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ASSOCIATION INC.

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31 May 2012

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

Dear Committee Secretary,

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

Please find attached the ABA submission to the Senate Economics References Committee on the *Inquiry into the post-GFC banking sector*.

Yours sincerely,

Steven Münchenberg



**AUSTRALIAN BANKERS'**  
**ASSOCIATION INC.**

## 2012 Banking Inquiry

Steven Münchenberg  
Chief Executive Officer  
May 2012

Australian Bankers' Association Inc. ARBN 117 262 978  
(Incorporated in New South Wales). Liability of members is limited.

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## 1. Introduction

On 14 March 2012 the Senate referred the following matter to the Senate Economics References Committee for inquiry and report:

*An examination of recent developments in the banking sector arising out of the impact of the global financial crisis and subsequent events.*

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comments to the Committee. Our submission addresses all terms of reference (TOR):

*(a) the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements;*

*(b) the impact on relative shares of specific banking markets;*

*(c) the current cost of funds for lending purposes;*

*(d) the impact on borrowing and lending practices in the banking sector both during and since the global financial crisis;*

*(e) the need for further consideration of the state of the broader finance and banking sector; and*

*(f) any other relevant matters.*

In making this submission, the ABA notes that it represents the interests of the banking community as a whole, including large and smaller banks, and the operations of international banks in Australia.

## 2. International regulatory changes

*(TOR (a) the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements)*

### 2.1. Attributes of domestic and international regulation

There are a number of desirable attributes of banking regulation, both domestically and internationally. Recent regulatory changes have not in all case had these attributes, and some examples are explored later in this submission.

First, regulation should conform to accepted principles for sound regulation, such as the following:

1. Regulation must yield a net benefit to the community, not just to a particular group or sector.
2. Regulation must be set to the minimum level necessary to achieve the objectives and to avoid unnecessary restrictions; it should be targeted at the problem.
3. Regulation should be integrated and consistent with other laws, agreements and international obligations. Any restrictions on competition should only be retained if they provide a net benefit to the community and if government objectives cannot be achieved by other means.
4. Regulation should not be unduly prescriptive and, preferably, be specified in terms of performance or outcomes. It should be flexible enough to allow businesses some freedom to find the best way to achieve compliance, while remaining adaptable to changed circumstances.
5. Regulation should be accessible, transparent and accountable. Not only should the public be able to readily find out what regulations they must comply with, but the regulations must also be reasonably easy to understand and they should be fairly and consistently administered and enforced.
6. Regulation must be clear and concise and communicated effectively.

7. Regulation should be mindful of the compliance burden imposed, proportionate to the problem being addressed and set at a level that minimises compliance costs while still achieving the set objective.
8. Regulation must be enforceable and embody the minimum incentives needed for reasonable compliance. Adequate resources must be provided for monitoring and to ensure reasonable compliance.<sup>1</sup>

Second, regulation must achieve a suitable balance between increased stability and cost of regulation, and between the risk it seeks to mitigate and the overall impact of its implementation, not only on the regulated entities, but the community and the economy as a whole.

Third and more specifically, new regulation in and for Australia should have regard to the experience and performance of Australia during the global financial crisis, in comparison with many of its trading partners; and, further that Australia has already committed to a substantially enhanced framework for the whole financial system.

Lastly, regulation should seek to balance the customer experience in person and online while reducing the incidence of financial crime.

## 2.2. Framework of banking regulation

An examination of banking regulation, particularly in the period since the global financial crisis commenced, requires consideration of the multi-layered framework for development and implementation of banking regulation. Banks in Australia operate within a complex and robust system of Commonwealth regulation, but they are also impacted by State and Territory regulation in areas such as duties and taxes and occupational health and safety, and by regulation at the local level, for example, laws relating to planning for new and existing facilities and infrastructure.

Banking organisations, even those operating entirely within Australia, are subject to extensive and complex international regulation. While this aspect has been brought into sharp focus by the reform process led by the G20 Leaders in response to the global financial crisis, there has been for many years, a high level of interconnectedness in the financial system, and a concomitant level of international regulation, both de jure and de facto.

International (or transnational) regulation can be introduced by a truly international body, such as the Basel Committee on Banking Supervision (BCBS), by a group of countries such as the European Union, or by a single country such as the United States.

Australian banks operating offshore need to comply with further country-specific regulation, which may also be multi-layered, for example in those jurisdictions with a federal system of government. Each piece of new or amended regulation adds to the substantial edifice of regulation already in place, and may do so in a way which alters the compliance requirements for existing regulation. Analysis of the impact of regulatory change must consider the whole, but it is not always apparent that regulators consider the overall regulatory impact in this way.

Following are some key examples of regulatory change developed in response to the global financial crisis, in each case described in the context of the broad and multi-layered regulatory framework.

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<sup>1</sup> Paul Coghlan, *The principles of good regulation, proceedings* of the Achieving Better Regulation in Services conference, Productivity Commission and ANU, June 2000.

## 2.3. Prudential regulation

### 2.3.1 Basel III

The BCBS<sup>2</sup> provides a forum for regular cooperation on banking supervisory matters. In response to the global financial crisis of 2008, BCBS and its oversight body, the Group of Governors and Heads of Supervision, developed a reform program to address the lessons of the crisis. These reforms delivered on the mandates for banking sector reforms established by the G20 at their 2009 Pittsburgh summit. Collectively, the new global standards to address both firm-specific and broader systemic risks are known as "Basel III".

Basel III is a comprehensive set of reform measures, developed by the BCBS to strengthen the regulation, supervision and risk management of the banking sector.<sup>3</sup> These measures aim to:

- Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source;
- Improve risk management and governance; and
- Strengthen banks' transparency and disclosures.

The reforms target:

- Bank-level, or micro-prudential regulation, which will help raise the resilience of individual banking institutions to periods of stress; and
- Macro-prudential, system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.

These two approaches to supervision are complementary - greater resilience at the individual bank level reduces the risk of system wide shocks.

The Australian Prudential Regulation Authority (APRA) is in the process of implementing Basel III in Australia, with draft capital standards under consultation. APRA will follow Basel III, but there are some important differences.

For example:

1. A more conservative approach to capital measurement:

*...we are not proposing to adopt the concessional treatments available to national supervisors that allow limited recognition of certain items in calculating Common Equity Tier 1...In short, we are proposing to maintain a more conservative approach to capital than the Basel III minimum requirements...<sup>4</sup>*

The ABA has argued for harmonisation and comparability of capital measurements.

2. An accelerated timetable for implementation (see Appendix 1):

*Firstly, ...The Basel Committee has stated explicitly, however, that...national authorities have the discretion to impose shorter transition periods and should do so where appropriate....*

<sup>2</sup> The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

<sup>3</sup> BCBS (<http://www.bis.org/bcbs/basel3.htm>)

<sup>4</sup> APRA Chairman Dr John Laker, "APRA's Basel III implementation", 23 November 2011, introductory remarks (<http://www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011.pdf>)



*Secondly, other supervisory agencies — in Singapore, Canada and New Zealand, for example — have also announced accelerated implementation timetables...*

*Thirdly, and most tellingly, the 1 January 2013 target is not a 'stretch' target for the ADI industry...ADIs in Australia have already passed it. The 1 January 2016 target will require larger capital levels on the part of a number of ADIs but the target is readily attainable, if current industry profitability is maintained.*

The ABA has argued that Australia should not put itself at a competitive disadvantage by implementing ahead of its major trading partners. The condensed timeframe has an impact on bank technology platforms, processes and staff resources.

### 3. Establishment of the Reserve Bank's Committed Liquidity Facility (CLF):

*The major circumstance, of course, that distinguishes Australia from most other jurisdictions is the shortage in our domestic markets of high-quality liquid assets that would enable ADIs to meet their LCR<sup>5</sup> requirement. The Basel III liquidity framework incorporates scope for alternative treatments and APRA and the Reserve Bank of Australia (RBA) have developed an arrangement — a secured committed liquidity facility — that is intended to cover an ADI's LCR shortfall.<sup>6</sup>*

This is a welcome solution to a structural issue in Australia. That is, the level of government debt in Australia (which is lower than in many other countries) is insufficient for banks and other ADIs to rely on this as an asset class to meet the Basel III LCR.

### 2.3.2 Dodd-Frank

The Dodd-Frank Act (Dodd-Frank) marks the largest legislative change to financial supervision in the United States since the 1930s. This legislation will affect every financial institution that operates in the U.S., many that operate from outside the country and will also have a significant effect on (non-financial) commercial companies. As a result, both financial institutions and commercial companies must deal with the historic shift in U.S. banking, securities, derivatives, executive compensation, consumer protection and corporate governance that will grow out of the general framework established by Dodd-Frank. While the full weight of Dodd-Frank falls more heavily on large, complex financial institutions, smaller institutions will also face a more complicated and expensive regulatory framework.

A summary of Dodd-Frank from the U.S. Senate Banking Committee can be found at: [http://banking.senate.gov/public/files/070110\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_comprehensive\\_summary\\_Final.pdf](http://banking.senate.gov/public/files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf). Despite its breadth, Dodd-Frank is focused on just three key outcomes: limiting risk in the financial system, increasing consumer protections and regulating the unregulated:

*The Dodd-Frank Act potentially subjects foreign non-bank financial companies, including Australian companies, to prudential supervision in the US. This will occur if, amongst other things, the foreign company is considered by the US regulator to be systemically significant or interconnected to the US economy.*

*The US reforms also allow US regulators to invoke an involuntary, orderly liquidation process which potentially applies to Australian financial companies doing business in the US. This power is available where, amongst other things, the failure of the financial company would have serious adverse effects on US financial stability.*

<sup>5</sup> Liquidity coverage ratio

<sup>6</sup> Ibid



*Some investment advisors in Australia (and other foreign countries) will now be required to register with the SEC to carry on business as investment advisors (formerly they were exempt). This may ultimately affect Australian advisors for private equity and other investments, as they will now be subject to a registration requirement where formerly there was none.*

*The new US regulation of derivatives activities is drafted to apply to non-US entities. This means, for example, that non-financial Australian entities which engage in swaps-related activities in the US will potentially have to put up margin (which they currently don't have to do).*

*"Foreign banking organisations" carrying on business in the US (though branches or subsidiaries) will be subject to restrictions on proprietary trading and hedge and private equity fund sponsorship<sup>7</sup>. ("Volcker Rule" – see below)*

## 2.4. Extra-territoriality

As noted above, Australian banks must deal with regulation emanating from other countries (in addition to international rule-setting bodies), often without apparent regard by the regulators concerned for the scope of the extra-territorial impact of the new rules.

Key examples, all from the U.S., include the Patriot Act, Sarbanes-Oxley, the Foreign Account Tax Compliance Act (FATCA), and Dodd-Frank. Dodd-Frank is described briefly above. In this section, one part of Dodd-Frank, the Volcker Rule, is considered in more detail.

The extraterritorial reach and range of the "Volcker Rule" is now much greater than had been anticipated in the original legislation and earlier statements of the policy intent, and the time to achieve compliance remains very short. President Obama's original announcement was expressed in a very American context:

*Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. If financial firms want to trade for profit, that's something they're free to do. Indeed, doing so — responsibly — is a good thing for the markets and the economy. But these firms should not be allowed to run these hedge funds and private equities funds **while running a bank backed by the American people**.<sup>8</sup> (emphasis added)*

Most observers had expected that the prohibitions would apply to American banks worldwide, but in relation to foreign banks, would apply only to their activities in the US. The position in the proposed rule is fundamentally different. For example, the proposed rule sets out the criteria by which "covered" non-US bank activities would be considered "solely outside" the United States. These criteria, effectively capturing any connection whatsoever with the United States, extend the coverage of s619 to much of the global activity of a non-US banking entity.

