16 December 2010

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir/Madam,

Senate Economics Inquiry – 'Competition within the Australian banking sector'

HSBC Bank Australia is pleased to provide the attached submission to the Senate Economics Inquiry – 'Competition within the Australian banking sector'.

HSBC is supportive of any initiatives that will increase genuine competition, choice and value for banking customers in Australia. We feel the move toward a 'level playing field' is a logical and valid aspiration.

Australia is a priority market for HSBC within the Asia Pacific region and in 2010, HSBC embarked upon an expansion plan in this market, to offer Australian customers an appealing banking alternative and strengthening our position as the leading international bank in Australia.

HSBC's strategy is distinct from other international banks in Australia insofar that we combine global economies of scale and global connectivity to provide value to our customers and our shareholders:

- Financial scale

  Over 100 million customers worldwide entrust HSBC with over US$2 trillion in deposits. With a tier one capital ratio of 11.5 per cent and a loan to deposit ratio of 80 per cent at 30Jun10, HSBC is one of the most strongly capitalised and liquid banks in the world. Our ADI in Australia fully funds its loan portfolio with customer deposits – the only significant bank in the Australian market to do so.

- Global scale and on-the-ground presence

  First established in Hong Kong and Shanghai in 1865, HSBC today works from 8,000 properties in 87 markets around the world. The global banking scope that this on-the-ground intelligence provides to our customers is unique.

- Geographic diversity

  HSBC's presence in Europe, the Asia-Pacific, the Middle East, North America and Latin America gives us the ability to support investment flows between developed and emerging markets, particularly between Australia and Asia.

- Diversified business model

  HSBC provides banking services to retail, commercial and corporate and institutional customers in Australia. As each sector responds differently to various point of the interest rate cycle, HSBC's diversified business model has the scope to provide value to customers consistently throughout the economic cycle.

- Relationship banking

  HSBC's business model is based on sustainable long-term relationships, giving our customers access to our complete scope of international products, provided in a way that suits their financial objectives.

As HSBC embarks on a strategy to grow in Australia, we are supportive of any initiatives that provide equitable treatment for institutions seeking to expand in new banking areas and give customers the genuine means to switch products and banking providers more easily.

We would like to thank the Committee for the opportunity to contribute to this important discussion around competition in the Australian banking sector.

Yours sincerely

Paulo Maia
Chief Executive Officer
HSBC Bank Australia

Submission to the Senate Economics Inquiry:

Competition within Australian banking

Introduction

HSBC first started operations in Australia in 1965 and was awarded a commercial banking licence in 1986.

Through its Australian network (34 branches and offices and growing), HSBC puts the best of its international products and services from Personal Financial Services, Commercial Banking, Global Banking and Global Markets to work for Australian customers.

In 2010, the HSBC Group identified Australia as a top six priority country within the Asia Pacific region, flagging the Bank's intention to expand its operations in Australia as a compelling financial services alternative for Australian consumers and increasing competition in this market.

Personal Financial Services

In Personal Financial Services, HSBC is expanding its Australian branch network as it increases 'main bank' relationships, continues to grow its mass affluent customer base and increase its distribution of credit cards directly and through retail alliances.

- HSBC has over 600,000 retail customers Australia and a growing Premier mass affluent customer base. HSBC Premier customers increased over 54 per cent in the first half of 2010 to approximately 50,000.
- HSBC expanded home lending by 28 per cent in the first half of 2010, taking its Australian mortgage portfolio to $7.3 billion.
- HSBC increased credit card lending by 18.5 per cent (double market growth) in the first half of 2010, now constituting over two per cent of the Australian credit card market (by receivables).

Commercial Banking

HSBC is expanding its Commercial Banking by focusing on Australian SMEs, middle market and large corporates with international needs, and consolidating customer relationships by focusing on core offerings that put HSBC's scale, international connectivity and on-the-ground global presence to work for our customers, such as: Trade and Supply Chain; Receivables Finance; Payments and Cash Management; and Global Markets.

