Senate Economics Committee

Inquiry in Post-GFC Banking Sector

Submission by Commonwealth Bank of Australia
June 2012

Contents

Introduction

CBA welcomes this Inquiry as another opportunity to update the Parliament and broader community on current conditions in the banking sector. CBA recognises that there are many reasons the community has high expectations of how it conducts itself and how it explains crucial decisions.

- CBA is one of the largest companies in Australia and the largest bank (by market capitalisation).
- It has a unique and long heritage.
- Banks play a key role in ensuring the continued economic well-being of Australians, whether it's as:
    - a guardian of deposits (CBA, excluding Bankwest which is making its own submission, has over 9 million deposit accounts);
    - a facilitator of loans to enable home and business ownership (CBA, excluding Bankwest, has around 2 million mortgage, personal and business loan accounts);
    - a reliable deliverer of payments (CBA currently processes over 3 billion transactions worth over $30 trillion in value annually across the multiple channels and payments systems, excluding Bankwest domestic payments processed exclusively by Bankwest);
    - an employer (CBA, excluding Bankwest, employs over 33,000 permanent staff in Australia alone);
    - an investment (CBA has 800,000 shareholders and 85,000 holders of hybrid notes and retail bond issues); or
    - a taxpayer (CBA has paid taxes and fees to Australian governments totalling over $10b since the GFC first impacted the Australian economy).

In turn, we ask of this Committee that it ensures the debate is based on the facts. It is unsustainable to be based on anything less. The debate must take account of the full breadth of the relationship a bank has with all its stakeholders.

CBA draws the Committee's attention to four previous submissions it has made to the broad inquiries into banking that this Committee has undertaken since September 2008 (when Lehman Brothers collapsed and is widely considered to be the commencement of the GFC), as well as numerous other submissions to other Parliamentary Inquiries in that time.

This submission is structured to provide a response to each of the Inquiry's terms of reference.

CBA also supports the submission of the Australian Bankers' Association (ABA).

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

Key points:

- There is a very high regulatory reform workload on the banks from multiple sources (international and domestic) which has a long time to run.
- Basel III is by far the most significant of the reforms.
- APRA (understandably) appears to be taking a conservative approach in implementing the BCBS's Basel III proposals but there are significant implications for bank capital, funding and liquidity management and therefore potential costs of credit.

The period since the commencement of the GFC has seen significant regulatory change in the banking sector. The scale of the change, much of which is still in various stages of consultation and/or implementation and will be until 2018[1], is greater than any episode of reform in the preceding two decades. The impact on the banking sector, and Australian consumers and businesses, will be significant.

The mix of reforms facing the Australian banking sector now is also more diverse and extensive than it has been in previous episodes. Since the commencement of the GFC there has been, and will continue to be, an increased number of international regulatory reforms emanating from international agreement in forums such as the G-20. There are also some international reforms that are at the instigation of a particular country and impact on an Australian financial institution (FI) solely because the FI has an offshore branch or deals with citizens of that particular country. The challenges with all internationally driven reforms is to ensure they are relevant for the local market (ie provide a proportionate response to a market failure which also exists locally) and able to implemented sensibly (ie take account of any unique characteristics of the local market). CBA has very real concerns that the extra territorial reach of some new "regulatory-induced" requirements will have inappropriate and adverse consequences on Australian FIs and other Australian companies and citizens.

Major international reforms

Basel III

The Basel Committee on Banking Supervision (BCBS) has developed a new Basel III framework for banking supervision. The key aims of Basel III are to raise the quality, quantity and international consistency of capital and liquidity for banks. The Basel III reforms are by far the most significant of the current regulatory reforms impacting the Australian banking sector. CBA recognises the case for Basel III and applauds the objective of international consistency.

[1] Transition arrangements for existing capital securities extend until 2022.

Basel III capital reforms in Australia

Despite the stated aims of Basel III, APRA's Basel III capital proposals, to be implemented on 1 January 2013, differ significantly from the BCBS Basel III proposals. In a speech to a Finsia conference in October 2011, APRA Chairman Dr John Laker acknowledged that "APRA's proposed approach will tend to produce lower 'headline' capital ratios"[2].

The four largest points of difference between APRA's Basel III proposals and the minimum BCBS Basel III requirements are:

- APRA requires full deductions from common equity for investments in non-consolidated banking businesses and insurance/wealth management businesses. The BCBS Basel III requirements provide discretion for national regulators to apply a threshold (10% of common equity capital) before a deduction is required.[3]
- APRA requires full deductions from common equity for deferred tax assets. The BCBS Basel III requirements provide discretion for national regulators to apply a threshold (10% of common equity capital) before a deduction is required in relation to deferred tax assets that relate to timing differences.[3]
- APRA continues to apply a more conservative minimum floor in calculating the amount of capital required to be held against mortgages than international regulators.[4]
- APRA continues to take a more conservative approach to the amount of capital required for interest rate risk within the banking book.[5]

As APRA has acknowledged, these differences will result in Australian banks reporting lower capital ratios than their international peers. This leads to important issues of perception and could adversely impact the competitiveness of Australian banks. Furthering this point:

- Australian banks will be placed at a competitive disadvantage when accessing global debt and capital markets as Australian banks' capital ratios will appear lower relative to international banks. This may lead to a higher cost and/or reduced access during stressed periods, relative to international peers - at least some of which would be passed onto Australian consumers.
- Australian banks will be placed at a disadvantage when competing for insurance/wealth management businesses and minority investments in offshore banking businesses (including within Asia) against international banks that have access to the equity investment threshold (unless they have

---

[2] APRA Chairman speech to the Finsia Financial Services Conference, 25 October 2011, page 3.

[3] Under the BCBS Basel III requirements an additional aggregate threshold test of 15% of common equity applies to the total of the amounts relating to investments in non-consolidated banking businesses and insurance/wealth management businesses and deferred tax assets.

[4] APRA imposes a minimum downturn loss given default (LGD) floor of 20% on retail residential mortgage exposures when calculating risk weighted assets. The Basel Committee and other international regulators (eg UK FSA) impose a lower LGD floor of 10%.

[5] APRA requires Australian banks to hold capital against this risk through an explicit requirement for risk weighted assets within the calculated capital ratios. The Basel Committee and other international regulators do not include interest rate risk in the banking book in their capital ratio calculations.

utilised their threshold previously). This discourages diversified financial institutions/bancassurance groups within Australia.

APRA contends that a common disclosure template proposed by the BCBS in December 2011 will address the concerns about international comparability.[6] CBA does not believe this solution will address the two key competitiveness issues raised above.

- The proposed BCBS disclosure template attempts to enable market participants to compare the capital adequacy of banks across jurisdictions. CBA does not believe it achieves this aim as it focusses on a detailed reconciliation of capital calculations (based on national regulatory capital rules) with the financial statements and does not contain comparable capital ratios calculated on an internationally harmonised basis.
- As a result, it requires investors to undertake more detailed analysis in order to compare bank capital ratios. Given the large number of investment opportunities available to international investors, the majority do not have sufficient resources to complete this analysis for all banks and use 'headline' capital ratios as a filter before conducting more detailed credit analysis. If Australian banks report lower 'headline' capital ratios due to APRA's conservative approach to the adoption of Basel III reforms they may be disregarded during the filtering process. This could lead to higher costs and reduced access to debt and capital markets.
- The disclosure template will not reduce the real capital and funding disadvantage Australian banks will face when competing for insurance/wealth management businesses and minority investments in offshore banking businesses against international banks that have access to the equity investment threshold.

The issues around international comparability are well exemplified in the following extract from an international report by RBS dated 24 May 2012[7], erroneously commenting on the Australian banks:

> *"**Australian banks are less capitalised relative to peers.** All four of the major commercial Australian banks fall below the 9% Core Tier 1 threshold, as required of European banks. The Australian regulator, APRA, is more stringent on capital ratios, making direct comparisons with overseas banks difficult. However, capital ratios appear to be lower than banks in northern Europe or the US. We believe that in order to be competitive in international funding markets, all four commercial banks will likely need to keep capital ratios at similar levels to these [European or US] banks."*

Basel III liquidity reforms in Australia

The Basel III liquidity reforms require banks to increase their holdings of liquid assets through a Liquidity Coverage Ratio (LCR), and to lengthen the duration of their funding through a Net Stable Funding Ratio (NSFR). The LCR is due to be implemented as a minimum regulatory requirement in January 2015 and the NSFR

[6] APRA Response Paper, Implementing Basel III capital reforms in Australia, 30 March 2012, page 6.
[7] The Revolver, RBS Macro Credit Research, 24 May 2012, page 7.

in January 2018. APRA has stated it will be “encouraging ADIs to manage their liquidity with a view to ensuring continuous progress with the requirement”.

The cost of these reforms will be dependent on a number of factors. CBA would like to highlight three specific factors for the Committee.

- The impact on the market of the ultimate conservatism of the requirements.
- The manner and extent to which APRA limits access to the RBA Committed Liquidity Facility, which can place additional demand on banks to acquire other scarce qualifying liquid assets.
- Market supply, conditions and competition for long-term wholesale funding, a high proportion of which is sourced from offshore investors.

CBA notes that the NSFR is still subject to significant global regulatory debate, but in this context CBA is concerned about the potential levels of conservatism, including limited recognition of local market conditions, which may be involved in the implementation of the liquidity reforms.

- CBA shares BCBS’s recognition of potential over-conservatism in some of the assumptions for retail/commercial banking, such as corporate deposits.
- In adapting the BCBS requirements to the local market, APRA has recognised the unique nature of Australia’s superannuation industry, but is proposing to implement this somewhat narrowly. For example, member directed superannuation deposits are treated as deposits from FIs rather than from the underlying retail members.
- APRA’s proposed approach to approval for the size of a bank’s Committed Liquidity Facility includes assessment criteria for balance sheet management which is focussed on specific liquidity risk minimisation actions. Whilst CBA understands APRA’s intent, the specific nature of the proposed criteria potentially imposes another layer of conservatism to Basel principles and standards for Australia relative to offshore jurisdictions.
- APRA is proposing to adopt a conservative approach to national discretion elements in the LCR, for example proposing a broader definition of credit and liquidity facilities than the BCBS definition which will increase liquid asset requirements of these facilities for banks and costs to customers.
- APRA is encouraging ADIs to manage their liquidity with a view to ensuring continuous progress towards compliance with the requirement by 2015 at the latest, notwithstanding BCBS is yet to finalise the requirements.
- There is uncertainty on whether basic term deposit (TD) products less than 2 years in Australia will be recognised as term funds in the LCR by APRA. This is due to uncertainty on whether these products are able to be broken at the discretion of customers under current laws. ASIC has engaged in industry consultation on proposed relief that would clarify the breakability of these products. However, ASIC may take a conservative interpretation of the current laws and hence propose “relief” that may not go far enough to accommodate the Basel III requirements and banking industry’s aim to recognise and reinforce stable funding sources. In addition, it is recognised that law reform is needed for TDs greater than 2 years to be recognised as

term funds, which is a potentially lengthy and uncertain process. Depending on the approach taken by ASIC and Treasury on these issues, an ultimate impact on both customers and banks could be to deny both parties the benefits of the term value of these funds. The significance of potential consequences to banks and customers should not be underestimated – TDs are the prime source of the most stable funding in the retail market in Australia if they can be managed and treated legally as at term. They represent a material component of bank funding, and the only basic deposit product for retail customers to invest at term. Legal treatment of these funds as quasi-at call or 1 month funding will prevent Australia from having a retail term funding market in contrast to other jurisdictions.

Living Wills

Another reform being driven by the BCBS, and endorsed by the G-20, is "Living Wills". This initiative will require banks to document their recovery and resolution planning for their local regulator. Living Wills are intended to strengthen the resilience of a bank in the event of an extreme financial shock and minimize adverse systemic impacts and taxpayer assistance. APRA is requiring the major Australian banks to submit final, Board approved, recovery plans by 31 July 2012.

Systemically important financial institutions (SIFIs)

Systemically Important Financial Institutions (SIFIs) is a third area of major reform from the BCBS with G-20 endorsement. While Australian banks have not been designated as Globally Systemically Important Financial Institutions (G-SIFIs), the Australian major banks will qualify as Domestic SIFIs (D-SIFIs).

CBA notes that D-SIFIs in Australia are already subject to significant additional scrutiny compared with non D-SIFI ADIs. This is the key mechanism through which Australian regulators have mitigated the higher risk such FIs pose to system stability.

To date APRA is not proposing to apply additional capital requirements on D-SIFIs, however CBA notes the recent report from the Financial Stability Board (FSB)[8] that indicates the BCBS and FSB will be developing a D-SIFI framework for submission to the G-20 Ministers and Governors Meeting in November 2012.

CBA would be concerned if this resulted in a change to APRA's current stance of not applying additional capital requirements on D-SIFIs, as it could result in an artificially imposed competitive disadvantage on the major banks. Any increased capital costs would have to be at least partly passed on to Australian consumers.

Other internationally imposed reforms

There is also an extensive list of other internationally driven reforms since the commencement of the GFC which will impact CBA and other banks. Of these reforms CBA highlights two which have originated from the US and have, as drafted, extensive extra-territorial reach on banks such as CBA which have only a limited connection to the US. The cost of compliance on CBA will be significant.

[8] FSB Progress Report to G-20 Ministers and Governors, "Extending the G-SIFI Framework to domestic systemically important banks", 16 April 2012.

Foreign Account Tax Compliance Act ('FATCA')

The FATCA legislation was essentially enacted by the US Congress to ensure that certain US investors with accounts outside the US pay tax on their income. To achieve this, FATCA will require all global FIs, not just banks, to identify and report the names and account details of all US persons on an annual basis. FATCA will significantly impact FIs along several points in their value chain requiring the collection of additional client data and new reporting mechanisms to be put in place.

Implementing the changes (on a staged basis from 2013) will be quite costly and resource intensive requiring specialist technical expertise and the coordination of implementation across multiple jurisdictions, reconciling several national legal frameworks. This spend will not result in any perceived benefit for either CBA or any of its customers. The ABA and other relevant industry bodies are making representations to US officials.

