

Chapter 4

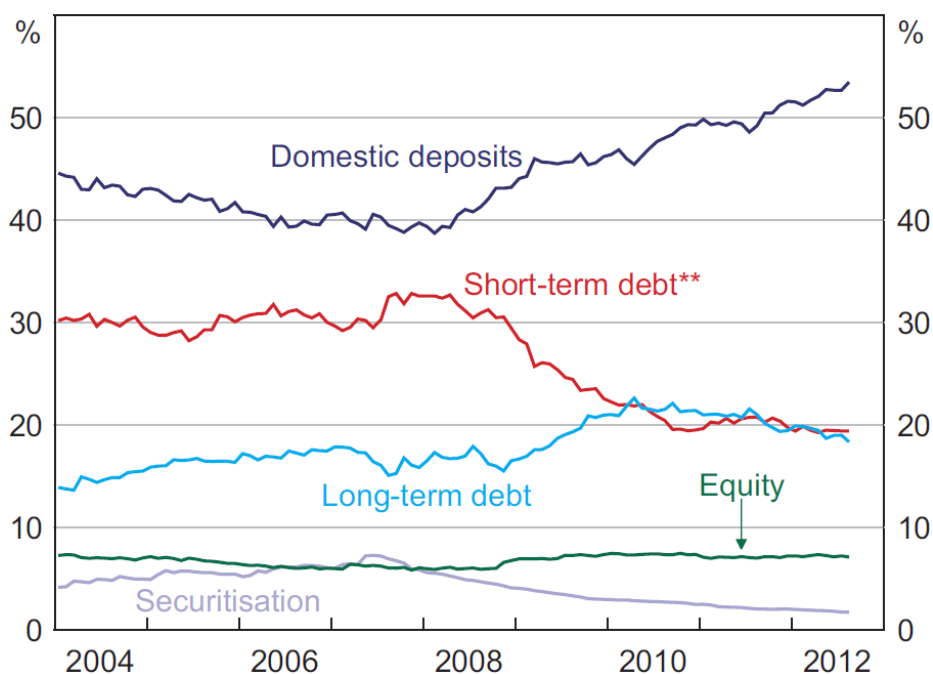
The sources and costs of bank funds post-GFC

4.1 In recent years, the rising cost of funds has often been cited by the major banks as to why they have not always strictly followed changes to the official cash rate made by the RBA. As these decisions impact the large number of Australians with variable rate mortgages, this explanation has been controversial and not generally well-understood in the community. This chapter explores the changes to Australian banks' funding mix and costs since the global financial crisis. It also discusses the relationship between the cash rate and funding costs, and examines various options put forward to help address funding cost issues.

Overview

4.2 The main sources of funds for Australian banks are deposits, with other major funding sources being long-term and short-term wholesale debt. Equity and securitisation provide other sources of funding. Figure 4.1 shows how Australian banks' reliance on each funding source has changed since the global financial crisis, with a significant shift towards deposits and long-term debt, and away from short-term debt and securitisation.

Figure 4.1: Funding composition of banks in Australia (as a percentage of funding)



** Includes deposits and intragroup funding from non-residents.

Source: RBA; based on data from APRA, RBA and Standard & Poor's. Data are adjusted for movements in foreign exchange rates.

4.3 The change can largely be explained by banks reassessing the risks associated with some funding sources during the global financial crisis and the repricing by investors of the risk of banks generally. The tightening of international funding markets during the midst of the crisis meant that banks encountered difficulties in rolling over their short-term debt.¹ Consequently, Australian banks have increased their utilisation of more stable funding sources such as domestic deposits and long-term wholesale funding (in place of short-term debt). This development is likely to be sustained as banks prepare for the Basel III stable funding requirements that will be imposed in 2018. However, these more stable funding sources have proved more expensive for Australian banks with competition for domestic deposits becoming more intense and the cost of long-term wholesale funding steadily increasing since the global financial crisis (relative to the official cash rate set by the RBA).

Relationship between funding costs and the official cash rate

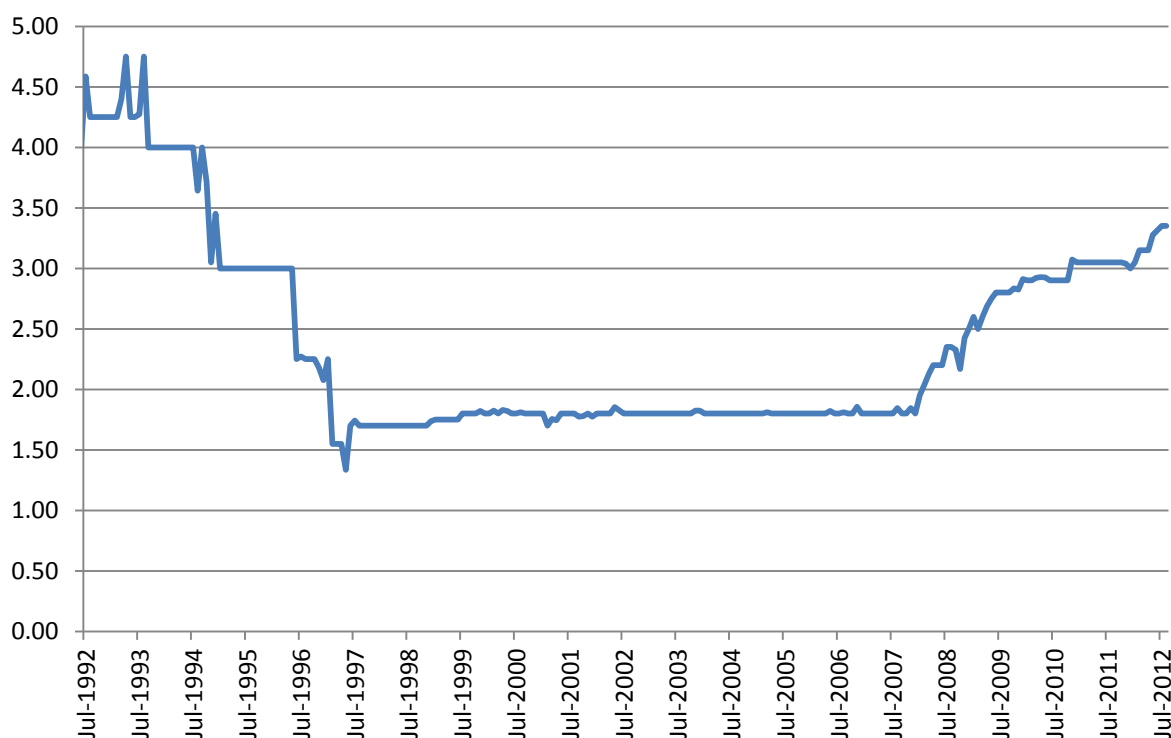
4.4 It follows that a bank's overall funding costs depend on the balance of funding sources it utilises, and the cost associated with each source. Before examining the changes to the funding sources, and given the continued public debate on this issue, it is helpful to discuss how movements in the official cash rate set by the RBA impact the cost associated with each funding source.

4.5 The prevalence of variable-rate residential mortgages in Australia means that movements in the cash rate can be expected to have a more direct impact on new and existing lending than in other countries.² From the mid-1990s until the onset of the global financial crisis, bank lending rates closely adhered to changes in the RBA's official cash rate (Figure 4.2).³

1 Owen Freestone et al., 'The rise in household saving and its implications for the Australian economy', *Treasury Economic Roundup*, 2011, issue 2, p. 71.

