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BY EMAIL

Dear Secretary

THE WESTPAC GROUP SUBMISSION TO SENATE ECONOMICS REFERENCES COMMITTEE'S INQUIRY INTO THE POST-GFC BANKING SECTOR

Introduction

Australia has a very strong, reliable and resilient banking system. The GFC reminded the nation, and the world, how important it is to have a safe and viable banking system. Australia came through the Global Financial Crisis, the worst global economic event since the Great Depression, because of the strength of its' banking system and because the Government, regulators, the major and regional banks and the community worked together to ensure that it has stayed strong.

Westpac is Australia's oldest bank. We have been serving the community for nearly 200 years, including through some of the most difficult periods in Australia's history.

We are deeply committed to serving the Australian community and to playing a positive role in the development of Australia. Westpac took its role during the crisis very seriously. We saw our obligation to our customers and to the communities we serve during this difficult period as paramount.

It is sometimes easy to forget the extremely serious situation Australia faced in the depths of the GFC. Swift and effective action by the Federal Government, the RBA and APRA, demonstrably supported by banks such as Westpac, protected Australia from many of the worst possible effects of the crisis.

At Westpac, we continued to lend, even when others pulled back. Ensuring that there was a steady supply of credit available through the crisis was probably the most important contribution we could make. At times in 2009 we were providing nearly 50 per cent of the new home lending in the market. We also supported smaller lenders by providing funding so they in turn could continue to lend.

We increased our support for customers experiencing financial distress, by further strengthening our "Westpac Assist" program and launching St.George Assist. We actively supported small business customers, many of whom were particularly affected by the crisis. We also invested materially in our business during this time, for example in our "Westpac Local" initiative, putting new and more senior bank managers and business bankers into our branches.

However, as we have seen on a number of occasions throughout the last four years, the GFC continues to have profound effects on global financial markets.

Two key impacts of the GFC for Australia have been driven by the reliance of our economy on offshore capital markets.

Unlike many other leading economies, a large proportion of Australia's current account deficit can be attributed to private debt; in other words much of the current account deficit can be seen to relate to wholesale funding offshore by the banking sector to facilitate investment in our own economy.

Westpac and all other Australian banks use wholesale funding, including funding from global financial markets, to supplement deposits from Australian households and businesses to meet our customer's needs. The GFC led to a large and enduring increase in the costs of wholesale funds globally.

The two key impacts are as follows.

First, increased competition for customer deposits. As the costs of wholesale funding increased, banks sought to raise more customer deposits and offered higher prices to do so. As a result, customers now enjoy some of the fiercest competition for deposits in the history of Australian banking. Banks have never competed as hard as they do now for customers' deposit business. For customers who are savers and for older customers and retirees in particular, this is an unequivocally positive competitive outcome.

Secondly, the increased price of funding – driven both by global markets and increased competition for deposits – which significantly increased the cost of lending to Australian consumers and businesses. It is not clear how long funding costs will remain volatile.

Westpac welcomes the opportunity to contribute once again to the Senate's inquiries into the Australian Banking industry. The Westpac Group made a comprehensive submission to the Senate Economics Committee Inquiry into Banking Competition 2010. That submission can be read as an adjunct to this submission. The report of that inquiry was balanced and delved deeply into the issues.

In regard to the specific terms of reference of the current inquiry Westpac would make the following points.

International Regulatory Changes

Term of Reference (a) requests the Senate Committee to examine the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements

Global Regulatory Reform Agenda

There is a significant international regulatory reform agenda impacting Australian banks. These reforms are either under the auspices of the G20, and as such are global in nature, or being introduced by other jurisdictions with significant extra-territorial impact on Australian banks.

The purpose of the following section in this submission is not to consider or debate the content of the reforms, but rather to highlight the impact this will have on both the banking sector and the broader economy. The reforms are being developed with the intention of increasing the safety and soundness of individual banks and the financial system as a whole. Safety and soundness are not costless; the challenge of policy design is to balance the cost and the benefits of the reforms, and much of the policy debate turns on this point. However, what is not in dispute is that there is a cost to the package, not only on the banks themselves but impacting on the broader economy through the pricing and availability of credit.

Regardless of any debate on the need or merits of the elements of the reform agenda, it must be taken into consideration that the impacts of such reforms will undeniably be that credit will be more expensive, and supply constrained relative to the experience of previous decades.

Basel III

Basel III is a comprehensive package of prudential reforms designed to improve banks' resiliency and loss absorbency. It increases the quantity and quality of capital that must be held by banks, and introduces three new requirements: a leverage ratio, a Liquidity Coverage Ratio (LCR), and a Net Stable Funding Ratio (NSFR).

