Chapter 2

Overview of the post-GFC banking environment

2.1 This inquiry focuses on developments in the banking sector arising out of, and linked to, the impact of the global financial crisis. Much has been written about the causes of the crisis and the impacts it has had and continues to have on the international and Australian economies. For the purposes of this report, it is not necessary to restate these details. Some discussion of how the banking sector responded to the crisis at the time, however, is relevant for this inquiry. It can be concluded that the Australian banking system avoided the worst of the crisis. When compared to the events and disruption in the key international banking centres, Australian banks appeared strong and resilient. The crisis also highlighted the sound regulatory regime in place in the years leading up to the crisis and the effective performance of the regulators charged with supervising the system and ensuring its stability—the Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA).

2.2 Nonetheless, an economic event the magnitude of the global financial crisis unsurprisingly had immediate and enduring effects on the Australian banking sector. This chapter provides an overview of the overall impact of the crisis on the sector and other relevant developments which have occurred in recent years. Distinct and significant issues arising out of the crisis, such as increased funding costs, changes by the banks to their funding mix, and the Basel III reforms, are examined in more detail in subsequent chapters.

Impact on bank funding

2.3 As an immediate consequence of the global financial crisis, banks everywhere were perceived to be more risky while investors became more risk averse. Given that the major Australian banks continue to be significantly reliant on offshore wholesale funding, the increased risk premiums demanded for bank debt following the crisis has impacted Australian banks considerably. The Australian Bankers' Association (ABA) noted:

> As revealed around the world, a high level of reliance on foreign funding exposes a country to greater shocks. Investors that extend money do so because they are confident in getting it repaid, and in situations of uncertainty, there is a bias to investment in their home countries.[1]

2.4 When the RBA was asked about the impact of the crisis, the change in risk premiums was the main point made in response:

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1 Australian Bankers' Association, *Submission 46*, p. 13.

> Dr Debelle: … prior to 2007 risk premia right across the board were really low. Since 2007 they have gone right up, and that has affected the banks' cost of funds and, in the opposite direction, it has affected the government's cost of funds by pushing it down. That is probably the main source of transmission to the domestic financial system.
>
> Senator CAMERON: So it was a transmission. It was not a Northern American financial crisis; it did impact Australia?
>
> Dr Debelle: Yes. As I said, because our financial system is connected to that and the rest of the world it certainly had an impact.[2]

2.5 Westpac also put rising funding costs as the key post-crisis development:

> … without any shadow of a doubt, funding costs are the most substantial issue that the banks have faced in the past three to five years. The issues continue and we are in the midst of quite a profound structural change in the way that banks are funded and how they fund themselves. This situation has gone on probably longer than many of us suspected it would and it has certainly become more entrenched as a structural issue rather than a passing pricing issue. Among the strategic issues that we have to confront, without any shadow of a doubt, that is the main one.[3]

2.6 Changes to funding sources, mix and costs are examined in more detail in chapter 4.

Market concentration and competition[4]

2.7 While stability is a feature of the Australian banking sector, the degree of genuine competition is less clear and has been questioned by market participants and other observers, particularly as the Australian banking sector is characterised by the large market shares enjoyed by the four largest banks—the Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac.

Market share

2.8 The market share of the largest firms is often used as a simple way of indicating a concentrated market; however, another measure of market concentration

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2 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 43.

3 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 1.

4 The state of competition in the Australian banking sector was examined comprehensively by this committee in 2010–11. This section will provide a brief overview of the current state of the market, however, the information and analysis presented by the committee in 2011 is still relevant. Readers seeking additional information about competition in the banking sector should refer to Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011.

often used in the analysis of markets, particularly in the context of mergers and acquisitions, is the Herfindahl-Hirschman index (HHI). The HHI takes into account the market share of all participants in the relevant market. It is calculated by totalling the squares of each firm in the market (for merger analysis the post-merger share of the merged firm and each rival firm is used, and the increase in the HHI is also considered).[5] An HHI can be expressed in two ways—either as a number between zero (representing perfect competition) and one (a monopoly), or as a number between zero and 10,000.[6] The Australian Competition and Consumer Commission (ACCC) uses 0.2 (or 2000 using the alternative method) as a guide for its merger analysis.[7]

2.9 It is clear that the banking sector has become more concentrated in recent years, with the major banks increasing their share of assets, deposits and home loans (Table 2.1).

Table 2.1: Measures of concentration in the Australian banking market

Date	Assets		Deposits		Home loans	
	Share of 4 largest banks (%)	*HHI*	*Share of 4 largest banks (%)*	*HHI*	*Share of 4 largest banks (%)*	*HHI*
1890	34	.06				
1913	38	.10				
1950	63	.14	64	.15		
1970	68	.16	68	.16	77[a]	.21[a]
1990	66	.12	65	.12	65	.13
Oct 2008 (pre-mergers)	65	.11	65	.12	74	.15
Oct 2008 (post-mergers)[b]	73	.14	75	.15	86	.20
June 2009	75	.15	78	.16	86	.20
June 2010	77	.16	78	.16	87	.21
June 2011	78	.16	78	.16	87	.20
June 2012	80	.17	79	.16	86	.20

[a] Assuming all owner-occupier housing loans were made by savings banks and accounted for all their loans.

[b] From 'Oct 2008 (post-mergers)' onwards, statistics for Bankwest and St George are counted as parts of the CBA and Westpac respectively.

Note: The table provides an indication of market share among ADIs—non-bank lenders are not included.

5 ACCC, *Merger guidelines*, November 2008, p. 37. See also Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, pp. 41–42.

