



John F. Laker AO
CHAIRMAN

6 March 2009

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir,

INQUIRY INTO ASPECTS OF BANK MERGERS

This letter and attachment have been written to assist the Senate Standing Committee on Economics in its inquiry into aspects of bank mergers in Australia.

By way of general background, APRA does not have responsibility for competition policy or consumer matters outside its core mandate. However, the *Australian Prudential Regulation Authority Act 1998* does charge APRA with balancing the objectives of financial safety and efficiency, contestability, competition and competitive neutrality in the prudentially regulated financial sector and, in balancing these objectives, to promote financial system stability in Australia.

In this context, APRA provides advice to the Treasurer on whether proposed mergers of larger prudentially regulated financial institutions under the *Financial Sector (Shareholdings) Act 1998* are in the 'national interest'. (APRA has delegation to approve applications under this Act for smaller institutions.) In the absence of any definition or guidelines regarding 'national interest', APRA prepares its advice based on the public interest criteria set out in section 5(1) of the *Insurance Acquisition and Takeovers Act 1991*. The test is whether the change in ownership is:

- (i) likely to adversely affect the prudential conduct of the affairs of the companies; or
- (ii) likely to result in an unsuitable person being in a position of influence over the companies; or
- (iii) likely to unduly concentrate economic power in the industry or the Australian financial system; or
- (iv) contrary to the national interest.

APRA's main focus is naturally on items (i) and (ii). It does not, in the normal course, offer advice on whether the proposed merger is likely to unduly concentrate economic power (item (iii)). Rather, it relies on the Australian Competition and Consumer Commission to provide that advice separately to the Treasurer.

Against that background, APRA is unable to assist the Committee on a number of the terms of reference for the inquiry. However, some topics that may be of interest to the Committee are discussed in the attachment.

APRA staff would be happy to appear before the Committee if that would be helpful.

Yours sincerely,

A handwritten signature in blue ink that reads "John Lake". The signature is written in a cursive style with a large, looping initial "J".

Encl.

INQUIRY INTO ASPECTS OF BANK MERGERS

1. Impact of the global financial crisis on funding costs of smaller banks and on competitive pressures

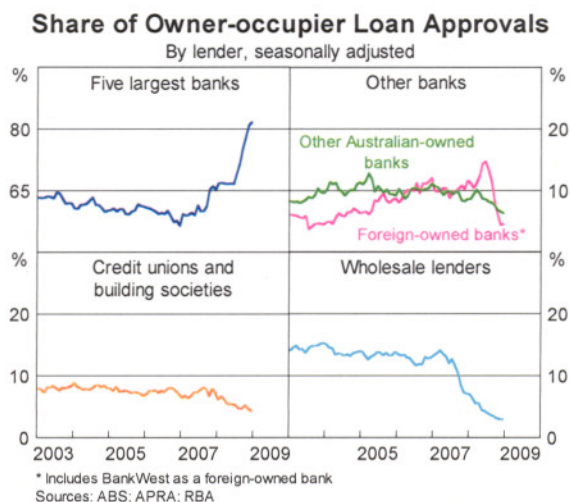
Since the start of the global financial crisis in mid 2007, lending institutions in Australia have experienced significantly higher funding costs and reduced availability of certain types of funding. However, the impact of the crisis has varied across institutions. The largest authorised deposit-taking institutions (ADIs) – i.e. the largest banks – have had the benefit of continued strong credit standing, diversified funding bases and longstanding wholesale funding programs across different markets. Notwithstanding dislocations in global funding markets, these institutions have been able to continue to expand their balance sheets to support new lending throughout the crisis. The smaller ADIs – i.e. most building societies and credit unions – have not traditionally relied on wholesale funding and have strong retail deposit franchises. Nonetheless, though an important element of the competitive landscape in Australia, these institutions on their own have generally lacked the size and scope to be a source of significant competitive pressure.

The largest impact of the crisis has been on the middle-tier institutions. The securitisation markets, on which regional banks, some larger building societies and unregulated wholesale lenders have relied heavily in recent years to fund their mortgage lending, have effectively been closed. In addition, foreign-owned banks have suffered from the effects of the global turbulence on their parent companies.

The Commonwealth Government's guarantee scheme for retail deposits and wholesale funding has helped to alleviate funding pressures for ADIs. Australian banks have raised over \$60 billion of longer-term wholesale financing since the guarantee of wholesale funding came into effect at the start of December 2008. Retail deposits have continued to grow strongly in recent months. However, securitisation markets have shown few signs of life.

According to the Reserve Bank of Australia, developments in funding markets have had a noticeable impact on the competitive dynamics of the Australian financial system and, in particular, on the pricing of home loans and the availability of housing finance.¹ The changing dynamics are evident from the graph below, which refers to owner-occupier housing loan approvals. The five largest banks now account for 80 per cent of such housing loan approvals – up sharply from around the 65 per cent level earlier in the decade – while the share of other lenders, notably the unregulated wholesale lenders and foreign-owned banks, has fallen sharply. The share of other Australian-owned banks, as well as building societies and credit unions, has also declined since the global financial crisis began.

¹ See Reserve Bank of Australia, *Financial Stability Review*, September 2008.



2. APRA involvement in monitoring and enforcing conditions imposed in merger approvals

The experience of the last 18 months highlights the critical need for prudential regulators to remain focused on their primary mission. APRA has responsibility for prudential matters, which are generally those directed at the financial soundness of regulated institutions and the stability of the Australian financial system. APRA would monitor, and enforce compliance with, any conditions imposed by the Treasurer on a bank merger approval that are prudential in nature. However, it does not have the responsibility or authority to monitor or enforce compliance with conditions that are imposed to meet competition or other non-prudential objectives; this is the role of other regulatory agencies.

3. Prudential aspects of offshoring of Australian bank services

APRA does not prescribe where particular banking services are to be conducted. In *Prudential Standard APS 231 Outsourcing* (APS 231), APRA has established prudential requirements governing the outsourcing by ADIs of their material business activities. The focus of these prudential requirements is on the identification and management of risk associated with outsourced activities, including activities that have been 'offshored'.

APS 231 provides that an ADI must develop an outsourcing policy, approved by the Board, that sets out its approach to outsourcing material business activities, including a detailed framework for managing all such outsourcing arrangements. The ADI's risk management framework must deal with the risk associated with outsourcing a material business activity.

An ADI must notify APRA when it outsources a material business activity; in the case of an offshoring arrangement, it must provide APRA the opportunity to assess the arrangement before it is put in place. APRA may request additional material it deems necessary in order to assess the impact of the outsourcing arrangement on the ADI's risk profile and the effectiveness of risk management. If necessary, APRA may require contingency plans and other risk mitigation measures to be put in place before the offshoring activity is implemented.

APRA routinely conducts on-site assessments of outsourcing and offshoring arrangements at banks and other ADIs. It also has access to service providers and may visit offshore sites to assess the adequacy of risk management measures and

oversight by the ADI. However, APRA does not collect regular statistical information on the extent to which Australian banks have offshored particular financial services.

Australian Prudential Regulation Authority
6 March 2009