2 For example, Dr Guy Debelle, Assistant RBA Governor, Financial Markets, observes that in the US, changes to the federal funds rate by the Federal Reserve have less direct influence on existing mortgages, such as 30 year fixed rate mortgages; Dr Guy Debelle, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

3 Although RBA Assistant Governor Dr Guy Debelle observed that while the standard variable interest rate mostly moved in line with changes to the cash rate, banks increased the discounts they offered on home loans between decisions on the cash rate. Dr Guy Debelle, *Committee Hansard*, 9 August 2012, p. 37.

Figure 4.2: Spread to the cash rate—standard variable housing loans

Source: Based on RBA data (F01, F05).

4.6 The close relationship over many years between movements in the cash rate and lending rates, particularly variable mortgage rates, has created a public expectation that changes to banks' standard variable mortgage interest rates should only be influenced by the RBA's decisions on the cash rate. In recent years, however, while banks have followed the direction of the RBA's decisions on the cash rate, they have not always altered their interest rates by the same percentage point change in the cash rate.

4.7 The RBA provided the following explanation about the role of the cash rate and how it interacts with banks' funding costs:

The level of the cash rate set by the Reserve Bank is a primary determinant of the level of intermediaries' funding costs and hence the level of lending rates. It is the short-term interest rate benchmark that anchors the broader interest rate structure for the domestic financial system. However, there are other significant influences on intermediaries' funding costs, such as risk premia and competitive pressures, which are not affected by the cash rate. At various points in time, changes in these factors can result in changes in funding costs that are not the result of movements in the cash rate.⁴

4.8 RBA Assistant Governor Dr Guy Debelle expanded on the impact of risk premiums:

4 RBA, *Submission 33*, p. 4 (footnotes omitted).

The longer you borrow at, the more people want a bit of compensation for that. As you move beyond overnight and further out in time, you get a premium to compensate you for that. On top of that, if you are a bank, you are a more risky proposition than we [the RBA] are, and so people want to be compensated for that as well. So the cash rate still plays a very important role in the cost of the banks' borrowing, but there are other risk premia and term premia, reflecting how long they are borrowing at, which move around with market conditions—and they have certainly moved around a lot over the past five years.⁵

4.9 The RBA also noted that since the onset of the global financial crisis in 2007 'there has been a lift in the whole structure of interest rates in the economy relative to the cash rate' due to increased competition for deposits and higher wholesale credit spreads.⁶ Dr Debelle observed that during the 2000s up to the onset of the crisis, 'risk premia were incredibly low and did not move'.⁷ This allowed for changes to variable interest rates to follow movements in the official cash rate during that period.

4.10 To enable an analysis of how the cost of individual funding sources for banks has changed, Dr Debelle was asked whether changes to the official cash rate are more relevant to either retail deposits or wholesale funding. Dr Debelle considers the effect to be 'roughly the same':

Dr Debelle: ... As I said, those other influences I talked about earlier have moved around a bit differently for some of those other types of funding—deposits versus wholesale funding. In particular, actually in the deposit market, there has been a lot of competition over the last couple of years, which has driven up the costs of deposits relative to other sources of funding, including wholesale funds. But, beyond movements in those different premia, the cash rate has roughly the same influence on all, regardless of the source of funding.

CHAIR: It feeds into the cost of deposits as well as the cost of wholesale funding to a roughly equivalent level.

Dr Debelle: Yes. As I said, those other things move around and they move around at different times, but, once that has all settled down, yes.⁸

4.11 What impact have the decisions by banks not to adjust their lending rates by the same degree as revisions to the cash rate had? Dr Debelle has stated that it has not significantly impacted the ability of the RBA to conduct its monetary policy functions:

5 Dr Guy Debelle, Assistant Governor, Financial Markets, RBA, *Committee Hansard*, 9 August 2012, p. 36.

6 RBA, *Submission 33*, p. 1.

7 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 37.

8 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 36.

... the Reserve Bank Board takes these developments into account in its setting of the cash rate to ensure that the structure of interest rates in the economy is consistent with the desired stance of monetary policy.⁹

4.12 And as this committee observed in 2011:

... if the banks increase their loan rates by more than the Reserve Bank's adjustment to its cash rate, it does not mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target. If the banks expand their margin over the cash rate, then the Reserve Bank will set a lower cash rate than they would otherwise have set.¹⁰

4.13 The issue is more one of public perception and widespread scepticism of the banks' arguments, not helped by some of the banks' actions.¹¹ During the Competition Inquiry, the CEO of the National Australia Bank reflected that, although the RBA's cash rate decisions influence the market by setting the trend for the direction of rates, they are not the main factor taken into account by banks when deciding their interest rates. Accordingly, in his view, the banks 'have made a problem for themselves here by continually moving in line with the Reserve Bank':

When spreads were very narrow, you must bear in mind that pre the global financial crisis we were borrowing in the spread range of perhaps 15 to 20 basis points over a benchmark. When that blew out to 250 basis points in the crisis, it was clearly even a broader disconnect, if you like, between our funding costs and the RBA. I have got a lot of empathy for the public who say, 'Hang on a second. For 15 years you have moved your rates in line with the RBA up and down. Suddenly there's a disconnect there. In some way you're taking a profit because you're not borrowing at that point in time.' The reality is that that is not the driver of our funding but we have, for many, many years, created that perception in the public's mind, so we have got to face the fact that this is something we have created through our own poor communication on the issue. I am hoping that, as we start to have these sorts of discussions going forward, people will start to see there is a different driver of funding. But I certainly do not blame the public at the moment for being upset about moves they see as not in line with the RBA.¹²

9 Dr Guy Debelle, RBA, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

10 Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. xvii (emphasis omitted).

11 Such as Westpac's 2009 attempt to explain its funding costs through a video based on the cost of bananas: see Julian Lee, 'Westpac goes bananas with email on rationale behind rate rise', *Sydney Morning Herald*, 10 December 2009, www.smh.com.au/business/westpac-goes-bananas-with-email-on-rationale-behind-rate-rise-20091208-khog.html (accessed 31 August 2012).

12 Mr Cameron Clyne, Chief Executive Officer and Managing Director, National Australia Bank, *Committee Hansard*, Competition Inquiry, 13 December 2010, p. 51.

4.14 Since the Competition Inquiry, banks have started to change how they review and announce their pricing decisions. On 8 December 2011, ANZ differentiated itself from the other major banks by declaring that any changes to its retail and small business variable interest rates would be announced on the second Friday of each month.¹³

Overall funding costs

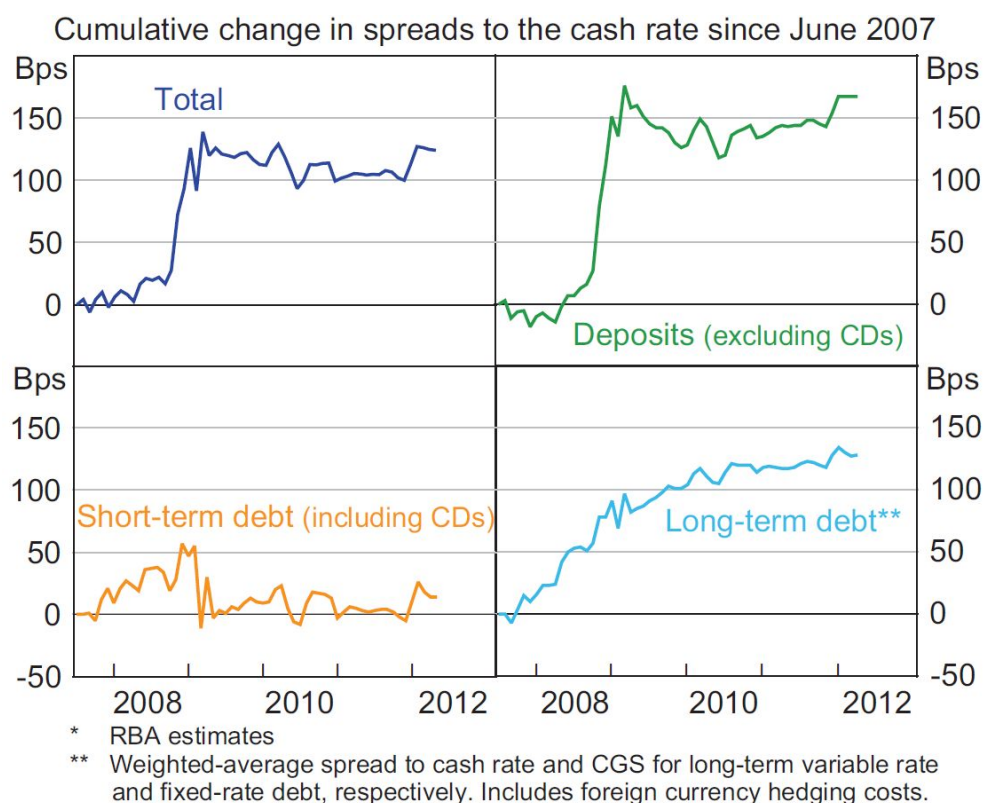
4.15 It is recognised that assessing the funding costs that banks face, even at a sector-wide level, is difficult:

[O]verall funding is a mix of various bank liabilities across differing maturities. Funding costs reflect two components, the general level of interest rates and credit spreads over and above the risk free rate (government rates) ... Moreover, particular funding costs, such as deposit rates may vary relative to the cash rate and government risk free rates, depending upon the degree of competition and movements in the relative cost of other forms of funding. The cost of those other forms, such as wholesale debt market funding, will depend upon the credit spreads which banks must pay for such funds and which can vary markedly over time in response to changes in general market confidence as well as assessments of individual bank risk. How bank funding costs vary over short periods of time is difficult to assess, because banks may be changing their mix of funding and rolling over maturing sources of longer term funding where movements in both the general level of rates and credit spreads since that debt was initially issued need to be taken into account.¹⁴

4.16 Figure 4.3 illustrates the RBA's estimate of how the major banks' overall funding costs have changed since mid-2007.

13 ANZ, 'ANZ cuts interest rates for mortgages and small business lending by 0.25% pa', *Media release*, 8 December 2011, p. 1.

14 Australian Centre for Financial Studies, *Submission 49*, pp. 13–14.

Figure 4.3: Major banks' funding costs*

Note: CDs refers to certificates of deposit, which are negotiable bearer debt securities with a fixed interest rate and maturity date issued at a discount to their face value.

Source: Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, no. 1 (March), p. 41; Bloomberg, RBA and UBS AG (Australia Branch) data.

4.17 As Figure 4.3 indicates, it is estimated that the major banks' funding costs have risen significantly since mid-2007. Overall, the RBA estimates that the major banks' funding costs have increased by about 140–150 basis points, relative to the cash rate, since mid-2007.¹⁵ The RBA also considers that, for regional banks overall, the rise in the cost of funds has been even greater:

The available evidence suggests that, in aggregate, the increase in the regional banks' funding costs since the onset of the financial crisis has been larger than that experienced by the major banks. This reflects the fact that smaller banks have experienced a larger increase in funding costs and have made a larger shift in their funding mix towards deposits.¹⁶

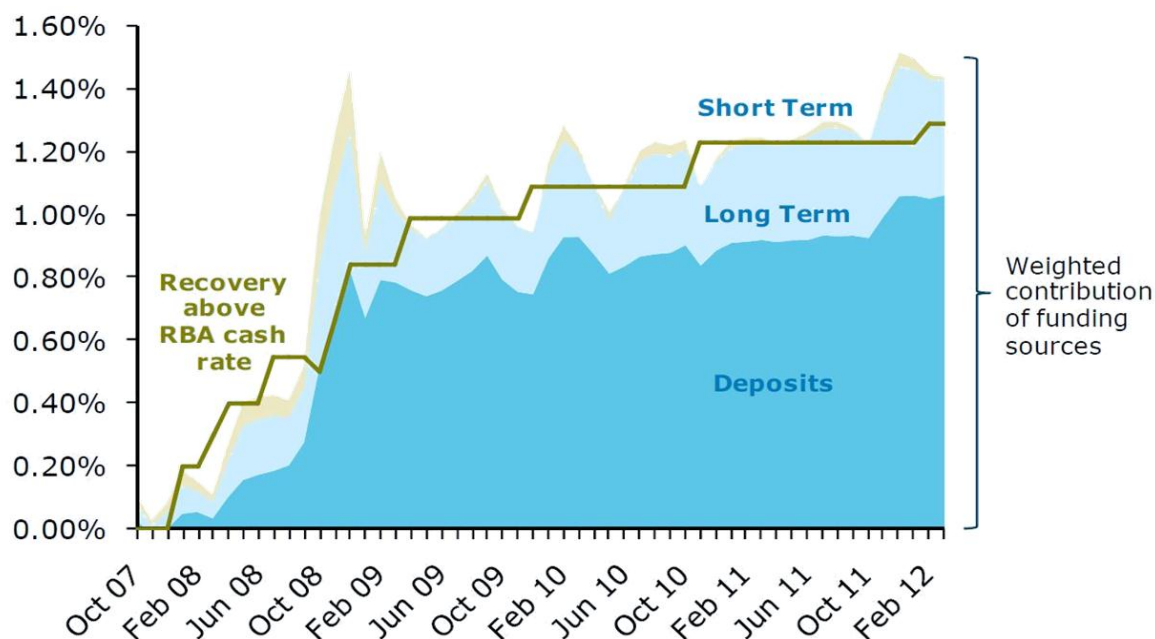
4.18 From the perspective of individual major banks, ANZ and the CBA provided the following charts of how their funding costs have changed and how much of this increase has been recovered. NAB advised:

¹⁵ RBA, *Submission 33*, p. 5.

¹⁶ RBA, *Submission 33*, p. 5.

Our costs of funds has risen, let us say, 140 basis points over that period. We have recovered 125. So there has been some compression in that. Then various business products are repriced similarly but not in the same way. So the net is that there has been some degradation, certainly for us, over that period.¹⁷

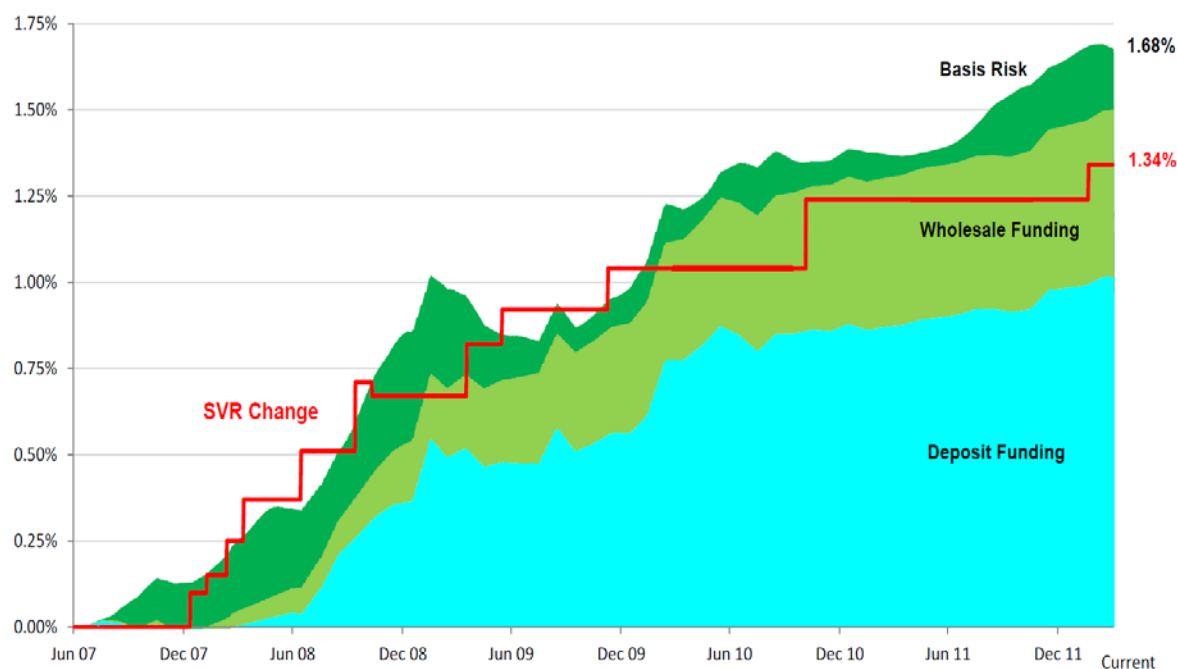
Figure 4.4: Change in ANZ's funding costs relative to the cash rate



