higher interest rates would be offered and this has been the case.

11. Should highly-rated mortgage-backed securities be allowed to count as liquid assets by banks? As you mentioned at Estimates, there is a problem that in the GFC the market for bank paper seized up.

Liquid assets are those assets that can be easily converted to cash within a very short period of time, and without a material impact on their price. During the global financial crisis, the market for mortgage-backed securities froze and those assets could not be easily converted to cash; even how, the market is thawing only slowly. Given the performance of these instruments, it is difficult to see how they could be regarded as liquid in times of stress and, for that reason, they are not included as high-quality liquid assets in the new Basel global liquidity standards.

12. From the viewpoint of the financial system as a whole rather than an individual issuer, what is the advantage of financial intermediaries securitising mortgages rather than issuing bonds to fund mortgage lending which remains on their balance sheet? Are there advantages in the organisation doing the credit assessment on housing loans continuing to bear at least some of the risk on them? If so, what capital requirements would there be for the originating bank?

The difference between the two approaches is the party that holds the credit risk. Where the loans are funded by the ADI and remain on balance sheet, the ADI remains at risk of default and needs to hold capital for that risk. As a result, the size of an ADI's balance sheet and its lending capacity will be limited by the amount of capital it has to absorb risk. In the case of securitisation, the risk of the loans is transferred to other parties. Because securitisation passes the risk to other parts of the financial system (domestically or offshore), it provides capacity/capital to fund additional lending beyond the capacity of the ADI sector itself.

In theory, securitisation should result in risk being passed to those agents best placed/most willing to manage it. However, the global financial crisis has showed that, because of the

complexity and opacity of securitised products, investors did not understand the risk they were bearing and, hence, credit was misallocated. As a result, global regulators are proposing that banks retain 'skin in the game': that is, retain an exposure to the underlying assets within the securitisation pool and hence to the quality of their original credit assessment. These proposals are yet to be fully developed but capital requirements will inevitably reflect the residual risk that an ADI retains.

Table 1: Fixed-rate vs variable-rate housing loans

Period	Sector	Housing - Fixed-rate $m	Housing - Variable-rate $m	Fixed rate %	Variable rate %
Dec 2008	Major banks	156,403.68	505,038.09	23.65	76.35
Dec 2008	Other Australian-owned banks	16,420.63	41,126.79	28.53	71.47
Dec 2008	Foreign subsidiary banks	13,919.69	32,090.41	30.25	69.75
Mar 2009	Major banks	150,040.94	540,038.11	21.74	78.26
Mar 2009	Other Australian-owned banks	14,939.68	44,200.66	25.26	74.74
Mar 2009	Foreign subsidiary banks	13,038.37	33,176.99	28.21	71.79
Jun 2009	Major banks	145,828.95	582,392.88	20.03	79.97
Jun 2009	Other Australian-owned banks	14,108.11	46,903.26	23.12	76.88
Jun 2009	Foreign subsidiary banks	12,310.36	34,654.67	26.21	73.79
Sep 2009	Major banks	143,412.50	606,663.32	19.12	80.88
Sep 2009	Other Australian-owned banks	14,418.04	50,226.61	22.30	77.70
Sep 2009	Foreign subsidiary banks	11,773.90	35,617.90	24.84	75.16
Dec 2009	Major banks	134,741.16	645,007.19	17.28	82.72
Dec 2009	Other Australian-owned banks	13,272.45	52,505.06	20.18	79.82
Dec 2009	Foreign subsidiary banks	10,643.77	37,097.40	22.29	77.71
Mar 2010	Major banks	124,996.94	677,934.62	15.57	84.43
Mar 2010	Other Australian-owned banks	11,945.29	54,460.34	17.99	82.01
Mar 2010	Foreign subsidiary banks	9,676.36	38,686.40	20.01	79.99
Jun 2010	Major banks	117,559.65	710,701.48	14.19	85.81
Jun 2010	Other Australian-owned banks	11,502.46	57,032.55	16.78	83.22
Jun 2010	Foreign subsidiary banks	8,912.56	40,301.56	18.11	81.89
Sep 2010	Major banks	111,498.41	734,570.04	13.18	86.82
Sep 2010	Other Australian-owned banks	10,575.69	57,736.70	15.48	84.52
Sep 2010	Foreign subsidiary banks	8,333.78	40,987.16	16.90	83.10