AFMA

8 June 2012

Senate Standing Committees on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam

Inquiry into the Post-GFC Banking Sector

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, traders across a wide range of financial and energy markets and industry service providers. We appreciate the opportunity to make a submission to the Inquiry. Our submission primarily focusses on the provision of financial intermediation services to Australian businesses and investors.

The global financial crisis (GFC) had a marked impact on Australia's banking sector and the financial markets they interact with, as outlined in the attached submission to this letter. For a number of reasons, including more extensive regulation, the cost of providing financial intermediation services in Australia is rising. Moreover, the GFC has led to some re-ordering of the financial sector in institutional terms and is having a structural impact on the way that business is done on financial markets. Further, the vital importance of having efficient capital markets to complement the banking sector was apparent during the GFC, through the financing options this provided to business.

The impact of these changes has not been uniform and some institutions and market segments fared better than others, reflecting the nature of their business and sensitivity to the environmental changes that occurred. Government policy priorities need to be adjusted to proactively manage the consequences in a way that builds on our strengths and minimises any detriment to the quality and competitiveness of our banking and capital markets.

AFMA's comments focus on corporate banking and our financial markets – including the securities markets, business lending and investment lending. I wish to summarise the key points set out in the submission as follows:

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Industry Context

- The corporate banking market is highly competitive with direct competition between the major domestic banks and foreign banks in particular.
- The securities markets provide competition for corporate financing – most obviously through issues of debt securities and less directly by equity issues.
- Overseas funding sources, notably syndicated lending by overseas banks and bond issuance overseas, increase the competitive pressures on local providers.
- Investment lending includes margin lending and capital protected products (like instalment warrants) which are specialised markets that broaden the spectrum of product and wealth management options for investors.

The Impact of the GFC

The GFC had a significant impact on the corporate banking and financial markets, with reduced competition, adverse impacts on profitability and employment, slower credit growth and greater offshoring of some financial market support functions:

- The long term trend to conduct financial intermediation through licensed banks intensified at the expense of securitisation and non-bank financial intermediaries.
- Within the licensed bank sector, the market share of total resident assets held by foreign banks and smaller domestic banks declined by over 40%; thus, the market share of the major banks increased. The withdrawal of credit to large business by European banks was a significant factor in this outcome.
- In the domestic corporate debt capital market, bonds on issue declined slightly and the turnover has not fully recovered from a downturn in 2008 and 2009.
- The equity capital market enabled companies to raise equity quickly to strengthen their balance sheet during the GFC when credit markets were constrained.
- In the equity market, stockbrokers are under pressure from reduced turnover (below its level of five years ago) in a highly competitive market, a growing regulatory burden, system upgrades and other operating costs and exceptional cost recovery charges for regulation.
- During the GFC and in the uncertain times since, the Australian over-the-counter (OTC) derivatives markets operated efficiently and effectively handled the management of risk between participants. Turnover declined for a period and the market is being structurally reformed to concentrate risk in clearing houses in keeping with G20 commitments.
- Investment lending activity fell sharply in the face of volatile share prices and new tax penalties on people who seek capital protection for geared investment.

- A higher cost base in Australia and consolidation by global banks post the GFC has led to job losses in Australia. Some banks relocated staff or transferred trading and operations to regional centres, including Hong Kong and Singapore.

The Impact of Post-GFC Regulation

The regulation of banks and financial markets intensified in response to the GFC, giving rise to higher costs of financial intermediation. The amount of the increase is difficult to quantify in practice, in part because banks have independently adjusted aspects of their business and risk management arrangements to take account of the lessons to the GFC.

- The Basel III capital and liquidity reforms are increasing the cost of financial intermediation by banks. The eventual cost will depend in part on APRA's approach to implementing the new liquidity standard in Australia. In addition, the Basel Committee is considering tighter trading book capital requirements.
- Consequent to a G20 agreement in 2009, OTC derivatives markets regulation is undergoing major reform with emphasis on moving to new infrastructure for trading, clearing and reporting coupled with changes to the regulatory capital cost for derivatives. These reforms are significantly increasing the costs of managing risk through derivatives for market participants, including end-users, and are changing market structures.
- Securities companies have implemented, or are preparing to implement, a wide range of regulatory reforms, such as short selling prohibitions and reporting, securities lending reporting, new market integrity rules and future of financial advice (FOFA) reforms that have been implemented in response to the GFC and related events. This has increased the operating cost base for the industry.
- Margin lenders have been required to absorb a significant change management burden through significant legislative changes, at a time when earnings have declined. This includes revisions to Chapter 7 of the Corporations Act that now classifies standard margin loans as a financial product and imposes a range of new obligations on lenders, as well as more general reforms (eg the Unfair Contract Terms Act, the Personal Properties Securities Act and FOFA).
- Government charges on industry to recover the cost of regulation have grown rapidly post the GFC. These charges impose a significant burden on the industry in financial terms and they distort market behaviour.
- Banks face potentially large compliance costs arising from the extraterritorial application of measures like the US Foreign Account Tax Compliance Act (FATCA) reporting requirements and the Dodd-Frank legislation (including the Volcker rule).

Policy Measures to Manage Change to the Benefit of our Economy

The Government could take steps to reduce the harmful impact of the GFC and reduce the impact of associated regulatory measures on the cost of financial intermediation:

Taxation

1. Remove the non-resident interest withholding tax on financial institutions, as recommended by the Australia's Future Tax System (Henry) Report and Australian Financial Centre Forum (Johnson) Report.
2. Remove the LIBOR cap and interest withholding tax on foreign bank branches funding from their parent banks (as recommended in the Johnson Report).
3. Reset the benchmark rate for interest deductibility of capital protected products at a realistic economic level.

Retail and Wholesale Bond Market

4. Amend the prospectus disclosure requirements so that offer documents take less time and are less expensive to prepare (this is currently being considered by the Department of Treasury).
5. Remove the tax bias (identified in the Henry Report) against investors taking up products that generate interest income, like corporate bonds and deposits
6. Consider whether superannuation fund managers and trustees can be encouraged to apply a greater proportion of the assets they manage to corporate bonds.

