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The Secretary
Senate Economics Reference Committee
Suite SG.64
PO Box 6100
Parliament House
Canberra ACT 2600

Date 29 May 2012

Subject **Submission to the Inquiry into the Post-GFC banking sector**

Dear Sir/Madam

Rabobank would like to thank the Senate Economics Reference Committee (the Committee) for inviting Rabobank to make a submission with respect to recent developments in the banking sector arising out of impact of the global financial crisis and subsequent events. Our submission has considered the questions as stated in the invitation and to the extent that they are related, we have combined them in our reply to those questions in our submission.

a) the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements;

Rabobank acknowledges the importance of global regulatory reform post the global financial crisis (GFC). Rabobank also agrees and appreciates the Australian Prudential Regulation Authority's (APRA) effort to take a leading role in implementing the global Basel III liquidity and capital requirements to further strengthen the overall banking system in Australia by proposing to accelerate the implementation ahead of the Basel III timetable.

However, we would like to express the view on the importance of striking a balance to achieve improved stability in the banking system in Australia on the one hand, while balancing those objectives with sustainable costs of compliance on the other that will not create uneven playing fields. Banking is a global business and the recent GFC has resulted in a number of foreign banks leaving or reducing their exposures in Australia. While we are not suggesting that such trend is to be continued, the high costs of compliance is likely to be a key consideration for all banks that operate in this country.

Since the finalisation of Basel III regulations on capital and liquidity last year and subsequent announcement by APRA to accelerate its implementation timetable for Basel III capital and liquidity requirements, banks have already shifted their focus in order to be early compliant. This has already resulted in significant changes in the banking landscape in Australia.

On the capital front, most of the listed local banks have raised more capital by means of directly tapping into the stock market either via issuing more common equity or hybrid instruments in recent times. This has the longer term implication of lowering the return on equity, which is already happening in some of the locally listed banks in their most recent profit announcement.

On the liquidity front, we have witnessed fierce competition for deposits, with internet based call deposits often being offered by many banks at rates substantially above the Reserve Bank's official cash rate.

Meanwhile the costs of holding high quality liquid assets, in order to fulfil higher liquidity requirements, have soared due to the limited supply of high quality Commonwealth Government securities. With the Federal government's intention to return the Federal budget to surplus, it is anticipated the supply of these securities will reduce further in the coming years, leading to even higher costs of holding these assets as required by the new Basel III rules. The regulatory pressures to hold these securities seem to be defeating the purpose of holding such assets, as most banks will hold onto these assets for their own liquidity management purpose, and thereby further reducing the circulation and liquidity of such assets.

In summary, the new regulatory liquidity and capital requirements have significantly added to the costs of providing banking business in Australia, either directly in the form of more capital required or indirectly in the form of more competition in deposits and higher costs of holding liquid assets. The increased regulatory cost pressures on the banking sector, if not absorbed by the banks, will to some extent be passed onto Australia customers (businesses and consumers). Ultimately leading to increased living and business costs, which could stifle growth.

b) the current cost of funds for lending purposes and its impact on borrowing and lending practices in the banking sector both during and since the global financial crisis;