The capital reforms not only require that banks hold more capital in order to support asset creation, but that capital must be overall of a higher quality. Higher quality capital is more expensive, and therefore increasing both quantity and quality has a combined impact on cost.

The liquidity reforms are likely to have a more direct impact on Australian banks due to the nature of our financial system. The LCR will require that a greater proportion of deposits and other liabilities are held in the form of high quality liquid assets, which by definition therefore means a reduced lending capacity for a given deposit base. The NSFR will require that lending activity is supported to a greater extent by more stable funding, in general directing liability raising activities towards retail deposits and long term wholesale funding. The price impact has been readily apparent to all observers, particularly in the retail deposit space, but price alone may not be sufficient to address the capacity of the market to supply stable funding to support credit growth.

The impacts of the components of Basel III are therefore unidirectional and cumulative, increasing the cost of, whilst constraining the capacity for, credit provision by the banking sector.

Systemically Important Financial Institutions

Systemically Important Financial Institutions (SIFIs) are a significant focus of reform development. A global package of SIFI reforms has been agreed that include the development of a resolution framework to reduce the impact of a SIFI failure, the development of recovery & resolution plans (RRPs, or “Living Wills”) to improve the management of either a potential or actual SIFI failure, and capital surcharges and more intensive & effective supervision to reduce the probability of a SIFI failure. The implementation of this framework requires both the identification of SIFIs and determining how the suite of SIFI tools will be applied to varying classes of SIFIs.

Work has already been completed on the identification of Globally Systemically Important Banks (G-SIBs) with the naming of 29 G-SIBs and the setting of capital surcharges announced November 2011. No Australian bank was named a G-SIB. By the end of this year the framework will be extended to a much broader group of SIFIs, including Domestically Systemically Important Banks (D-SIBs). Until the completion of that work on both the package of reforms and the institutions to which they apply, the impact cannot yet be determined. However, improved resiliency and resolution again necessarily comes at both a direct cost (in the form of say higher capital requirements) and the efficiency of credit provision (through say improved resolvability via enhanced separability). At present however we are facing uncertainty, which has a constraining impact on management planning decisions. Recovery and resolution impacts are discussed further in the next section.

Recovery and Resolution

Banks will be required to prepare Recovery and Resolution Plans. APRA has already commenced a pilot Recovery plan project, and that work is well advanced. We understand APRA will consider Resolution plans on completion of the Recovery plan pilot. The key element of RRPs will be the resolvability assessment process - can a firm realistically carry out its recovery options and can the regulators resolve a failed bank without systemic impact? The focus here is on separability, with a push away from centralised functions, intragroup guarantees and towards subsidiarisation of activities. The Vickers recommendations in the UK regarding the ring-fencing of retail banking from other activities are one example of possible policy outcomes. Such a separation of activities has a necessarily negative impact on the efficiency not only on the operations of banking entities, but on the provision of services to customers.

Additionally, the G20 has committed to introducing bail-ins. The Reserve Bank of New Zealand (RBNZ) has already imposed a requirement on NZ banks (including the subsidiaries of the four major Australia banks) to pre-position their deposit systems to implement the NZ version of bail-in (Open Bank Resolution). Further work at the G20 will be completed this year.

It is expected that the imposition of bail-ins will not only impose implementation costs on affected institutions (as is already the case in NZ), but is expected to increase the cost of raising liabilities, constrain the availability of unsecured funding, and very likely drive an increase in demand for secured funding.

Over-The-Counter derivatives

Over-the-Counter (OTC) derivatives are a critical risk management tool used by both banks and their customers alike. Corporations hedging their commodity and foreign exchange risks, banks managing their own interest rate risk, or the provision of fixed home loans to consumers are all made possible though OTC derivatives.

Therefore, as with all other reforms above, irrespective of the need for, or the exact nature of the reforms, safety necessarily comes at a both an increased cost and decreased provision of services against that which is currently available.

Shadow Banking

Reforms are due to be finalised at the G20 level later this year in relation to what is being termed “shadow banking”. Shadow banking in this context is defined as non-bank entities that provide credit intermediation, and includes non-bank mortgage providers and money market funds. The work not only covers the identification and regulation of shadow banking entities, but is also considering the imposition of regulations on the interaction of banks with such entities. These would be additional regulations on banks, in addition to the comprehensive banking regulation reforms already announced. This is work in progress and few concrete policy proposals have emerged.

Regardless of the detail of the reforms they will increase the cost, and constrain the capacity, of bank’s provision of financial services to non-bank financial companies, but it will also impact those entities directly, impacting the costs of providing services to their customers, and constrain their capacity to provide credit intermediation services.

