Financial System Inquiry 2014

Suncorp Bank Submission

SUNCORP BANK

Submission to the Financial System Inquiry

31 March 2014




Suncorp Bank has its origins in the Queensland Agricultural Bank established in 1902 to support Australian farmers and small businesses.

As the largest of the second-tier banks and having more than one million customers, Suncorp Bank, with its 'A+' credit rating, is the natural proponent to facilitate competition in the Australian banking sector for the benefit of consumers.

Suncorp Bank is part of the Suncorp Group, an ASX top-20 Australian company with a market capitalisation of $16 billion, 15,000 employees and nine million customers across Australia and New Zealand.

Suncorp Bank - Australian Financial Institution of the Year (Non-Major) 2012 and 2013

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31 March 2014

Mr David Murray AO
Financial System Inquiry
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By email: fsi@fsi.gov.au

Dear Mr Murray

Financial System Inquiry

Thank you for the opportunity to make a submission to this Inquiry.

Suncorp Bank is part of the Suncorp Group, an ASX top-20 Australian company with a market capitalisation of $16 billion, 15,000 employees and nine million customers across Australia and New Zealand.

As the largest of the second-tier banking sector, Suncorp Bank is the natural proponent to facilitate competition and is well placed to contribute to this debate and support solutions. 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 Australian consumers. Suncorp Bank has its origins in the Queensland Agricultural Bank formed in 1902 to support the growth of Australia's fledgling agricultural and small business industries. Our commitment to those sectors and our retail customers is as strong today as it was more than 110 years ago.

However, the reality at present is that the ability of the second-tier sector to offer long-term, sustainable competitive consumer propositions is undermined by the lack of competitive neutrality in relation to funding and capital. The cost of funds and existing capital holding requirements of regional banks relative to major banks has been greater in the years following the Global Financial Crisis (GFC) than for decades prior. The continuing disparity threatens to drive further consolidation and a diminution in competition.

Economic, funding, technology and regulatory developments have changed the operating environment for all banks, more significantly for non-majors. While the Australian financial services industry emerged from the GFC in relatively good stead, the crisis led to a series of events which served to strengthen the position and market power of major banks, at the expense of regional banks and non-bank financial services institutions.

Current domestic and international regulation are further constraining competition, meaning structural reform is urgently needed in order to ensure non-major banks can compete across more market segments and geographies for the benefit of retail, small business and agribusiness customers.

Another key factor in the current and future competitive landscape is the concentration of ownership in the manufacturing and distribution of banking products. Major banks have acquired regional banking brands and continue to expand their control over the banking value chain, particularly the mortgage broker networks and aggregator platforms. At question is the transparency of the ownership structures behind the products, mortgage broking networks and aggregator platforms and the incentive schemes driving sales. More than 47%[1] of Australia's mortgage customers seek impartial advice on the best product for them from aggregator groups.

Further, the settings for regulatory risk weightings significantly favour residential mortgages over small to medium enterprise (SME) and agribusiness lending, and our tax system discourages savings in deposits – factors that should be addressed as part a review of the structural financial settings.

[1] *Mortgage and Finance Association of Australia, February 2014 http://www.mfaa.com.au/default.asp?artid=3088&menuid=371*

It's in the best interests of consumers and our economy for a robust multi-tiered banking system to exist. The threat is that entrenched distortions in the way different tiers are able to fund themselves and the capital they have to hold will further restrict the ability of regionals and non-banks to create necessary competitive tension.

There are a number of options and initiatives which would maintain the integrity of the system, but open up the market by supporting greater competition. Underpinning these options are common objectives across the industry that with goodwill and negotiation on all sides, can be adapted to deliver long-term policy reform.

The key objectives of the Financial System Inquiry should be to advance reforms that deliver:

- Carefully engineered changes to the prudential framework to address the inherent competitive imbalances between banking tiers – in both capital holdings and the associated anomalies with credit rating uplifts and consequently funding;
- A more reliable, secure and diversified pool of funding options to support competitive alternatives for Australian consumers of financial services products and incentivise behaviours in the long-term interests of the economy;
- A regulatory framework that adopts scalable regulation, not a one-size-fits-all approach. Regulation should be fit for purpose, size and scale and consider impacts on stability, competition and efficiency;
- Settings that deliver efficient and appropriate risk-based allocation of capital in the economy to support small and medium enterprises and agribusiness, as well as residential mortgage customers; and
- Regulators who are closely connected and coordinated when it comes to changes that result in shared impacts for the industry and consumers.

Suncorp Bank's recommendations for the Panel's consideration include:

- A 20% risk weighting on the mortgage assets of regional banks operating under the standardised approach;
- A clear and stepped approach to advanced accreditation with credit, operational and market risk models de-coupled and capital relief provided at each stage;
- Greater transparency of the ownership and incentive structures in mortgage broking and aggregation;
- A range of measures to support bank funding including an increased cap on covered bonds and stimulation of the fixed interest investments market through superannuation;
- Capital, regulatory and taxation support to improve lending for SMEs and agribusiness; and
- A regulatory environment which: supports competition; is more coordinated across the regulatory bodies; considers the impacts of shadow banking; and is agile given the pace of technological change and consumer preferences.

I would also refer the Inquiry Panel to the Submission made on behalf of the Regional Banks (Suncorp, Bank of Queensland, Bendigo and Adelaide Bank and ME Bank), to which we have been a strong contributor.

A critical consideration for the Panel and the Government is timing. The Australian Banking System needs rebalancing now. Many of the pressures facing the non-major banks will have escalated further in 2014. Accordingly, I would ask the Panel to consider prioritising relevant matters as recommendations are developed.

Suncorp would welcome the opportunity to contribute further to the development of initiatives which support these objectives and deliver a more competitive, stable and efficient Australian financial services sector.

Yours sincerely

John Nesbitt
Chief Executive Officer
Suncorp Bank

Executive Summary

The Australian banking system is relatively stable but this does not mean the banking sector is without challenges. Nor does it mean the status quo in financial services should continue without being questioned as to its capacity to deliver good outcomes for consumers and the Australian economy into the future.

