

# **Submission to the Senate**

## **Economics Committee**

**through**

**Mr Tim Bryant**

**Committee Secretary**

**Senate Standing Committee on Economics**

**P O Box 6100**

**Parliament House**

**Canberra ACT 2600**

**Australia**

**From**

## Executive Summary

This submission broadly agrees with the approach taken by APRA in introducing Basel 3 capital ratios and in moving to identify balance sheet and liquidity problems. However it urges caution on the subject of transference with Australian Banks moving business internationally.

It also cautions that the movement to bank status for previously mutual groups is changing the landscape for short term banker benefits. That when the GFC was effecting liquidity in the world economy that 2 Australian Banks took up Term Auction Facilities (TAF) provided by the Federal Reserve in conjunction with the Reserve Bank of Australia (RBA).

That transference can also occur through international transactions from other bank sources as the American Justice Department was investigating the London Interbank Offer Rate (LIBOR) for manipulated values by cooperating organisations.

The bankers social contract with Australians, depositors, borrowers and capital providers all need to be addressed, especially by ADI efficiency. It discusses ADI attitudes to efficiency versus lending as a prerequisite to increasing return on equity.

It identifies the impacts of borrowing and lending through the document *“Banks and the Moral dimensions” Independent Australia, 16 April, 2012*. How the banks corporate cultures, current legislation and lending can be altered to facilitate an outcome for all concerned when a significant industry event perpetrated by the industry and acknowledged as an industry responsibility, occurs. How this affects society and particularly those disadvantaged.

It also considers through the published article “*NAB redacts website to hide customer refunds*” *Independent Australia*, 1 April, 2012. How a bank may effect outcomes of court cases and investigations by changing its published www material during the processes.

Through these articles and this submission there are not only identified problems but also opportunities to consider proposed remedies.

## Contents

	<b>Page</b>
Introduction	4- 5
1. The impact of international regulatory changes on the Australian Banking Sector, including changes to liquidity and capital holding requirements.	7
Definition of Capital and Weighted Capital	
Capital Adequacy Funding and combining ADIs businesses.	
Transference in Capital Compliance Situations	
2. The impact of relative shares of specific banking markets.	7- 8
3. Current cost of funds	8- 9
4. The impact of borrowing and lending practices in the banking sector both during and since the global financial crisis.	15- 16
5. The need for further consideration of the state of the broader banking and finance sector.	16-17
6. Any other relevant matters.	17- 18

## Annexures

1. APRA Prudential Standards and Guidance Notes for ADIs
2. NAB redacts website to hide customer refunds, “IA”, 1 April, 2012.
3. “Banks and the Moral Dimension” IA 16 April, 2012
4. Fixed Rate Interest Only Loan- Interest Refund (28 September 2006)

## Introduction

Since 2010 and the “Competition within the Australian Banking Sector” Inquiry there are several changes in policy, legislation, utilisation of resources and the Australian Prudential Regulation Authority(Guidelines) to be introduced from later this year and in the future.

Behind these changes are the Global Financial Crisis and bad and inadequate banking practices.

The writer notes the following changes:

- (a) Determination by the Reserve Bank of Australia (RBA) to consider reviewing settlement through Clearing Houses. “*Banking system out of date*” Edey, 26 March 2012.
- (b) New regulation and a new securities exchange.
- (c) An application for a clearing house with international facilities to clear securities transactions with close Asian links. (*The Australian* , “*Clearing the Way*” 15 April, 2011)
- (d) Derivatives trading regulation and clearing facilities.
- (e) Removal of exit fees from bank transfers of facilities.
- (f) An increased commitment to the International Monetary Fund.
- (g) Adoption and adaption to the “Basel 3” international guidelines to banking operations.
- (h) At the Committee Hearings into competition, one banker complained the cost of borrowing funds had increased but eventually conceded they had not.
- (i) a submission had been tabled with statistical information showing costs of money to banks was less than 2007, contrary to bank submissions to the popular press.
- (j) An economics legislation committee inquiry into the Bankruptcy Act 1966 (Cth) and former exit funds.
- (k) Currently there is a claim before the courts pursuant to the provisions of the “Banking Code of Practice”.