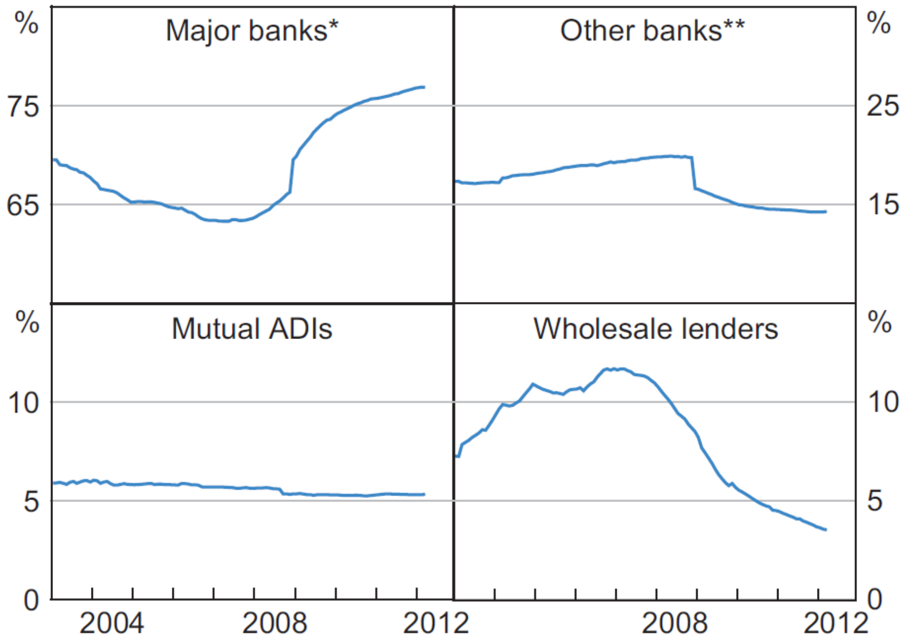
6 The different numbers yielded by the two methods arises as the market shares of the firms can be expressed either as proportions or as a whole percentage—e.g. the HHI of two firms with an equal share of the market (50 per cent) can be calculated as $0.5^2+0.5^2=0.5$ or $50^2+50^2=5000$.

7 ACCC, *Merger guidelines*, November 2008, p. 37.

Source: June 2009–June 2012 based on APRA data; other data reproduced from Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. 42.

2.10 The major banks' increasing market share of housing finance has been at the expense of all other categories of lenders—i.e. smaller banks, building societies, credit unions and non-banks (Figure 2.1).

Figure 2.1: Lenders' share of housing credit



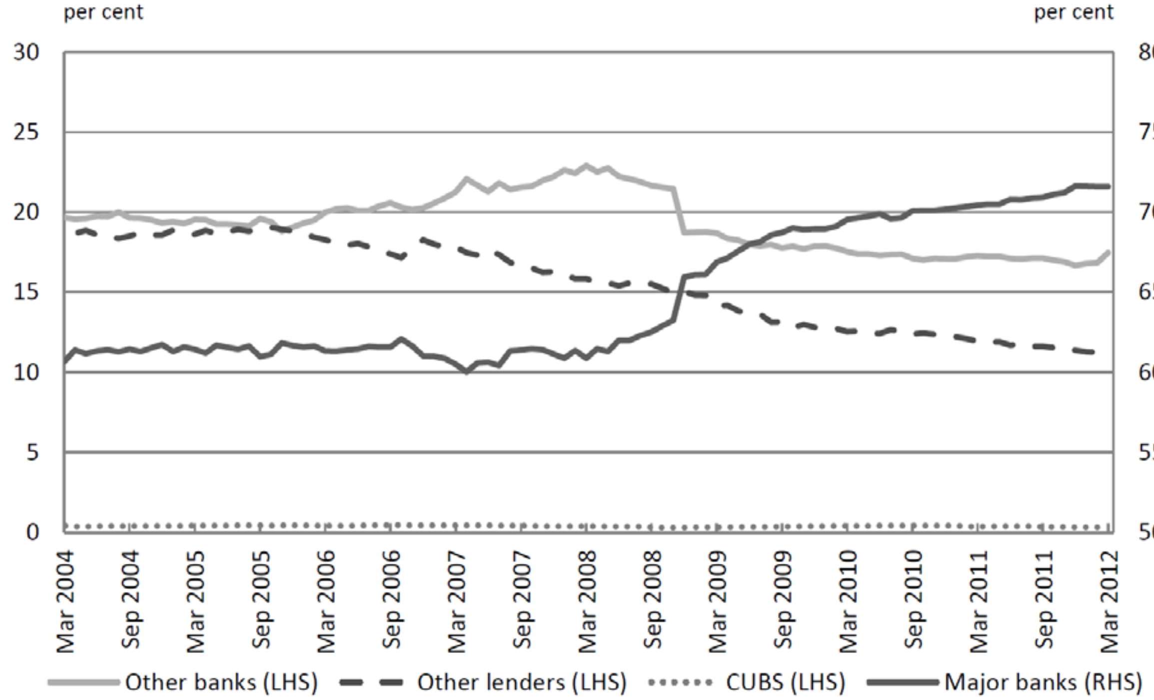
Source: RBA, *Submission 33*, p. 2; based on ABS, APRA and RBA data.

* Includes Bankwest from December 2008

** Excludes mutual banks

2.11 The major banks' increasing market share of business credit has also been observed (Figure 2.2).

Figure 2.2: Shares of outstanding business credit (by lender type)



Source: Treasury, *Submission 120*, p. 8; based on RBA data.

Notes: Major banks include Bankwest from December 2008; ANZ, CBA, NAB, St George and Westpac for entire sample. Other lenders includes cash management trusts, specialist credit card institutions and securitisers. Other banks include foreign banks as well as credit unions and building societies rebranding as banks.

2.12 Acquisitions by the major banks of key competitors in 2008 explain much of the increase in the major banks' market share.[8] Meanwhile, the activity of foreign banks in Australia has also decreased (Figure 2.2). European-owned lenders, faced with mounting problems at home, have reduced their activity in Australia (although countering this to some degree, some Asian-owned banks have expanded their operations). Consequently, the market share of the major Australian banks increased as they filled any remaining gap in the market. The RBA concludes:

> Although the number of foreign-owned banks operating in Australia has more than doubled since the early 1990s, their share of bank assets at the end of 2011, at 12 per cent, was broadly the same. From around the mid 1990s to 2007, they noticeably increased their share of bank assets, from around 10 per cent to 22 per cent, due to a combination of acquisitions, new entrants and organic growth. Since the onset of the financial crisis, however, the foreign-owned banks' share of assets has fallen. Only part of this was due to CBA's purchase of Bankwest in 2008, which was the largest foreign-owned bank at the time. The foreign-owned banks that expanded