Regional banks play an important role in the economy, in rural and regional Australia and within the financial services industry. The second-tier traditionally brings choice, balance and competitive tension to the market but events since the Global Financial Crisis (GFC) have challenged this. The GFC resulted in a significant shift in market dynamics and handed power to the major banks. Subsequent regulatory and legislative attempts to spur competition have not delivered desired outcomes. Continued concentration of market power is inconsistent with the fundamental principles of stability, competition and efficiency.

Any genuine desire to support a strong multi-tiered financial services sector must recognise the un-level playing field that exists between majors and others when it comes to capital, funding and regulatory imposts. That un-level playing field has undermined the second-tier sector, forced consolidation and it threatens the future of non-major banks and customer choice.

Regional banks do not need subsidies and Suncorp Bank does not advocate taxpayer-funded intervention in financial services. Such intervention distorts the market as is evidenced with the existing capital and funding advantages afforded the largest banks in Australia. A level playing field is needed.

While Suncorp Bank is competitive despite the funding, capital and regulatory inconsistencies in the industry, it could compete across more segments and geographies of the market for the benefit of consumers if competitive anomalies were addressed.

Regional banks do not need subsidies and Suncorp Bank does not advocate taxpayer-funded intervention in financial services.

Such intervention distorts the market as is evidenced with the existing capital and funding advantages afforded the largest banks in Australia. A level playing field is needed.

There is an un-level playing field created by three key factors:

1. Advanced accreditation allows the major banks to hold less capital than is required by the regional banks over mortgage portfolios with the same risk profile and regulatory framework;
2. The implicit guarantee of the major banks affords them credit rating upgrades which gives them access to greater funding sources at lower cost; and
3. The regulatory framework has a disproportionately high impact on smaller institutions.

The existing framework is entrenching a cycle of competitive distortions to the detriment of the overall banking system. If capital and funding anomalies are not addressed, the competitive pressure applied by the smaller institutions will be limited, to the detriment of Australian consumers.

Australia needs a strong multi-tiered banking landscape.

This Inquiry provides a unique opportunity to reflect on our regulatory structures and frameworks and ask some searching questions about whether that framework will see our economy prosper through the next 20 years.

Australia needs a strong multi-tiered banking landscape. Building the right regulatory foundations to drive meaningful competition is critical. Accordingly, this Inquiry should consider making far-reaching recommendations to bring balance across competition, stability and efficiency.

Recommendations

This submission makes a series of recommendations for the Panel's consideration. They include:

- **A 20% risk weighting on the mortgage assets of regional banks operating under the standardised approach**
- **A clear and stepped approach to advanced accreditation with credit, operational and market risk models de-coupled and capital relief provided at each stage**
- **Greater transparency of the ownership and incentive structures in mortgage broking and aggregation**
- **A range of measures to support bank funding including an increased cap on covered bonds and stimulation of the fixed interest investments market through superannuation**
- **Capital, regulatory and taxation support to improve lending for SMEs and agribusiness**
- **A regulatory environment which: supports competition; is more coordinated across the regulatory bodies; considers the impacts of shadow banking; and is agile given the pace of technological change and consumer preferences**

Introduction

This submission supports the development of a strong multi-tiered financial services sector for the benefit of Australian consumers and the nation's economic growth and future prosperity. That system must be founded on competitive neutrality. The document makes a series of recommendations and includes:

1. An overview of Suncorp Bank
2. Detail on the current competitive landscape
3. An outline of the competitive anomaly related to risk weighting of mortgage assets
4. The impact of competitive anomalies on SME and agribusiness sectors
5. Analysis of the funding markets
6. Detail on the regulatory environment
7. Perspectives on technology and innovation

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An overview of Suncorp Bank

Suncorp Bank is part of the top-20 ASX-listed Suncorp Group which has a market capitalisation of $16 billion, 15,000 employees and nine million customers across Australia. Suncorp Bank was founded in 1902 as the Queensland Agricultural Bank and has provided services to individuals, small to medium sized enterprises (SMEs) and agribusiness customers in regional communities of Australia for more than 110 years. As an Authorised Deposit-taking Institution (ADI), Suncorp Bank is regulated by Australian Prudential Regulation Authority (APRA), has an 'A+'credit rating [2] and is Australia's leading regional bank.

Suncorp Bank has been named Australian Financial Institution of the Year (Non-Major) for the past two years.[3]

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With a network of over 200 branches, agencies, business banking centres, over 2000 ATMs across Australia, and employing approximately 2900 staff, Suncorp Bank services more than one million individual, agribusiness, small-to-medium businesses and commercial banking customers. The Bank has a strong suite of financial services products, which include:

- Personal banking, including home and personal loans, savings and transaction deposit accounts, margin lending, credit cards and foreign currency services;
- Small business banking, including financial solutions for small to medium sized enterprises (SMEs) with borrowing requirements of up to A$1 million;
- Commercial lending, including solutions for SMEs with borrowing requirements of more than A$1 million; and
- Agribusiness lending, including financial solutions and serviced relationship management for rural producers and associated businesses in rural and regional areas.

[2] *Standard & Poor's issuer rating, December 2013*
[3] *Australian Banking & Finance Magazine (AB&F) "Australian Financial Institution of the Year, Non-Big Four" in 2012 and 2013*

As Australia's fifth largest listed bank[4] and only A+ rated regional bank[5], Suncorp presents a genuine alternative to the major banks.

Suncorp Bank provides simple everyday products for everyday Australians. Key competitive strengths include:

Big enough, but small enough.
Suncorp Bank has the mainstream product range and access options of a major bank with the customer service focus of a smaller regional bank, and has received a number of awards for its products and service. Suncorp Bank has been named Australian Banking & Finance Magazine (AB+F) "Australian Financial Institution of the Year, Non-Big Four" for the past two years (2012 and 2013). The Bank also won the AB+F award for 2012 Innovative Card and Payment Product (Visa pre-paid card) and achieved 2012 CANSTAR 5-star ratings for its Business Everyday and Premium accounts, Everyday Options Account, Kids Savings Account and My Home Package. Suncorp Bank was runner up for Business Bank of the Year at the 2012 Money Magazine Consumer Finance Awards.

