The Senate

Economics
References Committee

Competition within the Australian banking sector

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Acronyms

ABA	Australian Bankers' Association
ABS	Asset-backed securities OR Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACL	Australian Consumer Law
ADIs	Authorised Deposit-taking Institutions.
AOFM	Australian Office of Financial Management
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ASF	Australian Securitisation Forum
BSB	Bank-State-Branch system of numbering accounts
CDO	Collateralised Debt Obligation
CMB	Canadian Mortgage Bonds
EFTPOS	Electronic Funds Transfer at Point Of Sale
EM	Explanatory Memorandum
ESA	Exchange Settlement Account
FCS	Financial Claims Scheme
FHSA	First Home Saver Accounts
FOFA	Future Of Financial Advice
GFC	Global Financial Crisis.
LIBOR	London InterBank Offered Rate
LMI	Lenders Mortgage Insurance
LVR	Loan to Valuation Ratio
RMBS	Residential Mortgage-Backed Securities.
RSA	Retirement Savings Account
SIV	Structured Investment Vehicle.
SLC	Substantial Lessening of Competition
SMEs	Small and Medium-sized Enterprises

Summary and recommendations

An observed reduction in competition in Australia's banking sector in the wake of the global financial crisis (GFC), combined with the public outcry over a number of high profile decisions by the major banks, prompted this inquiry.

The global financial crisis: stability and competition

This report is being written in the aftermath of the GFC. In most respects the Australian financial system has recovered from the GFC better than those is many comparable countries. There does not seem to be an overall problem of lack of access to credit, although some banks may still be excessively cautious in certain areas, such as lending to small business, and borrowers that formerly relied on non-bank lenders funded through securitisation markets may be having difficulty finding finance, despite strong credit records.

As usual with financial crises, investors and customers showed a 'flight to quality', moving to longer established and larger financial intermediaries as they perceived these to be safer. At the same time, policymakers in Australia, as prudence demanded, accorded greater priority to the immediate stability of the financial system. The net effect, together with other forces at play during this period (including the relative inability of smaller insitutions to access funds at a competitive price) has led to a more concentrated banking market than existed prior to the financial crisis, with the 'big four' banks increasing their dominance across most if not all banking markets.

The committee considers that this increase in concentration has the potential for consequent undesirable impacts on competition.

Accordingly, as the threat to stability posed by the GFC subsides, it is appropriate that priority turn more to achieving an appropriate longer term balance between stability and competition. The Committee notes that the need to do so is a matter of public debate and that the Government has taken some steps in this direction but the Committee considers additional steps are required and this report describes some further measures that could be implemented. Action should be taken to remove obstacles to increased real competition and to facilitate opportunities for new and existing players in the banking markets to compete actively for business.

To that end, the Committee believes that, in general, competition rather than regulation will generate improved outcomes for customers. It agrees with Treasury that:

> Competition is the cornerstone of efficiency and productivity in any market. It promotes fair prices, enhances living standards and ensures that scarce resources are allocated to their highest value uses.[1]

Having identified some shortcomings in competition, the Committee suggests remedies. There is no 'silver bullet'. No single recommendation will transform the banking sector into a paragon of competition. Rather, a number of smaller recommendations are made, each of which will, if implemented, work to improve the competitive pressures within the banking market.

A broader inquiry into the financial system

Nor does the Committee believe that its recommendations, which focus on *competition*, exhaust all the possible useful reforms to the financial ssytem. The Committee supports a broader independent inquiry. Such an inquiry's work would be facilitated by more information being provided on bank profitability.

A model for such an inquiry could be provided by the five main inquiries into the Australian banking system described in this report; namely the 1937 Royal Commission, the Campbell Committee, the Vic Martin Review Group, the Stephen Martin Report and the Wallis Report.

Recommendation 1

3.91 The Committee recommends that a broad ranging inquiry into the Australian financial system be established, modelled on that conducted by the Campbell Committee. The terms of reference should be broad, covering the role of banks and other financial institutions in a post-GFC financial environment. The inquiry should be well resourced and have its own secretariat, independent of government departments.

Recommendation 2

4.111 The Committee recommends that the Reserve Bank publish further regular information on banks' interest margins and returns on equity; and compare these to returns in other industries to allow an assessment of whether risk-adjusted returns in the banking sector are sufficiently high to suggest that competition is inadequate.

Banks' home loan interest rates

There is a widespread belief that the banks' variable home loan rates should follow (and only follow) movements in the Reserve Bank's policy rate (the 'cash rate'). This belief has been reinforced by the banks generally behaving in this way for a number of

1 Department of the Treasury, *Submission 102*, p 1.

years and a consequent mis-belief that the banks' costs of funds is directly and significantly dependent on the cash rate.

The banks' costs of funds do not, however, always move in line with changes in the Reserve Bank's policy rate. Decisions by the Reserve Bank to change the cash rate are made solely to attempt to deliver inflation outcomes within its statutorily defined target range. These changes will have some impact on the cost of banks' funds but are not necessarily a primary driver of those costs, which are subject to many influences other than the Reserve Bank's cash rate.

It is reasonable that banks should be able to set their lending rates taking into account their overall cost of funds. When events such as the GFC, or a prudent move towards seeking longer-term and more stable funding, pushes up their cost of funds at a faster pace than the Reserve Bank is increasing the cash rate, it is understandable that banks will seek to increase their lending rates by more than official cash rate increases to cover those costs. A truly competitive market, however, will limit the extent to which banks can increase their lending rates and other fees to recover such increases in costs plus a small profit.

Similarly, as banks replace expensive borrowings during the GFC with cheaper funds (which may already be occurring), their average cost of funds will fall and, in a competitive market, customers should expect to see a reflection of this in lower home loan interest rates (or increases below those made to the Reserve Bank's policy rate).

For borrowers with a strong desire for their home loan rate to have an explicit linkage to the Reserve Bank's policy rate, the Committee welcomes the initiative by some lenders to provide 'tracker loans' which provide this certainty.

But importantly, if the banks increase their loan rates by more than the Reserve Bank's adjustment to its cash rate, it does ***not*** mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target. If the banks expand their margin over the cash rate, then the Reserve Bank will set a lower cash rate than they would otherwise have set.

Profitability and concentration in the banking industry

Even during the period of the GFC, when the real economy slowed markedly, the profits of the major banks held up well. The returns they offer investors more than match those from other comparable industries, despite the explicit and implicit government support they receive and the expectation by the market that they are 'too big to fail' which makes banking a less risky activity.

While the Committee prefers banks to be profitable rather than unprofitable, their very high profits are ultimately paid for by households and small businesses. They are also a reflection that competition is not as keen as it should be. This conclusion was reinforced by the finding that the Australian banking market is highly concentrated.

The Committee would accordingly be concerned if there were any further increase in concentration. The Committee therefore strongly supports the retention of the 'four pillars' policy preventing any merger between the four major banks. It also urges the Australian Competition and Consumer Commission (ACCC) to take a strongly sceptical view towards any proposal for one of the four major banks to take over one of the remaining regional banks.

The Committee views forced divestiture as a major intervention in a free market and regards it as a 'last resort' approach to increasing competition. The Committee prefers other means of increasing the number of players in the market. With the change to an explicit form of deposit insurance, a consideration of impediments to foreign banks offering stronger competition, such as the preference for foreign banks to operate as subsidiaries rather than branches, could be reviewed as part of the broader review of the financial system. This same review could also examine means whereby current non-banks could more directly compete with banks. This could include an examination of the restrictions on ownership arrangements for financial intermediaries.

Reducing barriers to customers moving between financial intermediaries

The costs and other impediments to moving between banks are important factors with the potential to weaken competition significantly. One such impediment is excessive exit fees on variable rate home loans. The Committee notes the importance of fees in underpinning the business models of non-bank lenders which bring competitive pressures to the market and that an outright ban will reduce competition from this sector. The Committee believes that banning exit fees may lead to higher upfront fees, including for borrowers who currently never incur exit fees. It is notable that the only financial intermediaries that openly welcomed the abolition of exit fees were the major banks.

Rather than moving to an immediate ban, the Committee favours giving the new consumer protection provisions a chance to work. These provisions, which restrict exit fees to reasonable amounts, only came into effect less than a year ago and are not yet well known or well utilised.

It is important, however, that borrowers are made fully aware of the extent of exit fees at the time they take out their loans.

Recommendation 4

7.34 The Committee recommends that the Government reconsider its decision to ban exit fees, before the amended regulations come into effect, with a view to allowing enough time for the effectiveness of the existing ban on unfair and unconscionable exit fees (as implemented through ASIC Regulatory Guide 220) to be assessed. If it proceeds with the ban, it should only apply to authorised deposit-taking institutions.

Recommendation 17

10.33 The Committee recommends that the Government introduce regulation of mortgage early exit fees (including deferred establishment fees), requiring disclosure of these fees upfront in a simplified and comparable format.

Recommendation 5

7.35 The Committee recommends that lenders be required to inform borrowers when they take out a loan of the provisions of the *National Consumer Credit Protection Act 2009* which relate to unconscionable charges.

Recommendation 6

7.36 The Committee recommends that borrowers be required to sign off on a form clearly disclosing any exit fees applicable to their home or small business loan before making any commitment.

Recommendation 7

7.37 The Committee recommends that lenders charging exit fees be required to explain on their website how the exit fee relates to relevant costs.

As well as excessive exit fees, the Committee identified other barriers to customers moving between lenders, which it believed should be addressed.

Recommendation 8

7.49 The Committee recommends that lenders mortgage insurance always be made either pro-rata refundable or transferable and that this be made clear to borrowers.

7.50 As an alternative, lenders mortgage insurance should be payable by instalments (eg. monthly, quarterly or annually) rather than as an upfront lump sum payment (as occurs in other jurisdictions).

Recommendation 11

7.73 The Committee recommends that the Government ask Treasury to investigate the feasibility of personal credit ratings to facilitate borrowers moving between lenders.

Recommendation 13

7.99 The Committee recommends that the abolition of stamp duties on refinancing of mortgages be placed on the agenda for the forthcoming tax forum and that the agreement on their abolition be implemented.

Allowing customers to readily transfer their saving and transactional banking between banks and other deposit-taking institutions is also important.

