Financial System Inquiry

Submission
in response to the
Final Report of the Inquiry

Level Playing Field
Regulatory Capital
Advanced Accreditation
Payment Systems

March 2015

Bendigo and Adelaide Bank Submission

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Bendigo and Adelaide Bank (BEN) welcomes the opportunity to respond to the recommendations of the final report of the Financial System Inquiry (the Inquiry).

We remain committed to the view that the Inquiry is a timely opportunity for Australia to review the current state of its financial system and determine the most appropriate framework for the future. BEN acknowledges that the recommendations of the Inquiry provide a robust framework to strengthen the financial system and position it to meet Australia's evolving needs and support sustainable economic growth.

BEN is participating in submissions to the Inquiry at three separate levels:

- through this submission which provides BEN's own response to specific recommendations of the Inquiry that seek to level the playing field in the banking and payments systems;
- together with other regional banks, we support measures recommended by the Inquiry to achieve a degree of competitive neutrality in the prudential capital framework for banks and address market perceptions that create capital and funding advantages for sectors of the banking system; and
- at an industry level through the Australian Banker's Association, that address recommendations of relevance to the broader banking and financial systems.

This submission provides specific responses to recommendations in relation to:

- regulatory capital requirements for banks; and
- payments system regulation.

More generally, BEN stands by its view that a bank's role within the economy should include financial, economic and social responsibilities, and regulation and government policy should support that role.

As our public statements have made clear, we believe we do more in our communities but get less from the current regulatory framework. Our extensive networks tell us there is a community appetite for a level playing field.

BEN again thanks the Inquiry for producing a final report that provides a future framework for the financial system. We are available to discuss our submission with Treasury and Government if required.

Yours sincerely,

Robert Johanson
Chairman,
Bendigo and Adelaide Bank

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Managing Director,
Bendigo and Adelaide Bank

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Introduction

Bendigo and Adelaide Bank (BEN) welcomes the opportunity to make a submission to Treasury on the recommendations of the final report of the Financial System Inquiry (the Inquiry). The Inquiry has made a number of significant and welcome recommendations aimed at promoting efficiency, resilience and fairness of the financial system and to increase competition in the banking system.

The Inquiry acknowledged the need to “level the playing field” in banking and proposed recommendations that builds confidence in Australia’s financial system and will deliver improved long-term competitive outcomes for consumers, small business, and the economy.

The financial system will benefit from a competitive multi-tiered banking system.

The existing prudential capital adequacy framework, and market perception that major banks benefit from implied Government support, tilts the playing field heavily in favour of particular sectors of the banking system by creating significant capital and funding advantages. This is specifically evident for banks deemed to be systemically important to the economy or perceived to have the implied support of Government and taxpayers. The advantages became more pronounced during the global financial crisis as well as through IRB banks progressively refining the risk weight assessments underpinning their internal models following accreditation in 2008.

BEN welcomes the recommendations of the Inquiry to reduce the gap in risk-weightings of housing loans, to strengthen the capital requirements for systemically important banks and banks reliant on global financial and capital markets, and to accelerate the process to achieve advanced accreditation under the Basel II prudential capital framework. BEN also welcomes the recommendations to level the playing field in payment regulation, interchange fees, and surcharging.

BEN strongly supports the recommendations of the Inquiry that address the competitive anomalies in the banking and payments systems. Implementation of the recommendations will not in any way detract from the strength or stability of the system. Continued concentration of market power is inconsistent with the fundamental principles of stability, competition and efficiency.

BEN requests that Government establish timeframes to implement the key recommendations of the Inquiry as soon as possible.

Any unnecessary delay will further exacerbate the one-sided nature of the banking system and further penalise smaller banks.

But there are consumer benefits too. A levelling of the playing field will increase competition across the whole banking system and deliver improved outcomes for consumers, small business, and the economy.

There’s not a moment to waste.

Community Connected Banking

The Bendigo and Adelaide Bank Group is a community focused retail bank that commenced operations in 1858, and is now the fifth largest domestic retail bank in Australia with a credit rating of at least "A-" from all three international credit rating agencies. This is only one rating notch below the major Australian banks on a standalone basis i.e. before the major banks receive a two notch upgrade because of implied Government support.