Community driven culture.
Suncorp Bank aims to capture Australians' sense of belonging and community connection via its "Genuine Regional Bank" positioning. Suncorp Bank's retail and business customer satisfaction ranks ahead of the major banks. For the year ended 31 December, 2013, national personal customer satisfaction was 84.7%, according to a Roy Morgan report that monitors overall customer satisfaction based on customers with at least a deposit/transaction account relationship with the institution. National business customer satisfaction was 81.2%, for 31 December, 2013 according to a Business Financial Services Monitor study.[6]

Efficiency and scale.
The Bank uses the Suncorp Group's infrastructure and services to more effectively manage cost and capability. Suncorp Business Services provides integrated shared services across the Group, including shared legal, procurement, statutory reporting, and finance support teams. In addition, the increased level of investment by the Group provides access to technology and resources that could not be sustained purely at the Bank level.

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[4] APRA Monthly Banking Statistics, January 2014, assets
[5] Standard & Poor's issuer rating, December 2013
[6] Where satisfaction is determined by asking customers the following question: "Please use a scale ranging from 0 to 10, where 0 means 'extremely dissatisfied' and 10 means 'extremely satisfied'. Overall how Satisfied are you with the following institutions?"

Stability of funding sources.
Since the GFC, the Bank has improved the stability of its funding profile by increasing the proportion of retail deposits to wholesale funding. Domestic and offshore funding programs for short and long term wholesale debt have been established. Short-term funding sources include Australia-based instruments as well as the commercial paper markets in the United States and Europe. Long-term wholesale funding sources include senior unsecured debt, covered bonds, hybrid capital instruments – long dated, and residential-mortgage backed securities in domestic and international markets.

Strong brand and customer relationships.
Suncorp Bank benefits from the Group's portfolio of leading brands in the financial services industry and seeks to leverage the nine million customer relationships of the Suncorp Group to grow its business in Australia. The Bank actively pursues the strategy of encouraging a customer of any part of the Group to hold multiple products offered by the Group, including deposits, transaction accounts and loans with the Bank, in order to deepen relationships and strengthen loyalty to the brand.

Suncorp Bank aims to be an increasingly competitive force in the Australian banking market.

Suncorp Bank aims to be an increasingly competitive force in the Australian banking market.

We believe the following key strategies will provide Suncorp customers and shareholders with sustainable value:

Geographic diversification.
Suncorp Bank continues to invest in its home state Queensland, while leveraging its expanded branch network and customer base across the country. In New South Wales and Western Australia the Bank has substantially increased its presence since 2010. As part of this strategy, the Bank is strengthening relationships with mortgage brokers in New South Wales, Victoria and Western Australia, building on the network of branches outside of Queensland and leveraging its longstanding agribusiness experience in Queensland to further develop the agribusiness offering nationally.

Modernising our banking platform.
Suncorp Bank is continuing the implementation of the Banking Platform Project, a modernisation and simplification of the Bank's operational systems to enhance the product and service offering for customers, particularly given the trend towards digital. In addition to improving the customer proposition, the project will deliver significant business benefits and efficiencies. These technology improvements will create a point of difference with competitors and enable the Bank to further develop more innovative digital capabilities in a competitive market.

Enhancing risk and capital management.
The Bank is enhancing its risk management procedures and processes and capital management capabilities, as it works toward attaining Basel II advanced accreditation from APRA for its risk management systems. These changes will underpin Suncorp Bank's long-term competitive positioning for the benefit of the business, the industry and consumers seeking choice. Robust risk management processes are crucial to stability.

Simplification.
Suncorp continues to improve its operations through branch and distribution optimisation, streamlined business processes and strategic partnering to improve efficiency and productivity. Suncorp Bank is clear on the need to continue to improve and evolve its operations to meet changing consumer needs, respond to the shifting economic environment and support the Bank's competitive positioning.

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Competition

Banks make a significant contribution to the community and economy, fuelling growth and job creation. Regional banks play a key role at both a national and rural/regional level. Australia needs a strong multi-tiered banking landscape. There is a critical need to ensure the settings are right in order to support and build a strong second-tier sector driving meaningful competition across all segments.

The trend toward consolidation in the financial services industry has created even larger competitors with broader ranges of product and services and greater geographical scope with increased access to capital and funding. This includes competitors not subject to the same capital and regulatory requirements as Suncorp Bank, and who are therefore provided with the settings to operate at a lower cost. Crucially, the regulatory environment has enhanced the position of the major banks through supporting a lower cost of funds and lower capital requirements for major banks versus that of all other financial services institutions. This continues to create a gulf between the competitive footings of majors and all others. This is driving consolidation and a diminution in competition. Within this context, the ability of the second-tier sector to offer long-term, sustainable competitive consumer propositions is undermined by the un-level playing field between majors and others when it comes to capital imposts, regulatory treatment and funding.

In the past six years the major banks have acquired regional bank brands and increasingly taken 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 becomingly 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.

Crucially, the regulatory environment has enhanced the position of the major banks through supporting a lower cost of funds and lower capital requirements for major banks versus that of all other financial services institutions.

Creeping acquisition in mortgage aggregation

The market share of the four major banks is now about 83%[7] of the Australian mortgages marketplace following the acquisition of St. George and BankWest by Westpac and CBA, respectively, in 2008. While the consolidation at bank level has been clear, less obvious is the creeping consolidation and control being exercised by the major banks in the mortgage broker aggregator space. This is having serious consequences for competition in the mortgage broker channel and overall in the mortgage industry.

CBA and NAB now have significant control of the brokered home loan market through their respective ownership interests. The broker market accounts for about 47%[8] of home loans written in Australia, highlighting the importance of this channel to consumers and to smaller banks.

Until 2010, aggregators were largely independent businesses. However, significant consolidation has occurred in the mortgage aggregator market due to the acquisition of RAMs and Aussie by Westpac and the CBA respectively. In 2009 NAB acquired Challenger, giving NAB ownership of the PLAN, Choice and FAST aggregator businesses and their platforms. In 2013 CBA acquired a further stake in Aussie while it also maintains an interest in Mortgage Choice. These aggregator platforms are the gateway for brokers selecting a product for their client. The major banks white label mortgages for sale on these platforms and these products are invariably on the front page of the aggregator platform/site, the first stop for most brokers.