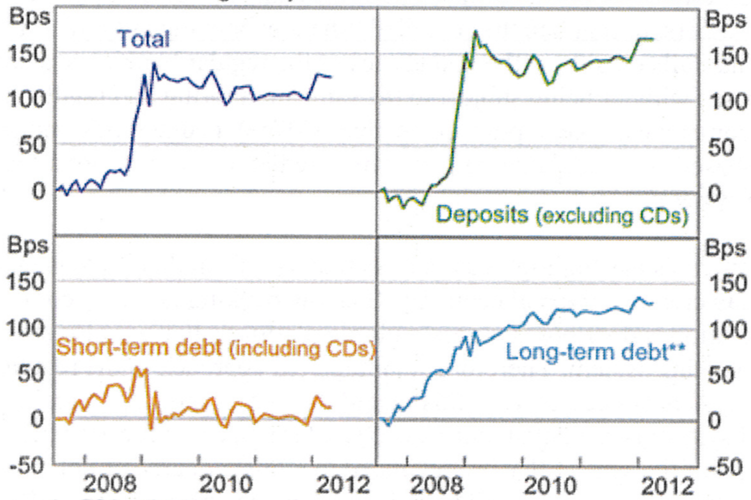
It is worth noting that the Reserve Bank has supported the view that the Australian banks have experienced higher costs of funding. The Reserve Bank in its most recent quarterly statement on monetary policy, has stated that "the banks' outstanding funding costs relative to the cash rate were estimated to have increased by about 20 basis points since mid-2011, partly reflecting the effects of ongoing competition for deposits".

On the one hand, the government and the prudential regulators are committed in maintaining a robust banking environment in Australia by requiring more capital and liquidity that will cost the banks, while on the other hand the banks are being confronted and criticised if they passed on the higher costs of compliance to their customers.

The higher costs of funds come from the fact that the new Basel III requirements dictate more stable funding to fund the balance sheet of banks, the sources of which are mainly from either long term wholesale funding or from retail deposits. As demonstrated in the chart below, both sources of funding have gone up substantially after the GFC.

Major Banks' Funding Costs*

Cumulative change in spreads to the cash rate since June 2007



* RBA estimates

** Weighted-average spread to cash rate and CGS for long-term variable rate and fixed-rate debt, respectively. Includes foreign currency hedging costs.

Sources: Bloomberg; RBA; UBS AG, Australia Branch

Despite the reduction in the cash rate since late 2011, the absolute level of Australian bank's funding costs remains high as shown by graph above, particularly in the cost of term deposits and long-term wholesale debt as financial market conditions deteriorated in late 2011.

The average cost of the major banks' funding is estimated to be about 120–130 basis points higher relative to the cash rate compared to mid 2007. The increase occurred mainly during 2008 and 2009 when the financial crisis was at its most intense, and a further increase of 20-25 basis points in mid 2011.

The higher funding costs are unlikely to reduce, as cheaper long term funding that were raised before the GFC and recent European sovereign debt crisis mature, only to be replaced by much higher current costs of long term or deposit funding. This means the weighted-average cost of funding is likely to continue to rise, putting further downward pressure on net interest margins of all banks that operate in Australia.

c) *the need for further consideration of the state of the broader finance and banking sector*

The foreign banks that operate in Australia have significant and important roles to play. For example, in the case of Rabobank, we are dedicated to providing specialised lending solutions and corporate financial services to the rural and farming communities across the value chain in Australia. The food and agribusiness sectors in Australia are increasingly becoming strategically important to Australia and to the rest of the world. Our Netherlands-based Rabobank parent is among the world's 25 largest financial institutions (based on tier one capital) and is one of Europe's most recognised financial institutions with strong credit rating. It is the dominant financial services provider in the Dutch market. Our presence here in Australia provides a viable and competitive financing alternative to the food and agricultural sector.

Shadow banking system

The credit crisis was the immediate cause for plans by the European Commission and the G20, amongst others, to regulate the so-called "shadow banking system" - the part of the financial system that falls outside of the boundaries of the regular banking system but can create the similar risks without being subject to the same monitoring and regulatory rules. Finance and leasing companies, special purpose vehicles (SPVs), hedge funds, money market funds and even internet-based shops and non-bank payment/settlement system are all part of the shadow banking system.

The credit crisis has highlighted the risks that a crisis in this somewhat non-transparent financial system can create in the real economy. Shadow banking is a very complex system as credit intermediation is distributed across multiple platforms that are also strongly intertwined with the regular banking system. Therefore, an integrated approach to the regulation of the shadow banking system is necessary. In this regard it is also important to realise that when part of the financial system is regulated more closely, a larger part of the activities are likely to shift to other parts of the system that are regulated to a lesser degree or not at all. For that reason, overregulation of the traditional banking system may prove to be ineffective in a macro view unless shadow banking is also appropriately regulated. The importance of taking action has become greater because of the stricter regulation of banks. Regulation of the shadow banking system is not easily achieved, but it should not be ignored either.