(l) A commitment by the Courts to accept claims under the “Banking Code of Practice” Contract.

(m) This may enliven settlement of Bankrupts claims pursuant to Section 60(2) of the Bankruptcy Act 1966 (Cth) and new Federal Court Rules commencing July, 2011.

This submission will deal partially with the terms of reference. identifying processes and headings considered necessary for further investigation, supporting policy and/or legislation. It supports the practice identified in ‘The role of reputation in banking’ 2009, (Buckley Ross P., Nixon Justen) Page 13 *Strong prudential regulation enhances the value of promises of banks and poor prudential regulation and weak internal governance standards decrease the value of a promise from a bank.*

**1. The impact of international regulatory changes on the Australian Banking Sector, particularly including changes to liquidity and capital holding requirements.**

*Definition of Capital and Weighted Capital*

- (a) On perusing the APRA” Prudential Standards and Guidance Notes for ADIs” at Annexure 1
- (b) The role of shareholders, depositors and users of credit facilities needs to be considered further and an industry wide definition for weighted costs of capital and cost of capital with a broader method of examining transference than those identified in APS 110 (Draft). Specifically during the period in review and subject to projection at 16 and 18 (f)(g) and then from (20) to APS 110 Attachment c-16 at 6. where applicable.
- (c) In Australia one major insurer collapsed when it’s balance sheet used re-insurance products. The GFC was at least in part caused by inadequate capitalisation through banks using derivative products to shore up Basel II capital ratios. It is noted that the Basel committee did not issue derivative valuations until after the GFC.

*Capital Adequacy Funding and combining ADIs businesses.*

- (d) At the time of writing this submission there are 18 posted submissions by far the majority of these submissions refer to Bank West and the Commonwealth Bank. Clearly part of the issue is the Commonwealth Bank of Australia (CBA) capital adequacy ratios. In the 1980’s the CBA was stated to be short \$900M in capital adequacy ratio. When CBA took over the Commonwealth Development Bank it completed the same moves against many customers as is happening with the Bankwest takeover. If capital adequacy ratios are part of the problem they could be the same problem in any bank takeover. Consequently capital adequacy ratios definitions are statutory and relate to international standards and so a solution to capital adequacy ratios and liquidity must be found without the constant move to create capital adequacy through the initiative of changing business structures to fit with the funding of the overtaking entity..

- (e) In 2004 when a submission considered the National Australia Bank Limited (NAB) corporate culture the manipulations associated with the practices came partly with the transfer of funds from “ Non- accrual “ account recoveries to Tier 1 Capital. However at the time (2004) the Australian Prudential Regulation Authority (APRA) stated this practice was acceptable and included a statement to that effect in Guidance Notes APS 220 1-4. NAB has now taken on its Balance Sheet 6.2Bn English Pounds of its UK subsidiary including CBRE loans., following a net loss of 187M Pounds in the UK banks. Will APRA be required to supervise this process of recovery against transference?
- (f) However the guidance may need to be reconsidered especially if the processes of writing down account values and interest continually paid as stated in Australian Banking Industry Ombudsman (ABIO Bulletin 27) could be misleading and deceptive conduct and liable to compensation if upheld in legal process. Or the changes in valuations on an industry wide basis where one of the Banks concerned is found to be effected by the GFC or taking advantage of the GFC is found to have a customer legal liability.
- (g) This creates the problem of how to address capital ratios and liquidity in a takeover or combining situation between Authorised Deposit Taking Institutions (ADIs). What assurances should Treasury, ACCC, ASIC APRA and the Reserve Bank require that customers will not be short term fodder for servicing prudential requirements?
- (h) One solution may be redeemable shares (*subject to APS 111-5 .13*) issued for an adequate time and realisable value sufficient to permit proper integration of the combining ADIs so as to cover capital ratios, possibly avoiding sudden shifts in customer and supplier facilities.