Macro-prudential tools

Work is being conducted in relation to expanding the suite and application of macro-prudential tools. These tools are defined broadly as mechanisms to increase the resilience of banking institutions during times of excessive credit growth. One such example often discussed in this area is dynamic Loan to Valuation Ratio (LVR) caps. That is, not only are maximum LVRs for mortgages set by regulators, but as house prices rise and consumer credit growth is deemed excessive, LVR caps are reduced.

Such a propose policy provides a direct example of our introductory comments that despite any argument regarding the need or merits of such a policy tool, its implementation will necessarily have the impact of restraining credit supply as credit demand increases in the economy relative to previous experience.

United States Dodd-Frank Act (DFA)

DFA in many respects represents the US implementation of the G20 reform agenda. However, DFA contains a number of reforms that either go further or are more onerous than agreed G20 objectives (such as OTC derivatives reform), or are unique to the US (such as the Volcker Rule). Further the proposed and final rules supporting the statute are crafted such that DFA will have broad extra-territorial application. In particular certain activities of Australian banks in Australian markets will fall under the direct regulation and constraints of DFA, even though the Australian jurisdiction has chosen not to adopt such reforms.

The impact here is greatest in financial markets, and Australian banks will therefore be subject to those additional costs and constraints over and above agreed G20 and domestic Australian policies in a manner which will impact the efficiency of domestic financial markets, and hence the provision of risk management services to customers.

Funding Costs

Term of Reference (c) requests the Senate Committee to examine the current cost of funds for lending purposes

For many years Australians were accustomed to home mortgage rate changes moving in line with Reserve Bank decisions about interest rates. However, the GFC has permanently changed this cycle for The Westpac Group and our customers.

The RBA cash rate is not the rate at which a bank borrows its funds. It is rather one factor that influences the price of money in capital markets, which (along with deposits) are where banks secure a significant proportion of their funds.

Previously, the RBA's cash rate and banks' lending rates were correlated largely because factors impacting lending rates, such as risk premiums, were relatively stable and because a significant portion of funding was short term.

However, global regulatory reforms around bank liquidity management have necessitated a fundamental shift in how Westpac manages its funding requirements. Basel III Liquidity rules see banks not only increasing liquid asset holdings but also require banks to source funding from more stable funding sources, such as customer deposits and longer duration wholesale funding.

Wholesale funding, previously readily and cheaply available, has become more difficult and expensive to secure. Further, to improve the quality and security of our funding, we are increasing the term of the funds we raise in the market and these come at a higher cost than short term funds.

Finally, the cost of customer deposits has dramatically increased due to intense competition for this source of funds.

These factors mean that the RBA's cash rate and the cost of funds for banks have not been moving in unison for some years.

Factors influencing increasing cost of funds

The cycle of global economic uncertainty and financial market dislocation that began in 2007 has caused a structural shift in the cost of money.

While the absolute cost of funds and lending have recently been lowered through reductions in benchmark interest rates in late 2011, the relative cost of funding has continued to increase due to a number of factors.

a) Ongoing global economic uncertainty continues to negatively influence both investors and international financial markets. Investors perceive that there are higher risks to investing in certain market segments, such as banks and financial services and as a result are demanding a higher risk premium for investing in bank wholesale funding programs. These risk premiums will incrementally increase for longer duration borrowings and will fluctuate as investor sentiment deteriorates or improves.

b) Deposit funding is a critical source of funding for banks. Competition pressures drive deposit pricing, particularly in term deposits, and have resulted in banks paying much higher spreads above the benchmark cash rate on deposits.

c) Westpac, along with the other major Australian banks, has significantly shifted its funding composition to fundamentally strengthen its' balance sheet in response to the changing landscape. Key funding compositional changes have resulted in a higher proportion of total funding sourced through deposits. Wholesale funding has shifted away from shorter term (higher risk and less costly) to longer duration funding (more stable and higher cost). These compositional changes strive to make the Bank stronger and more resilient in times of uncertainty. However, this increased strength has also increased the cost of lending.

Increases in Funding Costs – Wholesale Funding

The cost of long term wholesale funding has significantly increased since 2007. On average, 3 year term funding costs have risen by 105basis points in domestic markets and 160basis points from offshore markets, while 5 year term funding costs have risen by 150basis points domestically and 200basis points from offshore markets. The continued elevated wholesale funding costs have gradually increased the average costs of the wholesale funding portfolio as cheaper pre-crisis funding matures and is replaced with more expensive new issuance.