More than 16,000 public submissions were lodged with the joint agencies on the proposed rule, many of which raise serious concerns over the extraterritorial aspects of Volcker:

*I am particularly concerned that the proposed rule could severely impact the liquidity of Canadian government debt markets and interfere with the risk management practices of banks in Canada. The draft rule could also have serious unintended consequences for Canadian bank-sponsored mutual funds, hampering their ability to provide services to their Canadian clients.<sup>9</sup> (Canadian Finance Minister James Flaherty)*

<sup>7</sup> <http://www.freehills.com/6878.aspx>

<sup>8</sup> President Obama, 21 January 2010

<sup>9</sup> Canadian Government submission

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*Two specific areas of concern that I would like to raise for further discussion...On the first, I am concerned that the regulations could have a significant adverse impact on sovereign debt markets, including here in the UK...On the second, there may be a risk that the proprietary trading restrictions continue to have implications for firms foreign to the US which use US exchanges or other market infrastructure to carry out their business.<sup>10</sup> (UK Chancellor George Osborne)*

There has been widespread mobilisation of opposition to the Volcker Rule, but there are also many who are not only supporting the Volcker proposals but in some cases are also appearing to suggest a possible strengthening of the Rule.

The ABA submission on the proposed rule focused on extraterritoriality and the exemptions available under the Volcker Rule, and contains recommendations on the extra-territorial application of the Rule, proprietary trading, government securities, covered funds and compliance. Another theme was that a number of matters need to be clarified to avoid Volcker Rule provisions applying in unintended ways, with potentially significant adverse impacts on the wealth management operations of ABA members.

## **2.5. Other international regulation**

There are many other examples of new international regulatory developments impacting on the Australian banking sector, including the U.S. Foreign Accounts Tax Compliance Act (FATCA), the objective of which is to recover lost U.S. tax revenue, but places customer identification and reporting obligations on Australian and other foreign financial institutions globally.

## **2.6. Impact of international regulation**

The impact of international regulation on Australian banks can be very significant, and there is often little recognition of costs or benefits by international regulators. The direct cost of implementing anti-money laundering legislation in Australia, in order to meet international standards, has been hundreds of millions of dollars. This cost will continue to be built into the prices that banks are able to offer households and businesses.

In many instances the case for regulation is not clear cut. In this section the case for Basel III is examined briefly. ABA members are broadly supportive of Basel III, but there are significant issues to be considered in the impact analysis.

For example, there is a widely held view that increased capital and liquidity will increase stability and resilience, but Australia already has a strong and stable financial sector, as demonstrated by our performance during the global financial crisis. Seeking yet more capital beyond the Basel requirements might lead to a marginal increase in stability but at an ever increasing cost.

In addition, financial crises often originate outside the financial system itself. In such circumstances, banks and other financial institutions can become a casualty of an economic downturn or a sudden change in investors' confidence. Imposing regulation to increase the resilience of the financial system may not affect the likelihood of these crises occurring and the overall cost of the crises might not be reduced by any significant extent.

Asking Australian banks to hold more capital than their international peers may put them at a competitive disadvantage. This could put pressure on the prices that banks are able to offer households and business.

Additionally, these costs may come at a time of heightened uncertainty in international money markets. It has been argued that the costs of accessing wholesale funding for Australian banks will reduce as they

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<sup>10</sup> [British Government submission](#)

hold more capital and become less risky. The current reality is banks are being asked to raise additional capital in an environment where capital is becoming increasingly difficult and more expensive to obtain.

The approach proposed for Australia means the capital ratios of Australian banks appear lower than that of their peers, and that Australian banks will *appear* less capitalised than their peers. While in theory perfect information and adequate capacity allows for (overseas) investors to fully analyse the differences between APRA's approach and that undertaken by overseas jurisdictions, what happens in the real world can be quite different.

## 2.7. National regulation

At a national level, the banking and finance sector is one of the most heavily regulated sectors of the Australian economy, as it is affected by the activities of ASIC, ACCC, APRA, the ATO Australian Transaction Reports and Analysis Centre ('AUSTRAC'), the Federal Privacy Commissioner, the Reserve Bank, and others.

The structure of sector-specific regulation in Australia is based on the so-called 'twin peaks' model, with APRA responsible for prudential regulation and ASIC focusing on customer and investor protection and market integrity. As noted by the Taskforce on Reducing Regulatory Burdens on Business in 2006:

*A fundamental challenge arising from the twin peaks model is the need for the two regulators, notwithstanding their different roles, to maintain a high level of cooperation and coordination on regulatory development and administration. This is necessary to ensure that regulatory approaches do not conflict or overlap and that compliance costs are not imposed where differing regulation of a similar issue is required. It is also important that APRA and ASIC cooperate to ensure their supervisory activities are coordinated.<sup>11</sup>*

## 2.8. Significant national regulation affecting retail banking over the past three years

The Australian banking industry has been the subject of substantial regulatory change over the last three years.

Some of the regulatory initiatives have resulted from reform programs through the Council of Australian Governments (COAG). With respect to consumer credit regulation the COAG reforms were divided into two phases. For other reforms, these were initiatives introduced by the Government with the stated aim of facilitating efficiency and enhancing competition in the banking and broader financial services sector. Examples of regulatory reforms include:

- Transfer of responsibility for the regulation of consumer credit from the States and Territories to the Commonwealth with additional regulation for the introduction of a national credit licensing regime and responsible lending requirements for credit assistance providers and credit providers which commenced in part on 1 July 2010 with the remainder on 1 January 2011, all of which is administered by ASIC;
- Credit card lending practices due to commence on 1 July 2012;
- The provision to consumers of home loan key facts on request;
- Margin lending under the Corporations Act 2001;
- Prohibition of consumer mortgage exit fees other than for fixed rate mortgages;
- A national Consumer Law including a prohibition of unfair contract terms in consumer contracts;
- The creation of a single national register for the registration of security interests over personal (non-real estate) property together with a complete replacement of Australia's personal property security (PPS) law with a new model based on North American laws; and

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<sup>11</sup> [Rethinking Regulation, 2006](#)

- Price signalling offences for the wholesale and retail banking sector creating a per se offence for private pricing disclosures by authorised deposit taking institutions and further offence for pricing or business strategies disclosures that have the purpose of substantially lessening competition, due to commence on 6 June 2012.

Further national regulation affecting retail banking proposed by the Government includes:

- Enhancements to the national credit legislation expected to achieve Parliamentary passage in the Winter sittings;
- Introduction of reforms to the Privacy Act with the introduction of a single set of Australian Privacy Principles covering Commonwealth agencies and the private sector and the long awaited amendments to the credit reporting provisions of the Privacy Act that will permit credit providers to access and use more comprehensive information about the credit worthiness of consumers in order to reduce credit risk, due to be introduced into the Parliament in the Winter sittings;
- A national electronic conveyancing system to facilitate transfers of real estate, the discharge and creation of mortgages and other real estate transactions where registration of these transactions is necessary to ensure certainty of title;
- The Future of Financial Advice (FOFA) reforms, which are intended to improve the quality of financial advice, the regulation of financial planners, and the professionalism of the financial planning industry, and will have significant impact on product distribution. The reforms include the introduction of a client "best interests" requirement for advisers and restrictions on commission based financial advice.

The Government's banking competition reform package included both regulatory and self regulatory initiatives not mentioned above including:

- Bank deposit and mortgage account switching measures
- Monitoring and enhancing competition in the costs and access to ATMs
- Covered bonds
- Support for the RMBS market
- A permanent financial claims scheme

Suffice it to say that these regulatory reforms, some of which are intended to facilitate greater efficiencies and competition in lending (for example, PPS reforms, more comprehensive credit reporting and a national e-conveyancing system) and which will be of benefit to the credit industry and consumers, have entailed or will entail major implementation projects by banks and other industry participants extending to many millions of dollars.

Some of these regulatory reforms have not been properly investigated for their intended effects prior to their introduction. For other reforms it remains to be seen if they will address perceived market failures.

Any failure to properly understand the full impacts of proposed regulatory intervention first are a major concern to the ABA. The ABA accepts that it is ultimately for the Parliament, supported by its parliamentary committees, to draw their own conclusions about the efficacy and utility of particular regulatory reforms.

There is one critical aspect of the recent and extensive regulatory reform process that appears to the ABA to have been overlooked too often. This is in the setting of commencement dates for relevant legislation with insufficient regard to the time industry needs to implement the reforms in a timely and orderly way, including doing due diligence. Appropriate time is needed to achieve these results successfully, not simply from a compliance perspective but for the benefit of consumers. Where inadequate time is available for orderly implementation it is often necessary for banks to implement expensive one-off "workarounds" that are later brought into the integrated bank compliance framework.

## 2.9. Regulation impact assessment

The ABA is currently considering the approach to regulatory impact assessments, which the ABA believes should include factors such as:

- Analysis of the legislation once all primary and subordinate legislation has been finalised to understand the business impacts and risks.
- Which regulators oversee the requirements and what reporting and complaints handling processes are required?
- Timing of essential IT changes (should accord with future timed IT release packages for normal business applications changes).
- Implementation costs and timelines in relation to existing IT projects.
- Requisite compliance requirements – including how they will perform online and in person, with controls to ensure ongoing compliance.
- Testing of new procedures to ensure accuracy and performance.
- Sequencing the implementation processes so that each change that is dependent on a preceding change having been completed successfully is made after that change.
- Ensuring appropriate amendments are made to internal banking policies to ensure consistency with the regulatory requirements.
- Education and training requirements.
- Impact on bank capital or funding.
- Drafting of documents for compliance including internal procedural guidance documents.
- Need for changes to documents and systems for customer purposes (such as marketing material, PDS, application forms).
- Business process sequencing (to accord with the regulatory requirements).
- Business, risk and legal sign-offs required.
- Timing of internal communications to relevant stakeholders including compliance training (as close to the commencement date as feasible).

## 2.10. Impact on industry and customers

A particular example of a high impact regulatory change was the 2011 prohibition on mortgage exit fees.

On 1 July 2011, a Government legislative ban on consumer credit providers charging mortgage exit fees on variable interest rate mortgage loans came into force. The Mortgage Finance Association of Australia (MFAA) submitted to a subsequent Senate Economics Committee inquiry that in the period before the Government ban commenced banks removed certain exit fees which resulted in a situation described in The Age newspaper on 15 August 2011 in this way:

*“Small home lenders cannot compete with the big players, as the exit fee ban has hurt their business model, the association (MFAA) says.”*

Some small and non-bank lenders increased up front establishment fees applicable to all borrowers, as a result of not being able to charge deferred establishment fees (exit fees) to a smaller percentage of borrowers who terminated their contract early, a risk that was emphasized by industry to the Government during consultation.

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The result was stated by the MFAA and reported as:

*"While some switching of lenders may be occurring it seems to be really a recirculation of borrowers amongst the banks, with building societies, credit unions and non-bank lenders not getting a look in."*

## 2.11. Self-regulation

It should also be noted that there is also a significant degree of self-regulation in the banking industry. Key examples include the ABA's Code of Banking Practice<sup>12</sup> and the EFT Code of Conduct, which is administered by ASIC, but developed with industry. Both codes have a strong consumer protection emphasis.

## 3. Competition

*(TOR (b) the impact on relative shares of specific banking markets)*

Competition has been the cornerstone of Australia's regulatory philosophy regarding financial services since the late 1970s Campbell Inquiry. The inquiry found that the heavily regulated financial system was underperforming, leading to inequitable outcomes such as credit rationing and unnecessarily high interest rates for some customers, particularly low income customers. The inquiry ushered in a period of deregulation where all bank product price and credit controls were removed. Additionally, foreign banks were invited to compete in Australia in 1985.

This regulatory direction was reconfirmed with the 1997 Wallis Inquiry. Wallis made significant recommendations regarding the regulatory structure, advocating the regulation of financial products on a functional rather than institutional basis, but was strong in its advocacy that regulation should only address clear market failures and even where a market failure occurred, regulation should only proceed if the benefits outweighed the costs.

While the initial stage of deregulation in the 1980s probably contributed to some poor lending practices in commercial real estate in the late 1980s, the deregulatory approach in Australia has worked well. Australia has a highly banked population, access to credit is reasonably easy, and Australian banks have an international reputation for stability and protecting depositors' funds.

Australian banks performed well throughout three financial and economic crises: the 1997 Asian financial crisis, the 2000 'tech' wreck, and the global financial crisis. Through these periods, Australian banks managed to undertake their roles of taking deposits, making loans and facilitating payments with little disruption to consumers, although at times the price of these products and services has fluctuated in response to global developments.