***Transference in capital compliance situations.***

- (i) Transference in these situations was identified when six Australian Banks transferred funds to the United States (USA) from New Zealand (NZ) as capital



gains than England as tax paid dividends. It resulted in years of litigation both in Australia and New Zealand large Taxation penalties and in some cases convertible bonds with share options were inadequate to achieve the aims of the ADIs involved. (*Westpac Banking Corporation v The Commissioner for Inland Revenue*(HC AK CIV 2005-404-2843 [2009]; and *BNZ Investments Limited and ORS v The Commissioner of Inland Revenue* [2007] NZCA 356 921)

- (j) Clearly capital adequacy and liquidity were considerations when institutional investors approached NAB to reassess interest rates to increase Return on Equity (*Investors pressured NAB chief on rates, afr- John Kehoe and James Chessell 14 February, 2012*) . It appears the NAB approach was to reduce staff to increase efficiency in lieu of changing marketing policy.
- (k) In 2011 the American Justice Department was investigating potential market rigging of the Libor rate which sets the value for international settlement transactions daily. (*“Clearing the way”, The Australian, 15 April, 2011*) Consequently capital adequacy and dividends as set out in the APRA Guidelines could consider investor influence and market manipulation of contributing to costs of operation and possible transference in interest rate transactions.
- (l) Between the 6 November 2008 and 31 July 2009 the NAB through it’s New York Branch had multiples of \$1.5 Bn (largest) from TAF at rates from 7.46% to 4.07% daily rate. Westpac also used TAF through its’ New York Branch with \$1Bn(largest) from 8 October 2008 to 31 December, 2012 from rates 5.43% to 2.91% daily rate and notably \$900M from 20 December 2007 to 16 January, 2008 at rates of .20and .21%..)In a an article *“Trillions in risk lies under shell”, Business Today, Adele Ferguson March 2, 2010*, identified Australian Banks had \$13 Trillion of exposure. That to June,30 (1999) more over the counter derivatives trading was carried at \$69.9 Trillion than through the exchange \$26.5 Trillion. These figures require a “no surprises” regulatory approach and constant review of capital adequacy and prudential standards.

## **2. The impact of relative shares of specific banking markets.**

- (a) It is necessary to identify strategic marketing initiatives and banking service provided to understand the impact of specific markets.
- (b) Consistent with this theme is that the Australia and New Zealand Bank (ANZ) concentrates on spreading its market share in Asia, the NAB in business banking and the Commonwealth Bank of Australia (CBA) in technology and Westpac transactional services.
- (c) In the Banking Competition Inquiry it was stated at (*Submission 16*) the failure not to provide same day settlement had a damaging effect on the whole economy and was a simple barometer to customer orientation and strategic difference in ADIs. Since then the CBA has rolled out a new technology base and it is interesting to note there has not been a succession of announcements of CBA system downtime, with real time transaction services. Now a new clearing house for securities on same day settlement is being established.

It has had an effect in business circles where the aim is to provide transactional services, where competition is becoming more intense with published marketing strategy results and comparison of customer changes. (*“Big four in battle for corporate business”, AFR, J. Kehoe 14 May 2012.*)

- (d) Whilst all ADIs are now openly competing for depositors funds with APRA providing a quick and important roll out of new Tier 1 and Tier 2 capital requirements and operations that are accepted internationally. Australia lags the world in deposit to lending ratio and so makes up the difference with short term loans to lend long which was the major problem for ADSIs during the GFC with Australian examples including RAMS now Westpac.
- (e) Consequently when borrowing internationally this problem of lower deposit to lending ratios becomes relative. The one method of avoiding this risk is strong legislative operational processes. Something advocated by APRA and supported by the US Federal Reserve Ben Bernanke. As stated previously both Westpac and NAB used TAF in 2008-9 consequently regulation can not replace depositor strength and as international competition for funds to be held off shore in realisable accounts continues. The two edged sword of currency value and interest rates continue with currency exchange services being provided in Australian Post

Offices by international ADIs, Are we seeing at last some real competition in deposit fund previously unavailable to small customers? One issue can these businesses provide settlement services for customers of Pay Pal, eBay, Google, Apple, Dell etc., when 27% of Australians do not have access to everyday credit facilities.