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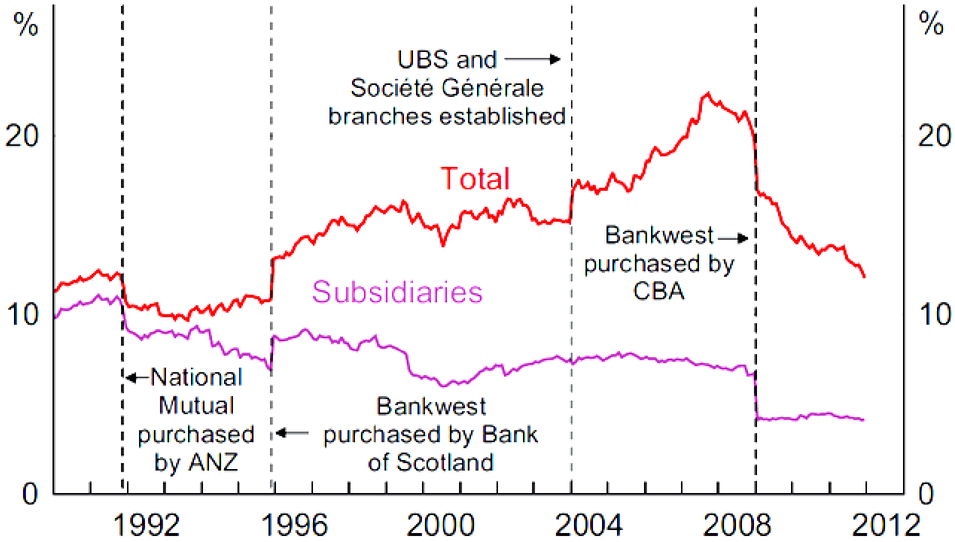
8 They were Westpac's acquisition of St George Bank (then Australia's fifth largest bank) and the CBA's acquisition of Bankwest. The Bankwest acquisition is discussed in more detail in chapter 7.

the most in the years leading up to the crisis have typically also seen the largest contractions in their assets in recent years.[9]

Figure 2.3: Foreign-owned banks in Australia: Share of banking system assets (domestic books)



Source: RBA, 'The Australian Financial System—Box A: Foreign-owned Bank Activity in Australia', *Financial Stability Review*, March 2012, p. 38.

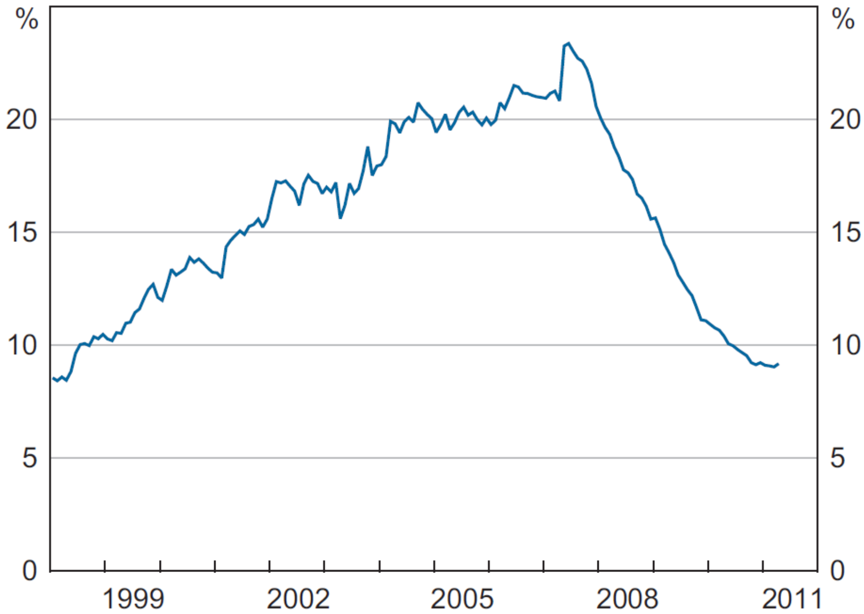
2.13 Non-bank lenders provided increased competitive tension in the Australian banking system when they commenced operations in the 1990s. Besides competing on price, these lenders also introduced technological innovations for consumers, such as internet banking.[10] The non-bank institutions utilised wholesale funding by securitisation to fund their activities. The deterioration of the securitisation market during the global financial crisis challenged these models—while securitisation was funding over 20 per cent of home loans by mid-2007 this decreased rapidly once the crisis hit, returning to late 1990s levels (Figure 2.4). The consequence of many non-bank lenders being unable to obtain sufficient quantities of suitably priced funds is demonstrated by the experience of RAMS Home Loans, a key non-bank lender that grew substantially in the 2000s. In 2007 RAMS sold its franchise distribution businesses and brand to Westpac in return for cash and assistance in securing funding, after advising shareholders that, in the absence of this deal, it was 'unable to locate alternative sources of new funding in sufficient volumes to meet the ongoing needs of the business'.[11]

9 RBA, 'The Australian Financial System—Box A: Foreign-owned Bank Activity in Australia', *Financial Stability Review*, March 2012, p. 39.

10 Mortgage and Finance Association of Australia, *Submission 52*, p. 3.

11 RAMS Home Loan Group Limited, 'RAMS funding and annual general meeting update', ASX announcement, 20 November 2007, p. 2.

Figure 2.4: Share of housing credit funded by securitisation



Source: Bernadette Donovan and Adam Gorajek, 'Developments in the structure of the Australian financial system', *RBA Bulletin*, 2011, no. 2 (June quarter), p. 39.

2.14 Other factors contributing to the major banks' increased market share include the 'flight to quality' during the crisis, where nervous customers moved their deposits and business to the major banks, perceiving them to be safer due to their size and longevity.[12]

Market contestability and indicators of competition

2.15 In addition to market share, there are many factors which influence competition in a market. The CBA considers that, for the banking sector, determinants include the barriers to entry and exit, the level of customer demand for banking products and the impact of regulatory reforms.[13]

2.16 There are signs of the banks competing on several fronts. Treasury is of the view that competition between the major banks 'remains strong', with 'NAB and ANZ being particularly aggressive in housing credit over the last year'.[14] The RBA expressed a similar view, noting that in the housing lending market 'the major banks have been competing for most of the past year for market share in an environment of slower credit growth'; although since early 2012 it has observed that competition has

12 As the committee observed in 2011, government responses to the crisis such as the wholesale funding guarantee, while overall a sensible and well-intentioned measure, may have exacerbated the 'flight to quality' due to the differential pricing for the guarantee based on credit rating. See *Competition within the Australian banking sector*, chapter 12.

