ING DIRECT
It's your money

31 May 2012

Mr T Bryant,
The Secretary
Senate Economics References Committee
Suite SG.64
PO Box 6100
Parliament house
Canberra ACT 2600

By e-mail: economics.sen@aph.gov.au

Dear Mr Bryant,

Inquiry into the post-GFC banking sector

ING Bank (Australia) Limited ("ING DIRECT") is pleased to have the opportunity to provide comments to the Committee on the recent developments in the banking sector arising out of the impact of the Global Financial Crisis ("GFC") and subsequent events.

In this regard ING DIRECT will limit its comments to:-

1. the impact of international regulatory changes on the Australian banking sector, relating to changes in liquidity and capital holding requirements; and

2. the current cost of funds for lending purposes.

1. The impact of international regulatory changes on the Australian banking sector particularly relating to changes in liquidity and capital holding requirements

There are a number of positive attributes to banking regulation, both domestically and internationally, and ING DIRECT strongly believes that it is because Australia has a sound regulatory base that, by international standards, we were able to withstand the GFC.

Having said this, today we are faced with the challenge of implementing regulatory change that is being imposed on us, both internationally and domestically, without thought being put into the process of regulation. Financial organisations need integrated and practical solutions that cover the entire regulatory agenda and beyond.

We believe that any post GFC regulation in and for Australia should have regard to the experience and performance of Australia during the GFC in comparison with many of its trading partners.

We believe that regulation should

- provide market solutions rather than regulatory solutions, so that implementation is for the benefit of all and promotes a competitive market;

- be consistent with other laws, agreements and international obligations. Any restrictions on competition should only be retained, if the overall benefit to the community far outweighs the adverse impact on competition, and only if the Government's objectives cannot be achieved by other means; and

- not be unduly prescriptive. It is important that when regulating, the Government is mindful of the compliance burden imposed by the regulatory change, proportionate to the problem being addressed and aims at minimising compliance costs while achieving the intent of the law.

Banks in Australia domestically operate within a robust system of Commonwealth regulation that is supported by State and Territory regulation in areas of duties and taxes and Local Government regulation in areas of planning and infrastructure. Internationally, Australian banks are also subject to extensive regulation in the jurisdictions in which they operate internationally.

ING Bank (Australia) Limited trading as ING DIRECT is a locally incorporated Authorised Deposit Taking Institution and is also a part of ING Group which is a global bank headquartered in the Netherlands. As part of a global bank, we have the additional responsibility of meeting obligations from the main Dutch regulator, De Nederlandsche Bank ("DNB") together with our local regulators such as APRA for example. Consequently, we adopt the most conservative approach of both regulatory environments. The practical challenge is to achieve the regulatory requirements in the most cost effective way while being competitive in the market. For example, under Anti Money Laundering laws we are obligated to meet "Know Your Customer" requirements, locally this means we have to comply with the AUSTRAC rules while simultaneously internationally we are bound by the ING Group global policies on Financial Economic Crime ("FEC"). The FEC is based on international laws and regulations and ING DIRECT management is responsible for the implementation of and compliance with this international policy.

Each piece of new or amended regulation adds to regulation already in place and in some way alters the compliance requirements for existing regulation. Furthermore, Government should be mindful of regulation not impeding innovation. This will allow industry to be competitive which helps deliver the best outcome for consumers.

Following are some major international prudential regulatory change which the Government should consider when introducing new national regulation.

- Basel III
- Foreign Account Tax Compliance Act ("FATCA")
- Over The Counter Derivatives ("OTC derivatives")

Basel III

This is a comprehensive set of reform measures aimed at strengthening the regulation, supervision and risk management of the banking sector. The Australian Prudential Regulation Authority ("APRA") is in the process of implementing Basel III in Australia with draft prudential standards under consultation. Basel III deals with implementing both liquidity reforms and capital measurement in Australia.

We appreciate the work undertaken by APRA to develop a framework that accommodates the particular features of Australia's banking and financial markets, while designing measures that give outcomes consistent with global liquidity standards.

The proposed scorecard governing the run off assumptions for retail deposits in the draft liquidity standard (APS 210) identifies a deposit that is primarily internet accessed for special consideration. These runoff assumptions in turn feed into the calculation of the Liquidity Coverage Ratio ("LCR") which is a key short term liquidity measure in the context of Basel III.