Another positive reference for the deregulatory approach is found in the evidence that has emerged since the global financial crisis. Even though the crisis has reduced the number of participants in lending markets, the data shows there are still high levels of competition in these markets. It appears the consumers are not being materially disadvantaged by fewer mortgage lenders. Indeed, there is evidence that competition is as strong today as it has ever been, particularly on the liability side of the balance sheet (deposit interest rates), for example, the ABA's submission to the previous Senate banking competition inquiry detailed structural changes in key banking markets, this submission recaps those findings. The following ABA analysis considers changes in market shares since the financial crisis in three key markets: housing finance; business lending; and deposits.

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<sup>12</sup> <http://www.bankers.asn.au/Industry-Standards/ABAs-Code-of-Banking-Practice>



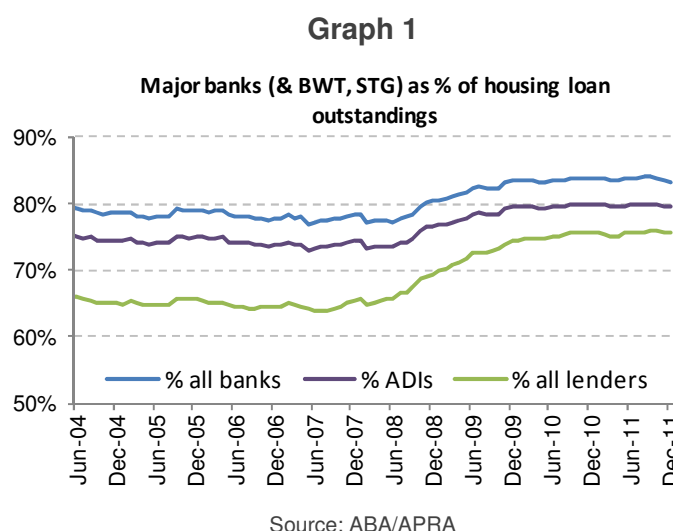
## 3.1. Market share

### 3.1.1 Housing finance

In the period 2000-2007, the major banks gradually lost market share to the non-major banks and other competitors like mortgage originators. This can be seen from Graph 1 which shows a decline in the stock of housing loans provided by the major banks between 2004 and 2007.

Note that this data is smoothed to remove the effect of the acquisitions of St. George by Westpac and Bankwest by the Commonwealth Bank.

As has been well documented, the global financial crisis was triggered by a spike in mortgage loan defaults amongst US subprime mortgage borrowers. Because US finance in this market is primarily a securitised market, investors throughout the world lost confidence in mortgage backed securities and this impacted on demand for Australian residential mortgage backed securities (RMBS) even though these securities continue to remain sound in terms of losses.



As a result, those institutions reliant on buoyant investor demand for their RMBS found conditions much more difficult. The mortgage securitisation model whereby no funding was secured from deposits came under severe strain. Many mortgage securitisers were bought out by banks or closed down. The fact that this happened in a relatively orderly manner was a significant benefit to consumers. Banks managed to take up the slack, and the market share of the major banks has increased to 84%.

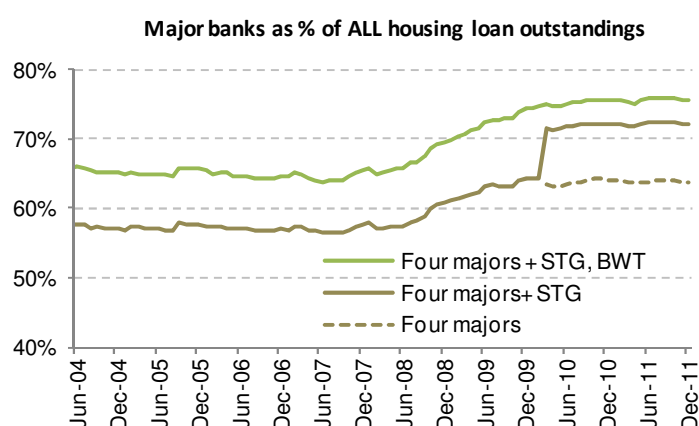
In addition, two regional banks, Bankwest and St. George were acquired by major banks. This had the effect of giving the major banks, as a category, a material lift in their market shares. This is evident from Graph 2.

A notable feature of this increased concentration is that it has not resulted in evidence of more opportunistic pricing behaviour. Margins on housing lending are similar to that of pre-crisis levels, suggesting that the market is considerably more competitive than is often assumed.

This should not be surprising. There are over 100 providers of housing loans and the market is characterised (by the ACCC) as a 'national' market, meaning the products of these lenders are readily available to all Australian consumers.



**Graph 2**



Source: ABA/APRA

### 3.1.2 Business lending

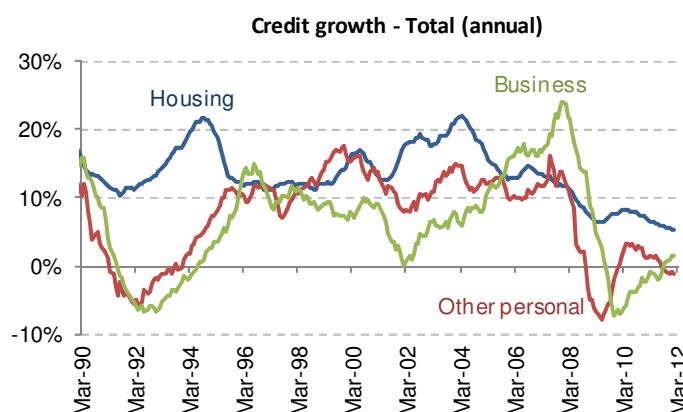
The business lending market has also consolidated in recent years as many foreign banks and specialist financiers have exited the business finance market.

The number of small business banking services has always been smaller than other markets, reflecting the more comprehensive banking needs of small and medium size business market. Businesses typically need a wider range of services, including facilities to manage payments with customers and other businesses, invoice reconciliation, and cash flow management. Many businesses also need convenient cash deposit facilities which puts a premium on branch presence.

As a result of these factors, the small business banking market is dominated by the major four banks. During the crisis, as many specialist financiers wound down, the major banks were instrumental in picking up much of the slack, although not all of it. Much of small and medium enterprise financing outside the major banks is of a riskier variety than that typically undertaken by the major banks. Additionally, business finance is riskier than housing lending, and business interest rates increase more than interest rates in the housing loan market (which would be expected in an environment where risk is being repriced).

In practice, those businesses wanting refinance with a major bank were required to post higher levels of collateral, such as personal houses, pay higher interest rates, and agree to more stringent conditions on repayment and leverage. This tightening from the supply-side, in addition to uncertain business conditions encouraging business to deleverage, caused a severe decline in business credit growth as can be seen in Graph 3. Indeed, business growth has only just recovered into positive territory after three years of negative growth.

Graph 3



Source: RBA

### 3.1.3 Deposit market

One compelling fact which has emerged since the financial crisis is the extent to which Australia is an importer of foreign capital in order to fund its investment and spending needs, and the extent to which this puts pressure on the banking system to facilitate this investment. In earlier decades, it was the Commonwealth Government which acted in this capacity.

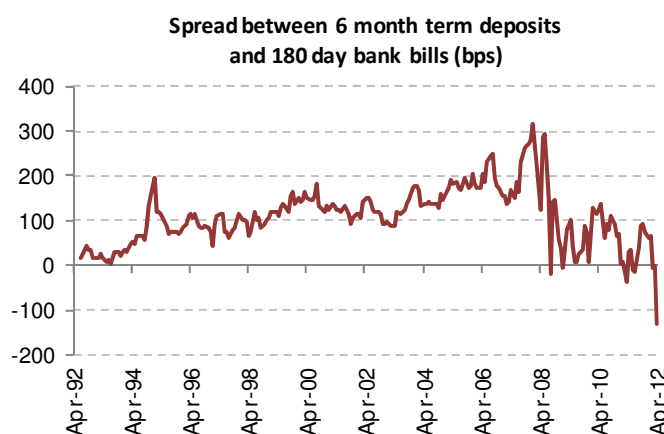
As revealed around the world, a high level of reliance on foreign funding exposes a country to greater shocks. Investors that extend money do so because they are confident in getting it repaid, and in situations of uncertainty, there is a bias to investment in their home countries.

In order to reduce this risk, the Australian banks have competed ferociously for household and business domestic deposits in order to fund growth in credit. This has been a bonanza for savers who are enjoying very good deposit deals. Further, foreshadowed regulatory changes for liquidity are giving banks incentives to further focus deposit competition onto term deposits.

The banks collectively have managed to increase the proportion of deposits available in Australia (partly due to a higher household savings ratio). The major banks have not materially increased market share.

Pricing is particularly attractive, as can be seen in Graph 4, by the margin between six month term deposit rates and the rate at which banks can access wholesale cash of the same maturity. On average, over the three years pre-financial crisis, banks could secure six months term deposits at 175 basis points below that of six month bank bills.

Graph 4



Source: RBA

### 3.2. Effect of price controls

In most markets, the most favourable pricing and supply outcomes is obtained by allowing interplay of demand and supply for the product or services. The outcome of these forces and the central focus for negotiation is price. In Australia, political and media pressure is frequently placed on large businesses to reduce their prices for goods and services, particularly in relation to petrol prices, bank interest rates and fees, supermarket prices, airline tickets, utilities, etc.

Standard economics finds that by restricting price in a market, the market will not clear effectively. Supply will fall and unmet demand will increase. Accountability for this outcome will be attributed to the actual suppliers, not the politicians that indirectly caused the shortage. The 1970s Campbell Inquiry found that for low-income households it was particularly difficult to obtain housing finance as a result of government controls on credit and price. However, there is little evidence that government was seen as responsible for this situation by the wider community.

### 3.3. Market opportunities

One of the major concerns stemming from the financial crisis is the impact that regulation is having on the supply-side of many banking markets. Regulations by definition have the effect of modifying behaviour, for example ensuring certain conduct is not undertaken. This makes businesses vulnerable to being impacted by regulation. If a business specialises in a type of conduct that is prohibited, then it will struggle to survive.

In housing lending, Commonwealth credit regulation has effectively closed down the high-risk housing lending market. While ABA member banks had little exposure to this market, there is a genuine market demand for this product which no longer has a substantial number of suppliers. There may well be benefits associated with closing down the higher-risk housing finance market, but there are also costs to those that will now be unable to access finance to purchase a home.

Deposit markets have become highly competitive, making market entry and opportunities extremely difficult. The margins on deposits have squeezed and this comes on top of a decade long decline in the amount of fees and charges collected from bank deposit bases. Indeed, in absolute terms, banks collect less revenue in fees and charges today than they did in 2001. As a proportion of bank assets, the decline in fee revenue is dramatic.

This makes opportunities in this market very difficult. Economic theory says that new entry into a market occurs when existing players are making above normal returns in that market. As deposit taking is now so competitive with very low pricing, it is difficult to see real opportunities for existing players or new entrants.

In contrast, business lending is probably the banking market where greatest opportunity resides. This is specialised lending, benefiting businesses that can spend resources in understanding the risks and opportunities of businesses.

### 3.4. Customers

Despite serious dislocation in banking markets in the Northern Hemisphere, Australian consumers have not experienced any material change in the product offerings of Australian banks. Most of the market turmoil has played out in the media and behind the scenes, but the actual product offerings of banks have remained markedly stable. This outcome is what is meant by the term 'financial stability' – a situation whereby a great economic or other shock to the system does not disrupt the deposit taking, credit provision and payment system functions of the financial system. For the real economy, the aim is that financial service provision will remain business as usual.

Table 1 below looks at three key banking products and indicative pricing of these products for three time periods: (a) average over the last decade, (b) the maximum price observed since the crisis, and (c) the current price. It does indicate, from a simple pricing perspective at least<sup>13</sup>, that banking markets operated normally through the crisis.

For example, as can be seen, the current interest rate on a standard variable mortgage is approximately 7.4%, roughly the average over the last decade. The maximum rate seen since the financial crisis was 8.4%.

