# NAB Submission to the Financial System Inquiry

nab

more give, less take

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# I. Summary of Recommendations

1.1.1. Reduce the tax bias against deposits by removing relative tax penalties for interest income which may be achieved by having an offset for inflation and/or a discounted tax rate.

1.1.2. Australian Prudential Regulation Authority (APRA) to introduce a new "run-off" category for superannuation deposits at 50%, higher than the run-off assumption for corporates (40%) but less than a bank or other financial institution (100%).

1.2.1. Create a deep and visible Public Private Partnership (PPP) transaction pipeline, in line with offshore markets.

1.2.2. Amend the size of PPP transactions so that projects come in smaller parcels, consistent with UK and Canadian markets.

1.2.3. Evaluate the adoption of a liquidity backstop facility for superannuation funds. This is required to increase the confidence of superannuation funds in investing in longer term assets without hindering their ability to meet member demands for switching or redemption. Specifically, the Inquiry should, at a minimum, investigate the following key questions with respect to implementing such a facility:

i) Who would be the best party to provide a liquidity backstop facility?

ii) What would be the likely cost of a liquidity backstop for superannuation funds?

iii) What would be the legal structure of assets held in such a facility?

1.2.4. Increase the depth and liquidity of the retail corporate bond markets to broaden funding sources for infrastructure (see below recommendations 1.3.1-1.3.4)

1.3.1. Remove tax penalties for fixed income holdings (e.g. tax discount for interest income; tax offset for inflation component in fixed income investments).

1.3.2. Develop national education programmes for retail investors, retirees and self-managed superannuation funds (SMSFs) on diversification, sequencing and risk/return trade-offs.

1.3.3. Reduce the distinction between retail and wholesale markets such as the wholesale investor criteria. In particular, this distinction could be removed for products that meet certain requirements, for example, corporate, investment grade rated bonds issued by companies that are already listed on a retail equity securities exchange.

1.3.4. Promote the listing of managed fund portfolios of fixed interest securities to allow efficient access by retail investors and SMSFs.

1.4.1. As banks will need to source long-term stable funding to meet the Basel III Net Stable Funding Ratio (NSFR) requirements, there is a need to incentivise investors to fund banks by:

– Removing relative tax penalties for fixed income (see 1.1.1).

– Eliminating regulatory barriers to facilitate more efficient structuring of securitisation transactions. This involves allowing Australian issuers to incorporate features that allow efficient master trusts to be established. This includes, but is not limited to, the use of seller share and date based calls. NAB notes APRA is in the process of reviewing APS120 and the introduction of master trusts is being considered.

– Supporting the corporate bond market (see 1.3.1-1.3.4).

– Incentivising the superannuation industry to supply funding (see 1.2.1-1.2.4).

1.4.2. In relation to the proposed implementation of the NSFR, the construction and calibration of this metric should reflect structural features in the Australian system that will support compliance without unduly impacting bank balance sheet structures or the flow of credit in the broader economy. An example would be to provide Required Stable Funding relief on internal residential mortgage backed securities (RMBS) held as collateral for the Committed Liquidity Facility (CLF).

2.1.1. Regulators should be permitted to supervise and/or restrict activities of non-prudentially regulated organisations, if, in their opinion, the activities of those organisations, either individually or in aggregate, pose a threat to the safety and stability of the financial system and/or to the broader economy. This could be achieved by granting the Reserve Bank of Australia (RBA) authority to designate that an entity should fall under APRA's supervisory mandate. The nature and level of regulatory oversight should be determined primarily by an organisation's activity and risk profile, rather than by its legal classification.

2.2.1. Where new stores of value or payment mechanisms emerge which are not subject to regulation, the RBA should be permitted to take whatever steps are necessary to curtail or discontinue their use, if, in the RBA's opinion, these instruments represent a material threat to the safety and integrity of the financial system or to the broader economy.

2.2.2. Where new stores of value or payment mechanisms interact with the participants in the regulated payments system, they should adhere to the same client identification requirements as regulated participants, so as to ensure the overall integrity of the payments system.

3.1.1. To harmonise the pace of adoption of international regulation, APRA should consider aligning future international regulatory reform implementation timetables with the majority of G20 countries.

3.2.1. To ensure the pace and impact of regulatory change is properly managed, consideration should be given to modifying laws or introducing a charter to ensure regulators adhere to a set of key principles and practices. This should entail:

- A clearly documented purpose and economic consideration of impacts to industry which would include an improved process for seeking cost impacts;
- Minimal duplication; and
- Consistency of approach across regulators.

3.2.2. NAB recommends that the Council of Financial Regulators (CFR) should be given a more formal structure and be tasked by the Treasurer to coordinate the implementation of regulatory change by APRA and ASIC. Where practicable, regulators and the banking industry can co-design the scope and timing of regulatory change to achieve a lower cost/lower risk financial system via:

- Practical commercial capability introduced in reform design to ensure faster and more effective policy making;
- Capacity support provided to policy makers to ensure they are able to execute to committed timetables; and
- Greater consideration and flexibility given to implementation timelines, once formal policy is confirmed.

3.3.1. Regulations should not discriminate on deposit value by channel. The other factors to derive quality are relevant and should apply equally to online accounts and accounts from other channels.

3.4.1. The capital requirements for each of the components of a banking and wealth management group operating under a non-operating holding company (NOHC) should be determined having regard to the greater level of separation and lower level of contagion risk afforded by the NOHC structure.

3.5.1. Unit pricing is currently the most effective method of fund valuation and plays an integral role in ensuring equity and fairness remain features of Australia's superannuation system. Unit pricing in superannuation funds ensures accurate valuations and equitable distributions for all members. Consideration should be given to making unit pricing a requirement of all collective investment, public offer funds.

3.6.1. With the new Government revisiting the scope of the National Broadband Network (NBN), the potential for a relatively small investment towards integrated national security controls could result in a significant benefit to Australian customers and businesses.

3.6.2. Accelerating the integration of businesses into the Australian Cyber Security Centre will provide an important step in closing the information gap between business and government.

3.7.1. Regulatory guidelines should encourage, and not limit, the industry advancement around the use of new technologies such as cloud or third party computing services via a clear set of industry principles. We support the maintenance of a principles-based approach rather than prescribed guidelines that will unnecessarily restrict the use of cloud computing.

4.2.1. A standard reporting methodology should be established for small amount lenders to allow the size and economics of the sector to be accurately assessed. Once the economics of this sector are fully understood, Government should give consideration to supporting new and existing microfinance alternatives that will provide fair, affordable and competitive small amount loan alternatives to those Australians experiencing financial exclusion.

# II. Executive Overview

## Purpose

National Australia Bank (NAB) appreciates the opportunity to respond to the Financial System Inquiry ("FSI" or "the Inquiry") Terms of Reference dated 20 December 2013.

NAB is supportive of the Government's review of the Australian financial system. As a member of the Australian Bankers Association (ABA), NAB has participated in the ABA's consultation process and is broadly supportive of the ABA's submission. This submission seeks to provide further comment on specific areas where NAB has specialised industry experience and considers it beneficial to the Inquiry.

## Background

Despite the relative strength of the Australian financial system, NAB recognises that, post the Global Financial Crisis (GFC), it is timely to examine how the financial system needs to be positioned to support and fund Australia's future long-term economic growth and respond to key industry forces, such as rapidly changing consumer preferences, growth in superannuation, market innovation, global financial integration and technology.

