

Executive summary

Australia's banks weathered the turbulent events that shook the international financial system in 2007 and 2008 relatively well. While the Australian government did have to act during the global financial crisis to shore up the sector and crisis-related acquisitions took place which have left the sector more concentrated, lending continued and the government did not have to take an ownership stake in any financial institution. Today, Australia's financial sector continues to demonstrate its resilience in the face of ongoing uncertainty in international markets.

Much has already been written about the impact of the crisis on Australia. This inquiry differs from others in that it examines the state of the sector a number of years after the key events of the crisis. This allows the developments that have proven more sustained to be identified and examined. The major international regulatory response to the crisis, which will further change how Australian banks operate, is also examined. The committee has made a number of recommendations that it considers will facilitate the further strengthening of the sector and, more immediately, will address some consequences arising from the imbalances that exist in the relationship between certain borrowers and banks.

An independent inquiry is needed

The key finding of the committee is that an independent, well-resourced and comprehensive inquiry into the Australian financial system is required. It has been fifteen years since the previous such inquiry reported (the 1997 Financial System Inquiry, better known as the Wallis Inquiry). While the onset and ramifications of the global financial crisis provided an argument for a new inquiry to be postponed, this argument is now less compelling. The shape of the future international regulatory environment is becoming clearer with the Basel III reforms agreed to and being implemented in Australia from 2013 onwards. The overall stability of Australia's banking system compared to other economies has been demonstrated, but has the impact of the crisis and the emphasis on stability weakened competition in the sector and limited the benefits that strong competition provides for consumers? While Australia avoided the worst of the crisis, this should not be allowed to result in complacency about the structure and performance of our financial system. There is now an opportunity to conduct a comprehensive examination of the banking sector and to debate what the post-crisis sector should look like and whether it is delivering what Australians want from it.

The crisis demonstrated the volatility of the international debt markets to which Australian banks remain significantly exposed. In response to this unstable environment, Australian banks have shifted away from short-term wholesale funds towards more reliable, but more expensive, long-term wholesale debt. A key feature of the new funding mix is that Australian banks are seeking to obtain greater amounts of term deposits. Competition among banks to attract these more stable funds has

noticeably intensified since the crisis, increasing the interest rates banks have to offer depositors, relative to the cash rate, and therefore the cost of these funds. While this is a welcome development for deposit holders, the sustainability of it and the implications for competition in the sector need further consideration. Further, there is a clear disconnect between Australia's growing pool of superannuation savings and the significant amounts of funds that banks need to raise in offshore markets. Whether there are policies that can encourage greater interaction between the banks and superannuation funds, in a way that is viable and in the interests of both sectors, also warrants examination by an independent inquiry.

The implementation of Basel III in Australia

Important changes to how regulators require banks to be able to absorb shocks are underway. These changes are driven by Basel III, the latest iteration of international standards on capital adequacy and banking supervision and the major international regulatory response to the global financial crisis. This inquiry facilitated a constructive public discussion about these technical changes and how they will be implemented domestically by the Australian Prudential Regulation Authority (APRA).

The committee supports APRA's overall approach to Basel III at this stage. Assuming the reforms are widely implemented internationally, and the committee acknowledges that Australia is ahead of many other countries in this regard, they will improve the stability of the international banking sector and will address some of the issues evident from the global financial crisis. Australian banks are well-placed to comply with the capital requirements of Basel III within the timeframe being followed by APRA. Some of the liquidity requirements under Basel III may be more challenging for Australian banks to comply with; however, the banks will have to work towards this. Being just one component of the global banking system, coupled with the need for Australian banks to raise funds offshore, it is clear that Australia cannot deviate significantly from what other international financial centres are doing. Any significant changes to Basel III will occur at an international level and the implications for Australia will have to be considered at that time.

The committee does consider that APRA could be more proactive in some areas. A particular issue is that Australian banks may appear less capitalised than their peers as a result of the different regulatory capital calculations that APRA requires. While the banks have a role in explaining this difference to international investors themselves, and the standardised reporting template developed by the Basel Committee may also assist, in the meantime APRA should facilitate the publication of headline capital ratios that are calculated according to the Basel Committee's standard requirements. The committee also encourages APRA to look at other ways that it could improve the understanding internationally of the Australian banking sector's underlying strength to ensure that Australians receive the full benefits of this.

