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SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Competition within the Australian banking sector

WEDNESDAY, 9 FEBRUARY 2011

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SENATE ECONOMICS

REFERENCES COMMITTEE

Wednesday, 9 February 2011

Members: Senator Bushby *(Chair)*, Senator Hurley *(Deputy Chair)* and Senators McGauran, Pratt, Williams and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Coonan, Cormann, Crossin, Eggleston, Faulkner, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Joyce, Kroger, Ludlam, Ian Macdonald, McEwen, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Stephens, Sterle, Troeth, Trood and Wortley

Senators in attendance: Senators Bushby, Hurley, Pratt, Williams and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

Competition within the Australian banking sector, including:

(a) the current level of competition between bank and non-bank providers;

(b) the products available and fees and charges payable on those products;

(c) how competition impacts on unfair terms that may be included in contracts;

(d) the likely drivers of future change and innovation in the banking and non-banking sectors;

(e) the ease of moving between providers of banking services;

(f) the impact of the large banks being considered 'too big to fail' on profitability and competition;

(g) regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis;

(h) opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers;

(i) assessment of claims by banks of cost of capital;

(j) any other policies, practices and strategies that may enhance competition in banking, including legislative change;

(k) comparisons with relevant international jurisdictions;

(l) the role and impact of past inquiries into the banking sector in promoting reform; and

(m) any other related matter.

WITNESSES

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Committee met at 6.04 pm

FOSTER, Mr David, Chief Executive Officer, Suncorp Bank

ROSE, Mr Anthony, Chief Financial Officer, Suncorp Bank

CHAIR (Senator Bushby)—Good evening. I declare open the sixth hearing of the Senate Economics References Committee's inquiry into competition in the Australian banking sector. The committee had originally planned to hear from Queensland witnesses in Brisbane on 24 January, but, recognising the difficulties the terrible flooding would cause for witnesses, the committee decided to postpone that hearing until March. I am pleased that the CEOs of the two Queensland bank who could not attend on the day of the rescheduled Brisbane hearing are able to be with us this evening.

These are public proceedings, although the committee may determine or agree to a request to have evidence heard in camera. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may of course also be made at any other time. I welcome our witnesses. Would you like to make an opening statement?

Mr Foster—Yes, thanks very much, and thanks for the opportunity to appear before the committee. We will be happy to take some questions, but first I would like to make a few comments about matters relevant to this inquiry. The events of recent years have fundamentally changed the dynamics of competition in banking. The terms of reference for this inquiry are particularly pertinent for our bank, due to the unique size and nature of our business in the Australian banking sector. As the largest of the second-tier banks, Suncorp Bank is the natural proponent to facilitate competition and is best placed to contribute to this debate and support solutions. We are in a stronger position than any of our non-major peers, but the last couple of years have been enormously challenging for all non-major banks.

As the only remaining A-rated retail bank, we know all too well the effect that the GFC has had on competition. This really was driven by funding. Pre-GFC, our cost of funds was only 10 or 15 basis points greater than the major banks. It is now up to 80 basis points more than what the major banks pay. The other regional banks pay an even wider differential on their funding. One of the key impacts of the funding issue was consolidation. Bankwest and St George have become parts of major banks, leaving Suncorp Bank as the largest regional, occupying a unique space between the majors, with their AA ratings, and other regional banks, which have BBB ratings.

Among the non-bank financial institutions we have also seen consolidation, with the major banks taking ownership of mortgage originators. Aussie is now a third owned by CBA. Wizard and the GE mortgage book are owned by NAB and RAMS is with Westpac. There are seemingly a number of participants in the market right now, many of them owned by major banks, due to consolidation in recent years. For the independent providers remaining, at question is their ability to offer a sustainable, competitive proposition going forward. The ability of the second-tier sector to offer long-term, sustainable, competitive consumer propositions is bound by a constrained and expensive funding market. That is a real risk to the competitive landscape going forward.

For Suncorp Bank, we have had to adapt. We have a larger balance sheet and a higher credit rating than other regionals but a lower rating than the majors. We believe that we have responded appropriately to the changing funding markets and competitive dynamics and as a result we have driven significant change in the shape of our bank over the last couple of years. The bank we operate today is far different to the organisation that it was in 2008, and this is as a result of changing funding dynamics, highlighting the criticality of funding in competition. The global financial crisis led to a series of events which served to strengthen the position of the market and the power of the major banks, at the expense of regional banks and non-bank financial services institutions. The gap between the cost of funds for major banks and that of all other financial services institutions has been greater in the past few years than for decades prior to the GFC. It does threaten to drive further consolidation and a further reduction in competition.

Current domestic and global industry dynamics are a further threat to competition. The competitive reform package announced in December by the government is a step in the right direction, but the key to competition is funding. In RMBS, continued support for this will be essential for a sustainable, competitive system. There are various measures that provide some support for this, but the full impact will need to be monitored over time. Likewise, the proposed introduction of covered bonds may provide additional sources of funding for Australian banks. But what impact it will have on enhancing competition is not known, given that the major banks will be able to source funding at a cheaper rate than the smaller regional players.

The Basel III package has also recently been released, and it was pleasing to see the efforts of government and regulators to put in place measures that reflect the differences of the Australian financial system versus other global markets. It is important to note that such industry reform, national and international, does carry an administrative and regulatory compliance burden which inevitably adds cost to the system and then, likely, consumers.

Whilst, as I said, we believe most of the initiatives announced are a step in the right direction, there are two areas I would make comment on. The proposed removal of exit fees is not a measure we believe will enhance competition. It is the smaller, non-bank lenders that will be hurt most by this. For the majority of banks, the deferred establishment fee was put in place as a competitive response to reduce the upfront albeit legitimate costs of taking on a new mortgage. In addition, the proposed legislation against price collusion stops the industry commentating and commenting on interest rate and market movements, preventing education of the community about interest rates and the factors that go into product pricing and exacerbating a one-sided debate.

We believe that the key objectives of enhancing competition and advancing any reforms should be to deliver enhanced funding diversity and system stability, the creation of securities that meet eligible liquid asset rules under the new Basel framework and cost-effective funding for the economy. We believe there is a significant opportunity to reduce the cost of funding for the industry and for consumers by leveraging the significantly untapped value of the residential mortgage collateral. There are solutions that exist and there are models for funding that could be adapted to the Australian environment. These could achieve a lower cost industry funding model while balancing the inherent public sector risk in ensuring the orderly functioning of the banking industry.

One option, similar to that in the Canadian system, would be to enable banks to access government guarantee for RMBS issuance for a fee, effectively creating a new class of security which would be seen by investors as an Aussie government guaranteed mortgage bond. This would supplement Australia’s low bond issuance volumes and provide significant liquidity to the important RMBS market. It would lower industry funding costs and provide the public purse with a revenue stream for any exposure it had to ensure a functioning banking system in a crisis scenario.

We think there are also some other opportunities to support competition through taxation reform to increase or eliminate the cap on concessional taxation treatment for bank deposits—where, currently, above the cap, depositors pay tax on the inflation component of their return—via further superannuation reform to encourage a greater proportion of fixed interest investments by superannuation funds, via removal of the fee differential on government guaranteed wholesale funds that still exists, via broadening government account holdings and investment mandates to include non-major banks, and via improving the ability to switch banks. Research certainly shows that consumers would prefer to bank with a regional, but the impediments to switch are significant. It is important to be mindful of the costs that would be associated with any switching.

Clearly, any changes need to be well thought through to avoid unintended consequences, such as further impacts on competition or additional cost to consumers. The government wholesale guarantee, while a necessary move at the time, had the unintended consequence of creating a greater funding gap between the majors and all other banks, further consolidating the position and market power of major banks at the time.

Another matter requiring careful consideration in relation to its impact on competition is the transition to the financial claims scheme and the expiry of the current government guarantee on retail deposits later this year. We still see significant volatility in financial markets. This transition must be handled well and the interests of smaller organisations protected. If not, this too could have a significant and adverse impact on competition given the reliance particularly of non-major banks on retail deposits to enable them to fund new lending. But we have the opportunity to put measures in place to ensure that there are increased competitive landscapes and alternatives for the Australian consumer. Well-constructed measures will ensure and avoid unintended consequences.

I am strongly of the view that competition initiatives should support multiple smaller banks and non-bank financial service institutions rather than simply replicating another big corporation or a fifth pillar. It is in the best interests of consumers and our economy for a robust, multitiered banking system to exist. Access to a variety of liquid funding markets will support this.

We certainly welcome the opportunity to continue the dialogue to support a more competitive banking system for the benefit of consumers. We would be very happy to take any questions the committee has.

CHAIR—Thank you, Mr Foster, for your opening statement. You have raised a lot of issues and, in particular, made a lot of suggestions as to how we could move forward, most of which probably were not addressed in your written submission. I was going to ask whether it is possible to have a copy of your opening statement now so that senators can look at it and ask questions if there is a need to do so.

Mr Foster—We can certainly provide that.

CHAIR—Thank you. As I said, you did raise a lot of issues, so we will try to deal with those in the time that we have got. You mentioned that, prior to the GFC the difference between you and the majors in terms of your funding cost was about 10 to 15 basis points and it is now about 80 or 90, but with the other banks it is wider than that. I presume that you had a funding advantage because of your A status prior to the GFC, and you still maintain that. Does that give you an ability to compete better compared to the second tier? Obviously the big banks have had an opportunity to consolidate their market share and improve it significantly as a result of events over the last two or three years. Because of your relative advantage over other, smaller players, have you had the ability to do the same thing within your space?

Mr Foster—There are probably two issues. For clarity, pre the GFC, given the broader market pricing, there was very little differential based on credit rating between organisations, so there was not too much difference—as I said, 10 to 15 basis points, and the BBB banks were a little bit wider than that but reasonably narrow. As it exists now, we do have some advantages over our BBB counterparts based on our A-plus credit rating, which I guess provides us greater access and depth to a number of funding markets that are not accessible to the BBB, not to the same extent as the major banks with a AA rating. I mentioned covered bonds in the commentary. There is an opportunity there, we believe, but yet to be tested, that we may be able to access covered bonds to supplement our funding position.