Cost Recovery for Regulation

7. Apply the principle that all cost recovery charges should be met by the principal beneficiaries of the regulation, taking account of the public benefits that accrue from the regulation (including tax benefits that flow to government).
8. Implement 'cost recovery' measures across agencies on a coordinated basis that takes into account the industry's capacity to pay and reasonableness, given the combined impact of cost recovery measures and the cost of regulatory compliance.
9. Design cost recovery programs to operate in a business neutral manner and avoid the associated charges operating in a similar way to a transactions tax.
10. Manage the moral hazard risk by giving industry an effective role in the governance arrangements for a cost recovery program and by government shouldering a reasonable proportion of the associated cost.

Australia's Competitiveness as a Financial Centre

11. Give priority to implementing the outstanding Johnson Report recommendations.
12. Require disclosure of how any proposed tax or regulatory reform will impact on Australia's competitiveness as a financial centre (particularly in comparison to our regional neighbours such as Singapore and Hong Kong) and attach a higher weighting to those impacts in the policy decision making process.

International Regulation

13. Continue to press for, through the G20 process, effective regulatory coordination between jurisdictions and for the Financial Stability Board to give priority to this part of its mandate.

In conclusion, we would like to emphasise that the sound performance of the Australian financial system during the GFC is testament to the underlying strength of the economy, prudent management by financial firms and effective regulators. This provides a competitive advantage for Australia that can be nurtured through the measures we have outlined above to further develop the capacity of our financial system to provide export income, preserve and grow quality employment opportunities and provide cost effective, high quality services to Australian business and consumers.

Yours sincerely

Duncan Fairweather
Executive Director

Submission to the Inquiry into the

Post-GFC Banking Sector

June 2012

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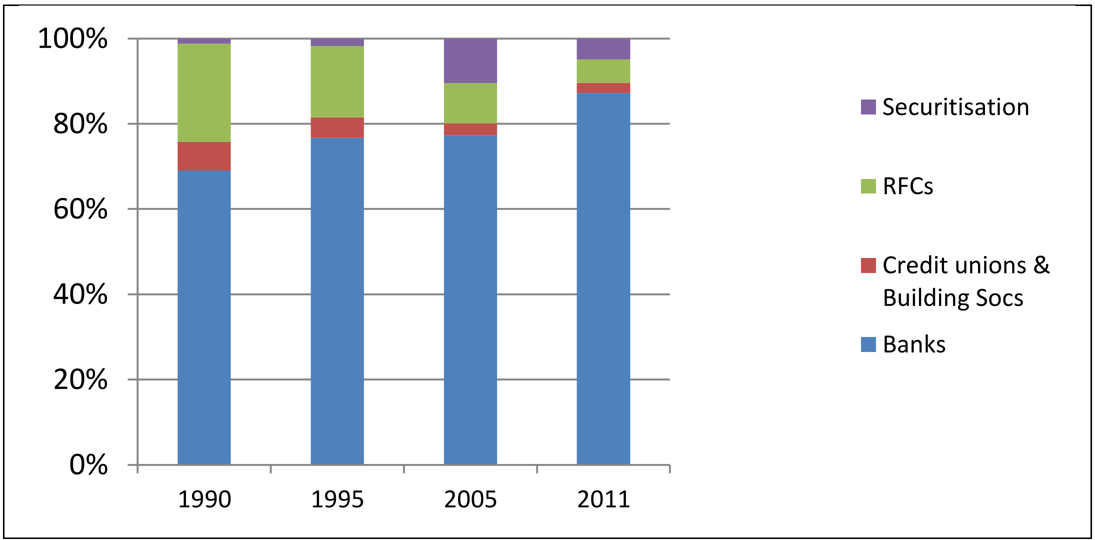
1. Financial System and Credit Intermediation Trends

Banks are part of the broader financial system and they face competition at various levels within the system. Institutions share the market place with other Authorised Deposit-taking Institutions (ADIs) and non-bank financial institutions. Banks also rely on, participate in and compete with the capital markets. One benefit of a well-diversified financial system is a reduction in systemic risk, assuming that there is proportionate regulation of the various subsectors.

Some short and long term trends to the institutional nature and form of credit intermediation are summarised in **Figure 1**.

Figure 1: Sectoral Share of Credit Intermediation over Time



Note: Chart data are derived from published RBA statistics.

First, the provision of credit by non-bank credit intermediaries has been in steady decline. In other words, Australia's 'shadow banking' sector is small and has exhibited continuous long-term contraction, as evident especially in the decline in importance of Registered Financial Corporations (RFCs), which include money market corporations and finance companies. Amongst other things, this reflects the gradual transition of the major merchant banks into prudentially regulated banks.

Second, the securitisation industry provided a potent and growing degree of competition from the mid-1990s until the onset of the global financial crisis (GFC), which altered investors' risk appetite for non-bank debt.

Third, the relative scale of non-bank ADI (credit union and building society) business has declined over the long term. More recently, this is affected by the reclassification of some such entities as banks.

In summary, it is evident that one impact of the GFC has been to increase the amount of credit intermediation undertaken through banks. While there are some long term trends at play in this outcome, the difficulty faced by non-bank institutions in funding their operations on a competitive basis since the GFC is a significant factor.

2. Business Banking Developments

The share of credit intermediation accounted for by banks has been growing consistently over time and, more relevantly to the Inquiry, has accelerated since the GFC. The impact of the GFC has been different in both the business and consumer banking markets. AFMA primarily focusses on the large business banking market, which remains a highly competitive market but one which has become more concentrated since the GFC.

The institutional nature of credit intermediation differs between the business and consumer loan markets (see **Table 1**). In particular, there is a more diverse range of providers in the business loan market and there is less market concentration than there is in the consumer loan market. This mainly reflects the significant presence of foreign banks and RFCs in this market.

Table 1: Sectoral Lending by Financial Institutions - Market Share, March 2012

	Business lending	Household lending
Major 4 banks	67%	74%
Other domestic owned banks	7%	8%
Foreign bank branches	11%	0%
Foreign bank subsidiaries	4%	4%
Credit unions & Building societies	0%	4%
Registered financial corporations	10%	2%
Securitisation (mortgages)	-	8%
Total $ billion Lending	$519bn	$1,399bn

Notes: Business lending is lending to non-financial corporations of all sizes. Household credit includes home loans, housing investment loans, credit card and other loans. Registered financial corporations include money market corporations and finance companies (excluding financial leases). Derived from data published by APRA and RBA.