The principal activities of the Group are the provision of banking and other financial services including lending, deposit taking, transaction banking, leasing finance, margin lending, superannuation and funds management, insurance, agribusiness, treasury and foreign exchange services (including trade finance), financial advisory and trustee services.

Our Group includes the retail banking businesses operating under the Bendigo Bank brand that provide a full suite of traditional retail banking, wealth and risk management services to customers through a national network of more than 500 branches. The Group's customer facing brands also include Rural Bank (a wholly owned subsidiary with a separate banking licence), BendigoWealth (incorporating Sandhurst Trustees and Leveraged), and DelphiBank. The Group also recently purchased the Rural Finance Corporation of Victoria, building further agri-capability and support for regional and rural customers.

The strategy of the Bendigo and Adelaide Bank Group is built on a vision of being Australia's leading customer-connected bank. This is based on focusing on the success of all stakeholders of the bank including shareholders, customers, our people, partners and communities.
Our footprint is not just distinctive from our origins in regional and rural Australia and a branch footprint that rivals major banks, but it is our unique relationship with Australian communities through our own Community Bank® model.

The bank developed the innovative Community Bank® model over 15 years ago to partner with communities to provide retail banking services and enable their sustainability. It initially grew out of the withdrawal of major bank branches from country towns and suburban shopping strips. Despite our scale and the regulatory framework, we took the decision at the time to invest in these critical financial hubs in local economies, but we also decided to build a new model that embedded community in our bank – and our bank in those communities.

Out of humble origins in the Victorian Wimmera, we established the first of three hundred Community Banks across the country.

The local model is centred on a community-based company that owns and operates the branch and covers the operating costs, while Bendigo and Adelaide Bank provides the banking licence, products and support. Banking revenue is then shared between the community company and the Bank, with the money generated by people doing their banking business, enabling the community company to pay dividends to its local shareholders and fund important community-building initiatives.

This unique banking model secures a significant and ongoing stream of revenue, which is then used to strengthen communities in many different ways. Importantly, this money eases the pressure on other sources of funding, and even provides opportunity for collaboration with many Community Bank® companies opting to co-fund projects with all levels of government and other organisations.

The social impact of Community Bank® is enormous, and the financial returns continue to experience sustainable and exponential growth.

The total economic and social impact across these communities to date has been:

- Over $135 million in community funding
- 308 new bank branches
- 2000+ new jobs
- 2000+ volunteer directors
- 750,000+ customers
- $26 billion+ banking business
- $37 million+ shareholder dividends

Based on this significant experience in working with communities, the Group's initial submission to the Inquiry advocated enabling communities to develop the capability and resources that underpin their sustainability, growth and resilience.

It also advocated for the creation and support of innovative solutions to address underserviced market demand, and drive improved productivity and inclusion.

While these priorities are unchanged for the Group, the immediate priority as a smaller ADI is to encourage competitive neutrality in the principles and recommendations the Inquiry ultimately puts to the Australian Government.

Such neutrality will partly recognise the positive role Community Banks play in each of their three hundred and eight communities across the nation.

We believe that this platform will give our community banks and their communities the opportunity to prosper, and for other towns and suburbs to take up the opportunity.

The burdens and barriers for smaller ADIs competing with major banks remain great; there will only be competitive neutrality when these are addressed and the implicit guarantees major banks receive from Government are counterbalanced.

Finally, the need to address market concentration and the accompanying distortions is not just a matter for smaller ADIs and their customers – it is also pertinent for the existing customers of the major banks and the wider Australian economy.

A level playing field ensures greater competition, delivers customers a choice and therefore drives better customer outcomes.

We believe we do more in our communities but we get less form the regulatory framework. It cannot last.

Regulatory Capital Requirements

RECOMMENDATION 1 – CAPITAL LEVELS

'Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.'

Bendigo and Adelaide Bank response:

The Inquiry recommended that Australian banks maintain capital ratios in the top quartile of internationally active banks. The recommendation seeks to enhance the resilience of the banking system and minimise the risk and cost to taxpayers, Government and the broader economy.