13 Commonwealth Bank of Australia, *Submission 81*, p. 9.

14 Treasury, *Submission 120*, p. 5.

eased partly due to increased funding costs.[15] The Mortgage and Finance Association of Australia (MFAA) noted that, despite funding challenges, non-bank lenders were still competing with the major banks on standard variable interest rates, with the average non-bank rate in May 2012 0.63 percentage points lower than the average rate of the major banks.[16]

2.17 Regarding deposits, competition among authorised deposit-taking institutions (ADIs) has noticeably increased as they seek to secure more stable funding sources. In the ABA's view, 'Australian banks have competed ferociously for household and business domestic deposits in order to fund growth in credit. This has been a bonanza for savers who are enjoying very good deposit deals'.[17] While more restrained in his comments, evidence from a senior officer at the Treasury broadly supported this contention:

> … at the moment … deposits are tight. Everyone is competing to build deposits up, so again, on that transition point, the major banks are seeking to move up their level of deposits to provide a stable funding source—they are paying for it—to reduce their dependency on offshore funding. You have got a number of people competing in the same space for deposits and, again, to some extent that is of benefit to the consumer. They are getting the benefit of that competition.[18]

2.18 Competition for small business loans, however, has decreased in intensity since the crisis. Treasury provided the following overview of competition in this market:

> On the competition angle in terms of small business loans you have to factor in from the lender's point of view that there is a higher risk with a business loan than there is with a mortgage. You have to factor that in. Secondly, what we see from our analysis and hear from the major banks is that between 80 to 90 per cent of borrowers get accommodation from a lending institution.[19]

2.19 Issues associated with small businesses accessing finance following the global financial crisis were examined by this committee in 2010, and more recently by the Parliamentary Joint Committee on Corporations and Financial Services.[20] To the

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15 RBA, *Submission 33*, pp. 1, 2.

16 Mortgage and Finance Association of Australia, *Submission 52*, p. 9 [table 3; based on Canstar data].

17 Australian Bankers' Association, *Submission 46*, p. 13. The issue of increased competition among ADIs for deposits is examined further in chapter 4.

18 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 4.

19 Mr Jim Murphy, Treasury, *Committee Hansard*, 8 August 2012, p. 11.

20 See Senate Economics References Committee, *Access of small business to finance*, June 2010; Parliamentary Joint Committee on Corporations and Financial Services, *Access for small and medium business to finance*, April 2011.

extent that it is relevant to lending practices and other matters being examined by this inquiry, however, the issue is examined further in chapter 6.

Profitability of Australian banks

2.20 Profitability is another indicator of the level of competition in a market. For financial institutions, profitability can be indicated by three main measures:

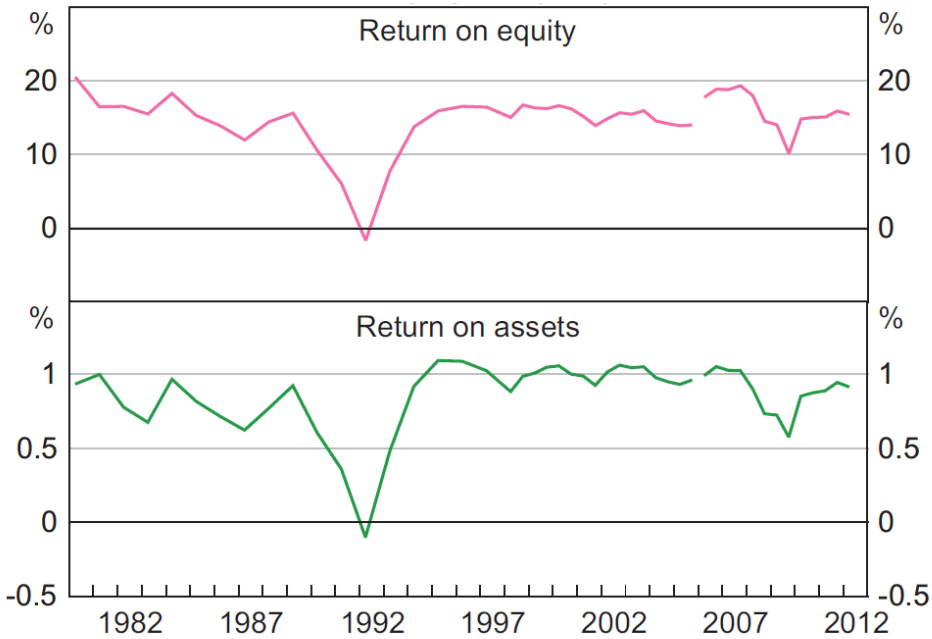
- return on equity (ROE)—the net income returned as a percentage of money invested by shareholders—i.e. how efficiently the shareholders' investments are being used to generate income;
- return on assets—the net income returned as a percentage of assets—i.e. how efficiently assets are generating income;
- net interest margins (NIM)—the difference between what a bank on average receives in interest payments compared to what it pays on average in funding costs.

2.21 The following paragraphs will examine the profitability of Australia's major banks compared to their profits prior to the global financial crisis, other major Australian companies, international banks, and other ADIs.

Comparison with pre-crisis profits

2.22 The RBA provided the committee with information indicating that the ROE of the major banks is currently around its long-term average (Figure 2.5).