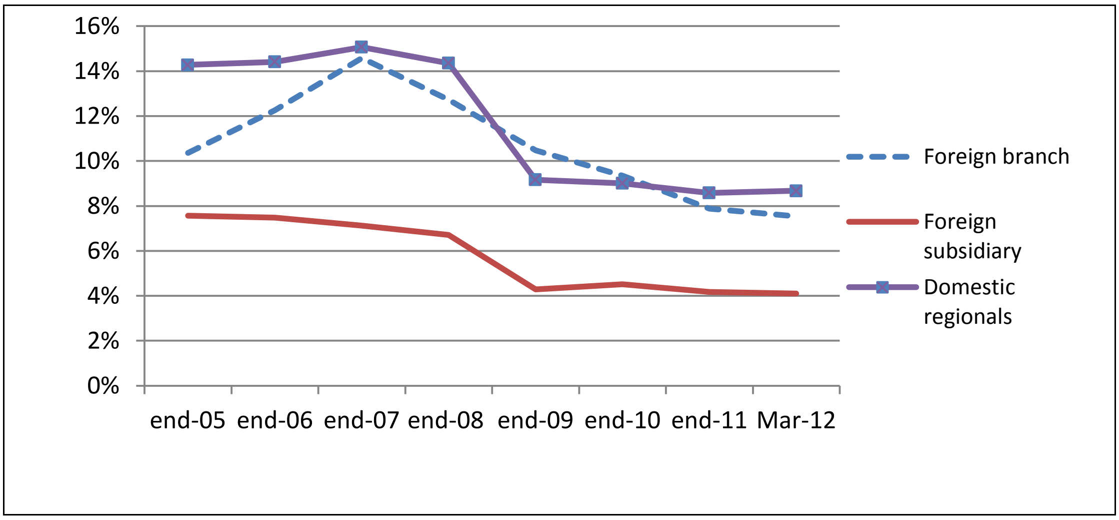
Foreign banks have a much larger presence in the business banking market, largely reflecting the focus of foreign bank branches on wholesale clients in keeping with their regulatory obligations. Policy reforms introduced in 1992 enabled the establishment of foreign bank branches and over the following decade, the largest merchant banks (which are not prudentially regulated by APRA) and many licensed bank subsidiaries converted to foreign bank branch status in response to a range of business and regulatory factors.

Foreign bank branches do not provide consumer banking services. However, foreign bank subsidiaries and the domestic regional banks provide both business and consumer credit. **Figure 2** summarises the trend in changes to the market share of foreign banks and the domestic regional banks (ie the non-major banks). In all cases, their market share has fallen noticeably since the GFC, with the corollary that the market share of the four major Australian-owned banks has risen commensurately.

In particular:

- The market share of foreign bank branches has fallen by almost half since the onset of the GFC, reversing their balance sheet rapid growth prior to the GFC that had the effect of reducing business loan margins.[1] This is largely due to contraction by European banks, with Asian bank exhibiting slight growth.
- The market share of both foreign bank subsidiaries and the domestic regional banks fell largely due to the sale of the acquisition of entities by the major Australian-owned banks.[2]

Figure 2: Banks - Recent Trends in Market Share (% of all banks' resident assets)



Note: Chart data are derived from APRA published statistics.

In relation to business loan margins, because the GFC had an adverse impact on the credit market and banks globally sought to re-evaluate and re-price risk at the same

[1] The Reserve Bank of Australia, in the March 2007 Financial Stability Review, observed in relation to business lending that "*The activity of foreign-owned banks appears to have been one of the catalysts for stronger competition in this market, which in turn has been associated with a contraction in lending margins.*"

[2] Foreign bank subsidiaries' market share fell, largely due to the sale of Bank West to CBA and Domestic regionals' market share fell, largely due to the sale of St George Bank to Westpac in 2008.

time that foreign banks reduced their lending in Australia, these margins have increased.[3]

The above data focus on lending by foreign-owned banks with operations in Australia. Foreign banks also provide finance in Australia from offshore and the Reserve Bank has recently observed that cross-border loans to non-financial businesses in Australia declined from about $48 billion in 2007 (equivalent to 8 per cent of domestic business credit) to about $27 billion in December 2011 (4 per cent of business credit).

The Reserve Bank has also estimated that the value of syndicated loans to Australian borrowers provided by foreign-owned banks nearly tripled over the decade to 2008, to about $240 billion, but has since fallen by around 14 per cent. As reflected in APRA data on foreign bank branches, a decline in lending by European banks was partly offset by an increase in syndicated loans provided by Asian banks.

3. Financial Market Developments

Our focus in this section is on the capacity of the debt and equity securities markets to provide competition for banks in the provision of finance to Australian business and investors. We do not analyse these markets from the perspective of banks as entities that also raise funds in those markets.

3.1. Debt Capital Market

Corporate bonds have similar characteristics to bank intermediated debt but they are not a perfect substitute for borrowers or investors; bank loan arrangements are more flexible than bonds but the latter are more readily tradeable.

Corporate bonds have continued to be a significant source of finance for Australian companies (ie non-financial corporates) since the GFC but, as with historical experience, most of the issuance is directed to the overseas markets where $146 billion was on issue by Australian companies at end-March 2012 (see **Figure 3**).

The US private placements market is particularly attractive to Australian companies and an important source of finance to them because it has good liquidity, long dated debt finance is available and deals may be brought to market quickly.

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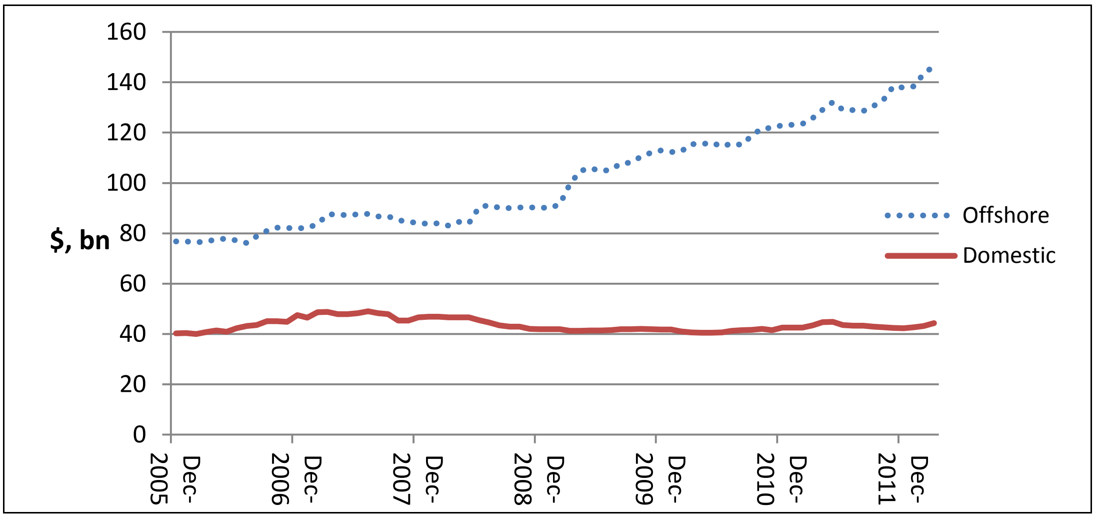
[3] Indeed, the international evidence is that foreign banks globally reduced credit more compared to domestic banks during the GFC – see Foreign Banks: Trends, Impact and Financial Stability, IMF Working Paper 12/10, *Claessens and van Horen.*