Note: The chart depicts the average change in cost of funding relative to the cash rate over the 12 month period ending September 2007.

Source: ANZ, *Submission 78*, p. 14.

17 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 68.

Figure 4.5: Change in CBA's retail bank funding costs relative to the cash rate

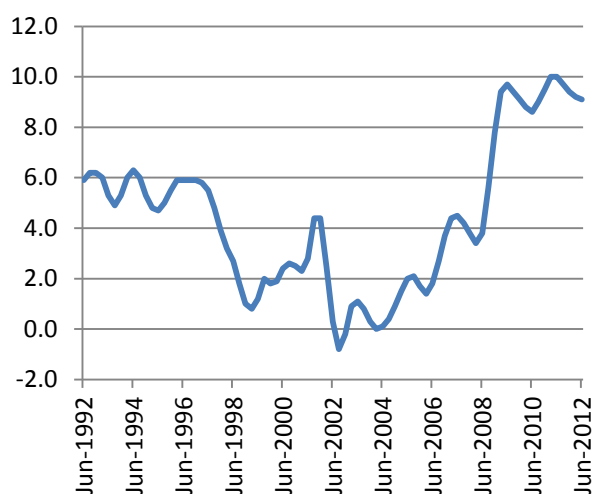
Source: Commonwealth Bank of Australia, *Submission 81*, p. 23.

4.19 The following paragraphs examine the changes in the utilisation and cost of each funding source, and the factors influencing these changes.

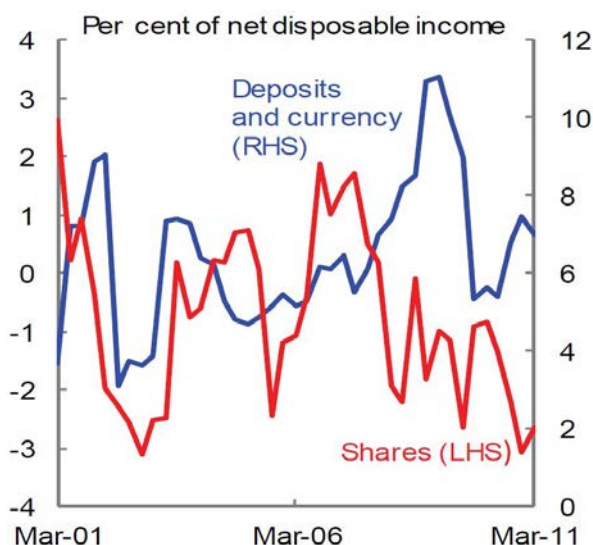
Deposits

4.20 The turmoil of the global financial crisis has had a sustained impact on saving behaviour. As illustrated by Figure 4.6, the level of household saving increased significantly with the onset of the crisis. Households also began to adjust their investment patterns, moving towards lower risk methods of increasing their savings such as term deposits, at the expense of investments associated with higher risk such as shares.¹⁸ This is shown in Figure 4.7.

18 Owen Freestone et al., 'The rise in household saving and its implications for the Australian economy', *Treasury Economic Roundup*, issue 2, 2011, p. 62.

Figure 4.6: Household saving ratio

Source: Australian Bureau of Statistics, cat. 5206.0.

Figure 4.7: Annual net asset purchases

Source: Owen Freestone et al., 'The rise in household saving and its implications for the Australian economy', *Treasury Economic Roundup*, issue 2, 2011, p. 64.

4.21 It is apparent that competition for term deposits has become more intense following the global financial crisis. The ABA provided the following account of how the crisis has affected the demand for deposits:

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. In order to reduce this risk, the 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. Further, foreshadowed regulatory changes for liquidity are giving banks incentives to further focus deposit competition onto term deposits.¹⁹

4.22 Businesses have also contributed to deposits:

... strong business profits and business caution have resulted in larger corporate cash holdings, which have been increasingly invested in deposits rather than other financial instruments, particularly short-term bank paper.²⁰

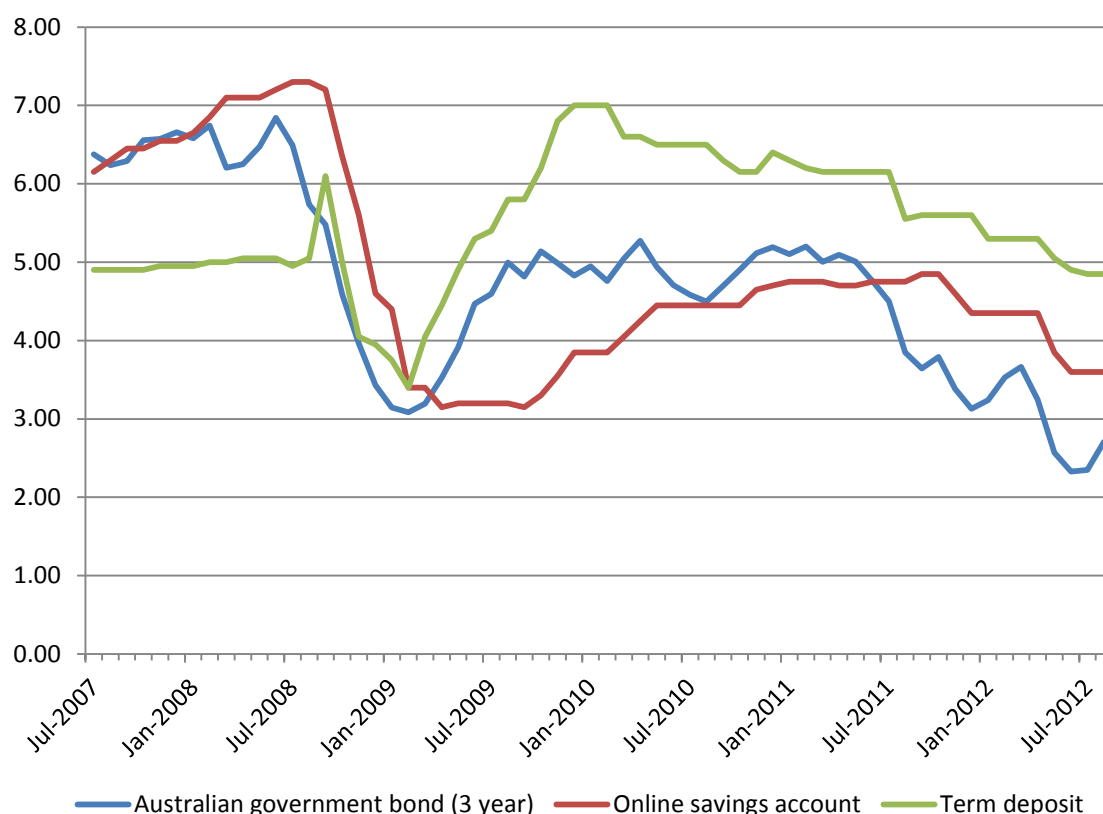
4.23 Figure 4.8 compares the interest rates for term deposits compared to retail online savings accounts and government bond yields, and it is clear that there has been a significant change to the returns associated with these products. The RBA notes that while deposit rates and yields on bank debt generally declined between mid-2011 and

¹⁹ Australia Bankers' Association, *Submission 46*, p. 13.

