Submission to the

SENATE ECONOMICS REFERENCES COMMITTEE

INQUIRY INTO THE POST-GFC BANKING SECTOR

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Introduction

The Secretary of the Senate Economics References Committee on Inquiry into the post-GFC banking advised that the Committee is interested in having a submission from me on the following issues before the committee:

1. the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements;
2. the impact on relative shares of specific banking markets;
3. the current cost of funds for lending purposes;
4. the impact on borrowing and lending practices in the banking sector both during and since the global financial crisis;
5. the need for further consideration of the state of the broader finance and banking sector; and
6. any other relevant matters.

Accordingly, I am making this submission on some of the aspects indicated above but not all given the time constraint.

The impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements:

After the Global Financial Crisis (GFC), the Basel Committee on Bank Supervision (BCBS) introduced a number of measures to ensure that the threats to banking stability are minimised so as to reduce the probability of occurrence of a crisis of this magnitude. In the following paragraphs, we first discuss the measures put in place and thereafter discuss the likely impact.

What are the international regulatory changes?

The reforms introduced by Basel came in two forms (a) Basel II enhancements also called Basel II.5 and (b) Basel III.

Basel II enhancement:

The enhancements to Basel II were introduced in July 2009 when the world was still grappling with the financial crisis. The purpose of these enhancements was to plug loopholes in the capital adequacy rules introduced by Basel II. The BCBS changed the treatment for certain securitizations in Pillar 1 (minimum capital requirements). Higher risk weights were introduced for 're-securitization exposures to better reflect the risk inherent in these products and ….. that banks

conduct more rigorous credit analyses of externally rated securitization exposures' (BCBS, 2009)[1]. Under Pillar 2 (supervision), the Basel stressed firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; and sound compensation practices. Under Pillar 3 (market discipline), requirements for some key areas were strengthened. These included securitisation exposures in the trading book; sponsorship of off-balance sheet vehicles; resecuritisation exposures; and pipeline and warehousing risks with regard to securitisation exposures.

Pillar 2 guidelines came in to force immediately. While Pillar 1 and 3 guidelines were to be implemented before 31 December 2010. However, before the deadline for implementation of these guidelines, Basel came up with Basel III regulatory reforms which subsumed the Basel II enhancements.

According to APRA (2011) 'The Basel II enhancements are expected to have only a limited impact on ADIs in Australia, which have largely avoided higher-risk trading activities in the lead up to and since the global financial crisis'.

Basel III:

Basel III had two aims. First, to strengthen the capacity of individual banks to absorb shocks and second to ensure that should an individual bank fail, the rest of the banking system is insulated from the spill over effect to other banks and from the financial sector to the real sector as far as possible. 'The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy[2]'.

The various regulatory changes introduced by Basel III are summarised in the form of a table (see attached). There are two major reforms (a) related to capital and (b) related to liquidity. The reforms related to capital in turn have three pillars. Pillar I is about capital, risk coverage and containing leverage. Pillar II is about risk management and supervision and Pillar III is about disclosures requirements.

Basel III essentially introduced three measures as follows:

- *Capital related:* change in mix, quality, and minimum capital ratio
- *Liquidity related*: two new ratios to be monitored viz., liquidity coverage ratio and net stable funding ratio

[1] Basel Committee on Banking Supervision (2009) Enhancements to Basel II framework, Retrieved from: http://www.bis.org/publ/bcbs157.htm on 18 May 2012.

[2] Basel Committee on Banking Supervision (2010) Basel III: A global regulatory framework for more resilient banks and banking systems, Retrieved from: http://www.bis.org/publ/bcbs189.pdf p 1 on 18 May 2012.

- *Leverage related:* a new leverage ratio to be monitored.

Consequently, the analysis of impact on Australian banking sector has been attempted with reference to the above three measures

How will the changes impact Australian banking sector?

