CFR Review into Small and Medium-Sized Banks

AMP Bank Submission

AMP Bank
February 2025

AMP BANK LIMITED ABN 15 0815 960 09

AMP

CONTENTS

About AMP Bank 3
Executive Summary 4
1. State of Competition 6
2. Recommendations 10
3. Conclusion 17

ABOUT AMP BANK

AMP Bank, a subsidiary of AMP Limited, was established in 1998 and provides a range of retail banking services, including residential mortgages, deposit products, and transactional accounts.

AMP Bank was founded as part of AMP's strategy to diversify its financial services and leverage its long-standing reputation as one of Australia's leading wealth management companies, originally established in 1849 as the Australian Mutual Provident Society.

In recent years, AMP has undertaken extensive business restructuring affecting technology, platforms, finance, and legal functions.

As part of this process AMP Bank is now fully digital and is pursuing growth opportunities, including the upcoming launch of a digital bank targeting small businesses.

These measures reflect AMP's commitment to positioning itself for sustainable growth in the evolving financial services landscape. Ensuring a competitive regulatory environment remains key to its commercial growth ambitions.

AMP

EXECUTIVE SUMMARY

Concerns about competition in Australia's banking sector are not new, particularly those about competition between major and smaller banks. While some of the details about relative advantage might still be contested, these clearly are marginal. The big picture remains:

a) that the banking sector is trending towards further concentration around the four large banks that already control 72% of the market;

b) that this trend is not in the long term interest of customers; and

c) that if efforts are not made by Government and regulators, this trend will continue and Australia will have fewer and less-able challenger banks, or ultimately none.

AMP has contributed to the Australian Banking Association's submission to this inquiry, and we fully support its recommendations. The recommendations that would have the most impact from AMP's point of view are the following:

1. **Proportional regulation** and supervision through a three-tiered regulatory system that would better match regulation and risk.
2. Enhancing **capital settings** by addressing the capital differential between standardised and internal ratings-based approaches.
3. Balancing **funding** by increasing the issuance limit for covered bonds from 8 per cent to 12 per cent of total assets and reinstating the RBA's Committed Liquidity Facility, or similar vehicle.
4. Including the **ACCC as a permanent member of the CFR** to balance competition interests with other agencies' focus on stability.

AMP's submission below makes recommendations that are supplementary to the ABA's. While we acknowledge further work is required across government and industry to test them, we would argue an exploratory approach is required if this inquiry is to make significant progress where prior ones have not.

It is now critical that industry, regulators, and the Government work together to optimise competition within our banking system in a way that ensures the smaller bank sector is sustainable. This outcome is not only in the commercial interests of smaller banks, but also in the interest of consumers and the Australian economy at whole. Moreover, it is also essential to public trust in Australia's banking system.

RECOMMENDATIONS

Recommendation 1:

Systemically important banks be required to publish minimum capital requirements under both IRB and Standardised approaches, and be mandated to apply the highest as the 'floor'.

Recommendation 2:

Reduction in the risk-weight gap between household and business lending.

Recommendation 3:

Repurpose the Consumer Data Right to achieve full account portability.

Recommendation 4:

Raise the Financial Claims Scheme's $250,000 guarantee cap per customer to $500,000 for non-major banks.

Recommendation 5:

The Government to request CFR to provide advice on whether there is merit in introducing a market share deposit cap (with a long transition period) into the Australian banking market.

Recommendation 6:

The Council of Financial Regulators consider the costs and benefits of giving the AOFM a permanent mandate to purchase RMBS.

1. STATE OF COMPETITION

1.1 Importance of competitive markets

Banking and financial services are foundational to the daily lives of Australian consumers, businesses, and households. Beyond the basic functions of payments,

AMP

transfers, and deposits, banks provide essential services that drive economic activity and enable wealth creation.

Access to financial services allows consumers to manage their finances, invest for the future, and protect against unforeseen expenses. For households, banks provide critical support through housing loans, personal loans, and credit facilities, enabling them to acquire property, fund education, and finance major life events. These services contribute directly to individual financial security and prosperity.

For businesses, banks play a pivotal role by providing access to credit and working capital, facilitating trade and investment, and supporting growth and expansion. From small businesses to large corporations, access to tailored financial products and advisory services enables enterprises to manage risk, seize opportunities, and create jobs. A competitive and innovative banking sector further empowers businesses by offering diverse financing options and competitive rates, which are essential for economic dynamism.

