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Dear Treasury

Financial System Inquiry Final Report – submission to Treasury

Thank you for the opportunity to make a submission to Treasury on the Financial System Inquiry Final Report. I am encouraged that our arguments have been acknowledged in the Report. Competitive neutrality is a critical and growing issue for the industry and consumers. As a priority, the existing regulatory settings should be amended to address the perverse competitive anomalies that threaten Australia's multi-tiered banking landscape. Changes to the setting of mortgage risk weights, which drive capital allocation, are needed to level the playing field. This would allow non-major banks, building societies, mutuals and others to better challenge the position of entrenched banks for the benefit of consumers and businesses.

As the leading regional bank, Suncorp Bank is the natural proponent to facilitate competition and deliver innovative products and financial solutions to Australians. With more than one million customers, the Bank has a strong presence in the market and is committed to remaining a viable and competitive option for consumers.

I believe it is in the best interests of the community and our economy for a robust multi-tiered banking system to exist. This is currently at risk because of the entrenched distortions in the way different tiers are able to fund themselves and the capital they have to hold.

Our enclosed submission focuses on the policy options in the Final Report that have the potential to address competitive anomalies in the market while maintaining the integrity of the system.

Suncorp Bank's recommendations to Treasury include:

- *Fast-tracked implementation of Recommendation 2 – the application of a 25% to 30% risk weighting of mortgage assets on advanced or Internal Ratings Based (IRB) banks;*
- *Support from Government and APRA for regional banks' aspirations to achieve Basel advanced status, including de-coupling of credit and operational risk (Recommendation 2) and consideration of a staged approach to achieving accreditation in mortgage and business books;*
- *Greater transparency of the ownership structures in mortgage broking and aggregation as outlined in Recommendation 40;*
- *Acceptance of Recommendation 6 – maintaining the ex post funding structure of the Financial Claims Scheme. We are concerned that a pre-funded 'deposit tax' scheme will disproportionately impact smaller banks, who rely more heavily on deposits for funding than larger banks;*
- *Further consideration of methods to address too big to fail, as outlined in Recommendations 1, 3 and 4. The objective should be to address the funding cost gap between major and non-major banks while maintaining system stability and consumer and investor confidence; and*
- *A regulatory environment which supports competition and is more coordinated across the regulatory bodies.*

I would urge Treasury and the Federal Government to implement key recommendations from the Inquiry in a timely manner. This includes recommendations which require action by the Australian Prudential Regulation Authority (APRA). I am concerned that efforts to maintain the status quo by major banks and regulators will delay implementation of recommendations to the detriment of the system and consumers. There may be calls for FSI recommendations to be held up while the Basel international committee deliberates on risk-weighted capital but this will take years. There is international precedent for moving outside the Basel timeline and process.

The Australian banking system needs rebalancing now. Given the rate of consolidation and concentration in banking since 2008, I believe there is some urgency in establishing a fairer and more level playing field. While I appreciate the challenges in implementing reform, I would ask the Government to prioritise Recommendation 2. This would improve the system of risk-weighting housing loans by narrowing the gap between small and large banks on risk-weighted capital. We would like to see some clarity on this by mid-2015. I would also support timely action on recommendation 40, which calls for greater transparency around mortgage broker and adviser ownership structure and incentives. This, as well as 'Too Big to Fail' (TBTF) measures, would ideally be agreed by mid 2016.

I have been working closely with my colleagues from Bendigo and Adelaide Bank, ME Bank and Bank of Queensland and I fully support the positions presented in our joint submission to Treasury.

I would welcome the opportunity to work with Treasury and the broader Government to contribute further to the development of initiatives which support and deliver a more competitive, stable and efficient Australian financial services sector.

Yours sincerely

John Nesbitt
Chief Executive Officer
Suncorp Bank

Financial System Inquiry

Suncorp Bank Submission to Treasury
31 March 2015

One Company
Many Brands

SUNCORP GROUP

1. Executive summary

Suncorp Bank welcomes the opportunity to make a submission to Treasury on the Financial System Inquiry (FSI) Final Report.

