Heritage
Building Society

14 January 2011

Senator Bushby
Chair
Economics References Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senator Bushby

Attached is the submission of Heritage Building Society to the Senate inquiry into competition within the Australian banking sector. We appreciate the opportunity to contribute our views, particularly given our position as Australia's largest building society, with over 135 years of supporting Australian families into home ownership through many economic cycles.

At the heart of our submission is the primary issue that is constraining competition with the big four banks – the availability and cost of funding for smaller competitors relative to that of the AA rated banks. Prior to the GFC, Heritage funded around one third more loans than today at a cost that allowed aggressive price competition. Now, we must use price and other levers to consciously constrain the volume of loans we originate to levels that we know we can prudently fund while maintaining our price advantage for our customers.

There is no simple solution to this situation, but if implemented, the recommendations contained in our submission would be highly supportive to competition, not just from Heritage, but from the broader mutual ADI sector. I look forward to discussing these recommendations and other questions that you may have when we meet on 24 January at the Committee's public hearing in Brisbane.

Yours sincerely

John Minz
Chief Executive Officer

Submission to the Senate Economics References Committee

Inquiry into competition within the Australian banking sector

HERITAGE BUILDING SOCIETY

People first.

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Heritage Building Society

INTRODUCTION

Notionally retail consumers in Australia have significant choice of banking providers, services and products. It is the opinion of Heritage Building Society ('Heritage') that the reality is somewhat different. Many members of the Committee will be unfamiliar with Heritage, though with $7.5 billion in assets, approximately 130 branches and mini branches and close to 100 ATMs in southern Queensland the organisation sits within the second tier of ADIs competing with the big four banks.

This demonstrates the very large gap between the big four banks and the next group of ADIs in size, financial resources, market share, distribution, sophisticated capabilities and product breadth.

Consequently, while an aggressive war in retail banking between the big four banks would potentially benefit consumers in the short term and apparently achieve one objective of the government, ADIs at Heritage's tier and below would struggle to hold our position in the market. Likewise, if the government introduces constraints aimed at the big four banks that apply across the industry, the impact is likely to fall more heavily on smaller ADIs causing a long term lessening of competition.

The result of either scenario would be an even more dominant banking oligopoly.

To ensure that growth of a diverse range of innovative competitors to the banks is stimulated rather than constrained by government actions, Heritage requests that the Committee ensures that their final recommendations:

- Do not harm building societies and credit unions through the imposition of measures that reduce our ability to compete.
- Support initiatives that specifically enhance the ability of building societies and credit unions to compete with the big four banks, particularly in the area of funding.

Heritage recommends that:

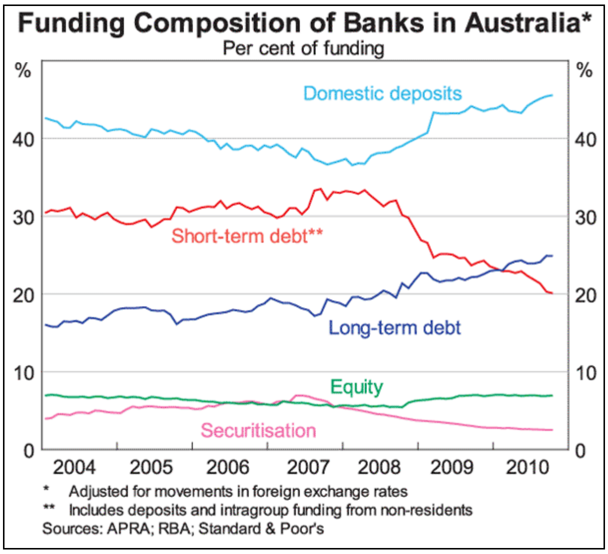
1. The $1 million cap on the Financial Claims Scheme for retail deposits held with mutual ADIs be retained.
2. The wholesale funding guarantee previously provided by the Government be reintroduced for smaller ADIs with an equitable fee arrangement, as against the previous inequitable structure.
3. The classification of ADIs be changed to Authorised Banking Institutions (ABI).
4. The support of securitisation be continued.
5. The risk weighting of mortgages for mutual ADIs be standardised to that applied by the big banks.
6. Additional Government support is made available so that small ADIs are the beneficiaries of the proposed introduction of covered bonds.
7. Change the RBA definition of financial assets eligible for repurchase agreements to include all investment grade ADI issuance.
8. An approach be agreed that allows mutual ADIs to utilise franking credits.
9. Intervention and regulation be carefully considered to ensure it does not result in unintended consequences that reduce the ability of building societies and credit unions to compete.