Capital related changes:

Under Basel III< Tier 1 capital (6 per cent) is now 75 per cent of the total capital (8 per cent) and Common Equity Tier 1 (CET1) is now 75 (4.5 per cent) of the Tier 1 capital. Basel III have raised the stake of common equity from 50 per cent in earlier Basel versions to 75 per cent thereby ensuring that better quality capital supports the bank balance sheet. It proposed that where the national regulator considers that the institution has reached or about to a non-viable status (wipe out of CET 1), the additional Tier 1 capital as well as Tier 2 capital instruments would be written off or converted to common equity.

Australian banks easily satisfy the norms:

'What this data shows is that using the minimum global standards, these banks would report an 8 per cent common equity Tier 1 ratio today. As is typically the case, APRA adopts a more conservative approach than the Basel minimum, and the outcome using APRA's proposed Basel III implementation is a 6.9 per cent common equity Tier 1 ratio' (Littrell, 2011).[3]

Littrell (2011)[4] adds: 'As noted earlier, Australia's banks already comfortably exceed the 2013 requirements. By the time the capital conservation buffer comes into play in 2016, we expect that the larger banks will add sufficient equity to give themselves an internal operating buffer over the benchmark 7 per cent common equity ratio. On their current earnings and growth profiles, this should be achievable mainly from retained profits and reinvested dividends'.

I envisage following consequences of the above provisions:

- As the risk for holders of instruments under Additional Tier 1 (for example, subordinated debt) and Tier 2 would increase, the cost of funding for banks would go up.
- The banks would recoup the incremental cost through either raising lending rates, reducing deposit rates or by improving operational efficiency. The recent reluctance on the part of

[3] Littrell, C. (2011) APRA's Basel III implementation rationale and impacts, http://www.apra.gov.au/Speeches/Documents/APRA-Finsia%20Basel%20III%20Implementation%2023%20November%202011%20CWL%202.pdf p.2
[4] *Ibid,* p. 3

banks to pass on in full the 50 basis point reduction in cash rate (4.25 % to 3.75%) is a pointer to this rising cost of raising capital.

- Banks allocation of capital to support various loan types such as business, small business, mortgage etc would get increasingly impacted by proportion of delinquencies in the type of loan. More the delinquency more the adverse impact on capital allocation. Alternatively, banks would charge higher risk premium in such advances. It is likely to have adverse impact on lending. For example, if China slows it would impact many businesses in Australia. It may lead to loan delinquencies in businesses that are directly impacted by China's economic situation which in turn would make banks to raise risk premium to conserve capital. Consequently, precisely at a time when the business would need a help line to survive, banks would be restricting credit.
- To meet increased capital requirements, banks would be required to attract capital by offering attractive rates of return on equity (ROE). The ROE in Australia for bank shareholders is already good as compared to banks overseas and as indicated in later paragraphs. Banks, however, appear to reach pre-crisis ROE levels. For the purpose, the operational costs would need to be controlled. It can be achieved by outsourcing, which in turn means job losses in Australia.
- The higher demand for ROE would lead to bank managements focussing on non-interest income (fee income) given that higher lending rates could lead to higher impairment of loans as loan affordability becomes an issue. Bank managements would diversify into fee based services such as wealth management.

- ***Impact on small ADIs:*** The small ADIs in Australia – credit unions and building societies- already comfortably meet the Basel III requirements. Littrell (2011)[5] states: The Basel III capital reforms will apply to all ADIs, but the great majority of building societies and credit unions already comfortably exceed the new capital requirements. Any economic impact is likely to fall upon the larger banks'.

  Though the small ADIs (such as regional banks, credit unions) did not cause the GFC, these institutions would face the new stricter standards of regulation. The APRA states that it will discuss the prudential guidelines to be made applicable for mutual institutions separately with them but there doesn't appear to be any special treatment for the mutual given the nature of their business.

- ***Impact on SMEs:*** As a segment, SMEs are always vulnerable. Their principal sources of funds are equity and bank loan. They can't tap the market directly as big corporations can. Consequently, any credit rationing by banks would severely affect SMEs. This is an important issue since Australian has nearly 2 million small and medium businesses which employ a sizable number of people.

