



**The Australian Banking Sector Post-GFC**

*Submission to: Senate Economics Committee*

*"Inquiry into the post-GFC banking sector"*

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## Introduction

The post-GFC period has been one of significant regulatory change for the banking sector, both internationally<sup>1</sup> and domestically.<sup>2</sup> The period has been marked by volatility, uncertainty and instability with further regulatory change still in the wings. The likely effects of these impending regulatory changes are yet to be fully discerned. In this submission we highlight a number of issues relevant to the Inquiry which have been identified in the work of, and work associated with, the Australian Centre for Financial Studies (ACFS). This submission touches upon only a small number of the important issues which can be addressed, and which warrant attention in a broader review of the Australian Financial Sector.

## 1. Summary of Recommendations

The following recommendations are made in the subsequent sections of this submission.

- 1.1. **Recommendation 1:** *The degree of competition in the financial sector and the extent to which undesirable barriers to entry exist warrant review as part of a major review of the workings of the financial sector. One aspect of that review should include an assessment of the extent to which implicit and explicit government support, after allowing for associated regulation, conveys competitive advantages on particular financial institutions.*
- 1.2. **Recommendation 2:** *Consideration should be given to whether the systemic importance of the Big Four Banks (or any other financial institutions) warrants some form of special regulatory treatment.*
- 1.3. **Recommendation 3:** *(a) the deposit guarantee cap under the FCS should be reduced; (b) consideration should be given to charging a fee for the deposit guarantee on competitive neutrality grounds.*

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<sup>1</sup> An overview of the international regulatory agenda for the post-GFC period up until early 2011 can be found in the report prepared by ACFS for the Melbourne APEC Finance Centre “Regulatory Reform Post the Global Financial Crisis: An overview”. The report can be accessed at:

[http://www.apec.org.au/docs/11\\_CON\\_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf](http://www.apec.org.au/docs/11_CON_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf)

<sup>2</sup> A review of how Australian and New Zealand financial sector regulation has changed in response to the GFC can be found in the Australian and New Zealand Shadow Financial Regulatory Committee’s report: ANZSFRC (2011) “The Global Financial Crisis and Financial Regulation in the Antipodes”, Chapter VI of *World in Crisis: Insights from Six Shadow Financial Regulatory Committees From Around the World*. The report can be accessed at: <http://finance.wharton.upenn.edu/FIC/FICPress/crisis.pdf>

- 1.4. **Recommendation 4:** *Consideration, on grounds of competitive neutrality, should be given to allowing any fee imposed for the deposit guarantee to be paid in the form of either cash or debits to franking account balances.*
- 1.5. **Recommendation 5:** *As part of a suggested review of the Australian financial system and its regulation, a substantive cost-benefit study of the impact of recent and proposed regulatory changes on the economy should be undertaken.*
- 1.6. **Recommendation 6:** *The merits of allowing banks (and other lenders) to adopt mortgage loan arrangements giving them complete discretion to adjust interest rates on existing loans should be examined.*
- 1.7. **Recommendation 7:** *A wide-ranging review of Australia's financial system and its regulation is warranted.*

## 2. Competition in the Banking Sector

- 2.1. There has been a significant increase in concentration in the Australian banking sector since the GFC, with the takeovers by Westpac and CBA respectively of St George and Bank West (which still trades under its own licence and name) being major contributors.<sup>3</sup> The share of total bank deposits held by the “big four” increased significantly from 62.2 percent in March 2007 to 79 per cent percent in March 2012. Likewise loan concentration also increased significantly with the “big four” holding 78.1 percent of total banking sector loans at March 2010.
- 2.2. Focusing only on banks understates the change in concentration. In domestic deposit markets, the ratio of deposits at credit unions and building societies (CUBS) to those at banks has continued to fall. In the early 2000s the ratio was around 7 per cent, had fallen to around 5 per cent by the onset of the GFC and is now around 4 per cent.<sup>4</sup> Likewise, the Registered Finance Corporations (RFC) sector comprising money market corporations and finance companies has had a relative decline. Whereas assets of the RFC sector were over 10 per cent of those of ADIs prior to the GFC, they have since fallen to around 6 per cent.
- 2.3. Similarly, the post GFC period has seen a significant decline in the role of securitization, and the size of securitization vehicles. At the onset of the GFC,