- HSBC has increased the depth and breadth of its support for Commercial Banking customers in recent years as international competitors have refocused use of their balance sheets within Australia. Approximately 50 per cent of ASX-listed companies have relationships with HSBC.
- HSBC increased its commercial, international and other lending to Australian businesses by four per cent in the first half of 2010, to A$4,410 million.
- HSBC is the 3rd largest provider Trade to businesses in Australia. It continues to grow market share year-on-year and currently holds approximately 13 per cent.
- HSBC is the 5th largest supplier of transactional banking to Australian corporate and institutional sectors, with approximately six per cent primary and six per cent secondary market share.
- In 2010 HSBC formally entered the SME banking space with the establishment of HSBC Business in Australia.

Global Banking and Markets

Global Banking and Markets will increase its support for Australian clients with international business needs as well as the local operations of multinational clients that HSBC banks globally. Global Banking and Markets gives these customers access to HSBC's global products: Trade and Supply Chain; Payments and Cash Management; Securities Services; Global Markets (Treasury, Trading and Sales for interest rates, FX and fixed income); and Global Capital Financing (including Debt Capital Markets and Project and Export Finance).

- HSBC banks nine out of the top 10 ASX-listed companies.
- HSBC acts as gateway for Australian clients issuing offshore and internationals issuing into Australia. HSBC is currently ranked #2 in international bonds for Australian and NZ issuers and #6 as a recent entrant in the Kangaroo bond market.
- HSBC is the largest sub-custodian in Australia with over A$500 billion in assets under custody, holding 67 per cent of assets for cross-border clients and almost 40 per cent of total Australian settlement transaction volumes (Jun10).

Recommendations

Leveraging HSBC's global scale and emerging markets strength, HSBC Australia is taking advantage of Australia's position as a mature market in an emerging markets region to increase competition and become the leading international bank in Australia.

This submission outlines what HSBC sees as critical steps that will benefit competition in the Australian banking sector:

1. Abolishing interest withholding tax – removing the key impediment to the growth of foreign banks in Australia.
2. Abolishing the LIBOR Cap – removing an unnecessary increase in cost of funds for foreign bank branches.
3. Allowing issuance of covered bonds – giving ADIs access to funding accessed by institutions in other markets.
4. Tax concessions on savings – to encourage savings and provide a deeper domestic funding source.
5. Positive credit reporting – to give borrowers more options when it comes to choosing a new lender.
6. Scalable regulations – that do not disadvantage those institutions with less domestic scale.

1. Interest withholding tax

Under current interest withholding tax arrangements, authorised deposit taking institutions in Australia are required to pay a 10 per cent interest withholding tax on the interest they pay for funds borrowed from their parent or affiliated banks offshore. Similarly, foreign bank branches in Australia are required to pay five per cent interest withholding tax on the interest they pay to their parent company.

Interest withholding tax was introduced in 1967 as a means of collecting tax on Australian sourced income from non-residents.

Interest withholding tax is a real cost for Australian borrowers as the foreign lender requires compensation for the interest withholding tax because they do not receive full tax credits in their own jurisdiction. It effectively discourages ADIs and foreign bank branches from bringing surplus funds held by their parents in other markets into the Australian economy to fund their loan book. With the global mobility of capital, it has to date been the key impediment to the growth of foreign banks in Australia.

In May 2010, the Government announced in its Federal Budget that the interest withholding tax applicable to such offshore borrowings will be reduced to 7.5 per cent in 2013-14, to five per cent in 2014-15, with an eventual aspiration of zero per cent. Immediate removal would lead to immediate flow of funding to Australia which would lead to lower rates for customers.

Both the Johnson Report and the Henry Review recommended the abolition of this tax.

HSBC recommends making Australian ADIs and foreign bank branches exempt from interest withholding tax as soon as possible to allow them to expand their operations in Australia without being penalised for lending in Australia those savings held by their parent company in other markets.

