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David Liddy, Managing Director & CEO

30th November 2010

Senator Bushby
Chair
Economics References Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Senator Bushby,

Thank you for the invitation to make a submission to the committee's Inquiry into competition within the Australian banking sector. As a regional bank that aims to be a real alternative to the major banks in Australia, we welcome the Government's interest in ensuring there is sustainable competition in the banking market, for the benefit of all Australians.

It is well documented that the banking industry has been structurally changed as a result of the Global Financial Crisis, with two of the largest non-major banks absorbed by major banks, and the retreat of a number of foreign and non-bank lenders. The concentration risk in Australian banking has significantly increased – and as experience in other countries has demonstrated, concentration in banking does not necessarily equate to stability.

Whilst competition is about more than simply the price of services, the ability to provide pricing competition is fundamental. The ability of non-major banks to provide the level of pricing competition there has been in the past has been severely impacted by a number of factors which have dramatically increased funding costs - and solving for this is the key to reinvigorating competition.

We have set out in this submission five key ways the Government could revive competition on a sustainable basis, all of which are focused on reducing funding costs, and re-establishing a level playing field (in terms of funding) for all participants.

I trust the Committee will find our submission informative. I would be happy to appear before the Committee to elaborate on these points or answer any questions.

Sincerely,

David Liddy
Managing Director & Chief Executive Officer

Submission to the Senate Economics References Committee

Inquiry into competition within the Australian banking sector

Bank of Queensland

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INTRODUCTION

Bank of Queensland (BOQ) welcomes the establishment of the Inquiry into competition within the Australian banking sector.

Given the number of submissions the Committee is due to receive for this Inquiry, including a submission from the banking industry representative the Australian Bankers' Association in which BOQ has participated, this submission will not re-address each terms of reference – instead, it will focus on the three key terms of reference the Bank feels it has a valuable contribution to make towards.

TERMS OF REFERENCE

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

There has been significant debate recently regarding competition in Australian retail banking post-GFC. This current debate was triggered by banks increasing their standard variable mortgage rates by more than the RBA cash rate increase in November.

Whilst there is more to competition in banking than purely price (ie. service, access to capital etc), pricing is fundamental to enabling genuine competition. Without the ability to provide pricing competition, it is difficult for a participant in the Australian banking sector to provide meaningful competition to the dominant players.

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

Post-GFC, it has been well documented that the securitisation market has been crippled, and despite the Government's $16bn investment in the RMBS market in an attempt to revitalise it, the cost of securitisation remains high. For the first time, there is a cost of funds differential for home loans which means the non-major banks, mutuals and non-banks are unable to provide meaningful pricing competition. 15 years of intensifying competition from regional banks, building societies, credit unions, and non-bank financial institutions has seemingly been almost completely reversed in the last two years.

If the Government is genuine in its intention to reinvigorate competition in the banking sector, BOQ believes the most effective and sustainable way to do so is to focus on reducing funding costs, and re-establishing a level playing field in terms of funding. Ways in which this can be achieved are set out in section (j).

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

Underlying approach to regulation

Many of the proposed reforms that are being canvassed publicly now may not have the desired intention of increasing competition, and will more than likely have the opposite effect. It is important for regulators to be conscious of the relativity of the costs regulatory change imposes on smaller institutions – smaller organisations don't have the same ability to absorb change and cost as much as larger organisations do.

For example, there has been speculation that a switching service should be introduced, in order to make it easier for customers to switch banks. Whilst the intention of this is to increase competition and BOQ is a supporter of the concept, if the solution requires all banking institutions to develop a costly IT solution to enable it, it will be detrimental to the smaller banks from a dollar cost perspective (and importantly from an opportunity cost perspective in terms of what other IT projects would be deferred).

Another example which has received much speculation is the introduction of a covered bond market. Whilst this is an important option for increasing the overall funding pool available to the banking sector, and BOQ therefore supports it, it should be noted that it will not be an option for any bank under an AA rating in the short term (ie. it will only provide a benefit to the major banks).

When considering ways in which competition in Australian banking can be improved, it's important that Government and regulators don't default to populist measures that would restrict the economy, like over-regulation; or regulations that in their implementation will inadvertently negatively affect non-major banks more than the major banks and thereby stifle competition.