Since the Wallis Inquiry reported its findings in 1997, the Australian financial system has proven to be sound, resilient, innovative and competitive. Key developments which now define the financial system are as follows:

- Between 1997 and 2013, Australian bank balance sheets averaged 10.8% p.a. growth,[1] versus 6.4% p.a. growth in nominal GDP[2] over the same period.
- Superannuation funds have grown from $301bn in 1997 to $1,618bn today[3] and now rival banks for household savings. Despite this growth, they have not accumulated correspondingly large positions in domestic debt securities.
- Despite strong growth in the Australian economy since 1997, the Australian corporate bond market remains relatively small and plays only a minor role in funding business growth.
- The growing interconnectedness of the global financial system has been a notable feature of the last 17 years and off-shore wholesale debt markets have become an important source of funding for Australian banks. Whilst this has delivered many benefits, it has also meant that instability in offshore financial markets is rapidly transmitted to the Australian financial system.
- Prior to the GFC, securitisation markets grew rapidly, but the GFC exposed the risks inherent in undertaking maturity transformation outside the regulated banking system and demonstrated how quickly confidence and liquidity in those markets can be compromised.
- Regulated financial institutions represent the vast bulk of the Australian financial system today, with Australia having a relatively small 'shadow banking' system.
- Since 1997, Australia's population has grown by 4.7 million, from a population of 18.4 million people in 1997 to 23.1 million today.[4] This has implications for the amount of funding required to develop the infrastructure necessary to support that growth.

1 Source: Australian Bureau of Statistics, *Australian National Accounts, Financial Accounts*. Cat. No. 5232.0, Table 8.

2 Source: Australian Bureau of Statistics, *Australian National Accounts, National Income, Expenditure and Product*, Cat. No. 5206.0. Table 1.

3 Source: Australia Prudential Regulation Authority, *APRA Superannuation Annual Bulletin*, Table 14.

4 Source: Australian Bureau of Statistics, *Australian Demographic Statistics*, Cat. No. 3101.0, Table 1.

## Summary of NAB's Key Themes

In light of the above context, NAB has identified four critical financial system themes for the Inquiry to address:

1. **Funding** – The Australian economy is substantially funded by Australian banks. The proportion of domestic deposit funding on Australian bank balance sheets has increased substantially since the GFC and domestic deposits now comfortably represent the dominant source of funding.

   Despite this trend, a significant reliance on offshore markets as a funding source remains, noting that a large proportion of this funding is long-dated and well diversified and Australian bank credit is well supported by international investors. While the Australian economy can be funded under most scenarios, the experience during the GFC demonstrated that Australia's reliance on offshore wholesale funding can come under pressure during times of crisis. During the GFC, the Commonwealth Government guarantee allowed Australian banks to continue to access offshore wholesale funding, and thereby provided a level playing field relative to other jurisdictions around the world and supported the domestic economy.

   Looking ahead, the shift in regulatory and rating agency requirements towards more liquid and stable funding sources presents challenges to how banks have historically funded themselves and thereby potentially impacts the consistent flow of funding for the Australian economy under certain scenarios. In this respect, NAB believes there is an opportunity to further strengthen Australia's funding model, making it more resilient to offshore events and supporting the stability of economic growth. NAB proposes a range of mechanisms to broaden the sources of domestic funding, including removing relative tax penalties for interest-earning investments; increasing the liquidity value the APRA places on deposits from superannuation; mitigating impediments to superannuation funds participating in long term funding via a liquidity backstop as well as changing the PPP bidding processes; promoting a deeper corporate bond market through the removal of wholesale investor criteria for plain vanilla bond issues; and facilitating more efficient structuring of securitisation transactions.

2. **Competition** – Australia has benefited considerably from competition in terms of greater transparency, innovation, and product choice, as well as lower costs of access to the system. A level playing field is vital for promoting innovation and ensuring that stability and consumer protection is maintained.

   NAB recommends the activities of shadow banks and alternate payments system players should be subject to regulation if they pose a threat to the safety and stability of the financial system and/or the broader economy.

3. **Regulatory Framework** – NAB believes Australia's current financial system regulatory structure has served it well and strongly supports the objectives of changes to the regulatory framework post GFC which in essence promote stability and consumer protection in the financial system. Nevertheless, the pace, burden and concurrent nature of recent regulatory changes have potentially created both a higher risk and higher cost financial system and resulted in unintended consequences for Australian financial institutions. For example, accelerated implementation of Basel III reforms places Australian banks at a competitive disadvantage when providing some derivative products. With respect to wealth management operations, the short implementation timetable for the Stronger Super reforms has increased the cost and risk of compliance.

   NAB recommends that Australian-based regulatory implementation should be better coordinated so that the scope and timing of regulatory change is achieved at a lower cost, whilst maintaining international competitiveness and without compromising systemic stability.

4. **Financial Inclusion** – NAB has led the industry in making banking fairer, simpler and more transparent through its *Fair Value* agenda. NAB has also supported government and not for profit initiatives designed to improve financial literacy and financial inclusion.

   Whilst recent legislative amendments have addressed some of the concerns around 'small amount lending', we believe that further improvement is required based on a better understanding of that sector.

   A more detailed summary of NAB's recommendations and issues identified against each of these critical themes is provided throughout this submission. NAB looks forward to the opportunity to discuss our submission and recommendations with the Inquiry panel in greater detail over the coming months.

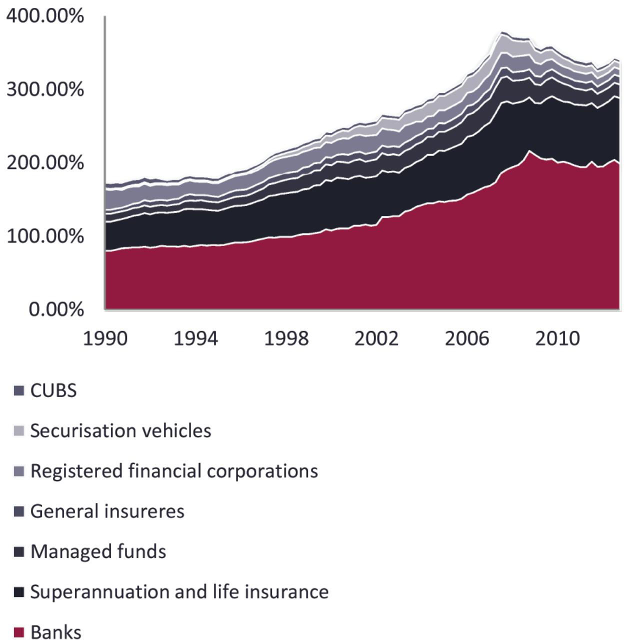
# III. Overview of the Financial System

The Australian financial system has proven to be relatively strong by international standards, featuring the virtuous circle of an independent central bank, banks that are well capitalised with high-quality asset portfolios, a relatively small shadow banking presence and a sound 'twin-peaks' regulatory framework which has supported the system through external shocks such as the GFC.

This relative strength has allowed Australian financial institutions to support the continued growth of the Australian economy over the past two decades. Assets of financial institutions have exhibited a 9.3% compound annual growth rate (CAGR) over the past decade to reach over $5.4tr in September 2013, with over 80% of assets in the financial system accounted for by banks and superannuation funds (Graph 1).[5,6] As we highlight later in this submission, the respective roles of these two pillars of the financial system as they relate to short term and long term funding of the Australian economy must be clearly defined. NAB's view is that there needs to be a more symbiotic relationship between banking and superannuation sectors, especially given the impact of Basel III on the banking system and the projected strong growth of superannuation savings over the next 15 years.

Given that it is difficult for Small and Medium Enterprises (SMEs) to access funding directly from capital markets and superannuation funds, banks are likely to remain the primary source of the short term funding required by these businesses. However, for long term funding needs (e.g. infrastructure projects), the importance of the banking and superannuation sectors working together becomes paramount. In this instance, banks would play the role of providing origination and short term funding, whilst superannuation funds would become the primary providers of equity and long term funding.

**Graph 1: Assets of Financial Institutions as % of Nominal GDP**




Source: Maddock, R and Munckton, P (2013) "The Future Demand and Supply of Finance," *"Funding Australia's Future: Australian Centre for Financial Studies"*, Figure 24 p.34.