2. LIBOR cap

Part IIIB of the Income Tax Assessment Act 1936 (Tax Act) treats a foreign bank branch as if it were a separate entity from its parent for key transactions, like intra-bank lending. Ordinarily, this would see a foreign bank branch taxed on its income only after allowance is made for expenses incurred in earning that income. Section 160ZZZA(1)(c) of the Tax Act, however, introduces an exception to this rule by limiting the tax deductibility of interest paid by a branch on borrowings from its parent to the London Interbank Offered Rates (LIBOR). When funds are provided at a rate in excess of the applicable LIBOR rate, the excess is not tax deductible. This is known as the 'LIBOR cap'.

The LIBOR cap was introduced as a convenient way to administer the tax law relating to intra-bank funding. Initially it was possible for bank branches to absorb the costs involved, however as foreign bank lending has increased in Australia, so has the LIBOR cap constraint.

The impact of the LIBOR cap on competition in Australian banking is:

1. It increases the cost of funding for foreign bank branches.
2. This tax cost is further exacerbated by regulators (including APRA) who as part of more stringent liquidity risk management are now requiring banks to have longer term funding. LIBOR does not prescribe any rates for lending terms of greater than 12 months. Hence, the tax deductibility of borrowing costs of longer than 12 months is artificially and unfairly capped at the LIBOR 12 month rate.
3. It subjects foreign bank branches alone to a technically inaccurate transfer pricing rule: LIBOR is not an accurate representation of the cost of funds from a foreign bank parent.
4. Foreign bank branches incur an additional tax compliance cost as they are required to manage and record processes verifying each borrowing against its relevant LIBOR rate.
5. Banks entering or trying to increase their presence in the Australian market are most impacted by the LIBOR cap as they do not have existing funding programs in Australia. As a result, they are more reliant on parent bank funding, to which the LIBOR cap applies.

Recommendation 3.5 of the Australian Financial Centre Forum report *Australia as a financial centre: Building on our Strengths* (the Johnson Report) released in January 2010 recommended that the LIBOR cap be removed. In May 2010 the Government asked Treasury to review the LIBOR cap, stating it will respond to Treasury's recommendation when the review is completed.

Both the Johnson Report and the Henry Review recommended the abolition of this tax.

HSBC recommends the LIBOR cap on deductibility of interest paid on branch parent funding be removed as soon as possible.

3. Covered bonds

The prevention of Australian ADIs from issuing covered bonds is blocking them from accessing a valuable funding source used by banks in other markets.

Covered bonds are a full recourse debt instrument secured by a pool of mortgage assets (or public sector loans). Similar to residential mortgage backed securities, they are backed by cash flows from the mortgages, but they differ insofar as they sit on the bank's balance sheet, where they are ring fenced to protect investors.

Because the bonds are full recourse, backed by the assets and the originator's ongoing assessment of the assets on their balance sheet, they are a conservative form of debt, typically rated AAA.

Covered bonds have a long history in Europe dating back well over 150 years without a single instance of default and are increasingly being used by banks in other markets to support their funding needs. In the EUR market there are EUR 885 billion of benchmark Covered Bonds outstanding out of total issuance of almost EUR 2.5 trillion. Benchmark issuance is dominated by German, French and Spanish banks – names such as BNP, Commerzbank, ING and BBVA have each issued more than EUR 5 billion of benchmarks since Jan 2009.

In June 2010, the New Zealand government established a covered bond market. Earlier this year, Canadian Imperial Bank accessed investors in Australia with the issuance of the first covered bond here in at least three years.

Access to covered bonds would increase competition in the Australian market by providing Australian institutions with:

- A better credit rating than their own
- A broader range of investors
- Longer debt maturity
- Lower funding costs

As Basel III regulations require institutions globally to hold more capital and liquidity, these factors will become more critical.

HSBC recommends legislation allows the issuance of covered bonds by Australian ADIs.

4. Tax concessions on savings

Current tax arrangements favour superannuation and property investment, at the expense of Australian savings.

The shortage of Australian deposits has increased the reliance of Australian banks on wholesale funding, and with it a whole raft of competition challenges relating to funding sources.

In the 2010 Federal budget, the Government announced the introduction of a 50 per cent tax discount on interest income up to $1,000 per year. Applicable on income earned on bank accounts, savings accounts, term deposits, bonds and annuities, the tax change was to take effect on 1 July 2011. Since then, however, the Government has announced the discount would be delayed by 12 months and the discount would be phased in: $500 in 2012-13 and $1,000 thereafter.