ING DIRECT believes there is a good case for APRA to consider modifying the definition to incorporate consideration of the Financial Claims Scheme ("FCS") threshold amount regardless of means of accessing the account. There are grounds to reasonably argue that the balance of the account is more relevant in practice than the means of accessing the account. The proposed definition could be read to imply that the deposit guarantee in the FCS applies differently depending on the means of accessing the account, which of course is not correct. For example, a $25,000 account is covered under the FCS regardless of the means of accessing the account. Internet access is only one withdrawal mechanism. There are many other means of accessing accounts such as ATMs, telephone banking, branches, mobile phone apps or other emerging technologies.

In practice, the means of accessing the account is of less significance over the 30 day period of the LCR calculation. Over this period, regardless of the means of access, all types of at call balances could be accessed. Therefore, differentiating substantially on the basis of access is not appropriate and would create an uneven playing field for internet banks such as ING DIRECT which then has an adverse impact on competition.

We have attached a copy of the submission made by ING DIRECT to APRA outlining our suggestions on implementing the Basel III liquidity reforms in Australia which represents an opportunity for APRA working with industry to develop the blueprint for liquidity management in the 21st century.

With regards to the changes to capital measurements, APRA aims at introducing a more conservative approach than the Basel III minimum requirements and work on an accelerated timetable for implementation. While this will lead to an increase in stability, this will be at an ever increasing cost and impact the end customer.

We urge the Government to consider their approach under today's global economic situation and once again emphasise the need for there to be consistency in regulatory reform. The Government needs to consider the impact these conservative approaches may have on the Australian banking system in the global market. Being part of a global bank, ING DIRECT is also subject to the Global Systemically Important Financial Institution policy framework which means that we have to comply with the more conservative standards to which the local banks are not currently subject. This may put additional pressure on the cost of funding and have a domino effect on the pricing of banking products.

Foreign Account Tax Compliance Act ("FATCA")

Another international regulation that will have a major impact in Australia is FATCA. The extraterritorial reach of FATCA has very complex compliance challenges for financial institutions and for ING DIRECT. We are now conducting a gap analysis and reassessment of the precise implications of the proposed regulations on our customers, products, processes and systems with a mandate of achieving cost-effective compliance.

Coupled with the complexities to be considered is the challenge of introducing a new FATCA compliant on-boarding process by 1 July 2013. The limited implementation period is a major concern and is another challenge we face with numerous regulatory reforms being considered for implementation today.

Over The Counter Derivatives ("OTC derivatives")

The Government has released the final report of the Council of Financial Regulators ("COFR") outlining the proposed next steps towards the implementation of Australia's G20 commitment to improve risk management and reduce systemic risk in the OTC derivatives market.

It is encouraging to note that the COFR supports industry solutions and flexibility and has noted that regulation may only be necessary to ensure timely implementation. Our view is that regulation must ensure that OTC derivatives markets are as harmonised and coordinated as possible. Global harmonisation would also reduce the risk of disruptions to cross-border activity which contributes to the efficiency and liquidity of domestic market.

The COFR has recommended a legislative framework that will impose a mandatory reporting requirement in respect of certain products and participants. It has proposed a central clearing process system.

Here again regulation must provide market solutions and promote a competitive market. We would like both Treasury and ASIC to engage the industry in the consultation process to ensure that regulation continues to create an even playing field.

In addition to the above international regulatory challenges, we also currently face a long list of domestic regulatory change that has very short consultation and implementation dates. These changes also have an impact on cost.

Some of the domestic regulations we are looking at today include:-

- Consumer Credit and Corporations Legislation Amendment (Enhancement) Bill 2011 which proposes major changes to the hardship process by 1 March 2013 while we are still awaiting the passage of the law and the release of the regulations.
- Current consultation process being undertaken to determine regulatory requirements for both small business lending and investment lending.
- Competition and Consumer Act 2010 introducing a prohibition on price signalling which commences operation on 6 June 2012.
- Financial advice reforms introducing a best interest duty and ban on conflicted remuneration stipulated to commence on 1 July 2013 will require a number of expensive system changes, however the law and the regulations are yet to be passed.
- Introduction of reforms to the Privacy Act with the introduction of a single set of Australian Privacy principles and positive credit reporting provisions are expected to be tabled in Parliament in the winter sitting.
- Exposure draft legislation has been released on introducing a national electronic conveyancing system to facilitate transfers of real estate, the discharge and creation of mortgages; and
- Regulatory changes to superannuation

