Statement Number 10 of
The Australia-New Zealand Shadow Financial Regulatory Committee

Melbourne April 11, 2012

Do the Big Four Australasian Banks Require Special Regulation?

Following the Global Financial Crisis, regulators internationally have paid increased attention to the role and regulation of systemically important banks (SIBs). In this statement the ANZSFRC examines the systemic importance of the big four Australasian banks and considers the appropriate regulatory response.[1]

We conclude that:

- The simple fact that any of the big four, if in trouble, would likely be "too big to swallow" by other banks means that a different regulatory approach is appropriate for them compared to other smaller institutions where regulators can arrange exit via takeovers or allow failure
- The emphasis in trying to avoid future costly financial crises should lie in trying to limit the negative social externalities of bank failures rather than simply in trying to make such failures less likely.
- Some mechanisms for reducing risk of failure are worth considering, such as special additional contingent capital requirements. A simple comprehensive, difficult to avoid, leverage ratio offers a better chance of avoiding future fragility than increasingly complex risk-weighted capital buffers
- The current differences in Trans-Tasman resolution arrangements do not appear to pose insurmountable problems in dealing with an individual troubled SIB, although they are unlikely to prevent the risk of Trans-Tasman runs by depositors and other creditors. Conversion of operations to Non-Operating Holding Company (NOHC) structures (where both Australian and New Zealand operations are separate subsidiaries of the NOHC) would reduce direct spillover effects, but in the absence of greater clarity on Australian Government attitudes towards dealing with troubled SIBs, perhaps not the risk of contagion,

Background

The global financial crisis highlighted the importance of problems resulting from interdependencies within the financial system. As a result, regulator focus has, in part, shifted from a *micro-prudential* emphasis towards *macro-prudential* or *system stability* concerns. Among recent proposals[2] are additional capital requirements for financial institutions deemed to be globally systemically important banks (G-SIBs) whose failure would cause negative social externalities through financial and economic disruption.

[1] While we focus on banks, we recognize that one of the major errors revealed by the financial crisis was the failure to realize that other financial institutions such as insurance companies are also systemically important.

[2] Basel Committee *Global systemically important banks: assessment methodology and the additional loss* absorbency requirement Rules text November 2011 http://www.bis.org/publ/bcbs207.htm

The Basel Committee determined that 29 large banks warranted designation as G-SIBs, with additional capital requirements proposed for phasing-in from the start of 2016. The criteria used for inclusion were: cross-jurisdictional activity; size; interconnectedness; substitutability/financial system infrastructure; and complexity

Although the big four Australasian banks (ANZ, CBA, NAB, Westpac; henceforth the Big Four) are relatively large by international standards, operate across national boundaries, and have substantial international wholesale market liabilities, they were not included in this list.

Too Big to Swallow: D-SIBs and R-SIBs

Although not considered G-SIBs, the Big Four are nevertheless systemically important. Their dominance of the banking systems in both Australia and New Zealand, and the consequent reliance of other financial and non-financial entities upon their services, means that their financial health is fundamental to domestic and regional economic stability. Equally important, they are clearly captured by any reasonable 'too-big-to-swallow' test, unlike the case of smaller institutions where regulators can facilitate takeovers of troubled institutions (or let them fail). It is extremely difficult to imagine circumstances in which any troubled member of the Big Four could be merged quickly with another member. As well as the scale of potential risks to the acquirer of such a transaction, it would exacerbate banking market concentration. Therefore, if any of them should face failure, direct government intervention of some kind will be required to avoid a system-wide collapse.

For this reason, from the perspective of regulators in Australia and New Zealand (and for some Pacific Islands), we believe the Big Four can be accurately described as Regional Systemically Important Banks (R-SIBs) and Domestic Systemically Important Banks (D-SIBs).[3]

This raises the obvious question: what is the appropriate regulatory approach towards such banks?