Table 1: Prices of key banking products through the GFC

Product	Standard rate April 2012	Average rate past decade	Maximum Since Sep 2008
Lending - Owner occupied standard variable housing loan	7.4%	7.3%	8.4%
Lending – Small business 3-year fixed loan	7.6%	8.0%	8.8%
Deposit – Bonus saver accounts	5.2%	3.8%	5.5%

Source: RBA Statistical Tables

In terms of deposits, the effect can be seen in the prices generated for the Bonus Saver Accounts offered by banks. Currently the rate is about 5.2%, 130 basis points above its ten year average, reflecting intense competition in this market. The maximum rate achieved since commencement of the crisis was 5.5%. Once again, the pricing in this market was favourable and not disruptive to consumers.

Business lending is probably the area of greatest difficulty through the financial crisis, owing to the riskier and more complex nature of this type of credit. As the fallout from the Lehman Collapse in September 2008 took hold, banks moved quickly to re-price business lending risk. The margins on business lending today are material higher than they were pre-crisis. This reflects continued uncertainty and also a market perspective that margins had fallen too low in the pre-crisis era to adequately price for risk.

<sup>13</sup> Note that the table does not present margin analysis.

In terms of hard numbers, Table 1 shows that the small business 3-year fixed loan rate hit a maximum of only 8.8% post 2008, only 80 basis points higher than its decade long average. Of course, this price data says little about access to finance issues which is another key indicator of financial stability. Anecdotally may be fair to conclude that at times through the crisis the banks did toughen their credit standards, particularly in the areas of high-risk mortgage lending and business lending.

Commercial property lending continues to be a point of tension. See section 5.3.3 below.

## 4. Funding

(TOR (c) the current cost of funds for lending purposes)

### 4.1. Funding markets

The process of financial intermediation, as practiced by banks, involves pooling savings and lending it to those that have insufficient funds to finance their investment plans, such as buying a house or factory. There are two key prices in this process: (a) the price (interest rate) savers charge to banks for use of their funds, and (b) the price (interest rate) charged by banks to household and business investors.

Because Australian banks are publicly owned institutions with equity that trades daily on the ASX and other platforms, a key corporate objective is to achieve Return on Equity (ROE) benchmarks sufficient to meet the return expectations of their own shareholders. In practice, this means the banks need to ensure they maintain a sufficient margin between (a) what average interest rate they pay to savers, (b) what they charge to borrowers. If this margin slips then, all else being equal, they will observe a decline in profitability.

While simple to understand at a high level, the task of definitively determining the cost of bank funding is complex. For example, it may be that the interest rates banks need to pay international investors for money increases by 1% in a particular month, but this will not impact a bank's margins unless the bank actually purchases money at this higher price. A higher price in the market does not automatically imply that the bank's average cost has increased, rather, that the marginal cost of obtaining new international funding has increased.

This is part of the reason why banks will often wait months before passing on higher funding costs implied in higher market prices. When the financial crisis began in mid-2007, the cost to banks of securing international financing spiked markedly. Yet, banks did not instantaneously respond to this higher marginal cost of funds. Instead, they waited approximately six months, assessing whether the higher costs were likely to be permanent or temporary, before adjusting housing lending and other rates 'out of cycle'.

Similarly, higher financing costs were observed in mid-to-late 2011 as concerns over Europe's stability were playing out. Banks did not respond to these higher marginal costs until early 2012.

A second complexity involves the extent to which higher funding costs impact particularly business models. There are various ways to categorise bank funding (known more technically as 'liabilities'), but the commonly cited carve up is as follows:

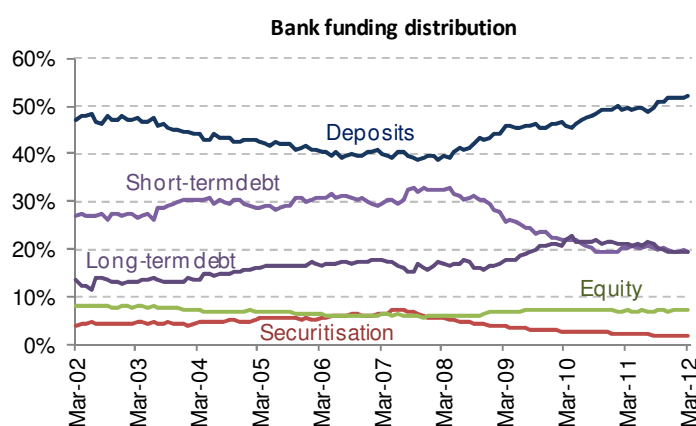
1. Bank retail deposits, both for households and businesses;
2. Wholesale short-term funds, both domestic and international;
3. Wholesale long-term funds, both domestic and international;
4. Equity; and
5. Securitisation.

If a bank is primarily reliant on equity and retail deposits to finance its lending, then any increase in the marginal cost of 'wholesale' funds will have little direct impact on their overall cost of funding. This complicates the task of generalising about the impact of funding costs.

Having said this, in the five years since the start of the financial crisis, some clear trends have emerged in relation to the sources of funding across the entire banking system. These can be observed in Graph 5 below. Domestic deposits now account for over 50% of bank funding, up from 40% in 2007, whereas short-term funding has fallen by a similar magnitude. Long-term funding has edged up by about 5% of bank funding whereas securitisation has fallen by about 4%. Securitisation accounts for only about 2% of overall bank funding.

These trends provide some insight as to why banks have faced such a difficult funding environment. The sources of funds which have increased in proportional usage, deposits and long-term wholesale, are the two sources of funds which are now structurally more expensive than they were pre-crisis. Short-term funding and equity is almost back to pre-crisis prices.

**Graph 5**



Source: RBA

## 4.2. Latest funding pricing

In a speech to the Australian DCM Summit 2012, covering funding costs, Assistant Governor Debelle advised that:

*"Compared to mid 2007, the average cost of the major banks' funding is estimated to be about 120–130 basis points higher relative to the cash rate...Most of the increase occurred during 2008 and early 2009 when the financial crisis was at its most intense. Since the middle of 2011, however, there has been a further increase in banks' funding costs relative to the cash rate of the order of 20–25 basis points...a fairly large part of this increase comes from the pricing of deposits."*<sup>14</sup>

<sup>14</sup> <http://www.rba.gov.au/speeches/2012/sp-ag-220312.html>

In the RBA Board's May meeting Minutes, the funding situation is described as:

*"Recent evidence suggested that the Australian economy was growing somewhat below trend. While the mining boom continued to gain momentum, overall growth was being weighed down by weakness in other sectors of the economy.*

*At the same time, credit growth for households had been marginally lower over the past year than over the previous year, and business credit was rising at only a very modest rate. Elevated competitive pressures had kept deposit rates in Australia high relative to the cash rate. At the margin, wholesale funding costs had declined over recent months, though they remained higher, relative to benchmark rates, than in mid 2011, and the lagged effects of this were still working their way through the funding structure. The rise in funding costs had led banks to increase their lending rates over recent months by around 10–12 basis points."*<sup>15</sup>

## 5. Bank lending

*(TOR (d) the impact on borrowing and lending practices in the banking sector both during and since the global financial crisis)*

### 5.1. Market analysis

As the terms of reference for this inquiry indicate, it is important to consider both supply and demand in the market for banking services, that is, both borrowing and lending activities and behaviour. In bank balance sheet terms, lending appears on the asset side, and borrowing on the liabilities side.

Appendix 1 includes a detailed analysis of bank assets and liabilities, credit growth and loan volumes over the period since the commencement of the global financial crisis.

Some key findings and observations follow.

### 5.2. Borrowing practices

See section 4 above (Funding) and Appendix 1, section 2 (Liabilities) for more detail.

Over the 10 years prior to the start of the global financial crisis (August 1997 – August 2007), the average annual growth rate for bank resident liabilities (in Australia) was 13%. During the 12 months after this, it reached as high as 32% (i.e. over the 12 months ending February 2008). Deposits grew at record levels in late 2007/early 2008.

More recently, over the 12 months ending March 2012, growth in bank resident liabilities was 8.4%, nearly 4 percentage points lower than the average pre-crisis rate.

In the five years since the start of the financial crisis, some clear trends have emerged in relation to the sources of bank funding (resident and non-resident):

- Domestic deposits now account for over 50% of bank funding, up from 40% in 2007, whereas short-term funding has fallen by a similar magnitude.
- Long-term funding has edged up by about 5% of bank funding whereas securitisation has fallen by about 4%. Securitisation accounts for only about 2% of overall bank funding.

<sup>15</sup> <http://www.rba.gov.au/monetary-policy/rba-board-minutes/2012/01052012.html>



### 5.3. Lending practices

See Appendix 1, section 1 for more detail. The level of bank resident (in Australia) assets changed very little from October 2008 to April 2010, over the period of the global financial crisis.

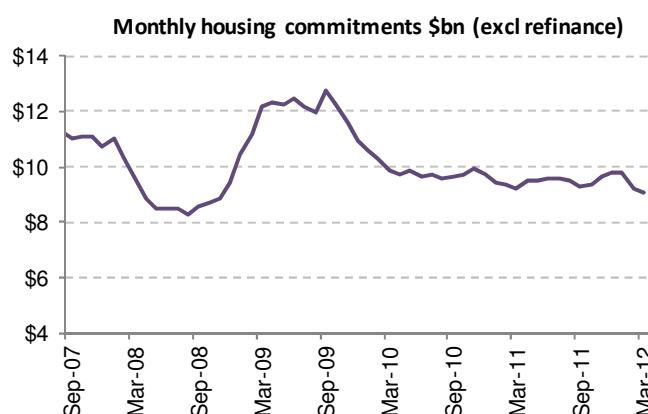
Housing loans continued to grow solidly during the global financial crisis, and this meant the total stock of bank resident assets grew from October 2008 to March 2012. The stock of commercial/business loans fell during the crisis, but is recovering.

Since the onset of the global financial crisis (August 2007) banks' share of gross loans and advances has increased from 87.3% to 91.7%. Much of this increase can be attributed to the direct and indirect effects of the crisis.

#### 5.3.1 Lending for housing

While bank housing lending continued strongly through the global financial crisis, there have been some changes on both the supply and demand side. Bank lending practices since the commencement of the financial crisis involve closer assessments of security and borrowers' lending capacity and lower loan to value ratios (LVRs). This has been a result of regulatory changes, for example in relation to non-conforming loans, and tightening of bank credit risk management in response to the financial crisis.

There has also been a slowing in demand. The following chart shows total monthly housing commitments (excluding refinancing of established dwellings) from the start of the financial crisis.

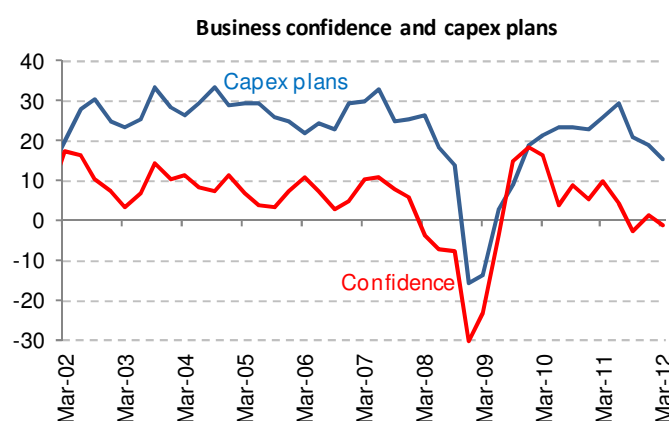


Source: ABS

The overall impact of market changes on customers for housing lending has however been limited. Banks have remained very much open for business, and any tightening of lending standards will in the end be to the benefit of the customer, by mitigating the risk of default.

#### 5.3.2 Business lending

Business lending did fall during the financial crisis, but is now recovering. The most significant factors were on the demand side. Businesses became more conservative. The following chart from NAB's Quarter Business Survey shows that business confidence and planned capital expenditure fell sharply during the crisis, and are currently in decline (outside mining).