While a large portion of the wholesale term funding portfolio has been refinanced at higher spreads, the average cost of funds has continued to rise. Over the last six months, the average cost of Westpac's wholesale term maturities have been refinanced with new term issuance at spreads approximately 85basis points wider and continue to drive up the average costs of funds.

Increases in Funding Costs – Deposit Rates

Westpac has increased the proportion of customer deposits as a proportion of total funding from 44% in 2008 to 54% in 2012. In addition, there has been a shift in customer deposit account preference from low interest bearing savings and transactional accounts to higher cost term deposit accounts.

In the new regulatory environment, term deposits are seen as a higher quality deposit, and as such banks have been competing strongly driving pricing higher. Term deposits are paying between 130 basis points and 180 basis points above the cash rate now, compared to around 40 – 70 basis points above the cash rate in June 2011. While the cash rate has decreased 50 basis points over this period the relatively cost of these deposits have increased by around 30 basis points.

Increases in Funding Costs – Summary

The rise in funding costs relative to the cash rate continues to reflect higher spreads on wholesale debt as investors' concerns around the global banking industry remain elevated and also reflects strong competition for deposits.

As noted by the RBA in its March Quarter 2012 Bulletin; 'Banks' funding costs and lending rates',

> *"Compared with mid 2007, the average cost of the major banks' funding is estimated to be about 120 – 130 basis points higher relative to the cash rate. Most of the increase*

> *occurred during 2008 and early 2009 when the financial crisis was at its most intense. Since the middle of 2011, however, there has been a further increase in banks' funding costs relative to the cash rate of the order of 20 – 25 basis points."*

While there has been a reduction in the benchmark interest rate over the last few months, the relative cost of funds between the benchmark rate and the interest rates paid by Westpac on both wholesales and customer deposits have not decreased to the same extent driving an increase in overall funding costs for lending purposes.

Borrowing and Lending Practices

Term of Reference (d) requests the Senate Committee to examine the impact on borrowing and lending practices in the banking sector both during and since the global financial crisis

The framework that Westpac has used to consider lending transactions has not changed as a result of the global financial crisis (GFC).

The Westpac Group's lending policies are guided by "*Our Principles for Doing Business"* which set out commitments governing our response to ethical issues, such as respecting human rights; preventing financial crimes and the management of environmental risks. We were also the first Australian bank, and one of 10 founding signatories globally to adopt the Equator Principles. We have agreed to provide loans only for projects whose sponsors can demonstrate their ability and willingness to comply with processes that ensure they are developed in a socially responsible manner, according to sound environmental management.

Credit decisions are based on our normal lending underwriting standards. These include evaluating the customer's capacity to repay the loan through cash flow using standard financial ratios such as debt service cover and interest cover ratios. Customer repayment and credit history, capabilities and the track record of the business managers are also considered as are the type and valuation of the security offered and loan to valuation ratios. Westpac also considers any proposal against our lending concentration appetite for particular industries and geographies.

Our underwriting standards are established 'through the credit cycle' and generally do not change materially. Apart from reducing the maximum loan to valuation ratio for commercial property lending, Westpac has not made any major changes to credit policies from those operating prior to the GFC.

Factors considered when determining the appropriate pricing level for a credit facility have not changed as a result of the GFC. However, we regularly review the inputs to our pricing models to ensure they reflect the current operating environment and the latest market and risk factors.

Australian prudential regulation impacts banks' costs and lending practices by discouraging lenders from engaging in risky lending behaviour. In our experience, this regulation is appropriate and important for the safety and stability of the Australian financial system. The consequence of a weak regulatory system, together with systemic mis-pricing of risk, was seen in the financial crisis of 2008 and its aftermath.

A comparison of the capital requirements of residential lending and business lending highlights the disparity in the cost of lending to business. Capital reserves required are three times higher for business lending than residential loans, reflecting the increased risk inherent in business loans. Although extremely low by international standards, nevertheless the default rate of business loans is approximately two-and-a-half to three times higher than for residential loans.

Conclusion

Australian banking has been transformed over the last three decades. The system enabled by financial deregulation, securitisation and prudential regulation serves Australia and Australian consumers well, and helped us withstand the worst impacts of the global financial crisis.

Banks remain willing to lend to customers, Westpac in particular remained "open for business" during the GFC when others cut back on their lending. We have not changed our lending framework in response to the GFC.

However, the ongoing uncertainty and volatility in the world economy in the wake of the GFC continues to have a significant impact on financial markets and, as we are currently experiencing, will result in lasting structural change to the way Australian banks fund themselves.

If you require any further information, please contact me directly.

Yours sincerely,

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