SUBMISSION ON POLICY ISSUES IDENTIFIED IN THE INTERIM REPORT

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The issues surrounding incentives and enforcement of current regulations are vital to building a sustainable and moral finance industry within Australia. 'Greed' has been identified as a large cause of the borderline criminal activity identified to date, but the issue is not quite that simple.

As it stands, we incent our major financial institutions to lend for non-productive use (housing over business). We then provide further incentive to write bad loans, through the securitisation of these mortgages, which are then sold to others who are unaware of the risks involved in the pool of RMBS sold to them.

All of these issues have been clearly identified, with hundreds if not thousands of cases arising throughout the Royal Commission hearings to date. However, the regulatory framework has not been scrutinized to the required level, given the implications of the framework.

Underlying causes of the poor behavior can largely tracked back to the following:

Credit Risk Weightings

A bank must allow for a portion of equity, commonly referred to as Common Equity Tier 1 (CET1) for every loan it creates. The amount of equity it must put aside is dependent on the perceived risk of the loan, commonly reflected in the "Credit Risk Weighting".

At present, APRA aims to make Australian banks "unquestionably strong", by increasing the amount of CET1 to risk weighted assets, i.e. the value of the loans they create, after allowing for particular risk weightings. The lower the risk weighting, the lesser CET1 required for that particular loan.

Looking at current risk weightings used by the four largest banks in Australia, who have all been approved to use an Internal Ratings Based (IRB) approach, it is clear that the cheapest way to make a loan (in terms of CET1) is to create a residential mortgage. Understandably, this is because the loan tied to a person's home is more likely to be repaid, than a business loan.

However, by accepting this premise at face value, we allow for a large increase in non-productive loans (now close to 65% of bank assets) and reduce businesses' ability to fund their growth.

Securitization of Residential Mortgage Backed Securities

When a credit provider agrees to lend money to a borrower, they must understand the borrower's ability to repay. This is not only good business, but it's also law under the responsible lending legislation. However, when an institution has the ability to re-sell that loan, or a pool of loans into the RMBS market, you remove their incentive to ensure the loan is 'not unsuitable', as they no longer hold the downside risk.

Rather than forever fine-tuning legislation to ensure banks are following the letter of the law, an incentive for banks to deal with the ramifications of bad loans in the long term will ensure the intent of the legislation is upheld.

Summary

Whilst this submission is extremely short, I contend the two points above are considered before the Royal Commission is concluded. Specifically, I suggest that:

1) Credit risk weightings are adjusted such that it benefits society (i.e. lending goes toward productive uses), not just the perceived risk of the loan

2) Banks are incentivised to write loans that are suitable, by dealing with the long-term ramifications of writing these loans.