'Volcker Rule'

Another proposed reform to emerge from the US is the 'Volcker Rule' which is a sub-section of the Dodd-Frank Wall Street reforms aimed at eliminating riskier financial practices from core banking activities within the US. In turn, it is envisaged that this will limit the potential liability to US taxpayers of a US bank failing.

The proposed regulations were highly criticised in many of the submissions recently received by the US regulatory authorities. Some of the most vocal opponents to the Volcker Rule are foreign. In particular it is the "unprecedented extraterritorial reach" that countries such as Canada, the UK, Japan and others consider problematic given the degree to which normal and long-standing banking activities get caught in a net purportedly designed to address riskier-than-encountered in Australia trading businesses.

As the rule is currently drafted and would apply to Australian banks, it would likely decrease the liquidity of Australian Commonwealth and Semi-Government Securities. Such an outcome severely undermines the implementation of Basel III requirements that banks hold greater amounts of high quality liquid assets, which in Australia and absent the Volcker Rule is expected to largely comprise Australian Government and Semi-Government Securities. The ABA and other relevant industry bodies are also making representations to US officials on this issue.

However, in a welcome move, the Federal Reserve Board recently provided an additional two years (until July 2014) to ensure compliance with the Volcker Rule.

Locally driven reforms

The Inquiry's terms of reference do not refer to the impact of domestically driven reforms. This is, however, another significant source of regulatory reform for CBA and which will impact our customers (either directly and/or indirectly such as through higher compliance costs). Domestically driven reforms since the commencement of the GFC and/or currently under development include the following measures.

- National Consumer Credit Protection Phase 1 reforms (which introduced national regulation of consumer credit from 1 January 2011)
- National Consumer Credit reforms Phase 2, which has been a very staged process and elements are still to be developed. Elements already legislated (although amendments are required) include the Home Loan Key Fact Sheet (from 1 January 2011) and various reforms to credit card lending (from 1 July 2012). Elements still to be legislated include reforms to hardship provisions and reverse mortgages (implementation to commence March 2013). Consultation is underway regarding proposals on investment lending, small business lending and short term small amount lending
- Regulation of margin lending (from 1 January 2011)
- Ban on mortgage exit fees (which applied from 1 July 2011 but which CBA removed before that time)
- Allowance of covered bonds (since October 2011) – further details in section (c)
- Creation of a single national Personal Property Securities Register (implemented in January 2012 but with significant shortcomings which may not be fully rectified)
- Price signalling reform (from 6 June 2012)
- Commencement of Australia's new carbon pricing mechanism whereby emissions units will be considered financial products under the Corporations Act 2001 (from July 2012)
- APRA review of the capital requirements for life and general insurance companies, which is expected to result in increased capital requirements across the insurance industry (most of the changes commence 1 January 2013)
- APRA regulation of conglomerate groups (designed to protect individual APRA regulated entities from contagion risk), which include imposition of additional capital requirements, especially on the funds management businesses (implementation in April 2013, but may be deferred by three to six months)
- A range of superannuation reforms including the introduction from 1 July 2013 of the new Future of Financial Advice reforms and My Super product (some aspects of which will significantly impact the banking operations of the CBA Group)
- Compliance with Financial Claims Scheme obligations regarding reporting of depositor holdings and the ability to maintain certain operations following a 'declaration event', both of which involve very substantial work (completion due by end 2015)
- Ongoing discussions around reform of the over-the-counter (OTC) derivative markets
- Amendments to the Australian Privacy Act (including comprehensive credit reporting) and privacy codes of conduct (commencement date to be determined).

ToR (b) "The impact on relative shares of specific banking markets"

Key points:

- The commonly used APRA market share data risks giving a distorted impression of the changes in competitive pressures in instances when two entities merge under a single licence yet remain individual competitors (as has occurred for Westpac and St George Bank which now report only aggregated market share).
- The other largest changes in market share since the commencement of the GFC, and more indicative of actual conditions, are in lending - the reduced share of non-ADI lenders in mortgages and the reduced share of 'other banks' (which includes foreign banks) in business lending.
- The evidence shows respectable levels of customer mobility in retail banking and understandably lower levels in business banking. The Government has reviewed, is reviewing or has removed several barriers to customer mobility in recent years.

Determinants of competition

Some commentary in the lead up to this Inquiry has indicated a belief that more concentrated markets necessarily result in less competitive markets. This is not true. There are many determinants of the competitiveness of a market. Determinants particularly relevant for the banking sector include:

- the barriers to entry and exit;
- the level of customer demand for banking products; and
- the impact of various regulatory reforms.

Furthermore, the range of competitors for banks is very broad - banks are one of a few alternative conduits or intermediaries between savers and borrowers. Alternative conduits which banks compete with include building societies and credit unions, the stock exchange, superannuation and managed funds, investment banks and non-bank FIs. The significant penetration of brokers in lending markets (prevalent in both mortgage and small business lending) adds a further dimension to competitive tension because their service proposition is to offer independent advice as to which lender's products will best fulfil a customer's needs. As a result, there are strong competitive pressures in intermediation.

Barriers to entry and exit

A key determinant of the competitiveness of a market will be the ease of a firm being able to enter and exit (ie the market's contestability).

In the case of banking the main barriers to entry are:

- regulatory licensing, if the firm wants to take deposits; and
- access to funding if the firm wants to make loans.

The licensing requirements in Australia are determined by APRA. As an aside, having a physical branch network to gather deposits has decreased significantly in importance in the past decade or more as a potential barrier to entry, as evidenced by the growth of online only banks (eg ING Direct and Ubank), the increased allowance of electronic verification and the increased use of the internet by the Australian population.

One lesson from the GFC so far is that lenders which relied exclusively or significantly on securitisation had unsustainable business models. Those firms had no contingency for accessing alternative more stable funding sources. Arguably, having access to contingency funding sources is, in the environment which has existed since the commencement of the GFC, not an unreasonable barrier. It increases the likelihood the lender will continue operating for an extended period of time, giving the borrower greater certainty that their loan remains with that FI and reducing the likelihood of having to potentially refinance if their lender fails. CBA also notes that the Government supported the Residential Mortgage Backed Securities (RMBS) market through investments via the Australian Office of Financial Management (AOFM).

The increased prevalence of mortgage brokers has also lowered the barriers to entry in lending.

Brand is sometimes cited as another barrier to entry to both deposit gathering and lending. However, the strength of a bank's brand can only ultimately be a reflection of customer experience; brand is therefore not a sustainable barrier if a bank acts uncompetitively and poorly towards its customers.

The key barriers to exit are the legislative requirements that a shareholding in an Australian financial sector company in excess of 15% requires the approval of the Treasurer under the Financial Sector (Shareholdings) Act. If the sale involves a foreign purchaser then the purchase (if over certain thresholds) must also be considered by the Treasurer under the Foreign Acquisitions and Takeovers Act. Under that Act "the Treasurer can block certain proposals that are contrary to the national interest or apply certain conditions to the way proposals are implemented to ensure they are not contrary to the national interest"[9]. In addition, an acquisition of a substantial interest in an ADI would require the approval of APRA under the Banking Act.

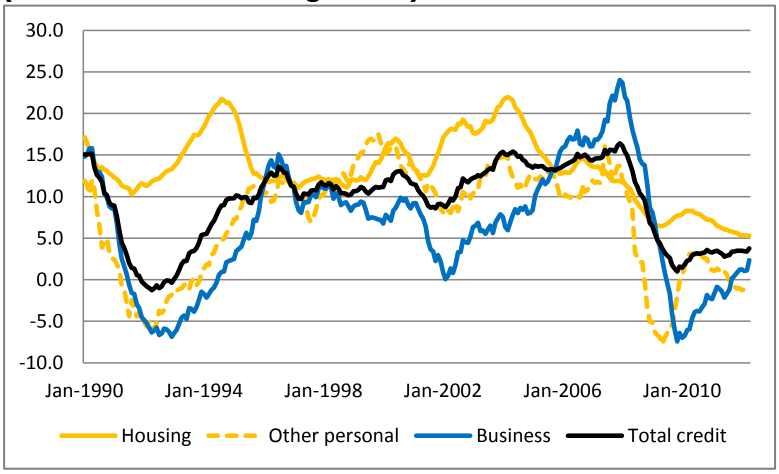
Consumer demand for banking products

Demand for credit since the commencement of the GFC has been very weak compared with pre-GFC (Figure 1).

- Mortgage lending growth has averaged half of what it did in the few years pre-GFC. As noted below, this is driven primarily by lower demand for credit by customers, rather than banks restricting the supply of credit.
- Business lending and other personal lending have experienced significant periods of negative growth and each are now at levels lower than pre-GFC (ie the market has decreased in size given the overall negative growth since the commencement of the GFC).

[9] Australia's Foreign Investment Policy, released by the Treasurer, January 2012.

Figure 1: Credit growth has been very weak post-GFC (12 month ended % growth)



Source: RBA

The weak demand for credit is due to a combination of factors, such as:

- consumer and corporate deleveraging;
- declining real asset prices;
- greater business and consumer conservatism in making major borrowing decisions combined with declining credit quality (refer to the discussion responding to the term of reference (d)); and
- in some business segments an increased capacity to internally finance major expenditures and/or to directly access capital markets at rates that are less than ADIs.

It is almost inevitable in a low growth or shrinking market that participants will undertake major restructuring (eg major reductions in cost bases, consolidations and exits). One of CBA's key areas of strategic focus, for example, is productivity improvements from closely examining CBA's processes and practices. Importantly, CBA has committed to not offshoring jobs and to avoid major redundancies.

Impact of regulatory reforms

The most significant impact of the extensive range of regulatory reforms detailed in the previous section and major shifts in global funding markets since the commencement of the GFC is that the deposits market has experienced a structural increase in competition because of the drive by the Australian banks to increase the proportion bank funding sourced from deposits. At times the price competition has been extreme. The higher level of competition is expected to remain given the introduction of Basel III reforms permanently alters the incentives for ADIs to be more deposit dependent and the continued expectation that there will remain a shortfall between the level of deposits and level of lending outstanding in the Australian banking sector (as evidenced in Australia's current account deficit).

Other regulatory reforms, such as the Financial Claims Scheme and ban on mortgage exit fees, have also permanently impacted individual product segments; these changes are discussed below.

The aggregate effect of the various regulatory reforms is that compliance and associated costs have increased across the industry.

Other comments

The combination of strong pressures on both sides of the banking balance sheet (loans and deposits) is a unique conjunction for the last two decades. It is evidence of the significant pressure the banking system is already under and expected to remain under for the foreseeable future.

The remainder of this section provides comments on changes in market share in individual key product segments and indicators of customer mobility/ease of switching provider. The reported market share data overstates, in CBA's opinion, the concentration in each product market because St George Bank's (SGB's) market share has been included in Westpac's (WBC's) market share data for regulatory reporting purposes since March 2010, although SGB is clearly operated as a separate bank – SGB has its own pricing, brand and customer service proposition.[10]

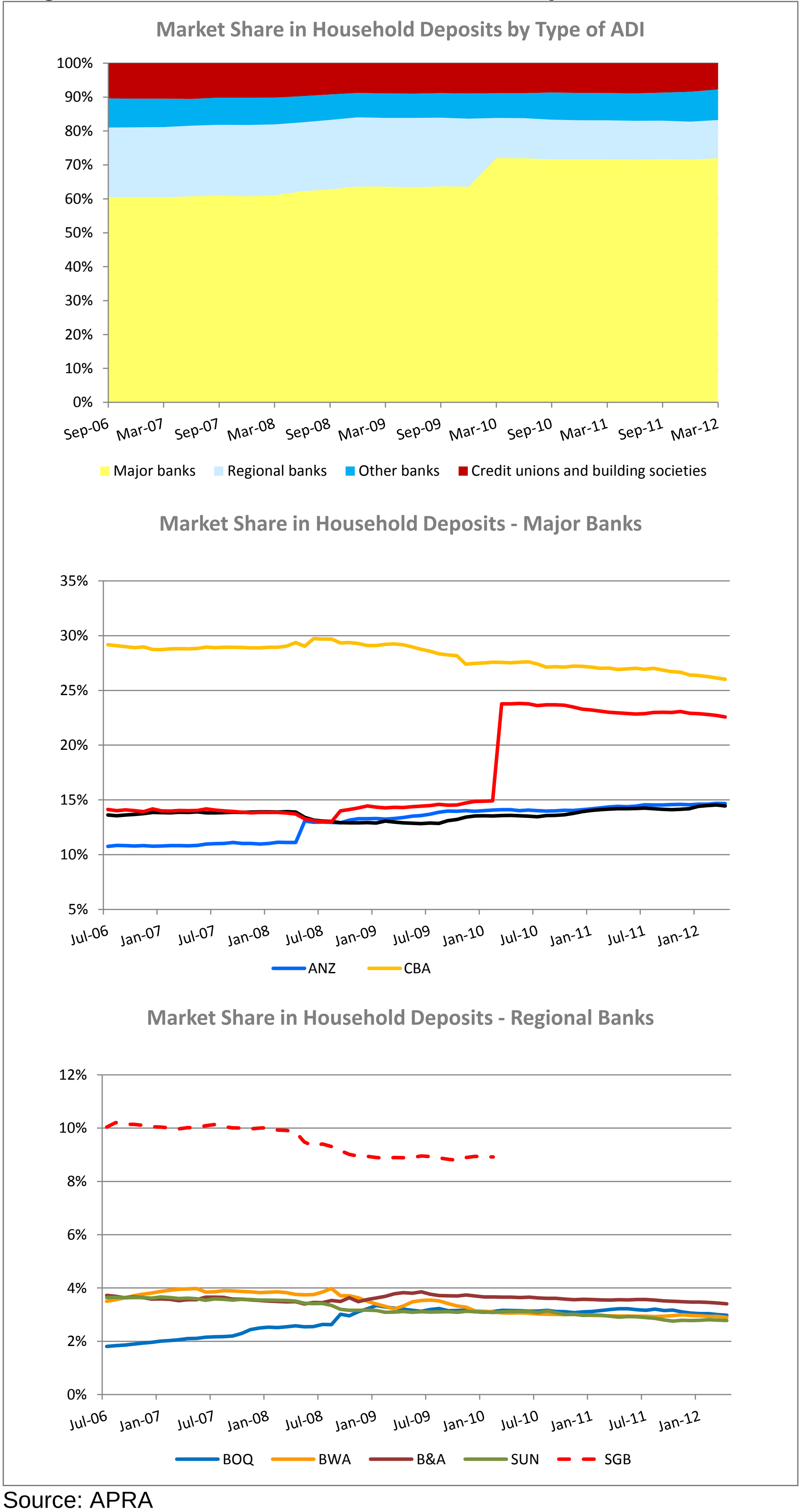
Personal Customers / Retail Banking

Household deposits

Putting aside the impact of WBC's acquisition of SGB, the key industry dynamic in household deposits since the onset of the GFC is that the combined market share of the major banks has been fairly constant (Figure 2). As noted in the next section responding to the cost of funding, this fairly constant market share is against a backdrop of very strong competition for deposits during this time as well the introduction of the Government guarantee on retail deposits (the Financial Claims Scheme).