Government wholesale funding guarantee fee

An example of regulation which restricted competition during the GFC (and is still restricting competition) is the fee structure that applies to the Government's guarantee for wholesale funding, which was introduced in 2008 and withdrawn earlier this year.

There is a tiered fee structure for accessing this guarantee dependent upon an institution's credit rating (70 basis point fee for an AA-rated ADI – ie. the four major banks; 100 basis points for an A-rated ADI; and 150 basis points for BBB (ie. BOQ) and unrated ADI's). Whilst this guarantee is no longer available, the fees are still payable on the outstanding debt, some of which doesn't mature for several more years – so it is still a current issue.

This fee structure had an unintended consequence of a 'double dip' on any non-AA rated ADI, as the credit markets 'looked through' the guarantee to the issuer's underlying credit rating anyway – for example, BOQ on it's first issuance paid

150bps to the Government for the fee on top of 115bps to the market. By comparison, the major banks were paying ~75bps to the market and only 70bps as the fee to the Government for the guarantee.

BOQ has advocated for a number of years for the fee for all future issuances to be flattened for all participants to 70bps. The Senate Standing Committee on Economics inquiry into the bank funding guarantees last year also recommended the equalisation of the fee, however this has not been implemented.

APRA interpretation of APS 120 – making it more difficult to obtain capital relief from securitisation

Another example of regulation that is restricting competition in the banking sector is APRA's recent instructions regarding its interpretation of APS 120, which will make it harder for institutions to obtain the capital relief from securitisation that was previously obtained. This action will materially reduce returns and make it harder to compete.

From the 31st December 2010, APRA's regulatory stance will practically prohibit non-major banks from recycling capital. This has been possible from securitisation funding that afforded bank issuers a capital relief for the securitised home loans. Capital relief allows participants to price more competitively for home loans while still achieving acceptable returns. If non-major banks are unable to recycle capital through securitisation, then mortgage growth will be constrained and competition will therefore be reduced.

BOQ believes APRA are taking a non-commercial stance to funding the mortgage market through securitisation, by over-protecting to an adverse market decline in housing values. This seems to ignore the long established history of mortgage default in Australia. If the market is starved of the supply of funding and capital through a negative regulatory stance, then this will only assist in increasing the dominance of the major banks.

Current regulatory differences between the major and non-major banks

Following is a summary of the key regulatory differences that currently exist between the major and non-major banks, for the Committee's information.

Regulatory Differences	Major banks	Non-major banks
Capital – Prudential Capital Requirement	8-10%	11-15%
Capital buffer	0.50%	1%
Liquidity	7-10%	10 - 20%
Risk Weighting of Assets - Home Loans (average)	17%	40%
Equity carried as a percentage of home loans	~2%	~4.5%
Return on Equity	~20%	~10%

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

BOQ believes it is important for the Government to implement reforms to the banking industry that will structurally change the industry to ensure that competition is cultivated and roadblocks are removed – so that the non-major banks, mutual sector and non-banks are able to sustainably provide genuine pricing competition to the major banks. The Government needs to ensure the settings are right to enable these financial institutions, and new entrants, to grow and provide genuine competition.

Following are some initiatives BOQ would like to put forward to the Committee for consideration. These have been prioritised in order of 'do-ability' and impact:

1. **Third tranche of RMBS investment**

   A short term measure is to **have a third tranche of AOFM investment in the RMBS market of a further $16bn** (ie. double the investment). The two features that are important with AOFM RMBS deals are (a) **driving pricing down to true AAA** market pricing, and (b) **providing capital relief** by either amending the current APRA regulatory interpretation, or extending the AOFM mandate to allow the purchase of lower tranches (AA- notes in the primary and secondary markets) which would reduce the capital held after securitisation. The AOFM could also be mandated to reinvest the run-off for securitisation investments in further RMBS issues.

   Benefit for competition:
   This would assist in driving down the cost of funds for the securitisation market, and would provide access to a volume of funding that is not otherwise accessible to non-major ADI's. It would allow ADI's to write new mortgages with recycled capital and provides confidence to smaller players in the market to originate mortgages. Importantly, all the above features will support the growth of both non–major banks *and* non-banks, thereby increasing competition in the mortgage market.