These recommendations are discussed from page five of this submission.

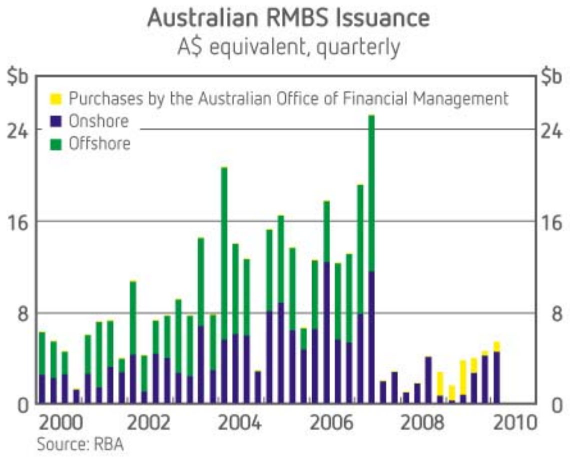
BACKGROUND

While the public debate regarding competition in banking has focused on mortgage lending, the ability to source funding at competitive prices drives the ability to lend in volumes and at prices that are competitive. In the lead-up to the GFC all manner of competitors to the big four banks thrived because of the availability of low cost securitisation, which overcame the funding advantages normally available to the major banks.

Because their AA ratings allowed them to raise wholesale deposits cheaply, securitisation played only a minor role in the funding of the big four banks.



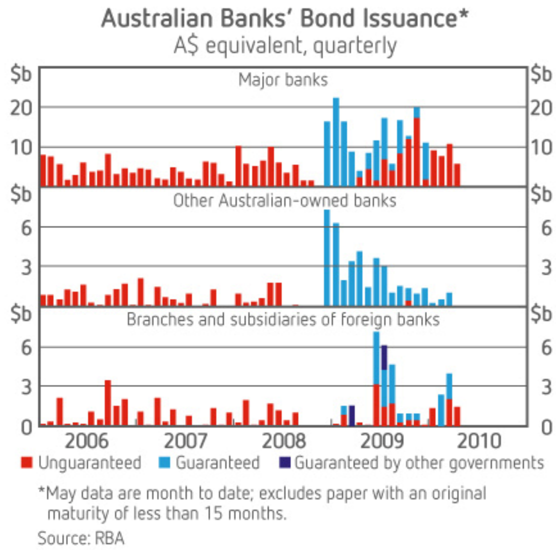
With the closure of securitisation markets during the GFC, it was the small competitors to the big four banks who really struggled. And, while the government's efforts through the Australian Office of Financial Management are welcome, their impact on driving competition is at the margin.



The primary impact of the GFC on the major banks was due to their dependence on offshore investors for their wholesale funding, so at the height of the crisis the wholesale guarantee was critical to ensure their continued ability to lend.

Given their preferential treatment in the pricing of the wholesale guarantee it is logical to assume that the big banks would have made most use of the facility.

In fact, while major banks were significant issuers in the early stages of the GFC, ongoing difficulties within securitisation markets forced some smaller, lower rated banks to continue to utilise guaranteed wholesale funding even though the cost was much higher relative to the big banks because of the increased guarantee fee and the additional premium demanded by investors because of perceived risks associated with lower rated ADIs.



As liquidity returned to the markets, the big banks' AA ratings allowed them to raise funds more cheaply without locking in the cost of the guarantee, giving them an immense advantage over their domestic competitors.

Without a guarantee, long term senior debt markets remain essentially closed for smaller ADI issuers, even today.

The availability and cost of funding during this period effectively capped the volume of loans that smaller ADIs could acquire, while also squeezing their margins. In the meantime, many of the foreign banks who had maintained competition and pricing pressure in the business and corporate banking market withdrew from the market, allowing the big banks to increase their margins by charging these customers more.

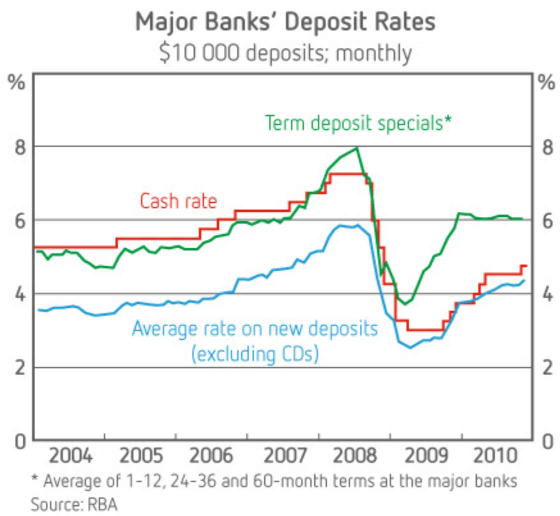
The retail competitors of the big banks, many of which relied on the major banks for funding, were amongst those corporate customers who had the cost of their funding facilities significantly increased.