Source: National Australia Bank

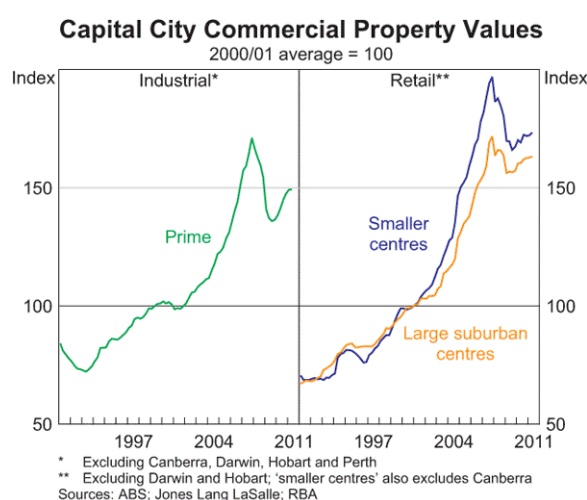
Some larger companies have chosen not to use bank intermediation and have sourced debt and equity funding directly from the markets.

There has also been some tightening of lending standards, with increased collateral requirements, changes in covenants and closer assessment of borrowers. This has had some impact on access to lending, and there have been price effects, discussed further in section 5.3.4 below.

### 5.3.3 Commercial property lending

Property lending is an important component of business lending, and is monitored carefully by the regulators because of the relative size of lending exposures (APRA) and the potential impact on financial stability (RBA).

There has been significant volatility in the commercial property market since the start of the financial crisis, and this sector has historically been volatile over previous downturns, due to a range of market variables, including vacancy rates, property values and rents. The following chart shows a rapid rise in commercial property values to 2007, followed by a sharp decrease over the next three years, and recovery since 2010, but not to 2007 levels.



The Reserve Bank notes that property-related lending “tends to be among the most cyclical components of lending, rising strongly during boom periods and then contracting sharply. It is also a component of lending on which defaults can rise quickly”.

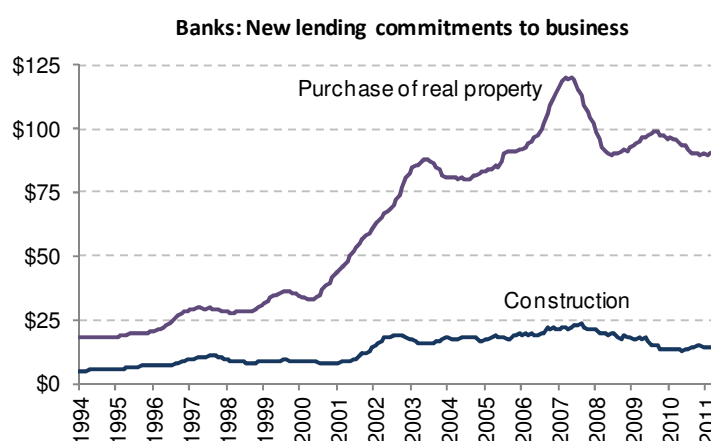
Reserve Bank Deputy Governor Battelino commented in October 2010 that:

*Since the peak in early 2009, commercial property lending has decreased by about 10 per cent. Foreign banks have led the contraction, reducing their exposures by a cumulative 35 per cent since the peak. Loan limits have fallen more than outstandings, so that usage of lending facilities has increased to about 90 per cent.*

*At the same time, funding through non-bank sources has also tightened. Commercial mortgage-backed securities, which at the peak in 2007 accounted for around 5 per cent of total commercial property funding, have contracted by about two-thirds since then. The contraction in mortgage trusts and some other funds, entities that were substantial investors in these securities, helped to drive the decline.*

*Adding to the cyclical in commercial property lending is the fact that these loans have tended to be among the most risky of bank loans.*<sup>16</sup>

Since the start of the financial crisis, ABA member banks have continued to lend to businesses for purchases of new property and construction, although construction has been muted. The following chart shows the volume of new lending commitments to business for purchases of new property and construction. The total level of new commitments for March 2012 was higher than for the same month in the previous 5 years.



Source: RBA

### 5.3.4 Pricing for risk – business loans

Banks must lend prudently and must price for risk. They must do this to comply with prudential regulation as well as meeting commercial objectives for their shareholders. Capital required by APRA to be held by banks for many business loans can be between three and seven times higher than for home loans.

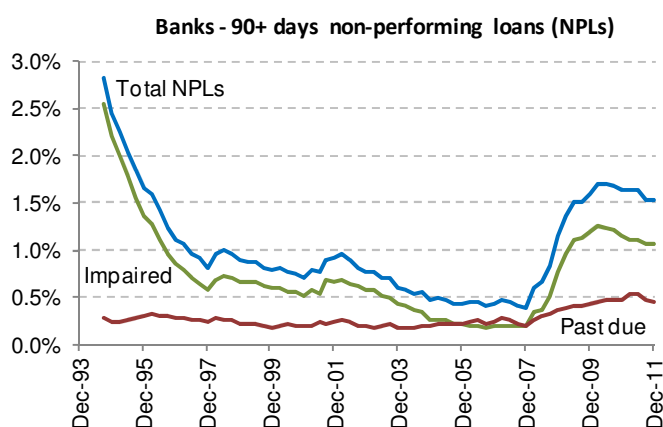
Loans are priced to cover the cost of funds as well as the risk taken on by the lender. The risk relates to how likely it is a customer will be unable to repay the loan (their probability of default) and what could potentially be recovered if that was to occur (the potential loss given default).

Income and expense profiles are very different for business and individual customers. For example, incomes for business owners can be quite variable in comparison with the fixed incomes of salaried customers.

<sup>16</sup> [RBA: Speech-Financial Developments](#)

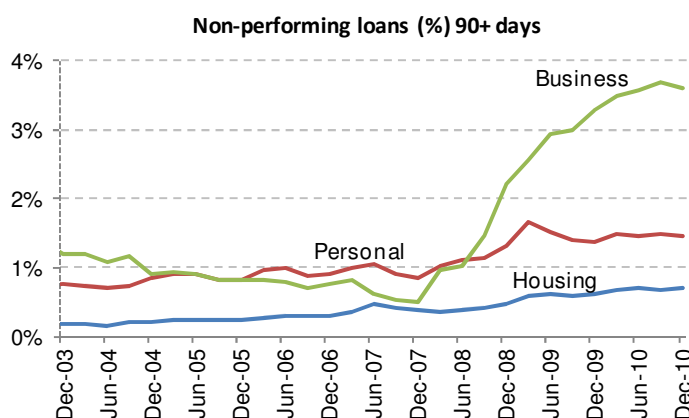
Typically the amount of deposits that businesses have is less than the amount of lending, and so banks must rely on wholesale funding to have the capital to lend to customers. The commercial lending portfolio sources the majority of its funding from the wholesale market and since the onset of the financial crisis, has been exposed to a greater level of increasing costs.

History has proven that many business enterprises have a higher probability of default compared with retail home loan customers. As at December 2011, the ratio of non-performing loans to total bank assets was 1.52%. This saw a significant increase over the past two years to mid 2010, reaching 1.69%, as a result of the global financial crisis, mainly a result of increased arrears in business lending. Since mid-2010, the rate of non-performing loans has improved.



Source: RBA

The chart below shows that while there have been rises in the ratio of 90+ days non-performing loans across each of the three loan portfolios, arrears rates for business lending has seen the most significant increase.



Source: RBA

Business customers also tend to have a higher loss once default has occurred. A factor driving this higher loss is the wider range of security options available to these customers, and the difficulty banks may have in realising the value of the security (on default).

## 5.4. Innovation in bank lending

There have been many positive developments in bank lending since the financial crisis. Product innovation has continued, in such areas as mobile lending. Additionally, industry has also made significant advancements in online servicing and origination, payments initiatives, more branches and ATMs, and weekend branch operations.

Positive credit reporting (for which the ABA has argued) would assist banks in enhancing their credit offerings and lending decisions, and would over time lead to improved access to finance for customers.

## 6. Sectoral issues

*(TOR (e) the need for further consideration of the state of the broader finance and banking sector)*

### 6.1. Further investigation needed?

There is a substantial history of banking inquiries in recent years. The 1996 Wallis Inquiry, completed in 1997, completed a very detailed analysis of the post-deregulation financial system in Australia. A summary of the Wallis recommendations and outcomes (to 2012) is attached as Appendix 2. There have been many parliamentary inquiries into aspects of banking since Wallis.

The extent to which another inquiry of the scale of Wallis might be required would depend very much on the circumstances of the day.

### 6.2. Cost of regulation

We note the 12 April 2012 communique of the Council of Australian Governments Business Advisory Forum:

*The Forum emphasised the importance of governments continuing to adopt a proactive approach to improve regulation in order to lower costs to the community and business – including adopting a risk-based approach to regulatory design, implementation, enforcement and review. COAG will discuss concrete measures to lift regulatory performance, including reducing complexity and duplication and increasing transparency and accountability.*

As a risk-based approach to new regulation is important, but can be undermined by a lack of consideration of the cumulative effect of regulation at the design stage, and in formal regulatory impact assessments (RIA). The amount of regulation already in place can greatly impact the overall net benefit to society from a new piece of regulation. Without consideration of the cumulative effect of regulation, the RIA of a proposed new piece of regulation may indicate a positive net impact on society while the result in practice (considering the amount of regulation already in place) may well be negative. This is most noticeably so when new regulation is put into place in response to unintended consequences of previous regulation; the unintended consequences would not have been taken into consideration in the original RIA and as such these effects, and those of the proposed regulation, must be taken into consideration in any subsequent RIA.

This amount of regulation already in place is especially important as the amount of regulation is approaching, or surpasses the point at which the net cost to industry exceeds the net benefits to consumers. At this point, any new regulation will have a negative effect on society since the cost to one part of society (industry) exceeds the benefits to the remainder of society. Removing regulation may also reduce the net benefit to society, since consumer benefits could be diminished and industry costs remain unchanged.

To overcome this lose-lose situation, regulators and legislators must consider the entire set of regulation in place with a view to dramatically removing or consolidating that regulation. One example where this may be required is where regulation has been continuously added in response to developments in technology. The regulation of payment systems could be viewed as falling into this category.

Given the volume of regulation currently in place in this area, there is potentially more value in conducting a total review of payments regulation (such as that concerning the use of different payment methods, including cheques, debit cards and credit cards) instead of implementing a new regulation (for example, for payments via smart phones). The new regulatory framework could be developed to encompass all existing payment technologies (while providing flexibility for future technologies) in one consistent, concise and user friendly manner.

Ideally, such a reduction in regulation would maximise the marginal return from regulation and allow 'room' for the implementation of future regulation before the next major review would be required (i.e. before the level of regulation again approaches the point at which industry costs exceed consumer benefits).

## 7. Other matters

*(TOR (f) any other relevant matters)*

As has been emphasised repeatedly throughout this submission, Australia's significant economic and financial vulnerability centres on our reliance upon international savings to finance our domestic investment and consumption needs. This reliance is reflected in the continued current account deficits run in Australia. In actual fact, Australia has operated a current account for many decades.

Yet, Australia cannot run a current account deficit forever, there is a limit. At some point we will have to start running current account surpluses. This is because current account deficits also represent an increase in foreign liabilities and foreign liabilities which ultimately have to be repaid.

It has been fashionable since the late 1980s to declare that current account deficits 'do not matter' but the evidence of the financial crisis has challenged that theory. Those advanced countries running deficits in the decade leading up to the financial crisis, now have unemployment rates 4% higher than pre-financial crisis. This compares to countries running surpluses, they collectively have unemployment rates on 0.5% higher.

These outcomes give an indication to how a current account deficit can expose a country to significant economic shocks. In ABA's view, the issue of our continued operation of deficits needs to be further examined.

Of course, the only sustainable means of eliminating a current account deficit is for a country's level of savings to exceed its levels of investment. Because we don't want less investment, the best means to eliminate a deficit is for higher domestic savings. This issue needs further debate.

## 8. Recommendation

This submission has described the impact of some of the regulatory changes emerging from the financial crisis, within Australia and internationally. There is at present a very significant regulatory implementation burden on the financial sector, with more changes to come, and the ABA recommends that at least in relation to Australian regulation, there be a suitable period of consolidation before any new regulation on the banking industry is contemplated. This would be to the benefit of customers as well as the institutions.

