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Loan, Nick

From: Lonsdale, John
Sent: Tuesday, 19 October 2010 9:30 PM
To: Douglas, Justin; Dickson, Tom; Loan, Nick
Subject: Fw: Letter re banking competition [SEC=UNCLASSIFIED]
Attachments: Letter to Treasury_J Lonsdale Final.pdf

Classification: [SEC=UNCLASSIFIED]

Nick

Could you pls examine.

John

From: Guy_Morgan@amp.com.au <Guy_Morgan@amp.com.au>
To: Lonsdale, John
Sent: Tue Oct 19 11:52:33 2010
Subject: Letter re banking competition

Hello John

Further to the discussion on 7 October, and the joint memo from the non-Major treasurers, I attach my thoughts on some of the 'how' issues - those aspects of regulation that may not sit neatly with government's intention to increase banking competition. Please note this is very much an AMP Bank perspective, and may not necessarily be the view of other non-Majors or Majors.

Regards
Guy

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AMP Banking
Level 4, 2-12 Macquarie Street
Parramatta NSW 2123 Australia

Locked Bag 5059
Parramatta NSW 2124 Australia

BankPhone 13 30 30
BankFax 1300 555 503

BankNet www.amp.com.au/banking

Email info@ampbanking.com.au

Mr John Lonsdale
General Manager, Financial System Division
The Treasury
Langton Crescent
Parkes
ACT 2600

19 October 2010

Dear John

I would like to thank you for the meeting on 7 October 2010, which I know all the bank treasurers found informative and engaging. I know we all look forward to catching up with Treasury again once the regulatory outcomes are a little clearer.

Further to the formal response from the combined group which addresses some of the differences in regulatory treatment of Major Authorised Deposit-taking Institutions (ADIs) and non-Major ADIs, we at AMP Bank would like to offer a few areas where AMP considers that the existing regulation designed to promote financial stability adversely impacts upon competition and innovation amongst the non-Major ADI sector. Whilst the promotion of financial system stability is paramount, we believe there are examples where the regulation is disproportionate to the risk being addressed, which we would like to elaborate on below.

In light of the Government's wish to encourage banking competition, it is appropriate to reconsider the regulatory approach to securitisation, as encapsulated in APS120. Some high level areas of APS120 that warrant reviewing in light of encouraging competition by the non-Major banking sector include:

- Enable B Note retention by banks without a capital impost;
- Remove the regulatory capital limit for investment in an originator's own securitisation vehicles, and rely on the 20% limit on investment in a pool. Each pool should have its own capital limit and should not be aggregated by the originator as each pool behaves differently from a credit and prepayment perspective;
- Enabling fixed income like securitisation structures – so as to meet fixed interest investors' requirements for a certain term and face value, and increase the investor base for securitisation instruments; and,
- Enabling date based call dates – so as to meet fixed interest investors' requirements.

In addition, and as outlined below, it is appropriate that in considering the state of banking competition, that Treasury reflect on:

- The regulatory treatment of B Notes;
- The reliance of the securitisation market on AOFM support;
- The interpretation and application of Basle regulatory developments in the Australian context; and
- The impact of the Government wholesale and retail guarantees

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Treatment of RMBS subordinated tranches under APRA

In APRA's recently released letter to ADIs, the operational requirements for regulatory capital relief significantly impacted upon many of the non-Major ADI's ability to undertake future securitisation transactions.

Subordinated tranches, or "B Notes" should not be seen as a 'first loss' piece – there are additional loss absorption features in securitised loan portfolios that are not present in on balance sheet lending:

- Securitised mortgages are 100% mortgage insured - this is not the case for on balance sheet loans, where sub-80% LVR loans are typically not mortgage insured.
  - Note that APRA gives credit for lender's mortgage insurance ((LMI) - LMI providers are regulated by APRA) with on balance sheet loans allowed a reduction in risk weighted assets. However per APRA's letter of 26 August 2010, off balance sheet insured loans are currently not considered to have achieved a significant credit risk transfer.
- The excess spread is only paid to the issuer after losses have been met. Once paid to the issuer, that excess spread is no longer available to the Trust, and so the issuer's credit exposure is reduced. In comparison, losses from an on-balance sheet loan portfolio can effectively claw back the historic spread earned. Excess spread in structures has been more than enough to meet losses to date, including any LMI adjustments to claims.

