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The Big Bank Tax

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FINANCIAL POLICY BRIEF

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The budget announcement of a six basis point levy on a subset of bank liabilities looks arbitrary, and is certainly politically opportunistic. But it could be rationalised as a response, albeit probably not the best response, to offsetting a number of distortions in Australia's banking market. The government, however, has not really spelt out a coherent explanation of the rationale for the levy. The levy will certainly have consequences for bank pricing, forms of funding and competition – and will interact in complex ways with other prudential regulatory changes in the pipeline.

The levy has the following features.[1] The four majors and Macquarie will pay a levy of six basis points p.a. on liabilities other than deposits protected by the Financial Claims Scheme (ie under $250,000) and additional Tier 1 capital instruments. As a ballpark estimate, it will apply to around 50 per cent of a bank's total funding, raising the overall cost of funding for the affected banks by around three basis points.

How can this impost be justified? One argument might be that the large banks receive a competitive benefit (lower borrowing costs) from an "implicit government guarantee" associated with being "Too Big To Fail". On this basis the levy could be seen as a charge for that benefit.

A second argument could be that (as in Europe) it would be desirable to establish a "resolution fund" to enable APRA to facilitate a smooth exit (eg by merger) of a failing bank. Although the levy goes into general budget revenue rather than a distinct fund, it could be further argued that by improving the fiscal health of the government it makes it better placed to support APRA in any needed bank resolution activities.

A third argument could be that the nature of the regulatory system (such as capital adequacy requirements) creates a competitive imbalance favouring the big banks. The imposition last year of higher minimum capital requirements for mortgage loans by banks regulated under the "Advanced" approach (the five banks subject to the levy) was only a partial response to this imbalance.

[1] It is not clear from the budget papers, but by categorising the impost as a levy rather than part of company tax, the banks may not generate further franking credits from payment of the levy (which otherwise could be passed on to shareholders and, through use of those credits, offset a large part of the revenue consequences for the budget).

A final argument could be that Australian banks have relied too much on funding other than "core/stable" deposits and capital, with potential consequences for safety and systemic stability. Indeed, the large banks have funded their increased share of home mortgage lending since the GFC to a significant degree from wholesale borrowings.

Each of those arguments has some merit – but there are other, and probably better, ways of dealing with the perceived distortions. Instead, the government has gone for a quick, politically opportunistic, measure which helps the budget position and will probably appeal to much of the electorate – even though almost all are bank shareholders indirectly via their superannuation accounts. And, together with other bank accountability measures introduced in the budget, it may neutralise whatever support exists for a Banking Royal Commission.

The levy is likely to have a number of significant effects on financial markets and consumers of financial services. The first point is to note that the levy will flow through the banks' funds transfer pricing systems to affect loan pricing. In this regard it is somewhat silly to simultaneously suggest that the big banks shouldn't increase loan interest rates, but that the measure will improve the competitive position of smaller banks. The latter will only happen if the large banks do respond in that way!

A second effect is that the large banks will have incentives to fund loans differently. In particular, by originating and then securitising loans (to get them off-balance sheet and funded by the capital market) they will avoid the levy on that part of their activities. However, that benefit won't apply if they use "covered bond" securitisation. The levy is thus likely to give a kick to traditional securitisation over on-balance-sheet lending, but stymie the growth of covered bond funding.

A third effect will be upon the structure of bank deposit interest rates. Because retail deposits are exempt from the levy, the large banks can be expected to bid for these deposits – pushing up the interest rates offered relative to the cost of borrowing in wholesale and large deposit markets. That is going to compound the already apparent effect on relative interest rates due to recently and forthcoming liquidity regulations being applied by APRA. But it will worsen the relative returns that superannuation funds can get on (their large) bank deposits and possibly induce them to look towards investing more in securitised products.

It is perhaps also worth noting that the budget involves changes which will increase competition for retail deposits. The case in point is the measure allowing individuals to make limited, tax advantaged, contributions to superannuation which can be subsequently withdrawn for a house deposit.

A further likely effect is to encourage banks to make more use of equity capital and additional Tier 1 (AT1) capital funding (the preference share structures listed on the ASX and held by many retail investors) relative to Tier 2 capital funding (provided by the wholesale and institutional markets) or other wholesale funding. While more capital funding is still required to meet the “unquestionably strong” criteria proposed by the Murray inquiry and accepted by the government, it is far from clear that increased reliance on the complex AT1 is a socially desirable outcome.[2]

How much of the impact of the changes will fall on shareholders in the large banks (and how large will the effect be) rather than upon customers? That is difficult to answer with any confidence without further detailed analysis beyond the scope of this article. The revenue to be raised is large in absolute dollar amount – but is relatively small as a percentage of current bank profits (in the order of 4-5 per cent).

It could be expected that some part of the levy will be passed on to customers, or avoided by the banks shifting to other forms of funding which do not incur the levy, such that the short-run direct impact on after tax profits and shareholders is somewhat less than that 4-5 per cent figure. But the big unknown is how the change, in conjunction with a plethora of other ongoing regulatory changes affecting the financial sector affects the competitive balance between the big banks, smaller bank competitors and capital markets and thus their longer run prospects. That awaits further analysis.

Disclosure: Kevin Davis owns shares in a number of Australian banks both directly and indirectly via superannuation.

This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies

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[2] Kevin Davis (2016) “Bail-in Securities: Is the game worth the candle?: Australian Centre for Financial Studies *Financial Policy Brief* 2016-03 http://australiancentre.com.au/publication/bail-securities-game-worth-candle/

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