By way of example in late 2007 Heritage utilised facilities with one foreign bank and one local big four bank to warehouse mortgages. With the withdrawal of foreign banks and RMBS investors, Heritage had to negotiate new warehouse facilities with two other big banks at prices many times higher than those available prior to the GFC.

Heritage recognises the problems associated with the mispricing of credit and accepts that market conditions should determine funding costs. However, the major banks were able to provide these facilities to smaller ADIs by utilizing funding raised via the wholesale government guarantee which smaller ADIs were not able to do because of the inequitable fee applied.

The outcomes emphasise the imbalances within the Australian banking market relating to funding that reinforce the pricing power of big banks, not only over the products they offer directly to mums and dads or through subsidiary brands and brokers, but also over the input costs of the products offered by their larger competitors.

The focus on funding meant that for the first time in possibly a decade, the big banks also aggressively competed for retail deposits, particularly for term deposits and online accounts. Their advertising emphasised their security, leveraging the fact that most of the public still do not realise that all banks, building societies and credit unions fall under the same Banking Act and the same regulator as the big banks.

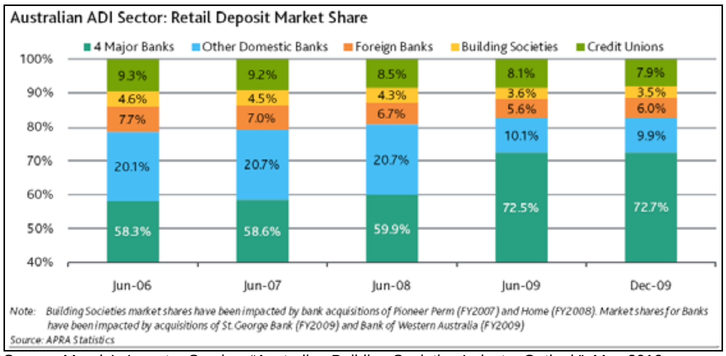


Retail deposits are the primary source of funding for many building societies and credit unions. The renewed price-based competition created by the actions of the big four banks had a marked effect on their funding costs and the availability of funding to provide new loans to members of mutual ADIs.

The government's retail deposit guarantee, particularly its high $1 million cap, was consequently of significant value to building societies and credit unions such as Heritage at a time when retail depositors were most concerned about security and when competition for retail deposits from the big banks had increased dramatically.

In March 2009, at the height of the global crisis, direct charging on ATMs was introduced. This new regime replaced interchange payments between ADIs for services provided to each other's customers with a fee charged directly to customers when they used a "foreign" ATM. The national network of ATMs and branches of the big banks now attracted transaction accounts which pay negligible interest. As a result, while direct charging was aimed at the interchange earned primarily by the big banks, these institutions benefited from the change through the low cost deposits in the transaction accounts they attracted.

Heritage, who has almost 100 ATMs across Southern Queensland, now pays Westpac to provide our members with free access to a national ATM network.



Source: Moody's Investor Service, "Australian Building Societies Industry Outlook", May 2010

RECOMMENDATIONS

In spite of these challenges, mutual ADIs such as Heritage Building Society continue to provide robust competition to the big four banks, particularly in regional and industry-based markets. Introducing constraints on banks is unlikely to support competition. Although it is not the intention, based on past experience it is more likely to impact negatively on the smaller ADIs rather than promote competition. To increase the challenge to the dominance of the big four banks the government must offer positive, meaningful support to mutual ADIs, particularly with initiatives that provide access to competitively priced funding and which encourage a supportive regulatory regime.

In this regard Heritage recommends:

1. Retain the $1 million cap on the Financial Claims Scheme for retail deposits held with mutual ADIs

The imposition of the retail deposit guarantee with a cap of $1 million ensured smaller ADIs retained their existing deposits and allowed them to compete with the big four banks for new deposits.