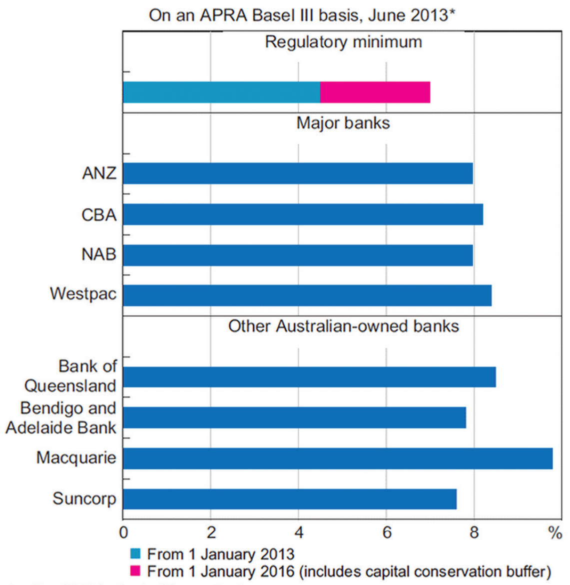
From a banking perspective, we have safe and strong banks which demonstrate relatively sound asset performance by international standards, even through external shocks such as the GFC, and generate profit returns which are in line with overseas banking systems (Graph 2, 3 and 4).[7]

5 Reserve Bank of Australia (2014), "B1 Assets of Financial Institutions."

6 Davis, K (2013), "Funding Australia's future: From where do we begin?," pp.29.

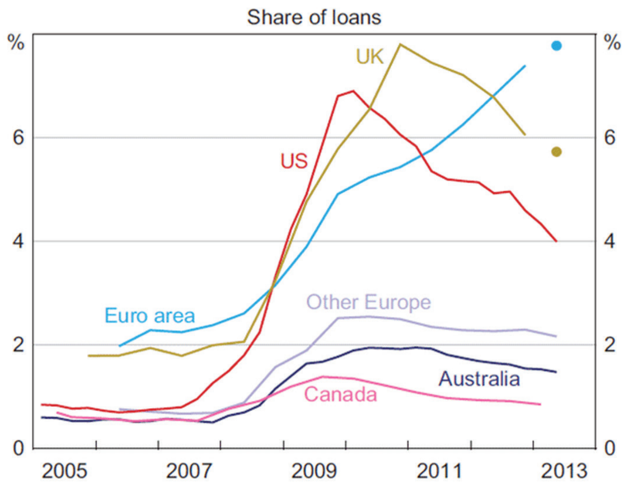
7 Reserve Bank of Australia (2013), "Financial Stability Review: The Australian Financial System," pp.19-35.

### Graph 2: Banks' Common Equity Tier 1 Capital Ratios




* May 2013 for Bank of Queensland
Source: banks' financial disclosures

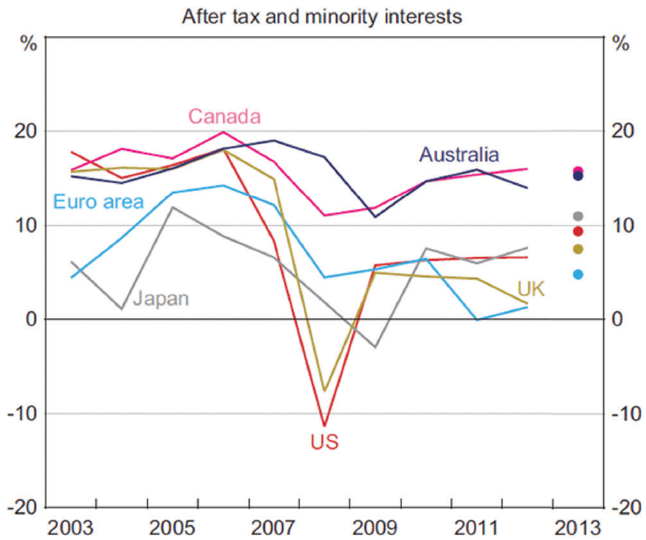
### Graph 3: Large Banks' Non-performing Loans*




* Definitions of 'non-performing loans' differ across jurisdictions, sometimes including loans that are 90+ days past due but well secured and in the case of Australia small amounts of non-loan assets; includes 18 US banks, 41 euro area institutions, 10 other European banks, four UK banks, six Canadian banks and four Australian banks; latest available ratios have been used for some euro area and UK institutions where June 2013 data are unavailable

Sources: APRA; RBA; SNL Financial; banks' annual and interim reports

### Graph 4: Return on Equity*




* Includes six US banks, eight euro area banks, four UK banks, three Japanese banks, six Canadian banks and four Australian banks; adjusted for significant mergers and acquisitions; reporting periods vary across jurisdictions; dot for Australia is analysts' full-year forecast, while dots for other jurisdictions refer to annualised profits in 2013 to date divided by total equity as at latest reporting date

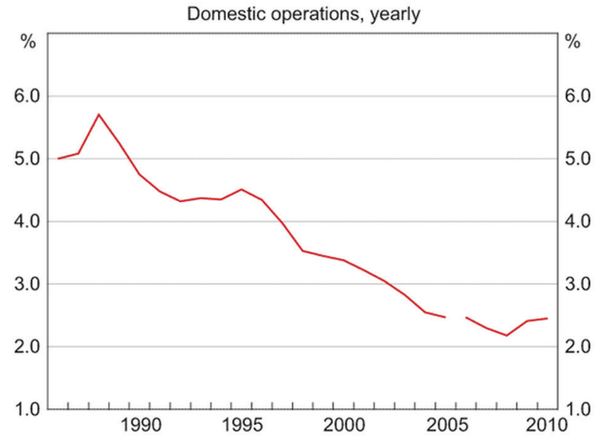
Sources: Bloomberg; RBA; SNL Financial; banks' annual and interim reports

Consumers have benefited from an increasingly competitive, innovative, and efficient financial system as follows:

- Since 2008, average fees on a standard variable rate mortgage have decreased by 16.5%.[8]
- Strong competition has driven a sharp decrease in net interest margins and a rise in both term deposit 'specials' and at-call savings deposits spreads (Graph 5 and 6).
- Since the GFC, there has also been significant pressure on banks to reduce or remove fees on core banking products such as transaction accounts, mortgages and credit cards. The RBA estimates that bank fees earned on deposits fell from $1.205bn in 2010 to $1.105bn in 2012.
- Notable improvements in price or value and product innovation (e.g. mobile banking, online-only value banking, 100% offset accounts).
- The major Australian banks have effectively leveraged technological innovation and managed expenses to drive a more efficient banking system (Graph 7).

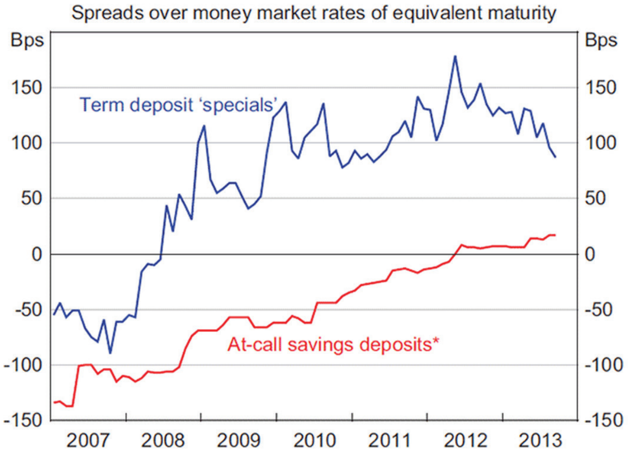
8 Reserve Bank of Australia (2010), "Submission to the Inquiry into Competition within the Australian Banking Sector," p. 24. Based on a $250,000 owner-occupied variable housing loan, terminated within 3 years.