CHAIR—Would you be able to do that on your own?

Mr Foster—We believe so.

CHAIR—Evidence we have had suggests that the issue of covered bonds needs to be in the order of $350 to $400 million to actually go ahead. That is something of a size that Suncorp could manage on its own.

Mr Foster—I think that is possible for us to do on our own. A couple of things to consider is that, which relates to the size of the organisation and rating. The other is, based on ratings, there is likely to be a phased ability for players to access that market. Anthony has been involved in the industry working group on funding alternatives, so I might see if he has anything to add.

Mr Rose—No, not at the moment; I think you have covered it.

CHAIR—In talking about consolidation, you also mentioned that there are a lot of players in the market but that a lot of them are owned by the majors. We have had evidence that there are an awful lot of people out there in the market offering mortgages—there was a suggestion that there were over 100, from memory. How many of those are genuine, in terms of being genuine competitors to each other? What proportion of them are less likely to be aggressive in competition? Does that number of 100 show that we have real competition in the mortgage market?

Mr Foster—I think the point to make is that certainly there are a lot more people in the market that are associated with or owned by the same institutions, which perhaps was different to what existed previously. The other factor is that the ability, particularly of smaller institutions such as a number of the regional banks, to compete has been constrained. And it is a little bit different by different markets. If you look at the deposit market, the regional banks have probably led the market in terms of competitive pricing on deposit offerings because that is a source of funding that the regional banks have been able to access readily in a constrained funding market more broadly, so that certainly has been a very competitive market, led essentially by the smaller banks and smaller players.

If you look at the lending side, that is an area in which the various things that have occurred during the past two years have enabled a number of the major banks to really strengthen and consolidate their position, through pricing and availability of funding, to aggressively grow those books. Whilst a number of players have stayed in the market over that period, their ability to compete aggressively during that period and uncertainty around both pricing and access to funding have constrained their ability to do that. I think that is the residual question that remains, particularly for smaller, lower rated organisations. They are in the market presently, but what is their ability to compete over the medium term if there is not certainty and efficiency in the market in terms of provision of funding?

CHAIR—You mentioned that Suncorp has had to change and adapt over the last couple of years. Does that mean that you have moved away from securitisation and looked at other sources of funding? What has Suncorp actually done to be able to do that, and how has that affected your share of the market?

Mr Foster—Some of the key pressures that we saw through the GFC were the cost and availability of funds, and that drove a couple of things. In terms of our ability to compete in particular markets, particularly the corporate banking market and the like, we made some decisions very early on. We did not believe we would be able to compete on a funding differential that existed at the time. We therefore made the decision to exit and run down those portfolios. The other catalyst, I guess, is that at the time we had a lower proportion of retail deposits funding our loan book. We had a higher proportion of short-term wholesale money, with offshore money and term debt supplementing that funding position. Just based on the change in dynamics of funding markets and so forth, we have essentially split our lending book in two to a piece that we do not think we can be competitive in on a go-forward basis. We essentially used the wholesale funding guarantee to fund that book and run it down. For our business that we are managing going forward, which is a significant part of the business, we currently fund roughly 70 per cent through our deposit base, which we have grown aggressively, as I mentioned before. The balance of that is funded with a combination of short-term and long-term funding, including securitisation. Certainly securitisation is a market where, as I mentioned in the commentary, we think there is enormous opportunity for Australian business in RMBS, but it has been impacted—probably unfairly—by the noise coming out of the US and Europe on securitisation.

CHAIR—On securitisation, the market is back to about $30 billion a year, roughly, from what we have heard in the past. It was up close to $50 billion prior to the GFC. The Reserve Bank told us when they appeared before us that they thought the $30 billion that it is approaching now roughly represents where it will end up, given that $20-odd billion of that $50 billion that did exist came from unsustainable investment vehicles that probably will not re-enter the market. Do you think that we are approaching a natural limit in terms of the securitisation market getting back on its feet without those vehicles, or do you think there is opportunity for us to grow it further with the right regulatory settings?

Mr Foster—I might let Anthony touch on that.

Mr Rose—There are a couple of answers to that. Firstly, I do not think that the securitisation market has returned to normalcy. Without the support by the AOFM, many participants in that market would not have the access to those transactions that they have completed, where the AOFM has cornerstoned a number of the transactions and has provided liquidity and the impetus for those transactions to actually occur. As for RMBS as an instrument today, part of the issue globally is that it fits into what international investors call structured product. Unfortunately, it has been tainted with a brush that fits in the same bucket as subprime lending and those subprime CDOs and COOs that have caused a lot of the grief. As a consequence of that, it is very difficult to get credit committees and investment committees to actually see Australian RMBS as a different instrument and then enable the limits and the volume to come into that market that it probably justly deserves given the credit risk that underlines those securities.

There are plenty of investors in that market who do see the value in that, but there are large components of the global pool of money that we just have not been able to penetrate. Some of the suggestions that we have talked about here are about how we break that nexus and how we can turn that into an instrument that enables us to use the collateral of the mortgages to really bring down funding costs and provide liquidity to the whole system, not just—

CHAIR—And your primary suggestion there is that the government guarantee the RMBS?

Mr Rose—Yes.

CHAIR—I am conscious of the time. We have other senators who need to ask questions, so I will just move on to some other issues. You mentioned exit fees. Obviously the government, as part of its package, is going to ban exit fees from 1 July this year. Prior to that the government had tasked ASIC with looking at the issue, and ASIC had come out with some guidelines on how it thought that exit fees should operate. Basically, it thought that they should cover the costs and no more and that would be reasonable. Do you think that that approach to addressing any real problems with exit fees had had an opportunity to work? Had ASIC been given a chance to get out there, do that and see if that actually solved the issues?

Mr Foster—I think there are a couple of issues. As I mentioned in the commentary, the main people that are going to be affected by this are the smaller non-bank lenders, who do have reasonably significant exit fees, and that is part of their operating model that they have operated. In the case of the majority of banks it is essentially, as I mentioned, a competitive mechanism. Rather than charging an up-front establishment fee for the set-up work and costs, including external valuations that are obtained for properties, in the interests of stimulating competition and encouraging customers to switch lenders that was then moved—at the option of the customer in many cases—to what we called a deferred establishment fee so that, in the event that the customer wished to leave within a short period of time, some of that cost was recovered—

CHAIR—Essentially they paid the costs of setting up the loan.

Mr Foster—So, from that perspective, we think that is legitimate and does provide a competitive incentive for customers to move.

CHAIR—And that is essentially what ASIC was going to do: it was going to ensure that exit fees only reflected real costs of entry and exit.

Mr Foster—I guess there is a little devil in the detail, so we need to see how that plays out in practice.

CHAIR—We really had not had a chance to see how that played out in practice, and we are about to get to the point where we are going to abandon it altogether.

Mr Foster—That is right.

CHAIR—Do you think that the approach that ASIC had been asked to take and what they had come up with—just requiring fees to be limited to those genuine costs—would have impacted in any material way on those non-bank lenders you were talking about, who do have higher fees? Would that have undermined their ability to operate? Some of them did charge ridiculously large fees.

Mr Foster—Yes.

CHAIR—If they were told that they had to limit it to reasonable costs that they could demonstrate, do you think that that would have undermined their business models?

Mr Foster—Probably not close to the financial dynamics of their business model. But certainly, as I said, our belief was that those would be the people most impacted by the implementation of that approach.

CHAIR—And even more so if they cannot even cover the actual costs.

Mr Foster—Yes.

CHAIR—You also mentioned super reform to try and encourage more of the super money into funding of financial institutions. We had John Brogden from the Financial Services Council appear before us. He obviously was not keen on the idea of mandating super money into it, but the concept of providing incentives to make it more attractive for trustees to make decisions to invest in banks as opposed to other options was raised with him. He did, though, say in that context that the second-tier and below institutions would even then be at a disadvantage because, even if the incentive was there to make it more attractive, they would tend to go to the big banks. Do you think that is right? Do you think you could sell your wares to superannuation trustees so that, if we as lawmakers changed the laws and made it more attractive to park money with you or with banks generally, they would not just park it with the big four anyway?

Mr Rose—I think the answer to that is that it is proportional to the size of your balance sheet. So, if you have a smaller balance sheet, your funding requirement on the market is smaller. If you are a BBB-rated bank, given the domestic market that we are talking about here, the BBB-rated banks are well-understood organisations. The investor base understands those institutions and would be able to understand the credit and allocate accordingly an appropriate pool commensurate with the size of their balance sheet, and likewise for A-rated banks. AA-rated banks would get a higher proportion, but they are bigger banks.

CHAIR—And probably the lower cost ones again too. Their offerings would be taken up at a lower rate that you have to pay to get it, which would inherently build in a problem again, wouldn’t it? It would be a disadvantage for smaller banks?

Mr Rose—We would like to think that, with greater supply, removing that supply-demand imbalance and reducing the reliance on offshore funding, you end up in a position where the whole industry benefits—

CHAIR—It would be in fact closer to 10 to 15 rather than 80 to 90? It would be somewhere in between?

Mr Rose—It would improve from where it is.

Mr Foster—The alternate securities vehicle could play a part in making it more attractive for super funds to invest in as well, which is the mortgage bond that we talked about earlier.

CHAIR—What needs to change to make it more attractive? Ignoring the idea of compulsion, what could be done to make it more attractive for super funds to invest in your industry?

Mr Rose—In the old world in superannuation we used to have increased contribution benefit limits for those that went into guaranteed annuity style product. You are talking about the same types of carrots I would think. The industry has seen it before. We would expect it would be able to work again. So lifting the limit on superannuation contributions as long as a higher proportion is going into fixed interest guaranteed product—

CHAIR—That would come at a cost to government revenue though, wouldn't it?

Mr Rose—It depends upon that equation around what proportion of the population you are covering in support payments in their retirement.