The Inquiry noted that the stability of the banking system was paramount. The recommendation aims to make banks less susceptible to shocks and the system less prone to crises, to minimise the use of taxpayer funds, protect the broader economy from risk, ensure core economic functions such as credit and payment services are available during times of financial stress, and minimise perceptions of an implicit Government guarantee and associated market distortions.

The primary focus of the Inquiry centred around banks systemically important to the economy and banks with a high degree of reliance on foreign sourced funding. It noted that the recommendation was particularly applicable for banks in either of these two categories.

Systemically Important Banks

During the GFC, Governments around the world provided significant support to stabilise their banking systems. This reinforced the perception that systemically important banks benefit from an implied Government guarantee. The implied support creates market distortions and confers a funding advantage for banks perceived to be systemically important. The Inquiry noted that removing perceptions of implied guarantees will reduce the contingent liability of Government, improve the efficiency of the financial system and economy, and contribute to restoring a more competitive environment.

APRA had previously designated the four major banks as domestic systemically important banks (D-SIB's) and determined that they hold a higher level of capital to reflect the significance of these banks to the domestic economy and payments systems. Regulators in other global jurisdictions also proposed that higher levels of capital be held by globally and domestically systemically important banks.

In addition, international credit ratings agencies, Standard & Poors' and Moody's, assign a two notch uplift to the ratings of D-SIB's in Australia to reflect the implied Government support available to those banks. The effect is that the perception of these banks in global capital and financial markets is artificially inflated compared to a standalone basis.

Bendigo and Adelaide Bank is now the fifth largest domestic retail bank in Australia with a credit rating of at least "A-" from all three international credit rating agencies. This is only one rating notch below the major Australian banks on a standalone basis i.e. before the major banks receive a two notch upgrade because of the implied Government support.

The Inquiry also contemplated a capital surcharge be applied to D-SIB's. The package of recommendations proposed by the Inquiry sought to remove the need for further structural reform such as ring-fencing certain operations of the major banks.
The GFC was not as acute in Australia compared to other countries, in part due to factors specific to the domestic economy and Government fiscal position. The Inquiry was concerned that the same circumstances may not exist in future periods of financial stress.

Regional banks and smaller ADI's are not deemed to be systemically important by regulators, international credit rating agencies, or the market.

A distinction should be made between D-SIB's and other ADI's when considering any increase in capital levels of Australian banks to address the risk of systemically important banks and the funding cost advantage that flows from the implied Government support.

Foreign Sourced Funding

The inquiry noted that Australia is a net importer of capital and the financial system plays an important role in facilitating funding from offshore capital and financial markets. It also presents a potential risk to both the economy and financial system. As such, Australia is susceptible to any dislocation of international funding markets or a sudden change in investor sentiment.

A further objective of the Inquiry was to increase the strength of banks that rely on funding from global capital and financial markets. The Inquiry was concerned that the Australia's banking system is highly concentrated to four major banks with broadly similar business models and a reliance on foreign sourced funding. It also noted it was critical that the Australian banking system was more resilient to shocks as any reliance on offshore funding makes the economy vulnerable to sudden changes in international investor sentiment. Maintaining foreign investor confidence is critical for banks to be able to access foreign funding on an ongoing basis.

The Inquiry proposed that banks reliant on foreign sourced funding maintain higher levels of capital. Regional banks and smaller ADI's only have limited or, in many cases, no reliance on international capital or financial markets. They are predominantly funded by retail deposits and, therefore, do not present any material risk to the economy from a reliance on offshore markets.

The systemic risk associated with any direct reliance on foreign sourced funding should be reflected in the benchmark capital ratios of banks that have substantial foreign debt.

Prudential Capital Comparisons

It is currently not possible to compare the prudential capital ratios of banks across the various global jurisdictions or between standardised and IRB banks in Australia. The standardised approach is far more conservative as more capital is held against higher assumed risks for each asset class rather than the assessed risk under the advanced approach. The risk-weights applied under the standardised approach are generally far higher than risk weights applied by IRB banks.