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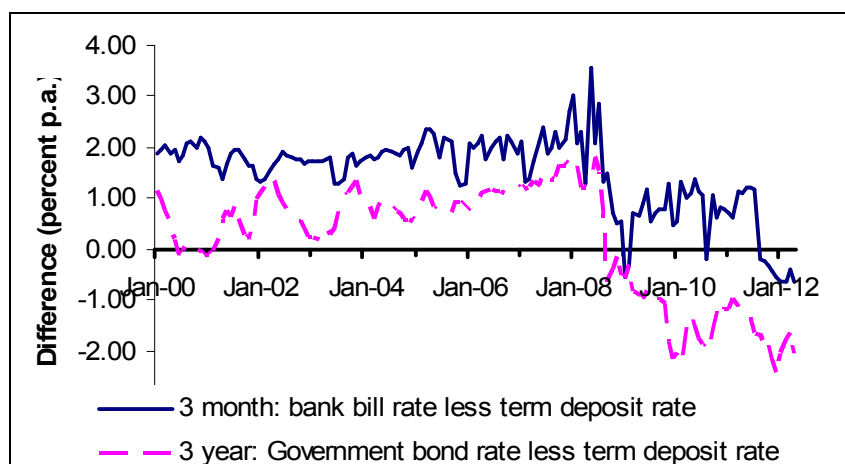
<sup>3</sup> K Davis “*The Australian Financial System in the 2000s: Dodging the Bullet*” in G Hugo and J Kearns *The Australian Economy in the 2000s*, RBA, 2010 provides a detailed analysis of the increased concentration in the Australian banking sector and the implications this may have. The paper can be accessed at: <http://www.rba.gov.au/publications/confs/2011/davis.pdf>

<sup>4</sup> The recent designation of some CUBS as “mutual banks” has led to a shift in classification in the official statistics (which thus puts the CUBS share at around 3.6 per cent in March 2012).

securitization assets reached a peak of around 14 per cent of ADI assets (from around 10 per cent near the start of the 2000s) but that ratio has since fallen to under 5 per cent at end 2011.

- 2.4. High concentration does not necessarily mean an absence of competition or abuse of market power. Indeed, in some markets, competition looks to have increased. One example is the market for retail deposits. Figure 1 shows how retail term deposit interest rates have increased relative to interest rates on wholesale market rates. Since late 2008, 3 year term deposit rates have exceeded the government bond rate, and there was also a marked narrowing of the gap between 3 month bank bill rates and 3 month term deposit rates.

**Figure 1 Bank Retail Term Deposit Rate Behaviour**



- 2.5. There is, however, another aspect to concentration which is the extent to which the major banks are dominant players across a wide range of financial services, and their roles in the vertical supply chain in provision of financial services and products. This is particularly apparent in the financial advice and wealth management sectors where banks own large financial advisory firms (and can direct customers towards such services), provide necessary software and platforms required by such advisors, and manufacture products for investment by clients of advisor firms. While there is a degree of competition in this sector from Life Companies and other financial firms, dominant positions of market power in one part of the supply chain can inhibit new entrants and competition in other parts of the supply chain.

- 2.6. The strong market position of the major banks across the whole financial sector is likely to be one of the reasons why they have been able to maintain profit levels which represent an accounting rate of return on equity of fifteen per cent

or more. These rates of return, and market to book valuation ratios exceeding unity (although lower than in some earlier times) are suggestive of inadequate outside competition. While inter-bank competition appears strong in many markets, it is competition within the constraint of prices set to achieve a particular return on equity target. That target appears high relative to the rate of return which shareholders require for the risk involved in their investment.<sup>5</sup> The paucity of new entrants as competitors to banks in the range of markets in which they operate in response to such high rates of return is suggestive of some barriers to entry. While those may be “natural” barriers, such as due to economies of scale or superior efficiency of the majors, they may also reflect market power and ability of widely diversified financial institutions such as the major banks to undercut potential new entrants into any particular single activity without major impact on aggregate profitability.