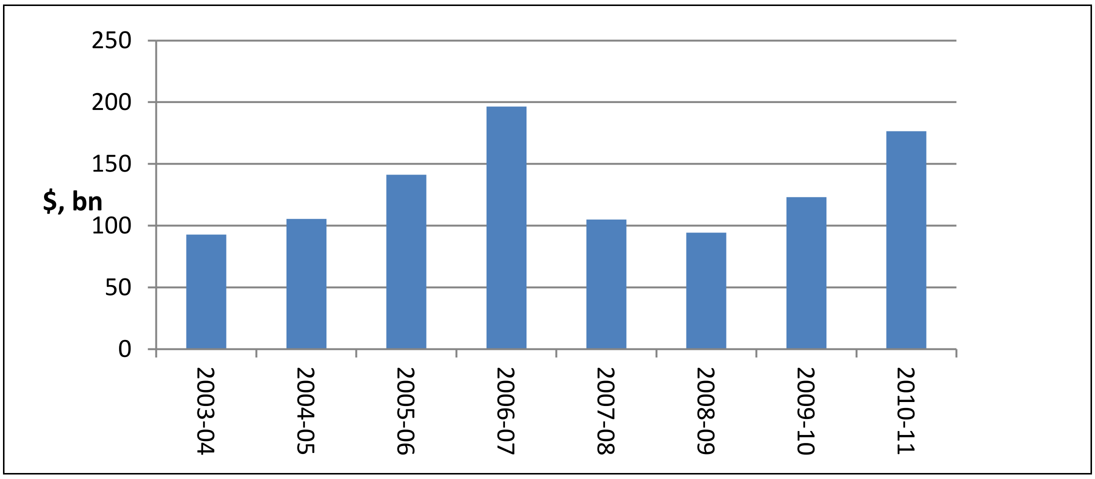
Figure 3: Stock of Bonds Issued by Non-financial Corporations – Domestic and Offshore Markets



Note: Derived from RBA published statistics.

Non-financial corporations account for only 14 per cent of the private sector bond market in Australia. Banks and other financial institutions are the main issuers of bonds accounting for 58 per cent of the market, followed by asset backed bonds at 28 per cent. The market as a whole complements the government bond market in providing a range of fixed interest investment opportunities for investors in competition with bank term deposits.

Figure 4: Domestic Bond Market Turnover – Corporate Debt



Note: Derived from *Australian Financial Markets Report 2011*, AFMA.

Reflecting the subdued nature of the domestic corporate bond market, turnover on the domestic corporate bond market contracted during the GFC but more recently has recovered somewhat (see **Figure 4**). [4]

[4] In contrast, turnover on the Government bond market has increased markedly as the amount of debt on issue increased.

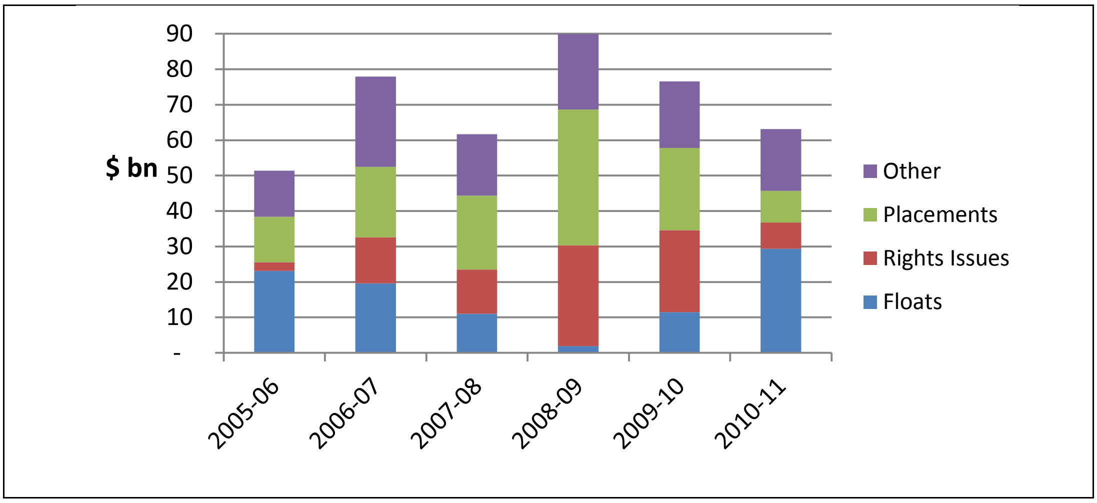
Data on the management and underwriting of private sector debt issues show there is a broad range of domestic and international banks and securities firms that service the domestic and international bond market. For example, the five leading issue managers accounted for 65 per cent of Australian dollar debt issues in 2011.[5]

3.2. Equity Capital Market

Companies seeking to raise finance for investment may tap the equity market as an alternative to debt funding though bank loans or marketable securities. While the intrinsic properties of debt and equity are different, they are nonetheless imperfect substitutes that may have more or less relevance at different points in time.

For example, the ability of listed companies to raise equity capital quickly during the GFC when debt markets were constrained was an important mechanism enabling many companies to reduce debt exposure and strengthen their balance sheets (see **Figure 5**).

Figure 5: ASX Listed Company Capital Raisings



Note: Derived from ASX data.