CHAIR—I am not saying that that is a bad thing, but in the current climate that might be a challenge. I want to ask about the impact of the floods on your business and your ability to compete. You are essentially Queensland based, although no doubt you extend further. Have the floods undermined your ability to compete against the big four banks in particular that operate across Australia? Have they caused you any challenges in your ability to compete essentially?

Mr Foster—The impacts of the floods and other events are still playing out in Queensland. Queensland does represent about 60 per cent of our business. Our immediate priority has been our staff and making sure that the operational components of the business are up and running, and that has worked quite well. We obviously continue to monitor in the different markets that we operate, particularly around our personal customers, SMEs and agricustomers, as to what the impact of the various weather events, including floods, cyclones et cetera, are on their business. You would expect that there will be certainly a short-term impact on the economy more broadly in Queensland and then probably in six months or so there will be a stimulus effect to the economy.

There is no doubt that for all businesses operating within the state, regardless of the proportions of their business, there will be some impact. As you pointed out, we do have a national business from a bank point of view and we are growing strongly in New South Wales and WA in particular. We have certainly still got growth opportunities there and we are part of a broader financial services group that has a diverse business.

CHAIR—You mentioned in your opening statement that you believe that the way forward is a strong second tier with I presume a number of players offering competitive products rather than consolidating the second tier into one fifth pillar or mergers between you and the Bank of Queensland, Bendigo Bank or whomever it might be to try to create a larger alternative to the big four. Why is that? Is that because you think that that would actually lead to a better and more competitive environment and that a fifth pillar would just become one of the big five and be lost? Why do you think that would be a preferable outcome?

Mr Foster—Our belief is that a strong multi-tiered banking system is the right model for the country. It provides a good competitive dynamic, good choice for consumers and business customers and good options for investors in terms of choice of different institutions. So, across a whole number of bands, we believe that a multi-tiered structure provides the best balanced outcome across the board. By supporting a fifth pillar alone, whilst there would be some benefits for that organisation in the near term, recreating the competitive environment that existed prior to the GFC, a multi-tiered structure would achieve that.

Senator HURLEY—I want to explore the exit fees issue a bit more. Is it set so that after five years people do not pay them, which is a common model with other banks? Or is a period not set for Suncorp?

Mr Foster—There is a period set. Of the top of my head I think it is four years. That arrangement is established upfront with the customer when the product is taken out. As I said, it merely reflects a deferral of what normally would be charged as an upfront establishment fee in the normal course.

Senator HURLEY—Different banks and mortgage originators and others charge different fees in different ways. I think an issue for consumers is being able to find out what the effective interest rate is. Let us set aside the exit fees, because you may or may not incur them. Do you have any thoughts, not necessarily on taking away all fees but providing a total at the end that enables consumers to compare effective interest rates easily?

Mr Foster—There is a mechanism that exists today, via the various regulations and presentation of product pricing and material, which does provide an effective interest rate which incorporates the interest rate being charged as well as the ongoing fees that apply to the product. In addition to that, it is quite transparent in the documentation and in our discussions with customers around what the fees relating to the particular product are. We participate in a number of the industry comparator products, such as CANNEX and the like, to make sure that our products are clearly disclosed and understood. Particularly from a mortgage perspective, the broking industry itself makes a living by being able to explain the differences in pricing to customers. We see about 40/45 per cent of the industry mortgages originated through brokers. So I think there are a number of mechanisms already in place, through existing documentation requirements driven by legislation and the like together with a number of the competitive mechanisms to disclose that information.

Senator HURLEY—The criticism has been that, if you do not deal with a broker, for example, or you are not savvy enough to look up CANNEX or whoever, you are quite a long way down the path of obtaining a loan before you get to the stage where the bank explains to you the effective interest rate.

Mr Foster—I think all that information is a core part of our discussions with customers upfront. It is available online and in our various promotional materials and so forth. I come back to the point that I made around the suggested change in terms of banks' ability to comment on interest rates and so forth. One piece that collectively the industry does need to do better is help educate customers about pricing mechanisms, how funding works and how that flows through to the end price that they pay. I think it is an important acknowledgement that we know we can do a lot better on that. But I think there is adequate information upfront on the actual product pricing itself, and it is an important part of the discussion we have with customers early on.

Senator HURLEY—I will go back to exit fees. We are talking about trying to let customers take advantage of lower interests, lower prices, lower fees and be able to switch accounts more easily. If we took away the ban on exit fees that is in a way contradictory, because people who have a large exit fee—Senator Williams might address this later—

Senator WILLIAMS—I probably will.

Senator HURLEY—might feel a bit constrained in switching accounts. It is no use being able to have account portability if you have this thumping great exit fee sitting there deterring you. So the argument will be that it is better to have it as an up-front fee even though, as you say, a lot of customers do not like it. But in terms of improving competition and people being able to switch between competitors an exit fee is not a good idea at all.

Mr Foster—For context from our perspective there is not a significant number of customers that have an issue with us, and it is not a huge financial issue from our perspective. But going back to the point around the reason for the change in structure in the last few years, it was to try to encourage competition. So I acknowledge your point that once you are somewhere it does put something in the road to move elsewhere, but, from a cost equation point of view, if the structure is reversed and an up-front fee is put in place the same challenge exits. Obviously the removal may lead to different pricing structures to cater for those legitimate origination costs that are incurred. That would need to be worked through if that in fact played out. But at the end of the day there are legitimate up-front costs that are both internal costs to financial institutions, plus services paid away to providers such as valuers and the like to originate loans.

Senator HURLEY—Can you tell me what percentage of your customers would incur an exit fee?

Mr Foster—It would be very low single digits.

Senator HURLEY—You mentioned price collusion and speaking out about price signalling. Has Suncorp generally moved their interest rates in line with the RBA in recent times or have they moved with the other banks—the majors?

Mr Foster—On an ongoing basis we monitor our pricing according to the competitive dynamic that exists at the time, as well as our own funding costs. As I mentioned earlier the inherent funding costs of the regional banks and smaller players tends to be higher than that of the majors. So we obviously need to maintain a competitive dynamic both in terms of our return to shareholders but also our place in the marketplace. Our movements over time have tended to vary our position in terms of where we sat against the major banks. As it stands today our mortgage rate is pretty well middle of the pack. However, on the small-business rate, which was a conscious decision, we only moved that rate by 25 basis points and we are the lowest in the market by some way. So it does depend on product and the various initiatives that are underway.

Senator HURLEY—So you are trying to build up your small-business loan portfolio.

Mr Foster—That is an area that we are looking to grow. We think that is an area that has been underserviced for a long period of time and we think that is a good opportunity for us to provide a good service.

Senator HURLEY—In regard to securitisation and how you fund that, you have talked about the importance of underpinning securitisation. Do you think that the government assistance that has been put in through AOFM needs to be increased in amount or do you think it is about right?

Mr Rose—It is keeping the market going for the time being. I suppose the question the industry is asking is: you would expect that there is a sunset for that type of support at a particular point in time and what is going to be left at the end of the sunset? Our submission goes to one of the things that we think can drive a replacement of that sunset and actually turn it into something that is more powerful for the sector.

Senator HURLEY—I would like to go into that but I suspect I am out of time, so I will go to another question. We heard from Professor Davis about an OECD proposal to encourage banks to change to a non-operating holding company structure where one part does the standard banking—taking deposits and making simple loans—and the other subsidiary part does the investment banking. Is that the kind of thing you have done with the split that you talked about?

Mr Foster—The Suncorp Group does operate with a non-operating holding company as at, I think, 7 January this year, so that the bank is one of the divisions within that non-operating holding company. The split I referred to earlier is not a legal, structural split. It is still part of our core banking operations, but in terms of operational delineation we have split the management and funding of it, the financial business around it, so it is quite clear, and we report on that basis to the market.

Senator HURLEY—Right.

Mr Rose—But we do not run an investment banking operation. We have a banking operation, and the other entities underneath the non-operating holding company are insurance businesses, both life and general insurance businesses.

Senator HURLEY—Okay. Do you see any advantage in other banks adopting the structure that Professor Davis has described?

Mr Rose—I think the reasons why we have adopted that are probably unique to our organisation. For us, it was about transparency and simplicity to be able to explain the operations of each of our businesses more clearly.

Senator HURLEY—We had some evidence from Tyro about the way that they are trying to forge a business in the area (and I will probably get some of the terminology wrong) of providing services to merchants who use credit cards—providing that intermediate service. Does Suncorp have any involvement as a bank in funding that service?

Mr Foster—I am not sure of the exact technicalities or whom you are talking about, but certainly we provide comprehensive merchant facilities in various forms, including credit card facilities, to our business customers.

Senator HURLEY—Okay. Do you know what percentage of the market you have in that area?

Mr Foster—Probably, given that it is a developing business, on a national basis it would be less than two per cent.

Senator HURLEY—And would you say that the major banks have a stranglehold on that at the moment?

Mr Foster—I think with most of the payment businesses—and ATMs are included in those—you are seeing some divergence in the provision of services. All the major banks participate strongly, but you also do see a number of independent organisations providing various payment services as part of the value chain, including ATMs.

Senator HURLEY—You say you provide that service to your business customers. Does that mean you provide it only to your customers and not to merchants who use other banks' services—in other words, who do not bank with you?

Mr Foster—We certainly have customers who only utilise merchant facilities within our base. But, obviously, a key objective of ours is to deepen the relationships that we have with our customers and therefore provide broader services.

Senator HURLEY—Okay. Thank you.

CHAIR—Senator Xenophon.

Senator XENOPHON—Mr Foster, thank you for your submission. In relation to exit fees, you are saying that if a bank cannot charge them they will find some other way of recouping the costs?

Mr Foster—No. I think the point that I was making was that there are legitimate costs incurred in originating a loan and that the change from an upfront fee to a deferred fee was put in place at the time to try to encourage a different competitive dynamic. So, depending on how the regulation played out—and different institutions would have to look at how they deal with that separately—there could be a broad spectrum of outcomes from working out whether it becomes an upfront fee again or whether they absorb the fees.