²⁰ Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, no. 1 (March), p. 38.

early 2012, these declines have not matched the reduction in the cash rate during this period.²¹ Term deposits now represent a greater share of overall deposits than prior to the global financial crisis.

Figure 4.8: Comparison of retail deposit rates with government bonds



Note: Online savings account and term deposit rates based on balances of \$10,000. Term deposits rates based on three year deposits.

Source: Based on RBA data (F2 and F4).

4.24 Westpac explained that competition among banks was particularly intense for term deposits, compared to online on-call deposits, as term deposits are regarded by regulators as a more stable source of funding, and banks want to have a greater proportion of their funding mix in a stable funding base.²²

4.25 The ANZ was asked how its expansion into several Asian countries, which generally have higher saving rates than Australia, is affecting the bank's overall funding needs. The ANZ acknowledged that its proportion of loans to deposits in Asia was 60 per cent, whereas it is 134 per cent for the ANZ Group overall, and that on occasion it had remitted surplus funds from Asia to fund its Australian operations. However the ANZ's Deputy CEO advised that 'our strategy is not to fund our domestic

21 RBA, *Submission 33*, p. 5.

22 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 2.

bank, if you like, from our Asian business; it is really to fund our Asian expansion through the deposits in Asia'.²³

4.26 Given that smaller ADIs traditionally have been more reliant on deposits as a funding source than the major banks, Abacus was asked how the increased competition for deposits among all ADIs was affecting mutual ADIs. Abacus advised that, under present market conditions, their members are able to secure a sufficient level of deposits. However, they raised some concerns about the long-term implications for mutuals:

Part of that is because lending demand is probably a little bit subdued at present ... should economic conditions or confidence increase and people take on more risk, you have that money leaving the deposit market. You also have increased demand for loans, so you have increased demand for funds. I think that is pretty interesting. So at the moment our liquidity is very high. It has always been very high and remains so. This is about the price point. The only distinction I would make between us and the banks, and why the deposit cost is so critical for us, is that we do not have the same diversity of funding that the major banks have, for instance, and therefore we do not get to spread that cost—it is all largely in one bucket.²⁴

4.27 The ANZ, however, does not consider competition for deposits will ease any time soon:

While we continue to see volatility in the global markets, in the interests of maintaining stability and certainty of our funding we expect the banks to continue to work very hard to raise domestic deposits. We would see those being at least at current level or, if we can achieve it, slightly higher levels as a proportion of our total funding than where they are today. I do not see that intensity for competition in the domestic deposit market easing off in the near term at all. I think, therefore, the likelihood that you are going to see an easing in those costs is small.²⁵

Wholesale debt

4.28 While deposits have always formed a large component of the major banks' funding mix, the overall shortfall in domestic funding sources means that banks have to participate in domestic and global debt markets. Smaller banks make less use of offshore borrowing than the major banks and instead rely more on other funding sources. The global financial crisis caused significant disruption and volatility in international financial markets. Following its feature role in the crisis in the United States the securitisation market collapsed, including in Australia even though we

23 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 18.

24 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 13.

25 Mr Graham Hodges, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 17.

suffered no failures here. Increased risk and risk-aversion has led to higher risk premiums for wholesale debt. Accordingly, following the global financial crisis both the cost of wholesale funds and the ways that these funds are utilised have changed.

Unsecured long-term and short-term wholesale debt

4.29 As noted earlier, the proportion of wholesale funding in the overall funding mix has decreased, with deposits being increasingly utilised (see Figure 4.1). Within the wholesale debt category, there has been an important development. Although the cost of long-term wholesale funding has increased significantly more than the cost of short-term funding, banks are increasingly utilising their proportion of long-term funding instead of short-term debt.²⁶ In doing this, banks are seeking to secure more stable funding sources and reduce the risk associated with replacing maturing wholesale debt. A Westpac executive told the committee that, from a risk-management perspective, the unstable nature of the markets has proved to be more challenging than the higher prices:

As you know, about 30 per cent of the money we raise comes from offshore markets. We are a price taker in those markets and the price of credit in those markets not only has stayed high but is extremely volatile. In fact, if there were an issue that really underpins the riskiness of it, it is more the volatility of the price rather than the absolute level of it.²⁷

4.30 As shown above in Figure 4.3, while the costs associated with short-term wholesale debt (relative to the cash rate) increased during the height of the global financial crisis and briefly at the start of 2012, for much of the period since the crisis there appears to have been a relatively small increase in the cost of short-term wholesale debt (relative to the cash rate) compared to the price banks faced prior to the crisis. However, the difference between the price of long-term wholesale debt and the cash rate has steadily grown compared to June 2007. Treasury's assessment is as follows:

In terms of the actual dollar figure, we can say aggregate funding costs in recent times have probably gone down. Relative to benchmarks, relative to the cash rate, they are still elevated.²⁸

4.31 The duration of long-term wholesale funding and the timing of its maturity affects the exposure of a bank to changing funding costs. Long-term funding is, by definition, obtained for some years. Higher costs at present for long-term funds

26 Long-term debt securities are usually bought by larger institutional investors for a fixed term, generally of up to five years. Short-term debt securities are issued with less than 12 months to maturity. The most common securities issued by banks are short-term certificates of deposit with maturity dates of up to three months. The 30-day and 90-day bank bill swap rates (BBSW) price the major banks' short term debt securities.

27 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 2.

28 Mr Ian Beckett, Acting General Manager, Financial System Division, Treasury, *Committee Hansard*, 8 August 2012, p. 5.

impacts the cost of *new* funds, whereas the banks' *average* long-term wholesale funding costs are influenced by the maturity date of their existing funds and the need to source new funds:

While the relative cost of new long-term wholesale funds is currently higher than that of maturing funds, this has had only a moderate effect on the major banks' average bond funding costs relative to the cash rate to date ... This reflects the fact that it takes at least 3 to 4 years for the major banks' existing bond funding to be rolled over. Since spreads began to rise sharply in August 2011, the major banks' issuance of new bonds amounts to about 12 per cent of their outstanding bonds. As a result, the cost of the major banks outstanding long-term wholesale debt is likely to have risen by about 25 basis points relative to the cash rate over the past year.²⁹

4.32 The timing and volume of this rollover is clearly important. Australian banks have been replacing cheaper, pre-crisis, debt with new debt at higher prices. The RBA recently observed:

While spreads on new wholesale debt have declined so far this year, banks' funding costs are about 50 basis points higher than they were in mid 2011 relative to the cash rate. In part, this reflects banks gradually rolling over their maturing long-term funding at higher spreads.³⁰

4.33 Other influences on the cost of wholesale funding are the strategies employed by Australian banks for obtaining and utilising long-term wholesale funding. Some banks are increasing the duration of their long-term funding; ANZ has increased their average duration from four to five years. While this provides greater stability to the funding mix, it generally comes at a higher cost.³¹ The management of interest rate and exchange rate risk also impacts funding costs. The banks enter into interest rate and cross-currency swaps, effectively hedging almost all of their bonds which were issued in foreign currencies back into Australian dollars. The banks also:

... tend to issue in markets where it is cheapest to borrow Australian dollar equivalent funds at that time. In this way, they take advantage of pricing differentials between alternative funding markets, using derivatives to manage the associated exchange rate risks.³²

4.34 Accordingly, while the relative cost of new long-term wholesale funds is currently higher than that of maturing funds, the effect of this is moderated 'if fixed-rate wholesale debt is assumed to be swapped back into variable-rate obligations. The extent of the rise in relative costs for individual banks varies

29 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, issue 1 (March), pp. 40–41.

