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The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Secretary

**Senate Inquiry into Bank Funding Guarantees - Submission to the Economic References Committee by ME Bank**

Members Equity Bank Pty Ltd (**ME Bank**) appreciates the opportunity to make the following submission to the Senate Inquiry into Bank Funding Guarantees.

## 1. Introduction

ME Bank has discussed the subject of the Inquiry with its peers in the market. While each institution is making its own submission based on the key issues facing that institution, there are some common themes between the parties. They are:

1) The cost of the Guarantee must be flattened between the major banks and the smaller / regional banks.

2) The current funding environment is uncompetitive for the smaller / regional banks and the Guarantee cost exacerbates this situation.

3) The Guarantee cost tiering should be more representative of the market cost.

4) The Guarantee, amended to reflect the above 3 factors, should remain in place for the full term.

While the Inquiry will seek to examine the impact of the Guarantee on a number of areas, this submission reflects ME Bank's views on the impact of the Guarantee on the Australian financial sector and interest rates, and, specifically, the impact on the Bank and its customers.

## 2. ME Bank Background

ME Bank has historically been a lender with a strong focus on residential home loans. Over 90% of the Bank's total asset portfolio is comprised of this type of lending.

As at 30 June 2009, ME Bank had liabilities totalling approximately $2.0 billion of which $1.2 billion benefited from the Guarantees. ME Bank's depositor base comprises predominantly customers who fall under the $1 million threshold, but we have three wholesale customers (with deposits totalling $4 million) who requested the cover of the wholesale funding guarantee.

Prior to July 2007 ME Bank sourced the majority of its funding requirements through wholesale capital markets. In particular, ME Bank utilised an off balance sheet model with securitisation forming the critical funding tool for the business.

The Global Financial Crisis (GFC) effectively ended ME Bank's ability to rely on securitisation as a funding source, and has required a total realignment of the funding model.

ME Bank is in the process of transitioning the off balance sheet funding to on balance sheet and the Guarantee on retail and wholesale deposits supports this transition.

## 3. Impact on the Australian financial sector

In ME Bank's view, the most significant impact on the financial sector is a reduction in competition with the larger financial intermediaries. This is due predominantly to the higher cost of available funding, particularly the higher cost differential to smaller institutions for funding.

Prior to the GFC, ME Bank was providing strong competition in the market and increasing its market share over time. The restricted funding and general market slowdown have severely weakened ME Bank's ability to compete in financial services. Data reflects that the major banks' share of the home loan lending market has increased from 70% to 90%.

Specifically, ME Bank is constrained in the following ways:

- the reduced availability of funds to advance to customers;
- repayment requests from existing wholesale funding providers; and
- the cost of funds in wholesale capital markets.

Access to additional wholesale market funding has effectively ended since the onset of the GFC. ME Bank has been restricted to advancing funds available through balance sheet deposit raising and the wholesale funding provided through the Australian Office of Financial Management purchases of Residential Mortgage Backed Securities.

The request by some wholesale funding providers to have their facilities repaid has further compounded the impact on ME Bank by reducing the amount available for advancing to customers.

To the extent that funds are available, they remain extremely expensive.

Broadly, the cost of funds under the guarantee is equivalent to the rate at which they are advanced to borrowers, allowing no margin for operating or other costs.

ME Bank's trading position relies heavily on our ability to be market competitive. ME bank does not seek to be the cheapest home loan provider, as we understand that this is not a sustainable long term strategy. We choose, however, to compete against other lenders by providing our customers with outstanding levels of service in terms of accessibility, friendliness, responsiveness and ease of understanding for our customers. Differentiating ourselves in this manner relies fundamentally on an even playing field when it comes to the price setting process.

The overall consequence of the increasing cost of funding (both from wholesale providers and as a consequence of costs of the Guarantee) is that the interest rates we charge to our customers have come closer to those of the big 4 banks, and ME Bank's ability to attract new customers has become more difficult. Our outstanding, and well recognised, levels of customer service are simply not enough to allow us to compete on a level playing field with the big 4 banks by attracting customers away from them. There have been recent observations that the Treasurer's simplification of the steps needed to move banks has not caused any significant movement in bank customers. Imposing additional levies on the costs of funding to the smaller banks means that major bank customers have even less impetus to move.

## 4. Impact on interest rates

While the cost of wholesale funding has increased as a result of the GFC, leading to higher interest rates, the lending rates that ME Bank is able to offer to its customers have also increased because of the costs associated with the Guarantee.

ME Bank operates only to generate fair returns for its shareholders and the increasing costs of funding are not only eroding profitability, but are compromising our value proposition, and causing higher costs to our customers.

ME Bank has been in operation in the residential loan market for over 15 years, offering a low cost, transparent alternative to the major established financial intermediaries. The product has a single rate for all borrowers and seeks to charge no fees. The simplicity, transparency and high level of customer service offered by ME Bank through its products have differentiated ME Bank from its competitors.

In providing this offering in residential home loans, the interest rate has always been considerably lower than the standard variable rate charged by the major banks. ME Bank has tried through the GFC to maintain this differential with its competitors.

The impact over time has been an erosion of the net interest margin earned by the Bank. Raising funds under the current guarantee arrangements would further erode this margin, and could threaten shareholder capital support for the business, due to the lower returns on equity.

As noted above, ME Bank seeks only to achieve fair returns on its business and is necessarily supported in this aim by its shareholders. There comes a point, however, where each investor will consider whether the returns, or any additional investment, are supportable.

A differential of 80 basis points between major bank costs and ME Bank (70 basis point guarantee cost versus 150 basis points) would, in time, force the Bank to increase the rates on its consumer products including residential home loans.

## 5. Conclusion

The GFC has significantly impacted ME Bank's ability to offer competitive products in the financial marketplace.

While the Guarantee is of assistance by providing access to funding, the cost of the Guarantee results in a less competitive position where the four major banks have been able to increase market share at a very low cost of acquisition.

As ME Bank has sought to migrate from an off balance sheet to an on balance sheet model, access to the Guarantee has been critical to continued deposit raising at the retail and business level. Even though accessing wholesale markets for funding remains uncompetitive, ME Bank may be compelled to follow this course to allow the business to continue to operate. The longer term impact of the differential pricing in the Guarantee will be a forced increase in product pricing to retain profitability and capital support from shareholders.

Yours faithfully

**Tony Beck**
**Head of Corporate Affairs**