Recommendation 14

7.131 The Committee recommends that a scheme based on those in Europe be introduced requiring a bank, upon being advised that a customer has left for a new bank, to reroute all direct debits and credits for 13 months and provide the new bank with details of those direct debits and credits.

Greater disclosure of information

The Committee believes better disclosure of information would help make the banking market more competitive.

Recommendation 9

7.69 The Committee recommends that the Reserve Bank and the Australian Prudential Regulation Authority draw on their data collections to publish regular information about the total cost of home loans (based on standardised assumptions on the average size and term) for the twenty largest ADI home mortgage lenders.

Recommendation 10

7.70 The Committee recommends that a working group be set up including Treasury, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Australian Competition and Consumer Commission, the Reserve Bank, the Financial Ombudsman Service, the Australian Bankers' Association, Abacus, consumer representatives and relevant academics to develop standardised words for financial products and their characteristics to allow consumers to more readily compare offers from different financial intermediaries.

Recommendation 12

7.93 The Committee recommends that banks should be required to contact customers before the expiry of term deposits advising them of the rate that will apply if they are automatically renewed and the current 'special' rates available.

Promoting more competitors

In terms of institutions, the most promising approach would be to enhance the ability of existing Australian non-bank institutions to compete with the banks and to facilitate further competition from foreign banks. Some of these measures involve easing taxes on them, and so will have an impact on revenue. But the Committee regards these measures as more effective than creating a development or rural bank or converting Australia Post into a bank. The Committee appreciates Australia Post's role in delivering banking services to some rural and regional areas. It is commendable that it provides services on behalf of a number of financial intermediaries and thereby promotes competition. Australia Post should continue to seek opportunities to improve access to financial services.

Recommendation 18

11.73 The Committee recommends that mutual financial intermediaries be allowed to refer to themselves as a 'mutual bank' or 'approved banking institution' and use terms such as 'credit union bank' in their name.

Recommendation 36

15.24 The Committee recommends that the Government require Treasury to review the GST input tax arrangements for mutual financial intermediaries having regard to the comments in the Henry Tax Review.

Recommendation 37

15.33 The Committee recommends that the Government require Treasury to review the treatment of building societies and credit unions in the franking credit arrangements and report publicly on the advantages and disadvantages of various options.

Recommendation 19

11.78 The Committee recommends that financial intermediaries not supervised by the Australian Prudential Regulation Authority be required to state clearly that funds placed with them are 'not guaranteed by government' but otherwise should not be prohibited from applying familiar terms such as 'debenture' where this would not be misleading.

Recommendation 34

15.10 The Committee recommends that interest withholding tax be abolished as budgetary circumstances permit to increase the ability of foreign banks to compete in the Australian market.

Recommendation 38

15.37 The Committee recommends that the Government require Treasury to review the abolition of the LIBOR cap to the tax deductibility of interest paid by a foreign bank branch on borrowings from its parent bank.

Recommendation 33

14.82 The Committee recommends that the Government direct the Australian Competition and Consumer Commission to conduct an examination of barriers to competition in the Australian payments system and publicly report by the end of 2011 on any legislative or other reforms that would enhance competition and efficiency in the provision of payment, clearing and settlement systems.

The securitisation market

The contraction in the securitisation market has had adverse consequences for competition. It represents an over-reaction to the deficiencies in some areas of the market that became evident during the GFC. With private sector institutional investors becoming unreasonably risk averse, there was bipartisan support for the government, through the Australian Office of Financial Management, supporting the market by purchase of residential mortgage-backed securities. The Committee supports a continuation of this programme for now, although of course it should not continue indefinitely. The Committee is keen to encourage the securitisation market as a means of promoting competition and therefore endorses a number of suggestions made to it to strengthen the securitisation market.

Recommendation 22

13.29 The Committee recommends that the Government ask the Australian Prudential Regulation Authority to review aspects of its prudential framework to ensure that there are no inadvertent impediments to the issuance and trading of bullet bonds.

Recommendation 23

13.38 The Committee recommends that, in order to retain incentives for careful credit assessment, an authorised deposit-taking institution which securitises a loan portfolio be required to keep a proportion of the resultant asset-backed securities on its balance sheet and hold appropriate levels of capital. The proportion should be set by the Australian Prudential Regulation Authority in consultation with the Australian Securities and Investments Commission to balance incentives to maintain credit standards with the desirability of encouraging the recovery of the securitisation market.

Recommendation 24

13.42 The Committee, having more confidence in the Australian Prudential Regulation Authority's oversight than in the opinions of credit rating agencies, recommends that the Reserve Bank accept as eligible paper for repurchase agreements long term debt issued by any authorised deposit-taking institution rather than just those rated above A.

Recommendation 25

13.58 The Committee recommends that the Australian Office of Financial Management programme be expanded to include asset-backed securities based on assets other than home mortgages and to include securities rated AA or A (rather than just AAA) or issued by a financial intermediary supervised by the Australian Prudential Regulation Authority.

Recommendation 26

13.59 The Committee recommends that the Australian Office of Financial Management be given the discretion to purchase residential mortgage-backed securities issued by entities with a substantial bank shareholding where it judges this would promote a more competitive market.

Recommendation 27

13.76 The Committee recommends that the Government commission a survey of potential demand for types of asset backed securities.

Recommendation 28

13.77 The Committee recommends that the broader inquiry into the financial system investigate ideas that may further the participation of smaller lenders in the securitisation market, such as greater standardisation and disclosure, liquidity support for securities issued by mutual ADIs meeting certain quality standards and better co-ordination between regulators.

Recommendation 29

13.78 The Committee recommends that Treasury develop a plan to introduce a support programme for RMBS similar to that operating in Canada in case a future deterioration in the securitisation market requires its introduction.

Recommendation 30

13.107 The Committee recommends that the Government establish a working group with an independent chair, representatives from Treasury, the Australian Prudential Regulation Authority, the Reserve Bank, and the banking and superannuation industries, and also including academic experts, to explore and assess options that could promote investment in deposits and fixed income assets by superannuation funds and other funds managers.

Price signalling

Anti-competitive price signalling refers to a corporation conveying to its rivals its future price intentions. By so doing, the corporation eliminates uncertainty about the price of its goods or services, thereby reducing the risks of competition and impeding the functioning of a competitive market.

The Committee believes that there is a need to address price signalling through an amendment to the *Competition and Consumer Act 2010*. It agrees with the ACCC that the Act is currently inadequate to prohibit statements which relay to the market the future pricing intentions of a company. Care needs to be taken, however, that new legislation should not prevent legitimate communication of pricing information that is not anti-competitive in its intent or effect. The Committee believes that it is better for a bank engaging in anti-competitive price signalling to go undetected than it is for a bank conducting legitimate communications to be inappropriately penalised. In this vein, the Committee is concerned that the Government's over-reliance on the proposed new ACCC notification regime in its bill may be cumbersome and restrictive for the banks, as well as a burden on the ACCC. The far better alternative is to replace the prohibitions with a competition test that applies to both public and private communications.

Recommendation 15

8.95 Subject to the release of the Government's independent legal advice, the Committee recommends that the *Competition and Consumer Act 2010* be amended to include a provision which states that a corporation engages in price signalling if it communicates future price-related information to a competitor, and the communication of that information has the purpose, or has or is likely to have the effect, of substantially lessening competition.

Recommendation 16

8.97 The Committee recommends that an amendment to the *Competition and Consumer Act 2010* to introduce a price signalling provision should be accompanied by ACCC guidelines providing:

- **examples of the type of communication that would fall foul of this provision;**
- **examples of the type of communication that would not fall foul of this provision; and**
- **the protection offered by the exemptions.**

Supervision of the financial system

There is much to be proud of in Australia's financial system at present, especially contrasting the performance here with how other countries' banking systems fared during the GFC. A strong supervisory system made an important contribution. But this should not be regarded as a reason for complacency. The proposed independent review of the financial system should include an examination of the extent to which the good performance reflected the structure of the Australian Prudential Regulation Authority, its current personnel or an element of good luck.

Automatic teller machines

The Committee commends the Reserve Bank for requiring ATMs to display fees before the customer completes the transaction. The Committee hopes this will in time lead to greater competition and ATM providers will advertise machines with lower fees. Measures to cap ATM fees would be counterproductive as they would lead to ATMs being removed from some remote locations.

Recommendation 31

14.45 The Committee recommends that the Australian Payments Clearing Association and the Australian Bankers' Association encourage their members to have their ATMs screens display a real-time warning to consumers where a penalty fee will be imposed if a particular transaction goes ahead.

Ensuring adequate community access to financial services

The Committee recognises that banks are accorded a special status and given special privileges. In exchange they have social obligations to provide banking services to the broad community. These are obligations that the banks should meet voluntarily rather than compulsorily. In areas where there are unmet demands for basic banking services which the government believes on social grounds should be provided to disadvantaged members of the community, the government should invite banks to tender to provide the services and the government pay to ensure they are provided.

Recommendation 32

14.46 The Committee recommends that the government deal with the problem of excessive ATM fees in remote indigenous communities by tendering for an ATM provider to install a network of ATMs in these areas which make specified minimal charges for balance enquiries and low charges for cash withdrawals.

Government guarantees for the financial system

The Committee believes providing temporary guarantees for bank funding was the correct response to the GFC but it could have been introduced more adroitly. The differential pricing for the gurantees exacerbated the 'flight to quality' to the major banks and had an adverse impact on competition.

Recommendation 20

12.36 The Committee recommends that, to increase the competitiveness of smaller lenders, the Government immediately standardise the fee for all borrowers under the wholesale funding guarantee to a uniform rate of 70 basis points.

Recommendation 21

12.53 The Committee recommends that the financial claims scheme should be retained in its current form pending the outcome of a full inquiry into a deposit insurance scheme, possibly charging risk-related premia. The inquiry should also examine the issue of guaranteeing non-ADI products that are close substitutes for deposits, with a view to being better placed to provide such a guarantee as future need arises.

The Committee supports the introduction of the 'Government Protected Deposit' symbol as a means of allowing mutual and smaller ADIs to compete on a more equal footing.

Taxation and related measures

Some other changes that could also foster competition were identified.

Recommendation 35

15.18 The Committee recommends the taxation arrangements applied to bank deposits and mutual ADI deposits should be reviewed by the inquiry into the financial system.