[5] *Ibid. p. 2*

One of the ways to ensure an unhindered supply of credit to the SME sector is for APRA to reduce the risk weights for SME lending. 'Blanket application of the Basel III regulations to those traditionally financing SMEs could in the medium term jeopardise the stability of SME financing and thus economic recovery' (Angelkorte and Stuwe, 2011)[6].

I believe national regulators do have some freedom to play around with the denominator of the capital adequacy ratio, that is, the risk-weighted assets. If, however, APRA feels that it is a global issue then APRA may like to take this up with Basel.

- ***Impact on Mortgage loans:*** Securitisation provided a major source of funding for mortgage loans. Under Basel III, there is enhanced risk weight for securitisation instruments. It may lead to lower financing for mortgage loans. Currently as per APRA Insight (September 2010- Statistics), nearly 65 per cent of major bank loans are mortgage loans. The lower risk weight for mortgage loans made the sector attractive for banks (risk weight was 50% under Basel. The higher risk weight of securitisation could impact in two ways: lower credit availability for home loans or rise in lending rates.

- ***Impact of enhanced risk coverage:*** Basel III has enhanced the capital requirements for OTC derivatives, repo and securitisation activities. It is envisaged that these measures would reduce procylicality and reduce systemic risk. There is to be a credit valuation adjustment (CVA) capital charge so that mark-to-market losses could be covered. The CVA measures adverse impact on the fair value of derivative instruments arising out of deterioration in the creditworthiness of the counterparty.

  Bank balance sheet provides a snap shot at a point in time. Banks are holding significant portfolio of derivative instruments in recent years. The exposure the banks have to the portfolio can change significantly even within a day as such instruments can be traded rapidly and have seen wide fluctuations in prices in recent years. 'the speed with which portfolios, and positions can be adjusted, e.g. in derivatives markets, make occasional balance sheet snapshot less informative and reliable as a guide to that institution's potential risk exposure' (Goodhart, 2005:96)[7]. It means the risk position of a bank as depicted in the balance sheet doesn't capture the changing reality and by the time the regulators, shareholders and investors know the reality it might be too late. A recent case of J P Morgan incurring a loss of $2 billion because of 'error' by the chief investment office is a pointer to the grim reality how fortunes of even mighty institutions can change overnight.

[6] Angelkort, A. and A. Stuwe (2011) *Basel III and SME Financing,* Retrieved from: www.nmanagerkreis.de on 24 May 2012.

[7] Goodhart, C. (2005) An incentive structure for financial regulation, in *The Emerging Framework of Financial Regulation,* Goodhart C. (ed) Central Banking Publications. U.K.

Obviously, external regulation that can't keep pace with these internal changes in risk position would be of little value. It means banks internal risk mechanism needs to be stronger.

Liquidity related changes:

Basel III introduces two new quantitative liquidity measures (a) Liquidity Coverage Ratio (LCR) and (b) Net Stable Funds Ratio (NSFR).

LCR: Basel requires LCR to be 100 per cent. It is a ratio of highly liquid assets to net cash outflow for 30 days. The LCR is introduced so that the bank can address an acute stress scenario. LCR becomes applicable from 01 January 2015.

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100 \text{ per cent}$$

Given the shortage of liquid assets (such as government securities) in Australia, the APRA and the RBI have proposed to allow an ADI to use a secured committed liquidity facility (CLF) for a fee to cover any shortfall in high-quality liquid assets (HQLA).

NSFR: APRA draft Prudential Standard 210[8] requires another quantitative measure the NFSR which is computed as follows. It has been established to encourage longer-term resilience. NSFR becomes applicable from 01 January 2018.