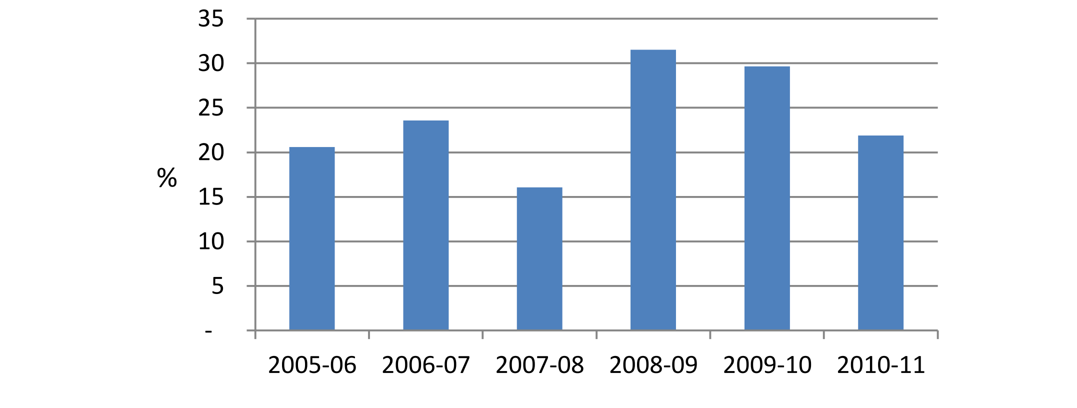
A more general indicator of the relevance of the equity market as a source of finance to Australian business is the ratio of equity capital raised on the ASX to new credit approvals by banks (see **Figure 6**). There are differences in business coverage across the two markets; in particular, many bank loan applicants are not ASX listed businesses and some do not have the scale of business to obtain a listing. However, this does provide a perspective on the relative significance of the equity market as a source of finance.

The experience of the GFC shows that more flexible capital raising arrangements available in Australia, assisted by corporate law reforms in 2007 to improve the efficiency of secondary market raisings, enabled the economy to better adapt to volatile

[5] Based on Thomson Reuters data.

economic circumstances and have helped promote financial stability. In summary, the reforms aimed at making capital raisings more flexible and efficient have served the economy well.

Figure 6: ASX Capital Raisings as a Percentage of Banks' New Credit Approvals



Note: Derived from published ASX and RBA statistics for loan approvals of $2 million and over.

The capital raising market in Australia is highly competitive and is serviced by a wide spread of stockbrokers and investment banks. The top five firms accounted for 53 per cent of the market in 2011 and firms with an overseas affiliation form the major part of the market.

The market for stock broking trade execution services is similarly highly competitive, with a broad range of market participants offering services to the retail and wholesale markets.

Turnover on the ASX equities market was adversely impacted by the GFC, falling by 30% in 2008-09, and it has not fully recovered to date. Moreover, current trends are not promising; ASX has recently reported that the value of turnover over the financial year period to April 2012 is 10 per cent down on 2010-11. Thus, market turnover is running at a level much below that at which it operated five years ago, in addition to which the brokers must contend with compressed commissions.

3.3. Derivatives and Other Financial Markets

Efficient and competitive institutional OTC markets are an important component in the provision of cost effective financial services to all users of the financial system. Australia is well serviced by a range of efficient cash and derivatives markets (both exchange and OTC markets, which are interconnected).

The wholesale OTC markets are substantially institutional markets, have a broad range of participants and are not dominated by any particular group of banks. They provide a wide range of essential liquidity, investment and risk management services to the financial services industry and to their business clients. Anecdotal and survey evidence supports the contention that Australia's wholesale financial markets are very competitive. Table 2 provides information on key markets and it should be noted that the identity of the top 4 providers varies from market to market.

Table 2: OTC Markets in 2010-11 – Selected Market Share Data

Market	Market turnover ($bn)	Top 4 providers
Government bonds	1,483	55%
Non-government bonds	908	69%
Interest rate & cross currency swaps	6,809	63%
Forward rate agreements	5,857	61%

Note: Derived from data compiled for the *Australian Financial Markets Report 2011*, AFMA

The GFC has not fundamentally altered this position, though some firms exited markets segments and others transferred traders to offshore jurisdictions. Turnover on the OTC markets in aggregate dipped by 7 per cent during the GFC but the markets performed effectively throughout.

3.4. Investment Lending

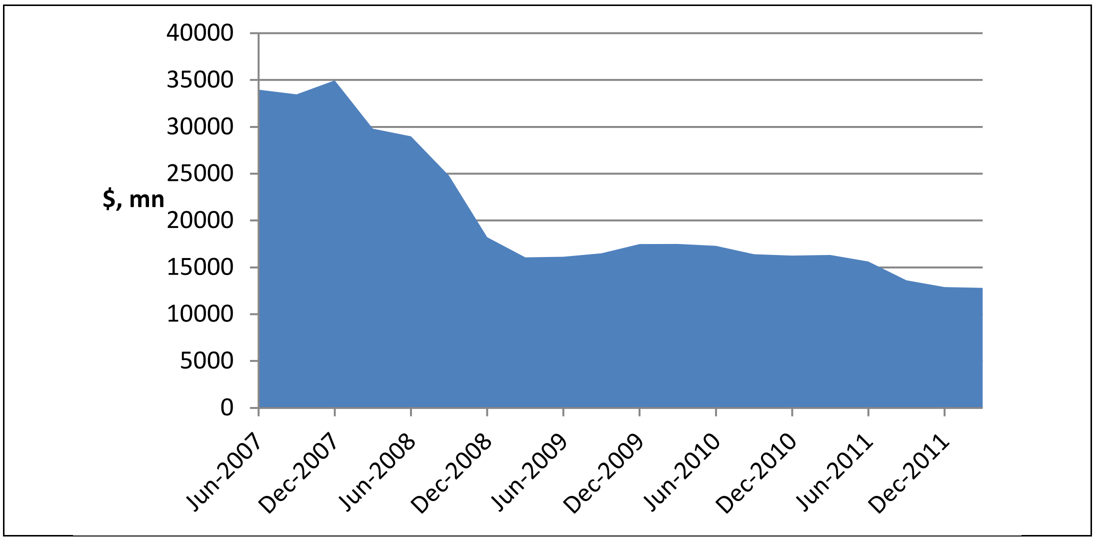
The market for investment lending has experienced very difficult conditions since the onset of the GFC for a variety of reasons. There has been a sharp reduction in business which has reduced income and employment in this sector of the industry.