Regulating SIBs: Minimizing Harm

History tells us that bank failures will occur from time to time. As in other industries troubled institutions should, on efficiency grounds, be allowed to fail. But they should exit the stage as gracefully as possible, with minimal social disruption and adverse consequences. It is the negative social externalities of failure of SIBs which give rise to proposals for special regulatory treatment. However, resolution arrangements (including "bail-outs" due to too big to fail considerations) which exist to shield stakeholders from

[3] In other countries there has been much debate about where to draw the dividing line for designation as a SIB. In the Antipodean case, the dividing line between the four majors and the others (with the possible exception of Macquarie) is so obvious that the debate is hardly necessary.

loss have the moral hazard downside of reducing market discipline and allowing (if not inducing) socially excessive risk-taking by SIBs.[4]

While increasingly complex regulations and intrusive supervision may reduce the probability of bank failures, recent experience does not provide much comfort in that regard, and there are significant costs involved. Thus we are more persuaded of the merits of minimizing harm from failures, rather than trying to prevent failures. Nevertheless, two proposals[5] which focus upon the latter objective are of interest.

Regulating SIBs: Reducing Risk of Failure

We believe that an additional contingent capital requirement for SIBs is worthy of further consideration - subject to determining appropriate design of such contingent capital securities (CoCos). While such hybrid securities (which convert into equity in times of distress) may appear to be expensive to the issuer, their role as a risk-absorber which protects higher ranking claimants should reduce the cost of other forms of debt. And if it does not, because those other creditors of SIBs believe that they will be "bailed-out" by government, that is an unwarranted private benefit to SIB shareholders arising from a negative social externality in the form of a contingent liability of the taxpayer. Because CoCos directly reduce the probability of failure – through the "topping up" of equity capital in times of need - and also indirectly because of increased incentives for monitoring and market discipline by holders of CoCos, that negative social externality is reduced.

We are of the view that greater consideration should be given to making the Basel Committee's proposed *leverage ratio* requirement a first line of defence against bank failure rather than a secondary backstop. That would involve a significant increase in the proposed required minimum. While SIBs may react to such a non-risk-weighted requirement by increasing the riskiness of asset portfolios, there is nothing to prevent regulators applying higher minimum requirements for individual institutions which they perceive as adopting increased risk.

The leverage ratio approach appeals because of its simplicity and potentially lesser scope for manipulation – which the risk-weighted approach of Basel was supposed to, but did not, prevent. While Australasian bankers and regulators are generally not in favour of the leverage ratio approach (having invested substantially in the costly Basel risk-weighting industry) there is little evidence that the risk-based approach has proven superior. At the very least, further cost-benefit analysis of the merits of the continually increasingly

[4] Whether these also provide a competitive advantage for SIBs which warrants offsetting regulatory treatment is also a question worthy of greater consideration.

[5] As well as additional capital requirements for G-SIBs, other suggestions not pursued here include: restructuring of banks ("retail ring fencing" as proposed by the UK Vickers Commission); limiting activities to reduce risk of failure (such as the Volcker rule in the US Dodd-Frank Act involving prohibition of proprietary trading); or additional taxes upon large and/or complex banks. Other ideas include trying to reduce organizational complexity and establishing living wills as a blueprint for action and are well worth pursuing.

complex Basel approach relative to a simpler (discretionary) leverage requirement is warranted.

Trans-Tasman Issues

Experience in the GFC has shown that it is very difficult for authorities in different countries to coordinate when cross-border SIBs get into serious trouble and risk failure: Lehman Brothers, Fortis and the main Icelandic banks are obvious examples. Two main approaches have been suggested to handle this. The first is to harmonize the arrangements across countries as far as possible and the second is to ensure that the parts of the SIB in each country are highly separable.

New Zealand has not merely chosen the second of these approaches but is also instituting a very specific resolution regime, labelled 'Open Bank Resolution' (OBR). OBR requires SIBs to be locally incorporated and capitalised and structured in a way that they can operate independently from their parent within the value day. Furthermore the resolution process involves a statutory manager stepping in, applying a conservative valuation to the extent of the losses, writing down the creditors, and reopening the bank (probably with a government guarantee) at the end of the day without operations ceasing. There will thus be no taxpayer funds used in this initial stage. Furthermore, there is no deposit insurance in New Zealand and depositors will be written down along with other junior creditors, subject to a de minimis exception.

Australia has been far less explicit about the resolution process, which itself poses a problem for the credibility of the arrangements, but it is clear that the approach will be different. The taxpayer will need to step in initially, not simply to handle deposit insurance but to keep the SIBs operating.