Competition

Many Australians are still not benefiting from higher deposit saving rates. The majority of retail deposits are still placed in low interest rate deposit accounts offered by mainly the larger domestic banks. It was only with the introduction of high yielding internet savings accounts lead by foreign banks that have resulted in more competitively priced savings accounts to be offered in the market place. Foreign banks and increased competition plays an important role in the Australian banking sector, for the benefit of Australian businesses and consumers.
On the lending side, competition has increased from subdued debt growth. Immediately after the GFC, consumers and corporates alike have restructured their personal finances and corporate balance sheets by deleveraging. This leads to very slow in credit growth across the markets in recent times, which in turn put pressure on banks to compete for lending and balance sheet growth. Some local banks have chosen to grow in overseas locations, thereby linking the Australia banking systems to other part of the financial world.

With most of the local banks heavily concentrated in the mortgage market, the recent slowdown in the housing market has forced the banks to look at other areas to compete for growth. This potentially may lead into a vicious circle of sacrificing credit quality and profitability for growth. Aggressive temporary pricing by domestic banks in certain segments of the market could also ultimately lead to reduced competition, with smaller players leaving that segment or the market entirely. In addition, the major local banks' high concentration in the housing mortgage market is susceptible to concentration and systematic risks and a down turn in the housing market may result in banks taking significant amount of provisions, which would further put more pressure on the profitability, capital and liquidity, and possibly weaken the financial strength of the entire banking systems.

The foreign banks have brought in capital, management expertise, job opportunities, liquidity and investments in Australia and they have been providing a real alternative to local corporate and private customers. It is therefore important to provide adequate incentives and to ensure a level playing field for foreign banks to compete and to operate in Australia.

d) any other relevant matters.

Withholding Tax and Libor Cap

Post the global financial crisis, we have seen reduced competition within the Australian banking sector with some foreign banks leaving the market or reducing its presence. Although already raised by the foreign banks represented by the Australian Financial Markets Association, the current local withholding tax impediments continue to limit the extent foreign banks can effectively compete against the larger domestic banks in terms of offering lower lending rates to its Australian clients.

Foreign banks cannot borrow funds from its parent without being subject to at least 5% Australian interest withholding tax. Although, the Government has already specifically announced that the interest withholding tax rate on foreign bank branches borrowing from their parent entities, will reduce from 5% to 2.5%, and eventually down to 0%. This phasing out of the withholding tax rate, has already been deferred one year and will not start to apply until 2014/2015. This delayed application continues to limit the flexibility and competitive advantageous that foreign banks can utilise to compete with the domestic banks.

Similarly, though less applicable to Rabobank, another tax impediment to increased competition is the 'Libor cap'. Foreign bank branches that borrow about the libor rate will be denied a tax deduction on the excess above the libor rate. Both the 'libor cap' and the withholding tax, stifles increased flexibility for foreign banks to sources cheaper funding which would be for the benefit of Australian clients, and promote competition within the banking sector.

All of the above factors add pressure to the long term viability of banks that operates in Australia. The banking market in Australia is relatively small in comparison to other financial markets such as United States or Europe. For that reason, many large local banks have to go overseas for asset growth and for funding. The Australian banking system is therefore linked to the rest of the world. It is important to realise the Australian banking system cannot be fully self reliant and be fully immune from global financial crisis. It is therefore important that the regulators are not only domestic focus but also taking a more global and holistic view of banking regulations, including regulation of shadow banking in order to ensure level playing field is maintained.

Yours faithfully

George Yau
Chief Financial Officer