Of great concern is the fact that customers view brokers as independent but the major banks have increasing influence over these channels which they now predominantly own, and coupled with generous incentive schemes, are able to direct increasing business flows to their products. For example, with some of the aggregator platforms, aggregator fees are being waived for brokers when they sell a product of the major bank which owns the aggregator site.

Undoubtedly, 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. Greater transparency is needed.

Of great concern is the fact that customers view brokers as independent but the major banks have increasing influence over these channels which they now predominantly own, and coupled with generous incentive schemes, are able to direct increasing business flows to their products.

Subsequent sections of this paper explore the competitive distortions that arise due to the existing capital adequacy regime, funding costs and regulatory imposts. With respect to mortgage aggregation:

- It should be recognised that consumers utilise mortgage brokers in order to receive independent advice and as such, brokering advice should be clear and transparent as to incentive structures and product and adviser salesforce ownership. There should be consideration of how the Future of Financial Advice Reforms apply to the mortgage broking industry (disclosure of commissions and the operation of the best interests duty).

[7] *Bank Market Share Report, Suncorp analysis of APRA and RBA data, January 2014*
[8] *Mortgage and Finance Association of Australia, February 2014 http://www.mfaa.com.au/default.asp?artid=3088&menuid=371*

Capital adequacy rules

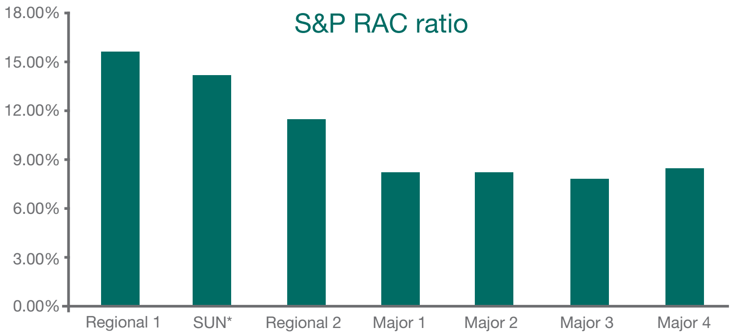
Prudential regulation exists to support a stable financial system. Capital plays a vital role in that.

The existing regulatory settings stemming from Basel II capital adequacy rules have created an entrenched disadvantage for regional banks. Capital ratios are often represented as being reasonably consistent across the industry, however, while Basel III focusses on improving the quality of capital (the numerator), it has not addressed the inconsistency that exists in the measurement of risk (the denominator). Currently major banks hold about two thirds less capital than the regional banks when the underlying mortgage portfolios of the banks have comparable risk profiles. To state this another way, regional banks are required to hold two to three times the level of capital of the major banks against equivalent mortgage portfolios. If a consistent methodology was applied, such as the Standard & Poors (S&P) approach, the ratios outlined in the graph below are evident. This makes clear the competitive differential driven by the regulatory settings. It also highlights that the framework is not based around pricing for the actual risk of the mortgage product. Perversely, it prices for the risk of the distributor.

Regional banks are required to hold two to three times the level of capital of the major banks against equivalent portfolios.

Capital

S&P Risk-adjusted Capital (RAC) methodology



This chart illustrates the actual capital held by banks using the S&P methodology which applies a consistent risk weighing across mortgage portfolios in view of their consistent risk profiles.

Source: Latest company reports for regional and major banks and S&P credit reports

The framework is not based around pricing for the actual risk of the mortgage product. Perversely, it prices for the risk of the distributor.

The Basel Advanced Internal Ratings Based (AIRB) capital requirements enable banks that have the accreditation to hold capital which is differentiated depending on the risk of their lending books. The big four banks and Macquarie achieved advanced accreditation from APRA under the global Basel banking rules, allowing them to model their own risk weights with enhanced internal systems rather than using standardised models. The smaller banks are still a few years from achieving advanced accreditation and are therefore required to put more capital aside to write loans, even when those loans carry equivalent risk to those written by the major banks.

Suncorp is committed to achieving advanced status in the next few years and welcomes the support of APRA in what is an increasingly complex and evolving process. The authorisation process for operational risk under advanced accreditation could be made clearer. Further, as the regulatory framework has evolved, the standards and benchmarks for accreditation have also shifted. For standardised banks wishing to achieve AIRB or advanced status, it means the goal posts for accreditation keep shifting.

All banks compete for capital in an open market and they all need to generate a suitable return for their shareholders. The cost of holding more capital impacts the financial performance of smaller institutions. This can create a scenario where non-accredited banks are encouraged to engage in higher-return business to produce adequate earnings. Higher-return businesses come with higher risks. Engaging in higher risk lending runs counter to the very rationale of prudential regulation and the accreditation framework.

The different approaches applied under standardised versus advanced accreditation in relation to risk weighting of comparable mortgage portfolios has created a competitive anomaly which disadvantages consumers.

Suncorp Bank has a 'vanilla' book with limited offshore business, no syndicated or complex lending and 80% of the business is mortgages. Additionally, much work has been done to improve the Bank's risk management capabilities under the program to achieve advanced accreditation. Suncorp welcomes the support of the regulator for this. Equally, the Bank encourages a consistent approach to the capital treatment of all banks' mortgage portfolios, reflective of the actual and consistent risk profiles of the underlying products.

The different approaches applied under standardised versus advanced accreditation in relation to risk weighting of comparable mortgage portfolios has created a competitive anomaly which disadvantages consumers.

To promote stability, competition and efficiency in the Australian banking industry, Suncorp Bank recommends the Panel give serious consideration to:

- The implementation of a risk-reflective capital treatment for residential mortgages of standardised banks. This suggests 20% as opposed to the current 35% under the standardised approach. The 20% risk weight recommendation is consistent with the advice given to the Basel Committee by APRA back in 2001[9]; and
- In addition to this 20% risk weighting on mortgage assets, Suncorp Bank would welcome a clear and stepped approach to advanced accreditation with credit, operational and market risk models de-coupled and capital relief provided at each stage of the process towards advanced accreditation.