Suncorp Bank agrees that the financial system has generally performed well in meeting the financial needs of Australians and facilitating productivity and economic growth. Equally, we agree there is no room for complacency and that timely implementation of key recommendations is critical.

The Report observed that the banking sector is competitive, albeit concentrated. It observed further that some aspects of the banking sector are not competitively neutral and identified components of the banking system that limit the capacity of smaller banks to compete on a level playing field. While Suncorp supports these observations, we feel that the extent of competition in banking is overstated and further consideration is needed to ensure there is a robust future state of competition to provide maximum benefit to consumers and businesses.

A healthy, multi-tiered banking system is essential to guarantee Australian consumers and businesses access to innovative and better-value financial products and services well into the future. This is not guaranteed unless the prudential and regulatory framework incorporates the principle of competitive neutrality.

Suncorp Bank has the following observations and recommendations in relation to the Final Report:

2. Key recommendations

2.1 Competitive neutrality: a stronger and more risk-reflective system of setting regulatory capital for housing loan assets

FSI Recommendation 1:
Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.

FSI Recommendation 2:
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.

Suncorp Bank supports unquestionably strong capital ratios as outlined in Recommendation 1 and the fast-tracked implementation of narrower risk weights as outlined in Recommendation 2.

The key feature of Recommendation 1 is to link Australian bank capital levels to an international benchmark. It requires those Australian banks which are systemically important to be in the top quartile for capital adequacy compared to an international peer group. Its purpose is to safeguard Australia's capacity to import capital to fund investments and finance the current account deficit. Implementing a dynamic benchmark assures Australian banks are highly capitalised relative to a peer group, thereby reducing the risk of major Australian banks being unable to secure funding in times of heightened risk. Suncorp Bank advocates that the Basel Committee's G-SIB list be used to establish the peer pool. As noted by Mr Murray, regional banks are not part of this G-SIB peer group and would be benchmarked against comparable international peers.

Suncorp welcomes the FSI Report observation in Recommendation 2 that the current system is not competitively neutral and believes a relatively small change to the current approach can deliver material benefits in terms of competition. Suncorp Bank advocates for timely implementation of a risk-weight floor of between 25% and 30% for advanced banks for the purposes of stability and competitive neutrality.

The benefits of this policy initiative will be to foster genuine competition in the low-risk housing finance market with a long-term benefit of increased pricing tension and better value for customers. Similarly, with a lower capital requirement, standardised banks will have more capital to lend to the SME market or invest in innovation and product development across all portfolios.

The regulatory settings stemming from Basel II capital adequacy rules have created an entrenched disadvantage for regional and mutual banks and a significant cost advantage for major banks. As a regional bank, Suncorp Bank is required to hold up to three times the level of capital of the major banks against equivalent portfolios with the same underlying risk. This makes clear the competitive disadvantage driven by the regulatory settings. It also highlights the barriers to entry in banking created by the onerous capital and regulatory environment for non-major banks.

The major banks are making strong and growing returns from the low-risk, middle Australia housing market by virtue of the regulatory settings in their favour. The advanced banks achieve significant Return on Equity (ROE) as a result of the application of advanced capital models to their lower risk LVR residential mortgage books.

Across mortgages with the same level of risk, the major banks can significantly discount interest rates and still achieve a ROE of 20%, as shown in the table below. By maintaining higher interest rates and booking the capital advantages of their favourable regulatory settings, they are making ROE of up to 35% plus on parts of their mortgage portfolios.

To achieve a ROE of 20%, the standard variable interest rate charged by a major bank in the current regulatory environment could be 4.35% versus 4.95% for a non-major bank. There is a high premium to be paid for <u>not</u> being an advanced accredited institution.