## Appendix 1 – Market Analysis

(re section 5.1 above)

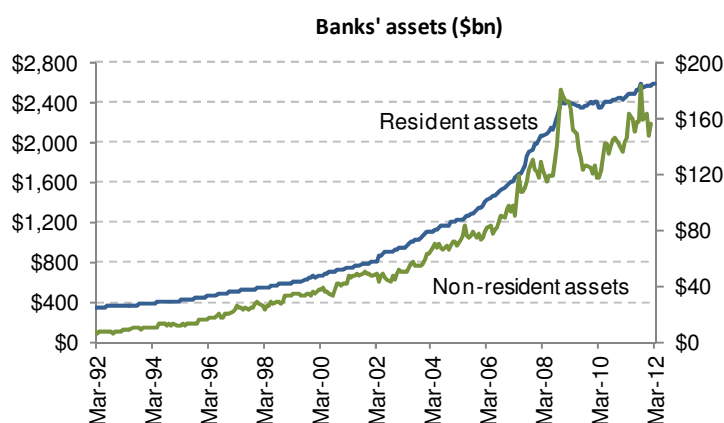
### 1. Assets

The following data are sourced from the Reserve Bank of Australia monthly statistics.

Unlike traditional “stock based” businesses, bank assets consist of financial assets which include cash and liquid assets, trading securities, investment securities, acceptances of customers and, by far the largest category, gross loans and advances.

#### 1.1 Bank assets - total

At the end of March 2012, total assets of Australian banks were valued at \$2.86 trillion, of which \$2.59 trillion were resident assets (i.e. assets on the books of banks with any individual, business or organisation domiciled in Australia), \$141.6 billion were non-resident assets (i.e. assets on the books of banks with any individual, business or organisation domiciled overseas) and \$122.2 billion was the amount due from overseas operations of banks.



Source: RBA

#### 1.2 Banks' asset growth and the global financial crisis

Over the 10 years prior to the start of the global financial crisis (August 1997 – August 2007), the average annual growth rate for banks' assets was 12%.

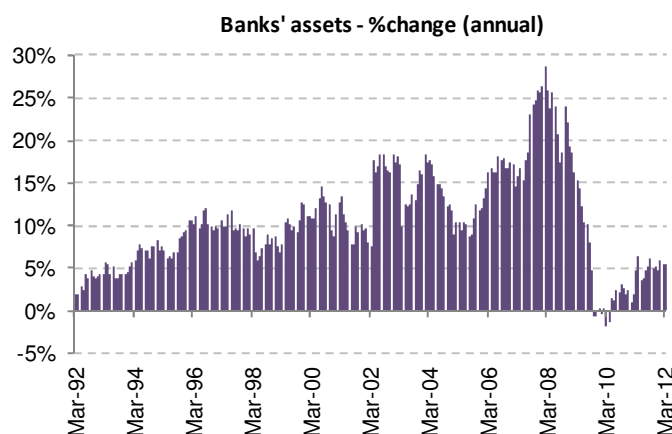
The disruption to capital markets after August 2007 saw a significant shift in customer demand for lending and other services from banks, with consequent growth in banks' assets. During the 12 months after August 2007, growth rates reached as high as 29% (over the 12 months to the end of February 2008).

Annual growth rates were below 20% briefly in August 2008 and September 2008, before rising to 27% in October 2008, a time when global financial markets were affected by the intervention to support US financial institutions Fannie Mae, Freddie Mac and AIG, and Lehman Brothers filing for bankruptcy.



From October 2008, growth rates fell sharply. Over the seven months to the end of April 2010, asset growth, on an annual basis, was negative. That is, the level of banks' assets was falling. In fact, over the year to the end of April 2010, bank assets fell by \$85 billion. Commercial/business loans accounted for 96% of this fall.

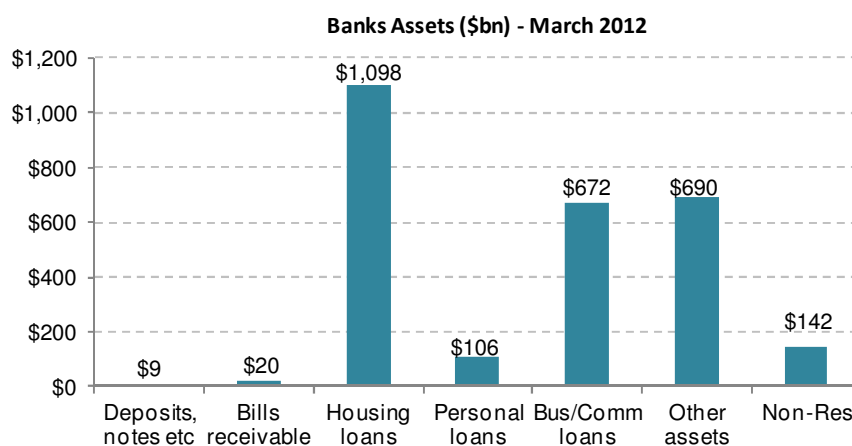
Bank assets grew by 6.2% or \$166.5 billion over the 12 months ending March 2012. The chart below shows annualised growth rates (measured monthly).



Source: RBA

### 1.3 Bank assets by type

A breakdown of bank assets by product type is provided in the chart below. Housing loans are, by far, the largest component of bank assets, at \$1.09 trillion (March 2012).



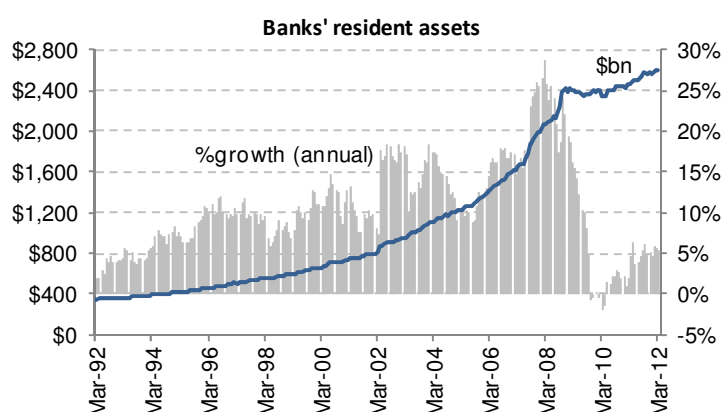
Source: RBA

## 1.4 Banks' resident assets

At the end of March 2012, total assets of Australian banks were valued at \$2.86 trillion, of which \$2.59 trillion (90%) were resident assets.

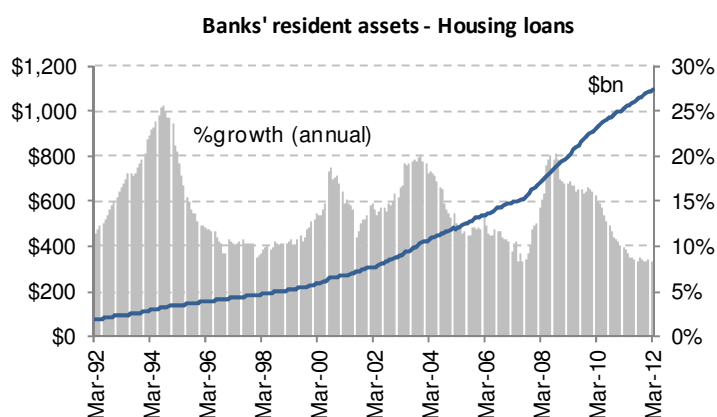
Bank lending accounts for 72% of banks' resident assets. As of March 2012, housing loans were the largest single category of bank loan assets at \$1.09 trillion or 42% of total banks' resident assets.

The level of bank resident assets changed very little from October 2008 to April 2010, over the period of the global financial crisis. Since April 2010 (to March 2012), however bank resident assets have grown by \$257 billion or 10.5%. The chart below shows the growth in the stock of assets (LHS) and annualised growth rates (measured monthly - RHS).



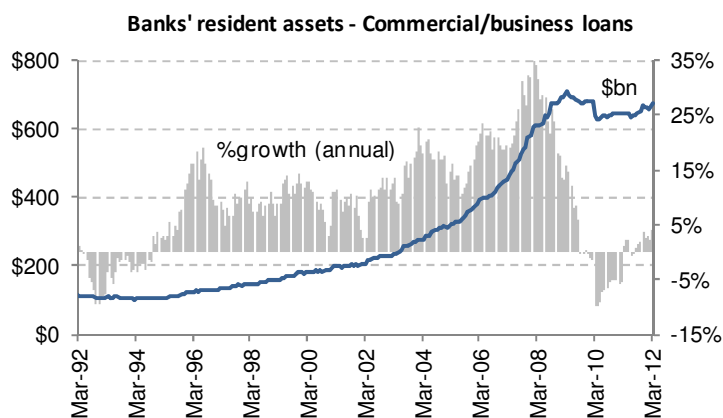
Source: RBA

The following charts show the levels and annual growth rate two of largest components of bank resident assets, that is, housing loans and commercial loans. Housing loans continued to grow solidly during the global financial crisis, and this meant the total stock of bank resident assets grew from October 2008 to March 2012.



Source: RBA

The stock of commercial/business loans fell during the global financial crisis, but is recovering.



Source: RBA

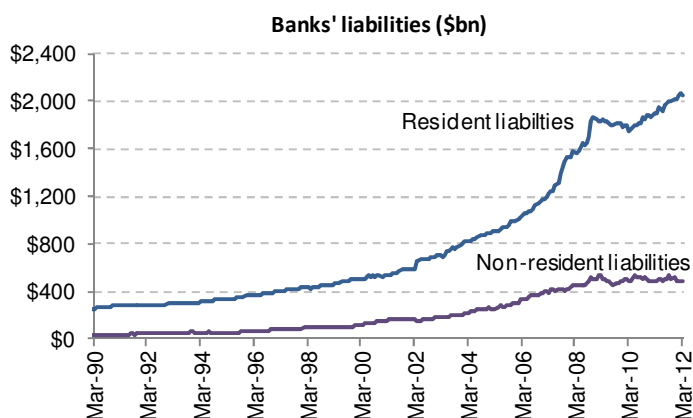
## 2. Liabilities

Bank liabilities consist of deposits, bill acceptances, other borrowings and other liabilities. Banks liabilities also include their short-term and long-term wholesale funding liabilities, both domestic and offshore (see section 4.1 Funding Markets for more detail on this aspect of bank liabilities).

### 2.1 Summary

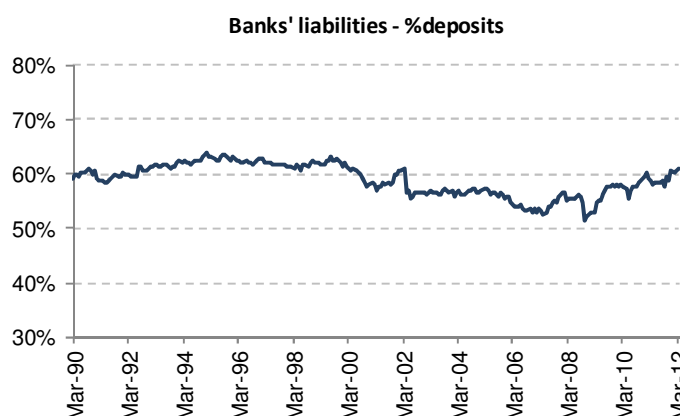
At the end of March 2012, total liabilities of Australian banks were valued at \$2.67 trillion, of which \$2.05 trillion or 77% were resident liabilities (i.e. liabilities on the books of banks with any individual, business or organisation domiciled in Australia), \$487 billion were non-resident liabilities (i.e. liabilities on the books of banks with any individual, business or organisation domiciled overseas) and \$129 billion was the amount due from overseas operations of banks.

The chart below shows the stock of resident and non-resident liabilities to March 2012.



Source: RBA

The largest component of bank liabilities is deposits (i.e. household deposits, business deposits and other deposits) making up 61% of banks liabilities as at March 2012. At the height of the global financial crisis, in late 2008, deposits as a proportion of bank liabilities were 52%. The chart below shows the change in contribution to liabilities made by deposits, to March 2012.