There are some additional issues that have been identified. Given the increasing prevalence of internet-based accounts and the apparent differences between how

APRA proposes to treat these accounts for liquidity purposes compared to the treatment applied by regulators in other jurisdictions, the committee suggests that APRA reviews its approach in this area. Also, the committee recommends that APRA addresses the unique issues that Basel III may pose for mutual ADIs as a result of their corporate structure without further delay, and that it publishes a document which sets out how these problems have been addressed.

Funding challenges and implications for stability and competition

As a result of the disruption in international markets triggered by the crisis, banks reassessed the risks associated with their funding mix and have moved towards more stable sources of funds. Investors also reassessed the risk of banks globally and repriced the risk associated with wholesale bank debt. Consequently, there have been multiple upward pressures on the cost of funds since the crisis and it is likely that costs will remain elevated. Banks continue to adjust to higher post-crisis funding costs as they compete for available deposits and rollover longer-dated wholesale funds obtained at lower pre-crisis prices. However, the overall increase in costs appears to have stabilised recently (although developments in Europe provide ongoing uncertainty).

The independent inquiry referred to above would consider the consequences of these developments. In the interim, steps can be taken to address policy inconsistencies that distort behaviour in the marketplace and which may impact the stability of the banking system and the ability of smaller financial institutions to compete with the major banks. Two issues examined by the Henry Review remain particularly relevant. First, the taxation of interest earned from deposits held in ADIs differs unfavourably to the taxation arrangements applied to various other methods of saving. These arrangements should be made more consistent to remove any distortions affecting saving decisions. In addition to these efficiency benefits, this would enable banks to compete more effectively for household savings helping ensure that lending activity can be funded when demand for credit increases and if other means of savings become more attractive. Second, the interest withholding tax that applies to financial institutions operating in Australia distorts funding decisions and is an impediment to foreign banks competing in the Australian banking sector. The tax burden may also be simply passed on to borrowers. Although removing the application of this tax to financial institutions creates a direct financial cost to the government, by providing an impetus for greater competition in the banking sector such a reform would have wider long-term benefits for the economy. Accordingly, the committee supports the removal of the application of interest withholding tax to financial institutions although it acknowledges that such action would need to be sensitive to the government's budget position.

An additional challenge for competition and funding mix diversity is the state of the securitisation market. Prior to the global financial crisis securitisation played a key role in supplying funds for smaller lenders. It therefore helped enable stronger competition in the sector. The securitisation market is recovering from the crisis with

the support of the Australian Office of Financial Management's RMBS program, but the recovery could be further assisted if foreign currency bonds collateralised by Australian assets were again accepted by key foreign central banks in their repurchase agreements. This could strengthen investor demand and enhance the liquidity of Australian asset-backed securities. While this is a matter for the central banks concerned—the European Central Bank was put forward as an example—the Australian government could push for wider acceptance of Australian securitisation.

Changes to lending practices and the attitudes of the banks

The inquiry also examined the impact of the crisis on lending practices. As an overarching observation, the committee considers that the regular collection and publication of additional information about market developments could provide a useful and timely indication of the state of the lending market for regulators, policy makers, market participants and market observers. The committee notes that a senior officer loan survey is conducted by central banks in a number of other countries and recommends that the Reserve Bank of Australia conducts one in this country on a quarterly basis and publishes the results. The committee also recommends that, following the Australian Small Business Commissioner's appointment becoming effective, the Commissioner provides an annual report to the Senate on small business finance issues.

The experiences of certain Bankwest small business customers since the crisis

A particular focus of the inquiry was whether there have been any changes in the attitude of lenders to certain categories of borrowers and whether these borrowers were treated unfairly. Most of the evidence received by the committee was from aggrieved borrowers of Bankwest who alleged mistreatment by the bank after Bankwest was acquired by the Commonwealth Bank of Australia in 2008 at the height of the global financial crisis. The inquiry provided an opportunity to air grievances about particular actions of banks and to consider whether the regulatory settings governing lending by the financial sector are appropriate. It is, however, fundamentally important to recognise that this committee is not a court. Disputes between individual parties to a contract that cannot be resolved through other means need to be dealt with through the judicial process. The committee has accordingly reviewed the evidence from a broader, systemic perspective.

