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(views expressed in this submission are personal)

Senate Economics Committee
Parliament House
Canberra 2600
Via email : economics.sen@aph.gov.au

Members of the Committee,

Competition within the Australian Banking Sector

This submission is relevant to the following terms of reference of the Committee:-

1. term of reference (d), likely drivers of future change and innovation; and

2. term of reference (i), assessment by banks of cost of capital.

Additional Sources of Funding from within Australia for Authorised Deposit-Taking Institutions

The purpose of this submission is to propose to the Senate a practical way in which Australia's superannuation system could be used to provide Australia's Authorised Deposit-taking Institutions (ADIs) with additional funding sources which could potentially increase competition between ADIs.

The Government's response (due shortly) to the recent Cooper Review into superannuation could be used to implement the proposals set out below.

Foreign Sources of Funding for Authorised Deposit-Taking Institutions

Prior to the GFC there was no systematic difference between the cost of offshore and onshore funding for Australian ADIs (regardless of their size). However the GFC has shown that offshore funding costs can vary significantly compared to the costs of onshore sourced funds. During times of increased financial uncertainty, investors tend to have a home country preference.

Because Australia's major banks source a large portion of their funding from overseas, the major banks are likely to experience large increases in offshore funding costs during times of increased financial uncertainty. For example during the GFC, the spread of major bank provided bonds above Australian Commonwealth Government Bonds at issuance was 400 bps in offshore markets compared to 200 bps in onshore markets (onshore funding availability would be expected to increase during distressed times because Australian funding would be expected to flow from more risky investments to ADIs at these times)

In addition, hedging costs for offshore denominated funding back to the Australian dollar adds to the funding costs for the major Australian banks, and the cost of hedging is generally not known in advance. Hedging costs (for the $US to the $A) increased from around 5bps to 80bps at the height of the GFC, and have reduced to around 30bps more recently.

Securitisation was a major source of funding for “non-major” banks before the GFC. Securitisation markets have reduced substantially in size since the GFC, indicating that “fundamental” sources of bank funding are superior to these sorts of “manufactured” funding sources, which need to be considered to some extent as opportunistic in nature.

Major banks generally have a stronger credit rating than non-major banks which means that wholesale short term and long term funding is cheaper for major banks than for non-major banks. These cost spreads appear to be larger for funding raised in offshore markets than for funding raised in Australia.

The conclusions from the material above are:-

- Government policy should facilitate the maximisation of funding for Australia’s ADIs occurring from within Australia because this is expected to both reduce the cost of ADI funding, and increase the predictability of that funding; and

- Maximisation of the funding of ADIs from within Australia is expected to assist in creating competition between ADIs because ADIs are on a more equal footing when raising their funding from within Australia than if funding is raised overseas.

In what way can superannuation be an additional source of ADI funding?

Currently little of Australia’s $1.2 trillion superannuation assets are “invested” with Australian ADIs. Most of the current holdings of superannuation funds in ADIs are in short term cash bank deposits which either represent part of the investment selection of those members of super funds who select a “cash” investment option (and there are relatively few of these), or represent the working funds of the superannuation funds themselves.

While the current low levels of secure bank deposits may be appropriate for super fund members who are not either retired or approaching retirement, super fund members who are retired or approaching retirement have near term income requirements which the member will withdraw from superannuation (we have called these amounts the member’s “drawdown” amount). For these super fund members, their “least risk” investment class for these drawdown amounts is likely to include a term deposit with an Australian ADI equal to the total of the member’s “medium term” drawdown amount.

For the vast majority of former private sector workers who are drawing down their superannuation through our major superannuation funds currently, the default product which is used is an “allocated pension” which is invested substantially in “risky” asset classes (eg equities and property) and does not include any allowance for the member’s least risk investment for the member’s medium term drawdown amounts (namely secure term deposits). The GFC has highlighted the losses which have been made by retired superannuation fund members, as amounts which are needed for drawdown have either been drawn down at the low market prices which have applied since 2007, or drawdowns have needed to be deferred, thereby causing hardship.

With the baby boom generation entering retirement now and for the next 20 years, it is anticipated that a substantial number of superannuation fund members will commence drawing down their superannuation over this period.

While the recent Cooper Review into superannuation covered this issue to some extent, the Review did not have any firm recommendation to make on the way in which drawdowns should occur. The Review did recommend that, because many members of superannuation funds rely substantially on the trustees of their superannuation fund to make the difficult decision on investments on behalf of the member, default superannuation should have additional standards applied. The Review proposed that default superannuation (including the Cooper Review additional standards) would be renamed “MySuper”. However, the Cooper

Review could make no firm recommendation on the default provisions which would apply under MySuper as retirement income is drawn down in the retirement phase.

Attached is an article (titled “My-POST-RETIREMENT-Super”) from the August 2010 edition of the Association of Superannuation Funds of Australia magazine (Superfunds) which sets out a possible approach under which MySuper could be extended to cover superannuation drawdown, in addition to MySuper’s coverage of superannuation accumulation as was proposed in the Cooper Review. Among the attached article’s detailed recommendations, the attached article suggests that, if MySuper is introduced, then:-

1. My-Post-Retirement-Super needs to specify a single default approach, which is expected to “look after” those people who are drawing down their super and who do not elect other alternatives for drawing their superannuation benefits or managing their assets post-retirement

2. My-Post-Retirement-Super would require secure investment arrangements to be established for assets covering these known future drawdown payments for the specified period. These known future drawdown payments would be matched by assets with a high level of security. ADI term deposits would qualify as such an investment.

The article mentions as one of the advantages of the proposal that “The need of retirees to have secure investments in retirement aligns well with the needs of Australian banks to increase their domestic sources of funding”.

Conclusion

This submission shows that, as part of its response to the Cooper Review into superannuation, the Commonwealth Government has an opportunity (if the Government’s response includes My-Post-Retirement-Super as outlined in the attached article) to provide a triple benefit to the Australian community, by:-

1. securing on commercial terms the medium term retirement drawdowns of those members of Australian superannuation funds who do not have investment expertise;

2. providing Australian ADIs with a potential substantial source of additional funding sourced from Australia; and

3. increasing competition between Australian ADIs.

If the Commonwealth Government responded to the Cooper Review in this way, ADIs would develop products which could be used by superannuation funds which offer a MySuper product, thus reducing the ADIs expected cost of funding because additional ADI funding would be sourced from within Australia.

Please contact us to answer questions on this submission.

Yours faithfully

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