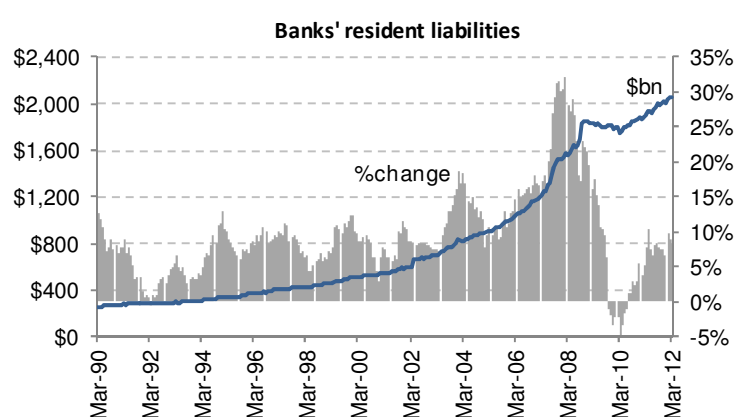


Source: RBA

## 2.2 Growth in liabilities and the global financial crisis

Over the 10 years prior to the start of the global financial crisis (August 1997 – August 2007), the average annual growth rate for bank resident liabilities was 13%. During the 12 months after this, it reached as high as 32% (i.e. over the 12 months ending February 2008). Deposits grew at record levels in late 2007/early 2008.

Over the 12 months ending March 2012, growth in bank resident liabilities was 8.4%, or \$160 billion. The chart below shows growth in the stock of bank resident liabilities and annualised growth rates, measured monthly.



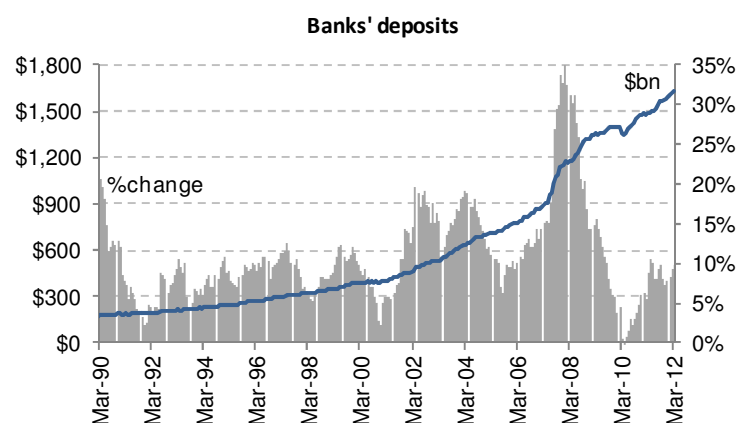
Source: RBA

## 2.3 Deposits

At the end of March 2012, total deposits of banks were \$1.63 trillion. This includes household deposits, business deposits and other deposits. Growth in deposits reached record levels, as high as 35%, over the 12 months to the end of January 2008. Over the 1990s, growth in deposits averaged 9% per annum.

The very high growth rate for deposits from August 2007 was a result of a combination of factors. Over this period:

- Households were shifting their asset mix away from equities and housing to bank deposits, particularly in response to large falls in the equities market.
- As the cost of bank funding increased, bank competition for deposit funding was strong. As such, interest rates on deposits were attractive (especially at a time when other assets such as equities and housing were not performing well).
- Large falls in housing interest rates over late 2008, as well as the fiscal stimulus, assisted in keeping the level of deposits high.
- Banks have been anticipating the changes in prudential requirements as a result of Basel III, including the need to expand their “stable funding” (as defined by BCBS) bases. This can be seen in the chart below.



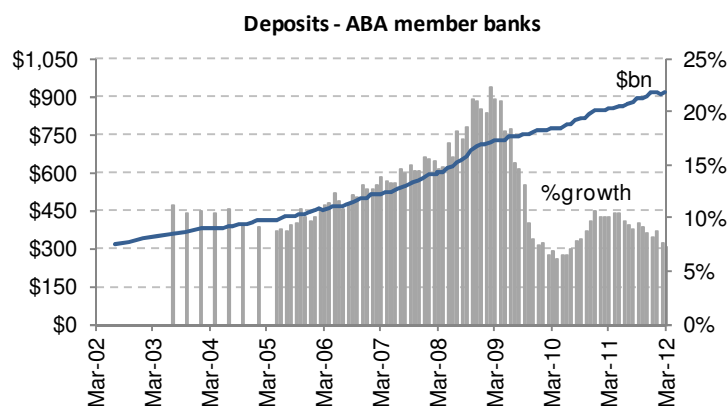
Source: RBA

## 2.4 Retail deposits

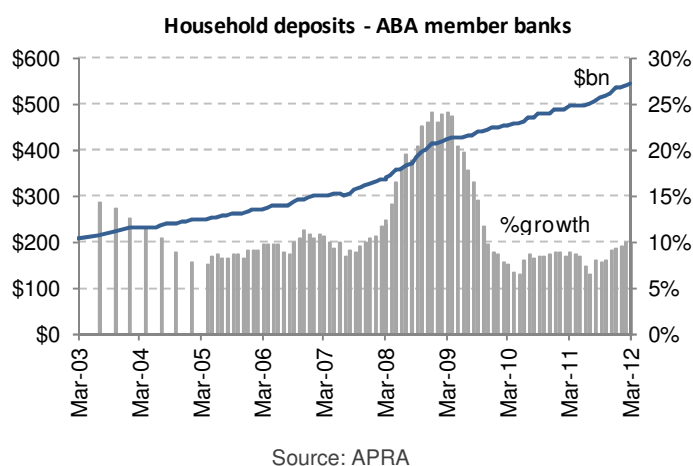
The definition of deposits used above is broad. More commonly, the concept used is ‘retail deposits’. These are deposits from households and businesses (non-financial corporations).

At the end of March 2012, a total of \$912 billion of deposits were held by ABA member banks from households and businesses. This is an increase of \$63 billion or 7.4% over the past year. Households made up \$543 billion (59%) of these deposits and businesses made up \$374 billion (41%).

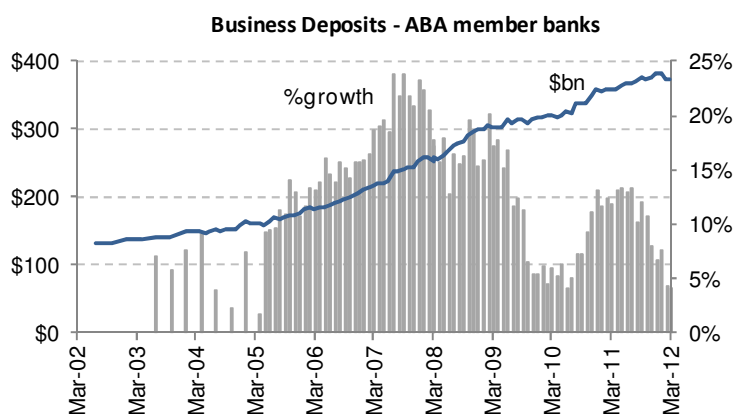
The chart below shows growth in the stock of bank resident liabilities and annualised growth rates, measured monthly.



The following chart shows that over the past year, to the end of March 2012, annual growth for deposits from households was 9.7%, an increase of \$48 billion over the year, and that for businesses, growth rates for deposits peaked in the August 2007, at 23.8%.



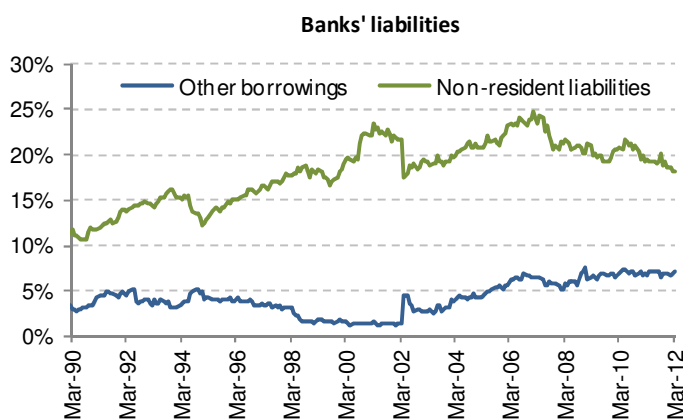
Over the past year to the end of March 2012, the annual growth for deposits from businesses was 4.1%.



## 2.5 Borrowings

A significant part of bank liabilities are the borrowings they make to support their funding needs in order to carry out their day to day business operations such as lending to customers. These borrowings are sourced either from domestic markets or from overseas.

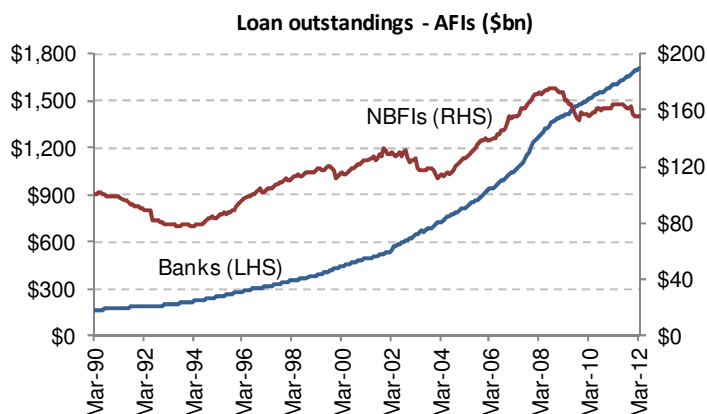
RBA statistics (to March 2012) show that non-resident liabilities of banks were at \$487 billion, or 18% of total liabilities, while other borrowings (which are resident liabilities) were \$190 billion, or 7% of total liabilities. The chart below shows the change in composition of these bank liabilities to March 2012.



Source: RBA

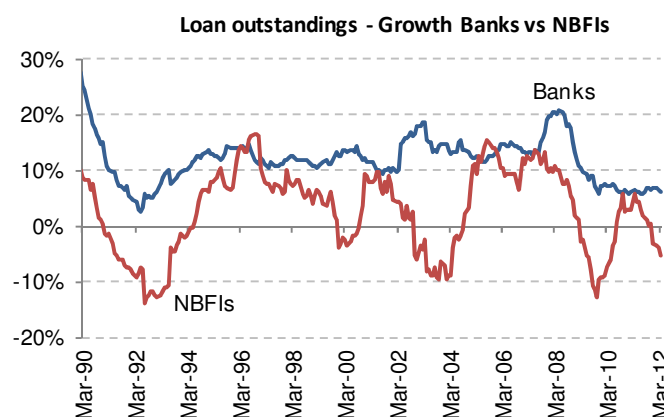
## 3. Credit Growth

Banks' loan outstandings (i.e loans and advances) were \$1.7 trillion at March 2012. This is 91.7% of the total loan outstandings for Australian Financial Institutions (AFIs), and an increase of 6.3% over the previous year. Non-bank financial institutions (NBFIs) had \$154.9 billion in loan outstandings, a fall of 5.2% over the same period. The charts below show the loan outstandings and growth rates for banks and non-banks.



Source: RBA



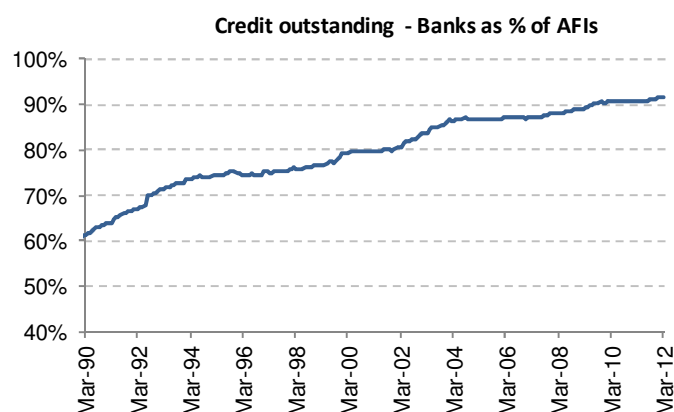


Source: RBA

The increase in bank lending is due to a number of significant structural and systemic changes, such as NBFIs becoming banks, banks buying or merging with NBFIs, more bank products and services being introduced, and foreign banks entering the system.

Since the onset of the global financial crisis (August 2007) banks' share of gross loans and advances has increased from 87.3% to 91.7%. Much of this increase can be attributed to the direct and indirect effects of the crisis. For example, as debt markets slowed or closed in 2008, more businesses sought their funding from banks, while the ability of smaller non-bank loan providers to access funds to support their lending to households and businesses was constrained.