### Graph 5: Major Banks' Net Interest Margin*



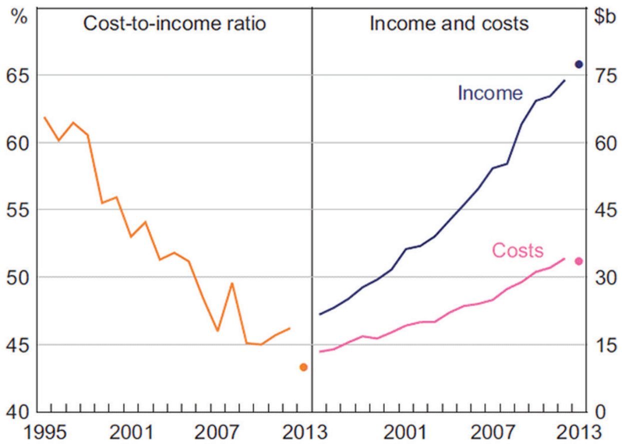

* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.
Sources: Banks' financial reports; RBA

### Graph 6: Major Banks' Deposit Rates




* Spread to cash rate; existing customers only; excludes temporary bonus rates
Sources: Bloomberg; RBA

### Graph 7: Major Banks' Cost to Income*




* Measured on an underlying basis; data from 2006 are on an IFRS basis, while prior years are on an AGAAP basis; includes St. George and, from 2009, Bankwest; dots represent financial year 2013 analysts' forecasts
Sources: Credit Suisse; Deutsche Bank; Nomura Equity Research; RBA; UBS Securities Australia; banks' annual and interim reports

In summary, the Australian financial system is relatively robust on the key dimensions of stability, competitiveness, innovation and efficiency. It is upon this sound platform that we must consider ways to prepare our financial system for the future growth needs of the Australian economy.

# IV. Key Themes and Issues

## 1. Funding

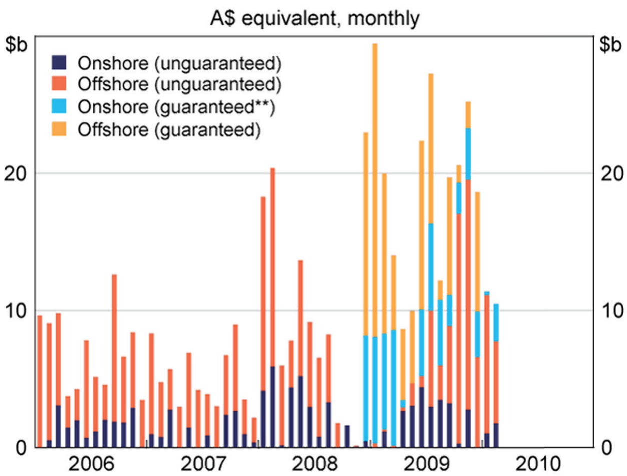
**Key Issues**

A stable and well-funded banking system which can withstand pressures from international shocks is critical to the long-term stable growth of a small open economy like Australia. In particular, Australia's banking system needs to be configured in a way that allows it to better finance the country's long-term infrastructure needs.[9]

The issue Australia faces is that its banking system has been overly reliant on offshore funding, making its future growth prospects subject to international market volatility. For example, Australia's major banks have regularly featured in the top 10 of global issuance, which is disproportionate for a country with ~2% of global GDP.[10]

While the Australian economy can be funded in most circumstances, the GFC highlighted that Australia's reliance on offshore funding can come under pressure during times of crisis. During the GFC, the Commonwealth Government guarantee allowed Australian banks to continue to access offshore wholesale funding (for which the Australian Government received a fee from the banks), but there is no certainty that such a mechanism would be available and/or effective to avert a future offshore funding crisis (Graph 8).

**Graph 8: Australian Banks' Bond Issuance***




* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** Includes A$3.25 billion of issuance guaranteed by the UK government
Source: RBA

While deposit growth post-GFC has allowed Australian banks to increase the proportion of their funding sourced domestically, banks are looking to continue diversifying the funding product and investor base to reduce their reliance on unsecured global wholesale funding.

The ability to issue covered bonds is an important element that has assisted in lengthening average tenor and attracting new investors.

Several issues which are hampering efforts to further diversify sources of funding for future growth and maintaining stability through the cycle are outlined below.

### 1.1. Impediments to greater use of interest-earning investments such as deposits

NAB suggests several ways in which regulation can be amended to make deposits a more attractive source of funding as follows:

i) **Tax treatment:** As outlined in the 2009 Henry Tax Review, there is currently a significant tax advantage for investments other than interest bearing investments. For interest bearing investments, including deposits, tax is calculated at marginal tax rates on nominal returns. By contrast, there are significant tax benefits afforded to other investment assets (i.e. franking credits, capital gains tax discounts, negative gearing).

ii) **Accessing superannuation funds:** There is a prudential regulatory impediment in sourcing deposits from superannuation, which now account for 17% of the total Australian deposit pool.[11] Deposits from superannuation funds other than SMSFs have less favourable treatment under APRA's Basel III liquidity requirements when compared with at-call deposits. Specifically, APRA has stipulated that the Basel III liquidity coverage ratio (LCR) requirements for directly sourced Retail or SME at-call deposits will have a 5-25% runoff, while deposits sourced from non-SMSF superannuation funds, which are generally treated as Financial Institutions (i.e. wholesale in nature with high liquidity risk), will have a 100% runoff rate.[12] This discrepancy makes it difficult from a liquidity perspective to provide a return that is sufficient to incentivise large superannuation funds to further invest in deposits.

**Recommendations**

1.1.1. Reduce the tax bias against deposits by removing relative tax penalties for interest income which may be achieved by having an offset for inflation and/or a discounted tax rate.

1.1.2. APRA to introduce a new "run-off" category for superannuation deposits at 50%, higher than the run-off assumption for Corporates (40%) but less than a bank or other Financial Institution (100%).

9 Infrastructure Partnerships Australia estimate that ~$700bn in essential infrastructure is needed in Australia.

10 Speech: 2012 Lowy Lecture: 'Funding Australia's Future' – Cameron Clyne, National Australia Bank.

11 Ibid.

12 APS210 Liquidity Standard includes a clause providing look through to underlying investor treatment for intermediary deposits that meet certain criteria. APRA adjusted this clause in the recent final rules to incorporate notification to APRA prior to utilisation of this definition. Very few deposit products are expected to be treated as intermediary under the current definition.

## 1.2. Increasing the role of superannuation in funding Australia's long-term growth and infrastructure requirements

Investment in infrastructure is vital to raising Australia's productivity to the levels that will be required to maintain its standard of living in the face of continuing population growth (estimated to increase by between 14.1 and 25.6 million over the next 50 years),[13] a near halving in the worker to retiree ratio from 5.0 today to 2.7 in 2050 due to an ageing population, and increasing life expectancy.

To date, government budgets, equity investors and debt providers, which are primarily the banks, have funded the nation's infrastructure needs. Notably, the level of funding from these sources is unlikely to be sufficient in the future, particularly in light of constraints on both the Government's fiscal position and bank funding due to Basel III. The large and growing pools of superannuation savings, which are $1.6tr today and projected to grow to be $3.0tr and $6.0tr by 2020 and 2030, respectively, become an increasingly vital source of long-term funding for nation building under this scenario.[14]

The superannuation system is an effective way to fund long-term infrastructure investment because it matches long-term liabilities in the superannuation system with long-term infrastructure assets. Notably, the superannuation sector has shown a willingness to invest in infrastructure assets at an equity level but involvement in the debt side has been limited to date. The key challenge to be addressed is how to make investing at the debt level of infrastructure projects more attractive to the superannuation sector. Increasing the superannuation sector's allocation to debt funding of infrastructure is expected to help nation building and also potentially provide more stable and secure pension returns through greater diversification. This would bring the asset allocation of the Australian superannuation system in line with that of global peers.[15]

The key impediments with respect to debt funding of long-term infrastructure projects by the superannuation industry include: the relatively uncertain yield, large size and undefined nature of infrastructure assets in the PPP pipeline; and the regulatory requirement for superannuation funds to be liquid to meet the '*at call*' nature of superannuation savings.

**Recommendations**

1.2.1. Create a deep and visible PPP transaction pipeline, in line with offshore markets.

1.2.2. Amend the size of PPP transactions so that projects come in smaller parcels, consistent with UK and Canadian markets.