30 RBA, *Submission 33*, p. 5.

31 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 18.

32 Susan Black, Anthony Brassil and Mark Hack, 'Recent Trends in Australian Banks' Bond Issuance', *RBA Bulletin*, 2010, issue 1 (March), p. 29 (footnotes omitted).

according to each bank's use of interest rate derivatives'.³³ For the example given in paragraph 4.31, the rise in funding costs relative to the cash rate may only be around ten basis points in the year to March 2012 rather than 25 points if it is assumed that fixed-rate wholesale debt is swapped into variable-rate.³⁴

Covered bonds

4.35 A recent development in wholesale funding was the 2011 amendments to the *Banking Act 1959* which allowed ADIs to issue covered bonds.³⁵ A covered bond is an instrument issued by an ADI where, in the event that the issuing ADI defaults on its payment to the bondholder, the bondholder may recoup their investment either from the issuing ADI or through a preferential claim on a specified pool of high quality assets. Treasury submitted that since the relevant legislation was passed in October 2011, banks have raised around \$30 billion through covered bonds.³⁶ Research by the RBA suggests that the issuance of covered bonds has not impacted the overall funding mix, although it has enabled funding of a longer duration—covered bonds issued so far have been for terms of five to ten years, rather than the three to five years applying to unsecured bank bonds.³⁷

4.36 The legislative amendments included provisions for smaller ADIs to pool their assets together to issue covered bonds and therefore take advantage of the higher credit ratings generally associated with these bonds.³⁸ ING Direct were asked how attractive this option was to smaller banks, but advised that they consider it to be something 'extremely difficult to do':

Mr Hellemans: ... considering the complexity that you have about combining a pool of mortgages—to be able to determine the standards of those mortgages and everything else, and the consequences. So it is actually extremely difficult. I think that a lot of people are just daunted by the complexities and the compliance issues that would be related to that kind of structure.

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- 33 Dr Guy Debelle, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).
 - 34 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, issue 1 (March), p. 41.
 - 35 This policy was announced as part of the government's 2010 *Competitive and Sustainable Banking System* package—the legislative amendments commenced on 24 October 2011.
 - 36 Treasury, *Submission 120*, p. 16.
 - 37 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, issue 1 (March), p. 39. That covered bonds are being issued for terms of five to ten years was supported by the ANZ's evidence; see *Committee Hansard*, 9 August 2012, p. 18.
 - 38 The explanatory memorandum for the legislation notes this process involves the participating ADIs establishing a new entity, called the aggregating entity (that is not an ADI), which would issue a debt instrument secured by covered bonds issued by each of the ADIs to the aggregating entity. Explanatory memorandum, Banking Amendment (Covered Bonds) Bill 2011, paragraphs 1.41–1.44.

CHAIR: So the suggestion that was raised at the time that covered bonds really would only assist the majors and effectively, again, provide them with yet another advantage in the competitive environment is probably accurate?

Mr Baker: Yes.³⁹

Securitisation

4.37 Securitisation involves bundling illiquid assets and converting them into a package of securities that can be issued into the capital markets. The resulting bonds are known as asset backed securities, a common type being residential mortgage-backed securities (RMBS) where various residential mortgages are the illiquid assets. As canvassed during the Competition Inquiry, the securitisation market has in the past been important for competition in the Australian banking sector. In particular, non-bank lenders relied on securitisation to compete with the major banks, as it allowed them to expand quickly without having to establish a large network of branches and compete for retail deposits.⁴⁰

4.38 One of the clear effects of the global financial crisis was the collapse in the securitisation market, as illustrated in Figure 4.9 below. APRA officials have commented that up until around 2004, securitisation 'generated clear benefits for competitiveness, efficiency, contestability, and neutrality' in Australia:

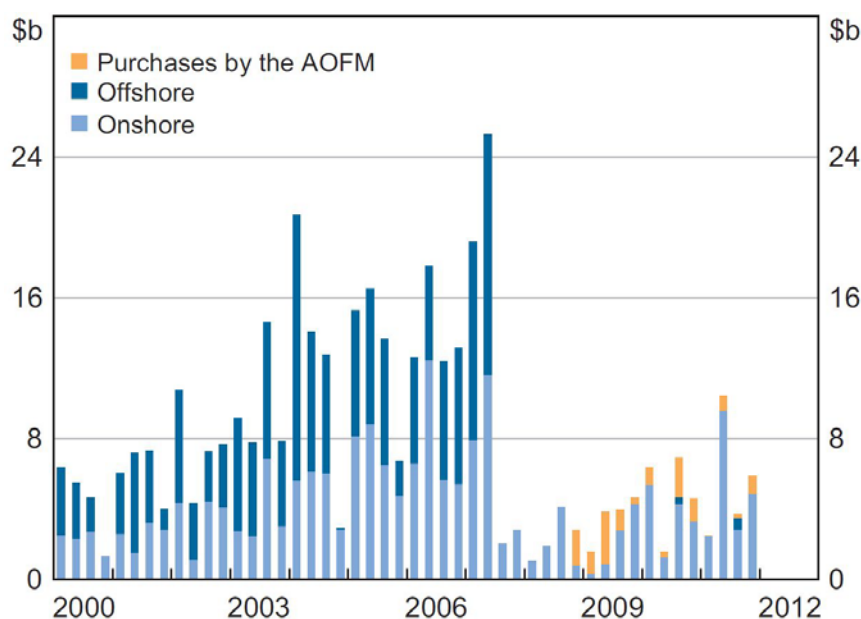
... for safety and systemic stability, in its earlier and simpler incarnation, securitisation was not a problem. The ADIs participating in this market generally maintained good lending discipline, abetted by the lenders mortgage insurance companies supporting the market. In Australia at least, unregulated lenders generally exercised some common sense in their lending and loan management.

We saw in America and Europe, however, that securitisation in the 2000s increasingly became a vehicle which supported over-complexity, reckless and too often fraudulent lending, and gross conflict of interest. The 2007–08 phase of the global financial crisis was not caused by securitisation, but securitisation structures and re-securitisation structures featured prominently in the capital losses and illiquidity associated with that crisis.⁴¹

39 Mr Bart Hellemans, Chief Risk Officer; Mr Glenn Baker, Chief Financial Officer, ING Bank (Australia) Ltd, *Committee Hansard*, 10 August 2012, p. 38.

40 See Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, p. 243.

41 Mr Charles Littrell, Executive General Manager, Policy, Research and Statistics, APRA, 'Prudential issues in securitisation', address to the Australian Securitisation Forum, Sydney, 21 November 2011, www.apra.gov.au/Speeches/Documents/speech%20PRUDENTIAL%20ISSUES%20IN%20SECURITISATION%20ASF%2021%2011%2011.pdf (accessed 30 March 2012).