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100 \text{ per cent}$$

It is envisaged that the CLF may give boost to asset-backed commercial paper (ABCP) market. It needs to be remembered though that ABCP essentially provides a credit risk transfer mechanism. Some authors contend that banks exploited 'the credit risk transfer mechanism for regulatory arbitrage and increased their effective leverage and exposure to aggregate risk by availing such mechanism' (Acharya, 2009:83).[9]. The RBA/APRA, estimates that the gap in liquidity as required under LCR and available securities is nearly 40 per cent of the GDP. It means substantial increase in ABCP market could be expected. RBA/APRA would need to carefully watch the credit risk transfer mechanism.

Yet another issue is CLF essentially provides a life line even before a stressed situation so the lender of the *last* resort role becomes lender of the *continuing* resort. The banks would pay a fixed fee of 15 basis points on both drawn and undrawn amounts. Basically, the banks are *purchasing* the LCR

[8] http://www.apra.gov.au/adi/Documents/Draft_APS_210_November_2011.pdf
[9] Acharya, V. (2009) *op.cit.*

compliance. The argument for CLF is lack of sufficient government debt instruments. However, Basel guidelines do provide that investment in sovereign securities of other countries are eligible instruments and it includes institutions such as the IMF. By investing in these securities banks would be earning interest and also complying with LCR. In the arrangement proposed banks would be paying for complying to LCR. It will raise the cost of funds of banks which would get passed on the customers one way or other. **The CLF in current form is like insurance for liquidity provided by the RBA on a continuing basis which would result in moral hazard. It could be possible that banks may resort to 'LCR games'.** As self-securitised RMBS are also eligible securities for CLF purposes and given the fixed fee of 15 basis points, banks would try to tap as much of CLF as they possibly can and invest other eligible purposes including cash in earning assets. It may actually reduce the liquid assets on the balance sheets of banks. In the earlier regime of non-callable deposit ratio (NCR) which was in operation in late 1990s in Australia, banks were bound to hold cash of one per cent of deposits such a restriction now doesn't exist under Basel.

The only advantage of LCR seems to be then that funds that would otherwise have been invested in securities such as that of the IMF would now be available for lending within Australia.

Recommendation

The LCR is likely to increasing 'liquidity games' by banks and RBA/APRA would need to watch the moral hazard effect generated by it. To curb such games RBA may consider a suitable variable fee with a floor of 15 basis points so as reduce dependency of banks on RBA CLF.

The impact of leverage ratio

During the crisis, it was found that some banks had leverage ratio of 50 times the capital even though they complied with Basel capital adequacy norms. High leverage can lead to severe problems when credit markets dry up – especially if the bank has used short-term sources to raise funds. Basel is putting an overall limit of 33 times the capital for leverage by banks. 'The Basel Committee has proposed testing a minimum Tier 1 leverage ratio of 3 per cent (33.33 times) to start with as a Pillar 2 measure which will eventually be made a Pillar 1 requirement[10]' (Mohapatra, 2012). The leverage ratio comes in operation from 2018.

On the aside, whether leverage ratio is an appropriate measure to monitor to avoid crises has been questioned by some researchers. 'We consider and contrast two mitigating regulatory interventions: leverage restrictions, and ex- ante specified resale price guarantees on securitized asset portfolios. We show that the latter tool performs strictly better than the former, by ensuring not only bank survival, but also enhanced social surplus arising from securitized lending' (Bhattacharya, et a. 2012)[11]. It is,

[10] Mohapatra, B. (2012) Implications of Basel III for Capital, Liquidity and Profitability of Banks, *Reserve Bank of India Monthly Bulletin,* April, p. 775.

[11] Bhattacharya, S., Chabakauri, G., and K. Nyborg (2012) Securitized Banking, Asymmetric Information, and Financial Crisis: Regulating Systemic Risk Away', Retrieved from: http://www2.lse.ac.uk/fmg/workingPapers/discussionPapers/fmgdps/dp704-AXA10.pdf on 24 May 2012.

however, an academic debate and for the moment and while the above claim gets examined, we have to follow the Basel leverage ratio.

According to APRA '… Australia's larger banks already comply, and are likely to be even more compliant by the 2018 introduction date. Smaller ADIs should also meet this test without difficulty (Littrell, 2011)[12].