Figure 2.5: Major banks' profitability

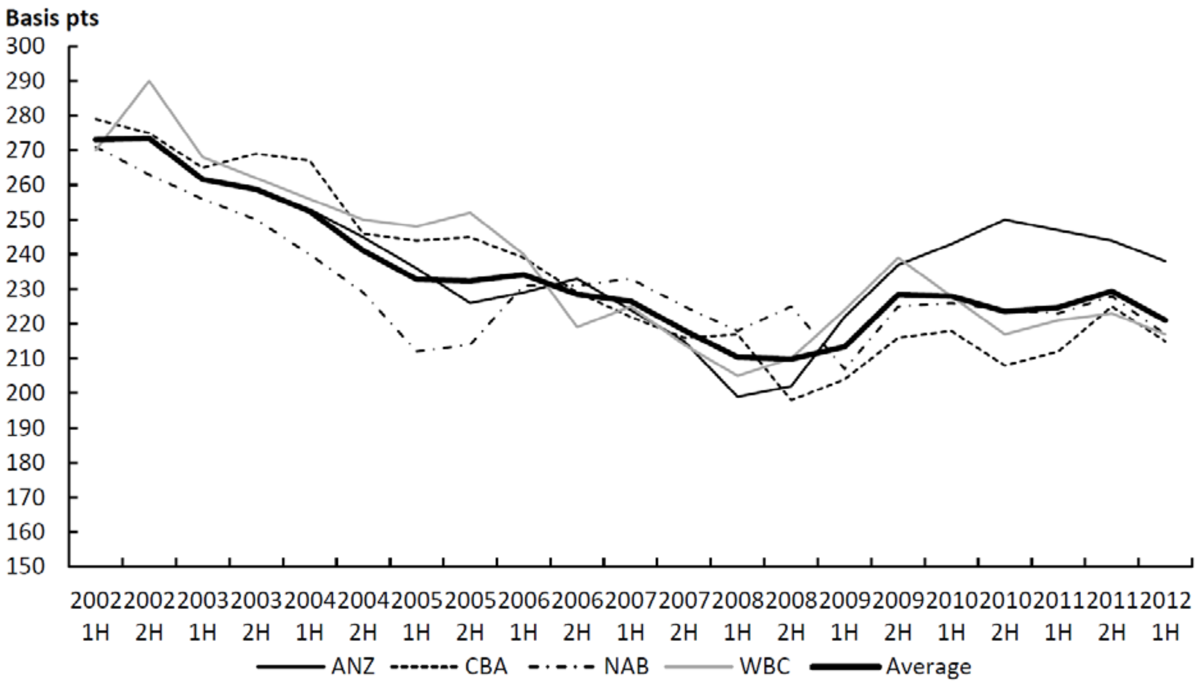


Notes: The chart shows underlying half-yearly profitability. In 2006 the banks began reporting on an AIFRS rather than an AGAAP accounting basis; data prior to 1998 are on a yearly basis.

Source: RBA, *Submission 33*, p. 7; based on RBA data and banks' annual and interim reports.

2.23 Treasury similarly provided information regarding changes to the major banks' NIMs over the past decade. Treasury observed that the major banks' NIMs were reduced during the global financial crisis but are currently, on average, around pre-crisis levels.[21] As Figure 2.6 shows, since the peak of the crisis there has at times been significant variation in the individual NIMs of the major banks, particularly during 2010.

Figure 2.6: Major banks' net interest margins



Notes: Data is half yearly and calculated as net interest income to average total interest earning assets on a group basis. ANZ data unavailable prior to 2004.

Source: Treasury, *Submission 120*, p. 11; originally sourced from major banks' financial disclosure documents.

2.24 While Treasury considers that NIMs provide 'useful, although lagging, indicators of the impact of funding costs on profitability',[22] the CBA questioned the usefulness of comparing pre-crisis NIMs with current levels. The CBA acknowledged that NIMs are 'one of the key drivers of profitability', but argued that they are inflated by the higher levels of capital banks now hold and that pre-crisis NIMs have not been adjusted for the under-pricing of risk at that time which, in the CBA's view, 'makes that a misleading reference point'.[23] The CBA also gave evidence that they have been

21 Treasury, *Submission 120*, p. 10.

22 Treasury, *Submission 120*, p. 10.

23 Commonwealth Bank of Australia, *Submission 81*, p. 39 (emphasis omitted).

seeking to increase their productivity, allowing the bank to maintain its profits despite higher funding costs.[24]

Comparison with other Australian companies

2.25 A bank's ROE can be compared against many other sectors and points in time. The RBA considers that the ROE of Australia's major banks are similar to those of other major corporations in Australia.[25] The CBA asserted that, although it is ranked second for market capitalisation on the ASX, by ROE it is ranked 34th.[26] The ANZ argued that, given that Australia's major banks are among the largest companies in the country, 'the dollar amount of profits made by the four major banks is a reflection of the size of the companies and the amount of capital employed'.[27] The ANZ continued by pointing out that its 2010–11 statutory ROE of 15.3 per cent is lower than that of the resources and telecommunications sectors and similar to the healthcare and supermarket sectors.[28]

2.26 Comparing bank profits with those of mining companies during a mining boom, however, is not a helpful comparison (and one purposely avoided by Treasury).[29] Additionally, as similarly observed by this committee in 2011,[30] one could counter that these comparisons are with other businesses operating in oligopolistic industries or otherwise have limited competition due to high barriers to entry or other obstacles, and thus have the opportunity to earn abnormally high profits. There are, however, factors unique to banking that affect the approach to profits, such as regulatory requirements. The CBA noted differences between how banks are expected to manage their business compared to other companies:

> … banks need to earn profits in excess of their cost of capital so that they can build up a buffer of equity which can be called upon, if necessary, in difficult times. If there is no buffer, the institution is more likely to fail in the first downturn. Banking is a cyclical and highly leveraged industry so that buffer must be significant.[31]

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24 Mr David Cohen, Group General Counsel and Group Executive, Commonwealth Bank of Australia, *Committee Hansard*, 9 August 2012, p. 25.

25 RBA, *Submission 33*, p. 6.

26 Commonwealth Bank of Australia, *Submission 81*, p. 36. The CBA also advised that it is ranked 80th by return on assets, however, it should be noted it is more difficult to meaningfully compare returns on assets of companies in different sectors.

27 ANZ, *Submission 78*, p. 25.

28 ANZ gave the following ROE figures for those sectors: resources sector (28 per cent); telecommunications (26 per cent); healthcare (14.4 per cent); and supermarkets (13 per cent). ANZ, *Submission 78*, p. 26.

29 See Mr Jim Murphy, *Committee Hansard*, 8 August 2012, p. 7.

30 See Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. 52.

31 Commonwealth Bank of Australia, *Submission 81*, p. 36.

Comparison with major international banks

2.27 The Bank for International Settlements has published figures showing that the major Australian banks are the most profitable in the developed world, with 2011 pre-tax profits equal to 1.19 per cent of total assets. Canadian banks, in second place, were the only others to have pre-tax profits above one per cent.