2. **Change the risk weighting of mortgages for non-major banks**

   The Government could consider changing the Basel II standard approach (which applies to all non-major banks) for housing mortgages to reflect the advanced risk weighting of 20% that the major banks have. Currently, non-major banks are operating under the 'standardised' approach to Basel II, which requires them to hold around double the amount of capital against mortgages than the major banks do (who operate under the 'advanced' approach). BOQ believes this is not a fair reflection of risk, given mortgages across major and non-major banks are written with fundamentally the same underwriting standards. Furthermore, non-major banks have historically performed at or above the standards of the major

banks from a credit perspective.

It's important to note this suggestion does not mean that non-major banks should be awarded Advanced Standing - it suggests changing the approach for mortgages only.

Benefit for competition:

This would reduce the amount of capital required to support mortgage growth for non-major banks. Non-major banks would be better positioned to lower their pricing on home loans and maintain their ROE's, thereby providing more competition with the major banks.

3. **Introduce a longer term solution for the securitisation market**

A longer term measure to address funding is to introduce a Canadian-style RMBS market, which delivers the same cost of funds for all participants. **A derivation of this which has been highlighted in the press recently is for the Government to guarantee the Loan Mortgage Insurance (LMI) of loans ("credit wrapping").** This would mean the Government would have a contingent liability on their balance sheet, however it would be also be a revenue source for the Government. Either option is positive, and will take longer to implement, but is a more sustainable solution than #1.

Benefit for competition:

Similar to # 1 above. Either option would assist in reducing the cost of funds, and provide access to a volume of funds. This solution would provide the basis for re-establishing a level playing field between all providers in the mortgage market over the long term.

Guaranteeing LMI on RMBS would reduce the credit support required for AAA-rated RMBS, driving down the cost of funds for mortgages and thereby allowing non-major banks to pass back to the consumer a lower borrowing cost.

In terms of the LMI guarantee solution, the cost to Government would only eventuate in a market with rapidly declining housing prices. Private LMI's insuring the most risky part of the market should bear most of this risk. If there is an orderly market, then this approach should add to Government revenue via a guarantee fee (Canada earns approximately $1b per year from their guarantee of home loans). The Government could invest some of this revenue in a fund as a capital buffer for use in a market downturn.

4. **Flattening the Government guarantee term debt fee**

An immediate way to boost competition is to flatten the Government guarantee fee for term debt for all participants. As per section (g), whilst this guarantee is no longer available, there is still outstanding debt that doesn't mature for several more years, so flattening the fee for the remaining years has a significant impact. The fee structure that was introduced had an unintended consequence of a 'double dip' on any non-AA rated ADI, as the credit markets 'looked through' the guarantee to the issuer's underlying credit rating anyway – for example, BOQ on it's first issuance paid 150bps to the Government for the fee on top of 115bps to the market. By comparison, the major banks were paying ~75bps to the market and only 70bps to the Government for the guarantee.

In FY10 the GG fee for BOQ was $41m, which will increase to $56m in FY11 – vs the majors paying $22m for the GG on a comparative basis. The cost to BOQ is ~12bps a year.

Whilst flattening the fee for all participants would translate to a loss of revenue for the Government, it would be minimal in the context of the revenue that would continue to be earned. BOQ's estimate is that around 90% of the funding raised during the guarantee period (by dollar value) was from the major banks.

Benefit for competition:

This would help reduce the cost of funding for the non-major banks that participated in the guarantee, enabling them to offer more competitive pricing.

5. **Encouraging superannuation funds to invest in RMBS**

The Government could **provide a tax incentive for super funds to hold capital-stable assets such as RMBS**. This would funnel superannuation contributions back into the Australian market to fund mortgages, rather than directing them to equities.

Benefit for competition:

This option could help retain capital in Australia and potentially reduces the requirement to fund offshore.

Whilst not a competitive benefit, it could also reduce the Government's potential exposure to the ageing population investing in growth assets. These assets can reduce in value rapidly when equity markets decline, as we saw in the GFC. The Government could find themselves in the position where they are required to fund peoples' retirement and health requirements due to superannuation shortfalls.