While these regulatory changes are intended to facilitate greater efficiencies and competition in financial services, they do involve major implementation projects for banks and other industry participants. ING DIRECT believes that proper consultation, with regulatory impact assessments and appropriate time is required to achieve the true intent of the law. The short time frames provided to implement and comply with some of these laws is of great concern to ING DIRECT as we need to plan to implement these projects while managing the daily operations of the Bank.

2. <u>The current cost of funds for lending purposes</u>

In many households around the country, the biggest monthly expense is the mortgage repayment. Given it is such a significant part of the family budget, people monitor movements in interest rates closely and the cost of funding has a direct impact on both deposit and lending rates.

Pre GFC

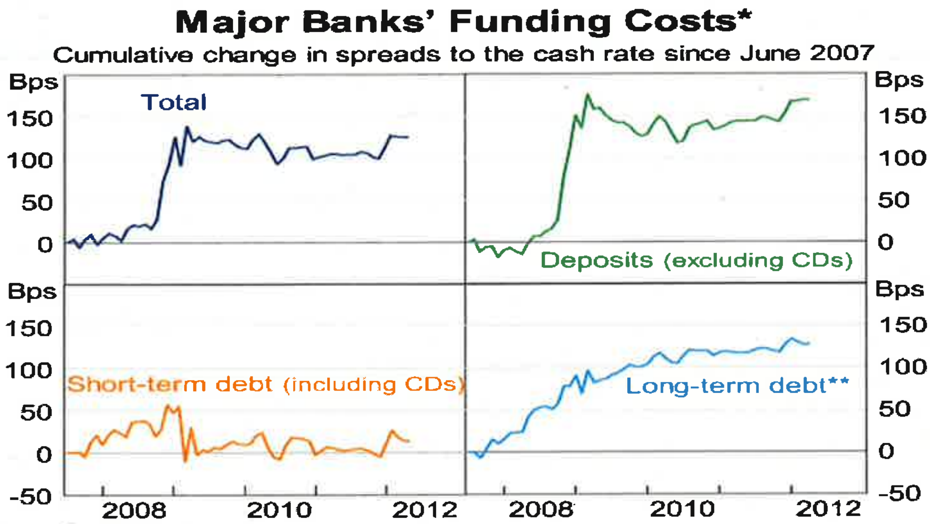
Banks historically have performed the role of liquidity transformation. This involves providing long term loans such as housing loans, with funding provided through a variety of largely short term wholesale and retail sources.

This approach was premised on the basis of being able to continually renew maturing funding, which was based on stable market conditions. The events surrounding the GFC highlighted that the assumption of continuous market access, embodied in the above approach, was invalid.

Post GFC

Against this background, banks have focussed on addressing this weakness in their funding models by lengthening the maturity profile of liabilities raised in both wholesale and retail markets. In addition, regulatory changes introduced and in prospect, have accelerated and reinforced this changed approach to liability management. In particular, the Basel III liquidity standard (APS 210) has been a key driver in this direction and a significant contributor to the higher funding costs banks are now facing.

Historically, retail markets have been a source of cheaper funding, however, over recent years, the cost of funds from this market has increased, in tandem with funding costs in longer term wholesale markets.



* RBA estimates
** Weighted-average spread to cash rate and CGS for long-term variable-rate and fixed-rate debt, respectively. Includes foreign currency hedging costs.
Sources: Bloomberg; RBA; UBS AG, Australia Branch

The above chart highlights the extent of the increase in funding costs over recent years. After a period in which funding margins levelled off across 2010 and most of 2011, (albeit at higher than pre GFC levels), funding margins again jumped in the final quarter of 2011.

Despite some improvement in the early months of 2012, funding costs remain at elevated levels reflecting the ongoing instability in European credit markets and ongoing domestic demand for retail term deposits.