These markets operate most effectively when there is healthy competition among banks, which drives lower prices, increased product diversity, and higher service quality. Competitive banking environments spur innovation, resulting in digital solutions, enhanced customer experiences, and more customised financial products that respond to evolving consumer needs.

Ultimately, a well-functioning banking system with vibrant competition fosters a resilient economy, ensuring that financial resources are allocated efficiently, customer satisfaction is prioritised, and both individuals and businesses have the financial tools to thrive.

1.2 The four major banks have long held a dominant position in the market

Depending on the data source, Australia's four major banks hold a market share of around 72% of total domestic assets.

The Global Financial Crisis marked a pivotal shift in the competitive landscape. Due to mergers between Westpac and St. George, and the Commonwealth Bank and BankWest, the major banks consolidated market dominance.

These mergers were primarily motivated by financial stability considerations, with competition outcomes deemed of secondary importance. 2008 also marked the year in which APRA introduced a dual approach to setting regulatory capital, giving the four largest banks a significant cost of capital advantage.

Outside the major banks, there are six banks with a market share greater than 1% of total assets. These are Macquarie Bank, Bendigo Bank, ING Australia, Bank of Queensland, and HSBC Australia. AMP Bank holds about 1% of the market. These

institutions are often referred to as Tier 2 banks. The remaining market share is held by credit unions and building societies.

Notably, the collective market share of the Tier 2 banks is less than that of the smallest major bank.

Overall, there has been considerable consolidation in the number of institutions providing deposit-taking and other financial services. Since 2004, the number of ADI licences has reduced from 242 to 142, a decline of more than one-third. Most of this consolidation has occurred among credit unions and building societies, considerably smaller entities that can be considered a third tier of banking.

1.3 The higher cost-to-income ratio is a major competitive disadvantage to smaller banks

A lower cost-to-income ratio is essential for banks seeking to maintain their market share, as it enables considerable flexibility in pricing. When faced with competitive challenges, a bank with a low cost-to-income ratio can afford to lower prices to counter market threats. In periods of lower competitive pressure, however, a low cost-to-income ratio allows for higher profitability.

Banks with a low cost-to-income ratio are also better positioned to reinvest more resources into strategic growth initiatives. Additionally, operational efficiency provides a buffer that helps them withstand economic downturns more effectively than banks with higher ratios, which may be more vulnerable to revenue drops or rising costs. A low cost-to-income ratio thus represents a form of internal financial strength that contributes to long-term stability.

Examining data from APRA's quarterly ADI performance survey, we can observe the difference in cost-to-income ratios between the four major banks and smaller banks. As of June 2023, the cost-to-income ratio for the four big banks was 47.0%, compared to 56.7% for Tier 2 retail banks.

Operating costs can also be compared through the metric of total operating expenses to assets. Using the same data source, major banks recorded a ratio of 1.0%, compared to 1.8% for smaller banks. On this metric, smaller banks have operating expenses nearly double those of the big banks.

These figures underscore the importance of ensuring there are no regulatory factors that disproportionately increase costs for smaller banks relative to larger banks.

AMP

1.4 Barriers to entry are high as demonstrated by recent exits of new banks

A concentrated banking system, characterised by a few large players holding substantial market share, can still foster competition if barriers to entry remain low. For example, when new players can easily enter the market, large banks are more likely to offer competitive pricing to deter potential entrants, doing so by lowering fees, increasing deposit rates, and providing favourable lending terms.

Unfortunately, the barriers to entry in the Australian banking sector are formidable, with regulatory compliance and significant capital investment posing challenges for new entrants. This dynamic has played out in recent years, with several high-profile entries and exits such as 86 400 (merged with NAB in 2021), Xinja and Volt Bank (both returned their licences in 2021 and 2022 respectively, citing difficulties securing funding).

1.5 Systemically important banks have higher capital requirements, but the additional cost is offset somewhat

For much of Australia's financial history, the status of the major banks as 'too big to fail' was never explicitly acknowledged, a policy known as 'constructive ambiguity'. Today, government policy more explicitly recognises banks that are 'too big to fail', formally known as 'systemically important'.