HSBC recommends more significant tax concessions are introduced sooner, in order to encourage savings and greater diversification of Australian investments.

5. Positive credit reporting

Australia currently exists under a negative credit reporting system, regulated by Part IIIA of the Privacy Act. Under this system a credit report may contain identification data, a list requests for credit and details of any negative performance data such as previous defaults.

Australia is one of only four developed markets with a negative-only reporting system (accompanied by New Zealand, France and Italy).

Australia's negative reporting system reduces competition in the Australian market by:

1. Giving larger lenders (with visibility of more customer data) an advantage in the assessment of risk, and consequently the provision of credit to new-to-bank borrowers).
2. Limiting borrowers' access to appropriate credit: the more a lender knows about a potential borrower, the better they can match their risk profile to suitable credit options.
3. Forcing borrowers who may have improved their credit performance to pay a higher price for credit, because their positive performance isn't reflected in negative reporting.

Positive credit reporting would allow more financial services providers with the information they need to make more accurate credit decisions. Research by Veda and HSBC indicates that under positive credit reporting, institutions can deselect the 30-40 per cent of the population officially in 'financial distress' (versus the 7-15 per cent they can deselect today).

In 2008 the Australian Law Reform Commission recommended a move towards comprehensive credit reporting with the inclusion of new elements: the type of credit account opened; the date each credit account was opened; the credit limit on each credit account; the date on which each credit account was closed; and the repayment history for credit accounts.

Draft legislation supporting this recommendation will shortly be the subject of a Senate Committee Inquiry.

HSBC recommends the adoption of comprehensive reporting as recommended by the Australian Law Reform Commission and broader participation by lenders in the sharing of financial information. This will support sustainable credit provision to consumers in Australia and expand the potential range of credit providers available to Australian borrowers.

6. Market concentration and domestic scale

While Australia has long been dominated by the major banks with significant market share, this has increased with industry consolidation in recent years. The domination of one market by a few banks is not unique (the top six banks in the UK account for two-thirds of all mortgages).

However, when the majors' domestic scale is combined with the speed and frequency of regulatory change now being discussed, Australia's largest domestic banks once more have an advantage in their ability to find, in their domestic scale, immediate resources for the process changes, system changes, compliance and administration that new regulations may require.

A recent example of legislation with the potential to inadvertently reduce competition in Australian financial services was the National Consumer Credit Protection Act, as it related to the provision of merchant point of sale credit. While fully supportive of the principles behind the reform, the burden of compliance requirements would have disproportionately disadvantaged HSBC and other affected credit card providers. Only through considerable consultation was relief provided in the form of revised guidance and regulations, allowing HSBC and other to continue driving competition in the merchant point of sale credit sector, providing customers with greater product choice.

When regulatory change is announced with a condensed consultation period, this issue is compounded as the balance of institutions do not have the scalability to provide appropriate resources at short notice without significant cost.

HSBC asks that any recommendations resulting form this Inquiry, give serious consideration to the real impact that regulatory change may have on the systems and processes of those institutions with less domestic scale than the majors. It is critical that the cost required to resource and administer otherwise well intended changes, do not in fact further reduce the competitiveness of organisations with less domestic scale.

Conclusion

As HSBC seeks to grow in Australia, we are supportive of any initiatives that will create a more 'level playing field' for organisations that provide financial services to Australian customers.

This submission has outlined what HSBC sees as critical steps to increase competition in the Australian banking sector, namely:

1. Abolishing interest withholding tax – removing the key impediment to the growth of foreign banks in Australia.
2. Abolishing the LIBOR Cap – removing an unnecessary increase in cost of funds for foreign bank branches.
3. Allowing issuance of covered bonds – giving ADIs access to funding accessed by institutions in other markets.
4. Tax concessions on savings – to encourage savings and provide a deeper domestic funding source.
5. Positive credit reporting – to give borrowers more options when it comes to choosing a new lender.

Improvements in these areas will support increased competition, choice and value for banking customers in Australia.