Recommendation 39

15.48 The Committee recommends that the Government require Treasury to review the operation of the First Home Savers Accounts scheme and report publicly on the advantages and disadvantages of various options.

Small business finance

Since the GFC, finance for small business has become more expensive, both absolutely and relative to housing loans. This appears to reflect a mix of banks more prudently acknowledging the risks in various types of lending and some reduction in competition.

Recommendation 3

6.42 The Committee recommends that the Australian Bankers' Association meet with small business representatives to develop a code of practice specifically relating to lending to small business.

Chapter 1

Introduction

1.1 Competition in Australia's banking sector, or the (alleged) lack thereof, has attracted substantial attention in recent times, especially so far as it manifests in interest rates charged to home loan borrowers. This report aims to put forward the facts about the extent of competition in the sector and, where inadequacies are identified, to suggest remedies.

Referral of the Inquiry

1.2 On 28 October 2010, on a motion by Senators Bushby, Williams and Xenophon, the Senate referred a number of matters relating to competition in the Australian banking market to the Senate Economics References Committee for inquiry and report by 31 March 2011. The terms of reference setting out the matters to be investigated during the inquiry were as follows:

> Competition within the Australian banking sector, including:
>
> (a) the current level of competition between bank and non-bank providers;
>
> (b) the products available and fees and charges payable on those products;
>
> (c) how competition impacts on unfair terms that may be included in contracts;
>
> (d) the likely drivers of future change and innovation in the banking and non-banking sectors;
>
> (e) the ease of moving between providers of banking services;
>
> (f) the impact of the large banks being considered 'too big to fail' on profitability and competition;
>
> (g) regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis;
>
> (h) opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers;
>
> (i) assessment of claims by banks of cost of capital;
>
> (j) any other policies, practices and strategies that may enhance competition in banking, including legislative change;
>
> (k) comparisons with relevant international jurisdictions;
>
> (l) the role and impact of past inquiries into the banking sector in promoting reform; and
>
> (m) any other related matter.

Conduct of the inquiry

1.3 The Committee advertised the inquiry in the national press on numerous occasions and on its website. It also wrote to relevant organisations and academics to inform them of the inquiry. After the Government announced a package of measures aimed at improving banking competition on 12 December 2010, the Committee extended the closing date for submissions to 14 January 2011. The Committee received over 130 submissions, which are listed in Appendix 1.

1.4 Reflecting the location of submitters, the Committee held public hearings in Canberra (15 December 2010 and 9 February 2011), Melbourne (25 January 2011), Sydney (13 and 14 December 2010, 21 January and 9 March 2011) and, after deferring it to allow witnesses to recover from the floods, Brisbane (4 March 2011). Teleconference facilities were used to hear witnesses from other locations such as Perth.

1.5 The witnesses included the CEOs of all four major banks and a number of smaller banks, the Governor of the Reserve Bank and senior government officials. The witnesses who appeared at these hearings are listed in Appendix 2. The Committee thanks those who contributed to the inquiry. It particularly thanks the Reserve Bank of Australia and the Australian Securitisation Forum for providing a briefing and useful materials.

1.6 In conducting this inquiry, the Committee was able to draw on its previous inquiries into bank mergers (September 2009), bank funding guarantee schemes (September 2009) and finance for small business (June 2010), as well as submissions to an inquiry by its sister committee on the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010.[1]

1.7 It was noticeable that banking competition appeared to heat up during the inquiry, with one major bank announcing it was 'breaking up' with the others, and banks cutting fees and offering enticements to customers to move to them. The Committee agrees, however, with one witness who commented:

> I would like to see an environment that ensures the competitiveness continues into the long term and not just for the duration of the Senate inquiry…[2]

1.8 There were other ways in which the world would not stay still while the Committee prepared its report. The Government, perhaps spurred by the attention the Committee's hearings were giving to the topic, announced a number of initiatives, referred to in the relevant chapters here.

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1 The Senate Economics Legislation Committee did not make a substantive report on the bill due to the calling of the 2010 federal election soon after the bill was referred.

2 Mr John Minz, Chief Executive Officer, Heritage Building Society, *Proof Committee Hansard*, 4 March 2011, p 15.

1.9 To enable the report to reflect fully the implications of these changes and the large volume of evidence compiled, the Committee viewed an extension of its reporting date as desirable and the Senate decided on 24 March 2011 to extend the reporting date to 27 April 2011.

Outline of the report

1.10 The report is effectively divided into two parts. The first part provides context and identifies the problems. Background information on the Australian financial sector and developments in competition are provided in Chapter 2. The previous inquiries into bank competition are discussed in Chapter 3. This chapter also endorses calls for a new comprehensive inquiry into the operation of the financial system. The degree of competition in the Australian banking market is assessed in Chapter 4 and it is noted that Australian banks are very profitable, offering large returns to investors and relatively low risk. The contentious issue of the relationship between the interest rate charged by banks on variable rate home mortgage loans and the policy rate set by the Reserve Bank is covered in Chapter 5. The overall conclusion reached is that prior to the global financial crisis (GFC) there was vigorous competition in lending markets. International factors then created serious problems for smaller lenders and the big four banks increased their market share as there was a 'flight to quality' by nervous investors and depositors. The Australian Government, like those overseas, placed greater emphasis on stability than competition during this period. As the effects of the GFC pass, and regulators respond to the lessons learned from it, competition has heated up for deposits but not yet for loans. The Committee believes the time has come to again place more emphasis on boosting competition.

1.11 Having identified some inadequacies in competition, the following chapters seek remedies. There is no 'silver bullet'. No single recommendation will transform the banking sector into a paragon of competition. Rather, a number of smaller recommendations are made, each of which will improve the operation of the banking market. In addition some other possibilities are identified which warrant further investigation. Small businesses are important customers of banks and their situation is addressed in Chapter 6. The ease of moving between banks, and in particular the role of mortgage exit fees, forms the subject of Chapter 7. The report then turns to competition and consumer issues, with Chapter 8 reviewing proposals to ban 'price signalling', Chapter 9 discussing mergers and measures to increase the number of competitors and Chapter 10 concerned with unfair banking contracts. Prudential supervision, including the new Basel III rules, while generally welcomed on prudential grounds, was raised as a possible impediment to competition and this is examined in Chapter 11. The role of government guarantees in potentially either encouraging or impeding competition is discussed in Chapter 12. Markets for bank bonds are the focus of Chapter 13 and Chapter 14 looks at competition in the payments system. Chapter 15 looks at taxation and related matters.

Chapter 2

Background - the Australian banking market

Australia has strong banks

2.1 There is much to be proud of in Australia's banking system at present, especially contrasting the performance here with how other countries' banking systems have fared during the global financial crisis (GFC):

> The Australian banks…are well capitalised and highly rated. They have benefited from years of rigorous supervision by Australia's world-class financial regulators, and this is no accident. An important feature of our regulatory infrastructure for many years is a common understanding between governments, the regulators and the industry on the importance of prudential regulation. No Australian bank has collapsed post the GFC. No banking firm has needed to be bailed out through the use of taxpayers' money. The Australian banking system has emerged from the GFC in a stronger position relative to banking systems in many other countries and for that good reason is highly regarded around the world.[1]

2.2 As the Committee noted in 2009, many wish to claim the credit for this:

> Views differ about the reasons for the recent relative strength of the Australian banking system. The banks themselves regard it as a vindication of good management. The supervisors believe it reflects their good work. There is some truth in both these views; Australian banks have largely eschewed the practices such as 'low doc' and 'no recourse' lending which generated large bad debts in the domestic lending of American banks. There was also an element of good luck. As Australia is a net borrower, banks here were concentrating on raising funds overseas to lend in Australia. This meant that unlike countries which generated excess savings, Australian banks were not looking to buy foreign securities, many of which had a complexity which disguised their low quality.[2]

2.3 The Committee also noted in its earlier report the long history of strong banks and good regulation:

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1 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 25.

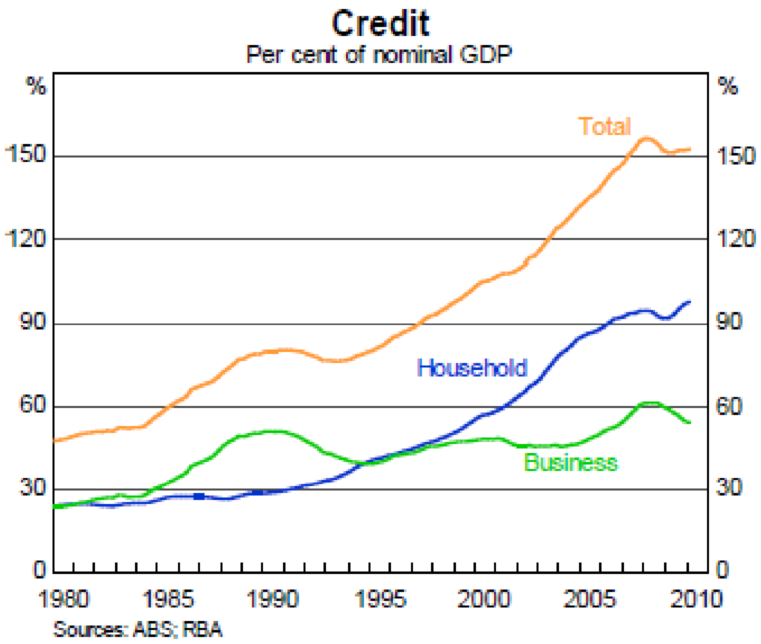
2 Senate Economics References Committee, *Report on bank mergers*, September 2009, p 4.

> It has been notable that the collapses and near-collapses of financial intermediaries have occurred among the unregulated non-bank intermediaries.[3]
>
> …since the 1890s depression…there is only one example of bank depositors losing money in an Australian bank, and that was a small rural bank in the 1930s when the depositors lost one cent in the dollar. In our research we have found no example of when taxpayers' money has been used to bail out any Australian private bank.[4]

2.4 There does not seem to be an overall problem of lack of access to credit (Chart 2.1). The Reserve Bank comments:

> Australian borrowers have enjoyed ready access to credit, with credit growing at about three times the pace of nominal GDP over the past 25 years.…A significant increase in demand, mainly from households, was accommodated by an increase in supply through new participants, more diverse products and some easing in lending standards.[5]

Chart 2.1



Source: Reserve Bank of Australia, *Submission 41*, p 2.