Increased wholesale funding costs have been driven by a number of factors, including;

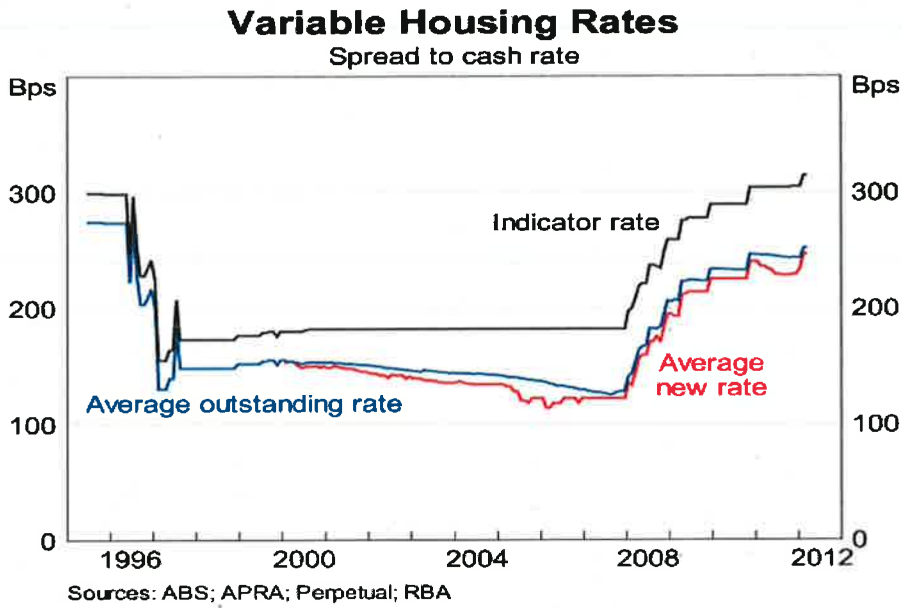
- Increased demand for term funding in both domestic and offshore markets linked to the changing regulatory environment.
- Reduced investor support for bank paper reflecting stressed credit market conditions.
- Increased basis swap costs incurred when foreign currency funding is hedged into AUD.

This means that cost of funds for lending continues to be on the rise.

Impact on bank lending costs

The combination of the above factors and the maturity of cheaper historic funding have intensified the increase in bank funding costs as depicted in the diagram below.

Banks now price off cost of funds and not the market benchmarks such as the cash rate.



The higher cost of funds translates directly into higher cost of debt at the client level.

A recent study by the Reserve Bank of Australia,("Banks' Funding Costs and Lending Rates" RBA Bulletin March 2012) provides a detailed analysis of recent developments in the structure and costs of funding for banks in the Australian market.

This analysis is consistent with our experience over the past several years.

Outlook for bank funding and lending costs

The regulatory environment is causing significant changes in funding markets. This, in combination, with the deterioration in credit markets over the recent past has resulted in significant fundamental changes in bank funding costs.

It appears likely that the higher funding costs will remain an aspect of banking that all stakeholders must confront in the period ahead.

The Australian banking sector is highly competitive and the challenge for Government and regulators is to ensure that changes that are introduced maintain competitive neutrality and promote competition.

Conclusion

The Wallis inquiry in 1997 found that Australia's regulatory environment was fragmented to the point where the level of complexity was causing substantial compliance costs and confusion to consumers. That report determined that Australia's financial service providers wishing to compete in global markets would be disadvantaged by inconsistencies in the regulatory framework and made significant recommendations regarding the regulatory structure.

Today, the global economy is facing considerable regulatory change. We believe that the regulatory process should be reviewed once again to determine how regulation can be made to work together towards implementing a single consistent approach to provide market solutions and promote innovation.

Australia has a healthy banking system that promotes investors and borrowers confidence. ING DIRECT believes it is imperative that a careful thought process into regulatory change is essential in order that it does not impede banking competition or in anyway adversely impacts the level playing field.

The GFC has seen the tightening of credit conditions, higher funding costs and increased risk aversion amongst both lenders and investors, coupled with a raft of international and domestic regulatory changes intended to strengthen our financial stability. In the face of regulatory change by international banking supervision agencies, Australian policymakers need to be cautious that supervision and examination policies are introduced to provide market solutions that will continue to encourage a competitive environment.

Once again we thank you for inviting us to provide our comments and we look forward to addressing any questions that you may have.

Yours sincerely

Don Koch
Chief Executive Officer
ING DIRECT