Margin Loans

A margin loan is a line of credit secured by collateral pledged by the borrower that is generally used to purchase a variety of investment assets (most commonly shares and managed funds). The borrower may be required to pay margin calls and is subject to other lender risk controls, like approved security lists. Margin loans are most commonly provided by bank groups prudentially regulated by APRA. The majority of margin loans are sourced through intermediaries, such as stockbrokers and financial advisers.

The impact of the GFC on the margin lending industry has been severe, and the difficult market conditions have persisted even as the sharemarket recovered from its lows (see **Figure 7**). Against the backdrop of these difficult market conditions, margin lenders have been required to absorb a significant change management burden through significant legislative changes. This includes revisions to Chapter 7 of the Corporations Act that now classifies standard margin loans as a financial product and imposes a range of new obligations on lenders, as well as more general reforms (eg the Unfair Contract Terms Act, the Personal Properties Securities Act and FOFA).

Figure 7: Margin Loans Outstanding – Post GFC



Note: Chart data exclude protected lending and is derived from RBA published statistics.

The net effect of all of this on the income and employment levels in the industry has been negative. While margin calls have normalised following a spike in late 2008 and the regulation of the industry has been improved as part of the credit reforms in 2009, investors still appear to be taking conservative investment positions, with the average gearing level falling from over 50 per cent in December 2008 to 32 per cent in March 2012.

Capital Protected Lending

Capital protected products include protected equity loans and instalment warrants. They are an efficient investment tool for retail investors to manage their financial risk and grow their wealth in a prudent way by investing in the Australian economy. These products have been adversely affected by the market downturn consequent to the GFC and especially by their penal tax treatment

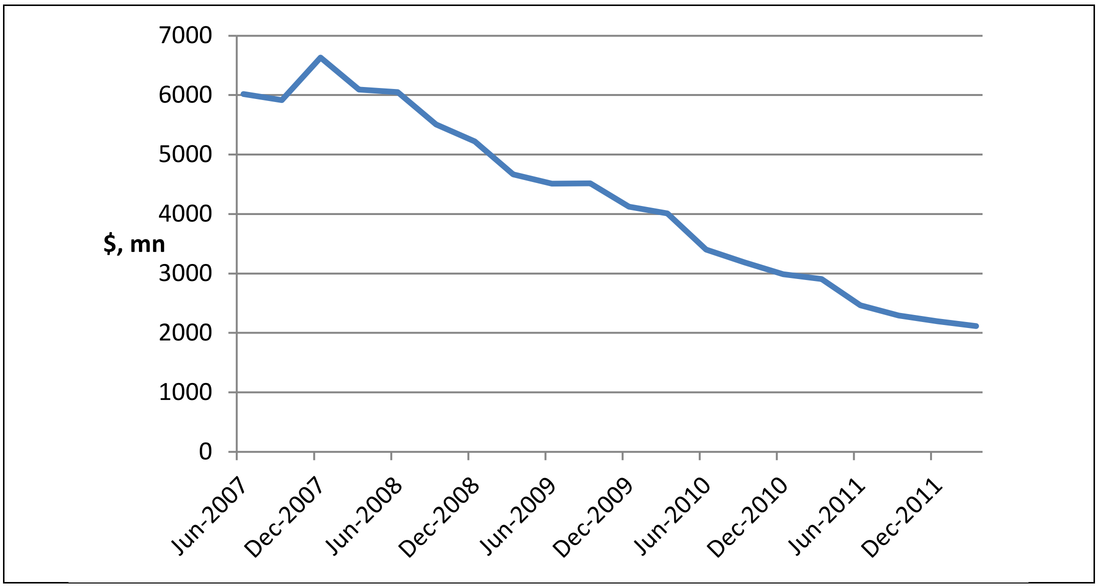
The benchmark rate for the tax deductibility on interest on capital protected borrowings was substantially reduced, to the indicator home loan rate plus 100 basis points, from May 2008.[6] This is not a fair reflection of the real borrowing costs and it stymies the market's ability to meet investor needs in a cost effective way. Given this and historical instability in the tax treatment of these products, investors have turned away from the market.

Figure 8 shows that investors have lost access to cost effective capital protection at the very time that market volatility placed a premium on this and investors appear to want

[6] Tax Laws Amendment (2010 Measures No. 5) Act 2011.

more conservative market exposures. Absent the tax problems, these products would have been expected to increase market share over unprotected lending.

Figure 8: Capital Protected Lending Post-GFC



Note: Derived from statistics published by the RBA.

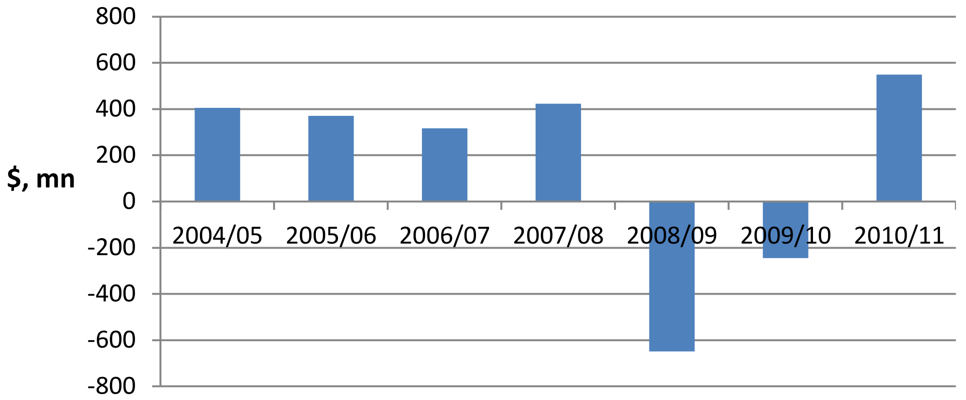
4. Profitability – Wholesale Banking & Capital Markets

The overall performance on different categories of banks and financial institutions was quite different during the GFC, in large part reflecting their business mix. Bank losses on business loans increased consequent to the GFC and this was one of the factors impacting their profitability. Securities companies encountered very difficult business conditions for different reasons, including significantly lower market volumes.

4.1. Wholesale Banking

Loan losses are most apparent for foreign bank branches, which have the greatest exposure to business conditions, as they operate in the corporate market and do not have a consumer loan base (see **Figure 9**). The economic effect of the GFC is reflected in aggregate losses for two years during the GFC, mainly due to losses sustained on commercial property loans.

