Bendigo and Adelaide Bank

30 November 2010

Committee Secretariat
Department of the Senate
Parliament House
Canberra ACT 2600
economics.sen@aph.gov.au

Dear Committee Secretariat,

Submission: Senate inquiry into competition within the Australian banking sector

Attached is Bendigo and Adelaide Bank's submission to the Senate inquiry into competition within the Australian banking sector.

We appreciate the opportunity to provide a submission to the Senate Economics Committee and welcome any request to provide more information, or oral submissions. We understand that the initial hearings will be held between the 13th and 15th December in Sydney and Canberra and we would be more than happy to make ourselves available to attend any of these dates.

Yours faithfully,

Mike Hirst
Managing Director

cc: Robyn Clay, Head of Government Relations

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Submission to the Senate Economics Committee

Inquiry into competition within the Australian banking sector

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1. Executive summary

Bendigo and Adelaide Bank (**BEN**) welcomes the opportunity to provide a submission to the Senate Economics References Committee inquiry into competition within the Australian banking sector. BEN believes that there has been an impact upon competition since the onset of the Global Financial Crisis (**GFC**), and that there are a number of sensible steps which can to be taken to ensure that a competitive environment is restored.

The GFC heightened the focus of policy makers on system stability. Whilst this focus was prudent at the time, we believe that the result of many of these measures has been to widen the competitive gap between the 'big four' banks (**major banks**) and the rest of the banking and financial services sector. The withdrawal of several international banks from the Australian market, the demise of many non-bank providers and the acquisition of some mid tier banks by the major banks have only served to magnify this change in market dynamics.

The current financial services landscape is characterised by several key factors, including:

- significant consolidation towards the major banks in important markets such as retail deposits and home mortgage lending;
- the lack of meaningful volumes of wholesale funding at competitive rates for the smaller banks and unrated sector, both domestically and on international markets;
- the increased cost of domestic retail deposit funding; and
- a relative disadvantage in capital position for the smaller institutions, which is exacerbated by current prudential standards.

BEN is concerned that any attempt to manage competition through increased regulation of the banking sector may have the unintended consequence of placing a higher burden of compliance and increased costs on the smaller banks in comparison to the major banks. It is often fundamentally more expensive for smaller players to comply with new legislation, if that compliance relies on system based solutions. The fixed cost of developing these solutions does not vary greatly in relation to the size of an institution, therefore the unit cost of compliance falls as the scale of business increases.

Issues such as the availability of funding at a competitive price – one symptom of the lack of a deep fixed interest market domestically – and discriminatory prudential standards need to be reviewed if the sector is to truly return to a relatively unfettered competitive state.

BEN believes that the following initiatives should be considered to improve competition:

- extension of the support for Residential Mortgage Backed-Securities (**RMBS**) through the provision of Government credit support through a guarantee or other similar measure;
- expansion of Repo eligibility to include term funding of all Australian ADIs;
- addressing the prudential capital requirements for all ADIs, to ensure that there is some flexibility in addressing obvious anomalies ; and
- adopting superannuation reform to support a more active domestic fixed income investment market.

BEN would welcome any request to provide more information, or provide oral evidence to the Committee.

2. About Bendigo and Adelaide Bank

BEN has in excess of 1.5 million customers and provides a range of banking and financial services primarily to retail customers and small-to-medium size businesses. The services are provided through third party channels, licensed external financial advisers, its financial planning arm ("Bendigo Financial Planning"), as well as directly to customers through its extensive retail branch network and **Community Bank**® network. BEN has also recently announced that it will increase its shareholding in specialist agribusiness lender Rural Bank from 60 per cent to 100 percent – further entrenching our commitment to provide banking services to rural and regional communities.

BEN is the independent financial services provider of choice in many markets. This is particularly the case in the third-party mortgage, retail banking, and margin lending sectors. BEN also provides significant banking competition in rural and regional Australia where the major banks have not always been willing to provide their services. BEN has gone further than providing banking infrastructure, and has actively supported and helped strengthen communities through its **Community Bank®** network. There are approximately 90 communities in Australia where BEN is the only financial services provider. BEN's **Community Bank®** network has also recently celebrated the milestone of returning $41 million back into communities for local projects and in excess of $14 million in shareholder dividends from **Community Bank®** companies.

3. The competitive environment within the Australian banking sector

3.1. The impacts of the GFC and regulatory environment

3.1.1. Competition

Competition in the banking sector has weakened significantly since the GFC due to the combination of:

- the pricing of the wholesale funding guarantee and the deposit guarantee for deposits over $1 million;
- the increased scale of the major banks through recent acquisitions (including St. George, BankWest, Wizard and Aussie) combined with a withdrawal of some foreign bank participants;
- the closure of the securitisation market and subsequent demise of non-bank financing; and
- in respect of the home mortgage market, the major banks' relatively lower prudential capital requirements.