The current cost of funds for lending purposes

Every time the RBA changes the cash rate there is expectation that banks would follow suit. Banks have been repeatedly saying that their lending rates are linked to funding costs and not RBA rates. In order to demonstrate the decoupling, the ANZ bank took the lead in announcing that it will set interest rates independent of cash rate movements of the RBA. RBA interest rate changes affect all the interest rates in the market so they do influence banks funding cost, consequently, it is hard to accept the proposition that there is little or no linkage between RBA rates and bank lending rates.

Even so, in the following paragraphs we examine the argument of banks that their funding costs are rising. I compare the data at two points in time July 2008 (proxy for pre-GFC data) and January 2012 (this note was prepared in March).

Are funding costs really rising?

Deposits constitute nearly 50 per cent of major banks funding. As per RBA statistics, the online savings account ($10,000) interest rates which peaked at 7.30 per cent (July 2008) are now 4.35 (January 2012) – decline of 295 basis points. The term deposit special rates –the most relevant rate for term deposit pricing- which peaked to 7.95 per cent (July 2008) declined by 260 basis points to 5.35 (January 2012).

Long term debt constitutes 25 per cent of banks funding. The gauge of cost thereof - spread over Australian Government bonds - was 216 basis points (June 2008) but hoovered between 197 to 207 basis points in January 2012.

20 per cent of bank funding is short-term wholesale debt. The gauge of cost thereof is the difference between one month and three month bank bill rates and overnight indexed swaps. The difference has marginally declined from 43 basis points (July 2008) to 42 basis points (Jan 2012) for 3 months and from 27 basis points (July 2008) to 24 basis points (Jan 2012) for one month.

Of the total funding, about 26 per cent is raised in overseas markets and banks harp that the cost thereof is rising. In 2008, the 3 month LIBOR-OIS spread (the gauge of overseas borrowing cost) was 364 basis points, last week it stood at 49.8 basis points says Bloomberg. Yes, it has increased from its recent low of less than 10 basis points. It is this aspect which the banks harp and would like us to forget the sharp decline compared to crisis year.

[12] Littrett. *Op.cit.,* p.3

Banks would like consumers to gloss over the fact that it is the cost of equity (alternatively return to shareholders) which is the culprit. Bank supporters conveniently use the word 'higher borrowing cost' to camouflage the impact of higher equity cost on their funding.

By delinking from RBA cash rate, banks are in effect saying that the rates are now linked to international borrowing cost. Why did they not bring down lending rates when international borrowing cost declined to less than 10 basis points?

The cost of equity is a product of proportion of equity in total funding and return sought by the banks. According to KPMG, the return on equity in the years 2009 and 2011 for the major banks was respectively ANZ (12.0, 16.2), CBA (15.8, 19.5), NAB (11.8, 16.2) and WBC (13.8, 16.0). The return on equity has sharply increased in the very years the borrowing costs have declined as above. The RBA stated in its March 2011 bank funding cost review that 'there has been an increase in the contribution of equity to total funding costs'. So the culprit really is return on equity. Bank would like return on equity to be 23.8 (2007) as was the case with one of the majors.

But what about lending rates and net interest margins?

Net interest margins (NIM) are a function of lending rates and debt funding costs. Though cost of equity is not included in debt funding cost, banks typically apply a cost to these funds while pricing loans. According to KPMG, the NIM of the four major banks in 2008 and 2011 respectively in basis points was ANZ (201, 246), CBA (202, 219), NAB (220, 224) and WBC (202, 219). The major banks have increased their NIM significantly relative to the financial crisis year.

As though it is not enough banks as for tax discounts on interest paid on savings accounts which in turn means passing on the cost to the tax payer which is an implicit subsidy for banks.

Some contend that banks deserve a pat on the bank. Do they?