Table 2.2: Profitability of major banks

	Pre-tax profits			Net interest margin			Loan loss provisions			Operating costs		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
Australia (4)	0.93	1.14	1.19	1.88	1.89	1.83	0.54	0.31	0.19	1.20	1.24	1.17
Austria (2)	0.60	0.82	0.23	2.45	2.62	2.56	1.23	0.94	0.93	2.05	2.01	1.96
Canada (6)	0.73	1.01	1.08	1.72	1.64	1.60	0.44	0.25	0.18	2.04	1.88	1.87
France (4)	0.18	0.44	0.26	1.01	1.03	1.02	0.36	0.23	0.22	1.09	1.16	1.12
Germany (4)	0.02	0.20	0.20	0.84	0.87	0.88	0.29	0.15	0.12	1.24	1.23	1.21
Italy (3)	0.36	0.37	–1.22	1.91	1.77	1.81	0.77	0.63	0.69	1.76	1.70	1.80
Japan (5)	0.34	0.51	0.54	0.94	0.87	0.82	0.25	0.11	0.02	0.76	0.75	0.85
Netherlands (2)	–0.39	0.30	0.41	0.84	0.98	0.98	0.28	0.13	0.24	1.14	1.26	1.18
Spain (3)	0.98	1.02	0.61	2.47	2.42	2.38	1.00	0.84	0.82	1.57	1.61	1.72
Sweden (4)	0.34	0.61	0.60	1.02	0.89	0.83	0.46	0.11	0.03	0.95	0.88	0.79
Switzerland (3)	0.22	0.60	0.33	0.56	0.54	0.53	0.10	–0.0	0.01	1.97	1.97	1.74
United Kingdom (6)	0.18	0.37	0.33	1.09	1.19	1.15	0.90	0.59	0.46	1.32	1.37	1.41
United States (9)	0.36	0.80	0.93	2.65	2.73	2.49	1.89	1.14	0.54	2.98	3.22	3.23

Notes: Largest banks in each country by total asset size. The number of banks in the 2011 data is indicated in parentheses. Operation costs consist of the sum of personnel and other operating costs. For Japanese banks, no personnel costs included.

Source: Bank for International Settlements, *82nd annual report*, 24 June 2012, p. 79; Bankscope.

2.28 It should be recognised that these data provide comparisons of post-crisis profits where, given the ongoing problems in other banking sectors and economies, Australian banks have clearly outperformed most of their international counterparts. When asked about the relative profitability of Australian banks, a senior Treasury officer's immediate response was to ask 'is it very surprising'? He went on:

> The traumas that other countries have had with their banking systems, to me, probably reflects the market and that they are being reasonably well run. We have had strong prudential regulation. The banks came through the GFC in a very strong position and that means that the whole ADI sector—I am not saying just the majors. One would think that you have got to get some benefit out of that.[32]

2.29 On a pre-crisis basis, the RBA considers that the returns on equity of Australia's major banks are similar to pre-crisis ROE of banks in other countries.[33]

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32 Mr Jim Murphy, Treasury, *Committee Hansard*, 8 August 2012, pp. 6–7.

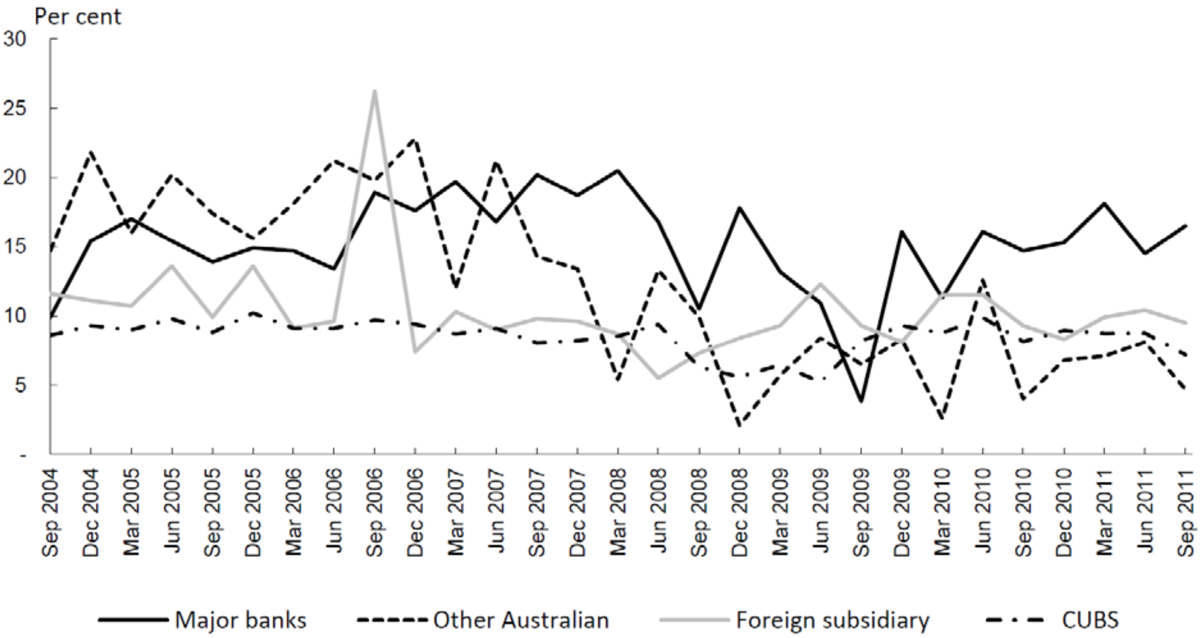
33 RBA, *Submission 33*, p. 6.

This point was also made by the CBA in relation to the United States and some European countries.[34]

Comparison with smaller banks, credit unions and building societies

2.30 Another basis for comparing the major banks' profits is by examining how they compare to their smaller competitors. Treasury provided the committee with some information about this (Figure 2.7).

Figure 2.7: ADIs' return on equity



Source: Treasury, *Submission 120*, p. 12; based on APRA data.

2.31 Treasury's submission stated that '[o]f note, other Australian banks were consistently more profitable than the majors in the period leading up to the GFC'.[35] However, the chart also shows that the other Australian banks have been consistently *less* profitable than the majors in the period following the crisis. Also of interest, the gap between the major banks' profits and other Australian banks has widened significantly, with other Australian banks achieving an average ROE of approximately five per cent in September 2011, compared to the more than 15 per cent obtained by the majors.