[10] This has occurred given that Group's move to a single ADI licence and the consequential change in APRA reporting requirements.

Figure 2: Market Share in Household Deposits



Source: APRA

Notes: Data reports deposits held by 'households'. Includes various series breaks as reported by APRA. Estimates for Credit Union and Building Society deposits

The announcement in October 2008 of the details of the Financial Claims Scheme (FCS), which provides a guarantee that depositors of an ADI which fails will have their deposit repaid in full up to a certain amount, has also impacted market share. While all banks benefited from the introduction of the FCS, and it was necessary in the context of extreme disruption to markets at the time, the main beneficiaries have been the regional banks and other smaller ADIs. Some regional banks and other smaller ADIs experienced outflows in the period immediately preceding the announcement of the FCS which stabilised or became inflows following the announcement. CBA, for example, experienced the mirror image of this pattern and had large withdrawals of deposits following the announcement of the scheme.[11]

APRA and the RBA have acknowledged that smaller ADIs were the main beneficiaries. For example:

> "*In particular, following the announcement [of the FCS arrangements] there was a reversal in potentially destabilising deposit outflows from a number of ADIs that had been evident in early October. By guaranteeing all deposits under $1 million, the FCS reduced the incentive for depositors to move away from ADIs that they perceived as being at risk.*"[12]
>
> *"It is also worth noting that smaller ADIs are the primary beneficiaries of the introduction of the Financial Claims Scheme . . . given their higher proportion of deposits as a share of liabilities.*"[13]

The introduction and permanent inclusion of the FCS (at a reduced threshold of $250,000 per depositor per ADI from 1 February 2012) following the Government's review, provides a permanent benefit to ADIs which are perceived as riskier than other ADIs because depositors are assured of receiving their deposit back irrespective of the riskiness of the ADI.

A final point is the impending introduction of simpler switching arrangements for personal transaction account holders from 1 July 2012. This follows the review completed by Mr Bernie Fraser in 2011 which recommended a simpler system for customers of personal transaction accounts to open an account at a new ADI, have their direct credit and debit arrangements switched to that new account, and the old account closed. Mr Fraser ruled out more extensive measures such as full bank account number portability on the grounds that such options "were not required – and could not be justified"[14]. The introduction of simpler switching should further increase the mobility of transaction account customers which, as indicated in Mr Fraser's report, is already substantial and compares favourably with systems in other countries.

---

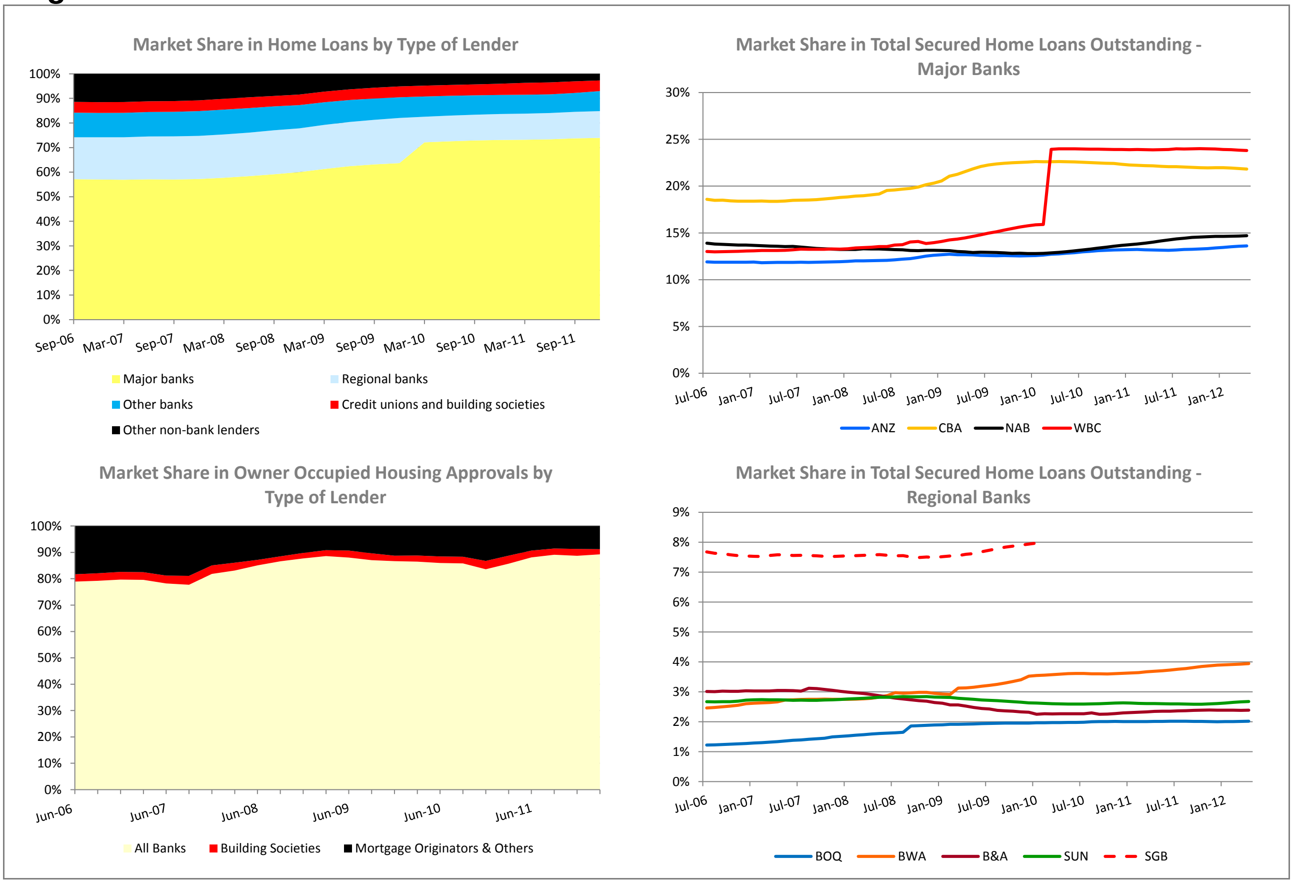
[11] Refer CBA's submission to this Committee's Inquiry into Competition within the Australian Banking Sector (December 2010).
[12] Joint submission from the RBA and APRA to the Senate Economics References Committee Inquiry into Bank Funding Guarantees, March 2009, page 5.
[13] APRA Answers to Questions on Notice, Senate Estimates, 2-4 June 2009.
[14] Banking services – cost effective switching arrangements, August 2011, page 7.

Mortgage lending

Mortgage lending constitutes approximately 60% of total credit outstanding (ie including all credit to households, businesses and the government sector by all financial intermediaries) and is by far the largest category of all lending.

Aside from the impact of WBC's acquisition of SGB, the single greatest change in market share in mortgage lending since the commencement of the GFC is the decline in the share of 'other non-bank lenders' (other than building societies and credit unions, eg non-bank mortgage originators dependent on securitisation). This is illustrated by both APRA and ABS data showing this type of lender's declining share of the total home loans outstanding (based on finance actually drawn down for owner occupied and investment properties) and declining share of mortgage lending approvals in the owner occupied market respectively (Figure 3).

Figure 3: Market Share in Home Loans



Source: ABS, APRA, RBA, CBA

Regulatory reforms since the commencement of the GFC have decreased the barriers to customer mobility in the mortgage market through the legislated ban on mortgage exit fees (which applied from 1 July 2011, although CBA and some other lenders abolished exit fees before that time).

Other potential barriers include:

- the sometimes significant legal fees and State government taxes and charges which can be involved;

- the need to complete a new credit assessment when a new loan is established. Borrowers may be reluctant to do this, especially if, for example, their income has decreased or their property value has decreased; and
- the potential need to take out a new mortgage insurance policy at the provider they switch to. Mortgage insurance is typically required for loans which are 80% or more of the property value (i.e. loan-to-valuation ratio of at least 80%). Mortgage insurance is not portable. The Treasurer has recently reviewed the case for portability and concluded that it "would be expensive, extremely complex to implement and administer, and would likely benefit less than 1 per cent of all borrowers".[15]

There is ample evidence of significant customer mobility in the mortgage market.

- The average time a customer holds their mortgage with their FI is currently 4-5 years. Many Australians therefore reconsider their mortgage provider at least a few times during the life of the loan.
- Currently, over 30% of all home loan finance approved is for refinancing. This figure has increased in the last couple of years. The figure excludes refinancing with the same lender and therefore understates the level of total refinancing occurring in the market.

Another indicator of competition is that the level of discounting customers have been able to receive in the last 18 months is significantly higher than in previous periods. As outlined in the next section (refer page 30), most customers do not pay the Standard Variable Rate (SVR) – they receive a discount off the headline rate.

Business banking

Business deposits and loans include those from non-financial corporations, financial corporations and the government sector. For the purposes of this Inquiry's terms of reference CBA has focussed its comments on changes in market share in the first of these three categories, non-financial corporations.

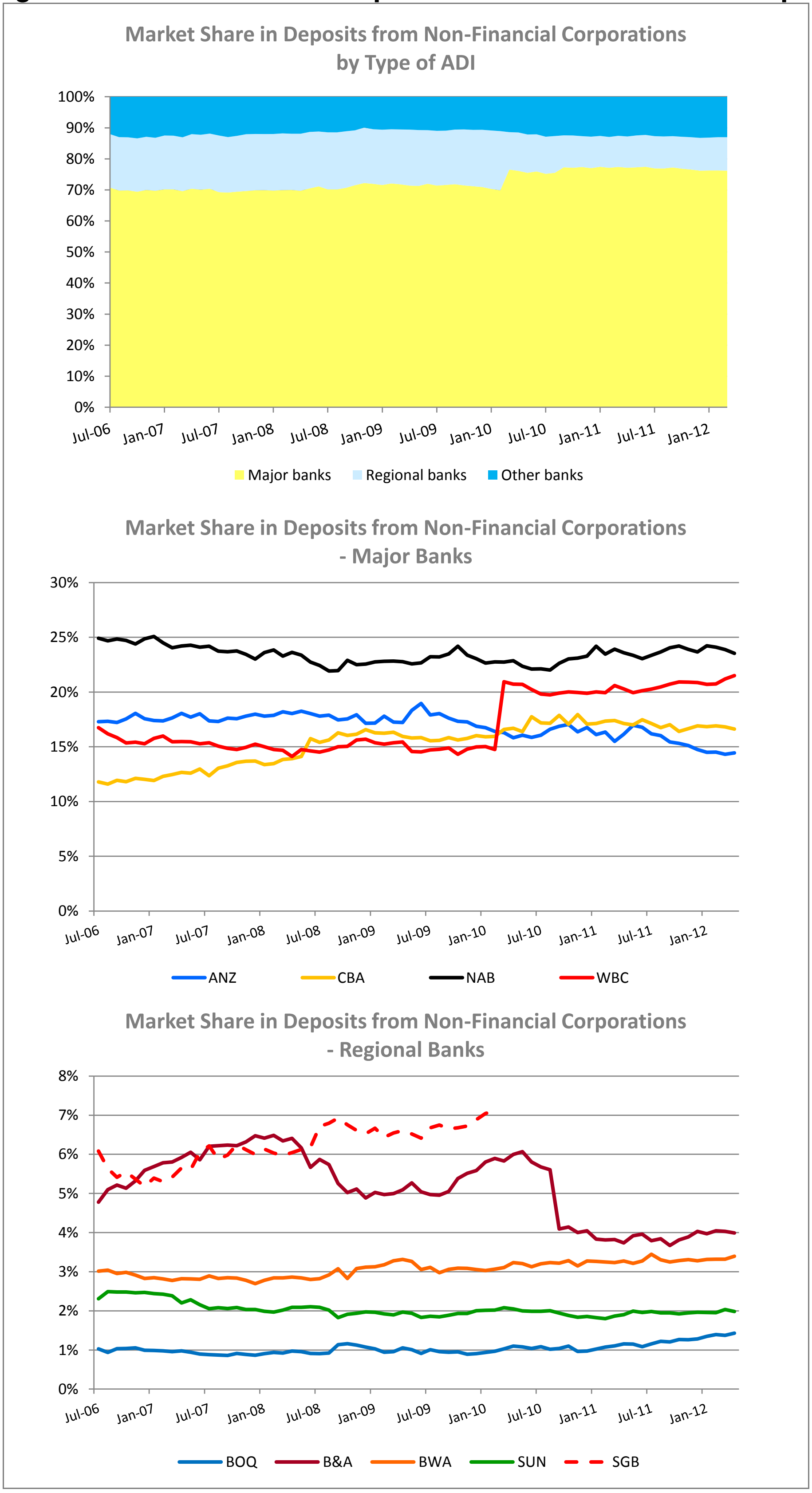
Business Deposits

Aside from the impact of SGB's inclusions in WBC's data, the other material change has been the decline in market share of 'other banks' (foreign banks and smaller banks outside of the regionals) immediately following the commencement of the GFC and the subsequent recovery of that market share (Figure 4). This change reflects the exit of foreign banks from the Australian market or their much more selective participation, as the parent company focussed resources on its home and core markets. It may have also reflected potentially increased concerns by customers of the level of commitment foreign banks have to the Australian market, although any concerns on the deposits side appear to have now dissipated.