Senator XENOPHON—So the broad spectrum of outcomes could include other ways for banks to recoup their costs?

Mr Foster—I could not comment on what other banks will do.

Senator XENOPHON—No, I mean what you would do.

Mr Foster—We will wait and see how the legislation unfolds.

Senator XENOPHON—Sure. Do you consider that there is a real issue with mortgage insurance, where you take out mortgage insurance and then switch banks? If you pay for mortgage insurance, there is a cost involved in that for the term of the loan. There is no transferability in respect of mortgage insurance at the moment, is there?

Mr Foster—No. That is exactly right. It is a good area to look at as part of the switching considerations. A significant number of borrowers utilise mortgage insurance for a number of reasons, and certainly there are a variety of providers. They include external providers, and a number of banks write that in-house as well. So exploring the portability of mortgage insurance would be an advantage to consumers. But it does not come without complications.

Senator XENOPHON—Sure. I think Bernie Fraser is going to look at the issue of portability and the technological aspects of that. But there is a simpler system in place that could still be effective, and that is in the Netherlands, where the onus is on the institution you wish to switch from to make it as seamless as possible. Do you have a view on the Netherlands model, if you are familiar with it? I think it is something that Choice prefers or says should be considered. And do you think increased portability will help the non four big banks in relation to this?

Mr Foster—Simply put, increasing the ability of consumers to switch banks is a positive from our perspective. We certainly support any initiatives to put in place to enable customers to switch more easily. In terms of what shape that solution takes, I think it is certainly worth exploring the technology solution, but that certainly is likely to be complex. I do agree that there are a number of pragmatic steps that could be taken, whether it be the model in the Netherlands or just some protocols around how things are done today to make that a better process.

Senator XENOPHON—Would you be able to provide the committee, on notice, with some details of what you think would be workable protocols for practical measures that would not be unduly onerous but could be helpful?

Mr Foster—Sure.

Senator XENOPHON—I put this question to Westpac, to Gail Kelly and her fellow executives, recently. It is on the issue of requiring insurance for damage to a property if you have a mortgage. I understand that in the UK and France it is mandated: if you take out a mortgage, you also need to have insurance for the property. Suncorp obviously has a huge exposure in the Queensland market but seems to offer a better product than many others. Do you require insurance to be taken out on home and contents, but on the home particularly, if you are providing a mortgage for a home?

Mr Foster—Yes, we do.

Mr Rose—Yes, it is a contractual obligation of the borrower.

Senator XENOPHON—Are you unique in that?

Mr Rose—No.

Senator XENOPHON—How many others do that?

Mr Rose—I would be surprised if it was not in every single loan.

Senator XENOPHON—I am talking about mortgage insurance, to ensure your home.

Mr Foster—General insurance, the home insurance? It is a pretty standard inclusion in most loan covenants in terms of terms and conditions.

Senator XENOPHON—I am talking about home insurance.

Mr Foster—Yes.

Senator XENOPHON—But not all banks require that contractually, do they?

Mr Foster—I do not have intimate knowledge of all others but my understanding is that it is a standard condition.

Senator XENOPHON—We might check that because I thought—and I might be wrong—that Westpac said it was not a requirement.

CHAIR—I bank with Westpac and they have always made me have a certificate of insurance.

Senator WILLIAMS—You need a certificate of insurance when you borrow money for a motor vehicle. It is compulsory, basically, if you owe money on a motor vehicle to have comprehensive insurance.

Mr Foster—That is right. Just on a couple of points were mentioned at an earlier meeting, it certainly protects a high proportion of the market. About 30-odd per cent of people actually have a mortgage and therefore it certainly helps protect those customers to a degree, but not the broader population necessarily. Certainly in our case about 71 per cent of our mortgage customers have Suncorp flood cover as part of their insurance.

Senator XENOPHON—You said there is an 80 basis points difference in the cost of funding since the GFC compared with pre-GFC. Is that correct?

Mr Foster—I said up to 80 basis points, and it does depend on whether it is domestic, offshore, and what the term of that funding is. Certainly the funding difference was far more significant during the last two years, but that is the current state of play as it stands today.

Senator XENOPHON—Has that been exacerbated by the bank guarantee, the Commonwealth guarantee, in the sense that it puts you at a relative disadvantage to the big four?

Mr Foster—The point we have made around the government guarantee is that, firstly, it was absolutely necessary for the whole industry at the time, so we certainly agree with that. The unintended consequence around that is essentially that the assumption was that everyone would be priced off the sovereign curve for the pricing; however, the market looked through that and essentially priced against the credit ratings of the various institutions, and on top of that was a fee differential.

Senator XENOPHON—So how do we fix that?

Mr Foster—The wholesale government guarantee has come to an end in terms of new issuance against that. That was earlier last year. However, on the residual balances of wholesale funding, there is still a significant cost to us each year by paying that fee differential on outstanding balances.

Senator XENOPHON—But being given access to the AOFM, which helps—do you have access to the AOFM?

Mr Rose—Yes.

Senator XENOPHON—Do you have a view as to whether Aussie Home Loans should have access to the AOFM?

Mr Foster—No, probably not.

Senator XENOPHON—That is all right. If you do not have a view, that is fine. Thank you.

Senator WILLIAMS—Mr Foster, you said in your opening statement that small institutions such as Aussie, Rams et cetera have virtually been taken up by the big majors due to consolidation. Is that correct?

Mr Foster—Correct.

Senator WILLIAMS—How do you define 'consolidation'?

Mr Foster—Essentially, in the case of Aussie, they are now a third owned by CBA. In the case of the others I mentioned, they are now completely owned by major banks.

Senator WILLIAMS—Are you saying that the bigger ones are consolidating and getting stronger?

Mr Foster—And buying the small—

Senator WILLIAMS—Is that how you define consolidation—those bigger banks just taking out competitors, perhaps, and getting more market share?

Mr Foster—Correct.

Senator WILLIAMS—I find it very concerning not only in the banking industry but right around Australia. In the grocery industry we have Coles and Woolworths with 80 per cent. We now have the big four with 90 per cent of the home loan market. It seems to me that we are getting this whole thing in Australia where big is powerful and if you are small you get squashed out. Do you see that in the banking industry? Do you have concerns that the small player is going to find it more and more difficult to survive in the future?

Mr Foster—As I mentioned earlier, our strong belief is that having a multitiered banking system is the right structure for the industry here, which means that you do have big players, medium players and smaller players. The big question mark really for all the industry in that regard is the long-term outcomes around the pricing and sustainability of funding. That is where certainly a number of the measures revealed as part of the competitive package, the steps taken in Basel III, as we acknowledge, are all steps in the right direction to help support that but will take time to have effect. And I guess there are still question marks around the degree to which they will have any impact. So that is essentially the residual question that remains. To ensure that there is a prosperous, multitiered banking system, we need to ensure that there is cost-effective funding for all players within that structure. Certainly we think that the measures taken are a step in the right direction. We think there are some other measures that are available either immediately or in the fullness of time when these other measures can be tested out to extend that function—but, again, that is a little bit unknown at this stage.

Senator WILLIAMS—During the GFC when the government had the wholesale guarantee, you paid a premium to the government and the government guaranteed those wholesale markets if you would repay the money to them—okay? Your premium was higher than the big banks'; is that correct?

Mr Foster—Correct.

Senator WILLIAMS—I will put that in relation to exit fees. You say you support exit fees. When I left a credit union I did not pay an exit fee. They were a second-tier bank, not a big operation, but there was no exit fee. Surely you would not need exit fees because, if you were competitive in the price of your product, why would someone want to exit?

Mr Foster—As I said, from our own perspective—

Senator WILLIAMS—Let me put it a different way. If I were banking with you and I wanted to leave you—unless there was a personality clash, which is very rare because the people in the banks at the coalface are always very friendly, very professional et cetera—it would probably be for a better deal. But if you could compete with a good deal, as good as anyone down the road including the big ones, I would never want to leave you, would I?

Mr Foster—It does depend a little bit, as you said, on the reasons why customers want to leave, but as I said before it is certainly not a significant issue for us in terms of the numbers of customers or from a financial point of view. But, as I made the point, the dynamic is around what is best from a competitive offering point of view and then, I guess, the way that the industry and different players will deal with that differently in terms of the actual costs that are incurred as part of that.

Senator WILLIAMS—Your bank is Suncorp. Used you to be Suncorp as well as QIDC and Metway, was it—and the three of you combined?

Mr Foster—Yes, the origins of the bank within Suncorp date back to 1902 with the Agricultural Bank, which—

Senator WILLIAMS—I know QIDC was a very popular—

Mr Foster—Correct.

Senator WILLIAMS—rural bank basically in Queensland, based at Goondiwindi and places like that, very good with farm and rural finance.

Mr Foster—That is right. About 12 years ago or so, there was a merger of Metway Bank, which was previously a building society, the Suncorp building society and QIDC, which brought that together.

Senator WILLIAMS—Good luck in the world of tough competition!

Senator PRATT—I have a question regarding small business credit. You have outlined how it is part of your agenda to continue to grow that space. Indeed, I think you said you have a lower interest rate than most of your competitors. In the themes that have come up in this inquiry, there has been some commentary about the difficulty for small business in gaining credit and the concern of many small businesses that they do not believe that their risk is judged fairly. I want to ask Suncorp how you approach that issue, particularly in relation to the relationship that many small businesses have with the equity in their personal house as opposed to the equity in their small business.

Mr Foster—It does depend a little bit on the size of the business that you are talking about. Certainly it is an area that we are very focused on trying to grow. I think, if you look at the market over the last year or two, there have been as many demand issues as there are supply issues in the provision of credit in the market. Certainly on the demand side of the equation many businesses have elected to deleverage—not invest—and therefore the underlying demand for credit has diminished anyway. And then, on the supply side—and that has probably evolved over the course of the last couple of years—certainly both pricing of risk and also inherent funding costs have increased, and there is a very different risk profile for business customers from that of a mortgage customer generally. That has been built into pricing, which for a variety of reasons had diminished over preceding years.