*2.7. **Recommendation 1:** The degree of competition in the financial sector and the extent to which undesirable barriers to entry exist warrant review as part of a major review of the workings of the financial sector. One aspect of that review should include an assessment of the extent to which implicit and explicit government support, after allowing for associated regulation, conveys competitive advantages on particular financial institutions.*

### **3. Bank Resolution and Consequences of the “Too Big To Swallow” Problem**

3.1. One potential source of competitive advantage for the big four banks lies in the fact that they are widely perceived as having implicit government support and will not be allowed to fail. That reflects the potential systemic disruption and negative social externalities which would be associated with a failure. In most cases of troubled financial institutions which are prudentially regulated, APRA is able to arrange a “smooth exit” by way of an arranged merger. The Financial System Stability Special Account established following legislation in 2008, provides a budget appropriation available to facilitate the potential costs involved. However, this is unlikely to be feasible in the case of the “big four” banks due to the sheer size and complexity of their balance sheets and operations. They are “too big to swallow” by other financial institutions in a situation of financial distress when the risks involved are likely to be substantial and hard to assess.

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<sup>5</sup> This question is addressed in ACFS Financial Regulation Discussion Paper 2012-1 *Banking Profitability, Bank Capital and Competition*, February 2012, <http://www.australiancentre.com.au/banking-profitability-bank-capital-and-competition/>

3.2. IMF researchers have estimated the value of “Too Big to Fail” perceptions for large international banks to be a funding advantage of around 20 basis points.<sup>6</sup> One consequence of this situation is that some form of differential regulation or imposition of other special taxes on large systemic institutions may be justified. Because potential failure would create negative social externalities, some form of special impost (regulation or tax) could be considered in order to compensate for such social costs and to provide incentives against institutions becoming systemic and creating such social costs. Similarly, where governments will provide implicit support (such as “bail-outs”) to prevent that disruption, *ex ante* imposts to compensate taxpayers for likely cost and to provide disincentives can also be justified. Whether such imposts should take the form of explicit taxes or levies or regulation such as higher capital requirements is an open question. While some governments have proposed special taxes on big banks, the Basel proposals for Global Systematically Important Banks (G-SIBS) have focused upon higher capital requirements. While these proposals do not affect the large Australian banks, they are domestic and regional SIBS (D-SIBS or R-SIBS), and similar arguments apply. The Australian and New Zealand Shadow Financial Regulatory Committee has suggested consideration be given to requirements for additional “contingent capital” – recognizing that such instruments need to be carefully designed to avoid creating of further risks.<sup>7</sup> Future international regulations seem likely to address requirements for such institutions.

3.3. **Recommendation 2:** *Consideration should be given to whether the systemic importance of the Big Four Banks (or any other financial institutions) warrants some form of special regulatory treatment.*

#### 4. Structure of the Financial Claims Scheme

4.1. The blanket guarantees that the Government placed on bank liabilities at the onset of the crisis give banks (and other ADIs) a privileged position by validating community expectations of implicit government support for such entities. It is worth noting that even though Australian banks received no explicit subsidies from the government in navigating the GFC, there was substantial implicit

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<sup>6</sup> The complete IMF report, “A Fair and Substantial Contribution by the Financial Sector” can be accessed at: <http://www.imf.org/external/np/g20/pdf/062710b.pdf>

<sup>7</sup> An analysis of potential regulation that could be imposed on Regional Systematically Important Banks can be found in the ANZSFC statement “Do the Big Four Australasian Banks Require Special Regulation?” The statement can be accessed at: <http://www.australiancentre.com.au/wp-content/uploads/ANZSFC-statement-number-10-SIFIs-final.pdf>

support in terms of the pricing of debt guarantees.<sup>8</sup> In general, the cost of debt guarantees to the Australian banks was less than that imposed by other nations who took similar action, and significantly lowered the cost of bank financing vis a vis borrowing on a non-guaranteed basis at that time.