3 Examples include 'merchant banks' such as Tricontinental, Nugan Hand, and Rothwells; Pyramid Building Society (in the period before building societies were supervised by APRA), and finance companies such as FCA. Senate Economics References Committee, *Report on bank mergers*, September 2009, p 3.

4 Mr Nicholas Hossack, Australian Bankers' Association, cited in Senate Economics References Committee, *Report on bank mergers*, September 2009, p 3.

5 Reserve Bank of Australia, *Submission 41*, p 1.

2.5 The challenge is to maintain the strength of the system but also to:

> …foster a competitive banking environment for consumers of banking services, particularly at the retail level, in an industry that has become more concentrated as a result of the GFC.[6]

2.6 Choice expressed what they believe to be a common view:

> …there is public recognition that politicians did the right thing at the time of the global financial crisis to ensure financial stability, but that the actions taken then have reduced competition now.[7]

2.7 The Committee believes competition is good. It should result in intermediation services being provided at low cost, finance being directed to where it can be best used and consumers and small business being able to access it on fair terms.

2.8 It notes, however, that some submitters are concerned that in an environment of strong competition, some lenders can become overenthusiastic, leading to excessive debt and asset price bubbles.[8] Allowing the benefits of competition to emerge without such a loss of stability is the role of the authorities. Prudential supervision is discussed in Chapter 11.

A short history of Australian banking competition[9]

2.9 The first bank in Australia, the Bank of New South Wales founded in 1817, obviously had a monopoly position. Its first substantial competitor was the Bank of Australia, established in 1826.

2.10 These two banks mainly catered to commercial customers. The New South Wales Saving Bank (more commonly known as Campbell's Bank) was established in 1819 to cater for the needs of households and to encourage thrift. By 1832 there were concerns about a private bank having a virtual monopoly over the colony's savings and the Legislative Council established the Savings Bank of New South Wales, which took over Campbell's Bank. Over the next couple of decades savings banks were established in other colonies around Australia.

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6 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 25.

7 Mr Nick Stace, Chief Executive Officer, Choice, *Committee Hansard*, 14 December 2010, p 27.

8 Associate Professor Steve Keen, *Submission 63*; Mr Andrew Selby Smith, *Submission 65*; Mr George Ivanov, *Submission 124*.

9 The main sources for this section are House of Representatives Standing Committee on Finance and Public Administration (1991), Butlin (1953) and Butlin, Hall and White (1971).

2.11 The demand for commercial banking grew with the pastoral expansion of the 1830s, the gold rushes of the 1850s and the long boom of 1860-1890. British interests established banks such as the Union and the Bank of Australasia whose branches spread across the continent.

2.12 By 1888 there were over forty banks operating in Australia. The 1890s depression brought the greatest banking crisis Australia has ever seen.[10] While external factors played a role, lax lending standards were the primary cause:

> …a boom, which had disregarded all caution, had out-built conceivable demand, and, stoked as it had been by blind assumption of continually rising prices, it crumpled when that assumption was first clearly falsified in 1888.[11]

2.13 Only nine banks remained continuously open through the 1890s, with many failing or being absorbed by their rivals.

2.14 A desire to improve competition was one of the motivations for the Fisher Government establishing the Commonwealth Bank in 1911:

> It was not established as a central bank; it was established to counter private banks. It was a publicly owned bank to compete against the private banks…the Labor Party in particular wanted a publicly owned, commercial bank to compete against the private banks.[12]

2.15 It was not, however, a particularly aggressive competitor, setting deposit interest rates below those of the private commercial banks and not encouraging staff to entice customers away from them.

2.16 The savings banks which survived the 1890s were mainly those run by the state governments. With the post office network as its agents, the Commonwealth Bank was a substantial competitor in this area. It took over the state savings banks in Tasmania and Queensland early on and those in New South Wales and Western Australia during the 1930s depression.

2.17 From the 1920s to the 1940s the Commonwealth Bank took on more of the characteristics of a central bank. This led to complaints from the private banks that the Commonwealth Bank was both player and umpire and in 1960 the central banking powers were placed with the new Reserve Bank of Australia.

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10 It still resonates with at least one submitter: Mr Andrew Oliver recalls 'I remember my Nana telling me her father was almost ruined by bank failures in Australia in the 1890's'; *Submission 1*, p 2.

11 Butlin (1961, p 280).

12 Mr Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 118.

2.18 In the first half-century after federation no new private banks were established and there continued to be mergers. By 1955 there were twenty banks. The four largest held around two-thirds of the market, double their share in 1888.

2.19 From the late 1950s the larger private banks established savings bank subsidiaries which although required to hold substantial amounts of government bonds also became significant home mortgage lenders.

2.20 Wartime controls on banks were made permanent in the *Banking Act 1945*.[13] The controls reduced competition between banks by placing ceilings on interest rates and prohibiting the payment of interest on current accounts. The controls on banks also led to them establishing non-bank subsidiaries (such as finance companies and merchant banks) and faster growth of less controlled mutual financial intermediaries such as building societies and credit unions. These met some of the demand for credit, notably personal loans, unsatisfied by the banks. The *Financial Corporations Act 1974* would have allowed the non-bank financial intermediaries to be brought under the regulatory net but was never fully implemented.

2.21 Instead the banking system was progressively deregulated during the 1980s with interest rate controls gradually removed. New technologies such as ATMs and EFTPOS were introduced, along with new financial products.

2.22 Foreign banks were allowed to enter the Australian market from the mid-1980s but there was a:

> …surge of foreign bank competitors driven out after sustaining heavy losses…[14]

2.23 But while foreign bank entry opened up the prospect of an increase in the number of banks, mergers were working in the other direction. Some mergers were at the behest of the authorities as a way of dealing with banks at risk of failing -- 'subtle arranged marriages' as one submitter termed them.[15]

2.24 Two large domestic mergers saw the 'six major' banks become the 'four majors' in the early 1980s. As the bankers themselves remarked:

> If you look at the family histories of the major banks, there has been consistent growth through acquisition throughout their long histories.[16]

2.25 The succession of mergers over the past 150 years is illustrated in the 'family trees' in Charts 2.1 to 2.5.[17]

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13 A suggestion made at this time to establish a parliamentary committee on banking was not implemented.

14 Mr Peter Mair, *Submission 2*, p 6.

15 Dr Carolyn Currie, *Submission 114*, p 2.

16 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Proof Committee Hansard*, 14 December 2010, p 103.

2.26 A number of building societies transformed from mutuals to listed companies and were then taken over by the major banks. Indeed, the largest remaining mutual characterised demutualising as:

> …selling to an unknown buyer…in demutualising in all likelihood you are going to be bought.[18]

2.27 The four major banks are not just dominant in the banking market:

> …they are also now the biggest players in the insurance, wealth management and financial advisory markets.[19]

2.28 A temporary challenge to the dominance of the banks emerged in the 1990s as new non-bank home lenders, funded by securitisation of their mortgages, developed. There was also an increased role for mortgage brokers:

> The role of mortgage brokers has I think has been overlooked. As the mortgage brokers entered the market you had greater transparency in the market that helped customers shop around as well. I think that put a lot of competitive pressure on as well.[20]

The impact of the global financial crisis

2.29 A veteran of 43 years in the banking industry reflected:

> There is no doubt that the GFC was the toughest period that I have ever seen or experienced in the industry. Probably one of the most significant outcomes of the GFC has been the negative impact to competition in our industry.[21]

2.30 The GFC affected competition because its impact was harsher for the smaller banks and non-bank intermediaries than for the large banks. The 'largest of the smaller banks' commented:

> Pre-GFC, our cost of funds was only 10 or 15 basis points greater than the major banks. It is now up to 80 basis points more than what the major banks pay. The other regional banks pay an even wider differential on their funding...The gap between the cost of funds for major banks and that of all other financial services institutions has been greater in the past few years

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17 To keep the trees legible, some small savings banks and building societies, and acquisitions outside Australia, have been omitted.

18 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 88.

19 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 15.

20 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 14 December 2010, pp 89-90.

21 Mr David Liddy, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 14.

> than for decades prior to the GFC. It does threaten to drive further consolidation and a further reduction in competition.[22]

2.31 In the global financial crisis securitisation markets dried up indiscriminately:

> …due to poor underwriting standards for home loans in many countries, the securitisation markets around the globe stopped functioning as investors became nervous about the quality of the assets they were investing in. The market did not discriminate between countries in the respective quality of the securitisation issues but simply threw the baby out with the bathwater.[23]

2.32 With access to securitisation markets cut off, and consumers wary of depositing with less familiar names, the non-bank home lenders struggled. Some were taken over by the major banks while others just contracted their activities.

2.33 Even some large banks were forced to reduce their operations. Treasury note:

> …some foreign banks have exited the Australian market or significantly scaled back their operations here due to funding constraints. These competitors were particularly significant in providing corporate business banking services.[24]

2.34 On understandable grounds, the Government prioritised the stability of the financial system. But whether inevitably, or because of design flaws discussed in Chapter 12, some of the measures had undesirable impacts on competition. At the same time the major bank benefited from a 'flight to quality' by households, reflecting the same return to financial conservatism that has seen the household saving ratio move from being negative to around its highest level in twenty years. Shifting the balance back towards competition is a key focus of the rest of the report.

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22 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 1. In early 2011 the major banks are rated AA, Suncorp is rated A and the other regional banks are rated BBB.

23 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, pp 106-7.