Standard & Poors' provides a separate assessment of the relative levels of capital held by banks in Australia. It utilises a globally consistent and comparable risk adjusted capital methodology (RAC) as a key element of its rating process for banks. The RAC ratio provides an alternative view of capital adequacy of banks compared to the regulatory capital ratios. The RAC ratios have consistently revealed that standardised banks hold significantly more capital under Standard & Poor's risk adjusted methodology than IRB banks. In addition, a recent survey of banks conducted by Standard & Poors' revealed that, on a risk-adjusted basis, regional banks in Australia are amongst the highest capitalised banks in the Asian region.

The benchmark capital ratios for standardised banks should acknowledge the higher and more conservative measurement of capital ratios under the standardised approach to capital.

Dynamic Capital Benchmark

The Inquiry recommended that Australian banks maintain capital ratios in the top quartile of internationally active banks. This is a dynamic benchmark that will constantly change in line with movements in the levels of capital held by both domestic and international banks.

The Inquiry's desire for Australian banks to be perceived as unquestionably strong is accepted although a dynamic benchmark may produce many unintended consequences and create an ever increasing target if banks in other jurisdictions adopt a similar benchmark. In addition, the benchmark may not produce an outcome that reconciles with the regulators perspective of appropriate levels of capital to be perceived to be unquestionably strong.

A dynamic benchmark may also produce inconsistencies and practical problems associated with readjusting capital on an ongoing basis. Issues specific to individual jurisdictions, economic regions, divergent banking models, the financial strength of individual banks at a point in time, and other factors not directly linked to stability or strength will invariably impact on the levels of capital held by individual banks.

The preferred approach is for regulators to determine a preferred level of capital that may be adjusted periodically rather than a dynamic benchmark that may not directly align to stability or strength.

Peer Group Comparisons

The Inquiry wants Australian banks to be perceived as unquestionably strong. At the same time, it was concerned with sectors of the banking system that create systemic risk. In particular, the Inquiry focussed on D-SIB's and banks reliant on foreign sourced funding. In addition, as it is not possible to compare the prudential capital ratios of standardised and IRB banks, any benchmark must reflect that distinction.

It is, therefore, important appropriate levels of capital for different sectors of the banking system are based on a relevant peer group comparison. Uplifts in capital should be applied to banks in the categories that present a higher degree of systemic risk including banks reliant on international capital and financial markets.

Benchmark capital ratios should be prescribed for each relevant peer group.

RECOMMENDATION 2 - NARROW MORTGAGE RISK WEIGHT DIFFERENCES

'Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.'

Bendigo and Adelaide Bank response:

The Inquiry identified competition as one of two general themes where there is significant scope to improve the functioning of the financial system. Strong competition encourages banks to innovate and increase operational efficiency. It also offers consumers, small business, and the economy generally with more genuine choice.

The Inquiry recognised that a significant competitive anomaly exists in the way housing loans are treated under the standardised and advanced IRB approaches to capital under the prudential framework. The Inquiry observed that APRA should adjust the requirements for calculating risk weights for housing loans to narrow the difference between average IRB and standardised risk weights. This should be achieved in a manner that retains an incentive for banks to improve risk management capacity and should also appropriately recognise the differences in the risks captured by IRB and standardised risk weights. The adjusted framework should remain compliant with the Basel framework and remain risk sensitive.

The Inquiry concluded that the average risk weights for housing loans for IRB banks should range between 25% and 30%. The recommendation seeks to strike a balance between system stability and competition.

BEN shares the views of the Inquiry and fully supports the specific recommendation to raise the average risk weight for housing loans of the IRB banks. This is based on the analysis contained in the final report and for the reasons outlined by BEN in its submission to the interim report of the Inquiry.

The argument that there is a competitive advantage for IRB banks is compelling when you compare the weighted average risk weights under the IRB and standardised approaches. The Pillar III reports lodged with APRA disclose that IRB banks generate an average risk weight of 18% across their entire housing loan portfolio and single digit risk weights for the highest quality loans. By comparison, regional banks have an average risk weight of 39% and a minimum risk weight of 35% on the highest quality housing loans. This is a stark difference in outcomes that is not reflective of the risk being assumed by standardised banks.

The banking system is concentrated with the IRB banks now representing over 80% of the housing loan market. The disparity in risk weights has become more evident over time as IRB banks have refined the risk weight assessments that underpin their internal modelling. IRB banks are now directing more of their funding to housing loans and they now represent a large and growing part of their balance sheets.