Figure 4.9: Australian RMBS issuance (A\$ equivalent)

Source: RBA, *Statement on Monetary Policy*, February 2012, p. 52

4.39 The Australian government supported the securitisation market during and after the global financial crisis by instructing the Australian Office of Financial Management (AOFM) to temporarily invest in AAA-rated Australian RMBS. In total, the AOFM has been instructed to invest up to \$20 billion. As of 12 September 2012, it has participated in just under \$15.5 billion worth of transactions.⁴²

4.40 The future strength of the securitisation market is still an open question. The CEO of the AOFM noted that while the infrastructure for securitisation has been persevered, demand for RMBS transactions has 'ebbed and flowed'. He observed:

There is no getting away from the fact that RMBS is a credit product. If credit globally is struggling as an asset class then so will RMBS, and no amount of buying by the Australian government is going to change that.⁴³

4.41 While a Treasury officer noted that securitisation 'has lost its bad odour from previously', he mused:

To some extent, it is still disappointing that the securitisation market has not got going again as strongly as we would like. It was always going to be around five per cent of funding in the whole system, but it is important because it does help some of the smaller lenders. But I will just finish on

42 AOFM, 'AOFM participation in RMBS transactions' www.aofm.gov.au/content/rmbs.asp (accessed 26 July 2012).

43 Mr Robert Nicholl, Chief Executive Officer, AOFM, *Proof Committee Hansard*, 21 September 2012, p. 7.

that point. I think internationally people are now seeing that they need to have a securitisation market, so I am hopeful that it will pick up again.⁴⁴

Are debt markets recognising the fundamental strength of Australian banks?

4.42 An interesting topic examined by the committee was the risk premiums for wholesale debt paid by Australian banks compared to banks in other jurisdictions. The Australian banking system is well-regulated, the major banks are the most profitable in the developed world and are among the most highly rated, and the broader economy is performing strongly compared to other developed countries; however, are these factors being adequately recognised by the wholesale markets?

4.43 At one of the public hearings, an argument was put forward that foreign government agencies have recognised the strength of the Australian economy and financial system, and are eager to buy Australian government bonds because they are low-risk and have a positive return, yet Australian banks were not being received with similar enthusiasm by wholesale markets. The head of Treasury's Markets Group suggested that, in his view, the soundness of Australia's financial system was not being fully reflected through lower funding costs. However, he added:

I think sometimes the way international markets look upon it is, 'A bank's a bank.' It is an Australian bank, and it is competing with Canadian banks and with Europeans, but it is a bank. And I think what you will find in markets now is that there is a greater risk in investing in a bank than there was pre-GFC. It does not matter what bank it is.⁴⁵

4.44 Treasury also pointed out that international lenders seek to diversify their risk, and accordingly would have a limit on the amount of money that they would be willing to invest in bonds that are linked to the Australian economy.⁴⁶ Perhaps explaining the apparent disconnect, the ANZ identified that Australian government debt would be more attractive as it is AAA rated whereas bank debt is AA rated.⁴⁷

4.45 RBA Assistant Governor Dr Guy Debelle indicated that there was a decreased willingness generally among bond holders to hold private debt compared to well-rated government debt—noting that the borrowing costs for the Australian government recently were the lowest since Federation—however, Dr Debelle pointed out that Australian banks are still benefiting in terms of funding costs due to their reputation relative to other banks, particularly European banks.⁴⁸ Westpac's evidence supported this contention, noting that they pay a premium of around 150 basis points, while an

44 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, pp. 3, 9.

45 Mr Jim Murphy, Treasury, *Committee Hansard*, 8 August 2012, p. 7.

46 See *Committee Hansard*, 8 August 2012, p. 7.

47 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 20.

48 Dr Guy Debelle, RBA, *Committee Hansard*, 9 August 2012, p. 40.

A-rated bank in London or New York, in its view, would likely be paying around 200 basis points. Westpac's evidence also highlighted how differences in base rates can conceal the advantage from debt markets that Australian banks receive compared to many of their international peers:

If I was the treasurer of RBS, NatWest or some other bank at the moment I would probably be paying well over 200 over the base rate ... Their base rate, Libor, is half of one per cent. I am paying 3½ on my base rate—that is, my 90-day bill rate—and I add 150 to that, so that is five per cent. If I were at RBS, London or Citibank, New York—that is, an A-rated bank—I would probably be paying 200 over, but my base rate, Libor, is only half of one per cent, so I am only paying 2½ per cent in absolute terms. But the spread over my base rate, because I am borrowing in US dollars, is actually higher.⁴⁹

Future direction of funding costs

4.46 It appears that funding costs will remain elevated for some time, on both the wholesale debt and deposit fronts. On the wholesale debt side, it has been observed that although the cost of issuing new unsecured wholesale debt fell during early 2011, relative to other benchmarks,⁵⁰ the cost has again increased since mid-2011 as investors demand more compensation for taking on bank credit risk globally.⁵¹ A senior Treasury officer reflected on the short-lived decline in costs, noting that 'everyone looks for light at the end of the tunnel'. In his view, however:

It will never go back to the lowest levels it was pre-GFC, which is probably a good thing. People thought things had settled down but this is a market and the market factors in risk.⁵²

4.47 RBA officials have noted that, for short-term debt, while the cost can increase for major banks during times of global uncertainty, it should stabilise when conditions improve:

Short-term issuance is somewhat of a buffer for the major banks. When global markets are dislocated, they tend to issue more onshore short-term debt. This tends to drive up the cost, which may also be rising at the same time because of the tensions which are causing the dislocation globally. Conversely, when conditions improve and term wholesale issuance picks

49 Mr Jim Tate, Acting Chief Operating Officer, Australian Financial Services, Westpac Group, *Committee Hansard*, 9 August 2012, p. 4.

50 Such as Australian government bonds and the overnight indexed swap rate.

51 Cameron Deans and Chris Stewart, 'Banks' Funding Costs and Lending Rates', *RBA Bulletin*, 2012, no. 1 (March), pp. 40.

52 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 5.

up, short-term issuance declines, reducing the spread with further downward pressure from the improved market sentiment.⁵³

4.48 There are two key elements to future wholesale funding costs—the amount of pre-crisis debt that is due to mature and be replaced at a higher post-crisis cost, and the direction of wholesale debt prices generally. The ANZ and NAB advised that they still had longer-dated (7–10 year) debt issued pre-crisis that is due to mature and which will need to be replaced.⁵⁴

4.49 Regarding the likely direction of wholesale funding costs, there was a general consensus that it would depend on global economic sentiment:

... is Europe going to collapse; is the US era over? Those sorts of things keep it high and those spreads move out very quickly when people get scared and then they just come in very slowly.⁵⁵

4.50 Westpac considers that the risk premium of around 150 basis points for a AA rated bank, compared to pre-crisis premiums of around 25 basis points, could conceivably 'be the new normal':

The question of whether 150 turns itself back into a quarter of a per cent is driven by investor preference, if they love us and are happy with the level of return.⁵⁶

4.51 Westpac also pointed out that with the international regulatory changes and continued de-leveraging, based on previous experiences of market downturns investors could be five years away from becoming comfortable with a lower risk premium:

You would like to think that there would be some longer-term reward for being well run. There should be a differential between a AA bank and a single-A bank. You would think that under normal, ongoing, quite predictable growth arrangements, that spread would come in. But we are not at that point. We are a good five years away from being at that point ... bear in mind that we have a lot of regulatory stuff that is going to flow through. It will not really flow through until 2015. There are other forms of regulation that will not come on until 2017–18. Until those regulatory impacts flow through and people are comfortable with them, I think people are always going to hold a bit in reserve in terms of price. That is why I say it will be five years—not because there is no macroeconomic improvement. It is just that these other discontinuities in the market are going to take some

53 Dr Guy Debelle, RBA, 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March 2012, www.rba.gov.au/speeches/2012/sp-ag-220312.html (accessed 25 July 2012).

