CUSTOMER OWNED BANKING ASSOCIATION

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Mr Chris Gower
General Manager – Resolution and Enforcement
Policy and Advice Division
Australian Prudential Regulation Authority

By email: ADIpolicy@apra.gov.au

Dear Mr Gower

APRA Discussion Paper: Increasing the loss-absorbing capacity of ADIs

The Customer Owned Banking Association (COBA) appreciates the opportunity to provide feedback on APRA's proposal to increase the total loss-absorbing capacity (TLAC) of ADIs.

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $116 billion in assets, 10 per cent of the household deposits market and 4 million customers.

We welcome APRA's announcement of action to implement Recommendation 3 of the Financial System Inquiry (FSI) and address the 'too big to fail' (TBTF) problem in Australia's banking market. FSI Recommendation 3 had two objectives:

1. Ensure Australian ADIs have sufficient loss absorbing and recapitalisation capacity in resolution to make it feasible to implement an orderly resolution.
2. Reduce perceptions that some banks are subject to an implicit Government guarantee to lessen market distortions created by this perception and improve competition in the banking sector.[1]

Given the state of the banking market, policymakers should be taking all reasonable opportunities to level the playing field and promote the competitive capacity of smaller competitors to the major banks.

COBA's key points:

- **APRA's proposed "simple" approach is supported subject to a proportion of the additional TLAC capital for domestic systemically important banks (D-SIBs) being Tier 1 capital**
- **This proportion should be 1.5% of risk weighted assets, increasing the minimum Tier 1 capital requirement for D-SIBs from 6% to 7.5%, and**
- **APRA should firmly commit to implementation by no later than 2023.**

'Too big to fail' problem

Addressing TBTF is one of the most important recommendations of the 2014 FSI Final Report. The Government's 2015 response the recommendation said:

> The Government agrees that steps should be taken to reduce any implicit government guarantee and the perception that some banks are too big to fail. Should an ADI fail, greater loss absorbing capital will facilitate orderly resolution. We endorse APRA as Australia's

[1] FSI Final Report, page 68

prudential regulator to implement this recommendation in line with emerging international practice.

Five years on from the FSI and four years on from the Government's response, action within the prudential framework to address the unfair funding cost advantage given to the major banks due to TBTF is overdue. This implicit guarantee has a distortionary effect on competition in the banking market and further reinforces the major banks' already significant advantages. Furthermore, addressing TBTF reduces the potential costs to the Australian taxpayer of a major bank failure and shifts these costs on to the creditors and shareholders of the major banks.

In line with the recommendation's importance to both competition and stability, COBA supports APRA's proposal that the major banks meet a TLAC framework by 2023.

While FSI Recommendation 3 and the Government response gave APRA leeway to move with 'emerging international practice', it is clear now that other jurisdictions have moved on TLAC and international practice has clearly emerged. From 1 January 2019, G-SIBs were required to meet the milestone TLAC requirements ahead of full implementation in 2022. Several other countries are on their way to implementing domestic frameworks for their respective D-SIBs.

COBA agrees on limiting the scope of this framework to the major banks given, as APRA notes in the paper, that "[for] most other ADIs it is likely that an orderly resolution could occur without the need for additional loss absorbency". This is particularly the case with the mutual ADIs, given the size of even the largest individual mutual ADIs. Given their size, and the fact they are not beneficiaries of any implicit guarantee on their senior debt, mutual ADIs should not be subject to this regime.

Should APRA require any non-major bank to maintain additional loss absorbency, in principle these ADIs should have the same time provided to D-SIBs to meet the requirement.

TLAC & Tier 1 capital

APRA expects the proposed framework would result in additional Tier 2 capital of between four and five per cent of risk weighted assets and no increase in Tier 1 capital for the major banks.

COBA suggests a number of important objectives would be more effectively achieved if APRA modifies its proposed framework to require around one-third of the additional TLAC capital to be Tier 1 capital.

These objectives are:

- increasing the amount of the highest quality form of capital in the banking system
- reducing the unfair funding cost advantage enjoyed by major banks and hence improving competition, and
- minimising disruption to the market for Tier 2 securities.

APRA is proposing to "provide flexibility for ADIs to meet the requirement via the issuance of any instrument that qualifies for inclusion in Total Capital"[2]. An explicit requirement to increase Tier 1 as part of the TLAC framework for D-SIBs will further support APRA's primary objectives of financial safety and financial system stability.