4.2. The size of the deposit guarantee cap under the Financial Claims Scheme (FCS) was wound back from \$1 million to \$250,000 in late 2011. There are two issues which warrant addressing regarding the FCS. First, the current level of deposit guarantee cap is excessive and reduces the potential development of other retail investment options such as a retail corporate bond market due to the relative premium that must be provided to investors in risky corporate debt as opposed to risk-free deposits.<sup>9</sup>

4.3. The second is the absence of any fee for the guarantee. A fee might be rationalized on either (or both) of two grounds. First, a fee could be seen as an insurance type premium reflecting the cost to taxpayers of providing such a guarantee and aimed at offsetting moral hazard (risk taking) behavior by the insured ADIs. In the Australian case, that argument has limited applicability. One reason is that the structure of the scheme (where APRA becomes a preferred creditor for amounts paid to insured depositors) means that the cost of failure falls primarily upon uninsured depositors and other creditors. Given the structure of the Australian ADI market it would also be difficult to design a feasible, fair, insurance fee structure. A second rationale for a fee is based on recognizing the competitive advantage the FCS gives to ADIs competing in retail finance markets. While it might be argued that prudential regulation imposes additional costs which offset any such advantage, it is far from clear that the offset is complete. There is thus a case for examining further whether the explicit deposit guarantee warrants some fee on competitive neutrality grounds.<sup>10</sup>

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<sup>8</sup> For more information on how the pricing of bank debt guarantees differed from that overseas, see ANZSFRC (2011) and ACFS Financial Regulation Discussion Paper 2010-01 "Taxing the Banks" <http://www.australiancentre.com.au/publications-and-articles/2010/072010-davis-taxing-the-banks-frdp-1.pdf>

<sup>9</sup> A discussion on the current impediments to an Australian retail corporate bond market can be found in the article "Can a corporate bond market solve the Super Equity bias?" The article can be accessed at: <http://www.australiancentre.com.au/publications-and-articles/2012/03212012-davis-corporate-bond-market-super-equity-bias-commentary.pdf>

<sup>10</sup> For a detailed analysis on a whether a fee may be suitable for banks covered by the FCS see "Deposit Insurance - Getting the Financial Claims Scheme Settled". The discussion paper can be accessed at: <http://www.australiancentre.com.au/publications-and-articles/2011/06052011-davis-deposit-insurance-frdp-3.pdf>



4.4. Although their declining market share suggests otherwise, the deposit guarantee should, by removing depositor concerns about safety, have increased the ability of small ADIs, such as the CUBs, to compete in deposit markets against the larger players. Reducing the size of the cap, and charging for the guarantee would thus appear to be likely to weaken competition from this source (referred to as a “Fifth Pillar” by the Treasurer in releasing the *Competitive and Sustainable Banking Sector* reforms in December 2010).

4.5. However, it would be possible to implement such a change simultaneously with resolving another concern of such institutions and offsetting such adverse effects on competition. The CUBS, as mutual organizations have long argued that the dividend imputation taxation system discriminates against them, because of their inability to distribute franking credits. While the strength of that argument can be debated, there do appear to be some grounds to support it.<sup>11</sup> Consequently, one option which is worth examining would be to introduce a fee for the deposit guarantee which ADIs could pay either by cash or by debits to available franking account balances. For mutual organizations for whom franking credits are otherwise locked up and wasted, this could provide an attractive option (and would not involve discrimination against other banks who could also choose to make payment in that form). In principle, such a choice could be given to financial institutions for payment of some other government charges such as supervisory levies.

4.6. **Recommendation 3:** (a) the deposit guarantee cap under the FCS should be reduced; (b) consideration should be given to charging a fee for the deposit guarantee on competitive neutrality grounds.