Figure 9: Foreign Bank Branches Profits 2004-2011



Note: Derived from APRA published statistics on net profits (after tax).

Bank profits for the domestic banks and foreign bank subsidiaries, as measured by return on assets, also show a marked transitory dip during the GFC, but it is not as accentuated as for foreign bank branches and they recorded a net profit throughout. However, APRA's published statistics do not identify the respective profitability of consumer and business divisions of banks.

4.2. Securities Companies

The downturn in turnover on the share market, together with a highly competitive market and softer conditions on the capital raising market has markedly reduced the profitability of stockbrokers. Some have recorded an annual fall in their overall brokerage and commissions of well over 20 per cent in their latest results reported to the market. This has occurred against a backdrop of increasing operating costs for participating in the markets as competition in market services was introduced, higher costs of regulatory compliance and the imposition of new cost recovery charges for regulation (in excess of $1 million per annum for large brokers, with a further significant change to be made following the 2011-12 Federal Budget). The difficult trading conditions in combination with these factors have resulted in staff reductions, with many hundreds of jobs being lost.

5. International Challenges Facing the Financial Markets Industry

The combination of the impact of the GFC on financial services and the high Australian dollar has placed the industry under significant pressure to maintain, not to mind expand, the number of high quality financial markets jobs in Australia. It is evident from AFMA's work with member firms through our market committees that some international banks have relocated staff or transferred trading functions to regional operations based in Hong Kong and Singapore. This process of consolidation is ongoing in some cases.

In relation to back office operations, AFMA's 2011 *Operations Survey Report* provides a comprehensive picture of operations functions for financial markets performed in Australia, including the significant challenges facing the industry.[7] In summary, the Report presents a declining trend in the percentage of traditional back office functions conducted in Australia:

- Back office functions are being taken or directed away from Australia;
- Offshoring of IT is common practice across the industry;
- Operations staff numbers have declined by 775, or 22%, compared to 2008; and
- Cost of operations and tax rates are important factors in offshoring.

On a positive note, there was an increase in the percentage of organisations who undertake market risk, credit risk and operational risk functions in Australia. However, the overall trend is still likely to be negative, especially with some significant reconfigurations of global banks with operations in Australia.

We can take steps by making Australia more competitive to protect existing jobs in Australia and enable international banks to bring more business to Australia. The Johnson Report in 2009, *Australia as* a *Financial Centre – Building on Our Strengths*, has provided the Government with a good analysis of Australia's strengths and weaknesses and our potential as an international financial centre. The report includes a range of recommendations relating to tax and regulatory matters that need to be addressed to achieve our national objective in this area. Progress in relation to several of the recommendations accepted by the Government is slow, so opportunities are being lost.

6. The Cost Impact of Financial Regulation

Financial regulation has undoubtedly brought about a material increase in the cost of delivering financial intermediation services, with more charges likely to come through the system as reforms currently underway get implemented. The precise amount will depend on the range of services being offered, the nature of the institution in question and the final form of regulation that will be imposed.

6.1. Wholesale Banking

The Basel III reforms will impose new, higher capital and liquidity requirements on banks. The Financial Stability Board (FSB) peer review has observed that Australian banks are well placed to meet the Basel III capital standards. However, additional

[7] The 2011 AFMA Operations Survey Report is available at – Report Link.

measures are still being developed by the Basel Committee, notably in respect of capital requirements for banks' trading books, which will require careful assessment to determine its likely impact on banks operating in Australia.

AFMA's main area of focus in this regard has been on the new liquidity requirements which will require a significant adjustment by banks operating in Australia and this will affect some OTC markets. Of most significance is the Liquidity Coverage Ratio (LCR) that comes into effect at the beginning of 2015. Banks are currently transitioning to the new requirement by extending the maturity of their funding liabilities; for example reducing their reliance on shorter term funding and drawing more heavily on bank term deposits.

In regards to available liquid assets, the Reserve Bank in conjunction with APRA has developed a Committed Liquidity Facility to assist banks overcome the practical constraint resulting from the amount of government debt on issue in Australia being insufficient to meet the regulatory needs of banks under the LCR.

Foreign bank branches face particular challenges in adjusting to the new Basel liquidity rules by altering their funding base because they are not permitted to tap the retail deposit market, while the domestic bill/certificate of deposit market in which they traditionally raise funds has contracted post the GFC. To help overcome this, it is expected that foreign bank branches will have greater reliance on parent funding. However, there are taxation barriers to this adjustment through interest withholding tax on parent funding and the application of the LIBOR cap (which limits the interest deductibility of interest paid on parent funding to the LIBOR rate), which is penal for those banks affected. LIBOR rates are only available for maturities to one year, so the cap imposes a doubly artificial constraint on the tax interest deductibility of interest on parent funds provided on a medium to long term basis.

Faced with these impediments, foreign bank branches could deploy their available funds in jurisdictions other than Australia or increase their lending margins to compensate for the increased tax cost; both of which would lessen banking competition.

6.2. Equities Market

Stockbrokers and other participants in the equities market have implemented a wide range of new regulatory measures that are either a direct or indirect response to the effects of the GFC (eg short sale prohibitions and reporting, securities lending reporting, margin lending and FOFA reforms). In addition, the introduction of market competition in the equities market generated a whole set of new rules and conditions on market participants and new trading systems that required the purchase, development and implementation of new operating systems and controls.

This permanent increase in the cost base for the industry took place against the backdrop of falling market turnover and declining commissions and fee revenue in many cases (as outlined above). ASIC has signalled its intention to introduce additional regulatory requirements (eg additional short sale reporting) that will impose further costs on the industry. These changes will inevitably create an even more challenging business environment that may cause revision of some business models and together with new cost recovery measures (see below) will harm the international competitiveness of our capital markets.

6.3. OTC Derivatives Markets

Consequent to a G20 agreement in 2009, OTC derivatives markets regulation is undergoing major reform and participants in key Australian OTC derivatives markets will need the capability to centrally clear certain transactions and may also need systems to report trades centrally, all of which introduces new costs.

6.4. Cost Recovery

The expansion of cost recovery programs for financial regulation accentuates the cost burden placed on the industry through regulatory reforms that are expensive to implement (eg credit reforms, market integrity rules) and is increasing the cost of financial intermediation. In some instances they jeopardise business models and risk compromising the underlying policy objective. At the very least, their unpredictability makes business planning difficult. There is significant concern in the industry about both the growth in cost recovery charges and the policy and practical basis upon which they are determined. The problem has become more significant post the GFC, as pressure on the Government's fiscal position increased, leading to a greater focus on cost recovery.