The major banks have capitalised on their increased competitive advantage by:

- utilising Government guaranteed funding – at prices materially favourable to those available to non-major banks – to fund increased market share;
- making a price-led push into the domestic deposit market to maximise asset growth at a time when regional and non-bank lenders were facing funding constraints; [1] and
- making major acquisitions of regional banks, mortgage originators, wealth managers, local subsidiaries of distressed foreign firms and off shore assets.

[1] Appendix Graph 1, source: APRA, UBS broking reports

The funding advantage handed to major banks as a result of the GFC has meant that much of the competitive gains and market diversification achieved over the past 20 years has been unwound in the space of 3 years.

3.1.2. Funding

The tiered pricing structure of the Federal Government wholesale funding guarantee had the effect of immediately increasing wholesale funding margins between major banks and non-major banks by approximately 65 basis points.

The effect of this on competition was:

a) that smaller lenders found it (and continue to find it) difficult to compete with the major banks on pricing without severely impacting their net interest margins;
b) that funding was limited or not available to mortgage originators which led to many of them being squeezed out of the market.

3.1.3.Innovation

History has shown that a competitive environment in the banking sector leads to meaningful innovation, usually driven by smaller competitors. However, with diminished competition due to funding constraints and with the disappearance of many smaller lenders, the acceptance by the market of innovation has decreased due to the market domination of the major banks.

BEN believes that the key driver of innovation in the future will be the change in customer demographic. The ageing population will create opportunities for wealth management product innovation. While income security products are often thought of in this area, BEN believes that there will be demand for appropriate products which provide customers with access to the equity they have built up in their homes, thus increasing the liquidity of many traditionally non-liquid assets. We deal with this further in our recommendations to enhance competition.

BEN believes that the starting point for any review of competition in the banking sector needs to be focused on the impacts of funding constraints for smaller banks and non-bank lenders.

4. Policies, strategies and practices to enhance competition in banking

BEN supports the introduction of initiatives that will enhance competition, particularly initiatives that will:

- improve the availability and cost of funding sources for smaller lenders; and
- provide a more even regulatory/legislative/prudential playing-field for all banks.

BEN suggests the following simple, practical solutions form part of any package aimed at increasing competition in the sector.

a) Supporting RMBS/CMBS transactions

BEN supports the continuation of the AOFM's direct investment into the RMBS market. We note that this solution should not be long-term and should only remain until the securitisation market is functioning more effectively.

BEN also suggests the Government guarantee the underlying asset of the AAA portion of all RMBS/CMBS transactions. This would have a two-pronged effect. First, it would allow all banks to raise wholesale funds on a far more level playing field. Second, it would reignite activity within the securitisation market – one of the great drivers of competition in the 15 years prior to the GFC. Apart from the obvious support of the Government's credit rating, the creditworthiness of the guaranteed securities would make them irresistible as qualifying assets for banks' prudential liquidity. Both of these impacts would result in significantly cheaper issuance costs. With cheaper funding for all institutions, there would be increased competition within the industry.

Under this proposal, the risk to which taxpayers are exposed would also be considerably less than guaranteeing a AA or BBB rated institution, as the guarantee would be specific to a AAA rated asset class rather than to the institution as a whole.

b) The Canadian mortgage model

BEN also suggests that the Government should investigate the benefits of the Canada Mortgage and Housing Corporation (CMHC) model and the application that it may have for the Australian banking sector. Canada's banking system was recently judged by the World Economic Forum to be the world's safest and was advocated by the G20 as a model for others. The CMHC's model includes the Government's explicit guarantee of the creditworthiness of conforming Canadian home loans on a commercial basis. As a condition of this guarantee, the government requires lenders to invest directly in their securitisation pools, to have some "skin in the game". Also, the British government recently announced that it would guarantee AAA-rated RMBS issues in an attempt to stimulate the securitisation market in the United Kingdom.

c) Covered Bonds

BEN recognises that some large players in the Australian financial services sector would benefit directly from the introduction of a Covered Bond (**CB**) market. However, in a relative sense these benefits would be applied in far greater scale to the major banks, and would further entrench their enhanced market power.

Any consideration of the introduction of a CB market should be considered in parallel with funding solutions that would be available and would benefit smaller lenders to counter-act the limited accessibility of a CB market (on commercial terms) for the non-major banks.

d) *Superannuation reforms*

BEN believes that superannuation reforms should be introduced to support a more active domestic fixed income investment market. There is a significant amount of the Australian taxpayers' savings in superannuation, the majority of which is invested in equities. If there were incentives for these funds to be invested in domestic fixed-interest bearing securities, there would likely be a welcome reduction in Australia's reliance on overseas funding. Importantly, as the Australian demographic ages, there will be a greater number of superannuants who should require assets that are better suited to the drawdown stage of their superannuation investment. Clearly products that have a greater ability for capital preservation, such as fixed interest, have a major role to play. The development of the domestic fixed interest market is paramount for these reasons alone.

e) *Regulatory review of capital requirements*

Current regulatory capital requirements are creating material distortions in the competitive dynamic of the banking sector. Most significantly this is represented by the different risk weighting applied to residential mortgages between banks operating under the advanced approach under Basel II, and those operating under the standardised approach under Basel II.