[9] *APRA Submission to the Basel Committee on Banking Supervision, May 2001*

Support for Small and Medium Enterprises (SMEs) and Agribusiness

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SMEs are the engine room of the economy, yet the existing risk weighting rules under Basel II implicitly encourage banks to favour residential mortgage lending over business lending.

Since the introduction of Basel II and the GFC there has been a lending bias towards the household sector. While there are policies that encourage mortgage lending such as the first home owners grant scheme and tax advantages associated with negative gearing, Basel II may have contributed to the redirection of bank capital into the higher return/lower risk retail banking market for home lending and away from business lending.

Under Basel II, residential mortgages attract a lower capital charge under both standardised and advanced accreditation frameworks. This is logical given the higher risk associated with SME and commercial lending but it does mean that banks can do on average three to four times more residential mortgage lending relative to business lending in terms of capital management. Consequently, the proportion of major banks' mortgage lending has grown from about 60%[10] to 83%[11] between 2007 and 2013, at the expense of SME and commercial lending.

There is an opportunity to assess how regulatory settings may be modified to encourage bank lending to SMEs and agribusiness. This could take the form of a scheme to support SME and agribusiness risk management, thus lowering bank's capital requirements and incentivising lending to business.

There is an opportunity to assess how regulatory settings may be modified to encourage bank lending to SMEs and agribusiness.

[10] RBA data in Australian Government Treasury Economic Roundup http://www.treasury.gov.au/PublicationsAndMedia/Publications/2011/Economic-Roundup-Issue-1/Report/The-Australian-banking-system-challenges-in-the-post-global-financial-crisis-environment
[11] Bank Market Share Report, Suncorp analysis of APRA and RBA data, January 2014

There is a need to address the repeated cycles of stress in the agricultural sector.

In addition, there is a need to address the repeated cycles of stress in the agricultural sector. Agricultural production is subject to volatility through weather and natural hazard cycles. Enhancement of income equalisation through Farm Management Deposit accounts could support farmers in managing through the cycles and saving for periods of production downturn by smoothing taxable income across multiple years.

Suncorp Bank's home loan customers as well as SME and agribusiness customers are central to Suncorp's business. The Bank is looking at ways to better support SME and agribusiness sectors. The Panel could consider whether the current regulatory environment can be better managed to support these segments, for example:

- Government and regulators explore the option of providing a service around risk mitigation and best practice for SMEs and where a business participates, the bank receives capital relief against that lending. This would create an incentive for banks to further support small business while managing the risks; and
- Encourage better management through weather and natural hazard cycles for agribusiness. This could involve assessing the opportunity to enhance income equalisation schemes for agribusiness customers to smooth taxable income in recognition of the cyclical nature of farming.

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Funding

As the only 'A+' rated regional, Suncorp Bank is in a stronger position than its regional peers when it comes to the cost and availability of funding options. But it's critical that the role of funding in competition is well understood if there is a genuine desire to facilitate a more robust second-tier and competitive banking market.

Suncorp Bank relies on credit and capital markets – both domestic and offshore – to fund the business and as a source of liquidity. In recent years, global credit and capital markets have experienced significant volatility, with such markets demonstrating periods of reduced liquidity, widened credit spreads and decreased price transparency. Disruptions, uncertainty or volatility in domestic or global financial markets increases funding costs, limits access to funding and reduces financial flexibility.

Domestically, as with the other banks, Suncorp Bank has responded to the volatility with a marked shift towards higher deposit funding and a lowering of risk demonstrated by the runoff of a portfolio of high-end corporate and property loans and Suncorp Bank's exit from these markets.

While Suncorp Bank has taken steps to strengthen its funding position, if current sources of funding prove to be insufficient, banks including Suncorp, may be forced to seek alternative financing and/or reduce their level of lending. For example, a significant change to consumer saving patterns, a taxation policy change on superannuation and/or a dramatic increase in credit flows would require a change in funding needs. These are real, potential risks.

The four major banks in Australia currently receive an uplift from the ratings agencies due to the implicit guarantee provided them by the Australian taxpayer.

Credit Ratings

Critically, credit ratings affect the cost and availability of funding from capital markets and other funding sources. Credit ratings are also typically important to customers and counterparties when evaluating a bank's products and services. They are determined upon an assessment of how confident an investor can be in an institution's ability to meet financial commitments, and are made with consideration to a number of factors – including what would happen in the case of a default. The four major banks in Australia currently receive an uplift from the ratings agencies due to the implicit guarantee provided them by the Australian taxpayer. All three ratings agencies (Standard & Poors, Moody's and Fitch) allocate a two-notch uplift to the major banks due to the perception that the Federal Government would step in to save these institutions in the event they faced insolvency. None of the regional banks receive this benefit and as such they are financially penalised in wholesale funding markets with reduced access to funds at significantly greater costs.

There is a growing body of evidence which points to the benefits large banks have as a result of creditors anticipating government bail-outs.

The implicit guarantee also has implications for regional bank access to the superannuation pool as a form of funding. Only about 10% of Australian superannuation savings are allocated to fixed income products. Of this 10%, most Australian funds managers allocate about 80% of their fixed income pools to 'AA- rated' institutions or above, ie the four major banks, some highly rated offshore institutions and governments. The remaining 20% is allocated to the 'A rated' and lower credit-rated institutions so this is shared between corporates and lower-rated banks. This is significant as it means the implicit government guarantee of the major banks is effectively limiting all other institutions to about 2% of the available superannuation funds in Australia.

There is a growing body of evidence which points to the benefits large banks have as a result of creditors anticipating government bail-outs. An International Monetary Fund Working Paper[12] estimated that the size of subsidies embedded in credit ratings for very large banks was 60 basis points at the end of 2007, rising to 80 basis points at the end of 2009. Applying a funding advantage of between 60 to 80 basis points to the most recent estimate of the borrowings and liabilities of the Australian major four banks provides an estimate of the implicit subsidy they receive of between $5.5 billion and $7.3 billion per annum. Addressing this funding advantage should be of paramount consideration to the Panel and Government. An informed and public debate is warranted.