The combined net profit after tax of the majors which stood at $17,693 million (2008) stands at $23,959 million (2011). The dazzling profit performance of banks hides the fact that their cost to income ratio is now worse than what it was during the crisis year. The ratio, according to KPMG, in 2009 and 2011 was respectively ANZ (45.7, 47.4), CBA (43.4, 45.5), NAB (43.9, 43.7) and WBC (38.5, 43.8). The banks also hide the fact that the borrowing cost they face is also because S&P recently downgraded their credit rating. To reduce the cost banks will be outsourcing jobs to India and the Philippines.

In all this, what way have ordinary Australians benefited? Consumers face lower deposit rates and higher lending rates and fees, and employees face job losses with more outsourcing.

Who cares for these social costs so long as the managers get hefty pay packages (Allan Fels noted Australian bank executives are highest paid even by international standards) and shareholders get enviable return which, incidentally, is high even by international comparison.

The impact on borrowing and lending practices in the banking sector both during and since the global financial crisis;

To assess the impact on borrowing and lending practices in the banking sector pre and post GFC, I perform common size analysis based on statistics available at APRA website. Table 1 provides details of how the asset composition of Australian banks have undergone change since 2004 (the year from which data is available at APRA website). Following observations can be made:

Lending practices

- Banks have considerably increased the proportion of earning assets from 73.83 per cent (2004 - 10.02 securities and 63.81 loans) to 77.37 per cent (2011-13.23 securities and 64.14 loans). This has been achieved by reducing their exposure to all other assets except intangibles. ' the ongoing shift in the composition of banks' portfolios towards housing and high-quality liquid assets, such as government bonds, which attract lower risk weights than other assets'RBA, 2012:31).[13]
- Within gross loans, proportion of home loans has jumped from 51.26 (2004) to 59.42 (2011) – a rise of more than eight per cent. The increased home loan proportion is indicative of banks reducing their exposure to more risky business loans. It is also due to the Basel norms which gave only 50 per cent risk weight to home loans. Small business loans are generally secured by business owners home and as such may get classified as mortgage loans.
- The rise in proportion of home loans could be seen from 2009 onwards. It is also a reflection of higher demand for home loans as people appear to have shifted resources from stock market to the more stable real estate market.
- The increased exposure to more secure home loans has not necessarily led to lesser impairments. Using proportion of provisions to gross loans as an indicator, the proportion has gone up from 0.87 (2004) to 1.18 (2011). The GFC effect can be seen as the proportion has exceeded one from 2009. The RBA (2012) states that the non-performing loans are mainly in the business sector. 'Banks' non-performing asset levels have come down a little recently, but remain higher than they were a few years ago, particularly for business loans' (RBA,2012).
- The exposure of the Australian banks to mortgage market, however, potentially raises the issue concentration risk. A sharp decline in house prices could be disastrous for our SIFI as well as for the Australian economy. Are house prices in Australia inflated? While a study by *The Economist London,* couple of years back stated that Australian houses are overvalued by more than 60 per cent, econometric analysis by IMF Economists in December 2010 found that the overvaluation was between 5-10 per cent[14]. Estimates may differ but the fact remains that there is a bubble in the market.
- Another worrying feature continues to be the high household debt to annual net disposal income ratio which continues to be 150 per cent.[15]

[13] http://www.rba.gov.au/publications/fsr/2012/mar/pdf/aus-fin-sys.pdf
[14] http://www.imf.org/external/pubs/cat/longres.aspx?sk=24507.0
[15] http://www.rba.gov.au/publications/fsr/2012/mar/pdf/0312.pdf p 45.

- As compared to the Australian banks loan concentration, Canadian banks have a more even spread of loan portfolio. As per bank statistics presented by Bank of Canada, at the end of February 2012, total loans outstanding of Chartered banks were Canadian $1,983 of these $861 billion (44 per cent) were home loans, business loans 720 billion (36 per cent) and personal loans were $401 billion (20 per cent)[16]
- The mortgage portfolio of banks is vulnerable to a sharp decline in house prices and unemployment rate. Diversification of loans by Australian banks would not only help business grow but would make banks less vulnerable at the same time contributing to increasing national income and employment. Banks shy away from business loans since such loans are more risky than the easy and safe mortgage loans. Rigorous credit assessment could help reduce business loans risk. However, banks are resorting to the cosy option of mortgage loans instead.
- Banks liking for the cosy option is also reflected in their recent moves to provide loans with higher LVR. The RBA (2012) states 'lenders resumed offering loans with 95 per cent loan-to-valuation ratios (LVRs) last year. Consistent with this, the share of new owner-occupier housing loans with an LVR above 90 per cent has risen from a trough of 11½ per cent in the June quarter 2010 to 17 per cent in the December quarter 2011'[17].