Another change is that CBA has grown its share in this market over many years as part of the Bank's strategic focus to address its underweight position (also Figure 4).

[15] Taking the Headache Out of Switching Bank Accounts, Treasurer's media release, 21 August 2011.

Figure 4: Market Share in Deposits from Non-Financial Corporations



Source: APRA
Note: Includes banks only

As with household deposits, the market for business deposits has become very competitive. Larger business customers have, for example, increasingly switched from placing funds on deposit with a bank through buying a bank bill to now placing those funds in a TD or high interest paying at call deposit account given the change in relative interest rates paid on those categories of investments.

The mobility of business customers is generally lower than for personal customers. This is to be expected. Business customers have more complex financial arrangements which often involve linked products and services so the customer maximises value (eg merchant clearing facilities linked to a deposit account enables at CBA for those funds to be available in real time). They also often have many more direct entry payments linked to their main transaction account. At the smaller end of the business market the mobility of customers is also impacted by the sometimes short lifespan of a business (which naturally reduces the scope for the customer to have considered switching bank). When a business customer does want to switch bank, most of the banks offer some degree of switching service.

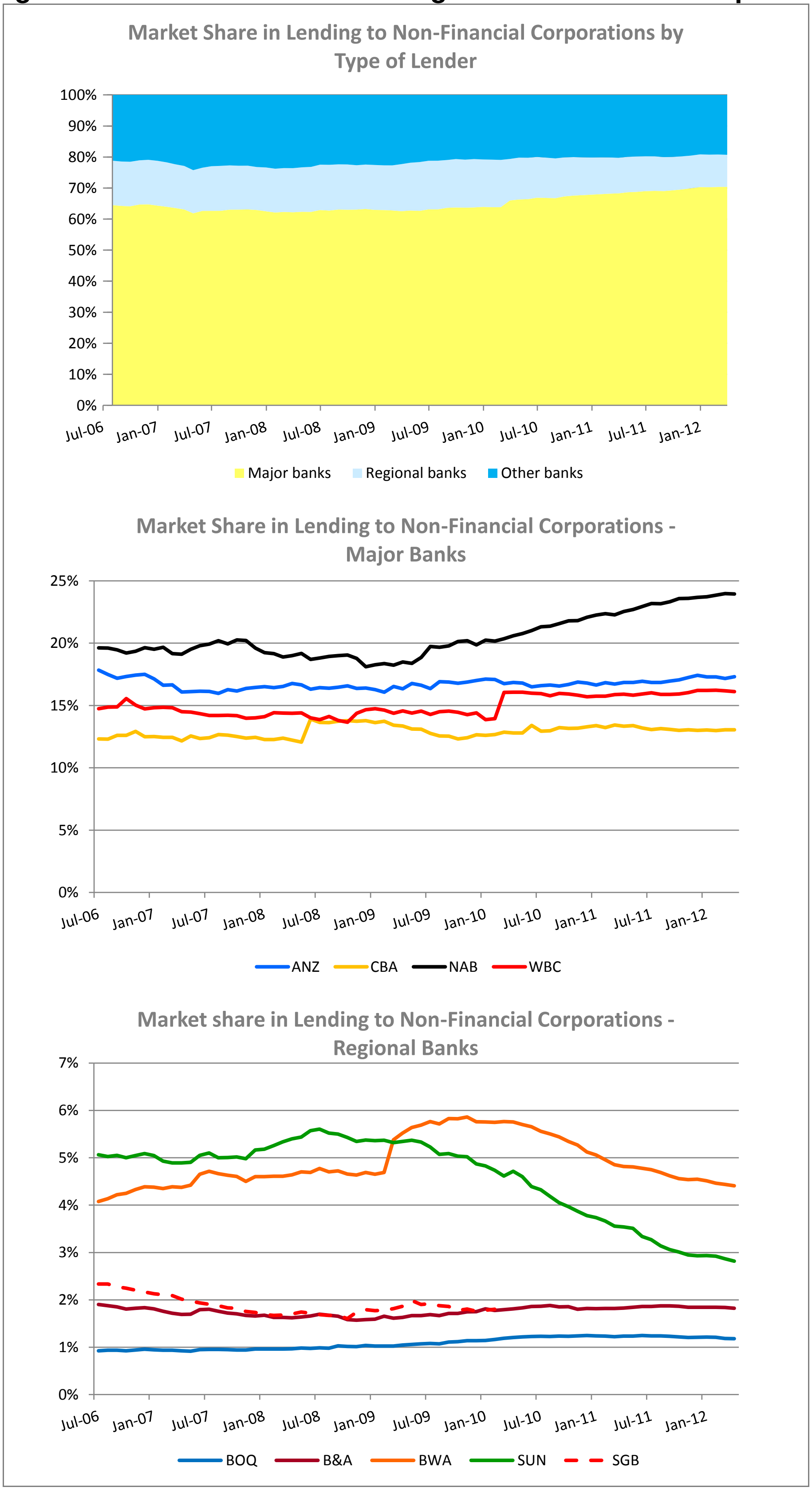
CBA notes that Treasury is considering, in consultation with industry, the case for extending simpler switching to business customer transaction accounts. The assessment includes consideration of the inherent greater complexities of the business segment and ensuring the impending simpler switching arrangements for personal customers are effective.

Business lending

The key change in market share in business lending is also the decline in market share of 'other banks' (ie foreign banks and smaller non regional banks, Figure 5). The reason is the same – the withdrawal from the Australian market or reduced participation. The effect is most pronounced in lending to financial corporations. However, unlike with business deposits, there is no sign yet of this group of lenders rebuilding their market share. That said, with the injection of funding some foreign banks have received via the European Central Bank's Long Term Refinancing Operations they *may* try to rebuild their presence in Australia; Asian banks are also looking to expand.

Some regional banks (namely Bankwest and Suncorp) have also reduced their market share in business lending (also Figure 5). These banks are in the process of improving the quality of their loan book.

Figure 5: Market Share in Lending to Non-Financial Corporations



Source: APRA
Note: includes banks only. Does not include lending finance through alternative means such as bills as this data is not reported by type of lender

CBA's acquisition of Bankwest

Some commentary leading up to this Inquiry has focused on the effect of banking mergers allowed during the GFC on the level of competition, such as the CBA Group's acquisition of Bankwest (completed in December 2008).

As noted in CBA's submission to this Committee's banking inquiry which was completed in 2011:

- the Australian Competition and Consumer Commission (ACCC) considered the merger and concluded it was "unlikely to substantially lessen competition" in the relevant markets;
- as part of the Treasurer's approval of the Bankwest acquisition (press release 18 December 2008), the CBA Group is required to meet a number of conditions that support "a strong and competitive Australian banking system" and, in particular, a requirement to maintain and grow the Bankwest brand; and
- if the CBA Group, or another institution, had not bought Bankwest the latter would almost certainly have collapsed and would not be in the market at all. This would have had a very negative impact on its customers, and created adverse perceptions of the entire Australian banking system.

CBA also notes one of this Committee's previous inquiries into banking concluded:

> "Were the crisis to lead to distressed banks in Australia, as it has overseas, there would be a stronger case for being more lenient towards takeovers. There is arguably no more reduction in competition from a bank being taken over than from it failing, and there are advantages in terms of financial stability and preserving jobs".[16]

There has also been some public speculation regarding the sale agreement CBA entered into to acquire Bankwest. This speculation is based on an erroneous understanding of the purchase price adjustment process and the alleged 'clawback' CBA received from Bankwest's former ultimate parent, HBOS plc (now Bank of Scotland). The facts are as follows.

- The sale agreement was entered into on 8 October 2008.
- Under the sale agreement, the actual acquisition date was 19 December 2008.
- The sale agreement set out a purchase price adjustment process, which is standard practice in this type of sale scenario. Under the purchase price mechanism, the initial price CBA paid for Bankwest could increase or decrease by reference to the financial accounts which were to be prepared for Bankwest as at 19 December 2008.
- As part of this process, the parties agreed HBOS Australia Pty Ltd (as seller of the Bankwest shares) would prepare draft financial accounts for Bankwest to reflect its financial position as at 19 December 2008. The headline values reflected in the draft accounts for Bankwest would, in part, be impacted by the

[16] Senate Economics References Committee Inquiry into Bank Mergers (reported September 2009) page 41.

level of provisions which HBOS Australia Pty Ltd allowed for when preparing them.

- Under the sale agreement, CBA would review the draft financial accounts and raise any issues with HBOS Australia Pty Ltd.
- If the parties could not agree the final accounts between themselves, the sale agreement provided for a final determination by an independent expert to assist them resolve any outstanding issues.
- Ultimately, the parties were unable to agree on a number of items, including that the level of individual provisions reflected in the 19 December 2008 accounts were appropriate in all cases.
- Ernst and Young was appointed as the independent expert to determine these disputed items. Ernst and Young's determination was final and binding.
- We are aware of speculation that HBOS plc paid CBA some $200 million as a result of the price adjustment process. This is not correct. The purchase price adjustment process was finalised by early July 2009 and resulted in a small increase in the purchase price for Bankwest.
- The price adjustment process was designed to achieve a 'zero sum' outcome. It could not, and did not, deliver any windfall gains. If the financial accounts finalised by Ernst and Young reflected an increase in value, CBA was to pay more and vice versa.
- CBA paid for the independently determined value it acquired in Bankwest, and Bankwest, under CBA ownership, has borne any losses it has subsequently incurred from loans that were not assessed to be impaired or in default as at 19 December 2008.

ToR (c) "The current cost of funds for lending purposes"

Key points:

- Funding costs for banks have increased very significantly since the commencement of the GFC, and by more than the increase in the SVR home loan rate relative to the RBA cash rate.
- Changes in lending rates (such as the SVR) cannot be looked at in isolation from changes in deposit rates - deposits are a crucial part of the overall funding mix and have increased the most in cost of all the different funding sources (eg term deposit rates are up to 100-150bp higher for customers relative to the RBA cash rate since mid 2007 and so a significantly more expensive source of funding for banks).
- CBA maintains a diversified funding programme to ensure maximum financial stability, preserve its funding flexibility and manage overall funding costs.

Since the commencement of the GFC the cost of funds for banks has increased significantly. The RBA's March 2012 Bulletin commentary on this issue notes that:

> "Over the past year, lending rates and funding costs have both fallen in absolute terms but have risen relative to the cash rate. The rise in funding costs, relative to the cash rate, reflects strong competition for deposits, particularly term deposits, and higher spreads on wholesale debt reflecting an increase in investors' concerns about the global banking industry. While spreads have narrowed recently, they are still noticeably higher than they have been over the past couple of years. Over the past six months, lending rates have generally fallen by more than funding costs."[17]

The elements that have caused the increase in funding costs for CBA include:

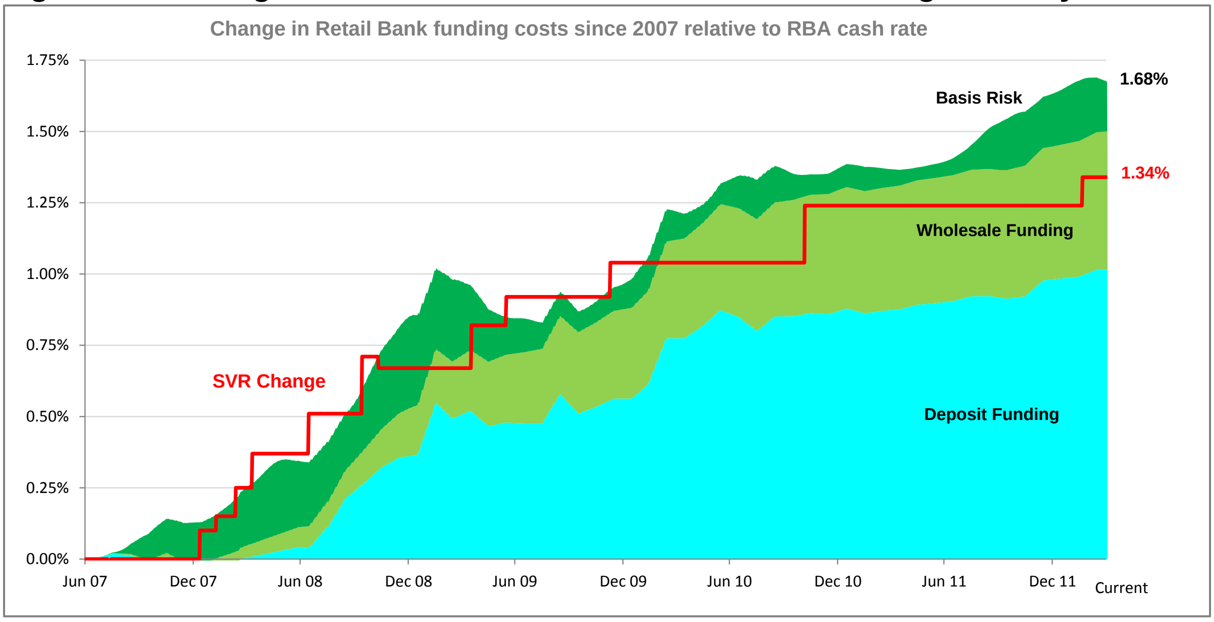
- **Wholesale funding:** since mid 2007, there has been a dramatic contraction in liquidity in domestic and international wholesale credit markets that has led to a significant increase in the costs of new bonds issued;
- **Deposit funding:** as banks have sought to reduce their reliance on wholesale funding, the competition for deposits has intensified. Banks have increased deposit rates and customers have migrated towards the deposit types that offer higher rates but are more costly to the banks;
- **Basis Risk:** is caused by the structural characteristics of Australian bank balance sheets. Australian bank balance sheets tend to have an excess of variable rate assets (such as SVR home loans) that are funded from fixed and floating rate funding (such as retail TDs and wholesale funding). The term basis risk refers to assets repricing with reference to one benchmark (Official Cash Rate) and funding repricing from another basis (fixed and floating rates). The cost of basis risk is the cost of interest rate hedging of this difference; and

[17] RBA Bulletin, March Quarter 2012, *Banks' Funding Costs and Lending Rates.*

- **Regulatory change:** Basel I and II were capital adequacy standards that did not materially impact funding costs. Basel III has important, new funding and liquidity standards that are raising funding costs via impacting funding mix and the financing of larger liquid asset requirements.