[12] *Ueda, K., & Weder di Mauro, B. (2012). Quantifying Structural Subsidy Values for Systemically Important Financial Institutions. Washington, D.C.: International Monetary Fund.*

Deep and liquid funding markets

Australian banks all have significant reliance on offshore funds. A deeper pool of funds is needed to support the supply of credit and economic growth. The Australian economy remains exposed to international volatility and when funding is restricted and costly, there is the very real threat of credit rationing, with broad economic impacts.

The Australian Office of Financial Management (AOFM) played an important role in stabilising the Residential Mortgage Backed Securities Market (RMBS) following the GFC. The AOFM commenced an orderly withdrawal in 2012 which was appropriate given the return of domestic institutional and offshore investors to Australian RMBS markets. But given the AOFM still has significant holdings it is important that AOFM withdrawal is measured, to allow the development of liquidity and maturity in the secondary market for trading of these securities. There could be substantial risks to the Australian RMBS market should the AOFM be directed to divest its holdings in RMBS.

Australia needs a robust, diverse and good quality range of funding sources that are able to carry the industry through any kind of stress. Having important players dip in and out of the market does not enhance long-term confidence in the system as a whole.

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The tax treatment of deposits versus equities, super and property

Banks are reliant on deposits yet that pool of investments does not attract the tax breaks of equities, super or property, undermining a source of funding for banks and the economy. Deposits are disadvantaged as compared to other investment and asset classes. This fact was recognised in the report commonly referred to as the Henry Tax Review[13]:

For interest bearing deposits, the effective tax rate exceeds the taxpayer's marginal statutory rate because the entire return, including that part representing compensation for inflation, is included in taxable income as it accrues annually.

[13] *Henry, Harmer, Piggott, Ridout, & Smith, (2010), Australia's Future Tax System: Report to the Treasurer Detailed Analysis Vol 1 p67.*

A working paper for the Henry Tax Review found that retail deposits in Australia are taxed at the highest rate of all surveyed countries, including European countries that are generally higher-tax jurisdictions.[14] This puts deposit taking institutions at a considerable disadvantage when competing against other asset classes. This has severe implications for economic efficiency as scarce investment funds are directed towards asset classes with more tax effective treatment rather than those delivering the highest return. The Henry Review made a range of recommendations which were unfortunately not implemented.

Wholesale funding is more expensive for non-major banks, higher levels of capital are required and the RMBS market is still recovering. Regional banks are forced to fund lending through retail deposits.

The pool of deposit funding has increased significantly in recent years. This has been a result of greater risk aversion in the wake of the GFC and also the security associated with the Government's deposit guarantee. As confidence returns to the economy, the deposit pool will begin to drain as money moves to generally higher-return managed funds and/or superannuation with its tax advantages.

This issue is of considerable concern to regional banks. Deposit funding accounts for about 75% of total regional bank funding, compared to 60% for the major banks.[15] To have such a reliance on this form of funding, yet to have the tax system work against this form of saving is a long term challenge that needs addressing.

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Superannuation and fixed-interest securities

The superannuation pool is disproportionate in size to that of the banking industry. Balance is needed through tax incentives for deposits and super funds investing in fixed-interest to broaden the banks' funding bases thus fuelling economic growth and supporting a more active domestic fixed-income investment market.

There is a significant amount of the Australian taxpayers' savings in superannuation, the majority of which is invested in equities. If there were incentives for these funds to be invested in domestic fixed-interest bearing securities, there would likely be a welcome reduction in Australia's reliance on overseas funding. Importantly, as the Australian demographic ages, there will be a greater number of superannuants who should require assets that are better suited to the drawdown stage of their superannuation investment. Clearly products that have a greater ability for capital preservation, such as fixed interest, have a major role to play.

The development of the domestic fixed interest market is paramount for these reasons alone.

Balance is needed through tax incentives for deposits and super funds investing in fixed interest to broaden the banks' funding bases thus fuelling economic growth and supporting a more active domestic fixed income investment market.

[14] Australian Treasury. (2008). Architecture of Australia's tax and transfer system August 2008. Canberra, p.209.
[15] APRA Monthly Banking Statistics, deposits, January 2014

Covered bonds

The 8% limit on assets funded from covered bonds does not provide sufficient headroom to fund growth.

In October 2011, the Banking Amendment (Covered Bonds) Act 2011 permitted Authorised Deposit-taking Institutions (ADIs) to issue covered bonds. Under this legislation, there is a cap on covered bonds which limits the value of a bank's cover pool to 8% of its assets in Australia. Due to internal risk and compliance buffers in place to ensure the 8% cap is not exceeded (and penalties are avoided), covered bonds are providing only 4% of Suncorp Bank's overall funding.

The introduction of covered bonds in Australia has proven to be a valuable additional source of funding for some market participants, facilitating incremental funding for Australia. As market sentiment continues to improve, the product could have wider application and therefore serve as an even greater source of funding. A change to allow banks to reach the 8% either through an increased overall cap, or flexibility to buffer the 8% cap would be welcomed. In Suncorp's case, this would allow an increase of $2 billion in covered bond issuance which would materially enhance the Bank's ability to lift mortgage competition.

Another possibility to consider would be for the regulator to impose a cap on total covered bond and securitisation issuance in the vicinity of 20% to 25%.

Following the successful establishment of covered bonds in the Australian Market in 2012, APRA could also allow covered bonds to be considered as Level 2 High Quality Liquid Assets (HQLA) consistent with European regulators. Despite this market being relatively new compared to Europe, the strength of the Australian Banking System, frequency of issuance, both domestically and offshore, in addition to a relatively liquid secondary market would justify their inclusion from 2015.

In addition, Suncorp believes all repo eligible bank paper (ie securities accepted by the Reserve Bank of Australia (RBA) as collateral for short-term lending) should be treated as Level 1 HQLA by the RBA. Further, eligibility criteria could be adjusted to include all ADIs regardless of their rating (including unrated entities) and RMBS. Such changes could be introduced quickly and easily, and they would go some way to restoring competition by providing a funding boost to non-major banks.