4.7. **Recommendation 4:** Consideration, on grounds of competitive neutrality, should be given to allowing any fee imposed for the deposit guarantee to be paid in the form of either cash or debits to franking account balances.

## 5. Basel III Changes to Capital and Liquidity Requirements

5.1. Australian banks are well placed to deal with the higher capital requirements that will be implemented under Basel III for the following reasons:

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<sup>11</sup> See ACFS Financial Regulation Discussion Paper 2010-06 *What is Fair Taxation of Credit Unions?* December 2010 <http://www.australiancentre.com.au/publications-and-articles/2010/12022010-davis-credit-union-taxation-frdp-6.pdf>

- 5.1.1. They successfully raised additional equity after the onset of GFC, have strong profitability and have high earnings retention - despite large dividend payouts - due to dividend reinvestment plans. Therefore, in the current slower credit growth scenario, they are likely to be able to meet much of any additional equity capital needs internally.<sup>12</sup>
- 5.1.2. Under the Australian dividend imputation tax system, any tax-induced cost of higher equity capital requirements relative to liability funding is lower than for banks overseas. This is due to many overseas countries maintaining a classical (or non-integrated) tax system which gives tax incentives to debt and deposit funding.<sup>13</sup>
- 5.1.3. Even though higher capital requirements may increase bank funding costs and loan interest rates, the effect is relatively small, and these effects can be offset by RBA interest rate policy.<sup>14</sup>
- 5.2 The proposed capital requirements may look high compared to the recent past, but they are still low compared to the longer term historical average. Davis (2012)<sup>15</sup> provides historical figures for Australian bank capital ratios showing the marked decline in the ratio of equity to total assets from 15.4 percent in 1901 to 6.7 percent in 1945 and to much lower levels by the 2000's.
- 5.3 While the banks should have little problem meeting the more stringent Basel III capital requirements, the nature of the Australian capital market presented some problems for adopting the Basel III liquidity requirements. The Basel definition of high quality liquid assets (HQLA) for calculation of the proposed Basel III liquid coverage ratio (LCR) requirement focused on home country government debt. The small size of the Australian government securities market, and large holdings of that by foreign investors meant that bank demand to meet the LCR would not be able to be met. Consequently, Australian (and some other nations') regulators were given approval by the Basel Committee to use an "Australian

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<sup>12</sup> See the article by ACFS Research Director, Kevin Davis, "Benefits of Slower Credit Growth" Australian Financial Review, 21 February 2012.

<sup>13</sup> See the article by ACFS Research Director, Kevin Davis, "Social Dimension to Bank Capital Ratios" Australian Financial Review, 30 Jan 2012

<sup>14</sup> A more detailed argument on this issue can be found in the article "*Higher Bank Capital: What's Wrong With That?*" The article can be accessed at <http://www.australiancentre.com.au/higher-bank-capital-what%e2%80%99s-wrong-with-that/>

<sup>15</sup> K. Davis *Bank Capital Adequacy: Where to Now* in M Ariff, J Farrar, A Khalid (eds) *Regulatory Failure and the Global Financial Crisis: An Australian Perspective*, Edward Elgar, Cheltenham, 2012. A pre-publication draft of the chapter can be accessed at: <http://kevindavis.com.au/secondpages/workinprogress/BankCapitalAdequacy-v2-24-5-10.pdf>

solution” to offset the shortage of eligible liquid assets. The “Australian solution” to the LCR dilemma is to allow banks to meet any LCR gap by inclusion of pre-arranged, fee based, liquidity facilities at the RBA, where the fee is to be set with the objective of involving similar cost to banks as would occur instead under a pure LCR approach. There is no unique fee which achieves that objective, and the RBA has set a fee of 15 basis points. This was lower than market expectations, but sufficiently attractive to encourage its use and limit the pressure on the government securities market which bank demand would have otherwise created.<sup>16</sup>