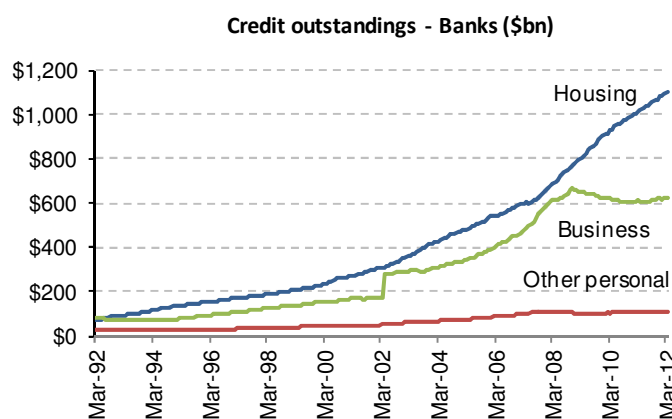
It is not unusual that banks' proportion of assets increases during times of economic disruption or downturn. Over the three years to the start of 1993 (the last major recession), banks' share of gross loans and advances increased from 60.9% to 71.2%, and over the two years from the downturn in 2001, banks' share increased from 80.0% to 84.9%.



Source: RBA

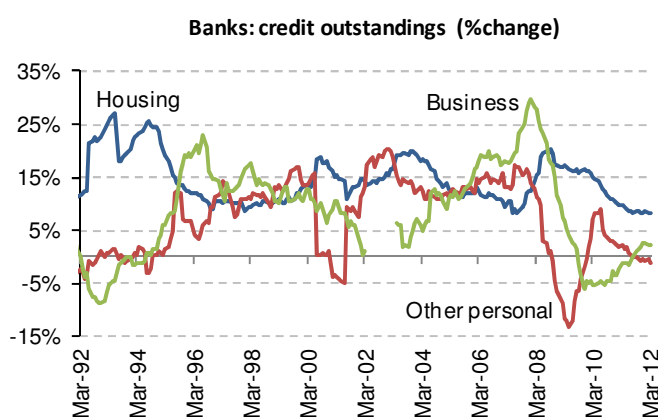
### 3.1 Composition of bank lending – loan type

At the end of March 2012, Reserve Bank of Australia statistics show that housing loans made up \$1.1 trillion of loan outstandings of Australian banks – with \$734 billion of loans to owner-occupiers and \$365 billion to investors. Business loans accounted for \$626 billion, personal loans were at \$106 billion and there was a total of \$243 billion of 'other' lending (to financial intermediaries and to the public sector).



Source: RBA

The following chart shows annual growth rates for the three key categories of bank lending. In the lead-up to the global financial crisis and throughout most of 2008, the growth rates for the stock of both housing and business loans were relatively high.



Source: RBA

### 3.2 Composition of bank lending - customers

At the end of March 2012, housing loans to owner-occupiers made up 40% of the loans on the book of banks while housing loans to investors made up 20%. That is, a total of 60% of loans made by banks are for housing. The remaining loans were to businesses (34%), personal loans (3.5%) and credit cards (2.4%).

The data show a significant rise in the proportion of housing loans (mainly to owner-occupiers). This result has been heavily influenced by generally lower interest rates for housing as well as the impact of government initiatives for first homebuyers.



Source: RBA

## 4. Loan Volumes: Housing and Personal

The majority of data below are collected by ABA from the main ABA retail banks and show the number of loans on the books of banks at the end of the year. It should be noted that some customers may have more than one loan. The aim of the data is to show the large volume of loans managed by banks not the number of home owners and investors.

### 4.1 Summary – Housing Loans

At the end of 2011, the main ABA retail banks had 5.4 million home loans on their books. If we allocate the 331,627 'Other loans' (see the table below) across owners and investors, it can be estimated that 3.7 million or 68% housing loans are to owner-occupiers and 1.73 million or 32% are to investors. Readers should be reminded that some customers may take out more than one loan or, in fact, two people may be purchasing a house, each with a separate loan.

**Table: Number of housing loans outstanding on the books of the main ABA retail banks**

End of year:	Housing loans			Total
	Owner-occupiers	Investors	Other	
2003	2,437,405	930,221	201,527	3,569,154
2004	2,483,104	1,277,196	217,441	3,977,741
2005	2,680,752	1,203,847	244,217	4,128,815
2006	2,894,758	1,288,116	273,067	4,455,941
2007	3,046,095	1,391,370	300,529	4,737,994
2008	3,221,598	1,506,096	319,984	5,047,678
2009	3,433,440	1,518,580	338,444	5,290,463
2010	3,416,858	1,570,157	335,659	5,322,674
2011	3,468,874	1,623,244	331,627	5,423,745

Source: ABA

While banks managed 5.4 million loans over 2011, they also approved many thousands of new loans. In fact, over 2011, 637,934 new housing loan commitments were made by ABA banks (estimated from ABS housing finance data).

If we look at both tables (above and below), we can then estimate that over half a million loans were paid out in 2011.

**Table: Number of housing loans commitments of banks**

	Owner Occupiers	Investment housing	Total
2003	471,371	237,581	708,952
2004	484,144	253,254	737,398
2005	474,959	215,621	690,580
2006	539,876	224,632	764,508
2007	568,602	236,963	805,565
2008	555,891	247,947	803,837
2009	542,909	211,391	754,300
2010	504,825	216,048	720,873
2011	447,087	190,896	637,984

Source: ABS

In 2011, 90% of housing loans had variable interest rates.

**Table: Per cent of housing loans on the books of the main ABA retail banks which are fixed and variable**

	Owner-occupiers	Investors	Total
<b>2008</b>			
Fixed	21.8%	23.3%	20.9%
Variable	78.2%	76.7%	79.1%
<b>2009</b>			
Fixed	15.8%	17.6%	15.8%
Variable	84.2%	82.4%	84.2%
<b>2010</b>			
Fixed	13.0%	14.7%	11.3%
Variable	87.0%	85.3%	88.7%
<b>2011</b>			
Fixed	10.6%	11.6%	10.1%
Variable	89.4%	88.4%	89.9%

Source: ABA

## 4.2 Average housing loan size on book

Using APRA data on housing loan outstandings, it is estimated that the average loan on the books of the main ABA retail banks is valued at \$196,600.

Table: Average size of housing loans on book

	Number	Value \$bn	Average size
2008	5,047,678	\$777.6	\$154,042
2009	5,290,463	\$906.7	\$171,386
2010	5,322,674	\$994.1	\$186,766
2011	5,423,745	\$1,066.3	\$196,600

Source: RBA/ABA

## 4.3 Summary – personal loans

At the end of 2011, the main ABA retail banks had 1.23 million personal loans on their books. A total of 470,103 personal loans were approved in 2011.

Table: Number of personal loans

	New loans committed that year	Total loans at end of year
2003	337,104	865,813
2004	412,504	937,837
2005	510,044	1,211,044
2006	476,096	1,114,549
2007	491,865	1,238,951
2008	515,717	1,315,883
2009	468,923	1,275,843
2010	432,380	1,246,273
2011	470,103	1,228,064

Source: ABA

## Appendix 2: Wallis outcomes

Key Wallis recommendations	FSAC Review 2003 (excerpts)	2012 position <sup>17</sup>
<b>Regulatory framework issues</b>		
<p>Wallis Outcome 1: Create a flexible regulatory structure which will be more responsive to the forces for change operating on the financial system</p> <p>Wallis Outcome 2: Clarify regulatory goals</p>	The regulatory framework has been implemented largely as envisaged by Wallis, with the creation of multiple independent regulatory bodies with clearly defined roles. Some exceptions have emerged on particular issues, notably interchange fees, where there are multiple regulators involved with possibly insufficient clarity as to their roles.	Achieved
	The reputation of the RBA needs to be preserved to ensure its credibility and to maintain its distance from industry.	Achieved
	In terms of the role of APRA, there is a need to ensure an appropriate balance between safety and efficiency is struck.	Largely achieved
	The overlapping consumer protection roles between Australian Securities and Investments Commission (ASIC) and APRA and between ASIC and the ACCC have been a source of confusion to industry. This issue requires further clarification.	Clarification achieved
	The specific role of the ACCC in the financial sector was perhaps not sufficiently examined by Wallis. This issue could also be considered in greater detail in continuing to define the role of the other regulators.	Clarification achieved

<sup>17</sup> ABA assessment

Key Wallis recommendations	FSAC Review 2003 (excerpts)	2012 position <sup>17</sup>
<b>Regulatory resources, accountability and coordination</b>		
Wallis Outcome 3: Increase accountability of the agencies charged with meeting those goals	The regulatory bodies have been vested with appropriate operational autonomy and generally appropriate governance arrangements. As advocated by Wallis, accountability and reporting by the regulators can be improved.	Further opportunities available
	There is scope for the regulatory agencies to improve their exchange of information, particularly it seems, in co-ordinating views on administrative policy issues prior to commencing public consultation processes. The Council has noted recent improvements in this regard. Implementation of the major reform initiatives has been smooth.	Further opportunities available
<b>Regulatory consistency issues</b>		
Wallis Outcome 4: Ensure the regulation of similar financial products is more consistent and promotes competition by improving comparability  Wallis Outcome 5: Introduce greater competitive neutrality across the financial system	A major theme recurring in Council discussions has been the appropriate balance between institutional and product-based regulation. While accepting that there are merits in the move towards product-based regulation, the Council's view is that although consistency is an objective of virtue, there may be circumstances where it would not be appropriate.	Further clarification required
	Further gains could be made in relying on disclosure-based regimes to achieve both corporate and prudential regulatory requirements.	Disclosure burden can be onerous
	The Council has noted in the past that risks appear to be emerging in the	GFC did demonstrate risk offshore



Key Wallis recommendations	FSAC Review 2003 (excerpts)	2012 position <sup>17</sup>
	non-regulated sectors (for example, hedge funds and re-insurance), underlining the need for regulators to monitor developments in wholesale markets.	in both regulated and unregulated sectors
<b>Market efficiency and consumer outcomes</b>		
Wallis Outcome 6: Establish more contestable efficient and fair financial markets resulting in reduced costs to consumers	The Council notes that Australia's financial system is relatively concentrated, but considers, on balance that this has contributed to favourable outcomes for consumers in what may otherwise have been an unstable global environment. Critical mass and scale among service providers have allowed considerable efficiency gains to be made within market structures that foster intense competition among larger firms. Consumers have benefited from cost savings, the emergence of alternative providers and through access to new technologies.	Benefits have continued
	Industry, particularly the larger banks face a considerable challenge to reverse a decline in customer satisfaction levels despite increasing access and quality of service. The major banks have recently focussed on this issue through the Banking Code of Practice and in-house measures. Customers are increasingly willing to make comparisons and seek alternative service providers intensifying competitive forces and placing increased pressure on margins. The home loan market remains competitive.	Customer satisfaction has recovered, but industry reputation has been impacted over the GFC.
	Funds will continue to flow rapidly into the wealth management sector. There will be considerable challenges for that industry in delivering acceptable returns in a more volatile global marketplace and in ensuring that such activity delivers positive value to conglomerate business.	Severe impact on returns during the GFC, and volatility continues

Key Wallis recommendations	FSAC Review 2003 (excerpts)	2012 position <sup>17</sup>
<b>Regulation of conglomerates and facilitating international competitiveness</b>		
<p>Wallis Outcome 7: Provide more effective regulation for financial conglomerates which will also facilitate competition and efficiency</p> <p>Wallis Outcome 8: Facilitate the international competitiveness of the Australian financial system</p>	<p>The Wallis perspective was that Australia's general competition framework should prevail over financial system mergers. In addition, Wallis recommended that general foreign investment policy should apply to the financial sector, but that regulation was warranted to ensure ownership diversity. The Government has retained additional policy restrictions on domestic and foreign mergers under the 'four pillars' policy. This may act as a constraint upon efficiency and international competitiveness in time and be brought into question during trade negotiations.</p>	<p>Four pillars policy unlikely to be amended</p> <p>Opportunities remain to enhance international competitiveness</p>