Recommendation:

Regulators and banks alike need to seriously consider the concentration risk in the mortgage market. The stability of our SIFI is critically dependant up on the mortgage market holding steady.

Borrowing practices:

Table 2 provides details of how the borrowing practices of undergone changes since 2004 as per statistics available at APRA website.

Deposits and long-term borrowing are the two major sources of funding for banks. It can be seen that deposits as a source of funds has increased from 55.99% (2004) to 58.20% (2011). Similarly, the share of long-term borrowing has increased from 9.11% (2004) to 14.43% (2011). The reliance on short-term borrowing is down from 8.93% (2004) to 6.68% (2011) due to rise in deposits.

The rise in deposits can be attributed to deposit guarantee introduced by the government in the wake of the GFC and continued thereafter though at a reduced ceiling of $250,000.

[16] http://www.bankofcanada.ca/wp-content/uploads/2012/04/bfs_april2012.pdf Table C1
[17] http://www.rba.gov.au/publications/fsr/2012/mar/pdf/0312.pdf p.43

Any other relevant matters:

Governance of SIFI:

Reserve Bank of Australia (RBA) has a lender of the last resort role which means the RBA really underwrites the banks when they are under severe strain. Given this role, RBA should have an incentive to monitor the systemically important financial institutions (SIFI –read the BIG Four bank as this is an inquiry into banking) more closely. Furthermore, the activities of SIFI have become increasingly complex and there is (at least 'was' as the GFC demonstrated) significant information asymmetry between regulators and the SIFI. Ben Bernanke, Chairman of US Federal Reserve admitted before the Financial Crisis Inquiry Commission that it was difficult 'to reliably see the whole picture of activities and risks of large, complex banking institutions' (FCIC, 2011: 55)[18]. While RBA has the role of lender of the last resort, prudential responsibilities are vested in APRA.

The current arrangement to monitor the SIFI mainly relies on reporting requirements (now even more increased reporting requirements – see below). However, the regulators currently do not have a direct monitoring role of the SIFI. Such a role is important especially when the government has introduced guarantee for deposits up to A$250,000 per depositor per bank and as such these small depositors would have little incentive to monitor the banks. However, when things go wrong it will be the government which would have to pay the financial claims of depositors. Also there is an in-built lag in a bank undertaking risky positions and the regulator being informed thereof when the outcomes are adverse.

In my opinion, in the case of SIFI, the APRA/RBA need to have a more proactive role. It can be achieved by having a senior APRA/RBA official / representative sit on the Board of the banks as a 'special invitee'. They can each appoint a representative or may appoint a single representative in consultation with each other. The special invitee may not have a power to vote and as such participate in the operational matters but would be an 'eye and the ear' of APRA/RBA. Such an arrangement would bring the supervisors more close to working of the SIFI. It will also help build confidence in public mind that APRA/RBA is closely involved in the proper working of the SIFI and excessive risk taking is addressed. Presently, no such arrangement exists. It is important to note that being a non-voting director on the Board, the APRA/RBA representative is not obstructing in operational decision of the banks and the bank Board could make decision as business conditions demand. However, the matter gets simultaneously reported, discussed and analysed at APRA/RBA level from systemic stability perspective.