5.4 More generally, the Basel LCR requirement is based on flawed logic. In a general liquidity crisis the central bank must step in and provide system liquidity through repurchase agreements or other mechanisms. Provided banks have sufficient repo-eligible securities, it does not matter whether they are government or private sector issued. Credit risk associated with the collateral provided by banks in such repo transactions can be managed by applying appropriate “haircuts” and margining requirements.<sup>17</sup>

5.5 The Basel III Net Stable Funding Ratio requirement requires banks to better align their use of longer term (one year plus) funding with their longer term loan commitments. It has the potential to significantly affect bank funding arrangements and loan arrangements for the following reasons:

5.5.1 It reduces the ability of banks to “ride the yield curve” (borrow short and lend long) and profit from its traditional upward slope.<sup>18</sup>

5.5.2 It reduces the extent of liquidity creation by banks, by forcing a reduction in the average maturity gap between loans and deposits. Such liquidity production is a key economic function of bank intermediation, and the merits of introducing and the calibration of such an impediment as the NSF ratio can be debated. Underpinning the NSF ratio introduction is the view that banks had become engaged in socially excessively risky liquidity production – the consequences of

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<sup>16</sup> A detailed discussion of the potential problems with the “Australian Solution” to the Basel III LCR ratio can be found in ACFS Financial Regulation Discussion Paper 2011-02 “Basel III Liquidity Options”. <http://www.australiancentre.com.au/publications-and-articles/2011/06012011-davis-basel-iii-liquidity-options-frdp-2.pdf>

<sup>17</sup> See ACFS FRDP 2011-02 *op cit*.

<sup>18</sup> Although banks could still do so by raising floating rate long term funding and making long term fixed rate loans.

which were seen during the Global Financial Crisis and the need for various forms of government support for ongoing funding.

5.6 The introduction of the NSF Ratio and the LCR Ratio can be expected to change aspects of bank intermediation.

5.6.1 The LCR ratio has required consideration of a change in the withdrawal penalty conditions of term deposits in order for them to be excluded from the calculation of liabilities against which liquid assets need to be held. Traditionally investors have been able to withdraw prematurely with penalty limited to an interest adjustment (and some other costs) but no exposure to loss of capital. This limited penalty reduces disincentives for term depositors to withdraw funds in time of crisis.

5.6.2 They have contributed to increased bank competition in retail deposit markets. An issue which is also raised in section 4.1.

5.6.3 There will undoubtedly be changes in the design of some loan facilities (such as reductions in longer term guaranteed liquidity provision) and innovations to shift liquidity risk to other entities.

5.7 To the extent that the cost of bank intermediation is increased by the capital and liquidity requirements, alternative non-bank intermediation and capital market financing arrangements are likely to be encouraged.

5.7.1 Securitisation is one such area. A slow recovery in the securitization market following the GFC is partly due to characteristics of bank loan pricing and increased investor aversion to securitized products. Slow growth in securitization is likely to continue as long as there is a discrepancy between the average and marginal cost of bank funding. With housing loan interest rates variable at the banks' discretion, banks are able to respond to increased funding costs by adjusting loan rates on their entire portfolio of old and new variable rate loans – and thus averaging the effect - rather than interest rates on new loans bearing the full effect. In contrast, interest rates on loans funded through securitization have to reflect the current cost of funding in capital markets.

5.7.2 The response adopted by the Australian Government to the decline in the securitization market during the GFC was to provide funding for the Australian Office of Financial Management to act as a cornerstone investor in new issues by smaller securitizers. As a temporary measure

in a period of market dislocation that may have assisted some issuers to preserve the viability of their business models, but there is no strong case for its use as an ongoing support mechanism. Similarly calls by some for provision of some form of government guarantee arrangements should be resisted – particularly since it seems unlikely that “fair pricing” of those guarantees would be easily achievable.