54 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 17; Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 74.

55 Mr Mark Joiner, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 74.

56 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, pp. 4–5.

time to really feed through and settle down. We have not been in this situation for a long time. I reckon there will always be a degree of premium in the price until people feel 100 per cent confident in the new regime.⁵⁷

4.52 The Deputy CEO of the ANZ speculated that 'there is a prospect that we could see the premium come in a little', but it would depend on a number of factors:

It has obviously come in from where it was in the worst parts of the crisis. If you are an international bond investor, in your mind is: 'I'm looking at return for risk.' They have really moved the pendulum to be lower risk but still reasonable return. I think they see the Australian market as being a lower risk market but not without risk. The sorts of concerns that you hear about from the bond investors include: the housing market here—whether it is sustainable, and we have heard for a number of years international concerns about whether we are going to see a sharp decline in the value of mortgages; we do not think that is the case and we tell them that—and Australia's dependence on China and the growth of China, so if China were to suddenly slow, what might that mean for Australia? There are those sorts of issues. There are some questions around the commercial property market here, particularly in some states where it has been particularly soft.⁵⁸

4.53 Turning to deposits, it is clear that competition for term deposits among the banks has intensified for some time, leading to higher costs for banks (although obvious benefits for depositors). Abacus argues that, while this is being managed by mutual ADIs at present, it raises some questions about the long-term funding stability of that household deposit market:

... one of our concerns is not so much about us competing with much larger institutions right now but about what would happen should, for instance, economic situations change and people have more risk appetite and want to take their money out of banks and put them into, for the sake of argument, equity. If we are continuing to fight ferociously over a shrinking pool of deposits that is a far different scenario than the one we are facing right now.⁵⁹

Other issues which may impact the cost of funds

4.54 As the previous chapter noted, the implementation of Basel III and other regulatory changes may have an impact on funding costs, particularly the stable funding requirements. However, in addition to global market developments and regulatory change, certain characteristics of the Australian financial system and the broader economy may also have an impact.

57 Mr Jim Tate, Westpac Group, *Committee Hansard*, 9 August 2012, p. 5.

58 Mr Graham Hodges, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 20.

59 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 13.

Perceptions of risk

4.55 A paper prepared by KPMG and the Australian Centre for Financial Studies identifies three key characteristics of the Australian banking system that could be perceived to be areas of risk. They are:

- the relatively heavy reliance on foreign wholesale funding compared to other banking systems, which could leave the system vulnerable to upward pressures on funding costs resulting from international developments;
- that investors may consider there is a greater risk of contagion or systemic shocks as a result of the dominance of the big four banks and their similar funding patterns; and
- the large emphasis on residential property lending compared to other banking systems could be perceived to be a risk (the paper argues the low-risk nature of this is 'not fully appreciated in international circles').⁶⁰

4.56 Professor Milind Sathye also noted the reliance on residential loans, submitting that the proportion of housing loans within gross loans has risen from approximately 51 per cent in 2004 to 59 per cent in 2011. Professor Sathye argued that this exposure of the Australian banks to the mortgage market may pose some risks:

A sharp decline in house prices could be disastrous for our [systemically important financial institutions] as well as for the Australian economy. Are house prices in Australia inflated? While a study by *The Economist London*, [a] couple of years back stated that Australian houses are overvalued by more than 60 per cent, econometric analysis by IMF Economists in December 2010 found that the overvaluation was between 5–10 per cent. Estimates may differ but the fact remains that there is a bubble in the market.⁶¹

4.57 In a 2010 report, the IMF also noted that the major Australian banks were significantly exposed to other economies, particularly New Zealand:

Home-host relations between Australia and New Zealand are particularly important, as approximately 90 per cent of New Zealand's banking system assets are controlled by the four major Australian banks. Conversely, all four of the major Australian banks are materially exposed to New Zealand risks.⁶²

4.58 Further, the ANZ's Deputy CEO observed that bond investors would consider the reliance of Australia's economy on China, and implications for Australia if China suffered an economic shock, although he added that 'most bond investors worry a lot

60 KPMG and the Australian Centre for Financial Studies, *The future of Australian bank funding*, March 2011, pp. 3, 4. The International Monetary Fund has previously noted similar issues—see *Australia: Basel II Implementation Assessment*, May 2010, p. 3.

61 Professor Milind Sathye, *Submission 31*, p. 11.

62 International Monetary Fund, *Australia: Basel II Implementation Assessment*, May 2010, p. 29.

and they are always finding new things to worry about, but, in the range of worries they have, Australia is a relatively small worry'.⁶³

Funding advantages from being a large ADI

4.59 There are other aspects of the Australian financial system which could be more positive for the major banks in securing their offshore funding. The Australian Centre for Financial Studies submitted that the major Australian banks could be receiving a competitive advantage compared to other banks as 'they are widely perceived as having implicit government support and will not be allowed to fail':

In most cases of troubled financial institutions which are prudentially regulated, APRA is able to arrange a "smooth exit" by way of an arranged merger. The Financial System Stability Special Account established following legislation in 2008, provides a budget appropriation available to facilitate the potential costs involved. However, this is unlikely to be feasible in the case of the "big four" banks due to the sheer size and complexity of their balance sheets and operations. They are "too big to swallow" by other financial institutions in a situation of financial distress when the risks involved are likely to be substantial and hard to assess.⁶⁴

4.60 This would have domestic competition implications. IMF researchers have estimated the value of these perceptions for large international banks to be a funding advantage of, on average, around 20 basis points.⁶⁵

Credit rating agencies

4.61 While the reputations of credit rating agencies were clearly damaged by the global financial crisis, the ratings they issue are still closely observed. The major rating agencies (Standard & Poor's, Moody's and Fitch) currently give the Australian major banks a AA- rating. The ANZ's 2011 annual report includes a useful discussion of how credit ratings affect its funding costs and operations more generally:

ANZ's credit ratings have a significant impact on both its access to, and cost of, capital and wholesale funding ... A downgrade or potential downgrade of ANZ's credit rating may reduce access to capital and wholesale debt markets, potentially leading to an increase in funding costs, as well as affecting the willingness of counterparties to transact with it. In addition, the ratings of individual securities (including, but not limited to, Tier 1 Capital and Tier 2 Capital securities) issued by ANZ (and banks globally) could be impacted from time to time by changes in the ratings methodologies used by rating agencies. Ratings agencies may revise their

63 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 9 August 2012, p. 20.

64 Australian Centre for Financial Studies, *Submission 49*, p. 5.

65 International Monetary Fund, *A fair and substantial contribution by the financial sector: Final report for the G20*, June 2010, p. 14; cited in Australian Centre for Financial Studies, *Submission 49*, p. 6.

methodologies in response to legal or regulatory changes or other market developments.⁶⁶

4.62 The importance of a high credit rating for obtaining lower cost funding was made by a major bank. It used this to argue why increased funding costs had to be passed on:

Mr Joiner: You could ask: why don't you eat more margin and why do you feel the need to pass those things on? We always have a cautious weather eye to the general health of the banking system, at least as perceived by the ratings agencies. We are one of seven or eight AA banks left in the world and we are barely in that category.

CHAIR: Four of them are the Australian big ones.

Mr Joiner: Yes. We are AA-. We have been marked down to the bottom category in AA. I think the rating agencies take a good deal of comfort in the profitability of the banks as well as in the regulatory regime, the state of the sovereign and so on. I think that, if you allow the profitability of the industry to drift away, you will quite quickly find that you do not have a AA banking system. And, if you do not have a AA banking system, it typically puts pressure on the sovereign rating.⁶⁷

66 ANZ, *2011 Annual Report*, p. 78.

67 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 69.