In countries where banks are publicly owned, the prudential regulator sits on the Board and also votes. Such an arrangement is not possible in a privately owned financial institution. But at the

[18] http://www.gpo.gov/8709FBD4-C427-4E15-A103-4C63014BD46B/FinalDownload/DownloadId-539CDB0BC4E72BD89DFDEBA960C5BC75/8709FBD4-C427-4E15-A103-4C63014BD46B/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

same time given the importance of SIFI (from the havoc they can unleash on the society as the GFC demonstrated), an arrangement such as having a 'special invitee' on the Board without a right to vote may be necessary. In theory, it would mean that the regulator is up to speed on the financial position of the SIFI on a regular basis and can in-turn provide necessary warning or cautionary note to relevant departments within the regulatory structure. Acharya et al., (2009:192)[19] also suggest similar solution to the problem of strengthening regulatory monitoring. '… one possibility is that the board of director of the LCFI (Large, Complex Financial Institutions –full form added by the author) should include a prominent debt holder or a regulator'. However, in my opinion such a director should be a non-voting director and a 'special invitee' only.

A closer oversight through special invitee is necessary as recent JP Morgan losses also reveal. "Even as the chief investment office swelled in size and made increasingly large bets, regulators did not put any examiners in the unit's offices in London or New York' (NYT,2012).[20]

Recommendation:
It is recommended that the Senate Committee may consider that a representative of RBA or APRA is included as a 'special invitee; on the Board of SIFI's in Australia. It may require suitable amendment to the RBA/APRA Act.

Rise in compliance cost due to increased reporting requirements:

APRA have proposed a reporting regime under the Prudential Standard for Liquidity APS 2010 which requires that scenario analysis ADIs have to submit LCR data, 'going-concern' data monthly, and NSFR data quarterly. It is likely to impose significant compliance cost on ADIs. These are likely to get passed on to the consumer ultimately.

Recommendation:
Appointment of a 'special invitee' as suggested above may reduce the need for more frequent reporting.

Executive compensation

As per APRA (2011: Table 5)[21] liabilities constituted nearly 94 per cent of the total assets of major banks ($2509b / $2671b). Of these, 58 per cent were deposits leaving 30 per cent raised from other sources and shareholders' equity was 6 per cent.

[19] Acharya, V., Carpenter, J, Gabaix, X, John, K, Richardson, M., Subramaniam, M., Sundaram, R., and E. Zemel (2010) Corporate Governance in the Modern Financial Sector, in *Restoring Financial Stability: How to repair a failed financial system,* (ed.) Acharya, V. and M. Richardson, Stern School of Business, New York.
[20] New York Times (2012) Regulator's role at Chase Scrutinised, Retrieved: http://www.nytimes.com/2012/05/26/business/regulators-role-at-jpmorgan-scrutinized.html?_r=1&nl=todaysheadlines&emc=edit_th_20120526

Of the debt holders, deposit holders would have little incentive, if any, to monitor the performance of banks, that is, the value creation by banks. Other debt holders, especially if they are secured, may not take much interest in total value creation by banks. The shareholders would be interested only in shareholder value creation as they can quickly exit if they see signs of weakness such as lower shareholder returns. Consequently, bank management focus solely on shareholder value creation rather than value creation for the entire organisation (total value creation). The total value creation is not only important from debt holder perspective but also from regulatory perspective.

It is interesting, however, that executive remuneration remains linked to shareholder value creation. For example, the typical performance measures used in Australian banks for short or long-term incentives are typically linked to ROE or EPS (indicators of shareholder value maximisation) instead of ROA which is an indicator of total value maximisation. As Acharya et al., (2010: 193) state ' such a compensation structure induces high leverage choices and risk taking on the part of managers and traders'.

Recommendations:

Executive remuneration should be linked to total firm value maximisation rather than shareholder value maximisation from systemic stability perspective.

The Financial Stability Review Report should discuss changes in return on assets (total firm value) along with changes in return on equity (ROE). Currently, only the latter is discussed.

[21] Australian Prudential Regulation Authority (2012) Statistics: Quarterly Bank Performance December 2011, Retrieved from: http://www.apra.gov.au/adi/Documents/BANK%20Quarterly%20Publication%20(Dec11).pdf