The cost of each of the first three elements is reflected in Figure 6 below. This chart shows how the cost of each of the sources has changed cumulatively since mid 2007. It shows that for CBA's Retail Bank, as at the end of March 2012, funding costs were 168 basis points (bps) higher relative to the RBA cash rate.

Figure 6: Funding costs in the Retail Bank have increased significantly

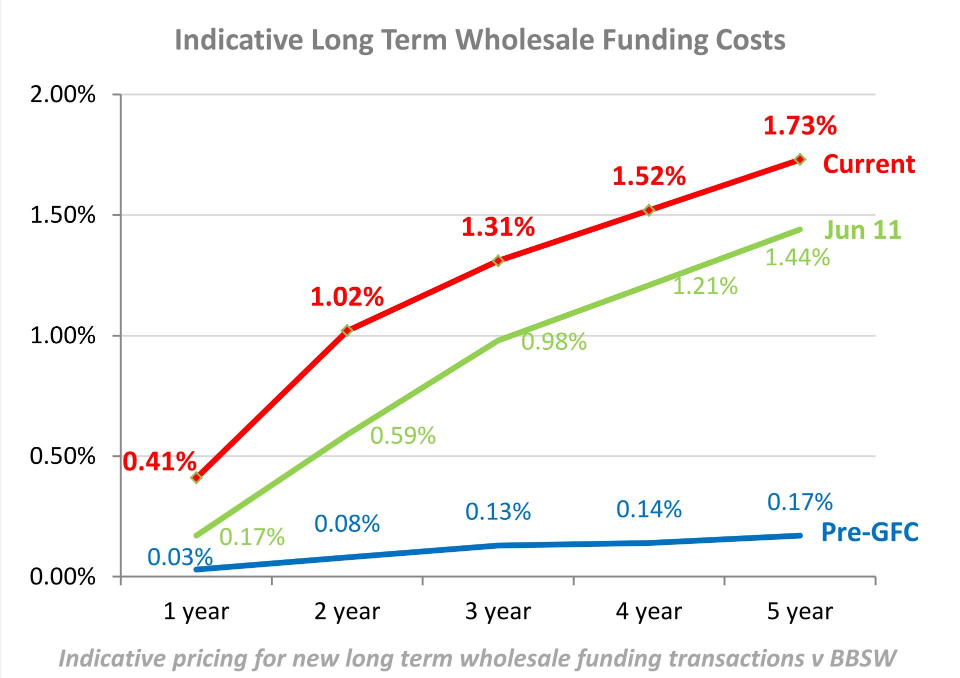


Source: CBA

Wholesale funding

In the past five years, wholesale credit markets have undergone probably the most dramatic transformation since the Great Depression in the 1930s. The cost of new bond issuance for CBA for various terms is summarised in the Figure 7 below, noting this chart shows wholesale funding is now more expensive than prior to the GFC for all terms.

Figure 7: Wholesale funding costs at all durations are higher

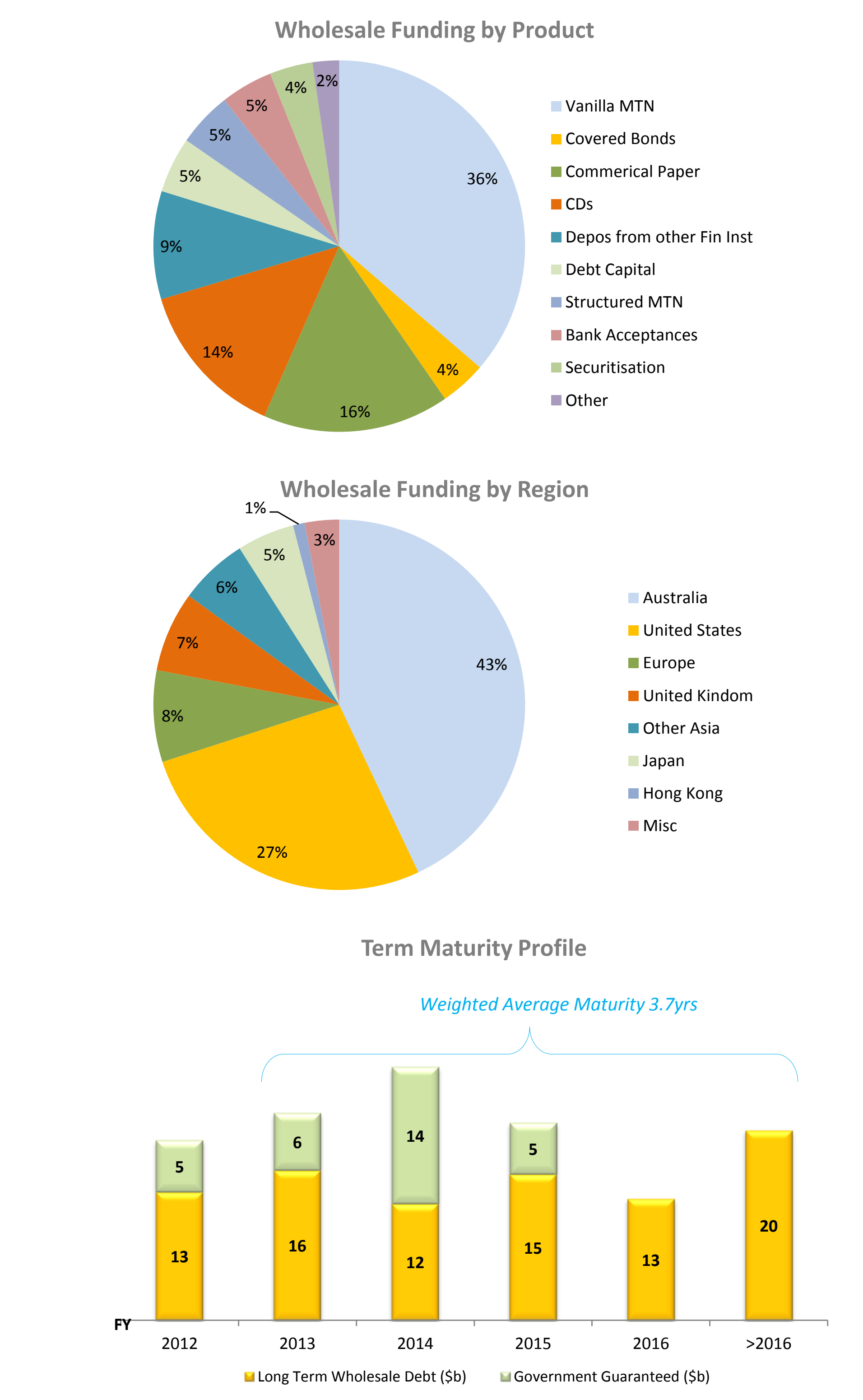


Source: CBA as at 30 May 2012

One of the most significant impacts of the GFC and particularly the more recent European Sovereign Crisis is that *bank* funding costs are now at levels in excess of some blue chip corporates. This is due to investors becoming saturated with bank names in their bond investment portfolios and also perceiving that bank bonds should command higher risk premiums than for some corporate borrowers due to regulatory uncertainty and a number of other factors (eg in the case of European banks hard to determine quality of lending books by investors).

CBA has invested heavily in a diversified wholesale funding programme. This programme is illustrated in Figure 8 below. CBA aims to diversify its wholesale funding through issuance across markets, geographies, currencies, terms, product and offering types, legal formats, time periods and maturities. This ensures maximum financial stability, preserves CBA's funding flexibility and allows CBA to maintain access to wholesale funding when certain markets become inaccessible or conditions deteriorate.

Figure 8: CBA's wholesale funding programme is diversified



Source: CBA

Covered bonds

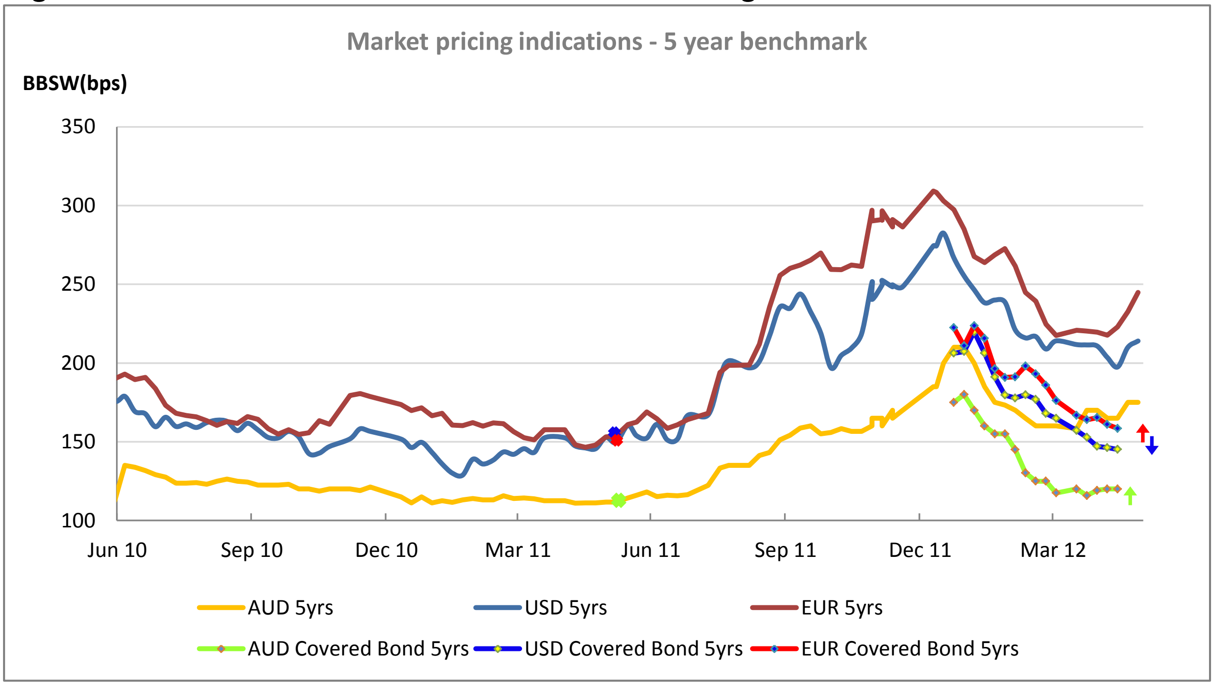
A key change in funding conditions since the previous inquiry's report is the commencement of Commonwealth legislation permitting Australian ADIs to issue covered bonds.

Covered bonds are wholesale funding instruments that carry a dual guarantee: firstly, repayment is guaranteed by the issuing ADI; and secondly, should the need arise, repayment is guaranteed by a separate ring-fenced pool of high quality assets that belong to the ADI. ADIs are restricted to issuing covered bonds up to 8% of their total Australian assets, which in the case of CBA would currently permit around 30% of total long term wholesale funding to be in covered bond format. Of that 30%, since the inception of the programme, CBA has issued $11b or 8.7% of total outstanding long term wholesale funding as at 31 May 2012.

The major banks are able to issue covered bonds that are rated AAA, compared with their ordinary vanilla bonds that are rated AA-. CBA estimates that AAA rated covered bonds issued by Australian banks would still cost around 200bps more to issue than the Commonwealth Government's AAA-rated bonds of similar term.

CBA's $11b of covered bonds issued has raised funds from Europe, US and Australia (out of a total fund raising of $27b completed to date in FY12). The cost of these funds has averaged 175bps above the Bank Bill Swap rate, which is around 30-40bps less than if covered bonds were not available. Note, however, that covered bond costs today are generally higher than senior unsecured funding costs twelve months ago prior to the introduction of covered bonds (Figure 9).

Figure 9: Covered bonds lower wholesale funding costs



Source: CBA

The advantages of covered bonds are several and inter-related.

- They can attract a new category of investor that CBA could not access through pre-existing borrowing programmes due to the increased credit rating of covered bonds and the popularity of the covered bond format amongst certain types of investors.

- They enable banks to borrow for longer terms than conventional wholesale funding as investors are more willing to take on longer term risk in a secured asset.
- They provide greater funding access in periods of heightened market uncertainty.
- They reduce the overall cost of funding for CBA relative to issuing only senior unsecured debt.

CBA welcomes the timely allowance of covered bonds as a material improvement to the regulatory landscape of the Australian banking system which will deliver enduring benefits.

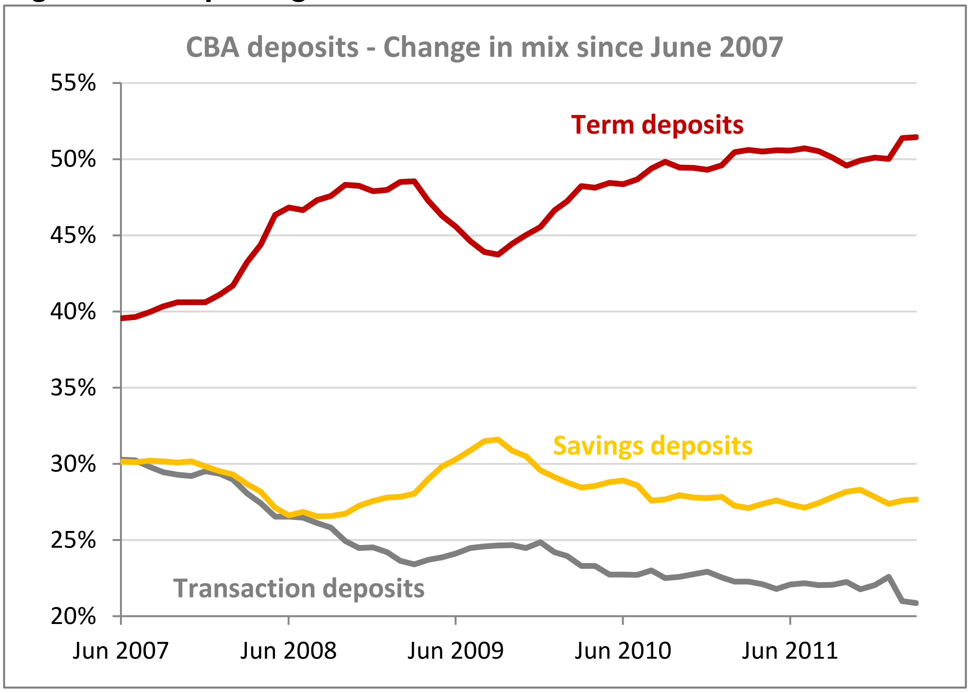
Deposit Funding

The component that has contributed most to the increase to overall funding costs is deposit funding. For CBA's Retail Bank, the cost of deposits has increased by 1.63 percentage points since mid 2007 above changes in the RBA cash rate (and this contributes 62% of total funding for the Retail Bank).