The amounts involved in cost recovery are significant (as is the overall regulatory cost burden on the industry). For instance, the 2011-12 Financial Institutions Supervisory levy (substantially covering APRA's budget) is $127 million. In addition, the AUSTRAC supervisory levy is a new annual charge of $30 million per annum on reporting entities to pay for the cost of money laundering and terrorism financing regulation. In the relatively narrow area of ASIC market supervision, the Government is charging the industry $62.6 million for the period from 1 January 2012 to 30 June 2015.

The May Budget included several increases to the cost recovery imposts on the industry over the forward estimates including $33 million for ASIC market, $82.4 million for APRA and another $23.9 million for ASIC to cover implementation of the FOFA reforms.

The Government does not seem to have a coordinated mechanism to monitor and report on the totality of cost recovery measures. Moreover, there appears to be no effective check on the compliance costs that new regulatory reforms impose on the industry, with inadequate account of the capability of the industry to bear the cost of these reforms or associated cost recovery charges for regulation.

Financial market participants are experiencing significant revenue and cost pressures globally. Prudent business management may result in some entities scaling back their business activities or moving activities to locations that are more cost effective.

6.5. International Regulation

Notwithstanding the commitments of the G20 government meetings, Australian financial institutions are concerned that different jurisdictions may enact regulatory reforms in a way that creates an uneven playing field and where differences in approaches to regulation could give rise to competitive imbalances and/or regulatory arbitrage opportunities between jurisdictions.

This issue is most apparent in relation to derivatives market infrastructure. Banks and securities firms that undertake significant cross-border activities are concerned that they may be subject to overlapping and incompatible regulatory requirements in different jurisdictions. This is because major jurisdictions are making rules for derivatives market infrastructure in their jurisdictions that are unilateral in character so creating problematic extraterritorial challenges and issues of legal uncertainty.

The Financial Stability Board was established to coordinate at the international level the work of national financial authorities and international standard setting bodies. The mandate of the FSB includes two points that are relevant in this context:

- Promoting coordination and information exchange among authorities responsible for financial stability.
- Undertaking joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps.

In addition, Australian banks and other financial services providers face potentially large compliance costs arising from the extraterritorial application of specific jurisdiction measures like the US FATCA reporting requirements. Many of these matters are under consideration and are not yet resolved.

7. Policy Measures to Manage Change to the Benefit of our Economy

The above sections provide an outline of key developments affecting the Australian banking system post the GFC. Clearly, the economic and commercial impacts of the GFC has been uneven across the wider banking system and costs are rising due to regulatory measures designed to strengthen our system to avoid the types of problems that occurred in the GFC. The situation is complicated by the high value of the Australian dollar, which makes Australia less competitive as a location to conduct many financial markets operations.

The Government can take measures, as outlined below, to:

- Respond to structural change in our financial system post the GFC by enhancing competition in banking directly and indirectly through the capital markets;
- Contain the regulatory pressure on financial intermediation costs within the limits of the underlying policy objectives;
- Maintain, and potentially grow, employments levels in the financial sector by lifting our international competitiveness.

Taxation

1. Remove the non-resident interest withholding tax on financial institutions, as recommended by the Henry and Johnson Reports - *This would improve the capacity of domestic banks to obtain cost effective funds overseas and improve the capacity of foreign institutions to add to competition in the domestic market*.
2. Remove the LIBOR cap and interest withholding tax on foreign bank branches funding from their parent banks (as recommended in the Johnson report) - *This would lower their funding costs, help adjustment to the new Basel liquidity rules on a cost effective basis and improve competition in the domestic business banking market, reducing financing costs for Australian businesses*.
3. Reset the benchmark rate for interest deductibility of capital protected products at a realistic economic level (eg the mid-point between the housing loan and personal loan rates) - *This would remove the tax penalty on capital protection for retail investors and stimulate trading activity*.

Retail and Wholesale Bond Market

4. Amend the prospectus disclosure requirements so that offer documents take less time and are less expensive to prepare (this is currently being considered by the Department of Treasury).
5. Remove the tax bias (identified in the Henry Report) against investors taking up products that generate interest income, like corporate bonds and deposits.
6. Consider whether superannuation fund managers and trustees can be encouraged to apply a greater proportion of the assets they manage to corporate bonds.

Cost Recovery for Regulation

7. Apply the principle that all cost recovery charges should be met by the principal beneficiaries of the regulation, taking account of the public benefits that accrue from the regulation, as well as the tax and other related benefits that flow to government - *The cost of regulation needs to be recovered on a fair and reasonable basis having regard to the beneficiaries, including government*.[8]

8. Implement 'cost recovery' measures across agencies on a coordinated basis that takes into account the industry's capacity to pay and reasonableness, given the combined impact of cost recovery measures and the cost of regulatory compliance - *Cost recovery measures should not undermine otherwise effective business models and should fit within a coordinated policy framework for cost recovery.*

9. Design cost recovery programs to operate in business neutral manner and avoid the associated charges operating in a similar way to a transactions tax - *It has been the policy of successive governments to reduce the complexity of taxation and financial transactions taxes have been shown to be inefficient and distortionary.*

10. Manage the moral hazard risk by giving industry an effective role in the governance arrangements for a cost recovery program and by government shouldering a reasonable proportion of the associated cost - *Effective governance and accountability arrangements ensure that cost recovery charges are reasonable and contained over the long term*.

Australia's Competitiveness as a Financial Centre

11. The Government should implement the outstanding Johnson Report recommendations as a matter of priority.

12. Require disclosure of how any proposed tax or regulatory reform will impact on Australia's competitiveness as a financial centre (particularly in comparison to our regional neighbours such as Singapore, Hong Kong and India) and attach a higher weighting to those impacts in the policy decision making process.

International Regulation

13. The Government should continue to press for, through the G20 process, effective regulatory coordination between jurisdictions and for the Financial Stability Board to give priority to this part of its mandate.

[8] For example, financial institutions' compliance with anti-money laundering and counter-terrorism yields substantial public benefit in assisting the Government to combat crime and terrorism. In dollar terms, it yields $320m in tax revenue and other social cost recoveries.