1.2.3. Evaluate the adoption of a liquidity backstop facility for superannuation funds. This is required to increase the confidence of superannuation funds in investing in longer term assets without hindering their ability to meet member demands for switching or redemption. Specifically, the Inquiry should, at a minimum, investigate the following key questions with respect to implementing such a facility:

- i) Who would be the best party to provide a liquidity backstop facility?
- ii) What would be the likely cost of a liquidity backstop for superannuation funds?
- iii) What would be the legal structure of assets held in such a facility?

1.2.4. Increase the depth and liquidity of the retail corporate bond markets to broaden funding sources for infrastructure (see below recommendations 1.3.1-1.3.4).

## 1.3. Impediments to growth of the deeper and more liquid corporate bond market

There are several issuer and investor issues which have impeded the growth of corporate bond markets in Australia.

For Australian issuers, the key obstacle to overcome is the relative cost of raising corporate debt via issuing domestic bonds versus borrowing (either from domestic banks or offshore) or issuing equity capital. Moreover, the majority of potential corporate issuers are not large enough to have a credit rating which is a necessity for corporate bond issuance.

Investors have demonstrated a limited appetite for corporate bonds, reflecting the current tax bias against fixed income versus equities, partial awareness of the risk/return trade-offs in portfolio management, a tendency by fund members to not move away from default superannuation options which rely on equities to fund retirement incomes, and difficulty in accessing fixed income as shown by ASX listed volumes being very small compared to the unlisted market ($34bn vs. $450 bn).[16] These above impediments are exacerbated by restrictions around selling bonds to investors who do not fulfil the wholesale investor criteria. This creates the situation where retail clients are often able to access equities but not the bonds of the same issuers, despite bonds generally being more secure and stable from a capital structure perspective.

13 Source: ABS; Australia's estimated residential population to rise from 22.7m in June 2012 to between 36.8 and 48.3 million by 2061).

14 Sawers, R (2013), "What is required to design, develop and carry through the effective provision of infrastructure to sustain the development of modern society?" (SMART Infrastructure Facility – International Symposium, Sydney, September 30 2013).

15 The 2013 Global Pension Asset Study reveals the Australian Superannuation system has 15% invested in bonds and 54% in equities versus the pension systems of global peers such as Netherlands and Switzerland which have circa 30% invested in equities and 57% and 34% invested in bonds, respectively.

16 AFMA (2013) Australian Markets Report.

**Recommendations**

1.3.1. Remove tax penalties for fixed income holdings (e.g. tax discount for interest income; tax offset for inflation component in fixed income investments).

1.3.2. Develop national education programmes for retail investors, retirees and SMSFs on diversification, sequencing and risk/return trade-offs.

1.3.3. Reduce the distinction between retail and wholesale markets such as the wholesale investor criteria. In particular, this distinction could be removed for products that meet certain requirements, for example, corporate, investment grade rated bonds issued by companies that are already listed on a retail equity securities exchange.

1.3.4. Promote the listing of managed fund portfolios of fixed interest securities to allow efficient access by retail investors and SMSFs.

## 1.4. Regulatory threats to funding Australian growth in normal markets

The Basel III reforms have been progressively implemented since January 2013. An additional major item to be finalised is the NSFR. The NSFR measures the maturity mismatch between Liabilities and Assets. The ratio is defined as the proportion of Available Stable Funding (ASF) to Required Stable Funding (RSF), with banks required to comply with an NSFR of greater than 100% by January 2018.

In January 2013, the Basel Committee released draft NSFR rules for consultation. Once finalised these rules will be interpreted by APRA and applied through prudential standards for Australian banks. The deployment of the CLF to meet the Liquidity Coverage Ratio (LCR) requirements, serves as a recent precedent of how APRA has adopted an Australian specific response to a Basel III standard. As security for the CLF, Australian banks lodge repo eligible assets (including internal RMBS) with the RBA and treat them as Qualifying Liquid Assets for the purposes of the LCR calculation. Our view is that the implementation of the NSFR may require a similar Australian specific solution as banks may be challenged to hold sufficient stable funding to support their asset base under the proposed rules. If banks are forced to change their balance sheet structures to meet NSFR, their ability to fund economic growth could be adversely impacted.

As Australian banks consider the potential impacts of the NSFR, longer term, matched funding options will become more important. Securitisation of banks' assets provides one solution. APRA is currently updating its securitisation standard, APS120, which is due for release this year. APRA has indicated some key changes which include the ability for issuers to use master trusts. These master trusts represent an evolution of the static RMBS stand-alone structures with the key enhancement of allowing continual replenishment of the trust with new loans. Master trust securitisation structures only need to be set up once and can be used to issue numerous series of notes linked to just one asset pool. This means that there is always a constant balance of assets in the trust to allow for scheduled amortisation and bullet notes with a pre-defined maturity profile. Master trusts in the UK were developed to overcome the prepayment risk for investors and borrowers and are well developed and mature.

Master trusts provide an efficient funding tool for issuers to access the market more quickly, issuing smaller placements tailored to individual investor's demands, utilising assets that are not currently easily securitisable using existing structures and structuring securities with a more predictable payment profile. In principle, master trusts should reduce the cost of the currency swap and therefore the cost of offshore funding. In NAB's view, an area of concern is that some critical structural features (for example, related to the use of seller shares and date based calls) may be excluded from the updated standard which will reduce the efficiency of master trusts in Australia versus offshore jurisdictions.[17]

17 Seller shares generate principal payments that allow for more effective management of both repayment profiles and volatility of receivables balances. Date-based call options are applied to soft-bullet note tranches and are designed to support the repayment of principal when cash accumulated from underlying assets prior to maturity is insufficient, this mitigates extension risk for investors and swap providers.

**Recommendations**

1.4.1. As banks will need to source long-term stable funding to meet the Basel III NSFR requirements, there is a need to incentivise investors to fund banks by:

- Removing relative tax penalties for fixed income (see 1.1.1)
- Eliminating regulatory barriers to facilitate more efficient structuring of securitisation transactions. This involves allowing Australian issuers to incorporate features that allow efficient master trusts to be established. This includes, but is not limited to, the use of seller share and date based calls. NAB notes APRA is in the process of reviewing APS120 and the introduction of master trusts is being considered.
- Supporting the corporate bond market (see 1.3.1-1.3.4)
- Incentivising the superannuation industry to supply funding (see 1.2.1-1.2.4)

1.4.2. In relation to the proposed implementation of the NSFR, the construction and calibration of this metric should reflect structural features in the Australian system that will support compliance without unduly impacting bank balance sheet structures or the flow of credit in the broader economy. An example would be to provide RSF relief on internal RMBS held as collateral for the CLF.

# 2. Competition

**Key Issues**

Australia has a vibrant and competitive banking system allowing customers to benefit in terms of price and value, choice, innovation and flexibility. Within the constraints of a highly regulated financial system, market forces should be allowed to operate to drive greater efficiency and better outcomes for consumers.

It is also important to consider competition from non-regulated shadow banks and alternative payments entities. By international standards, Australia has a small shadow banking system, which consists of niche players that leverage their strategic advantages to capture small but profitable value pools. These players often bring innovation to the market (e.g. digital platforms), but they can also increase risk in the financial system.

NAB's views on the competitive issues for the Inquiry to consider are outlined below.

## 2.1. Threat to systemic stability posed by shadow banking

Shadow banks are entities or activities that undertake credit intermediation either fully or partially outside the regular banking system.[18]

In strong economic times, shadow banks usually increase their share of financial system assets. They look and act like regulated banks, despite lacking the support mechanisms used by regulated banks to manage the risks inherent in the maturity transformation process. This includes access to liquidity support from a central bank, strong prudential regulation, and well capitalised balance sheets. Only when economic conditions deteriorate does the absence of these support mechanisms become problematic, causing investors to withdraw funding. In periods of extreme stress, such as the GFC, the withdrawal of funding can be rapid and disorderly. The shadow banking sector loses share, until economic conditions improve, and the cycle repeats.