In relation to competition, APRA notes that its current proposal, where additional TLAC capital is expected to be comprised of Tier 2, will result in competition being "marginally improved". This is because "requiring larger ADIs to maintain additional loss absorbency may help mitigate potential funding advantages that flow to larger ADIs."[3] Competition will be further improved if the additional capital includes an appropriate proportion of Tier 1 capital because this could further reduce the funding cost advantage enjoyed by major banks.

If the additional TLAC capital for D-SIBs is comprised entirely of Tier 2 this could flood the market for these securities, with disruptive impacts on pricing for all ADIs. Access to reasonably priced subordinated debt markets is particularly important for mutual ADIs because Tier 2 capital instruments have traditionally been the preferred capital option for our sector. Tier 2 issuance presents far less complexity for mutual ADIs than Tier 1 capital instruments because capacity to issue Tier 2 instruments

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[2] APRA Consultation Paper, page 13

[3] APRA Consultation Paper, page 12

does not necessarily require mutual ADIs to change their constitutions as may be the case with Tier 1 (equity) instruments.

As APRA notes in the paper, Tier 2 capital instruments are generally the most cost-efficient form of capital eligible for inclusion in Total Capital.[4]

COBA recommends that the minimum Tier 1 capital requirement for D-SIBs should be increased from 6% to 7.5% as part of a TLAC framework that increases the Total Capital requirement for D-SIBs by between four and five percentage points.

State of banking market

The FSI saw competition and competitive markets as the primary means of supporting the financial system's efficiency.

> "Although the Inquiry considers competition is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time."[5]

The FSI was concerned to address market distortions created by implicit guarantees.

> "Actions taken by governments both in Australia and overseas to support their financial sectors during the GFC have reinforced perceptions of an implicit guarantee.
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> Implicit guarantees arise when creditors believe that, if a bank were to fail, the government would step in to rescue the institution. Implicit guarantees reduce banks' funding costs by moving risk from private investors onto the Government balance sheet — a contingent liability for Government. As a result, the creditor takes no (or a reduced) loss, making it less risky to invest in the institution. Creditors will therefore accept a lower interest rate, which lowers funding costs for the bank and provides a competitive advantage to those institutions most affected.
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> Empirical studies have found that Australian ADIs, especially the largest ADIs, benefit from an implicit guarantee. This is also evident in the credit ratings of the major Australian banks, which all receive a two-notch credit rating uplift from credit rating agencies Standard & Poor's and Moody's due to expectations of Government support. Implicit guarantees create inefficiencies by:
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> - Providing a funding cost advantage for banks over other corporations.
> - Giving large banks an advantage over smaller banks.
> - Weakening the market discipline provided by creditors.
> - Potentially creating moral hazard that encourages inefficiently high risk taking."[6]

The FSI considered that its recommendations to increase the resilience of the banking sector, especially of the largest banks, will reduce perceptions of implicit guarantees over time and help contribute to restoring a more competitive environment.

Since the FSI reported in 2014, a number of inquiries have reinforced the need to take action to promote competition in the banking market.

The Productivity Commission's (PC) 2018 Inquiry into Competition in the Financial System noted that:

- Major banks as a group hold substantial market power, as a result of their size, strong brands and broad geographical reach
- "This is substantially supported by regulatory settings, which contribute to the major banks' structural advantages. As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability — with minimal loss of market share." [7]
- Major banks' market power is a defining feature of the financial system: "There is evidence that [the major banks] have sustained prices above competitive levels, offered inferior quality

[4] APRA Consultation Paper, page 14

[5] FSI Final Report, page xvi

[6] FSI Final Report, page 45

[7] PC Competition Inquiry Final Report, page 37

products to some groups of customers (particularly those customers unlikely to change providers), subsumed much of the broker industry and taken action that would inhibit the expansion of smaller competitors in some markets. All are indicators of the use of market power to the detriment of consumers."[8]

The PC found that what allows market power to be sustained in Australia's financial system is a combination of features evident in the way providers, consumers and regulators operate, including regulatory arrangements and funding advantages.

The PC also found that:

- neither foreign entrants nor fintechs appear to pose a substantial threat to major banks' dominant positions, i.e. more entrants alone are not a panacea to drive sustained competition across Australia's financial system, and
- a substantial gap also remains between the average operating costs of Australia's major banks and its smaller institutions.