Structural reform needs to provide increased funding options for banks to support competitive alternatives for Australian consumers of financial services products.

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Experience through the GFC has proven the value of diverse and stable funding sources. It is imperative, particularly for stability, efficiency and competition that banks have access to as wide a funding base as possible, by both product and jurisdiction.

Australia needs a deeper and more reliable pool of funding options which support the second-tier banking sector. To support this objective, we recommend that:

- The cap on concessional taxation treatment for bank deposits should be increased or eliminated to incentivise savings and address the anomaly in tax treatment between deposits/savings and superannuation. Specifically, the Henry Review Recommendation 14 in respect of a discount for savings income for taxation purposes should be adopted;
- The structure and regulation of superannuation funds should be reviewed to determine if a greater proportion of fixed interest investments could be held by superannuation funds;
- In light of the operation of the covered bond market, the existing limit on the covered bond pool should be lifted. Alternatively, flexibility should be introduced to allow ADIs to reach the full 8% and manage that limit over a reporting year;
- Consideration could be given to imposing a cap on total covered bond and securitisation issuance. This cap should be in the vicinity of 20% to 25%;
- APRA and the RBA could amend the appropriate settings to allow for all repo eligible bank paper to be treated as Level 1 Liquid Assets. For High Quality Liquid Asset purposes, covered bonds should also be confirmed as a qualifying Level 2 Liquid Asset, in line with global regulatory standards; and
- There be support for the development of a strong and liquid secondary RMBS market and that any divestment of RMBS by the AOFM be done in an orderly and moderate way based on the performance of that secondary market.

6

Regulation and regulatory supervision

Overall, with the support and oversight of the regulatory framework, Australia's financial services industry managed well through the GFC. However, in the past few years the roles, powers and jurisdictions of the various Australian regulators have become increasingly blurred and the burden of regulation has grown substantially.

Suncorp Bank, like its peers, is subject to extensive laws and regulations. These cover capital, liquidity, solvency, provisioning, accounting and reporting requirements, taxation, remuneration, consumer protection, competition, bribery, anti-money laundering and counter-terrorism financing, to name a few. Suncorp Bank is supervised by a number of different regulatory authorities which have broad administrative power over our businesses, including APRA, RBA, ASIC, ATO, ASX Limited, ACCC, AUSTRAC, the Office of the Australian Information Commissioner, the Privacy Commissioner, State/Territory Fair Trading Commissioners, and State Revenue Offices. International Regulatory Bodies also have significant influence domestically.

If the Bank fails to comply with applicable laws and regulations and voluntary industry codes of practice, they may be subject to suspensions, restrictions or loss of operating licences, fines and penalties or limitations on its ability to do business.

Where the Australian environment exhibits different characteristics to overseas markets, regulators should be pragmatically adopting regulation, or modifications, suited to the local market.

The weight of domestic and international regulation

With so many regulators taking an interest in the banking industry, and a more activist approach by policymakers on financial and regulatory issues, there has been substantial regulatory change, at great cost, in recent years. Perhaps the most significant example for banks is the Basel II and III packages, agreed to internationally and implemented in Australia by APRA. The domestic implementation has had major consequences for the Australian banking industry and its ability to serve the broader Australian economy.

It is widely accepted that Basel is a set of principles developed for global use but given the breadth of their application, compromise is required. Where the Australian environment exhibits different characteristics to overseas markets, the regulator should be pragmatically adopting regulation, or modifications, suited to the local market. This should include careful consideration of impacts on economic growth, competition and costs to consumers.

Other examples of extensive change include the recent banking competition reform package (bank deposit and mortgage account switching measures, ATM access monitoring, and a permanent financial claims scheme) and the Future of Financial Advice (FOFA) reforms for the financial planning industry. There have also been major reform programs through the Council of Australian Governments (COAG) on consumer credit regulations and e-conveyancing, ongoing changes to anti-money laundering obligations, and comprehensive changes to privacy laws.

While banks see competition as a key principle to balance against other considerations, the regulators prioritise other factors. For example, APRA places greater emphasis on minimising risk and promoting stability, versus promoting competition and efficiency. Similarly, ASIC prioritises consumer protection, at the expense of innovation and efficiency.

Further, with their respective regulatory development powers, APRA, ASIC and even the RBA (through payments policy) have engaged in extensive policy formulation. The resulting pace, volume and layers of reform have created complexity and duplication. There is a dire need for a robust framework through which regulators can share information, coordinate requests and better understand the impacts of the weight of regulation.

There are many examples of regulatory change where there have been conflicting objectives and considerations. In these instances, the industry has had to navigate compromises, rather than these being reached between regulators. One example is the conflicting position between regulators on term deposits, with APRA wanting banks to hold more non-breakable deposits (ie enforce the term or timeline of a term deposit) while ASIC requirements under the Corporations Act allows for term deposits under two years to be 'at call'.

There are many examples of regulatory change where there have been conflicting objectives and considerations.

Disproportionate impact of regulation on regional banks

Regulation has the unintended consequence of placing a higher burden of compliance and increased costs on the regional banks relative to the major banks.

Regional banking institutions typically have lower risk, more vanilla businesses and products yet they are subject to regulatory regimes similar to that of complex international financial institutions. Given scale, it is often fundamentally more expensive for smaller players to comply with new legislation, particularly where that compliance relies on system-based solutions. The fixed cost of developing these solutions does not vary greatly in relation to the size of an institution, therefore the unit cost of compliance falls as the scale of business increases.

Without appropriate balances, regulatory reform may improve stability in the short to medium term but diminish competition as smaller players struggle to absorb the change and cost relative to larger banks. In the long term this results in increased risk as the market consolidates into the hands of a few very large institutions which become 'Too Big to Save'.

Without appropriate balances, regulatory reform may improve stability in the short to medium term but diminish competition as smaller players struggle to absorb the change and cost relative to larger banks. In the long term this results in increased risk as the market consolidates into the hands of a few very large institutions which become 'Too Big to Save'.