There is certainly a lot of dialogue and a lot of discussion around this particular issue with industry groups and with customers directly, and we are very active in doing that, but there will always be a mismatch, particularly from a risk point of view, in terms of what perhaps an unsecured need of a small business is versus a credit appetite of a financial institution. What you have seen is that a number of the providers that existed pre the GFC and filled that niche in the market of higher risk, more cash flow based lending to small business either essentially withdrew or contracted and therefore left a hole in the market for some small businesses.

Senator PRATT—Does your lower interest rate mean that you are judging risk more conservatively? It is interesting that you are targeting it as an area to grow, and yet it seems that, as you have indicated, a lot of the growth in that market historically comes from lenders who are prepared to take on more risk. I am really trying to come to terms with the competitive dynamics in this.

Mr Foster—I think there are two parts to that. One is in terms of the sort of facility that I am talking about. It would typically be a customer that utilises either their commercial premises or their residential premises to support their borrowing requirements. That market, just like the other part you mentioned, historically has grown solidly as businesses have evolved. But certainly we have seen that contract in recent times.

The separate issue to that is a part of the market that existed previously in terms of a requirement of businesses to source, I guess, higher risk, unsecured type credit. There were providers in the market that provided that, but they are the ones that perhaps have—

Senator PRATT—So you would accept the argument of small business that they are not being treated completely fairly by the banks, in that that risk is largely mitigated by the equity of the home that is secured against the loan, and perhaps banks are not adequately taking that into account in their risk assessments?

Mr Foster—No, I do not think banks are generically treating small business customers unfairly. I think there are two separate issues at hand. One is that there is a part of the market that banks did not participate in and still do not participate in. But those who did participate in that market, for a variety of reasons, have either wound back or exited. That is where a lot of the noise is being created. In terms of inherent risks, there are very different statistics and requirements from a regulatory point of view around capital weighting, default scores and real experiences in defaults and so forth in small business versus mortgages. There are some very fundamental differences.

Senator PRATT—Irrespective of the equity in your house or any default costs, yes.

Senator XENOPHON—The question put to Westpac was: do they require mandatory flood insurance for homes? They do not. What is the position with Suncorp? Is flood insurance an optional extra for someone who takes out a mortgage with Suncorp?

Mr Foster—No. The point I made before was that 71 per cent of our mortgage customers have Suncorp insurance that includes automatic flood cover. The Suncorp product, which is the product that we distribute and sell through the bank, has flood cover as an automatic inclusion.

Senator XENOPHON—So Suncorp is ahead of the pack compared to other institutions?

Mr Foster—Correct.

Senator XENOPHON—That is good.

Mr Rose—To clarify, a customer can come in and chose to go with another provider of comprehensive insurance that does not include flood cover. We would have customers in that category in our portfolio.

CHAIR—I have a final question. In terms of the wholesale funding guarantee, if the government were to remove the differential in fees on your ongoing funds, what difference would that make to your ability to compete, particularly with the big banks?

Mr Foster—It will certainly be a significant, ongoing cost to our organisation for the coming years, so that would certainly feed into our overall funding costs and dynamic and into our pricing decisions as a result.

CHAIR—Thank you very much. Thank you for assisting us.

[7.08 pm]

LIDDY, Mr David, Chief Executive Officer, Bank of Queensland

McMULLEN, Ms Tarryn, Head of MD's Office, Bank of Queensland

CHAIR—Welcome. Would you like to make an opening statement?

Mr Liddy—I would firstly like to thank the committee for the opportunity to appear tonight. Competition in banking is a topic that is very close to my heart and something that is particularly pertinent to any non-major bank in Australia in the aftermath of the GFC. Our commitment to greater competition in the marketplace is matched only by our commitment to our customers in delivering them a differentiated banking experience. BOQ's model is quite unique in the retail banking sector of this country and in fact worldwide as we allow our managers to take direct ownership of their branches. We promote this model of owner managed branches as we believe the most efficient interface in a community is still small business and local market management.

For the benefit of senators who are not familiar with BOQ, we have: 269 branches nationally, almost 200 of which are owner managed branches; 10 business banking centres nationally; a national finance division which offers equipment finance and vendor finance; and we recently purchased a consumer credit insurance business called St Andrews. What we do not have in comparison with the major banks is a wealth management arm. However, we are trying very hard to be a genuine alternative for consumers to the major banks in Australia.

Later this week, I will have been in banking 43 years—33 years of which were with a major bank and the last 10 with BOQ. There is no doubt that the GFC was the toughest period that I have ever seen or experienced in the industry. Probably one of the most significant outcomes of the GFC has been the negative impact to competition in our industry.

Whilst there is more to competition in banking than purely price, such as service or access to capital, I am sure the committee appreciates that pricing is fundamental to enabling genuine competition. An important caveat here is that it needs to be non-predatory pricing competition—that is, players do not engage in unsustainable pricing designed to squeeze out competitors in the short term in order to enjoy higher profits in the long run. Without the ability to provide sustainable pricing competition, it is difficult for a participant in the Australian banking sector to provide meaningful competition to the dominant players—that is, the major banks.

Prior to the GFC, non-major banks, the mutual sector and the nonbanks were able to price competitively with the major banks and in fact assisted in driving interest rates down despite being a fraction of their size and having lower credit ratings. This is because there was access to a funding source which acted as a leveller—securitisation. Access to the securitisation market was the fuel that allowed non-major banks to grow and compete as it allowed an equal cost for funds for lending.

Post GFC, it has been well documented that the securitisation market has been crippled. Despite the government's $16 billion-plus investment in the RMBS market in an attempt to revitalise it, the cost of securitisation today remains high. If the government is genuine in its intention to reinvigorate competition in the banking sector, BOQ believes the most effective and sustainable way to do so is to focus on reducing funding costs and to focus on re-establishing a competitive playing field in terms of funding.

The government released its competitive and sustainable banking system reforms after BOQ had submitted its submission to this committee. We believe that some of the reforms canvassed are useful. However, part of the risk in responding to the specific initiatives put forward is that we do not believe they canvassed all the sustainable competitive issues facing Australian banking. For genuine competition in banking, we believe a more realistic framework is needed. I will try to succinctly explain what I mean.

Banking is a unique sector in our economy. It plays a fundamental role in intermediating and reducing the costs of connecting savers with borrowers. It provides capital, interest and access certainty to savers who deposit funds with banks and it manages the risk of different interest rate requirements and term maturity requirements of the savers versus the borrowers using its equity, liquidity, credit and balance sheet management skills and in the process pooling thousands of transactions into a portfolio and thereby diversifying and reducing the overall risk.

For banks to deliver the operational capabilities necessary to achieve these three things, equity capital is needed. It is equally important when considering expansion in competition that emerging players authorised to collect deposits from retail or wholesale investors possess the required operational and capital strength to maintain investor confidence in the Australian financial system. Regional banks with established capabilities are essential in this equation.

A robust, healthy banking system must support a sustainable return on equity in order to maintain the attractiveness of the sector for the providers of capital—both investors to provide new capital and also to allow for greater retention of existing profits. Increases in equity capital in banking increases the buffer on impairment risk on banking assets eating into liabilities owed to all depositors. In this context, government policy should allow banks to operate at acceptable returns on equity, ROE, and this should be encouraged rather than shied away from.

We believe objectives for genuine competition policy need to address three key factors. The first factor is the ease with which a new entrant or an existing player can enter or grow in the banking sector to reach the ROE enjoyed by the industry leaders. This will determine the number of real alternatives available to consumers as new and existing players jostle on improving their value proposition to win over customers.

The second factor is to ensure the differing needs of banking customers are met adequately by the system, be they consumers borrowing for housing or personal needs or businesses borrowing to invest in the productive capacity of our economy. They must all have access and terms of debt, including pricing, which are reasonable and fair in terms of the risk-reward equation for the banking shareholders. In this context, one segment of customers subsidising another needs careful consideration. It can be a useful strategy for competition but, if sustained for long periods of time, it will impact on resource allocation in the different customer bases and therefore asset allocations in our economy.

The third factor is accessibility of banking transaction infrastructure. Whilst most credit unions and building societies can offer competitive home loans and deposit rates, they are not all equal in terms of accessibility of funds through national branch footprints, internet banking, Treasury operations et cetera. In this context, a direct charging type approach to other transaction infrastructure services may overcome the disadvantages that are faced by smaller subscale players. These three factors need to be kept in mind when crafting genuine competition policy.

In our submission BOQ outlined five ways we thought the government could assist in enhancing competition. These initiatives are practical ways the government could act; however, upon reflection, after reviewing the December banking competition reforms, I am not sure our proposed initiatives go far enough in establishing true sustainable reform. So, to the list of five initiatives we proposed to the committee, I would like to add another one. At the risk of raising yet another inquiry, I think we need a far more fact based view on the sources of competitive advantage in banking. I think the merits of maintaining the current biases towards major bank regulations needs independent analysis.

The four major banks are unique not just in terms of their size in the banking market; they are also now the biggest players in the insurance, wealth management and financial advisory markets. It could be argued that they already have an implied guarantee from the government, as they are systemically important and too big to fail. This is worth $1.3 trillion, or 100 per cent of GDP. So, if we want to ensure there is genuine competition to this oligopoly, then we really need to get into the detail and understand what the current competitive advantages are and have independent experts provide advice on the way forward. When I say 'independent experts', this should be in addition to the current regulators, as it is important to recognise the narrow mandates that the RBA and APRA have and to understand that it precludes them from a broader view on some issues. For example, the RBA's focus is rightly on stability and this does not always fit the lens that is needed for a broader issue, such as competition. Any genuine competition debate should address concentration issues and potential contagion risk. It is obviously important to balance promoting competition with minimising systemic risk. An independent inquiry—like the independent commission on banking in the UK—could be charged with this task.

I will not go into detail on the five initiatives included in our submission, as you have already covered many of them in your hearings today. We believe they are important to implement in the short term, so the advantages built up by the major banks over this period is not allowed to be consolidated and entrenched. In this regard, dealing with the return on equity discrepancy between the majors and all other participants, including new entrants which are needed for genuine competition, is critical.