Table 1: Interest rates to achieve a 20% ROE under the differing regulatory capital settings

20% ROE	Majors	Non-major
Standard Variable Rate	4.35%	4.95%
3 year fixed	4.47%	5.07%
5 year fixed	5.02%	5.62%

The average risk-weighting ratios for the residential mortgage asset class for the four major Australian Banks is around 18% whereas these ratios are around 39% for Regional Banks (APRA, July 2014, p. 74). The difference in risk-weighting ratios translates to a pricing differential of around 46bps to achieve a Return on Regulatory Capital (RoRC) of 12%. Regional Banks' RoRC reduces to less than 6% if they were to fully absorb the cost differential by offering the same market price as Advanced IRB (IRB) banks.

The current risk-weight framework for residential mortgages has a range of unintended consequences. It provides greater incentive for banks on the advanced approach to lend to low risk mortgages holders relative to other types of lending, like Small and Medium Enterprises (SME). It also reduces genuine competition in the low-risk housing market and enables high margins to be earned by major banks. This further encourages major bank lending into this asset class at a time when property affordability and investment in housing has been flagged as a macro-prudential issue – and noted as a concern in the Interim Report.

2.2 Assistance for standardised banks to achieve advanced accreditation

The Report's **Recommendation 2 includes**: *"To promote incentives for ADIs to develop IRB capacity, APRA could also 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."*

Suncorp Bank supports the Report option of assisting standardised banks to attain advanced accreditation. Suncorp Bank is in the process of seeking advanced accreditation but the process is lengthy and complex. Suncorp seeks the full support of the Australian Prudential Regulation Authority (APRA) for regional banks' efforts to achieve advanced status.

APRA could establish a dedicated team to work with the regional banks to support them through the accreditation process, in a similar way that the major banks were supported during their accreditation. As part of this, it would be beneficial for major banks to provide data to regionals – via APRA – to support the move toward advanced e.g. market and operational risk data. Market and operational risk data would be particularly beneficial as the larger banks have much bigger data sets to model. Suncorp has a number of risks which are encountered relatively infrequently, so modelling to a high enough standard to achieve advanced accreditation is likely to continue to be challenging and time consuming. This process should lead to the overall system being enhanced and strengthened.

APRA could also assist regional banks in achieving advanced status by implementing a staged approach, to enable standardised banks to achieve accreditation progressively across their respective portfolios and operations, i.e. decoupling market, operational and credit risk models to support standardised banks to achieve advanced accreditation would be a practical and sensible solution.

Also, accreditation could be achieved in a staged approach for mortgage and business banking book. This is not out of step with international precedent. The logical place to start with this staged approach is housing loans as it is a core business of regional banks and the risk is well understood.

2.3 Addressing the funding cost advantage for banks deemed 'Too Big to Fail' (TBTF)

FSI Recommendations 1: As above.

FSI Recommendation 3:
Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.

FSI Recommendation 4:
Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.

FSI Recommendations 1, 3 and 4 seek to address the matter of TBTF. Suncorp Bank sees both promise and risk associated with these options. Further modelling and work is needed to understand the implications for the market, investors and customers. The primary issue for regional banks is that banks deemed systemically important receive a significant funding and pricing advantage from implicit government support. Finding a balanced solution to this problem has proven difficult, but there is a strong case for addressing this issue in order to reduce taxpayer support for TBTF institutions as well as addressing the funding cost disparity. Whatever the solution, for Suncorp Bank, a key agreed objective should be to address the funding cost gap between major and non-major banks while maintaining system stability and consumer and investor confidence.

2.4 Improving the disclosure arrangement for mortgage brokers to ensure customers of brokers are fully aware of a broker's ownership structure and potential conflicts of interest

FSI Recommendation 40:
Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.

Suncorp Bank recommends greater transparency and pre-sale disclosure be introduced to ensure consumers understand the level of independence or otherwise when using advisers and mortgage brokers. Repaying a housing loan is probably the largest financial commitment a household will ever make, and any compromise in terms of the most suitable loan has financial implications.