The increase in cost reflects many factors, including:

- increased competitive pressures (compared with pre-GFC) as all banks have sought to increase the proportion of deposit funding; and
- increasingly sophisticated customers who actively shop around and manage their deposit balances, often between a number of different banks, to ensure a greater share of their funds are in higher paying types of accounts. As highlighted by Figure 10, TDs have grown significantly in importance as a source of deposit funding compared with lower yielding transaction accounts, which have decreased noticeably.

Figure 10: Deposit growth has been in TDs

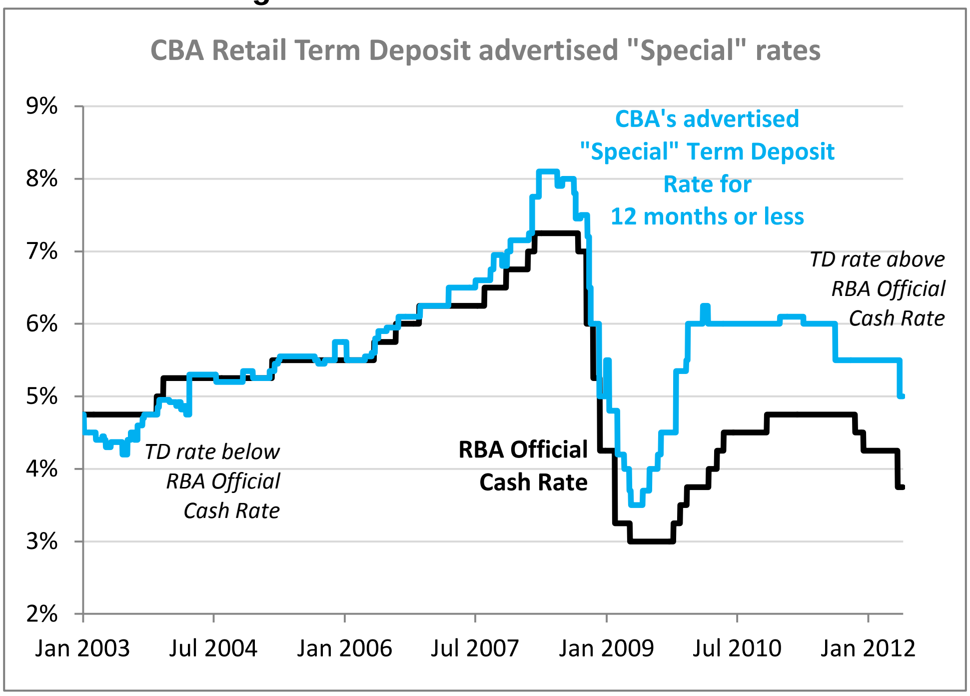


Source: CBA

Moreover, not only have depositors benefited from higher interest rates since the commencement of the GFC, there has also been improved functionality on many deposit products (eg 24/7 account access and enhanced capacity to sweep funds between accounts to ensure the customer earns maximum interest rates and more of the higher paying accounts being at call).

Figure 11 illustrates the advertised headline or “special” TD rate offered for the most popular term deposits by the CBA Retail Bank. This is an iconic interest rate that is applied to the TDs of nearly 1 million individual customers. This is the advertised rate and TD rates specifically tailored to individual customers are also available from time to time. TD rates before GFC were typically just below the Official Cash Rate. In recent times TD rates have typically been 100-150bps above the Official Cash Rate. It may be of interest to the Committee to note that the cost of TD funding for CBA has increased by a very similar amount to the increases announced to the SVR mortgage.

Figure 11: TDs have become a significantly more expensive source of funding



Source: Cannex, CBA

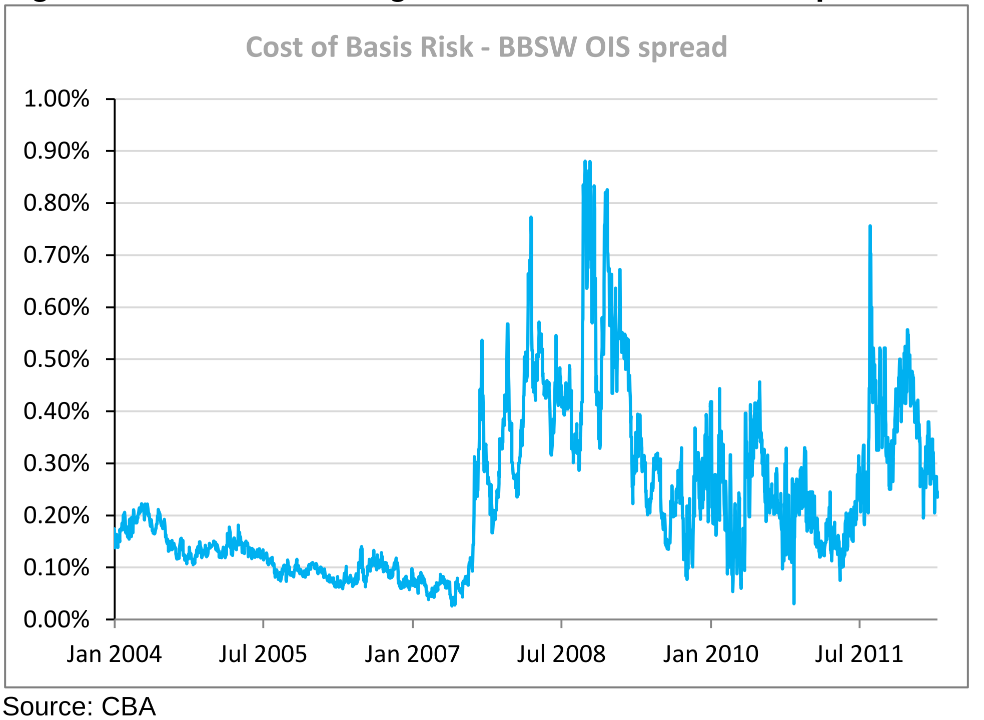
As noted in CBA’s submission to this Committee last year, competition in the deposit market is likely to remain structurally higher than prior to the commencement of the GFC. One of the lessons from the GFC so far is that banks that rely upon the deposit market for a significant proportion of their funding are generally safer than banks that source a high proportion of their funding from the capital markets, particularly short-term wholesale funding markets, including securitisation.

Basis Risk

Basis risk is caused by structural features of Australian bank balance sheets. Australian bank customers have a strong preference for variable rate mortgages and loans, and in aggregate deposit far lower balances into variable rate deposit accounts. This pattern leaves a structural deficit where assets and liabilities are priced relative to different benchmarks. For example, currently around 85% of CBA's home loan borrowers have elected to pay a variable rate, in preference to a fixed rate home loan. CBA has approximately $150b excess of variable rate lending over variable rate deposits.

The benchmark that is used to price TDs and wholesale funding is called the Bank Bill Swap (BBSW) rate. This is the market rate, for say 90 days, used by banks to lend and borrow from one another in wholesale markets. The BBSW rate is also the rate that is used as a reference rate for all wholesale funding, including long term bond issuance in the domestic market and in foreign currencies reflecting the use of currency swaps to convert non-AUD funding into AUD funding. The cost of hedging the expected RBA Official Cash Rate to the 90 day BBSW rate is shown in Figure 12. It is evident that this spread has increased from a relatively stable 10-20bp prior to the GFC to a much more volatile cost with spikes well above 50bp since late 2007. This represents an additional cost to mortgage and cash-funded lending by CBA.

Figure 12: Basis risk is higher and more volatile than pre-GFC



Source: CBA

Regulatory Change

Basel I and Basel II were international bank regulatory standards that dealt primarily with capital adequacy. These standards sought to define how much capital banks needed to survive losses.

As noted in the discussion responding to the term of reference (a), the Basel III standards are a response to the GFC. The rules require capital levels to be increased substantially but, importantly, in addition there are increases in funding and liquidity minimum requirements (with consequential costs). Deficiencies in funding and liquidity caused insolvencies of major banks and financial institutions. In particular, prior to 2007 many organisations sought to maximise profits by increasing their funding and liquidity risks. For example, Northern Rock Bank in the UK became insolvent in August 2007 (more than a year before Lehman Brothers) with a regulatory capital ratio of 9.74%, which was satisfactory under Basel II.

The important point to note about Basel III is that the liquidity requirement changes in particular will significantly increase funding costs. Both the LCR and NSFR require significantly more (lower yielding) liquid assets, far more (expensive) long term stable funding and stable and diversified deposits, and less (cheaper) short term wholesale funding and short term concentrated deposits. All of the characteristics of the new LCR and NSFR rules will serve to increase the safety of banks but will also increase costs.

Flow through to loan and deposit pricing

While the Inquiry's terms of reference only refer to the flow through of the cost of funds to lending, the discussion above about CBA's mix of funding sources highlights that CBA cannot look at prices for lending purposes in isolation from prices for deposit purposes.

Individual product pricing, whether it is on the lending or deposit side, is a complex balancing decision. Factors considered include: the cost of funds (to fund a loan) or worth of funds (in the case of a deposit which can then be used, in part, to lend out); our assessment of the risk of the product and customer; and CBA's competitive and strategic positioning in that particular product or type of customer.

As a general comment, CBA takes a whole of relationship view of pricing for our customers. The most prominent example of this is that the headline Standard Variable Rate (SVR) for home loans is paid by a minority of customers. The majority of customers take out a Home Loan Package (which involves an annual fee) and receive a significant discount off the SVR as well as benefits on other products they choose to take up (eg fee waivers on a transaction account)[18].

There is a misconception amongst some commentators that there is, and there should be, a one-for-one relationship between changes in the RBA cash rate target and specific product rates, especially the SVR home loan. This misconception persists despite the best efforts of this Committee in its Inquiry last year, the RBA and the banking industry to explain that there is not a one-for-one relationship between the cash rate and the SVR. The simple reason why there cannot be such a relationship is that funding costs, one of the major drivers of product pricing, has not moved one-for-one with the RBA cash rate. As noted earlier CBA's Retail Bank funding costs have increased by 168bps outside of changes in the RBA cash rate

[18] As an aside, this is one reason why comparing CBA's SVR to a credit union's SVR is misleading – credit unions do not typically offer package discounts.

between end June 2007 and end March 2012. Looking at the funding cost for CBA's Retail Bank home loan book of nearly $270b, this translates to $4.5b p.a. in higher funding costs. So lending rates, including the SVR home loan rate as highlighted by this example, have had to increase relative to the RBA cash rate.

CBA takes pricing decisions very carefully and is cognisant of its important role and position in Australian society. This is why, since the commencement of the GFC, CBA has absorbed some of the increase in funding costs. Importantly, at some points in time, the profitability of some products (including SVR home loans and TDs) has been very finely balanced and even negative. Yet extended periods of negative profitability cannot be sustained for any length of time by any type of business, including by banks.

Furthermore, as the RBA has stated on numerous occasions it takes into account its expectations for what banks will do with lending rates into the RBA Board's decisions on the appropriate level of the cash rate target. As this Committee itself has previously concluded "if the banks increase their loan rates by more than the Reserve Bank's adjustment to its cash rate, it does not mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target."[19] (And, of course, this logic also applies in a decreasing rate environment.)

Pricing of business products is even more complex and CBA refers the Committee to its most recent submission on this specific issue (to the Parliamentary Joint Committee on Corporations and Financial Services, which reported in April 2011). CBA notes that the Committee did not raise any major concerns with banking industry practices.

A final misconception CBA wishes to address is the belief expressed by some commentators that if wholesale funding costs decrease for a period of time this should be passed on in full to lending rates. CBA's weighted average maturity of term funding is 3.7 years (and the effect of the GFC has been to increase the average tenure). Therefore, when the cost of new funding changes (the marginal cost) it impacts only a small proportion of CBA's overall funding cost (and assuming funds are raised at that point in time). CBA will, and does, reduce lending rates as we become confident those lower funding costs will be sustained for a meaningful period of time. Further, there is still funding maturing in CBA's portfolio that was sourced prior to the GFC and needs to be replaced with more expensive post-GFC funding. As a result, the average cost of wholesale funds continues to increase and will for some period of time.

[19] Senate Economics References Committee: Inquiry into Competition within the Australian banking sector (reported May 2011) (page xvii).

ToR (d) “The impact on borrowing and lending practices in the banking sector both during and since the global financial crisis”

Key points:

- CBA has not changed the broad criteria it assesses loans against as a result of the GFC; nor has CBA ceased lending or rationed credit.
- But as a result of changes in the economic environment and the consequential impact on the financial performance and position of some individuals and businesses, some of these individuals and businesses have experienced difficulty meeting normal (unchanged) criteria.
- CBA has very considered and fair processes for handling customer hardship.