This does not take away from the more robust approach required to achieve accreditation under the IRB approach but the historical performance of housing loans of smaller banks indicates that the gap is far narrower than the disparity in the risk weights that the standardised and IRB approaches infer. BEN has made a significant investment to achieve accreditation and expects to lodge an application later this year.

The market for housing loans is very competitive. Base rates offered by all banks are broadly comparable as are net interest margins. The main disadvantage for standardised banks is the impact on the return on equity (ROE) by being required to hold, on average, more than twice as much capital to support housing loans than IRB banks on a weighted average basis. It is not possible to deliver the same return to shareholders due to the capital arbitrage available to IRB banks under the prudential capital framework. The capital advantage also provides greater scope for IRB banks to offer heavy pricing discounts to borrowers to drive growth.

The proposed change to average risk weightings for housing loans recommended by the Inquiry is critical to rebalance the "playing field". It is unsustainable if there is no change to the current arrangements.

RECOMMENDATION - ACCELERATE THE ADVANCED ACCREDITATION PROCESS

While not a formal recommendation of the Inquiry, it made the following observation:

'To promote incentives for ADIs to develop IRB capacity, APRA could consider how to make the accreditation process less resource intensive without compromising the (necessarily) very high standards that must be met. APRA has already indicated it is willing to explore a proposal to decouple the need to achieve internal model accreditation for both financial and non-financial risks simultaneously. That is, an ADI may be accredited for regulatory capital models for credit and market risks without having been accredited to model operational risk. The Inquiry supports exploring such initiatives.'

Bendigo and Adelaide Bank response:

BEN recognises the benefits of accreditation and accepts the prudential distinction between the standardised and IRB approaches. The prudential framework provides a significant incentive for banks to achieve accreditation. BEN is committed to seeking accreditation and has invested significantly in new risk management processes and systems. Advanced accreditation benefits all stakeholders including BEN, the banking system, customers, and the economy by being able to compete on a level playing field.

The current path to accreditation is inefficient and creates significant delays in the process. There is scope to accelerate the process without jeopardising the integrity of either the process or the ultimate outcome.

BEN welcomes the suggestions of the Inquiry, in particular, any proposal to accelerate the accreditation process and decouple credit and market risk from operational risk.

Payments System

RECOMMENDATION 16 – CLEARER GRADUATED PAYMENTS REGULATION

‘Enhance graduation of retail payments regulation by clarifying thresholds for regulation by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.

Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.’

Bendigo and Adelaide Bank response:

BEN broadly supports the findings and recommendation of the Inquiry on the basis that it creates something approaching a level playing field by bringing all participants, both old and new, under the same regulatory framework. We support having a more transparent approach to regulation however this should not involve the creation of new additional mechanism’s but seek to lower compliance costs and make more efficient use of existing forums and resources.

RECOMMENDATION 17 – INTERCHANGE FEES AND CUSTOMER SURCHARGING

‘Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.

Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.’

Bendigo and Adelaide Bank response:

Interchange Fee Regulation

Whilst this recommendation has far reaching implications for participants, BEN supports the intent and believes the impacts of recommendation 16 are directly linked to some of the issues the Inquiry has highlighted and is seeking to resolve.

We do urge caution when considering the path forward in developing interchange fee regulation as this may actually lead to a reduction in innovation, investment, and customer choice. While change is required, a graduated approach is needed to ensure impacts are able to be appropriately implemented and managed.

Customer Surcharging Standards

We support the recommendation however further consideration of the challenges and cost involved in implementing the complex solutions put forward by the Inquiry is required to ensure some participants are not unduly impacted in an effort to benefit others. Our preference would be to remove surcharging if an effective interchange fee regulatory framework is achieved.

We view the recently created "Australian Payments Council" as playing an important role in further discussions and policy development relating to these recommendations.

BEN also notes that the industry is currently considering an issues paper, "Review of Card Payments Regulation", released by the Reserve Bank of Australia in March 2015. We do, however, seek assurance that further policy discussions and development will be done in a co-ordinated manner given the issues paper was released prior to the conclusion of the Inquiry consultation process.