AOFM support to securitisation sector

As discussed with Treasury, the AOFM's investment has been critical to the securitisation market that is the lifeline for many non-Major ADIs. In response to APRA's newly stated regulatory capital requirements, Treasury could consider modifying the investment mandate under the AOFM's RMBS program, extending it to include investment in the subordinated piece (B Notes) for new and previous issues. This would assist greatly in continuing to promote banking competition.

Basle regulatory developments

The changes to the Basle liquidity regime are explicitly intended by Basle to establish a minimum level of liquidity for 'internationally active banks'. It is reasonable that the liquidity management horizon for systemically critical banks be extended to 1 month. However, should this requirement be extended for smaller financial institutions, such as non-Major ADIs, it would be a significant cost and competition impediment - all for a systemic risk that is not as significant as that generated by Major banks.

Similarly, Basle has signalled that banks that are 'too big to fail' banks might warrant an extra capital impost. Switzerland has already responded, and the UK/US appear to also be considering an extra capital impost for such banks. While this has not yet been intimated in Australia, it would again detract from banking competition, were regulators to again apply a regulatory approach intended for systemically significant ADIs to the non-Major ADIs.

In Australia, the Major banks have qualified as 'Advanced' banks and thereby the risk weighting for residential mortgages is assessed at c17%. Small financial institutions which are subject to the 'Standardised' approach, incur a significantly higher risk weighting of 35%-40%. As this is basically for the same product, and as an additional operational risk charge may be imposed on securitised mortgages for some banks, this is a significant impediment to capital efficiency for small banks. There appears to be little rationale for the same product on one ADI's balance sheet incurring one capital charge, and nearly double that on another ADI's balance sheet.

The Basle rules in relation to Level 2 liquidity are presently in development, and Australian regulators have been asked to make representations to Basle regarding the appropriate definition of liquid assets in countries where there is an insufficient supply of Government stock or non-financial corporate stock. It is important that Australian representatives at this Basle discussion advocate that RMBS be a qualifying liquid asset for the purposes of Level 2 liquidity. Also, given the very limited supply of Australian Government and non-financial corporate stock, it is appropriate that the Level 2 cap of 40% be increased.

It should be noted that while pre-GFC trading liquidity for RMBS was not high, ultimately the liquefiable nature of any asset is determined by its acceptability at the central bank repo window – where it can be exchanged for cash.

Government Guarantees

As Treasury noted, there is a significant refinancing risk for banks around the impending rollover of previously issued Government guaranteed debt. In determining the assistance required to address that risk, regulators should note that because the Majors are recognised appropriately as too big to fail, they are thereby in effect provided by the Government a lower cost of funds, a lower cost of capital and a higher return on equity, than non-Majors. Absent that now explicit guarantee, Majors may have a substantially lower rating. It is appropriate that:

a. the Government equalise the fees on existing and future Government guaranteed debt, recognising the pre-existing subsidy to Majors; and,
b. require undertakings from all banks that ensure future Government guaranteed debt issuance is used in a manner consistent with the Government's objectives.

In addition, Treasury is considering the alternatives available to it in relation to the impending expiry of the Government guarantee of ADI's retail deposits. It would be appropriate that if such a guarantee were provided to banks, that Treasury consider charging a fee based on the total volume of retail deposits guaranteed. This would ensure Majors' competitive position was not further advantaged relative to non-Majors, and go some way towards addressing the subsidisation of the banking sector as a whole relative to other retail investment opportunities.

In summary, as noted by Treasury, the balance of regulation has tilted in recent years towards financial stability. As Government seeks to tilt the 'playing field' toward banking competition, it is appropriate to review existing regulation related to banking and its interpretation which developed to address stability, to achieve that end.

With securitisation such an important funding tool for the non-Major ADIs, it is important to banking competition that the securitisation markets function efficiently.

I would be happy to respond to any queries you may have or to discuss these matters further.

Yours sincerely

Guy Morgan
AMP Bank Treasurer &
Deputy Group Treasurer

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ABN 15 081 596 009
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