APRA designates the major banks as domestic systemically important banks (D-SIBs) based on criteria such as size, interconnectedness, and complexity, meaning their distress or failure would significantly disrupt the domestic financial system and economy.

To reduce the risk of failure, D-SIBs are required to meet higher loss absorbency (HLA) requirements by holding an additional 1 percentage point of Common Equity Tier 1 (CET1) capital, which is high-quality but more costly funding. This additional CET1 capital lowers the probability of failure but has a negative impact on banks' return on equity (ROE) and profitability.

While D-SIB status may increase equity funding costs, it can also reduce debt funding costs, as credit rating agencies view the additional loss absorption favourably. In other words, the higher funding costs associated with the HLA may be partially offset.

1.6 Implicit government support for big banks provides an additional credit rating boost

Perceptions of government support for major banks, confirmed by their designation as systemically important, have positive implications for their credit rating assessments.

Credit rating agencies, such as Standard & Poor's, provide the major banks with a two-notch credit uplift, which is higher than that given to any other bank operating in the Australian market.

2. RECOMMENDATIONS

2.1 Dual regulatory capital system must be optimised

AMP

Recommendation 1:

Systemically important banks be required to publish minimum capital requirements for both IRB and Standardised approaches, and be mandated to apply the highest as the 'floor'.

In Australia the Government, through its banking regulatory agency APRA, requires banks to hold a minimum amount of capital to absorb losses and provide resilience.

How this minimum capital requirement is calculated has been a longstanding issue for smaller banks, as it has resulted in larger banks achieving lower minimum capital levels and, consequently, more leverage and lower funding costs.

Under the current framework, there are two distinct approaches for setting minimum capital requirements for banks: the Advanced approach and the Standardised approach. To use the Advanced approach, a bank must have APRA authorisation.

The Advanced approach, also known as the Internal Ratings-Based (IRB) approach, allows banks to assess their own risk parameters for their exposures, such as probability of default (PD), loss given default (LGD), and exposure at default (EAD).

In contrast, under the Standardised approach, APRA assigns fixed risk weights to different asset classes (e.g., mortgages, corporate loans) based on a standardised set of criteria, rather than allowing banks to develop their own models.

APRA has estimated the cost of capital advantage for IRB banks to be in the order of 5 basis points (ACCC, 2023, p. 37). However, more recent estimates by the ABA place the benefit closer to 20 basis points.

This gap has narrowed since the Murray Financial System Inquiry recommended in 2014 that the major banks maintain higher capital levels to meet the benchmark of being 'unquestionably strong.'

Even so, the existence of any gap remains a problem for competition, particularly as the main lending product of retail banks—mortgage lending—is virtually commoditised. It is not clear that IRB banks manage mortgage risk any better than ADIs using the Standardised approach.

While the IRB system provides capital relief to the large banks, it acts as a major force for market consolidation. It is worth noting that a key argument used by ANZ and Suncorp to support their merger was the prospect of lower capital requirements. In an investor briefing, ANZ noted: *'The transaction will also provide an opportunity to realise cost synergies and potential capital release upon achieving A-IRB.'* (ANZ, 2022, p. 16)

AMP

In the United States, regulators have addressed the competitive disadvantages of this dual regulatory capital system. The largest banks there must calculate minimum capital using both the Advanced and Standardised methods and publish the results. Under the Dodd-Frank Act stress testing requirements, large banks must hold capital based on the higher of the two calculated results. In other words, Dodd-Frank establishes a capital 'floor,' creating a level playing field.

This is an effective system that provides a potential model for Australia. Systemically important banks could be required to publish minimum capital requirements calculated by both methods, with actual minimum capital levels set based on the higher of the two calculations.

If APRA's claim that the IRB approach provides only a marginal benefit to large banks (5 basis points) is correct, applying a floor based on the Standardised approach should have no material impact on the market. Given that the floor approach is used in the US, it also has strong international justification.

2.2 Access to finance for small business

Recommendation 2:

Reduction in the risk-weight gap between household and business lending.

Small businesses are a critical part of Australia's economy, accounting for over 40% of GDP and employing nearly half of the workforce. Limited access to finance constrains their ability to invest, innovate, and grow.