It is not automatically the case that a collection of disputes, even if they share certain characteristics, should trigger regulatory change that would impact entire groups of borrowers. While there are many sad and distressing stories now on the public record, the committee cannot help but observe that, in some cases, although the aggrieved borrower may have been able to operate successfully during periods when the business environment was relatively good, the more challenging times presented by the global financial crisis placed extra stress on less robust and more speculative projects. In many cases, loans were sought for ventures that were a considerable risk even during the more stable economic environment that existed prior to the global

financial crisis. This of course does not apply to every case, nor does it excuse Bankwest—under its previous owners Bankwest was willing to enter into these loans. When its small business borrowers are experiencing difficulties, Bankwest has a duty to make genuine attempts to work with the borrower, to clearly explain what is happening and why, and to treat them with courtesy.

Nonetheless, while most dealings between small businesses and banks are not problematic from a regulatory perspective, the evidence received by this inquiry and previous inquiries indicates that there are still issues with current arrangements. Small business owners are busy individuals focused on the day-to-day operations of their business. They may not have the time or expertise needed to fully consider how certain actions, such as changes to facility terms, will impact them. Small businesses are also confronted with a significant imbalance in negotiating power with large financial institutions and face difficulties in seeking to have any disputes with these institutions considered.

The committee wishes to ensure that the regulatory settings in the financial sector relating to small business lending encourage entrepreneurial activity and allow sufficient flexibility for parties to enter into agreements that best suit the particular circumstances of the commercial operation. Rather than government intervention for small business finance, the committee considers that it would be preferable for the industry to commit to solving the evident problems. The committee calls on the Australian Bankers' Association (ABA) to meet with small business representatives to develop a code of practice specifically relating to lending to small businesses. At a minimum, the code should require:

- changes to facility terms to be accompanied by a document that clearly explains the changes to the borrower;
- any initial valuation reports associated with the purchase of a small business be relied on by the bank for a reasonable amount of time, such as for the first two years of the loan, unless a major defined shock or event occurs;
- borrowers to be automatically provided with copies of valuation reports that they have paid for or which the bank intends to rely on to demonstrate that the borrower is in default, and that all instructions given by banks to valuers be provided to the borrower on request;
- notices of demand from lenders to small business borrowers include a minimum deadline of 14 days for repayment, but that a further reasonable period of time should also be available to allow for the finalisation of necessary contracts if refinancing has been secured, or to allow negotiations to continue if an offer of finance is reasonably likely;
- banks to cooperate with any reasonable requests for information made by the borrower that would assist the borrower secure refinance; and
- default interest rates to be clearly specified in the facility terms, not linked to other documentation.

Failure by the ABA and the banks to develop an appropriate code of conduct for small business lending may strengthen the case for more prescriptive government regulation in this area. Given the arguments from the sector about the cost and burden of added regulation in general, the committee is of the view that if banks genuinely have these concerns they have both the obligation and opportunity to demonstrate that the sector takes concerns about small business finance issues seriously and is willing to proactively develop a stronger self-regulated solution.

The options available to small business owners for seeking redress is another area of concern to the committee. While the sector's external dispute resolution scheme, the Financial Ombudsman Service (FOS), may consider small business disputes there are a number of limitations on FOS which limit its relevance and effectiveness for these disputes. Accordingly, the committee recommends that the caps on the value of the claim and maximum compensation for small business disputes considered by FOS be increased to \$2 million.

The committee also considers that there is a specific flaw in the current external dispute resolution framework as when a receiver is appointed by a secured creditor, FOS cannot review their actions or require them to stop enforcement action such as selling the company's assets. This is not to say that FOS should be required to review the conduct of receivers—a receivership is a fundamentally separate issue to the provision of a financial service—however, the current arrangements could be improved if borrowers have, and are aware of, the opportunity to seek a review of the substantive matters of a dispute by FOS before the lender takes enforcement action. Further to the committee's recommendation that notices of demand should include a reasonable minimum deadline for repayment, such a notice should also be required to include information about FOS.

The committee is also concerned about some outcomes that can arise once a receiver is appointed. While legislation is in place that imposes an obligation on receivers to take all reasonable care to sell properties of a company at market value or the best price that is reasonably obtainable, it is inherently difficult for borrowers to challenge such actions. The committee considers that when a business is placed in receivership, the receiver should be required to demonstrate to the borrower that they have considered every unconditional offer when exercising their power of sale in respect of a property. If the borrower can produce sufficient prima facie evidence that indicates that the sale process may not have been in accordance with section 420A of the *Corporations Act 2001*, the receiver should bear the burden of proof for demonstrating that they fulfilled their obligations. The committee also considers that further investigation of the challenges that small businesses face in pursuing review of actions taken by banks, receivers and other bodies is warranted.