24 Murphy (2010, p 47).

Chart 1: Australian Banks Family Tree

I. Commonwealth Bank of Australia

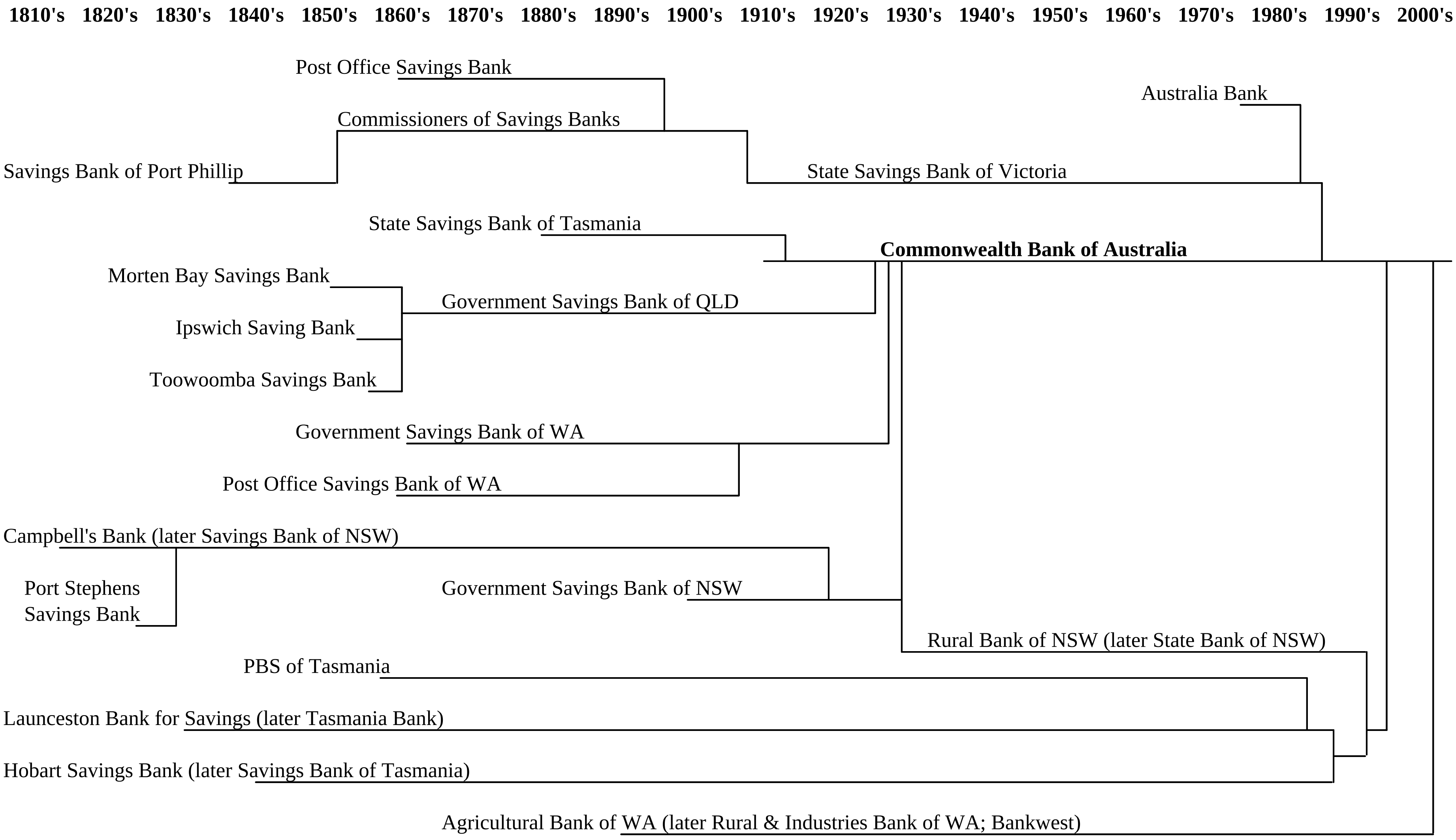


Chart 2: Australian Banks Family Tree — II. ANZ Bank

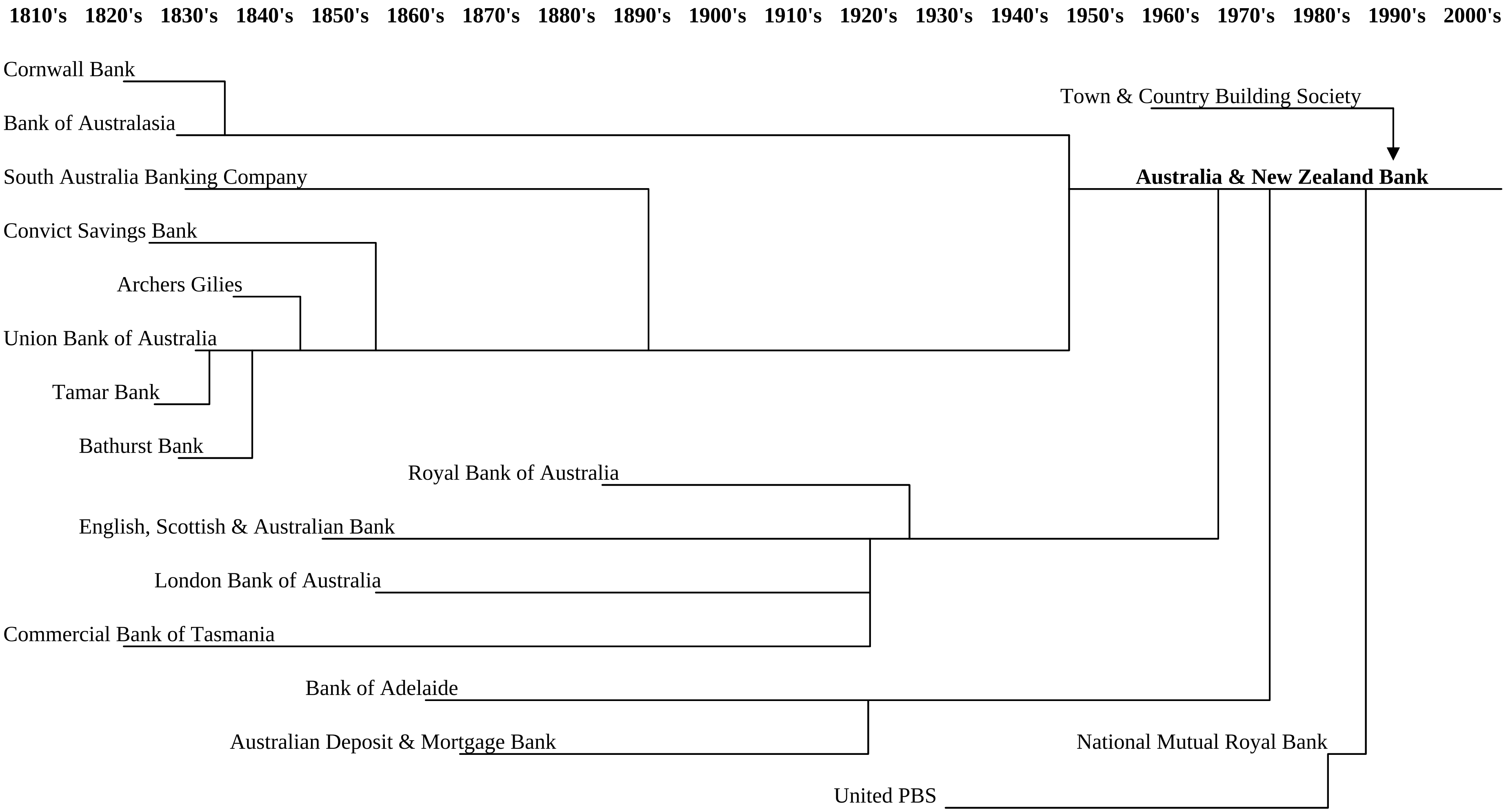


Chart 3: Australian Banks Family Tree III. NAB

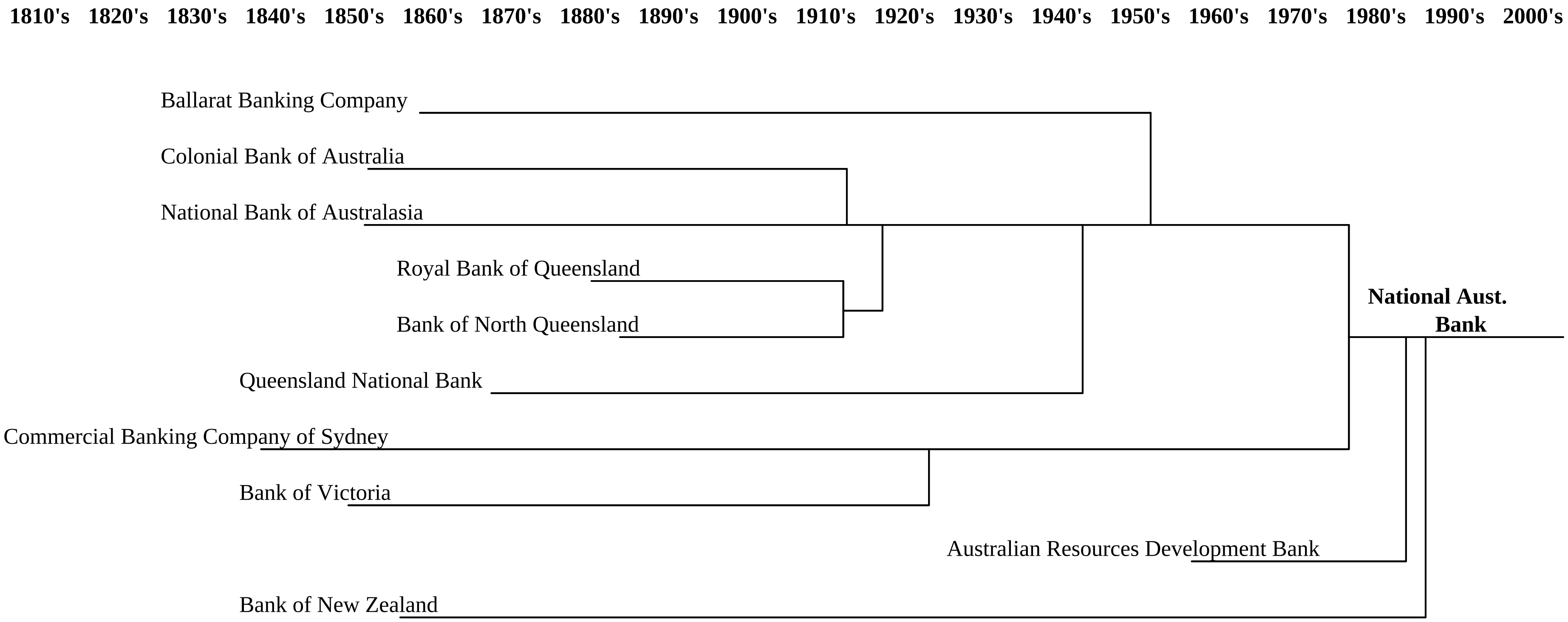


Chart 4: Australian Banks Family Tree IV. Westpac

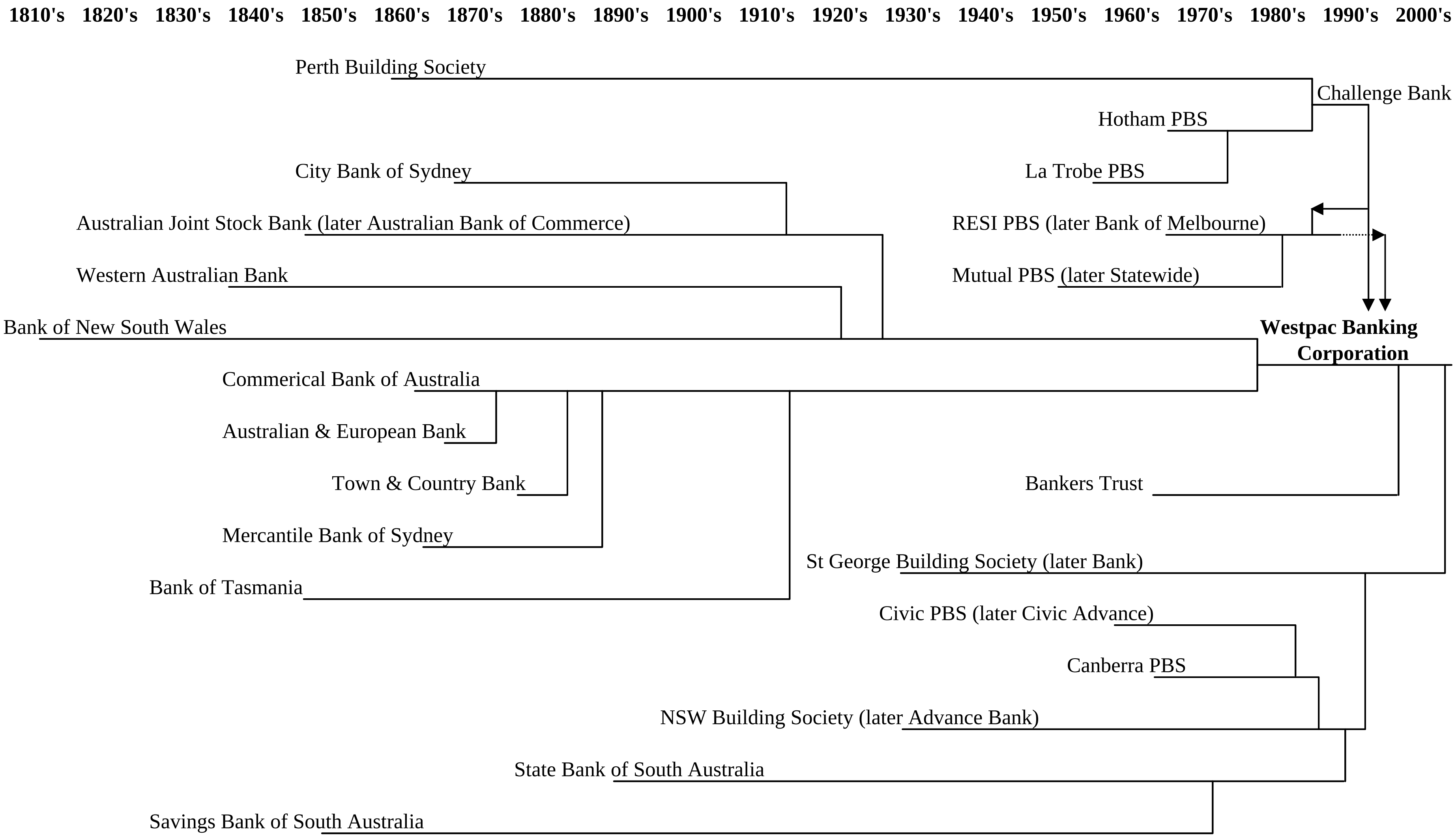
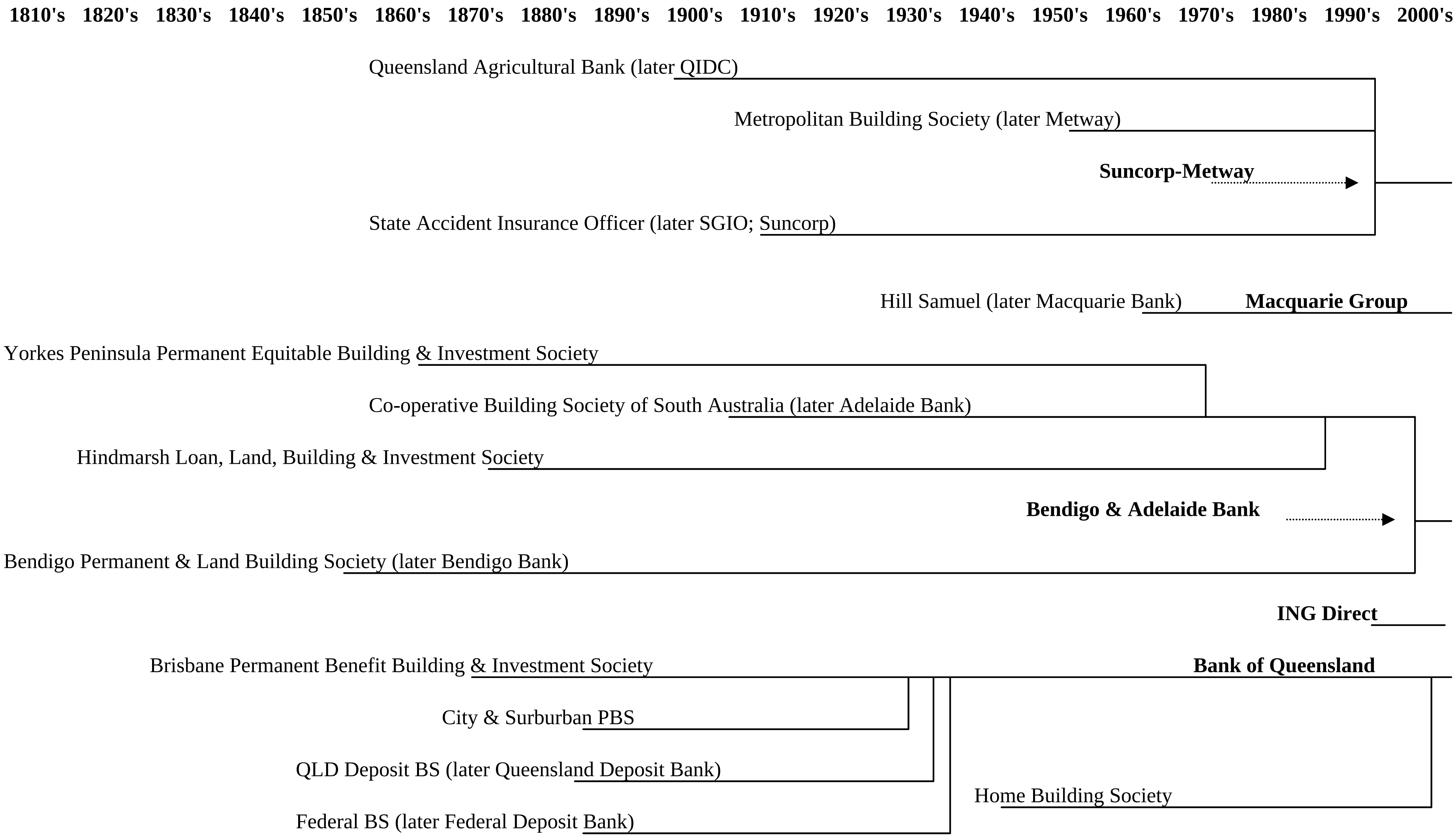


Chart 5: Australian Banks Family Tree V. Other



Chapter 3

Past reviews and calls for a new review

Introduction

3.1 This chapter both looks back to previous inquiries into the banking system and forward to calls for a new inquiry.

3.2 Five main inquiries into the Australian banking system, mostly following crises, have been identified by Associate Professor Selwyn Cornish.[1] These are the 1937 Royal Commission, the Campbell Committee, the Vic Martin Review Group, the Stephen Martin Report and the Wallis Report. After briefly discussing some earlier inquiries, this chapter examines each of these in turn, and then some recent parliamentary inquiries.

3.3 Drawing on Sir Harold Knight's[2] comments on the Campbell Committee, Mr Cornish described the role of the inquiries as being:

> …*an* agent of change rather than being *the* agent of change. It hastened the process of change and it did so by refocusing a hitherto inchoate or rather amorphous debate much more sharply on the key issues. It provided coherence and authority. An impressive report was produced, which set out the issues systematically. It argued judiciously and it concluded succinctly.[3]

3.4 The Committee hopes that future historians will make the same judgement about this inquiry.

3.5 But a difference between this inquiry and earlier inquiries is that this inquiry is more tightly focused, examining in particular *competition* in the banking system. By contrast, the earlier inquiries:

> …have not focused on what might be considered micro-economic issues; they were focused more on macro issues.[4]
>
> …have focused on bank stability, APRA regulation issues, bank accounting procedures and generally structural issues concerning bank operations. The

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1 Associate Professor Selwyn Cornish, *Submission 9*; *Committee Hansard*, 13 December 2010, p 112. Mr Cornish has written extensively on the development of economic policy in Australia and is currently working for the Reserve Bank on its official history from 1975 to 2000. He has written a shorter history of the Bank in Cornish (2010).