The four major banks enjoy ROEs of around 15 to 18 per cent; while regional banks are between seven and 10 per cent. The quickest way to enhance competition and to enhance the ROEs available to nonmajors and new entrants—that is, to create the level playing field that will entrench competition in the banking sector—is to lower the funding costs available to them. As I have stated, pricing is a key variant of competition, and lower funding costs allow more competitive pricing with the market leaders.

The initiatives in our submission address ways to achieve this—for example, expanding the RMBS program to levels where there is a meaningful impact on competition. The extra $4 billion investment in RMBS is a welcome addition. However, adding this to the existing $16 billion does not add any incremental funding, given the amortisation of the original $16 billion will be around $4 billion in a year, as a rule of thumb. A good statistic to keep in mind is that housing loans in Australia are $1 trillion. So even a below average growth rate of, say, seven per cent will require $70 billion in funding. So doubling the RMBS investment by another $16 billion would be meaningful to competition.

Introducing a Canadian style RMBS mortgage structure or introducing a government guarantee of lenders mortgage insurance would certainly assist in reducing the cost of funds and providing a sustainable basis for re-establishing a level playing field between all providers in the mortgage market over the long term.

We have called for reducing the capital ratio required on mortgages held by the nonmajors under the standard importation of Basel II framework to the levels enjoyed by the majors under the advanced approach to Basel II. A feature of the global application of the advanced Basel II framework has been the relative advantage gained by the Australian majors in the level of capital required to support their mortgage products. This outcome has created a significant competitive disadvantage for the nonmajors, who apply a standard capital release which could be addressed in conjunction with APRA.

And, of course, there is the old chestnut: flattening the fee for all remaining payments as part of the government guarantee on wholesale funding. I should note that this very committee concluded, in your inquiry into the bank funding guarantees in 2009, that this fee had had an unintended impact and should be reviewed. If the government guarantee on wholesale funding were flattened to the fee that the major banks pay for all remaining payments, BOQ would be able to immediately reduce our variable mortgage rate by 20 basis points.

I will end now as I began. We are unique in the banking sector of this country and we are proud to deliver to people a banking experience that, I believe, they cannot find anywhere else. BOQ is firmly committed to this mantra and to enhancing and fostering genuine competition in the Australian banking sector. I am of course happy to take any questions that you may have.

CHAIR—Thank you. You finished up on wholesale funding. You mentioned that, if that were flattened and the price differential were removed for the funds that you have under that guarantee, you could reduce your price by 20 basis points. What impact would that have on your competitive position? Do you think that that would enable you to increase market share?

Mr Liddy—We would be the cheapest variable rate mortgage provider in Australia today.

Senator XENOPHON—By how much?

Mr Liddy—By one basis point. There is quite a variance, as you probably realise, in all the rates charged by all the banks, but that would certainly bring us back below all the other banks—and all the other providers, for that matter.

CHAIR—We have gone through this before, as you mentioned, in a previous inquiry, and in this inquiry as well, but ultimately the government has made a decision to price on the basis of rating, which they say reflects risk. Do you think that the ratings as they have been allocated to financial institutions in Australia accurately represent the risk to government from the guarantees?

Mr Liddy—I do not believe so. APRA are a tremendous regulator and do their job exceptionally well. When the guarantee first came in, a AA bank was charged 70 basis points to access the guarantee, an A rated bank was charged 100 basis points and a BBB bank—or any non-rated bank, for that matter—was charged 150 basis points. So the difference between, say, a BOQ and a Westpac was 80 basis points. When you go into the markets and borrow funds under the government guarantee, as my colleague from Suncorp mentioned in his address before, investors take account of not just the sovereign status of the AAA rated guarantee of the Australian government; they look through to the actual rating of the issuer. So it is a double dip. You are paying 80 basis points more for the guarantee, and then you are paying the difference in your credit rating to the investors. I think that was an unintended consequence, but I think it is easy to fix.

CHAIR—I think Treasury acknowledged, at the hearing when we looked into it, that they had not anticipated that happening. Nonetheless it has and it means that you are paying twice, effectively, compared to the major banks. Ultimately the Treasury evidence at that hearing was that they have a responsibility to protect the taxpayers' funds and so they have priced it according to the risk. The easiest way to do that was with the ratings. So the question is whether that is an accurate way of assessing the risk to the taxpayers or not.

Mr Liddy—I do not believe so. We are regulated by APRA, we have minimum capital holdings that we have to have, we have minimum liquidity holdings and we are supervised very closely, believe me.

CHAIR—Very good. You mentioned the government's competition in banking package. When that was released, I think you were in the media as saying that this was not a silver bullet and was not even a copper bullet, or words along those lines. Today you have been fairly measured in your comments about it. I think all the evidence we have had suggests that it is a move in the right direction to some extent. To what extent do you think that that package actually delivers on enabling institutions such as yours and other non-major banks to compete in the market?

Mr Liddy—I think time will eventually tell. I think some of the initiatives are very good. One of the biggest issues that was made as a result of that was the introduction of a potential for covered bonds in this marketplace. Covered bonds will form a new form of funding in the Australian market, and liquidity, but a bank like ours, a BBB rated bank, will not be able to issue AAA rated securities. The investors will look for AAA rated securities. Whilst it will improve liquidity in the Australian market, I think the majority of that benefit will go to the major banks because they will be able to issue AAA rated securities.

CHAIR—So it will improve liquidity but not necessarily enhance competition.

Mr Liddy—No.

CHAIR—Are you saying that, even if you joined with other institutions, you would not be able to issue AAA-rated covered bonds? We have had some evidence to suggest that that may be possible.

Mr Liddy—There have been suggestions of pooling. If we joined with our colleagues in Melbourne—Bendigo Bank, a BBB rated bank; Suncorp are an A rated bank—I am not sure whether we would still get to the AAA rated status. The issue is that there will be a limit placed on how much of your assets can be issued under covered bonds. It is either going to be five or perhaps 10 per cent. The main part of that will be issued by the major banks. The names associated with that will benefit the major banks. That is my personal feeling.

CHAIR—What percentage of your funds would have been raised through securitisation before the GST?

Mr Liddy—About 28 per cent.

CHAIR—What is it now?

Mr Liddy—About 14 per cent.

CHAIR—How have you made up the difference, or have you contracted in terms of your lending?

Mr Liddy—Retail funding has obviously been a key focus of all the Australian banks and we have certainly improved our position in retail funding, albeit it is expensive. We have been able to change the mix of short-term and long-term wholesale funding. So we are a pretty balanced bank today in terms of that. The AOFM has certainly assisted us. We have raised about $3½ billion through securitisation since 2009. The AOFM have taken about $1¼ billion of that onto their own books, with investors taking the rest.

CHAIR—We discussed the flattening of the guarantee term. Item 5 in your submission related to superannuation. We had John Brogden from the Financial Services Council appear before us earlier. We discussed the idea of getting some more superannuation money into the banks. He was obviously strongly opposed to compulsion in that regard. In terms of changing the regulatory structure so that we could assist in making it more attractive, he had a concern that even if we did do that the trustees would make investment decisions that sent that money to the big banks anyway and it would not necessarily enhance competition. Do you think that is the case or do you think that a bank like yours could adequately compete for those funds and attain them at a price that would enable you to then compete?

Mr Liddy—The whole idea of the importance for superannuation from a covered bond perspective was that in Australia we are heavy on equities and low on fixed interest investments. My view or our view was that if we could encourage the superannuation funds to invest in covered bonds, it moves towards more of fixed interest investments and improves liquidity in the Australian banking market. Whether the superannuation funds would choose a Bank of Queensland bond over a Westpac bond, for instance, is questionable, but I am sure it is a step in the right direction.

CHAIR—You also advocated the doubling of the RMBS by a further $16 billion, saying basically that an investment of that size is what is needed to make a difference. What cost would that come to for the government?

Mr Liddy—In terms of the existing RMBS process, obviously the government is investing in bank paper and it is receiving a return on those investments. So, from a cost perspective, it has got a liability to Australian banks as issuers, but apart from that I do not think the cost is significant at all.

CHAIR—That is my understanding as well. We will be asking at estimates to see what sort of money they are making on it at the moment as well. Given the time, I will hand over to Senator Hurley.

Senator HURLEY—I want to continue to explore that very point. You were talking about a couple of measures—doubling the RMBS investment and also levelling out the wholesale funding guarantee. It does beg the question: how important is it to the government to direct money into reducing interest rates by something like 20 basis points? Why, in your view, is it so important that the government pour so much money into maintaining your organisation and other similar organisations?

Mr Liddy—Firstly, this is a government inquiry into competition, so the government is interested in competition and perceived that there is a lack of competition. Otherwise, I am sure we would not be having this inquiry. Pre-GFC, there was a great equaliser in terms of funding that enabled smaller players to compete head-to-head with similar pricing and in many cases much lower pricing—that is, when Aussie Home Loans came into the market 10 years ago. They brought down the cost of mortgage lending significantly. The reason they could do that was that they were able to securitise their loans. So that was the big equaliser, and it was exactly the same for us. All I am saying is that the government has already indicated its willingness to support competition through the RMBS issuance, given that the international markets are virtually closed. The word 'mortgage' or 'home mortgage' worldwide, apart from Australia, is a dirty word. We have never had the experience of defaults in this country in our home mortgage market, so it is a safe investment. The government gets adequate return on its RMBS portfolio and it enables the smaller players to compete, as I said, on a much more level playing field.

Senator HURLEY—I think you are comparing this with the nineties, when, as you quite rightly said, there were many players in the market using securitisation as a funding vehicle. But there is an argument that we have heard in this committee that those were very unusual times. So you are asking the government to try and bring back those days when, globally, securitisation was forming a big pool of funding. You are asking the government to artificially bring it up to a similar level by government intervention. I am querying whether that is such a good idea.