As recently noted by Federal Bank of New York staff members, Adrian and Ashcraft:[19]

> *"...it is the maturity transformation that renders financial intermediaries intrinsically fragile, since by definition an entity engaging in maturity transformation can at no time honour a sudden request for full withdrawals. The explicit, official liquidity and credit backstops by central authorities have reduced this fragility for banks, an arrangement that comes with the quid pro quo of subjecting these institutions to oversight and regulatory capital and liquidity requirements."*

If financial sector regulation is focused solely on ensuring the stability of the regulated banking sector without also considering risks inherent in the shadow banking sector, then systemic risk will not be reduced. Similarly, imposing excessive restrictions on the activities of the regulated banking sector simply creates arbitrage opportunities that see risks move into the shadow banking sector.

.8 Based on the definition used by the Financial Stability Board (FSB), Refer FSB, *Global Shadow Banking Monitoring Report*, 2013, p.5.

19 Tobias Adrian and Adam B. Ashcraft, "*Shadow Banking Regulation,*" April, 2012. Federal Reserve Bank of New York, Staff Report no. 559.

There are several ways in which shadow banks have the potential to pose a risk to the regulated financial system and to the broader economy as follows:

1. If shadow banking assets grow to represent a large proportion of the financial system overall. This is not yet the case in Australia. In 2012, the RBA estimated that (as at the end of 2011) non-prudentially regulated institutions represented 15% of Australian financial system assets, down from around 25% in 2007;[20]
2. If risks in the shadow banking system are not transparent; and
3. If shadow banks are interconnected with participants in the regulated financial system.

It is the combination of these three factors, not any one factor in isolation, which causes risks in the shadow banking sector to be transmitted to the broader economy.

**Recommendation**

2.1.1. Regulators should be permitted to supervise and/or restrict activities of non-prudentially regulated organisations, if, in their opinion, the activities of those organisations, either individually or in aggregate, pose a threat to the safety and stability of the financial system and/or to the broader economy. This could be achieved by granting the RBA authority to designate that an entity should fall under APRA's supervisory mandate. The nature and level of regulatory oversight should be determined primarily by an organisation's activity and risk profile, rather than by its legal classification.

## 2.2. Regulation of alternate payments systems

The payments system is a key transmission mechanism for systemic risk. For this reason, it is critical that participants in the payments system be subject to stringent regulatory controls.

In addition, participants operating within the regulated payments system have made significant investments in technology and processes, to reduce the likelihood that transactions can be used for criminal purposes, for example, via Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) rules as well as 'Know Your Customer' requirements. Payments systems operating outside the regulated framework have not been required to make these investments and do not adhere to these requirements. As a result, they are at greater risk of being used for criminal activity.

Over time, we have seen new payment mechanisms and stores of value emerge, some of which have been absorbed into the regulated payments system. More recently, we have seen the emergence of 'alternative' or 'virtual' currencies which operate entirely outside the regulated payments system. To date, these instruments have not represented a material proportion of value or transaction activity. Nonetheless, in the future, digital technology and social networking is likely to see a proliferation of these alternative platforms.

These alternative payments systems offer a means by which customers and businesses can store and exchange value, often for very little transaction cost.

As long as the use of these alternative instruments remains limited, they pose little risk to the overall financial system. Failure of these instruments would impact only those individuals and businesses that had chosen to store value on them or transact via them. However, if their use grows to a point where they represent large stores of value and/or material transaction activity, or if they interact with regulated financial system participants to any material degree, then failure of these instruments would represent a risk to systemic stability.

As payment systems increasingly move to real time clearing and settlement, it will become more difficult to recover fraudulent or other criminal transactions. This highlights the importance of having in place uniform client identification and reporting processes across all payment platforms.

**Recommendations**

2.2.1. Where new stores of value or payment mechanisms emerge which are not subject to regulation, the RBA should be permitted to take whatever steps are necessary to curtail or discontinue their use, if, in the RBA's opinion, these instruments represent a material threat to the safety and integrity of the financial system or to the broader economy.

2.2.2. Where new stores of value or payment mechanisms interact with the participants in the regulated payments system, they should adhere to the same client identification requirements as regulated participants, so as to ensure the overall integrity of the payments system.

20 Reserve Bank of Australia, Financial Stability Review, March 2012, based on 2011 data.

## 3. Regulatory Framework

**Key Issues**

Australia's prudential regulatory framework has made the Australian financial system resilient to external shocks such as the GFC. NAB believes Australia's current financial system regulatory framework has served the country well and strongly supports the objectives of changes to the regulatory structure post GFC such as Basel III and the G20 regulatory reform agenda. These latest reforms further promote stability and consumer protection in the financial system. Nevertheless, we see a range of regulatory issues for the Inquiry to consider.

### 3.1. Harmonisation and pace of domestic adoption of international regulation

There is an ongoing concern that the rate of adoption of international regulatory standards is not uniform across domestic jurisdictions, with Australian regulators generally being early adopters of international regulatory standards. In many instances there is no clear case for accelerated adoption. For example, in relation to the Risk Weighted Asset (RWA) Credit Valuation Adjustment (CVA) capital charge introduced under Basel III, APRA requires capital be held for all derivative counter-parties (except qualifying central counterparties, consistent with the Basel III framework). Post APRA's implementation, the European Union has diverged from Basel III by adopting the CVA charge in a form which exempts transactions facing non-financial corporate counterparties.[21] This means that when quoting for derivative business in competition against EU-based banks (in Australia and abroad), Australian banks are at a competitive disadvantage as they must hold a materially higher amount of capital than their European bank counterparts.

The speed of reform has also increased the risk of unintended consequences. A staggered implementation may have allowed APRA, the RBA and the banks to better understand the implications of the CLF and impact of banks owning 30% of the Government Debt market.

**Recommendation**

3.1.1. To harmonise the pace of adoption of international regulation, APRA should consider aligning future international regulatory reform implementation timetables with the majority of G20 countries.

### 3.2. The pace and burden of recent regulatory change has potentially created both a higher risk/higher cost financial system and unintended consequences

Recent regulatory change has been costly and complex, with NAB's regulatory and compliance spend rising more than 250% over the past three years. This increased regulatory burden is a result of requirements based on process rather than outcome, tight and concurrent timelines for compliance, and ongoing uncertainty post the change of government.

Two recent examples highlight that a more measured approach to regulatory change may have created a lower cost/lower risk financial system as follows:

1) **Stronger Super:** Of the 10 key Stronger Super obligations due 2H 2013, all were subject to continuing ambiguity necessitating Regulator or Class Order relief, and/or changed or clarified specifications, within 3 months of the compliance date. There are multiple agencies with jurisdiction over wealth management (APRA, ASIC, Australian Tax Office (ATO) etc.) with the ability to implement regulation that imposes added cost and complexity. Stronger Super and FOFA are expected to cost ~$2bn to the industry as well as further ongoing compliance costs. This cost will ultimately impact members via higher fees, fewer market participants or lower capacity for innovation and investment in customer benefits.

2) Level 3 Conglomerate reform has been another example of policy delays creating unnecessary cost. Having commenced discussions in 2010, formal prudential standards and guides remain unavailable at 17 March 2014, with a 1 January 2015 deadline. In addition, the implementation of what may be considered simple reporting requirements by APRA, for example the proposed Level 3 reporting requirements due 28 calendar days after the end of the quarter, will create significant cost with no clear commercial or prudential benefit.

   Notably, there were more than 60 regulatory changes active over the 24 months to March 2014, managed by multiple domestic and international regulators. A calendar of recent major regulatory change highlights that the financial system has experienced concurrent and uncoordinated regulatory change in Australia (Table 1), creating the potential for increased operational and compliance risk at firm and industry level.