2 Sir Harold served as Governor of the Reserve Bank from 1975 to 1982.

3 Associate Professor Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 112.

4 Associate Professor Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 114.

> issue of competitive environment was not generally addressed, nor do the banks encourage it to be addressed.[5]

3.6 One difference between the various inquiries was the extent to which they were independent of government. The 1937 inquiry was a Royal Commission and the Stephen Martin inquiry, like this one, was by a parliamentary committee. Of the others, Professor Valentine's view is that:

> The Campbell inquiry was completely independent. In fact, I can tell you now, many years after the event, there were some rather furious confrontations with the then secretary of the Treasury, John Stone…He, for example, did not want the committee to recommend a floating exchange rate. The Wallis committee was half and half. It had an independent committee but the secretariat was...basically a Treasury secretariat.[6]

3.7 A common feature is that they were initiated by governments in response to public concerns. It has been noted that governments have reflected concerns about banks in their rhetoric for a long time:

> Looking at it over the last 20 years, every Treasurer, Prime Minister and minister has attacked the banks, verballed them, said awful things, threatened them, wept and cried…but nothing has changed.[7]

3.8 One submitter traced these concerns much further back:

> “The issue which has swept down the centuries and which will have to be fought sooner or later is the people versus the banks”; Lord Acton (1875)[8]

Early reviews of banking competition

3.9 Before the 1937 Royal Commission, there were at least three parliamentary committees which inquired into the banking system. As one witness observed:

> All the inquiries we have had, going back to the New South Wales upper house inquiry into monetary confusion in the 1840s, have talked about introducing new players and stimulating competition—and so did the Campbell and Wallis inquiries.[9]

3.10 The Tasmanian Parliament appointed a select committee in 1934 to review the financial system in that state. Influenced by the theories of the Douglas Social Credit

5 Mr Mervin Reed, *Submission 5*, p 14.

6 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 66.

7 Mr Peter Strong, Executive Officer, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, p 10.

8 Cited by Mrs Barbara and Mr Richard Wright, *Submission 18*, p 1. Lord Acton is probably best known for his dictum that 'power corrupts and absolute power corrupts absolutely'.

9 Mr David Richardson, Australia Institute, *Committee Hansard*, 15 December 2010, p 32.

movement it was critical of the 'monopoly of finance as represented by the private banks and their subsidiaries'.[10]

The 1937 Royal Commission

3.11 The Royal Commission into the Monetary and Banking Systems in Australia[11] (1935-1937) arose from concerns that the banking system had exacerbated the depressions of the 1890s and early 1930s. At the 1935 election the Country Party (and the Labor Party) had promised an inquiry and when the conservative government led by Joseph Lyons was forced to form a coalition with the Country Party, he agreed to establish an inquiry.[12]

3.12 The Commission was chaired by Justice John Napier and among its members was future treasurer and prime minister Ben Chifley.[13] The Commission held 105 public sessions and heard from 200 witnesses.[14]

3.13 The Royal Commission concluded the best system would be one:

> …in which trading banks and other financial institutions are integral parts of the system, with a central bank which regulates the volume of credit and currency.[15]

10 Parliament of Tasmania, *Monetary System: Report of Select Committee*, 1935.

11 Its full name was *Royal Commission appointed to inquire into the Monetary and Banking Systems at present in operation in Australia, and to report whether any, and if so what, alterations are desirable in the interests of the people of Australia as a whole, and the manner in which any such alterations should be effected*.

12 Chapter One of Sutherlin (1980) discusses this in more detail.

13 The other members were Edwin Nixon, an accountant who had also served on the Royal Commission on Taxation; Richard Mills, Professor of Economics at the University of Sydney (who according to Groenewegen (1986) and Sutherlin (1980, p 47) was responsible for much of the drafting); Henry Pitt, Director of Finance at the Victorian Treasury; and Joseph Abbott, president of the Graziers' Association of New South Wales. The secretary was W Harris, a Treasury accountant, and the staff economist was John Phillips, a student of Mills then with the Retail Traders Association who went on to become the Reserve Bank's second governor. The Government sounded out some overseas experts about being on the commission but could not find someone they regarded as suitable who was willing to participate; Sutherlin (1980, pp 32-35). Phillips reflected much later that 'the Royal Commission's major impact was the education of Ben Chifley'; Sutherlin (1980, p 278).

14 Hearings were advertised and 'all who intimated their desire to appear before the Commission were given an opportunity to appear'; Royal Commission into Monetary and Banking Systems, *Report*, p 5.

15 Royal Commission into Monetary and Banking Systems, *Report*, p 201. Mr Chifley dissented, preferring a 'system from which the profit motive is absent'; p 263.

3.14 It recommended stricter controls – both of a direct and indirect nature – over the monetary and banking systems of Australia. Many such controls were introduced as temporary wartime measures, and then made permanent by Mr Chifley in the *Banking Act 1945*.

3.15 The Commission also suggested that banking licences be issued and only those organisations possessing one should be able to style themselves as 'banks'.[16]

3.16 The Commission remarked on the essential role played by banks and the subsequent obligations this involved:

> Under modern industrial conditions practically no branch of industry can be carried on without adequate supplies of bank credit…therefore, these banks should be regarded as enjoying a privileged position which closely resembles that of a public utility.[17]

3.17 The Commission noted the lack of adequate disclosure of profits and the lack of comparability in reported results, and made recommendations to address this.[18] The lack of good information impeded the Commission in reaching conclusions about bank profitability but it opined that the banks:

> …are entitled to a fair return for the services which they render…If these [profits] are found to exceed what may be regarded as a fair return for the services rendered, the Government should consider whether the profits of the trading banks should be regulated or limited as in the case of some public utilities.[19]

3.18 Perhaps because at the time there were ten major banks rather than four, competition was not a major focus:

> So far as they have gone, amalgamations do not appear to have lessened the competition between trading banks, which, as we have already pointed out, is in some measure restricted.[20]

3.19 The Commission supported the Commonwealth Bank continuing as a competitor with the trading banks.[21]

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16 Royal Commission into Monetary and Banking Systems, *Report*, pp 248-251. State banks and savings banks established under state law could also call themselves 'banks'.

17 Royal Commission into Monetary and Banking Systems, *Report*, p 247.

18 Royal Commission into Monetary and Banking Systems, *Report*, pp 238-246.

19 Royal Commission into Monetary and Banking Systems, *Report*, p 247. Mr Chifley recommended legislation limiting bank profits to the lower of 5 per cent on shareholders' funds or 8 per cent on paid capital; p 268.

20 Royal Commission into Monetary and Banking Systems, *Report*, p 238.

21 Royal Commission into Monetary and Banking Systems, *Report*, p 224.

3.20 The Commission's report was initially well–received, with *The Economist* comparing it favourably to similar investigations in Britain, Canada and New Zealand.[22] But growing opposition from the private banks prevented the Lyons Government implementing its recommendations.[23]

3.21 For those nostalgic for a more regulated financial system, the Commission was:

> The last inquiry to offer decent insight into the financial sector in Australia…[24]

Campbell Committee

3.22 A broad-ranging inquiry into the Australian economy in 1965 recommended a review of the credit system noting the marked changes in the monetary field since the Royal Commission, but as with most recommendations in the *Vernon Report*, no action was taken.[25] It was not until 1979 that there was another comprehensive review.

3.23 The Committee of Inquiry into the Australian Financial System (1979-1981) arose from a government promise to hold an inquiry into capital markets, which was widened to cover the whole financial system.

3.24 Associate Professor Cornish summarised the Campbell Committee report as seeking to:

> …explain how the regulatory system had broken down. The world had changed. If the monetary authorities were to succeed in combating current problems of which inflation was the major one then new systems of operation had to be implemented. The report's principal recommendation included the deregulation of bank interest rates; the introduction of tender systems for the marketing of government debt; and a managed float of the Australian dollar, not a free float. Some of these reforms were underway before the Campbell Committee reported.[26]

3.25 The reforms arising from the Campbell Committee allowed the Reserve Bank to formulate the cash rate system, which is now the major operational instrument for conducting monetary policy in Australia.

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22 *The Economist*, 16 October 1937, cited in Sutherlin (1980, pp 3, 177). See the fifth chapter of her thesis for more deatil on the reaction from the media, the banks and acdemics.

23 Sutherlin (1980, pp 237-256).

24 Dr Evan Jones, *Submission 81*, p 15.

25 *Report of the Committee of Economic Inquiry*, Volume 1, p 272.

26 Associate Professor Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 113.

3.26 For Mr Cornish, the Campbell Committee report is the most impressive of the five. A contrary view was presented by Dr Evan Jones:

> … the stellar reputation of the Campbell Report is undeserved.[27]

3.27 Dr Jones argues that the inquiry started from a view that deregulation was desirable and interpreted all evidence in this light. Dr Jones claims this led to undesirable recommendations:

> The Campbell report bequeathed us abolition of specialist (including government-owned) institutions, market-based banking regulation (generally confined to hands-off prudential regulation), and market-based monetary policy (generally confined to manipulation of the cash rate). The abolition of specialist institutions has been a significant mistake…The over-dependence on prudential regulation has produced failings – lack of control over credit excesses (indeed contributing to it by the discounting of capital requirements on residential mortgage lending), lack of control over bank tendencies to illiquidity; lack of control over off-balance sheet manoeuvrings – but the attraction to the system (not least because of Basel-based global legitimation) remains undiminished. The ludicrous overdependence on the single short term cash rate instrument has produced manifest failings – a fundamental enhancing of boom and bust…[28]

3.28 The Campbell Committee emphasised free entry (or 'contestability' in the jargon) as the key to competition :

> As argued throughout this Report, any competitive deficiencies will generally be short-lived so long as there is effective freedom of entry…the mere *threat* of new entry will act as a strong incentive for established firms to remain efficient and competitive.[29]

3.29 It did, however, call for the Reserve Bank to be accorded a watchdog role:

> …the committee recommends that the Reserve Bank should undertake regular reviews of the overall functioning of the financial system, in the context of which it should diagnose and report on any structural problems that appear to exist and any barriers to effective competition, especially government-induced barriers.[30]

3.30 The Campbell Committee noted concerns about concentration in the banking industry and observed:

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27 Dr Evan Jones, *Submission 81*, p 15.

28 Dr Evan Jones, *Submission 81*, p 15.

29 *Committee of Inquiry into the Australian Financial System*, pp 531 and 538.

30 C*ommittee of Inquiry into the Australian Financial System*, p 533.

> While exactly comparable figures from other countries are not available, levels of concentration in Australia appear to be at the upper end of the spectrum by world standards – at least in respect of banking.[31]

3.31 The only response it regarded as appropriate, however, was:

> …the use of the *Trade Practices Act* to prevent an individual institution from acquiring a dominant position in the market and, in the process, substantially lessening competition.[32]

Vic Martin Review Group

3.32 The Australian Financial System Review Group (1983-1984) was commissioned by the Hawke Government soon after its election, essentially to review the Campbell Committee's recommendations in light of the incoming government's economic and social priorities. The Group was chaired by Vic Martin, the chair of the MLC insurance group, and also included Treasury and Reserve Bank officials and an academic.[33] Given the extensive recent consultation by the Campbell Committee, and its short timeframe, the Group decided against inviting public submissions or holding hearings.