Research conducted by Heritage indicates that, irrespective of their dislike for the big banks, customers perceive them to be more secure than the alternatives. This belief relates both to the size of the banks and to a common belief that they have an explicit government guarantee that the building societies and credit unions do not.

Heritage is consequently concerned that the big banks will be the beneficiaries if the Financial Claims Scheme reduces the level of explicit depositor protection, particularly with regard to the depositors of building societies and credit unions. Heritage recommends that as a minimum, the Financial Claims Scheme retains the $1 million cap for retail deposits held with mutual ADIs.

Together with the introduction of the “government protected” logo and the supporting community awareness campaign, this would ensure consumers understand that their money has the same level of protection across the whole ADI sector. This will level the playing field, allowing smaller ADIs to compete aggressively with the big four banks for deposits.

2. The wholesale funding guarantee previously provided by the Government be reintroduced for smaller ADIs with an equitable fee arrangement

The market for senior debt issued by an ADI remains skewed in favour of the major banks. Since the wholesale guarantee was removed in March 2010 only one senior debt wholesale markets transaction has been completed by an ADI with a credit rating below A (long term).

Heritage believes the Government needs to level the playing field in relation to access to funding at cost effective levels by reintroducing the wholesale guarantee for smaller ADIs.

While Heritage supports the initiatives applied in relation to securitisation (refer point 4 below), we do not agree with the Government’s assumption that RMBS should be the core solution to provide cost-effective, capital efficient access to wholesale funding for smaller ADIs. The RMBS market is resource dependent, overly complex and creates an ongoing operational burden for issuers due to the requirements created by external stakeholders such as credit rating agencies.

In addition, changes in external stakeholder views or a shift in risk appetite, as well as the punitive regulatory changes insisted on by APRA (often applied retrospectively), reduce the efficiency of this channel from a capital and operational perspective. We note also that in Heritage’s opinion there is an over-reliance on mortgage insurers (another oligopoly within Australia) to support RMBS structures, which in the current market environment makes effective execution of securitisation transactions very difficult, particularly without a meaningful subordinated note investor base.

Retaining the ability for smaller ADIs to pay for a government guarantee would be less complex, more operationally efficient, and provide meaningful access to wholesale investors.

A wholesale guarantee would only assist smaller ADIs if an equitable fee arrangement is applied. The previous version relied on a fee structure determined by reference to credit rating, and gave virtually no weight to the strong regulatory regime provided by APRA. Heritage recommends a flat fee be applied and, to manage the Government’s total exposure, suggests that the guarantee only be made available to smaller ADIs that satisfy key balance sheet metrics.

The residual risk to the Government is incremental given the modest size of the funding need and the oversight regime imposed by APRA, for which smaller ADIs get very little discernable benefit. We note the significant amount of low risk fee income the Government has generated as a result of the previous wholesale guarantee structure.

3. Change the classification of ADIs to Authorised Banking Institutions (ABI)

Heritage is a potential beneficiary of the government's announcement that APRA will quickly approve over 20 mutuals to use the term 'bank' if they apply. While this would unambiguously signal our regulatory position relative to the big four banks to customers and potential customers, the experience of other smaller banks has not demonstrated a material benefit.

Banks such as Challenger Bank, Bank of Melbourne, St George Bank, Adelaide Bank and BankWest have now disappeared, while those remaining, such as Suncorp Bank, Bank of Queensland, Bendigo and Adelaide Bank and ME Bank, faced similar challenges to those faced by mutual ADIs during the GFC and subsequently.

Given the current consumer and political backlash against "the banks" and their generally poor public perception, Heritage believes it may create difficulties in differentiating our customer owned model from the profit driven model of the listed banks if we, too, were a bank. This difference is important to us since it sits at the heart of our culture and our brand.

Heritage instead recommends that the term Authorised Deposit-taking Institution (ADI) be changed to Authorised Banking Institution (ABI) and that the words "bank" "banking" and "banker" be approved for use as descriptors of the services we clearly provide. The right to do this could perhaps be provided after application to APRA. For consumers, this may overcome negative perceptions relating to security by more effectively aligning the services provided by, for example, Heritage Building Society with that of the big banks and would accurately describe our business while not losing our differentiator from the banks of being owned by our customers.

The change to ABI designation and approval to use "bank", "banking" and "banker" in reference to our services, reinforced by the introduction of the "government protected" logo and community awareness campaign, will reflect the government's stated intention of promoting mutual ADIs as the "fifth pillar" and a viable alternative to the banks. The cost to the Government of this recommendation is inconsequential but the improvement to public perception would, in our opinion, be substantial.