The premise of a mortgage broker is that a consumer can receive an objective and independent assessment of what is the best housing loan available for their needs. It should be recognised that consumers utilise mortgage brokers in order to receive personal, independent advice and as such, brokering advice should be clear and transparent as to incentive structures and product and adviser salesforce ownership.

A key factor in the current and future competitive landscape is the concentration of ownership in the manufacturing and distribution of banking products. At question is the transparency of the ownership structures behind the products, mortgage broking networks and aggregator platforms and the incentive schemes driving sales. About 50% of Australia's mortgage customers are seeking impartial advice on the best product for them from aggregator groups.

In the past six years the major banks have acquired regional bank brands and are increasingly taking control of the broker-originated home loan market through their acquisition of aggregator businesses. While there are plenty of brands in the market, the ownership of those brands is becoming increasingly concentrated in the hands of a few. Customers must have a clear and transparent view of products promoted by these consolidated broker networks and aggregators.

Further, even if a broker is impartial as to the volume of loans directed to competing banks, the broker can reward their owner bank by directing a higher proportion of quality loans, i.e. those with LVRs less than 80%.

These models have implications for consumers seeking independent information on the best mortgage for them. Customers may be unaware that advice and commission structures are tied to specific providers and there is also little transparency about the product provider relationship in many cases.

It should be recognised that consumers utilise mortgage brokers in order to receive personal, independent advice and as such, brokering advice should be clear and transparent as to incentive structures and product and adviser salesforce ownership.

2.5 A regulatory environment which supports competition and is more coordinated across regulatory bodies

FSI Recommendation 27:

Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.

Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

Suncorp Bank supports this recommendation and believes the Government and regulators need to take more account of the potential implications of regulatory change on competitive neutrality. This applies to both the design of regulation and the volume of regulatory change to which industry segments are subject.

The regulator mandates require refinement in terms of scope and breadth to ensure regulatory settings do not materially disadvantage some segments over others. The market design that best provides for stability, competition and choice for consumers should be the goal of regulatory policy.

Additionally, there needs to be a shared understanding of the financial sector's regulatory landscape, between regulators and relevant departments, to reduce overlaps and conflicts, improve effectiveness, reduce regulatory burden and improve sequencing of regulation and regulatory change. The industry needs appropriate, scalable regulation and there is a need for greater coordination among regulators.

2.6 Maintain ex-post funding of the Financial Claims Scheme

FSI Recommendation 6:
Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.

This recommendation is good policy and will ensure there is less disincentives for savers to take out deposit products.

The previous Labor Government announced in 2013 it would set up a Financial Stability Fund (FSF) to support the FCS and build the balance of this fund through a levy based on the size of a bank's deposit base. The Financial System Inquiry Report recommends against this and instead opts for maintenance of the ex post funding structure.

With a strong focus in the FSI report on bolstering competition in banking, Suncorp is disheartened by proposals to ignore this FSI recommendation.

Smaller banks rely more heavily on deposits for funding than larger banks. As a result, smaller banks will bear proportionately more of this tax than the major banks that have greater levels of wholesale funding.

A tax on savings will also discourage customers from taking out deposit products.

We ask the Government to consider the consumer and competitive impacts of this new tax proposal.

By retaining the post-event funding design characteristic, the Government avoids having to go through the process of establishing a pricing methodology to determine contributions. If pre-funded, there would be pressure to set contributions based on some external risk rating, such as ratings issued by credit agencies. These ratings are skewed by the Too Big To Fail (TBTF) factor and, therefore, competitively disadvantage smaller banks, mutuals, credit unions etc.

The regional banks note that pre-funding deposit insurance schemes is common throughout the world but Australia is different from most other countries in that deposits are protected through depositor priority. Depositor priority puts depositors ahead of other senior creditors in the event of insolvency. With this mechanism, the need for any pre-funding of insurance schemes is reduced. In fact, no depositor has lost money in an Australian bank since the 1890s depression.