- (f) The major issue in all ADIs future is can they recover their lost credibility with Australians while NAB claims it has lured new customers with the lowest variable home mortgage rates. CBA has just reduced its fixed rate to the lowest of the major banks. Customers are moving to fixed rate lending if deposits go up where is the margin going to be at the end of the fixed rate term. In Australia the hip pocket nerve drives most decisions how are the ADIs going to compete if the \$A rises and international deposit competition hots up.
- (g) The most common way of account settlement in the future could be tapping two iPhones together and topping up the plastic.
- (h) Whilst there is now an array of deposit products where are those disadvantaged by productivity drives that are now lost to credit facilities and those whose cash has been resourced to bank scams. The redistribution of wealth schemes and the releasing of capital from farmer and other businesses said to lack productivity and so liquidated has been lost and now there is no ready user of small capital funds to increase productivity as happened in the rural sector and with home building flat because of necessary credit changes, there is becoming more and more limited ability to create wealth from small capital outlay with security.
- (i) This serves as a reminder that the productivity drives were good for credit growth with funds for return on equity but created under investment in the group deciding the productivity decisions Australian Banks. Between 1992 and 2007 loan growth was the barometer of successful banking and productivity was the measure so values were distorted by loan numbers. Now with numbers dropping there is no marketing policy that can increase productivity. Australian Banks have lost their

efficiency with it becoming more and more obvious regulation may need to control investment. Under investment in technology has made some Australian banks a productivity basket case.

- (j) Returns on shareholder funds were distorted by this under investment between 1992 and 2007 and credit growth took debt from Government to the individual entity. Now with 27% of Australians now being unable to use credit that leaves 77% to reduce their personal debt. With tightening credit there is no doubt that lead times for payment between businesses is going to increase so consequently the bank investors now must accept banks need to turn around their own productivity.
- (k) This opens up the question should international banks such as the Japanese banks with their low interest rates be encouraged to invest in Australian Banking and if so how?
- (l) If Australian banking needs to be restructured should APRA be prepared to facilitate specialist banks based on Government deposit funds such as the Farm Deposit schemes for specific banking investment in agriculture and rural pursuits etc.
- (m) Creating the process for distribution of drought and rural aid away from the well recorded distortions of the schemes by existing banks.
- (n) In Australia some ADIs have moved to become banks.
- (o) This same process happened in USA with the community ADIs' becoming banks and the creation of Freddie Mac and Fannie May distorting lending by financing specialist mortgages with specialist ADIs.
- (p) With all these many credit creating institutions using intangible derivatives to support credit growth and distorting the true value of the original security.
- (r) ANZ use of Trustees and third parties to hold securities and lending is now shown unsuccessful as they move to recover those facilities.

- (s) This model is also unsuccessful as the Bank moves the lending off balance sheet and is required to return the lending to recover to balance sheet. NAB is now completing a similar process to return its UK banks to profit a possible across borders process raising alarm bells around transference.
- (t) Whilst APRA now takes at least some of this lending into Tier 1 and 2 capital should this distortion of liability be considered as specialist lending.
- (u) Off balance sheet lending with credit growth was the cause of the GFC. The lending of Tier I capital in Australia such as NAB to allow the trading in the UK of its subsidiaries. Whilst it may be recorded for APRA process is just another form of credit growth distortion and an interesting legal question of liability.

