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15 June 2017

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Submission - Major Bank Levy Bill 2017

Introduction

ME Bank appreciates the opportunity to make a brief submission to the major bank levy inquiry hearing regarding the levy's purported aim of increasing competition in the banking sector.

ME Bank as a small bank with a unique business model due to its connection with Industry Super Funds, is heavily dependent upon policy settings that promote competitive neutrality. We have made regular submissions over recent years to various inquiries, including the Financial System Inquiry, and actively engaged in the public debate concerning competition, conduct and culture and the pressing need to 'level the playing field'.

Background

In our view, prior to the GFC, a relatively level playing field existed for large banks, regional banks, foreign-owned banks, credit unions, building societies and non-ADIs. However, post GFC, regulation has tilted the playing field materially in favour of the large banks by lowering their capital costs, and relative funding and compliance costs. As a result, there is compelling evidence of efficiency and competition issues in financial services and retail banking.

The four largest domestic banks continue to increase their market share and are very profitable by international standards. Market concentration is significant in most markets and return on equity (ROE) is higher for the larger banks, despite the heavy asset weighting towards low-risk domestic housing assets.

ME Bank believes now is the time to identify, acknowledge and discuss issues of competitive neutrality in a constructive way with a view to improving the system for the future. The best means of mitigating the trend towards further concentration is to refocus banking regulation. Competitive neutrality is about ensuring all service providers compete on an equal footing and that regulatory arrangements do not favour some service providers over others.

In our various submissions, we have identified several regulatory changes to preserve customer value and choice to allow regional banks and other providers to compete more broadly for the benefit of consumers and the economy.

In this submission, we limit our comments to the issue of Too Big to Fail (TBTF)

Implicit banking subsidies - Too Big to Fail

In the case of Australia's major four banks, the government provides a subsidy implicit in the designation of these banks as being systemically important.

Prior to 2013, no Australian government agency had ever publicly acknowledged the existence of the TBTF subsidy. Policy makers relied upon a concept of 'constructive ambiguity' to manage the problem of TBTF banks. Under this approach, no government authority would either confirm, deny or even discuss the existence of TBTF banks. This had a dual purpose:

- it was intended to maintain investor discipline on large banks because investors had no hard evidence that big banks would receive bailouts, and
- it allowed government to exercise a free hand in how to manage a potential failure.

This approach changed on 23 December of 2013 when APRA issued a press release that explicitly designated the four major banks as being systemically important. While the media release maintained that the designation did not make the major banks 'immune' from failure, it was a clear signal that they were considered as critical to economic stability.

"In October 2012, the Basel Committee on Banking Supervision finalised its D-SIB framework, which involves a set of principles on the methodology to identify D-SIBs and on the higher loss absorbency (HLA) capital requirement for banks identified as D-SIBs. The Basel Committee's framework responds to the strongly held view of the G20 Leaders, including Australia, that no financial firm should be 'too-big-to-fail' and that taxpayers should not bear the cost of resolution. The framework also emphasises that other policy tools, such as more intensive supervision, can play an important role in dealing with D-SIBs.

"The information paper provides details on the methodology APRA has used to identify D-SIBs in Australia and how the higher loss absorbency (HLA) capital requirement will apply.

"APRA's assessment methodology has regard to the Basel Committee's four key indicators of systemic importance: size, interconnectedness, substitutability and complexity. Based on its assessment of these indicators, APRA has determined that the following authorised deposit-taking institutions are D-SIBs:

"Australia and New Zealand Banking Corporation

Commonwealth Bank of Australia

National Australia Bank

Westpac Banking Corporation."

As a consequence of the implicit guarantee a funding price gap opened up between D-SIBs and non D-SIBs, which is not reflective of underlying risk and management capability, but largely reflective of taxpayer support for D-SIBs.

This fact is made clear in public ratings of banks issued by Standard & Poor's (S&P) where they publish two ratings:

a) a 'stand-alone' rating and
b) a supported rating. The latter factoring in their assessment of the likelihood of official support in the event of a pending default. S&P now provides a 'three-notch' uplift factor to Australia's four major banks.

Value of the Subsidy

There are several mechanisms to calculate the value of the TBTF subsidy. Respected investment banker and banking analyst Chris Joye recently commenting on the value of the subsidy to the major banks (noting this was before S&P's decision to downgrade the credit rating of 23 Australian banks including ME but excluding Australia's four largest domestic banks), said;

"This rating upgrade directly lowers the price they pay for wholesale money, which is what the levy precisely targets (retail deposits excluded).Specifically the majors currently pay 0.94 per cent annually above the cash rate benchmark when raising capital via their 5 year senior bonds .

If the two-notch government support assumption is removed from these bonds their cost would jump by 0.17 percent annually to 1.11 percent above the cash rate based on current pricing of identical securities. So the majors are only paying 35 percent of the true cost of their too big to fail subsidy…"

The effect of this subsidy is to create an unlevel playing field which is prejudicial to ME Bank's ability to fairly compete on even terms. This acts to distort the market, reducing consumer choice and allowing price setting to maximise returns on equity by the major banks.

It is in the public interest that government drive a policy agenda to level this playing field.

Major Bank Levy Bill 2017
The budget papers in describing the levy said inter alia;

"It will complement prudential reforms being implemented by the Government and APRA and provide a more level playing field for smaller banks and non-banks"

For the reasons outlined we strongly support the levy as an important initiative that will have some positive impact on banking competition.

We respectfully submit however that the competitive intention of the legislation would be improved by amending section 4 (3), levy threshold to <u>fully reflect the benefit</u> and linking the application of the levy to those banks designated by APRA as systemically important.

It is APRA's designation of particular banks as D-SIB, which gives rise to the implicit guarantee which the levy seeks to ameliorate. Drawing this connection in the legislation would serve to ensure ongoing policy integrity.

Conclusion
As a small bank with a very strong customer satisfaction rating we directly feel the negative impact of the implicit guarantee and the consequent funding advantage afforded to D-SIB banks. We applaud the Government's initiative in proposing a major bank levy to …'provide a more level playing field.'

Accordingly, in the interests of policy integrity we propose the bill be amended by directly referring to APRA's D-SIB designation and fully reflect the benefit it provides D-SIB banks.

[redacted]

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