Despite the current level of separation between the Australian SIBs and their New Zealand subsidiaries, it is not realistic to think that the two operations will be immune to very serious repercussions in the event of failure in one or other country. If the parent fails the New Zealand subsidiary will need to be put under statutory management immediately. Similarly, the subsidiaries in New Zealand are sufficiently large that their failure would either bring down the parent through losses of equity and written down claims, or generate the fear that this will happen.

There are bound to be considerable counter-claims in the resolution over abnormal flows between the subsidiaries and the holding company. The parent may have advanced funds in the hope of keeping the New Zealand subsidiary open, and vice-versa if it was the Australian operations that were in trouble.

It is thus not realistic to assume that the two resolution processes can be treated as if they are completely independent. New Zealand has probably gone about as far with independence as is realistically possible. Australia on the other hand might want to protect itself by insulating the parent banks from potential problems in their New Zealand subsidiaries.

One possible way of achieving this might be by insisting that the Australian and New Zealand banks be separate subsidiaries of an Australian non-operating holding company. That would reduce direct financial spillover effects (although interbank loans would still be relevant). But in the absence of more clarity regarding dealing with troubled SIBs, reputation risk remains and is likely to mean that there will still be considerable contagion (and potential runs).

Dealing with potential failure of one Australasian SIB in isolation is difficult enough, but Trans-Tasman differences in regulatory approaches do not appear to greatly exacerbate those difficulties. If all banks face similar problems (such as in the GFC) cross-country differences in stated resolution and depositor protection arrangements are likely to become immaterial.

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Previous Statements

Since December 2006 the following statements have been issued by the ANZSFRC:

1. "**Managing Bank Failure in Australia and New Zealand: Rapid Access Matters**" (Sydney, December 2006).
2. "**Lessons from Recent Financial Turmoil**", jointly with the Shadow Financial Regulatory Committees of Asia, Europe, Japan, Latin America and the United States (Copenhagen, September 2007).
3. "**Responding to Failures in Retail Investment Markets**" (Melbourne, September 2007).
4. "**Mortgage Markets after the Sub-Prime Crisis**" (Wellington, June 2008)
5. "**Making Securitization work for Financial Stability and Economic Growth**", jointly with the Shadow Financial Regulatory Committees of Asia, Europe, Japan, Latin America and the United States (Santiago, August 2009).
6. "**Is a Credible Exit from Government Debt and Deposit Guarantee Programmes Possible?**" (Melbourne, September 2009)
7. "**Retail finance: A path forward for education, advice and disclosure**" (Auckland, September 2010)
8. "**Capital Market Integration and Stock Exchange Consolidation in the Asia-Pacific**", jointly with the Asian Shadow Financial Regulatory Committee (Queenstown, April 2011)
9. "**Impact of Global Financial Crisis**", jointly with the Shadow Financial Regulatory Committees of Asia, Europe, Japan, Latin America and the United States (Washington, October 24 2011)

E-book: "**The world in crisis: Insights from Six Shadow Financial Regulatory Committees**", Joint Shadow Financial Regulatory Committees, November 01, 2011

Independence of the Committee
The Australia-New Zealand Shadow Financial Regulatory Committee meets approximately twice every year in one of the major cities in Australia and New Zealand. The 'shadow' function of the ANZSFRC is related to the Committee's purpose of following and analysing critically the existing and evolving regulatory framework for financial institutions and markets. At the end of each meeting the ANZSFRC issues a public statement on topics discussed during its meeting and presents this at a conference or briefing session. The Committee is fully independent of the providers, regulators and supervisors of financial services whose behaviour it aims to evaluate.

Analytical Mission
The analysis of the regulatory framework is based on existing and proposed national regulations in Australia and New Zealand, recommendations by international forums such as the Basel Committee and the Group of Thirty, and on relevant academic research in this field. Typically, the Committee tries to translate concepts drawn from academic literature into concrete policy recommendations with respect to certain subject areas.

Worldwide Network of Shadow Committees
The ANZSFRC is part of an emerging worldwide network of Shadow Financial Regulatory Committees (SFRCs). Once every year or two years the Shadow Committees of Asia, Australia-New Zealand, Europe, Japan, Latin America, and the United States meet in a major international city to discuss a theme of common interest, resulting in a joint policy statement. The last joint meeting took place in Washington in October 2011

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