Lending policies and practices

In general terms, CBA assesses loan applications for mortgages and other retail/personal loans against four criteria. This has been CBA’s longstanding practice and has not been impacted by the GFC. The four criteria are:

- The <u>character and conduct</u> of the borrower - eg, their history in repaying debts, saving, income, own commitment of equity to the financing of the asset;
- The <u>capacity</u> of the borrower to repay (or service) the loan – eg, an assessment that the repayment schedule is manageable on the borrower’s income and other obligations and taking into account the stability or volatility of that income;
- The <u>conditions</u> of the loan – eg, the repayment schedule, the pricing (interest and fees), other conditions (such as valuations or covenants on activities which will or will not be undertaken to protect the value of the asset); and
- The <u>collateral</u> (or security) of the borrower – eg what is it, and whether it is acceptable to CBA.

For business lending, consideration is also given to capital, the amount of equity the shareholders have in the business, and their capacity to provide further equity.

At no point since the commencement of the GFC has CBA ceased lending or rationed credit.

During this period, CBA has:

- changed the maximum loan-to-valuation ratio allowed on residentially secured mortgages from time to time;
- increased the risk margins on business loans, which are widely acknowledged to have become unsustainably low before the commencement of the GFC;
- increased/reduced limits (appetite) for some types of counterparties and credit exposures; and
- set caps on concentrations to certain industry sectors.

The economic environment since the commencement of the GFC has adversely impacted the financial profile and flexibility of many enterprises, as well as some individuals. As a result, these enterprises and individuals have found it increasingly difficult to meet normal (unchanged) criteria relating to maintaining existing debt facilities or loans. Since the commencement of the GFC there has been a reduction in second tier lenders who would ordinarily consider these enterprises and individuals a suitable refinance proposition. In some cases this has resulted in overall borrowing increases (both working capital and term debt in the case of enterprises) from larger lenders such as the CBA. Normally, however, this is only if the borrower has shown a continued ability to meet commitments and/or pledged additional collateral. In the main, the aggregate debt offered to borrowers of a stable credit profile would have remained the same over the GFC, but many borrowers with stable credit profiles would have reduced their indebtedness based on their more conservative settings for leverage.

Hardship and loan work outs

A small proportion of customers do experience financial difficulty, or hardship. This can be due to a range of factors – including some macro (eg high AUD, natural disasters) and some micro (eg unemployment, family breakdown, loss of a key revenue earning contract, fraud).

When a customer is identified as experiencing some form of financial difficulty, CBA's standard practice is to assess, with the customer, whether the debt can be restructured/repaid in a mutually satisfactory manner, having regard for the specific circumstances. Where this is not possible, CBA will follow the usual procedures for troublesome or impaired assets.

In the event that CBA does proceed to exercise its rights to sell security property or has a Receiver sell the property, CBA or the Receiver would be legally obliged to act in good faith when selling the property, in accordance with current codes and laws.

In particular, where borrowers are companies, the Corporations Act (Section 420A) requires a Receiver to take reasonable care to sell the secured property for its market value (where a market value exists) or otherwise the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold. Similar provisions exist in some States in relation to the sale of individual borrowers homes (eg see Section 111A Conveyancing Act, New South Wales and Section 85 Property Law Act, Queensland).

Whenever CBA (or a Receiver appointed by CBA) exercises its power of sale, valuers and agents with the appropriate experience would be engaged to advise on the advertising and sale process as well as provide indications of the value of the property to be sold.

Commercial Valuations

In the lead up to this Inquiry there has been some commentary regarding the valuation practices banks use for commercial lending.

CBA has a panel of independent valuers that it uses for all CBA initiated valuations.

To be approved as a CBA appointed valuer, the valuer must be a registered valuer with the Department of Fair Trading or similar state based association as well as holding Associate membership of the Australian Property Institute.

All CBA initiated valuation reports are required to be signed by a valuer that holds a minimum of five years' experience within that area of property valuation.

All CBA initiated valuations go to firms that are nominated annually by CBA to its panel and monitored by our Risk Management Property Consultancy team (RMPC). These firms are to abide by the standards and requirements set out in our letter of appointment which is signed by the Director and/or nominated person of that firm along with the standards and requirements of Australian Property Institute. Where the quantum of the valuation is in excess of $1m CBA requires the report to be countersigned by the Valuation Director of that firm.

An acceptance of any instruction to value real property for CBA acknowledges that the valuer has no interest in or association with our client or the property to be valued, either directly or indirectly.

All firms are required to hold a minimum level of Personal Indemnity Insurance coverage of not less than $2m to maintain their position on the panel.

The benefit of the use of a real property/business valuation panel is that:

- CBA will use valuers who are well regarded in terms of skills and professionalism, which means less risk to CBA;
- the valuers carry adequate professional indemnity insurance for the benefit of both CBA and the customer; and
- the scope and engagement of valuation assignments is consistent across the portfolios and in relation to the valuation of a customer's security over time.

CBA will also accept valuations initiated by customers from other valuation firms so long as such valuations are acceptable to CBA, are addressed in favour of CBA and have been reviewed by our RMPC division.

Valuations of an asset relate to a specific point in time and can cover a range of outcomes. These outcomes are restricted in their terms of reference by CBA, but also the valuation firms and their insurance coverage.

Since the commencement of the GFC, CBA has tightened up its appointment terms and the number of valuers on its nominated panel. For valuations above $7.5m in value the valuations must now be carried out by a specifically nominated valuer within each firm as per the letter of appointment provided by CBA to the individual firms. This variation has resulted in a reduced number of valuers being appointed to CBA's panel – these nominated valuers are appointed and monitored by our RMPC division and can be removed or appointed as seen fit by this division.

This is a variation from our previous policy which nominated whole firms to the panel. It is considered that the individual appointments will provide for a greater level of accountability and certainty in skill levels and experience in the valuation process.

Below the threshold of $7.5m, there has been no change in CBA's policy during or as a result of the GFC.

ToR (e) "The need for further consideration of the state of the broader finance and banking sector"

Key points:

- Much of the public discussion about banking in Australia boils down to an assessment of the profitability of the sector.
- The facts show, contrary to popular opinion, that the sector is not earning unusually high profits relative to other large Australian listed companies or overseas banks or compared with pre-GFC levels. Also, the Net Interest Margin in the Retail Bank in particular is well below pre-GFC levels.
- CBA shares the benefits of its profitability with many stakeholders – government (taxes and fees totalling over $10b since the GFC first impacted the Australian economy), shareholders (dividends totalling over $18b in that time frame), employees (non-tax staff expenses totalling over $18b in that time frame and ensuring over 33,000 permanent Australian jobs), providers and suppliers (payments totalling over $17b in that time frame) and the community (various programs). The contribution of bank profits to Government revenues is rarely acknowledged.

Australian bank profitability is not excessive

The magnitude of bank profits is often taken out of context with little regard for the size of the institution, the amount of assets deployed to generate income and the volume of transactions. CBA competes for equity against other listed companies from within and outside the banking sector. Return on Equity (ROE) and Return on Assets (ROA) are market-recognised measures of profitability.

While CBA is one of the largest Australian companies on the Australian Stock Exchange (ASX) the fact is that it is far from being the most profitable measured on a ROE or ROA basis. Notwithstanding, and reflecting CBA's relative size, CBA ranks very highly for taxes paid and dividends declared (Table 1).

Table1: CBA ranking against ASX100 for profitability

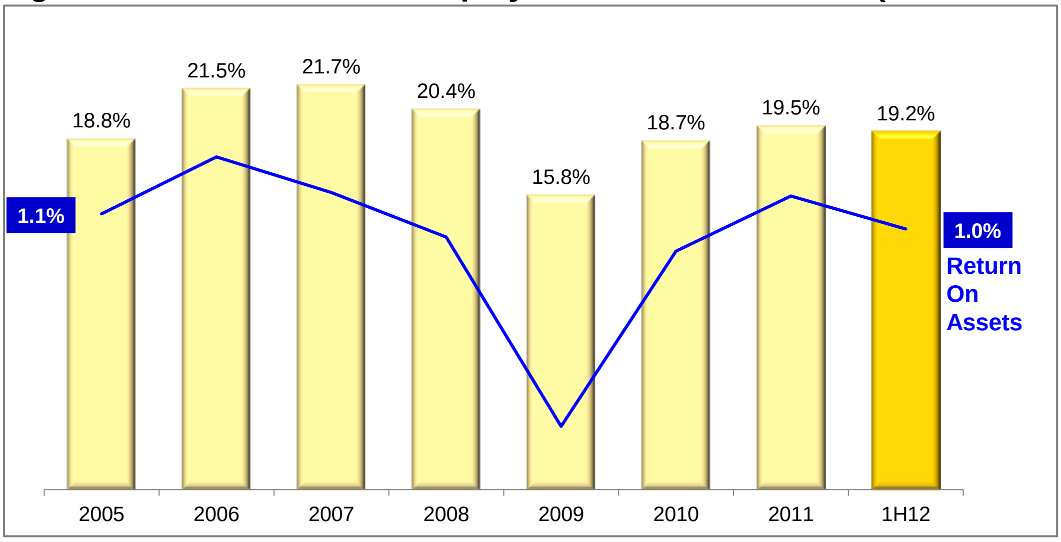
	CBA Rank[1]
Market Capitalisation (ASX)	2nd
Return on Equity (ROE)	34th
Return on Assets (ROA)	80th
Dividends Declared	2nd
Taxes Paid	3rd

Source: Bloomberg 18 May 2012
Notes: 1. Most recent annual results data amongst ASX 100 companies

Another important fact sometimes missed in the profitability debate is that banks need to earn profits in excess of their cost of capital so that they can build up a buffer of equity which can be called upon, if necessary, in difficult times. If there is no buffer, the institution is more likely to fail in the first downturn. Banking is a cyclical and highly leveraged industry so that buffer must be significant. Profits earned today are also helping make the transition for banks to the higher capital and liquidity requirements of Basel III outlined in the response to terms of reference (a) in this submission.

Another fact is that neither CBA's current ROE nor ROA is back at pre-GFC levels (Figure 13).

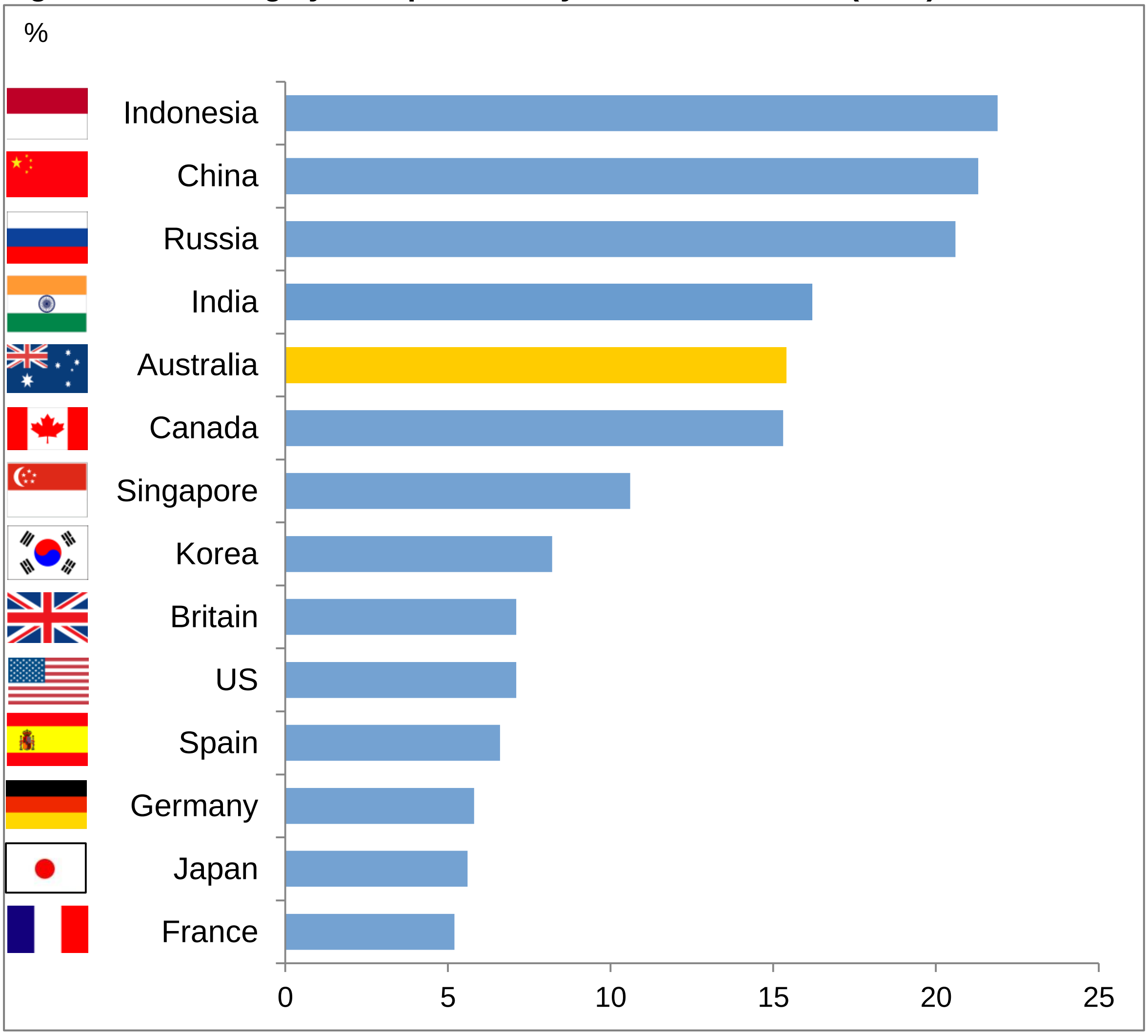
Figure 13: CBA's Return on Equity and Return on Assets (cash earnings)



Source: CBA

Another fact is that while Australia's banking system ranks well by international standards for profitability, it falls far short of the top performing international systems (Figure 14). Indonesia, China, Russia and India all have more profitable banking systems (and these are large and fast growing systems so should not be dismissed as insignificant) when measured on a ROE basis. Australia ranks similarly to Canada for system ROE. This is not surprising given the similarities between the systems. Also not surprisingly, the Australian system ranks ahead of the US and many European systems given Australian banks have not be weighed down by high levels of loan write-downs as has occurred in those countries. CBA notes that banking system ROEs in the US and some of those European countries in the period preceding the GFC were similar to the Australian banking system current ROE.