21 Point (4) of Article 382 of the Capital Requirements Regulations (CRR) published in the Official Journal of the European Union, June 2013

**Table 1: Schedule of Selected Major Regulatory Changes (2010-2013)**

| Name of Regulatory Change | Australian Regulator | Date Initiated | Date of Commencement | Final Guidance Provided (Y/N) |
|---|---|---|---|---|
| APRA CPS 220 Risk Management (included as part of Level 3 program) | APRA | 18-Mar-10 | 1-Jan-15 | N (Draft Issued) |
| APRA Level 3 Conglomerate Supervision | APRA | 18-Mar-10 | 1-Jan-15 | Y |
| Basel III – Liquidity – APS 210 Qualitative Requirements | APRA | 16-Nov-11 | 1-Jan-14 | Y (20 December 2013) |
| Basel III – Liquidity – APS 210 Net Stable Funding Ratio | APRA | 16-Nov-11 | 1-Jan-18 | N |
| Basel III – APS 330 Public Disclosure | APRA | 9-Apr-13 | 30-Jun-13 | Y (26 June 2013) |
| ASIC CP 169: Term Deposits that are only Breakable on 31 Days' Notice: Proposals of Relief | ASIC | 4-Nov-11 | undefined | N |
| AUSTRAC Proposed Customer Due Diligence Reforms | AUSTRAC | 9-Dec-13 | 1-Jun-14 | Y |
| Stronger Super | ASIC | 21-Sep-11 | 1-Jan-14 | N |

In addition, the Australian financial system is also dealing with regulation that has extra territorial impacts such as Dodd-Frank and FATCA. In this regard, there is a clear need for consistent adoption of these requirements and Australian Government support is needed in selected areas (for example, FATCA implementation in Australia relies on an inter-governmental agreement and enabling legislation to be passed to support Australian entities).

**Recommendation**

3.2.1. To ensure the pace and impact of regulatory change is properly managed, consideration should be given to modifying laws or introducing a charter to ensure regulators adhere to a set of key principles and practices. This should entail:

- A clearly documented purpose and economic consideration of impacts to industry which would include an improved process for seeking cost impacts;
- Minimal duplication; and
- Consistency of approach across regulators.

**Recommendation**

3.2.2. NAB recommends that the Council of Financial Regulators (CFR) should be given a more formal structure and be tasked by the Treasurer to coordinate the implementation of regulatory change by APRA and ASIC. Where practicable, regulators and the banking industry can co-design the scope and timing of regulatory change to achieve a lower cost/lower risk financial system via:

- Practical commercial capability introduced in reform design to ensure faster and more effective policy making;
- Capacity support provided to policy makers to ensure they are able to execute to committed timetables; and
- Greater consideration and flexibility given to implementation timelines, once formal policy is confirmed.

## 3.3. Regulatory treatment of online savings versus branch deposits

APS210 Liquidity Standard currently assigns a higher run-off rate to online-only deposits compared to branch deposits. An online-only account generally delivers a weighting that classifies the deposit as “high run-off less stable deposit” requiring that 25c in the dollar to be held as liquid assets. For a corresponding branch or other channel deposit the requirement is 10c in the dollar. As there is now a growing level of new savings accounts that are online access only, this distinction does not reflect how the market is evolving.

**Recommendation**

3.3.1. Regulations should not discriminate on deposit value by channel. The other factors to derive quality are relevant and should apply equally to online accounts and accounts from other channels.

## 3.4. Capital treatment for bank-owned wealth managers

There are considerable consumer benefits in bank ownership of wealth businesses through potentially lower costs to the consumer arising from economies of scale, advice covering bank and wealth needs, and the strength of a trusted brand & balance sheet standing behind the quality of advice. Typically, banking and wealth needs converge as individuals approach retirement so, in the context of an ageing population, the ability for a wealth manager to meet both banking and wealth needs becomes critical. Also, financial products should be needs based, and should to available to customers at their critical life event stages. Banking and wealth businesses often are uniquely placed to be with and be aware customers at these critical life event stages.

The Australian banking industry has responded to these evolving customer needs by acquiring and establishing wealth management businesses, and in the process becoming financial services conglomerates, with the licensed banks being the ultimate holding companies of these groups. Licensed banks now sit at the top of a group of companies that deal with a more diverse set of business risks than traditionally managed by banks.

It has become an issue of how best to address the new risks associated with these conglomerate groups. To date, the regulatory response has been focussed on capital. There has been a series of regulatory changes (AIFRS, Basel II, LAGIC and Basel III), where Australian banks are now required to fund 100% of any investment in Wealth managers with Tier 1 equity. This approach seeks to address the perceived contagion risk between the banking entity and the wealth management subsidiary by simply adding more capital.

NAB does not believe this is the most effective way of dealing with the issue. The new capital imposts have made the bank headed conglomerate groups less competitive as a result. Ultimately, this becomes a cost to the consumer.

NAB believes legal separation is the most effective way of mitigating contagion risk, and believes it would be far more likely to succeed if the legal separation was reinforced by explicitly directed regulatory policy.

The non-operating holding company (NOHC) structure is an effective way of achieving legal separation. Under this scenario, the licensed bank would cease being the holding company in the group. The NOHC would be the new holding company, non-banking subsidiaries would be transferred out from underneath the bank to sit as “sister subsidiaries” of the bank under the common NOHC. The licensed bank would have no direct means of contagion to it – there will be no equity exposure in the bank balance sheet, and no direct governance responsibilities. Similarly, resolution schemes in the event of distress would be easier to implement. The capital requirements for the NOHC in respect of the wealth subsidiaries should be the same as for any holding company of a wealth business, thereby creating competitive neutrality in the industry.

NAB believes that mitigation of contagion risk is a crucial systemic concern. Regulatory policy should both encourage and reinforce legal separation. The current system does neither.

**Recommendation**

3.4.1. The capital requirements for each of the components of a banking and wealth management group operating under a NOHC should be determined having regard to the greater level of separation and lower level of contagion risk afforded by the NOHC structure.

## 3.5. The equitable distribution of capital: unit pricing

The accuracy and method of fund asset valuation is critical to the integrity of the investment process and ultimately, investor confidence. In particular, there is a need to mitigate the risk of member arbitrage. Daily unit pricing obviates the threats posed by member arbitrage; the alternative is the crediting rate method, which is generally applied either weekly, monthly or quarterly. Notably, APRA and ASIC issued a joint document entitled Unit Pricing Guide to Good Practice, Joint ASIC & APRA guide and made the following observation:

> *"...unitisation provides a more direct link to movements in asset values, investment income and transaction costs, as unit prices are calculated at, or closer to, the time unit holders acquire or dispose of products. Unit pricing avoids transferring investment returns between entering, leaving and ongoing unit holders (generations of unit holders). That is, unitisation may be perceived as providing more transparency and resulting in more equitable treatment of beneficiaries and fund members..."* [22]

Many public offer funds do not have daily unit pricing as a feature and apply a relatively infrequent crediting rate. As highlighted by the GFC, funds which held illiquid assets and used infrequent crediting rates exposed members to intra-fund member arbitrage. In the absence of daily unit pricing, fund members will continue to experience intra-fund member arbitrage, a phenomenon that has the potential to diminish superannuation savings and confidence in superannuation generally.

In a member-centric superannuation system that features fund choice, member investment choice and portability to facilitate inter-fund membership flows, it is imperative that appropriate steps are taken across the industry to accurately price fund holdings.

### Recommendation

3.5.1. Unit pricing is currently the most effective method of fund valuation and plays an integral role in ensuring equity and fairness remain features of Australia's superannuation system. Unit pricing in superannuation funds ensures accurate valuations and equitable distributions for all members. Consideration should be given to making unit pricing a requirement of all collective investment, public offer funds.

## 3.6. Cyber-security and digital identity

Cyber-crime continues to remain a significant and growing concern for the financial sector. Advancement in the sophistication of malicious tools used against the sector to commit fraud, disrupt service and data theft remain key challenges.