4. Continue to support securitisation

The size of the securitisation market and its cost to participants prior to the GFC provided funding that allowed lower rated ADIs and even unrated mortgage originators to compete effectively for retail mortgages with the big four banks. Securitisation also allowed mutual ADIs like Heritage to use capital more efficiently as assets were transferred from our balance sheet and supporting capital was freed for reuse.

Earlier discussion demonstrated how far the current securitisation market is reduced today from where it was prior to the GFC. Although it is welcome, it also showed the relatively marginal likely impact of the support provided by the government to stimulate the market through the Australian Office of Financial Management.

Heritage believes that the securitisation market is unlikely to return in either volume or pricing to where it was pre-GFC. While this makes it less attractive, Heritage encourages the government's support of the market, since we believe that securitisation will continue to play a part in a broadly diversified funding strategy.

APRA has also recently made it clear that the benefits of securitisation will primarily be in relation to access to wholesale funding, and not from a capital management perspective. This view is reflected in the proposed Basel 'III' amendments. For mutuals such as Heritage who are now largely restricted to increasing core capital through growth in retained earnings, the value of securitisation is consequently reduced further.

However, while strictly correct from a technical point of view, APRA's approach ignores the "real world" situation. Heritage strongly believes that a slight moderation in APRA's attitude would be beneficial without, in our view, increasing the real risk which APRA is trying to reduce.

5. Standardise the risk weighting of mortgages for mutual ADIs to that applied by the big banks

While Heritage wishes to re-emphasise that competitively priced funding is critical, the weight of public discussion concerning competition in banking has been around mortgage lending. Like the banks, mutual ADIs must hold capital in support of the mortgages on their balance sheets. One of the constraints on growth in the mortgages held by mutual building societies and credit unions has been the limited options available to increase the capital necessary to support that growth. Securitisation facilitated the recycling of capital as explained above, but it is Heritage's view that these benefits are likely to reduce over time. Mutual ADIs currently have a 6% share of the housing loan market. The implication of the inability to use securitisation as a capital management tool is that our ability to grow market share will essentially be dependent upon our rate of profit generation.

Under Basel II the risk weighting given to mortgages held by small ADIs is around twice that of the big four banks, meaning that small ADIs must provide substantially more capital in support of their mortgages than do the big banks. This makes the cost of mortgages higher for small ADIs than the big four banks and is also one impediment to mutual building societies and credit unions growing at a faster rate.

Given that mutual building societies and credit unions typically have significantly lower arrears rates for their mortgages than those of the big banks, it is recommended that the risk weighting for mortgages held by mutual building societies and credit unions be aligned with that of the big four banks. This initiative levels the playing field for smaller ADIs. It also frees capital to allow mutual building societies and credit unions to grow their share of the retail mortgage market more aggressively in competition with the banks.

6. Government support be made available so that smaller ADIs are the beneficiaries of the proposed introduction of covered bonds

Heritage believes that the introduction of covered bonds is unlikely to provide sustainable funding benefits for smaller ADIs.

The manner in which ratings for covered bond transactions are determined means smaller ADIs are unlikely to attain a AAA rating for their securities. In reality most second tier ADIs such as Heritage will be able to attain a modest credit rating, where there is very limited investor appetite.

In addition an ADI is required to establish complex securitisation-like legal structures and provide a substantial level of over-collateralisation of supporting assets to facilitate a covered bond transaction. This imposes significant operational burdens and complexities similar to those mentioned in regard to securitisation in point 4 above.

It is also likely that APRA will impose heavy capital charges for the support facilities required, particularly by smaller ADIs.

In Heritage's opinion smaller ADIs will therefore have a limited ability to utilise covered bonds. At best the channel will be merely a supplement to current funding options as part of a well diversified funding base.

Despite reservations, Heritage supports the promotion of covered bonds to facilitate funding diversity for Australian ADIs. However Heritage recommends that the Government consider initiatives designed to support the use of covered bonds by smaller ADIs. Such initiatives may be designed to either expand the investor base or to provide support facilities to mutual ADIs so as to facilitate a better rating outcome for covered bond structures.