Figure 14: Banking system profitability around the world (ROE)



Source: Factset. Weighted average for listed banks in each country. ROEs weighted by shareholders' equity. Data as at 18 May 2012

Another fact is ongoing profitability is an important component in maintaining CBA's high credit rating. Rating agencies wish to see sustainable and appropriate profit levels of highly rated banks. Higher ratings enable CBA and the other Australian major banks to source more diverse and cost-effective sources of funds. Because Australian banks have such a relatively large wholesale borrowing requirement compared with their peer international bank group, their high credit rating is crucial to enable that size of borrowings to be completed at the costs which have been paid. [20]

Some commentators also look at the net interest margin (NIM) as a measure of profitability. Bank NIMs are defined as the difference between the average interest rate earned on assets minus the average interest rate paid on borrowings plus the

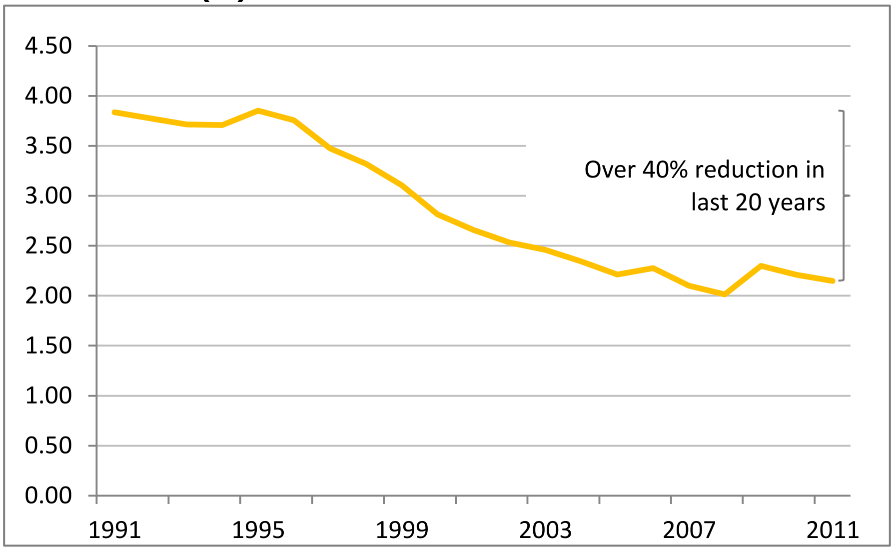
[20] Standard & Poor's states in its recent Bank Rating Methodology and Assumptions report that "... the criteria assess the quality of capital and earnings by looking at the composition of, and trend, in TAC [total adjusted capital], and the stability and predictability of earnings. When the projected RAC [risk adjusted capital] ratio is at the upper end of a scoring range, high-quality capital can push the capital and earnings assessment into a stronger category. Conversely, when the projected RAC ratio is at the lower end of a range, weaker capital or earnings can push the assessment into a weaker category", 9 November 2011.

benefit of interest free liabilities, provisions and equity. NIMs are therefore one of the key drivers of profitability, although not the only driver. The fact is bank NIMs do not:

- abstract from the effects of the higher levels of capital banks have deliberately held so as to increase their safety (the effect of higher capital is to inflate the NIMs reported);
- nor adjust for the underpricing of risk in the period immediately preceding the commencement of the GFC which makes that a misleading reference point. Indeed the underpricing of risk (small margins) globally was one of the causes of the GFC.

For all of these reasons, comparing Australian banking NIMs today to NIMs pre-GFC is a misleading measure of changes in bank profitability. Nevertheless, the important fact with NIMs is they have been on a long-term downward trend. From a broader perspective, the banking sector NIM is around 50bp below the levels prevalent at the start of the last decade, and even more so over a longer time horizon (Figure 15).

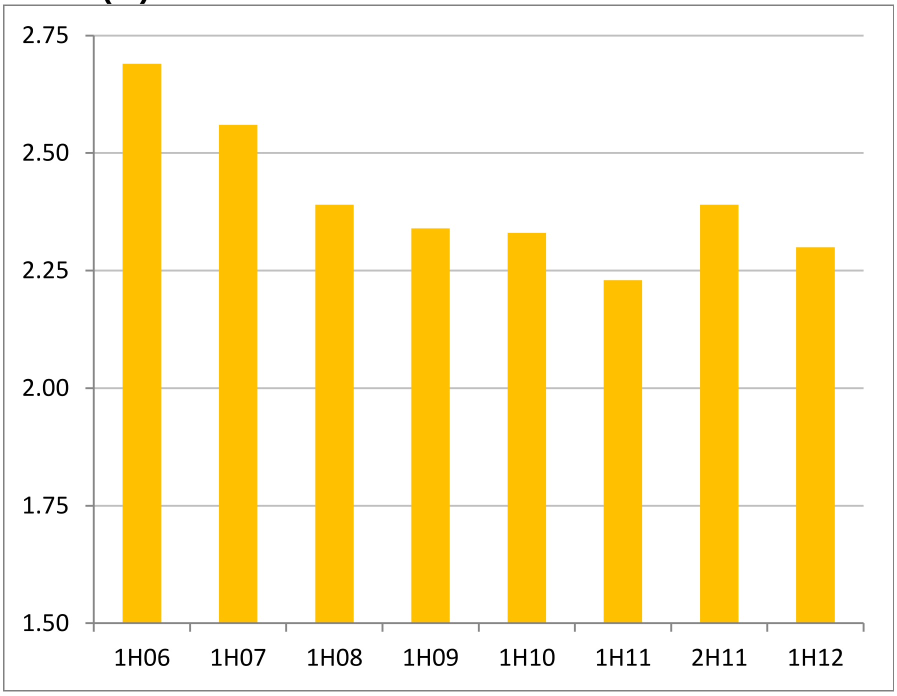
Figure 15: Australian banking sector NIMs have been in long term decline (%)



Source: Bloomberg, CBA
Note: Individual bank NIMs reported in Bloomberg may differ from those reported by the individual banks but the calculation of NIM is consistent across all the banks and through time

For CBA, the Retail Bank NIM is well below pre-GFC levels (Figure 16). So notwithstanding the out of cycle interest rate changes CBA has made to its SVR home loans and that it is holding greater capital, CBA is earning a lower NIM now than previously.

Figure 16: CBA's Retail Bank NIM is well below pre-GFC levels (%)



Source: CBA

The benefits of a profitable bank are shared widely

CBA's strong performance has benefited many stakeholders.

CBA has delivered a strong and consistent income stream to the Commonwealth and State and Territory governments over many years. For the year to 30 June 2011 (the most recent full financial year) CBA will have paid over $2.5b in Australian tax (including over $2.3b to the Commonwealth Government which goes directly to helping balance the Budget). CBA has paid over $10b in Australian taxes in the four and a half years since the GFC first impacted (that is, in the period beginning 1 July 2007 through to 31 December 2011). CBA is the third highest tax paying company in the ASX100.

An often overlooked fact is that CBA has also paid the Commonwealth Government over $600m in fees for the use of the Government Guarantee on wholesale borrowings since that guarantee was introduced in late 2008 as a necessary measure to ensure credit continued to flow to the Australian economy. CBA estimates it will pay a further approximately $300m to the Commonwealth Government over the remaining life of the borrowings that were guaranteed at the time and have yet to mature. No cost has been imposed on the Australian taxpayer by virtue of the operation of the Government Guarantee.

CBA's shareholder base is very large and diverse – it includes 800,000 shareholders (individuals and institutions, including superannuation funds), 83% of which are Australian. Many Australians share in CBA's profitability either directly through their own investments or indirectly through their superannuation funds. Dividends paid out (cash and reinvested) in the four and half years since the GFC first impacted (that is, in the period beginning 1 July 2007 through to 31 December 2011) amount to over $18.5b with an average payout ratio in excess of 70% (ie on average more than 70% of after-tax earnings have been paid out in dividends). By any measure this is a very substantial stimulus to the economy.

CBA has remained a strong employer. CBA today employs over 33,000 permanent employees in jobs in Australia (this excludes people employed by Bankwest), which is nearly 1,000 more jobs than it was pre-GFC. During these globally turbulent times, CBA has committed to not offshoring jobs and to avoid major redundancies.

CBA also engages a wide range of providers and suppliers. Expenses paid out to providers and suppliers in the four and half years since the GFC first impacted (that is, in the period beginning 1 July 2007 through to 31 December 2011) total over $17b. This is spread widely across the economy, and includes expenses for goods and services such as property and equipment leasing, IT and related, fees and commissions, including for professional services, and marketing.

Finally, CBA is committed to the Australian community. CBA focuses on supporting the things that our customers and our staff regard as important including: Indigenous reconciliation; teaching financial literacy to more than 200,000 school and TAFE students each year; providing grants to organisations that support the health and wellbeing of children; providing our volunteering skills to community organisations; and sponsoring a range of sport, arts and social welfare initiatives. CBA's staff are enormously proud of the work done by the Staff Community Fund which commenced in 1917 and has been supporting the health and wellbeing of Australian children ever since.

ToR (f) “Any other relevant matters”

Key points:

- Best-practice Regulation Impact Analyses should be conducted for any reform proposals to ensure those proposals do indeed deliver net benefits to the Australian public.
- Policy and law makers should not underestimate staff training and IT system changes as practical constraints to implementing change.
- Implementation costs should not be dismissed as one-offs, especially in an environment of frequent and extensive change as has existed since the commencement of the GFC and is forecast to persist for a while yet based on already known reforms.

As the Committee develops its views and conclusions CBA urges it to be cognisant of:

- the very high regulatory workload already in place for the sector as a result of both domestic and international reform initiatives and the importance of effective cooperation between national regulators and international agencies;
- the fact that the effects of that existing regulatory workload will not be known for many years so it is an ever changing landscape for all stakeholders;
- the competitiveness of the sector and absence of any major market failures; and
- the level of preparation and complexity involved in introducing new reforms in large scale businesses (further details are provided below).

In the event the Committee recommends further regulatory reform to the Australian banking sector, CBA highlights the important role that Regulatory Impact Analysis (RIA) processes have in developing good quality policies which ultimately generate a net benefit for the community. CBA is concerned that the Council of Australian Governments’ (COAG’s) best-practice principles for regulation making have not been sufficiently addressed in many of the proposals and regulations introduced into the financial services sector.

CBA emphasises in particular the following principles for ‘good’ regulation.

1. The proposed regulation does in fact address a real problem and not a perceived problem (which may be based on anecdotal information).
2. The proposed regulation is the most effective of all options for addressing the problem and is proportionate to the problem.
3. Stakeholders are allowed sufficient time to consult on the proposals.
    - Shortcomings in consultation, and industry engagement more generally, has, for example, been identified as an area for improvement in Treasury’s recent Strategic Review[21] and various reviews undertaken by the Productivity Commission.
4. The proposed regulation takes into account the practical constraints faced by the sector in implementing change.

[21] Published in December 2011.

For CBA the two major practical constraints to implementing change are often staff training and IT system changes. These constraints should not be underestimated. CBA takes the proper implementation of the regulatory reforms very seriously given that non-compliance could disrupt the normal course of business for our customers and can often mean civil or criminal penalties for staff and/or for CBA.

In relation to **staff training**, CBA's Retail Bank, for example, has over 14,000 frontline staff (as well back office and support staff who may also need to be trained) which necessitates detailed change management planning. CBA needs to consider impacts to different sales channels (eg branch, call centre, on line, mobile bankers etc) and training techniques for those different staff so that they understand the change and the resulting changes to their processes, policies and procedures. Design phase of in-house training can therefore only commence once all impacts to all processes, policies and procedures are fully scoped and understood, and this can only occur when regulations (and regulator guidance, where required) are finalised. Design phase can take some months if the change is complex.

In relation to **IT system changes**, there are only a limited number of changes CBA can make every year to the IT environments, driven primarily by the contention for resources. Exceeding this threshold increases the risk of IT systems failures that may directly impact our customers. In order to accommodate any increase in compliance and regulatory related projects, CBA would have to reduce the projects that add value to our customers such as improving services or introducing new products. In order to manage risk, portfolio planning is undertaken a year in advance. Defining the requirements for all systems impacted, which then help design the change, can take between three to six months depending on the number of systems impacted by the change. In some cases systems for external parties and integration between them also needs to be taken into consideration (eg third party mortgage broker systems). As noted for staff training, it is critical that the legislation and any related regulations and guidance are clear so that the change is implemented correctly.

Implementation start dates are also extremely important. CBA takes interruptions to regular services seriously and therefore has change freezes for IT related changes during expected peak processing periods such as end of financial year and end of the calendar year. Any regulatory changes that come into effect at the same time (1 July or 1 January) will further add to the complexity of having to implement, test and be ready ahead of the IT change freeze timeframes. These dates are also challenging for staff training given the higher than usual absences around Christmas/New Year and higher than usual workload to assist customers with end of financial year inquiries. As a result, staff training may have to occur well in advance of the actual launch date, which can lead to difficulties with ensuring that the training is effective and reaches all staff employed in affected roles at the change date. There is a likely need for further training post implementation.

CBA supports the **ABA's implementation project template** in introducing new regulations.

5. Finally, taking into account the above points, an assessment is made that implementation of the proposed regulation is in the net public benefit (ie the net present value of benefits exceeds costs taking account the foreseeable potential risks[22]).

   Importantly, the cost-benefit assessment should factor in implementation costs and the ongoing compliance costs such as licence management, monitoring and supervision. Regulation Impact Statements usually do not take these costs into account despite these costs being a real impost on the banking sector and its customers. Moreover, in times of high change, such as the past few years and the next few years, the concept of implementation costs being 'one-off' does not match the reality; banks have been incurring, and will continue to incur, significantly higher than usual compliance and implementation costs outside of 'business as usual' costs.

[22] For example, if the net benefit of a reform is only marginally positive but there is a non-trivial negative risk to system stability then it is questionable whether the reform should proceed.