In the last 12 months, the financial sector has seen a significant growth of Distributed Denial of Service Attacks (DDoS) both domestically and internationally. These cyber-attacks are usually a response to a country or government entity for a chosen action.

Countries with significant high-speed network infrastructure take on a special risk. These countries are often a target to host Trojan Robots (botnets) as the significant network infrastructure allows very large attacks to be generated from a single computer in these environments.

As Australia rolls out the National Broadband Network, the potential threat presented to the financial sector in Australia will increase. Attacks from countries with fast network capability have shown that Australians computers will become a greater target to be used to host malicious botnets.

The need to share real-time actionable information will be crucial in addressing new threats faced by Australian companies. Integration of businesses into the Australian Cyber Security Centre will provide an important step in closing the information gap between business and Government.

Currently the Australian Government is not planning to implement a coordinated national control to prevent the NBN from being used for malicious purposes, rather leaving this to each service provider of the NBN to define. With a plan to migrate businesses and consumers to this national network, the opportunity to make major inroads into centrally disrupting botnets used for fraud, service disruption and data theft exists now.

### Recommendations

3.6.1. With the new Government revisiting the scope of the NBN, the potential for a relatively small investment towards integrated national security controls could result in a significant benefit to Australian customers and businesses.

3.6.2. Accelerating the integration of businesses into the Australian Cyber Security Centre will provide an important step in closing the information gap between business and government.

22 Unit Pricing Guide to Good Practice, Joint ASIC & APRA guide, November 2005

## 3.7. The changing procurement and delivery paradigm of technology

The advancement of technology as a service (e.g. cloud computing) and the ability to deliver high quality, resilient and accessible infrastructure, platforms, and services is changing the way we think about technology.

As this technology matures, recognition of security and privacy requirements are rapidly evolving to be enterprise class, and in many cases more efficient, capable and cost effective than individual companies can achieve alone. The effective use of cloud computing will be part of the next stage of technological advancement, and will be an essential competitive advantage to those that establish mature usage of those services.

As it continues to become cheaper to buy versus build technological solutions, the ability to bolt on added features or services and the secure integration of those services will become critical. Rather than simply purchasing staffing or outcome-based agreements, full managed services will continue to rise as the preferred choice of service delivery. Typically, those services will be made available through private, semi private or public cloud capability.

Understanding the benefits and limitations of where financial services institutions, could and should leverage these capabilities, is in the best interest of those institutions and its customers. The scale of resilience and redundancy at effective pricing, when implemented with high degrees of automation, will ultimately decrease operational risk, increase privacy awareness, and require much more sustainable security practices than bespoke or individual solutions.

APRA is currently creating guidelines for the use of cloud computing by financial services companies and it is imperative to consider the efficiency and performance benefits of this technology capability along with security, stability and customer privacy.

**Recommendation**

3.7.1. Regulatory guidelines should encourage, and not limit, the industry advancement around the use of new technologies such as cloud or third party computing services via a clear set of industry principles. We support the maintenance of a principles-based approach rather than prescribed guidelines that will unnecessarily restrict the use of cloud computing.

# 4. Financial Inclusion

NAB believes that it is important that all Australians have the opportunity to access the products and services of the Australian financial system, on a fair and equitable basis.

NAB has taken a leadership position in addressing financial exclusion in Australia. In 2011, in partnership with the Centre for Social Impact (CSI), NAB completed the first detailed measurement of the extent of financial exclusion in Australia and its relationship with social and economic disadvantage. Since then, this Financial Exclusion indicator has been published annually.

NAB's approach to financial inclusion has several key elements:

***Making banking more affordable:*** NAB has been working to make banking more affordable and accessible for all Australians, by providing basic, good quality products and services, ensuring fair fees and charges, helping and advising customers and showing compassion and support to those customers experiencing hardship. Examples of this include:

- Abolishing over-limit fees for new and existing credit card customers (prior to the introduction of legislation which made this compulsory);
- Removing application and early exit fees on home loans;
- Abolishing dishonour fees on personal and business transaction accounts;
- Delivering a 65% reduction in overdrawn fees charged to small business, as a result of the introduction of a $1,000 buffer for overdrawn fees;
- Introducing personal transaction accounts with no monthly account fees; and
- Creating a dedicated "NAB Care" team, to help ease financial hardship for customers.

***Providing world leading microfinance programmes for low income Australians:*** In conjunction with Good Shepherd Microfinance, the Commonwealth Government and selected state governments, NAB supports a wide range of microfinance initiatives in Australia. NAB has committed $130m of capital across the following schemes:

- No Interest Loan Scheme (NILS);
- Step UP Loans (small loans with a low interest rate);
- AddsUP matched savings plan;
- NAB Microenterprise Loans;
- Community Development Financial Institution (CDFI) Pilot; and
- Good Money Community Finance Hubs (a high street alternative to "fringe" lenders).

***Supporting Indigenous programmes:*** NAB has supported indigenous programmes that focus on providing better access to banking services to some of the most financially disadvantaged communities in Australia. This has included the introduction in 2013 of a new *Indigenous Business Australia (IBA)* split home loan product and improved Indigenous customer ID processes.

## 4.1. The importance of financial literacy

Underpinning these elements is an approach to build improved financial capability and understanding, which leads to enhanced financial literacy.

NAB has embedded financial literacy in all its microfinance offerings, believing that capability building is better achieved through experience than through general financial information sessions or brochures. All the programmes are underpinned by clients having a one-on-one interview with an experienced microfinance worker, who can help them with their individual circumstances. Workers are skilled by attending specialised training, such as the annual NILS Conference and Biannual StepUP worker training.

NAB also supports the following financial literacy initiatives:

- In April 2009, NAB developed the Indigenous Money Mentor Network;
- In December 2010, NAB launched a new on-line help and education section on its website, to help customers better understand banking products and services;
- In February 2012, we made available on our website information to help customers better understand how credit cards and the associated interest rates work; and
- NAB supports ASIC's "Money Smart" financial education programmes, which are part of the Federal National Financial Literacy Strategy. In 2013 NAB was recognised with Good Shepherd Microfinance for its contribution to research, as part of the Awards.

## 4.2. Small amount lending

Small amount lending is the provision by non ADIs of short term loans of $2,000 or less, that must be repaid within 16 days to 1 year. The sector providing these loans is often referred to as the 'informal lending sector,' 'fringe' or 'payday' lenders. The introduction of the Consumer Credit and Corporations Legislation Amendment (Enhancements) Act 2012 has addressed some of the concerns around this sector by introducing a cap on amounts that can be charged, in order to address the high interest rates, fees and charges and loan rollover practices adopted by some lenders.

There are currently no mainstream banking equivalents to small amount lending. Fair and affordable alternatives such as those delivered by NAB's microfinance programme are part of a considered response however, they are not direct substitutes for payday lending, as they are only available to people on government benefits and do not meet all market needs. Government needs to consider ongoing support that underpins existing alternatives and new innovative responses designed to provide fairer options for Australians experiencing financial exclusion.

In order to make further improvements to small amount lending practices, the economics of the sector need to be better understood. This includes:

- Accurately determining the size and characteristics of the sector (customer numbers, frequency of use, dollar value of loans outstanding); and
- Disaggregating the economics (loss rates, disclosure of income from fees and the nature of fees charged, cost to serve and marketing and distribution costs, etc).

**Recommendation**

4.2.1. A standard reporting methodology should be established for small amount lenders to allow the size and economics of the sector to be accurately assessed. Once the economics of this sector are fully understood, Government should give consideration to supporting new and existing microfinance alternatives that will provide fair, affordable and competitive small amount loan alternatives to those Australians experiencing financial exclusion.

## Concluding Remarks

NAB has welcomed the opportunity to highlight some of the key issues facing the Australian financial system.

We look forward to the opportunity to discussing our four critical themes and the recommendations that underpin this submission in more detail with the Inquiry over the coming months.

We would be happy to supply further information on specific issues as the Inquiry progresses its work and identifies areas of detail that require further examination and analysis.

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