Statement from regional bank CEOs

Competition underpins a strong, efficient economy and fosters innovation. But most importantly, a competitive landscape gives customers choice and improves the ability for banks to provide innovative products and great services.

However, the inherent disadvantages built into Australia's tiered banking system is having a direct impact on the ability of Australian families and small business to get a better deal – to access more competitive home and business loans and to experience innovative banking.

Since 2007, prudential and regulatory decisions have served to further entrench the four major banks' market power and share from 75 per cent to 82 per cent. The remaining 18 per cent is shared among more than 100 other, smaller banks.

While there are many competitors, more can be done to increase competition.

The current prudential and regulatory settings need to be critically assessed to challenge the status quo and ensure they foster competitive neutrality across the whole banking system instead of protecting, and strengthening, the market power of the four major banks.

As a regional bank group, we have identified three settings that require urgent attention from the Federal Government and regulators to improve competition and ultimately enable banks outside the big four to help more Australians access competitive and innovative banking products and services.

1. **Balance 'too big to fail' with equitable access to wholesale debt**

The four major banks have a significant funding cost advantage that comes from the Government's 'too big to fail' guarantee. This implicit subsidy affords the four major banks with access to cheaper wholesale funding than the smaller banks – giving a 20-120 basis point discount and ultimately a significant head start on margins. Lower funding costs create greater capacity for them to invest in new solutions and customer experiences, further elevating their competitive position.

The Federal Government can ensure better and fairer access to high quality, low-cost debt for smaller banks by allowing greater use of the covered bond financing markets. This can be done by increasing the current cover bond caps applied to small banks from 8 per cent to 15 per cent.

Covered bonds are low risk for wholesale investors, so they are typically cheaper than other wholesale debt. Regional banks estimate this initiative could – if fully utilised by smaller banks – reduce funding costs by around $200 million over five years. While covered bonds help to lower funding costs, they will also help to diversify the funding mix which supports open markets in different economic environments.

2. **Reduce the entrenched capital advantage afforded to major and non-bank lenders**

The four major banks benefit from an entrenched and significant capital advantage they hold over smaller banks.

For each loan a bank makes it is required to set aside a portion of capital as security against the loan. This is determined by a risk-weight setting approved by APRA.

APRA requires smaller banks to hold 50 per cent more capital than the four major banks. This big four advantage further intensifies on the lowest risk mortgages where small banks are required to hold up to 600 per cent more capital compared their big four counterparts. These settings contribute to the major bank's return on equity that is sitting around 50 per cent or more higher than the regional banks.

Smaller banks compete not just against large banks, but also against non-bank lenders. In some areas, they enjoy a regulatory advantage, for example, non-banks are not required to apply APRA's 2.5 per cent interest rate buffer on serviceability for home loans. We welcome fair competition across all segments of the banking sector, but a level playing field is necessary.

The exclusive requirement for smaller banks to hold more capital increases our costs and impacts our ability to sustainably provide lower lending rates to customers and compete with major banks and non-bank lenders. Higher capital also limits the number of customers smaller banks can serve, as each dollar of our equity supports less lending than a dollar held by a major bank.

These risk-weight settings build a significant capital advantage for the major and non-bank lenders and have a direct impact on borrowers from smaller banks by limiting their access to capital and cheaper rates.

To help offset this advantage, the regional banks advocate for:

a) APRA to reduce the risk weight gap between small banks and major banks for low risk mortgage loans.
b) ASIC to impose a 2.5 per cent interest rate buffer on all lenders through its responsible lending guidelines (RG 209) for home loans, aligned with APRA requirements.
c) APRA to apply 150 basis points of unquestionably strong capital (UQS) to D-SIB banks only, with all other banks required to hold 50 basis points of UQS capital reflecting each D-SIB's significance on the economy.

3. Proportionate regulatory agenda

Smaller banks bare a disproportionate level of regulatory burden compared to their size and the stability risk we represent. The competitive position of the smaller banks is further challenged as the non-bank sector is held to substantially lower regulatory standards allowing them to have a lower cost base and leaner operating model.

Further, a competitive anomaly currently exists in Australia's banking system with respect to serviceability standards. Under APRA's rules, a bank must factor into its loan decision an interest rate that is 2.5 percentage points above the rate paid by the borrower. But this obligation is <u>not</u> imposed on non-banks. The reason is that non-banks are <u>not</u> subject to APRA's mortgage lending guidelines (APS 223) yet have free range to the entire mortgage market.

We acknowledge APRA's increasing willingness to ensure its regulations reflect the principle of proportionality. Application of this principle helps to lower the regulatory burden, but not compromise standards.

Regional banks advocate for government and regulators to:

1. Continue to allow smaller banks longer timeframes to comply with the same regulations so we can use the limited pool of consulting talent after the major banks.
2. Implement regulations that are proportionate to the size and risk of the bank.
3. Hold the non-bank sector to similar regulatory standards as the rest of the banking industry.

Finally, the regional banks strongly support the Productivity Commission's recommendation that the ACCC be appointed to the Council of Financial Regulators to act as a 'competition champion' when discussing and determining regulatory policy.

Customers ultimately benefit from greater competition

We believe addressing the entrenched advantage held by both the majors and non-bank sector will enable Australian mortgage holders and small business owners to have easier access to credit at more competitive rates. Greater competition will result in greater outcomes for everyday Australians who are wanting to get ahead.

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