Access to finance for small businesses in Australia has long been a challenge, compounded by the regulatory risk-weighting framework that exacerbates this problem.

Risk weights, which determine the capital banks must hold against different types of loans, favour household lending (especially residential mortgages) over business lending, impacting the availability and cost of credit for small enterprises.

Residential mortgages typically attract lower risk weights (e.g., 35%) due to their perceived lower risk, while small business loans, particularly unsecured ones, attract higher risk weights (e.g., 75%-100%). The lower risk weights for residential mortgages

AMP

allow banks to allocate less regulatory capital to this type of lending, making it more profitable compared to business loans. Business lending is also more resource-intensive than housing mortgage finance, which is largely commoditised.

This regulatory incentive has contributed to a shift in bank lending portfolios, with a significant emphasis on housing finance at the expense of small business lending.

Getting the risk-weighting of business lending right is a crucial commercial issue for AMP Bank as we prepare to launch our Business Bank in 2025.

2.3 Re-purposing the CDR into seamless account portability

Recommendation 3:

Repurpose the CDR to achieve full account portability.

The Consumer Data Right (CDR) in Australia is a regulatory framework designed to give individuals greater control over their data and foster competition across industries.

The CDR was legislated under the Treasury Laws Amendment (Consumer Data Right) Act 2019 and was first applied to the banking sector, where it is often referred to as Open Banking. It was inspired by similar international frameworks, such as the EU's General Data Protection Regulation (GDPR) and Open Banking initiatives in the UK.

The goal was to enable consumers to access and share their data securely with accredited third parties. It was expected that this would encourage innovation by allowing fintechs and smaller firms to compete with established banks.

The implementation of the CDR has been a significant cost burden for smaller banks, involving system upgrades, data standardisation, and regulatory compliance. Within the retail banking industry, there is considerable frustration over the very high implementation costs of the program, particularly given the dismal consumer take-up.

Over time, it has become apparent that the CDR may have had a structural flaw from its inception. While the data made available to consumers was deemed highly valuable, its true value is realised only when transferred to another bank. In other words, the system's focus on enabling data access for individual consumers has

AMP

proven less impactful than anticipated. A more effective approach would have involved facilitating direct bank-to-bank account data transfers, utilising a simple customer authorisation process.

What is more valuable for consumers is a system akin to number portability in telecommunications. In the telco industry, customers can switch providers easily without the disruption of changing their phone number or notifying family, friends, and business contacts to update their systems.

A similar system should be implemented in retail banking: account portability. The work already done on the CDR can, at relatively low cost, be leveraged to enable the introduction of account portability. Repurposing the CDR in this way would justify the significant investment made in the program, provide a genuinely useful service for consumers, and enhance competition. Banks offering the best value products could acquire customers more easily, with less friction in the process.

Banks offering the best value products could acquire customers more easily, with less friction in the process. Needless to say, a nearly seamless process for customers to switch banks would greatly enhance competitive pressure in the market, penalising banks with poor service and product value while rewarding those with superior offerings

2.4 Financial Claims Scheme

Recommendation 4:

Raise the FCS $250,000 guarantee cap per customer to $500,000 for banks that are not DSIBs.

The Financial Claims Scheme (FCS) is a government initiative designed to protect deposit holders and certain policyholders in the event of the failure of an authorised deposit-taking institution (ADI).

The stated purpose of the FCS is to provide quick access to protected deposits and maintain confidence in the financial system by offering safety nets during financial institution failures.

Only institutions licensed by APRA have access to the scheme. It covers banks, building societies, and credit unions. Each deposit account holder is protected for losses up to $250,000 per institution. A wide range of deposit accounts is covered, including savings accounts, term deposits, and current accounts.

If an ADI fails, the government guarantees repayment of protected deposits within seven calendar days.

From a competition perspective, it is important to recognise that while the FCS helps provide a level playing field for smaller banks with respect to customer deposits up to $250,000, there remains a skewed playing field for deposits exceeding this threshold.

This disparity is particularly significant for business deposits, where working capital accounts can often exceed $250,000. Many high-net-worth individuals will keep deposits in excess of the current FCS insurance threshold.

For customer deposits above $250,000, banks that benefit from implicit government protections (i.e., D-SIBs) enjoy a distinct competitive advantage for larger deposits. To mitigate this advantage and help level the playing field the government should consider raising the FCS limit to $500,000 for smaller ADIs.