Mr Liddy—As I said, the mortgage market was tainted as a result of exposures in the US—North America, mainly, but I guess in Europe as well. So a lot of people who were investing in those mortgages will not invest in mortgages today, because a mortgage is a mortgage is a mortgage, regardless of where it originates. In our country, we do not have anywhere near the default rates of other countries in terms of our mortgage portfolio. So I believe it is a safe investment for the government. If the government wants to assist in competition and in reducing the cost of funding to enable more relevant competition, then that is a key mechanism for it to do that.

Senator HURLEY—You do not accept the argument that we have come out of a highly unusual period in the securitisation market?

Mr Liddy—No. I believe the GFC was a very unusual situation, perhaps a once-in-a-lifetime situation, in financial services. That is what caused the unusual nature. I am sure, if we did not have a GFC, Australian mortgages would be very readily accepted overseas. Today Australian personal loans—cars, equipment finance—securitised as leases, are sold in the international markets, yet a mortgage cannot be. Why? Because mortgages have been tainted.

Senator HURLEY—So your view is that the government should actively step into the market?

Mr Liddy—As I said, if we have growth of seven per cent in mortgage lending in Australia, that requires $70 billion worth of new funding. We want a competitive and dynamic environment. I am not asking the government to go to $70 billion, but the government proved that it could bring competition back into the market through the $16-odd billion that it already put into the market. If we doubled that, it would enable a much more competitive environment.

Senator WILLIAMS—That is seven per cent over what period of time—a year?

Mr Liddy—Yes, if we had seven per cent growth in mortgage lending.

Senator WILLIAMS—Is that normal—seven per cent growth in mortgage lending a year?

Mr Liddy—It is low.

Senator WILLIAMS—You normally grow your mortgage lending more than that?

Mr Liddy—Much more.

Senator XENOPHON—In terms of volume, which could be a reflection of house prices.

Mr Liddy—Yes. The mortgage market is subdued this year. It is probably less than seven per cent at the moment, but in previous years it has been 11 per cent, 14 per cent, 16 per cent. Over that period BOQ has, in system growth terms, more than doubled system growth. The only reason we could do that was to be competitive. As a small player we are a net receiver of disgruntled customers from major banks, and hopefully we do not lose too many that come over. But price is very, very important to consumers. If you are not competitive on your pricing then it takes a big leap of faith to say that BOQ is the better proposition than one of the majors.

Senator HURLEY—So the wholesale funding guarantee that the government brought in as a result of the GFC was clearly of benefit to you?

Mr Liddy—It was the saviour for the Australian financial services market, but it had to follow the worldwide trend. Ireland led with it. Once one government moved many governments did move. But we moved very quickly and we did it both on the lending side and also on the deposit side. It was very, very timely and certainly needed.

Senator HURLEY—I think it is a very important point that you raised about predatory pricing in your introduction. You said it as though—and I could be wrong on this—that there was predatory pricing being undertaken at the moment.

Mr Liddy—No, I do not think so. All I am saying is that if you have got the strength and the power, you can move the market which ever way you want. The major banks have a massive ability to cross-subsidise one area for another. For instance, in the retail deposit market in Australia, if you chose to put a 7½ per cent term deposit rate out there today when the market is six per cent, you could do it as a major bank, because you cross-subsidise any loss you had on that portfolio with a gain somewhere else. That is the facts. All I am saying is that that is not good for competition.

Senator HURLEY—Are you saying that the way to stop that is by maintaining competition or are you saying that there should be some regulation to prevent that?

Mr Liddy—I think it needs to be looked at in the whole competition theory issue that we are discussing today. I am certainly not saying that there is predatory pricing happening. But there is the potential for it to happen. Senator Williams raised the issue of retailers. We all know what has happened with major retailers in terms of pricing. Now it has all come back to a more level playing field, if you like. But the ability is there to price what you want.

Senator HURLEY—Yes, I think that clearly encapsulates why the government is concerned about maintaining competition in the banking sector. Thank you, Chair.

Senator XENOPHON—Thank you for your submission and being here today. Further to Senator Hurley's line of questioning on predatory pricing, do you think the ACCC should have additional powers to deal with the issue of predatory pricing?

Mr Liddy—I definitely think it needs to be a consideration in the overall competition theory, yes.

Senator XENOPHON—Do you think our current predatory pricing laws are inadequate, either in terms of what is on the statute book or enforcement? I am not asking you to give a legal opinion on this, but is it your impression that it is either not actively enforced or not strong enough?

Mr Liddy—I do not think I have seen examples of predatory pricing. All I am saying is that I think the ability is there if a competitor chose to do that.

Senator XENOPHON—But the fact that the ability is there, does that affect behaviour in the marketplace, do you think?

Mr Liddy—Well, it could, certainly.

Senator XENOPHON—So you do not actually have to engage in it without it causing detriment to consumers?

Mr Liddy—In some cases it would be a plus for consumers. If one of the banks decided to go out with a terribly aggressive deposit rate, they will get customers, believe me. Customers move on rate; that is a fact—certainly on the deposit market. The average term of liabilities in banks these days is much, much shorter than it used to be. That is because customers will change.

Senator XENOPHON—Can I ask you about switching. You would have heard Suncorp's evidence. What is the Bank of Queensland's view on switching? In particular, Choice was quite praiseworthy of the Netherlands model, where there is an onus on the institution that you wish to switch from to provide the paperwork, to do the relevant things so that it is much more seamless and easy for a consumer to be able to switch. Would you have a problem with that sort of model?

Mr Liddy—No, not really. As I said, we are net receivers of people who do not want to bank with a big bank, so I encourage any mechanisms that allow it to be easier to move between organisations. The only question I have got is: if it becomes a very expensive technology issue, then the smaller players are going to find it hard.

Senator XENOPHON—I am not talking about the expensive technology approach, I am talking about the Netherlands, which seems to be more an onus and a paper trail in a sense.

Mr Liddy—I am not totally familiar with the Netherlands model but I would support any mechanisms that make it seamless for a customer to switch banks without undue burden.

Senator XENOPHON—When *Choice* did a survey of Queensland businesses it found that those banking with the Bank of Queensland were more satisfied than those banking with the majors, which is good from your point of view. What prevents that good customer survey translating into increased market share for you? The big banks are still the big banks and they have got the lion's share of the marketplace. You seem to have happier customers—

Mr Liddy—It is a great question. Post GFC the majors control roughly 90 per cent of the mortgage market, for instance. That is probably around the mark. BOQ has a national market share of around about 2.5 per cent. If we could double that to five per cent that would obviously make a major impact. We have to remain competitive to gain customers and we do. Our owner managed branch model is unique. It is run by small business people whose small business happens to be a bank. Believe me, they know their customers much better, I believe. If they do not look after their customers they basically do not feed themselves. So the level of service has to be good. We gain a lot of business from word of mouth. We are probably underspent by eight to one by most of the other banks in terms of advertising on television or radio, but we gain customers through word of mouth.

Senator XENOPHON—You made reference to Aussie Home Loans and the impact they had on the marketplace. I agree with you in terms of their impact and competition. Aussie Home Loans cannot access the AOFM because it seems that there is a view by government that it is a subsidiary of the Commonwealth Bank. The Commonwealth Bank has a 33 per cent share but John Symond controls four of the six board seats. Do you consider Aussie Home Loans to be a subsidiary of the Commonwealth Bank?

Mr Liddy—My understanding is that it is owned about 30 per cent by the Commonwealth Bank.

Senator XENOPHON—It is 33 per cent.

Mr Liddy—My understanding—and I have seen what John has said—is that the Commonwealth Bank do not have any direction in terms of the running of Aussie Home Loans. Knowing John Symond I would probably think that is correct.

Senator XENOPHON—But it is not a subsidiary in any corporate sense.

Mr Liddy—Not in a legal sense. It just happens to have a big elephant sitting on top of it.

Senator XENOPHON—Is that the case though?

Mr Liddy—I do not know. I am not involved in the Commonwealth Bank or Aussie Home Loans. I think it was a pretty tough deal to have that securitisation pulled.

Senator XENOPHON—Pulled from Aussie Home Loans?

Mr Liddy—They were due to go to the securitisation markets through the AOFM and it was stopped.

Senator XENOPHON—So you regard it as pretty tough on Aussie Home Loans?

Mr Liddy—I thought it was tough.

Senator XENOPHON—This line of questioning comes under the 'what the hell were you thinking' category and that relates to the fact that you have offered a deposit account where the return is effectively a lottery. I think you know what my views are on that. Is that product—if you want to call it that—still being offered?

Mr Liddy—Yes, and it is not a lottery. Under a lottery, or gambling, a depositor or a consumer puts their capital at risk. With our Save to Win account the capital is guaranteed.

Senator XENOPHON—But the interest is at risk.

Mr Liddy—The interest is one per cent, but there is a chance that you can get a prize going forward. We have just had the first draw of that.

Senator XENOPHON—Is that being a bit disingenuous? Whilst the capital is not at risk, if you put your money into an account where you have an interest rate of X per cent, you are actually saying, 'Punt on the interest you will get,' in terms of your savings remaining static. If you lose you do not get any interest. If you win—you have a 20,000 or 50,000 chance—you will get a bonus. You are putting your customers interest at risk in that sense.

Mr Liddy—No, I think we are encouraging savings. Firstly, as I said, I am here to talk about competition, by the way, but I am happy to talk about this for a second.

Senator XENOPHON—I will draw it back to competition in a minute. But go ahead.

Mr Liddy—To us it is an innovation—it is an innovation to provide competition to the major banks in getting new customers. It pays a nominal interest rate of one per cent—

Ms McMullen—Guaranteed.

Mr Liddy—guaranteed—and the capital is guaranteed. We do not expect customers to put all their savings into these accounts, but we are seeing customers put some of their savings in. They may bank with a major bank; they may bank with a credit union. And they are putting some of their savings in with Bank of Queensland. It offers choice—

Senator WILLIAMS—Is there a minimum amount required?

Mr Liddy—Yes: $250.