The Australian Competition and Consumer Commission (ACCC) also sees the banking market as oligopoly where the major banks use their power to stifle competition. According to the ACCC's November 2018 Residential Mortgage Pricing Inquiry Final Report, the major banks have an "accommodative and synchronised" approach to pricing:

> "Building on the signs of a lack of vigorous price competition set out in the Interim Report, we observe that opaque discretionary pricing by the Inquiry Banks stifled price competition during the price monitoring period."
>
> "We consider that the big four banks profit from the suppression of borrower incentives to shop around and lack strong incentives to make prices more transparent." [9]

The September 2018 Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry found that competition within the banking industry is weak and barriers to entering the industry are high.

> "Each of the four largest banks is a powerful player in the market.
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> "Important deterrents to misconduct are, therefore, missing from the banking industry. Competitive pressures are slight."[10]

Given the state of the banking market, policymakers should be taking all reasonable opportunities to level the playing field and promote the competitive capacity of existing smaller players in banking. Effective competition will drive innovation in product offerings, improvements in product quality and variety, greater efficiency and lower prices, for the benefit of business and consumers. This can be achieved without compromising financial safety and financial system stability.

The major banks clearly benefit from the perception that they are 'too big to fail'. This artificially and unfairly lowers the major banks' funding costs, which exacerbates the problem by allowing them to become even larger and more systemically important.

APRA's introduction of a TLAC regime should be unambiguously intended to reduce the major banks' unfair funding cost advantage. This funding advantage is significant. A COBA-commissioned independent assessment estimated that it was worth 22-34 basis points or between $2.9 billion and $4.5 billion a year.[11] Subsequent RBA research on the implicit subsidy noted that the major banks have received an unexplained funding advantage over smaller banks of around 20 to 40 basis points on average since 2000. The annual dollar value estimate of the major banks' subsidy was around $1.9 billion.

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[8] PC Competition Inquiry Final Report, page 4

[9] PC Competition Inquiry Final Report, page 4

[10] Banking Royal Commission Interim Report, page 268-9

[11] http://www.customerownedbanking.asn.au/images/stories/submissions/2014/Macroeconomics%20Research%20for%20COBA.PDF

APRA must establish a fixed timeline to ensure there are no more delays
COBA urges APRA to commit to ensuring that there is a domestic TLAC regime in place by 2023. Assuming compliance by end of 2023, this provides four years to adjust to these requirements (assuming a regime is put in place by the end of 2019).

Any extension beyond 2023 will continue to give the major banks an unfair funding advantage over their smaller competitors, expose Australian taxpayers and reduce APRA's ability to pursue an orderly resolution. This will have a negative impact on both competition and financial stability. The implementation of this FSI recommendation has already been delayed for too long and the unfair funding advantage must be addressed.

The current absence of a fixed timeline for Australia's TLAC implementation has been driven by the FSI's caveat (subsequently endorsed by the Government) that APRA "implement this recommendation in line with emerging international practice". The case to wait for emerging international practice no longer exists given that G-SIBs are now on their way to meeting their TLAC requirements[12], with regimes in place in many FSB member jurisdictions.

The FSI found that the problem of TBTF exists in the Australian context and the introduction of this framework has been endorsed as one of the solutions by the FSI and the Government. By shifting the costs of a crisis onto major bank creditors and shareholders a TLAC regime reduces the potential costs to taxpayers in a financial crisis. The FSI Final Report indicatively estimates that "if the cost of financial crises is reduced by 10 per cent, it would provide an expected average benefit of 0.25–0.3 per cent of GDP per year ($4–$5 billion)."[13]

The introduction of the TLAC regime is an opportunity for APRA to advance both the financial stability and competition components of its mandate.

COBA urges APRA to implement the framework in a way that moves toward a more level playing field for all ADIs in a stable, efficient and competitive financial system.

Your sincerely

MICHAEL LAWRENCE

Chief Executive Officer

[12] G-SIBs are required to meet a Minimum TLAC requirement of at least 16% of the resolution group's risk-weighted assets (TLAC RWA Minimum) as from 1 January 2019 and at least 18% as from 1 January 2022. Minimum TLAC must also be at least 6% of the Basel III leverage ratio denominator (TLAC Leverage Ratio Exposure (LRE) Minimum) as from 1 January 2019, and at least 6.75% as from 1 January 2022.

[13] FSI Final Report, Page 71