5.7.3 Those types of responses focus on supporting the demand for securitized products. It may be worthwhile examining whether there are competitive impediments to funding conditions which affect the ability of small securitizers to compete with major banks. The supply chain of securitization requires mortgage originators to accumulate a pool of mortgages which require temporary funding either through “warehouse loans” or commercial paper issuance facilities. For those institutions without a large deposit based balance sheet, they are dependent for such facilities upon larger banks and institutions with whom they are competing in mortgage markets.<sup>19</sup>

5.7.4 The issuance of covered bonds by the major banks is also likely to have an impact on the recovery of the securitization market as many investors are likely to see covered bonds as a substitute investment for traditional securitized assets. As securitization has typically been used as a loan financing strategy by smaller institutions coupled with the fact that covered bonds are likely to only be utilized by the “big four”, it is expected that the ability of smaller financial institutions to compete in the loan market will also decrease.<sup>20</sup>

5.7.5 While there are a range of initiatives to develop the local corporate bond market, which any increased cost of bank intermediation will aid, there remain a number of impediments. At the retail investor level, standard issuance arrangements impose costs and alternative approaches warrant examination.<sup>21</sup> Also, the high level of the deposit guarantee cap under the FCS (allied with higher rates on bank term

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<sup>19</sup> This issue is discussed more fully in the op-ed by ACFS Research Director Kevin Davis “RMBS feel the squeeze” *Australian Financial Review*, December 9, 2009.

<sup>20</sup> Further insight into the reduction in the securitization market can be found in the ACFS/KPMG report “The future of Australian bank funding”. The report can be accessed at: <http://www.australiancentre.com.au/publications-and-articles/2011/042011-acfs-kpmg-report-the-future-of-bank-funding.pdf>

<sup>21</sup> See, for example, ACFS FRDP 2010-02 “Deregulating Retail Bond Issuance” for examples of such proposals. <http://www.australiancentre.com.au/publications-and-articles/2010/072010-davis-deregulating-retail-bond-issuance-frdp-2.pdf>

deposits) can be expected to inhibit retail investor demand for (risky) corporate debt.

5.8 The likely overall consequences of the Basel reforms are difficult to assess, given the quantum of changes involved and the range of other regulatory reforms occurring domestically and internationally. The UK *Financial Services Authority* has recently released a cost-benefit analysis of the impact of prudential regulation changes on the British economy.<sup>22</sup> Given the debate which the regulatory reform process has engendered, a similar exercise for Australia, ideally undertaken using expertise from outside the regulatory sector, would seem warranted.

**5.9 Recommendation 5:** *As part of a suggested review of the Australian financial system and its regulation, a substantive cost-benefit study of the impact of recent and proposed regulatory changes on the economy should be undertaken.*

## 6. The Cost of Bank Funding

6.1. Assessing bank funding costs is difficult as overall funding is a mix of various bank liabilities across differing maturities. Funding costs reflect two components, the general level of interest rates and credit spreads over and above the risk free rate (government rates). While the cash rate influences the general level of interest rates:

- i. It is only one (very short term) rate and the (term) structure of risk free rates by maturity can vary substantially.
- ii. It is set by the RBA in the context of what level of lending rates they think is appropriate and thus is influenced by overall bank funding costs.

6.2. Moreover, particular funding costs, such as deposit rates may vary relative to the cash rate and government risk free rates, depending upon the degree of competition and movements in the relative cost of other forms of funding. The cost of those other forms, such as wholesale debt market funding, will depend upon the credit spreads which banks must pay for such funds and which can vary markedly over time in response to changes in general market confidence as well as assessments of individual bank risk. How bank funding costs vary over short periods of time is difficult to assess, because banks may be changing their mix of

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<sup>22</sup>FSA, "Measuring the impact of prudential policy on the macroeconomy", Occasional Paper 42, May 2012. <http://www.fsa.gov.uk/static/pubs/occpapers/op42.pdf>

funding and rolling over maturing sources of longer term funding where movements in both the general level of rates and credit spreads since that debt was initially issued need to be taken into account.<sup>23</sup>

6.3. The Basel reforms are likely to have some effect on the cost of bank funding. The higher capital requirements are unlikely to have a significant impact, although the liquidity requirements seem likely to be more significant. However, in evaluating those effects it should be noted that they involve a reduction in risk taking by banks which brings with it other social benefits. Moreover, lesser risk taking by banks should be reflected in the required returns of shareholders – providing some offset to any increase in other funding costs- and which shows up only indirectly in aggregate funding costs as return on equity targets of bank management are gradually adjusted.