International regulatory changes

2.32 Another feature of the post-crisis banking sector is the amount of regulatory change from various international sources. This was a topic raised by a number of banks and their representative groups. They did not argue about the merits of the changes—Westpac argued that it had been 'very forthright in supporting the whole

34 Commonwealth Bank of Australia, *Submission 81*, p. 37.

35 Treasury, *Submission 120*, p. 12.

regulatory reform agenda in terms of its philosophy'[36] but warned about the pace of the reforms, and implications of the changes in terms of added costs—costs that may be compounded by inconsistency between different jurisdictions. The CEO of the ABA provided a useful overview of the sector's view that the benefits of added regulation and its costs need to be carefully considered. He acknowledged that some changes are not unreasonable because 'if we learnt anything out of the global financial crisis it is the extent of the harm that can be caused by instability and collapse in parts of the financial system', however:

> One of the things that policy makers need to continually bear in mind is that stability, as desirable as it may be, does come at a price. What the banking system is really about is managing risk. At its most simple level, we take the risk of lending money to people and the risk of being able to pay money back to those who have given us money to look after for them. You cannot remove risk from the banking system—that is what it is about. The more that you try to do that the more you are going to have these impacts around the availability of credit, the price of credit and the willingness of banks to fund marginal parts of the economy particularly—and in marginal I am including things like the entrepreneurial parts of the economy. We have to constantly check that balance between very desirable stability and the consequences of pursuing that stability.[37]

2.33 Westpac added:

> Regardless of any debate on the need or merits of the elements of the reform agenda, it must be taken into consideration that the impacts of such reforms will undeniably be that credit will be more expensive, and supply constrained relative to the experience of previous decades.[38]

2.34 Accounting for different regulatory regimes and changes can be particularly challenging for foreign banks, as they have to comply with the requirements of multiple regimes, which may place them at a competitive disadvantage in some markets. ING Direct stated:

> … the fact is that in the end the group itself is subject to specific regulation by its home regulator, the Netherlands. Here we are subject to our regulation that comes to capital. There are differences between the two systems but the fact is though, we have to comply with both, so in the end

36 Mr Richard Gray, Executive Director of Regulatory Reform, Group Finance, Westpac Group, *Committee Hansard*, 9 August 2012, p. 8. Perhaps borrowing a famous quote from *Yes, Minister*, Mr Tate from Westpac acknowledged that it would be a 'courageous decision' for a bank to rally against greater regulation following the global financial crisis.

37 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 17.

38 Westpac, *Submission 34*, p. 3.

> we have to take the strictest interpretation or the most severe interpretation of the legislation.[39]

2.35 The most significant of the regulatory changes is Basel III, the latest iteration of the Basel Accords. Chapter 3 focuses on Basel III and its implementation in Australia, however, some of the banks' observations about the Accord are relevant here. A main argument put forward by the banks is that Australia was diverging from how Basel III was being implemented in other jurisdictions, and that this inconsistency was posing compliance challenges and increasing their costs. The ANZ Deputy CEO provided a summary of his bank's view:

> One of the concerns that we had about the fragmentation that was happening around Basel III, and the different rules, was that we were starting to see different regulatory regimes across many countries. We operate in 32 countries. So, if you have to build a bank across multiple regulatory regimes, it increases your costs and the complexities of doing business—which is not good.[40]

2.36 In addition to the Basel reforms, the committee was advised of a number of regulatory changes in other countries which, through extra-territorial effects, have impacted Australian banks. Legislation from the United States in particular was highlighted. Mr Tony Burke from the ABA explained why the US legislation was being framed in this way:

> The US is constructing very complex laws and is determined that smart bankers and their lawyers will not find ways around those laws. So it cast them very widely and inadvertently captures a whole range of activities outside of the US's borders or unrelated to US entities. The laws have quite strong punitive clauses as well and it effectively brings in operations overseas.[41]

2.37 Examples provided in submissions include:

- the US *Dodd-Frank Wall Street Reform and Consumer Protection Act* (particularly the Volcker rule);
- the US *Foreign Account Tax Compliance Act* (FATCA); and
- the UK *Bribery Act 2010*.

2.38 The Volcker rule would prevent banks that take retail deposits that are federally insured in the US from (a) engaging in proprietary trading that is not directly related to the market making and trading they do for customers; and (b) owning or

39 Mr Vaughn Richtor, Chief Executive Officer, ING Bank (Australia), *Committee Hansard*, 10 August 2012, p. 31.

40 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 23.

41 Mr Tony Burke, Policy Director, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 18.

sponsoring hedge funds or private equity funds. The ABA argues that the drafting of the rule effectively captures any connection whatsoever with the US. An example given was the use of exchanges based in the US by non-US banks when the exchange relates to foreign transactions and does not pose a risk to US taxpayers.[42] For these and other reasons, a number of foreign governments have questioned the extra-territorial implications of the Volcker rule. The US Securities and Exchange Commission's website lists submissions on the Volcker rule from, among others, the Canadian Finance Minister, the UK Financial Services Authority and the European Commission.[43] Formal public representations by the Australian government or its agencies do not appear to have been made. It was perhaps with this in mind that NAB felt obliged to write in its submission:

> Industry associations in the US have advised that direct government to government/regulator comments are affective [sic] at influencing the way the regulators in the US approach final regulation. Any additional support the Australian Government could provide to the industry, either directly or via regulators would be appreciated.[44]

2.39 FATCA was another piece of US legislation whose extraterritorial effects were highlighted by Australian banks. In its submission, the ABA explained that the objective of this Act is to recover lost US tax revenue, but to help achieve this aim it places customer identification and reporting obligations on foreign financial institutions globally.[45] A further explanation of the implications for Australian banks was given as follows:

> … because of connections that Australian banks have with the US, it requires us—we are still sorting it out—to identify American citizens here in Australia and report directly from the banks to the Inland Revenue Service in the US the banking activities of US citizens. We run into all sorts of difficulties with going to Customs and asking if you are a US citizen or not. Of course, there are big penalties if we do not find all the US citizens … It is inadvertent but is very problematic for us. It is fair to say the US administration does not the rate the concerns of other countries terribly highly in its own issues at the moment.[46]

2.40 ING Direct also highlighted FATCA, noting that the US government is the only beneficiary of the law and that it was requiring Australian banks to incur costs

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42 Australian Bankers' Association, *Submission 46*, pp. 5–6.