7. Change the RBA definition of financial assets eligible for repurchase agreements to include all investment grade ADI issuance

The RBA's definition of eligibility for repurchase agreements is crucial to investors during times of liquidity stress and reduced market appetite for credit risk. At the height of the GFC the expansion of this definition to include securitised issuance was a fundamental decision underpinning the Government's success in easing systemic pressures.
The current rules applied by the RBA unreservedly favour the major banks, in that the existing definition only provides 'repo' eligibility for long term debt issued by ADIs that are rated above A. This definition only

includes a handful of larger Australian banks. The result is that investor appetite for crucial long term issuance by smaller ADIs is severely restricted. As highlighted in point 2 above, the long term senior debt market remains effectively closed for smaller ADIs. This is directly as a result of the investor reticence created because this type of issuance is not readily exchangeable for cash with the RBA.

It is Heritage's opinion that the current RBA definition relies too heavily on credit rating opinions and does not give weight to the strong regulatory environment under which all ADIs operate. A relaxation of the RBA definition to incorporate all investment grade issuance would enhance the market for senior debt issuance for smaller ADIs by providing access to a more diversified investor base and reduce the need for smaller ADIs to rely predominantly on securitisation.

8. Allow mutual building societies and credit unions to utilise franking credits

Because retained profits are the primary means by which mutual building societies and credit unions generate the capital required for growth, dividends are generally not distributed to members. This means that while mutual ADIs pay tax at the same corporate rate as the listed banks, the franking credits generated are typically unable to be distributed and simply accumulate over time.

These accumulated franking credits could be used against a mutual ADI in the event of a predatory takeover attempt by a listed entity. Such a predator could offer to pay a dividend that incorporates Heritage's accumulated franking credits as an incentive to encourage members to accept their unsolicited offer of acquisition. In real terms this enables a predator to use the funds of members to help finance an attempted takeover.

Heritage recommends that mutual ADIs be able to utilise franking credits either to enhance member benefits through their distribution as part of the income earned in relation to an investment instrument or alternatively used to reduce the tax we pay and thereby increase profit generation and subsequently the rate of capital generation. The latter could be achieved through either the imposition of a lowered tax rate reflecting our inability to distribute franking credits or by allowing the trade of franking credits to offset tax payable.

9. Carefully consider unintended consequences of intervention & regulation

Due to their size, resources and the diversity of their businesses, the capacity of the big four banks to take advantage of government or regulator imposed changes is far greater than that of smaller ADIs. As a result, the imposition of initiatives directed towards the big four banks often impacts more on the smaller ADIs, making competition more difficult, reinforcing the existing banking oligopoly. Past and potential future examples include:

- The cost of the wholesale guarantee
- The introduction of ATM direct charging and discussed future intervention
- The introduction of covered bonds
- Ongoing regulatory changes including;
    - Ever expanding consumer protection regulation and bureaucracy imposed on all irrespective of size of operations and demonstrated integrity over the long term.
    - The interventionist designation of approved and disallowed fees and charges
    - The potential cost and complexity of account switching initiatives arising from the Fraser inquiry
    - The impact of the introduction of Basel III regulations

The government's announced banning of exit fees is a simple recent example.

On the surface this initiative should be attractive to both consumers and smaller ADIs. Instead, it is likely to disadvantage smaller ADIs whose balance sheets have a higher proportion of mortgage loans and therefore rely more on income derived from those assets. Only two of the big banks charge exit fees, demonstrating that they can recoup the actual cost of closing a mortgage from other areas within their broad business mix while retaining the competitiveness of their retail offering. Smaller ADIs typically do not have this luxury, with increased interest rates or other charges on mortgages or reduced services the only options to reflect the true cost of a refinance. The alternative is for mutuals to absorb the cost and reduce profitability, also reducing potential future growth.

This seemingly attractive initiative may therefore have the perverse outcome of reducing the competition that the government is attempting to stimulate. ASIC's RG 220 appears to provide a more flexible approach that allows legitimate costs to be recouped while protecting customers from gouging.

CONCLUSION

Heritage has been providing banking services to Australian families for over 135 years so we have seen economic cycles and competitors come and go. This year alone we will provide new mortgages for the homes of around 6,500 Australian families.

The Global Financial Crisis strengthened the competitive position of the big four banks due to the actions taken to reinforce the stability of Australia's financial system, the withdrawal of investors from all but the highest rated assets and the departure of foreign banks from active competition in Australia.

There is no single action that can be taken by the government to facilitate greater competition; a package of changes is required. It is Heritage's view that these solutions need to address customer misconceptions about smaller ADIs, funding imbalances that currently exist within the market and inequities in the treatment of capital. Accordingly Heritage's recommendations are designed to provide greater access to cost effective funding and capital for smaller ADIs and in doing so provide a meaningful and sustainable banking alternative to the major banks.

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