6.4. Community focus upon bank funding costs arises largely from the way in which bank lending rates are set in Australia, meaning that changes in both general and bank-specific funding costs are passed on to both existing and new borrowers. In a submission by ACFS to the Senate Economics Committee's 2010 Inquiry into Banking Competition,<sup>24</sup> the consequences of banks having discretion to vary mortgage interest rates at their pleasure were outlined. Alternative loan interest rate setting arrangements, including use of adjustable rate loans, where the loan rate is adjusted at regular intervals in line with (and at a fixed margin over) some market indicator rate (but not the cash rate), are worth further examination.

6.5. **Recommendation 6:** *The merits of allowing banks (and other lenders) to adopt mortgage loan arrangements giving them complete discretion to adjust interest rates on existing loans should be examined.*

## 7. Banks in a Complex Financial Sector

7.1. The Australian financial sector is marked by:

- i. A large, concentrated banking sector
- ii. A large equity capital market and derivatives markets

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<sup>23</sup> Further information related to the cost of bank funding post-GFC can be found in the ACFS/KPMG report "The future of Australian Bank Funding". The report can be accessed at: <http://www.australiancentre.com.au/publications-and-articles/2011/042011-acfs-kpmg-report-the-future-of-bank-funding.pdf>

<sup>24</sup> Housing Mortgage Contract Design and Banking Sector Competition (Senate Economics Committee Bank Competition Inquiry, Submission #8)

- iii. A less well developed, although growing bond market
- iv. A very large and growing superannuation sector.<sup>25</sup>

7.2. All of these sectors are interconnected, and consequences of changes in regulation or growth in one sector require analysis of the whole. Moreover, banks operate across much of the financial sector creating interdependencies at the institutional level, and therefore, potential implications for competition beyond “traditional” banking markets.

7.3. The Wallis Inquiry called for independent stock-takes and reviews of the financial sector and its regulation on a ten-yearly basis. Almost 15 years has passed since that Inquiry and much has changed. While deferring such a review was warranted during the GFC and its immediate aftermath of wholesale international regulatory change, there is now enough clarity about the international regulatory agenda and trends in Australia’s financial sector to warrant a new review.

7.4. One issue which has grown in significance since the Wallis Report has been the recognition of how financial system structure can create systemic problems. While the Australian financial system and banks coped well with the GFC, there are characteristics of our financial system which warrant further examination with regard to systemic stability (as well as efficiency of intermediation).

7.5. For example the reliance of the big four Australian banks on wholesale funding is well known, as is their large proportion of residential loans in total lending. 2011 statistics released by the IMF show that the proportion of real estate loans to total loans held by Australian banks was in excess of 60 percent, approximately double the average of the 20 countries listed in the report.<sup>26</sup> This similarity in funding structures and balance sheets of the large Australian banks means the fortunes of the individual institutions in the Australian banking sector are highly correlated - as can be observed in the correlation of bank equity prices and in forward looking estimates of their equity volatility. Understanding better how

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<sup>25</sup> For detailed information on the superannuation sector see the ACFS/KPMG report “Superannuation trends and implications”. The report can be accessed at:

<http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/kpmg-acfs-monograph-superannuation-trends-and-implications.pdf>

<sup>26</sup> The similarity of the “big four” banks funding structures and loan portfolios is addressed in the ACFS/KPMG report “The future of Australian bank funding”. The report can be accessed at:

<http://www.australiancentre.com.au/publications-and-articles/2011/042011-acfs-kpmg-report-the-future-of-bank-funding.pdf>



such balance sheet similarities among dominant financial institutions and the interlinkages between them (and other financial sector institutions) affects financial stability warrants further investigation.

**7.6. Recommendation 7:** *A wide-ranging review of Australia's financial system and its regulation is warranted.*