In essence, non-major banks are being required to hold approximately two times the capital being held by major banks against assets that have almost identical underwriting and credit performance metrics.[2] These additional costs – in the form of regulatory capital – are providing another barrier to competition for the second tier banks. We acknowledge that the major banks have to hold additional capital for operational risk under the advanced model but all the analysis we have done would suggest there remains an advantage in capital efficiency for those on the advanced model.

The advanced model is aimed at banks that have a wide range of business risks. For banks that have a relatively simple offering, the risk weightings of assets relative to the major banks appears to be a disadvantage that doesn't truly reflect the risks being assumed.

f) *Expand repo eligibility*

BEN believes RBA repo eligibility criteria should be adjusted to include all ADIs regardless of their rating (including unrated entities) and RMBS. BEN believes such changes could be introduced quickly and easily by the RBA. Similarly, the non-major ADIs could quickly adapt to the eligibility changes.

BEN believes that if the RBA eligibility was expanded it:

- would go some way to restoring competition by providing a funding boost to non-major banks; and
- may provide sufficient funding to allow smaller banks to extend focus to business lending where the majors have opportunistically expanded margins.

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[2] Appendix Graph 2; Source: based on company information released under APRA Prudential Standard 330 as at June 2010

g) Comprehensive credit reporting

BEN believes that the Government's proposed move to positive credit reporting will help to spread critical credit risk information across the sector, and allow better credit decisions to be made. This will hopefully lower default rates and have downward pressure on interest rates and charges. These tangible economic outcomes should of course be viewed alongside the significant social benefits that would be realised through a more equitable and transparent reporting system that helps reduce the rate of credit default across Australian households, giving peace of mind to policy makers and Australian families alike.

h) Changing Banks

The key constraints on customers moving between banks are:

- For borrowing products, the costs associated with those products, such as application fees, valuation fees, legal fees and statutory fees and charges to discharge and register mortgages; and
- For transaction accounts, the hassle and inconvenience of dealing with third parties whose payments/funds transfers may be linked to those products (i.e. direct debits, standing orders, superannuation etc).

BEN believes that all banks are entitled to charge fees to cover such costs, but we equally believe that more could be done to assist customers to switch and to make switching administratively easier.

An initiative that the Government should consider is making mortgages portable. There is a current opportunity to enable this by working with the project that is examining e-conveyancing on a national level. Implementing a system where titles and loan documentation for refinanced mortgages could be automatically transferred from one lender to another or where mortgages could be transferred from one property to another, would alleviate some of those costs. The industry would play a part in this by agreeing on a set of standard terms and conditions for mortgages that would allow mortgages to be assigned without incurring various fees and charges.

Similarly, we believe it may be a reasonably simple matter to build a system that would enable customers to swap transaction providers. By interrogating existing data, ADIs may well be able to electronically provide a customer's new account provider the information it needs to seamlessly notify all direct debit and credit providers of the customers changed banking information. We would be happy to discuss in more detail how we think this could work.

However, any move to empower customers needs to be closely considered in terms of its impact on smaller lenders, and in particular with a focus on any additional compliance costs it would place on them. As you will appreciate, the smaller banks in Australia do not have the resources of their larger counterparts and customer facing changes can prove to be costly and complex to implement. For example, our experience of implementing the reforms associated with Financial Services Reform Act and Anti-money Laundering legislation shows that such customer facing changes are as complex and difficult to implement for the smaller lenders as they are for the larger players.

i) Homesafe Equity Release Product

BEN believes that the ageing population will create opportunities for wealth management product innovation. One such innovative product offered by BEN, as part owner of Homesafe Solutions Pty Ltd, is the Homesafe equity release product. This is an equity release product for retiree homeowners achieved through the sale of a fixed percentage of the future sales proceeds of the retiree's home. BEN has identified strong demand for such a product, and is certain that, with our ageing population, demand will continue to grow. This product also addresses many of the concerns that have been raised in relation to the draft Regulation Impact Statement in relation to Equity Release Product Reforms.

Homesafe has the potential to offer significant social and economic benefits to Australians (i.e. liquidity for retirees, protection against longevity risk), whilst delivering net benefits to the Government. It has the potential to reduce reliance on government assistance by many retirees, and will help ensure that our ageing population can better fund their retirement.

By increasing competition, through more cost effective funding options, this will help drive and foster future innovation by smaller lenders.

5. Summary

Since the GFC, there has undoubtedly been a major shift in market dynamics in the banking sector, which has resulted in a less competitive environment. BEN supports the Government introducing measures to enhance competition and to empower customers to switch providers or find the best deal. However, without resolving the key funding and capital requirement barriers that smaller banks are facing, such moves to enhance competition and empower the customer will have little or no effect. In essence, the smaller banks and non bank financial institutions do not have access to enough competitively priced funding to allow them to issue the volume of product required to improve competition. In the absence of such funding, the competitive pressure applied by the smaller institutions will remain very much at the margins.

BEN would welcome any request to provide more information, or provide oral evidence to the Committee.

Yours faithfully,

Mike Hirst
Managing Director