Senator XENOPHON—Mr Liddy, you say it is innovation. Others say it is an abomination, including consumer groups such as Choice. But the reason I have asked is that this is an inquiry about competition in the banking sector. Does this account that you offer, this so-called product, suggest that the pressure of competing with the major banks can push smaller banks such as yours into offering what many would consider to be an irresponsible product?

Mr Liddy—Firstly, we do not think it is an irresponsible product. It is a registered product. It is overseen by ASIC. It is a tier 1 product in terms of selling, so there are certain requirements that our staff have to go through in terms of selling that product. And, as I said, it is a unique offering in this market. It already exists in New Zealand. It already exists in the UK. And of course we have to innovate, to be different.

Senator XENOPHON—One per cent is below the market rate—way below the market rate.

Mr Liddy—A $20,000 prize every month is way above the market rate.

Senator WILLIAMS—It depends on how many customers you have got. If you had only 10,000 customers it would be. But if you had 10 million it would be below the rate.

Mr Liddy—I wish I had 10 million customers—I would not worry about it!

Ms McMullen—It should be noted: the account has been set up not as a savings account; it has been designed to attract people who have some spare cash, basically, to put away. That is why the minimum amount is $250 to get an entry into the draw. It is capped at $20,000. So, for anyone who puts in: if they have $250, $500, $1,000 or up to $20,000, the interest rate they would get on a term deposit at six per cent at the moment compared to what you would get on an interest rate of one per cent per month is, in actual dollars, not that different. So it is an incentive for a culture of savings for people who perhaps would not normally save.

Mr Liddy—And people will make a choice.

Senator XENOPHON—I cannot see how you are encouraging a culture of savings when you are giving way below the market rate, on a punt. But how do you advise customers to treat these accounts when compiling their tax returns?

Mr Liddy—It is taxable. Any interest is taxable on deposits.

Senator XENOPHON—And the winnings, if they happen to win the jackpot?

Mr Liddy—Taxable.

Senator XENOPHON—I will be asking ASIC some questions about it, so please do not think I am only picking on you. I think Senator Williams had some further questions, but I will leave it up to the chair.

CHAIR—Senator Williams.

Senator WILLIAMS—Mr Liddy, I am very interested in predatory pricing. That concerns me. My colleague Barnaby Joyce made amendments to the Trade Practices Act—the Birdsville amendments—to see that the big end of town cannot just go out there and undersell at a price to squash the little competitor away. I do not think those movements have gone far enough in the Trade Practices Act. Have you seen any sign of predatory pricing, whether on investment rates or lending rates?

Mr Liddy—No.

Senator WILLIAMS—Good.

Mr Liddy—As I said, competition is hot in the Australian market at the moment, particularly in deposits. If you are going to compete, you have to be competitive in terms of pricing. But certainly I have seen no instance of predatory pricing.

Senator WILLIAMS—The committee is well aware of the competition. Prior to the GFC there was competition in lending money; now there is competition in getting money in.

Mr Liddy—That is right.

Senator WILLIAMS—You are seeing exactly that?

Mr Liddy—That its purely because of the cost of wholesale funding. There is about a 90 basis points difference between pre GFC and post GFC for us.

Senator WILLIAMS—If I made you dictator of Australia, hypothetically, tomorrow for one week, what would you change at a government or regulation level to give more competition in the banking industry?

Mr Liddy—I think I have covered that in the submission, but just to recap—

Senator WILLIAMS—Do you mean the five points?

Mr Liddy—Yes, the five points I have raised. I think levelling the playing field in terms of access to funding is probably the most important one, because it does enable the smaller players to compete head to head. If you look at what has happened in our marketplace, we have had the three main non-bank lenders disappear. We have had the two major regional banks disappear. You can call that consolidation or whatever you want to.

Senator WILLIAMS—A takeover, abolishing competition—whatever you want to call it.

Mr Liddy—We still have competition in the marketplace. I am not saying we do not have competition. I am saying we can make it a much more even competition by addressing some of the issues we have raised in our submission.

Senator WILLIAMS—Thanks, Chair.

CHAIR—I have a couple more questions before we finish. You referred to the Canadian model of RMBS funding. How would that translate to Australia? How do you see that could work here?

Mr Liddy—Sorry, Senator?

CHAIR—The Canadian model of essentially supporting the RMBS market.

Mr Liddy—The Canadian model involved a whole series of initiatives, but essentially they took the risk through an RMBS type scheme guaranteeing the banks' paper—and providing significant liquidity in the Canadian market, for that matter. So it helped both on pricing and certainly in terms of the liquidity of paper in the Canadian market. There have been a lot of objections to it on the basis that such a scheme potentially creates a contingent liability for the government. But at the end of the day, as I said, if you look at the size of the big banks in this country—and I believe that they are systemically important—that is a liability for the government anyway.

CHAIR—So you are saying that there is an implicit liability anyway, in the same way that formalising the deposit guarantee side of things—

Mr Liddy—I cannot see the Australian government allowing one of our major banks to fail.

CHAIR—No. So the implicit guarantee that exists in terms of the banks themselves is really no different, in effect, to providing an explicit guarantee here for the RMBS in the same way that the Canadian model does?

Mr Liddy—No. I believe so.

CHAIR—Okay. So there is no real difference in risk, whether it be implicit or explicit.

Mr Liddy—No. And there would be a significant benefit to the Australian government. The Canadian government get around $1 billion in fees through their RMBS scheme.

CHAIR—You would think that, at this point in the cycle, that would probably be quite attractive to the government, $1 billion in fees.

Mr Liddy—I think it would be too!

CHAIR—Yes. Is that annually?

Mr Liddy—I think that is over the period of the issue. I cannot be sure about that.

CHAIR—We might check that. Another thing that you mentioned in your submission was the change to the risk-weighting of mortgages for non-major banks, which obviously comes out of Basel II. Do the announcements that were made by APRA just prior to Christmas have any impact on your submission and what you were recommending at that point?

Mr Liddy—No, not really. My point there was that we accept APRA's status in terms of Basel II. APRA have also made amendments to Basel III, which I think is probably in the interests of the major banks more than anyone else's because it involves capital. If you were defined as systemically important, you had to put in one to 2½ per cent of additional capital. Now, that is not going to apply to the Australian banks. Under Basel II, there were many issues that came from that. One was that the major banks were granted advanced status in terms of Basel II, which gave them risk-weighting on their mortgage portfolio of circa 20 per cent.

CHAIR—But you could apply for advanced status, couldn't you, if you were prepared to—

Mr Liddy—No.

CHAIR—No?

Mr Liddy—We could apply for it, but it would take years.

CHAIR—You would need to change your systems and do things like that, yes.

Mr Liddy—Exactly. But we were instructed—I use that word, but it is probably a bit strong—that there would be four advanced statuses issued (there were three initially and then one of the majors came in later) and the rest would be on a standardised approach. My point is that the cost of capital to us on a standardised approach is, say, 40 basis points, as opposed to 20 basis points. Our origination systems, our mortgages, our insurance et cetera are identical. So I do not want advanced status across the board, but I think in terms of mortgages it is appropriate, because the risks, to me, are identical.

CHAIR—And that difference in cost comes about because of the administration side of it—how much capital you have to hold because you do not have advanced status?

Mr Liddy—Yes. Because we work on a standardised approach, we have to hold double the capital, basically, for that mortgage portfolio.

CHAIR—That is based on Basel II, which is negotiated internationally. Is the Australian government bound to apply that to you or is there any flexibility

Mr Liddy—My understanding is that that is at the regulator's discretion. Regulators, as you have seen recently, have already made concessions in terms of Basel III.

CHAIR—They had to be negotiated. I was asking regulators at every estimates over about two years how they were going with Basel III, and they kept on telling me that they would tell me in the end. Quite rightly, they did not want to expose what they were negotiating because they did not want to undermine the potential for them to deliver an outcome that would advantage—

Mr Liddy—The operational risk aspects of a smaller bank compared to a major bank are different. We could not get to advanced status in a short period of time. It would probably take us a minimum of three years.

CHAIR—If this committee were minded to try to address that issue, what would we have to recommend and what is within the realm of government that they could actually change to assist in delivering that outcome?

Mr Liddy—I believe that if the government instructed APRA to apply a part of Basel II in relation to the mortgage portfolio in Australia to give it the same risk weighting across the board that would be—

CHAIR—It could do that without breaching internationally agreed rules?

Mr Liddy—I believe so. That is my understanding.

Senator XENOPHON—What has happened to Basel III? Has that been finalised at this stage?

Mr Liddy—No.

Senator XENOPHON—That is what I thought. So it is still in negotiations.

Mr Liddy—It is indicated that Australian banks will not be classified has systemically important under the definition of Basel III, which means that Australian banks will not have to put additional capital in place as a result of that.

Senator XENOPHON—Some of the witnesses have said that we will see increased pressure on funding costs. That together with European governments having to refinance their sovereign debt means things could be tighter by the end of this year in terms of finance and the cost of money. Do you think there is a risk of that?

Mr Liddy—I think there is a definite possibility. There is going to be a huge demand for funds over the next 12 months as the rollovers happen and the major banks are certainly more involved in that than the smaller banks in terms of the volume.

Senator XENOPHON—With Basel III, could that be a factor in the sense that could we be caught up to some degree in the fact that there will be stricter prudential requirements on banks globally even though the Australian banking sector has been very strong and robust in terms of its regulatory framework?

Mr Liddy—Definitely. A lot of it has not been finalised, so the change to liquidity is still years away. But the capital issues are there now. But we still do not know all the details, so it is a bit hard to guess what the impact may be. The search for funding is a big issue globally and there are a lot of countries requiring funding and our banks will be involved in that. There is only so much to go around.

Senator XENOPHON—And Basel III does not say anything about lottery type accounts?

Mr Liddy—It does not say anything about accounts called Save to Win, no.

Senator XENOPHON—I call them lottery accounts. Maybe it should.

CHAIR—Thank you Mr Liddy and Ms McMullen for assisting us tonight.

Committee adjourned at 7.59 pm