43 See www.sec.gov/comments/s7-41-11/s74111.shtml.

44 National Australia Bank, *Submission 79*, p. 7 (emphasis omitted).

45 Australian Bankers' Association, *Submission 46*, p. 6

46 Mr Tony Burke, Policy Director, Australian Bankers' Association, *Committee Hansard*, 8 August 2012, p. 18.

'that are not actually relevant to our being good at providing the services to our customers locally'.[47]

2.41 There have been recent developments regarding the compliance burden imposed by FATCA. In July 2012, France, Germany, Italy, Spain, the UK and the US announced a model intergovernmental agreement to address these issues. The agreement seeks to minimise compliance costs by establishing:

> … a framework for reporting by financial institutions of certain financial account information to their respective tax authorities, followed by automatic exchange of such information under existing bilateral tax treaties or tax information exchange agreements. It addresses the legal issues that had been raised in connection with the Foreign Account Tax Compliance Act, simplifies its implementation for financial institutions and provides for reciprocal information exchange.[48]

2.42 The Australian government recently announced that it is 'is exploring the feasibility of an intergovernmental agreement with the US' as an alternative to individual agreements between financial institutions and the US Internal Revenue Service. Treasury initiated a consultation process on this proposal on 28 August 2012.[49] Formal discussions on an agreement have commenced.[50]

Libor-fixing scandal

2.43 During the course of this inquiry, a number of international banking scandals occurred. A US Senate committee released a report revealing that HSBC, which it had selected as a case study, failed to act on laundering of drug money and other suspicious funds.[51] Standard Chartered was accused by a New York state authority of hiding transactions with Iran—in contravention of US law—and accepted a fine of US$340 million.[52]

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47 Mr Bart Hellemans, Chief Risk Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 33.

48 *Joint communiqué by France, Germany, Italy, Spain, the United Kingdom and the United States on the occasion of the publication of the Model Intergovernmental Agreement to Improve Tax Compliance and Implement FATCA*, 26 July 2012, www.treasury.gov/press-center/press-releases/Documents/joint%20communique.pdf (accessed 6 September 2012).

49 See www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Intergovernmental-agreement-to-implement-FATCA.

50 The Hon. Wayne Swan MP, 'Australia and the US commence discussions on Foreign Account Tax Compliance Act', *Media release*, 7 November 2012.

51 US Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, *U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History*, July 2012.

52 'Bank Standard Chartered settles Iran probe for $US340m', *Sydney Morning Herald*, 15 August 2012, www.smh.com.au/business/world-business/bank-standard-chartered-settles-iran-probe-for-us340m-20120815-2479j.html (accessed 6 September 2012).

2.44 The most dramatic scandal, however, was the admission that Barclays Bank had been manipulating Libor (the London interbank offered rate). Libor indicates the cost of unsecured borrowing in the London interbank market and is a key benchmark globally for short term interest rates.[53] While the integrity of Libor had been the subject of some earlier speculation, in June 2012 it was publicly confirmed that traders at Barclays had been submitting false rates. Barclays acknowledged that, generally between 2005 and 2008, certain traders requested rates that would benefit their position and requested traders at other financial institutions to also arrange for favourable submissions for their institution. Further, to avoid media speculation that the bank's high US dollar Libor submission might reflect liquidity problems, between 2007 and 2009 Barclays' management ordered its submission to be lowered.[54] As a result, various US and UK authorities imposed fines on Barclays totalling around £290m.[55] However, as it seems that a bank acting alone would have a limited ability to influence Libor, a number of other investigations by regulatory authorities have commenced.[56]

2.45 Given the importance of Libor, the committee was concerned about possible implications for Australian consumers and financial institutions. The RBA was questioned about this; Assistant Governor Dr Guy Debelle provided his analysis of the possible consequences for Australia:

> There is an Australian dollar Libor; banks in London are asked what their Australian dollar borrowing costs are. Very few financial products that we can work out actually reference that. There are some but it is a handful. The impact here is not a big deal. Do Australian entities, including the banks, borrow or have contracts which reference Libor? Yes they do. Australian banks raise money in the US and borrow at a rate that would be Libor plus some spread. They then take those US dollars and swap them back into Australian dollars. That swap contract is also Libor. From the Australian banks' point of view, Libor basically washes out. That is true of an Australian funds manager who is hedging something or BHP when it is borrowing in US dollars and swapping them back to Australian dollars or any Australian corporates that do that. I am sure there are some people who

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53 The Libor for each currency is calculated based on submissions from a selection of large, active banks, which respond to the question: 'At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am?'. A certain number of the highest and lowest submissions are omitted and an average rate is calculated from the remainder.

54 US Department of Justice, 'Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty', *Media release*, 27 June 2012, www.justice.gov/opa/pr/2012/June/12-crm-815.html (accessed 6 September 2012).

55 'Timeline: Barclays' widening Libor-fixing scandal', *BBC News*, www.bbc.co.uk/news/business-18671255 (accessed 7 September 2012).

56 Private proceedings have also been instituted; in August 2012 *The Economist* reported that at least 28 lawsuits had been filed, with cases brought by small banks and mutual funds; 'Suing the banks: Blood in the water', *The Economist*, 4 August 2012, p. 59.

> have products which are affected by Libor but a fairly large chunk of Australian borrowing would not be that affected by it.[57]

2.46 The committee was also concerned about the likelihood of similar conduct occurring with Australia's equivalent, the BBSW. The BBSW is referenced in many financial contracts in Australia, however, the RBA advised that how the BBSW is calculated by the Australian Financial Markets Association (AFMA) differs from how Libor is set. The two major differences are:

- the composition of the panel—for calculating BBSW, AFMA uses a panel which consists of the four major banks (as the issuers of bank paper) and ten dealers (the buyers of bank paper); and
- the question that the panel responds to—'what is the rate that a prime bank in Australia can borrow at?', whereas Libor asks the banks what they think they can borrow at.[58]

2.47 Accordingly, in the RBA's view, the BBSW is less susceptible to manipulation than Libor, although the RBA noted that AFMA is examining BBSW in light of the developments in the UK.[59]

Committee comment

2.48 The admission that Libor, a benchmark rate referenced in an enormous number of contracts globally, was being manipulated for a number of years during the global financial crisis is a troubling development and indicative of the worst types of conduct in the financial system. The committee understands that the Australian benchmark rate, BBSW, is calculated in a fundamentally different manner to Libor and that regardless, the process for calculating BBSW is being examined by AFMA. However, the committee considers that AFMA should make public the results of its review of BBSW to ensure that there can be greater public confidence in the Australian equivalent of Libor.

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57 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 39.

58 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 39.

59 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 39.