2.5 Deposit Market Share Cap of 10%

Recommendation 5:

The Government to request the CFR to provide advice on whether there is merit in introducing a market share deposit cap (with a long transition period) into the Australian banking market.

Similar to Australia's experience, the U.S. banking industry underwent significant deregulation in the 1980s and 1990s. Major legislation, such as the Riegle-Neal

Interstate Banking and Branching Efficiency Act of 1994, removed many restrictions on interstate banking.

Potential rapid growth among large banks raised concerns that deregulation might lead to the emergence of very large institutions. One response to this was the adoption of a 10% deposit cap within the Riegle-Neal Act. The cap aimed to limit banks' market power while allowing the benefits of interstate banking.

Following the 2008 financial crisis, concerns around large, systemically important banks increased, leading to major regulatory reforms. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 reinforced regulatory scrutiny on large banks, introducing further measures to monitor and limit systemic risk.

While Dodd-Frank did not directly change the 10% cap, it increased regulators' power to scrutinise mergers and acquisitions that might raise concentration concerns and introduced additional restrictions to limit systemic risk.

In addition to containing systemic risk by preventing institutions from growing too large, the 10% cap creates space for greater competition, providing more opportunities for regional and community banks to compete with large banks that benefit from 'too big to fail' status and materially lower funding costs.

Given the heavily concentrated nature of Australia's banking system and the regulatory bias towards promoting competition, a U.S.-style deposit cap may be an effective tool for enhancing competition. A 10% cap would likely be too low for Australia given our smaller population base, but a cap of 15-20% could be useful. A long transition period (i.e. 5 years) would ensure such a cap did not have any stability implications or overly disrupt the business plans of large entities.

There is natural reluctance for commercially focused businesses like AMP Bank to advocate a heavy interventionist policy such as a deposit market share cap. However, given the U.S. experience and the need for policy ideas to support both competition and stability, it is an idea worthy of consideration. The costs and benefits of a deposit cap would be a useful subject for investigation through the work of the CFR.

2.6 Making AOFM purchase of RMBS permanent

Recommendation 6:

AMP

The CFR consider the costs and benefits of giving the AOFM a permanent mandate to purchase RMBS.

During the Global Financial Crisis (GFC) and the COVID-19 pandemic, a key initiative of the Government to safeguard competition during times of extreme financial stress involved directing the Australian Office of Financial Management (AOFM) to purchase residential mortgage-backed securities (RMBS). These initiatives successfully played an important role in ensuring the financial system remained competitive post-crisis.

In the United States, the housing market is supported by a permanent arrangement for purchasing residential securities through government-sponsored corporations known as Fannie Mae and Freddie Mac. Their primary role is to purchase mortgages from lenders, package them into securities, and sell these securities to investors. This process provides lenders with fresh capital to issue more mortgages, fostering greater access to home financing.

By standardising mortgage terms and underwriting criteria, Fannie Mae and Freddie Mac play a pivotal role in stabilising the U.S. housing market, especially during economic downturns. Their existence is a key driver of competition, ensuring that small lenders are not unfairly constrained by deposit and other funding limitations. Major banks, with their implicit government guarantees, can easily access wholesale markets to fund asset growth, whereas smaller banks face greater difficulties in sourcing wholesale debt at competitive pricing.

While permanent agencies like Fannie Mae and Freddie Mac are not necessary in Australia, establishing a more permanent arrangement allowing the AOFM to purchase RMBS on an ongoing basis would be a powerful driver and safeguarding mechanism of competition.

Currently, such RMBS purchases are authorised only occur during times of crisis, but competition could be significantly enhanced by adopting a more permanent framework. Of course, sound design principles would be essential to ensure the program's success.

3. CONCLUSION

In conclusion, this report highlights potential policy reforms in Australia's banking sector to foster greater competition. The dominance of the major banks has created a concentrated landscape where smaller institutions, despite offering high-quality, innovative, and customer-focused services, struggle to increase their market share.

This concentration has led to higher costs for consumers, slowed innovation, and limited funding for sectors vital to economic growth, such as small businesses and start-ups.

AMP looks forward to discussing these issues further with the CFR, Treasury and the ACCC.