Australia needs a regulatory environment more conducive to competition and efficiency. Currently the regulatory framework has a disproportionately high impact on smaller institutions which struggle to deal with the cost and administrative burden. Recent commitments from APRA are welcomed in relation to opportunities to reduce compliance costs as part of the Federal Government's regulatory cost-saving initiative, which includes the target of an annual net reduction of $1 billion in compliance costs across the economy.

International regulatory reform

Australia should not be at the forefront of costly change which undermines its internationally competitive position, particularly when experience indicates international peers ultimately fail to adopt the reform, certainly within original timeframes. The impact of international regulation on smaller banks cannot be underestimated.

There are many examples of new international regulatory developments impacting on the Australian banking sector. Among them is the US Foreign Account Tax Compliance Act (FATCA), the objective of which is to recover lost US tax revenue, but it places onerous customer identification and reporting obligations on Australian and other foreign financial institutions. The cost to Australian banks is estimated to be at least $100 million. In Suncorp Bank's case, in complying with FATCA, there are a very small number of customers currently reportable as the Bank does not directly operate in US markets or with US customers. Yet there's a requirement to implement an intensive compliance program costing more than $1 million, within aggressive timeframes. At time of writing, Australia is also yet to formally execute an Intergovernmental Agreement (IGA) with the US to reduce that compliance requirement, posing great uncertainty. As the burden of FATCA has been realised, OECD has announced its plans to develop a global equivalent to reduce tax avoidance - a Standard for Automatic Exchange of Financial Account Information - which would result in banks needing to cater for up to 32 OECD member customer identification requirements.

There are many examples of new international regulatory developments impacting on the Australian banking sector.

Coordination of regulation

The regulatory compliance burden has been exacerbated post-GFC by the dramatic increase in information requests, over and above routine reporting, with some of it already supplied. Timeframes for complying with ad hoc requests are usually tight. The cost and administrative burden is substantial.

A coordinated approach by all regulators around new regulation and the development of a system for storing and sharing information would prevent significant duplication, reduce costs and create a more efficient and accessible regulatory environment for regulators and banks.

Shadow banking

Financial institutions which are not captured under the prudentially regulated banking system enjoy a cost and competitive advantage over their regulated peers, however they do pose greater risks than regulated entities. These shadow banks can be defined as the entities (and activities) outside the prudentially regulated banking system. They are not bound by the directives that are followed by the rest of the banking system, because they do not take deposits and therefore are not under the supervision of APRA (some are regulated by ASIC).

Safeguards need to be taken to ensure costly and complex regulation does not result in unregulated entities mushrooming to meet a need in the market that can no longer be met by regulated entities under strict and costly risk frameworks.

The stability achieved since the GFC is at the cost of competition and innovation. There is a need to find a more satisfactory balance.

We support regulation which delivers stability, competition and efficiency and as such, we recommend that:

- Australia needs a regulatory environment more conducive to competition and a regulatory development framework that recognises that there is typically a disproportionately high impact on smaller institutions which struggle to deal with the cost and administrative burden. The industry needs appropriate scalable regulation, not one-size-fits-all;
- A register of regulator requests should be formulated. While this could be a very simple electronic clearing house, having reference to this would enable efficiencies to be found within and between regulators, aid in the formation of better regulation, and would help the industry better resource internal compliance teams. This could also incorporate a framework for regulators to jointly share and store information gathered;
- In regards to reform that emanates from international sources, the Australian Government could coordinate assessment and application to protect the interests of the industry and its customers, as well as balance domestic and international needs;
- The application of Basel principles needs careful and pragmatic assessment for its relevance and appropriateness in the Australian environment;
- Increased attention should be given to shadow banking entities by policymakers in order to protect the safety and stability of the financial system by ensuring that their level of regulation and supervision is commensurate with the risks shadow banking poses for the financial system; and
- The burden of regulation should also be reviewed in light of the shadow banking sector growing in response to gaps in the market where regulated entities cannot meet a need due to regulatory cost and complexity.

Technology and innovation

7

Suncorp Bank's success and sustainability relies on many factors, key among them being the ability to offer products and services that satisfy evolving customer preferences, habits and sentiment.

A strong competitive product and service offering which adapts to changing consumer behaviour and technology is essential to attracting, maintaining and growing a customer base. Increasingly, customers demand the ability to bank wherever they are, however they want and in a timely manner. The majority of customers are eager to adopt new approaches that make their banking more convenient and faster. Technology also serves banks and regulators, providing more information with which to manage and supervise banking activities.

Suncorp Bank's continued implementation of its Banking Platform Project will bring significant business benefits and improve the customer proposition.

The banking industry is working on ways to embrace technology and respond to changing consumer demands. Regulatory and legislative frameworks have to be agile and flexible to keep pace with this evolution.

Given legislative and regulatory handbrakes, the banking industry has been impeded in adopting new technology and customer fulfilment processes such as electronic forms and online documentation. This has opened up the market to new entrants that do not face the same regulatory requirements.

While technology is going to deliver benefits to both the industry and to consumers, and competition is good for consumers, these developments are not arising without risks. We need to have a regulatory framework that is agile and responsive to changing consumer preferences, while remaining secure. For example, while the payment system is well regulated and supervised by the RBA, we need to make sure that new entrants are regulated appropriately to maintain the safety and soundness of the payment system.

We need to have a regulatory framework that is agile and responsive to changing consumer preferences, while remaining secure.

Further, across the regulatory framework, many of the current rules on disclosure are designed on a paper-based, face-to-face transaction model. This creates a very real barrier for responding to consumer preferences. A move to balance electronic forms of communication with paper across the various pieces of regulation offers many benefits, including a more measurable and interactive engagement with disclosures, faster and more convenient services, and the possibility of an easier process for multiple services.

We recommend the Panel give consideration to:

- Regulators being properly resourced to ensure they are sufficiently flexible and agile to respond to developing trends in technology and consumer preferences;
- Regulation should not impede the ability of technology to meet changing customer needs, while ensuring any risks that arise are appropriately managed; and
- Disclosure regulations across banking and financial services products are modernised to ensure they are efficient and effective in a digital age, respond to changing consumer preferences and are given the same weighting as paper forms of communication.