### **3. The current costs of funds.**

- (a) A submission to the banking competition inquiry conducted by this committee heard from various sources including the Chief Executive Officer of NAB that costs of funding had increased to above the 2007 value. However an analysis by a Australian National University academic showed that this was mathematically and statistically incorrect. The NAB CEO eventually conceded the point saying it will increase in the future. At that point the cost of funds value credibility evaporated from industry propositions.
- (b) The reality the more internal funds are raised the better the credit rating for Australian banks the less international funds are required and the lower the currency risk and the greater the lending margins become important.
- (c) This creates competition for both \$A funds , transaction business and banking efficiency. Banks can not complain about cost of funds when they have not increased their efficiency in the same way they demanded of their customers since 1992 except perhaps CBA now partly rolling out its new technology.
- (d) APRA and the regulators generally should now demand all ADIs conduct business in real time and abolition of clearing fees and interest withholding periods on deposits where the ADI does not conduct best practice , same day transactions.

- (e) The current costs of funds are effected by the clearing house processes and the four day hold over of use of dividends and returned capital. NAB provided a service where credits for interest received could be credited to another debit account but is reported to have abandoned that process. Irrespective of the reasons whether to encourage reduction of personal debt or whatever the cost of obtaining funds is increased by the loss of that service.
- (f) ADIs' have a duty to Depositors (their creditors), Borrowers and Capital providers and social responsibility to provide efficient, transparent, services because of their privileged position. It is obvious they have not kept up with productivity gains (efficiency) when they complain about cost of funds.
- (g) ADIs rely on the interest margin as a sign of their costs structure but when assessing productivity in businesses they do not allow for the banks inefficiencies in effecting the customers business. Why?
- (h) There is no doubt that improved efficiency in banks can improve cash flows for their business customers. In reality cost of funds is related to lending charges and variation in lending charges relates to institutional efficiency and market values.
- (i) Any commentator looking at costs of funds has only to refer to the costs of establishing a facility. The NAB made admissions it had corrupted accounts with its past refund activities then redacted its web site when it realised the situation *“(NAB redacts website to hide customer refunds, “IA , 1 April, 2012.*
- (j) In an article *“Not all bankers fret over image” The Australian, March 19 ,2012).* Michael Ulmer previously NAB Deputy Chief Executive expressed the opinion in 2011 that NAB still had a way to go to correct its corporate culture. ANZ also admitted a costly corporate culture. There is no question in this inquiry into how these cultures effect bankers economic and operational efficiency despite having some identified real costs.
- (k) Regulators may consider that these cultures also include propositions such as “Storm” and when constructing terms of reference for ADIs include a question as to how much costs of funds etc are affected by these inefficient and capital destroying processes.

- (l) Funds taken from depositors and borrowers by ADIs behaviour do not find their way back to cash investments even when credit products.
- (m) If an ADI finds costs of funds a difficulty then industry benchmarking could reveal the reason and in fact should be a prerequisite to any serious complaint.

**4. The impact of borrowing and lending practices in the banking sector both during and since the global financial crisis.**

- (a) The impact of borrowing and lending policies above is restricted by the policies, legislation and practices before the GFC. These factors were current at the time and many continue. In the submitted article at this position "*Banks and the Moral Dimension*" IA 16 April, 2012, the article covers various remedies for many banking problems and settles on a remedy for many of the problems faced by falling asset values.
- (b) It also covers the problem of the banking code of practice and the obvious relationship between the banks and the morality of destroying borrowers value and financial lives to avoid banking industry mistakes.
- (c) It discusses the proposition of banking records and their manipulation in accordance with current law and the propositions of a major shareholders demanding return on their investment.
- (d) The article discusses some legislative remedies and propositions to support home buyers including first home buyers. Then identifies a remedy proposition where the banking industry could accept interest on the fresh value of the mortgaged property under the correct circumstances but retain the contract on redemption at its original value.
- (e) The article is attached as annexure 3.

**5. The need for further consideration of the state of the broader banking and finance sector.**

- (a) From the material above there is a definite need for further consideration of banking and finance.
- (b) There is a need to provide a process and explanation of policy and changes to policy and legislation to provide for certainty when takeovers and consolidations occur between bankers and /or financial houses. This inquiry is providing the circumstances for such an inquiry as the vulnerable in our society have spoken of their losses due to these factors in many submissions to this inquiry. The article “Banks and the Moral Dimension” IA 16 April, 2012, has provided some suggestions to enable such an investigation.
- (c) The following areas need special investigation.
- (1) Industry and corporate cultures of the players and the relationship with;
  - (2) Individual organisations,
  - (3) Industry service providers,
  - (4) Courts and enforcement authorities,
  - (5) APRA and other government authorities and regulators,
  - (6) Treasury including IMF Reserve Funds and the purpose of the IMF
  - (7) Reserve Bank and its circumstances in relation to the IMF, and industry supervision including when it serves on industry boards.
  - (8) International Credit providers,
  - (9) International money markets and
  - (10) International Regulators such as the Federal Reserve in USA.
  - (11) Interrelationship with LIBOR and the international situation with Australian Banks and settlements.
  - (12) The relationship between the Renimbi and the \$A in future transactions and when to actively discourage settlement in American Dollars for international payments.
  - (13) A process for settling Renimbi transactions and settlement with China for internationally acceptable currency, until it becomes a floating currency.



- (14) The relationship between Australian Banks and BASEL 3 and international Ratings agencies with proposed Australian deficiencies in Deposit- Lending Ratios.
- (15) The outcomes from this inquiry not comprehensively and satisfactorily dealt with by existing regulation.
- (16) The proposal to move bank lending off balance sheet such as practised unsuccessfully by ANZ (for the customers) and proposed by NAB.

**6. Any other relevant matters.**

- (a) In 2011 your committee investigated changes in the Bankruptcy Act to remove farmer payments of \$170,000 to leave the land from Bankruptcy estates.
- (b) During this process a submission was made using the NAB past refund activities www published list of refunds from 2005 on. This showed a refund for incorrect charging of default interest since 1992 annexed at 4 is a copy of the actual refund advice to affected account holders.
- (c) After this inquiry was announced and court matters using this document were imminent NAB redacted their web site to remove the NAB past refund activities advice and replaced the document with interest variations and particular fees missing.
- (d) Annexed at 2 is a document "*National Australia Bank redacts website to hide customer refunds*" *Independent Australia*, , 1 April, 2012.
- (e) The seriousness of this comes about because in 2005 the Australian Government through the Department of Agriculture, Forestry and Fisheries after Council of Australian Governments in Darwin, introduced a process with all state cooperation to record Farmer Interest Subsidy Payments because of anomalies.

- (f) In 2008 the Productivity Commission published that farmers in Victoria were refused subsidy but when they applied in New South Wales it was granted.
- (g) The Australian Government has recently removed interest subsidies from the list of emergency relief.
- (h) Certain facts on the NAB list of refunds indicated that since 1992 the bank and possibly other banks may have claimed incorrect values for interest subsidies purposes.
- (i) The original document published on the www by NAB and shown in the IA story showed these possible incorrect values as refunds to account holders and not mentioning the Interest Subsidy refunds to Government. Annexure 4 ;. *Fixed Rate Interest Only Loan- Interest Refund (28 September 2006)*
- (j) This now raises an important issue for this committee to investigate. How the NAB corporate culture and acts possibly denied by redacting a web site, to avoid discovery of facts, for an inquiry that may identify refunds due to the Australian Government and the farmers, relating to overcharged interest to farmer accounts. *[Bankruptcy Amendment (Exceptional Circumstances Exit Package) Bill 2011, 21.9.2011 , Submission 9 Name Withheld (PDF 5412KB)]*

Signed ..... 31 May 2012.