3.33 The Group concluded:

> Market-oriented policy…is seen as having considerable advantages for monetary policy purposes…the Group does not consider controls over bank interest rates as appropriate for either monetary policy or prudential purposes.[34]

3.34 It supported competition in banking:

> Competition provides incentives for firms to produce at minimum cost, to price in accordance with the cost of production, and to respond to changing community needs by innovating in product design, extending product variety and so on.[35]

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31 *Committee of Inquiry into the Australian Financial System*, p 537.

32 *Committee of Inquiry into the Australian Financial System*, p 540.

33 Mr Richard Beetham from Treasury, Mr Des Cleary from the Reserve Bank and Professor Keith Hancock from Flinders University.

34 Australian Financial System Review Group, *Report*, pp 361-362.

35 Australian Financial System Review Group, *Report*, p 53.

3.35 The Group noted that mergers had led to the creation of four large banks, although at this time there were also a number of state-owned and regional banks.[36] Nonetheless the Group opined:

> …the oligopolistic structure of the industry and its regulated nature suggest that policies to enhance competition would benefit the Australian community.[37]

3.36 As well as regulatory barriers the Group identified as a barrier to increased competition:

> …the perceived difficulty of competing with the established banks, which have a substantial (albeit declining) base of non-interest-bearing deposits and strong ties with established customers.[38]

3.37 It supported the entry of foreign banks (with some limitations) but wanted to keep banks distinct from other intermediaries:

> The Group supports, as a general principle, the continuation of a basic distinction between banks and non-bank financial institutions…It reflects the view that undoubted confidence in banks is crucial to a well-functioning and stable financial system.[39]

3.38 Mr Cornish characterised the Group as:

> …a follow-up to the Campbell committee…Prime Minister Hawke and Treasurer Keating commissioned a small group…to investigate the Campbell Committee's recommendation in the light of the new government's social and political priorities. The Martin Group gave the major Campbell Committee recommendations a big tick,..[40]

3.39 Dr Jones regards it as having:

> …effectively facilitated the Hawke Labor Government 'taking ownership' of the Campbell report agenda.[41]

Stephen Martin Committee

3.40 The House of Representatives Standing Committee on Finance and Public Administration was referred an inquiry into banking and deregulation (1990-1991).

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36 As the Group puts it, 'The perception of the banking industry as oligopolistic must be modified, to some degree, by acknowledging the competition provided by State banks'; *Report*, p 53.

37 Australian Financial System Review Group, *Report*, p 54.

38 Australian Financial System Review Group, *Report*, p 51.

39 Australian Financial System Review Group, *Report*, pp 52-53.

40 Associate Professor Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 113.

41 Dr Evan Jones, *Submission 81*, p 15.

The inquiry was established to assess the consequences of the financial deregulation that had ensued after the Campbell Committee's report. Its report, *A Pocketful of Change*: *Banking and Deregulation*, found that Australian banks were highly profitable by international standards. Deregulation had led to narrower interest margins overall but it appeared business was gaining more benefit than were consumers.[42] Cross-subsidies were being unwound as 'user pays' became more prevalent.

3.41 The Committee concluded concerning the impact of deregulation on competition that:

> …the four major banks have retained their market share and, accordingly, their dominant position in the industry; at the regional level, vigorous competition for market share is provided by locally based State banks, regionally operating banks and non-bank financial intermediaries; and foreign banks have had limited impact…[43]

3.42 The Committee warned that:

> The concerns which exist among various sections of the community about the trend towards increased concentration in the banking industry are shared by the Committee. There are dangers that increased concentration, by reducing the number and influence of competitors, ultimately could affect the level of industry efficiency, as the incumbent banks would be under less pressure to generate improved performances. Equally, there is greater likelihood of collusive or anti-competitive practices emerging, with consumers having less opportunity to move their business to alternative institutions. Clearly, such outcomes would be counter to the aims of financial deregulation.[44]

3.43 Accordingly, the Committee recommended:

> …the Treasurer, in considering proposals for mergers or acquisitions in the banking industry, refer to the Trade Practices Commission[45] for determination the question of whether the proposed merger or acquisition would substantially lessen competition in a substantial market, and whether there are any public benefits which would outweigh the detriment from the substantial lessening of competition.[46]

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42 A summary of the report's conclusions on banking and deregulation is given in Martin and Hawkins (1992).

43 House of Representatives Standing Committee on Finance and Public Administration (1991, p 117).

44 House of Representatives Standing Committee on Finance and Public Administration (1991, p 127).

45 The Trade Practices Commission was the forerunner to the Australian Competition and Consumer Commission.

46 House of Representatives Standing Committee on Finance and Public Administration (1991, p 128).

3.44 While the Committee was broadly supportive of the impetus to competition from deregulation, it acknowledged that banks had made some mistakes in handling the transition to a deregulated market. Access to the payments system was identified as a remaining barrier to competition.[47] The long-standing reputations and extensive branch networks of the four major banks were seen as a barrier to entry for potential competitors in the retail banking market.

3.45 Dr Jones gives the report mixed reviews:

> The [Stephen] Martin report did desirably concern itself with banking concentration (Ch.6), noting that the deregulation years had brought the Big 4 to market dominance. The Committee declined to succumb to the industry's siren song that competition was raging; indeed, it presciently raised the concern that things might be getting worse, with the threat of 'group dominance' of the entire finance system because of the latter day appearance of 'financial conglomerates'…Concerns for increasing concentration and lessening competition apart, the weighty Martin report was a fizzer.[48]

3.46 The Committee itself assessed how its recommendations had progressed a year after the report in a review called *Checking the Changes* (illustrating an advantage of an inquiry being done by a body with an ongoing existence.) This noted that the government had 'responded quickly' with some of the recommendations on foreign bank entry, supervisory arrangements and payments system matters implemented within three months.[49] A few months later the government agreed to the recommendation that a 'substantial lessening of competition' test be applied to mergers.[50] The Committee was given a continuing role in reviewing the banking industry.

3.47 The review itself concentrated on those recommendations directed to the banks, concluding:

> …most banks have made genuine efforts to implement specific recommendations and to respond to the general tenor of the Banking Report.[51]

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47 House of Representatives Standing Committee on Finance and Public Administration (1991, pp 136-142).

48 Dr Evan Jones, *Submission 81*, p 16.

49 House of Representatives Standing Committee on Banking, Finance and Public Administration (1992, pp 1-2).

50 House of Representatives Standing Committee on Banking, Finance and Public Administration (1992, p 2).

51 House of Representatives Standing Committee on Banking, Finance and Public Administration (1992, p 116).

Wallis Committee

3.48 The Financial System Inquiry (1996-1997) was established soon after the Howard Government took office, fulfilling a promise to examine the consequences of financial deregulation.

3.49 It set out an underlying philosophy:

> Free and competitive markets can produce an efficient allocation of resources and provide a strong foundation for economic growth and development.[52]

3.50 These philosophical underpinnings for the Wallis Committee have been questioned:

> As Professor Harper, who was on the Wallis inquiry, has said, they were based on the assumption that the financial markets were efficient.[53]

3.51 The Wallis Committee commented on the role of competitors to the four major banks:

> Regional banks have been an increasingly important competitive force in recent years. In particular, along with credit unions and building societies, they have led the way on service, innovation and pricing on some products...However, there is nothing immutable about the present position of regional banks.[54]

3.52 Notwithstanding this recognition of both the positive role and vulnerability of these competitors, the Wallis Committee's recommendations envisaged a reduction in controls on mergers:

> The *Trade Practices Act* should provide the only competition regulation of financial system mergers...The 'six pillars' policy – which separately imposes a government prohibition on mergers among the largest four banks and the largest life companies – should be removed.[55]

3.53 As with earlier inquiries the payment system was identified as an area for reform:

> Access to clearing systems should be widened to include all institutions fulfilling objective criteria set by the regulator.[56]

3.54 The Wallis Committee recommended creation of a separate prudential regulator for all deposit-accepting institutions, including the insurance and

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52 *Financial System Inquiry Final Report*, p 177.

53 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 105.

54 *Financial System Inquiry Final Report*, p 455.

55 *Financial System Inquiry Final Report*, pp 425 and 428.

56 *Financial System Inquiry Final Report*, p 401.

superannuation industries. These recommendations on supervision, realised in the creation of the Australian Prudential Regulation Authority, were lauded by some submitters:

> At least the Wallis Inquiry appears to have achieved something beneficial in the national interest. It is reported that the government of the day overwhelmingly adopted his report and established APRA…It is likely that without APRA and its regulatory framework the Australian economy may not have emerged as unscathed from the GFC.[57]

3.55 Again, Dr Jones is less enthusiastic about the report:

> …its untarnished reputation is undeserved. Its views on competition are insipid…It kowtows to the contemporary prestige of contestability notions…[58]

Recent parliamentary inquiries

3.56 There have been a number of inquiries by parliamentary committees into aspects of competition in banking in recent years. Disappointingly, there have been no formal government responses to them.

Home loan lending (2007)

3.57 A House of Representatives committee examined home loan lending practices. It noted how the entry of new players into the home loan market and an increased preference for residential lending among existing financial intermediaries had led to a reduction in interest margins but also a loosening in credit standards which had led to an increase in mortgage defaults. The committee recommended that:

> ..the Commonwealth Government regulate credit products and advice. This includes the regulation of mortgage brokers and non-bank lenders.[59]

Competition in banking and non-banking (2008)

3.58 Perhaps the inquiry most similar to this one is that by this committee's sister committee in the House. While the global financial crisis was still raging they reviewed the state of competition in the banking market and options to improve it. Their report observes:

> The non-banking sector, which has primarily relied on securitisation as a means of funding, has been the hardest hit and, as noted above, there has

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57 Mr Lindsay Johnston, *Submission 97*, p 14.

58 Dr Evan Jones, *Submission 80*, p 17.

59 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Home Loan Lending*, September 2007, p 49.

> definitely been a reduction in the amount of providers and products in the mortgage market.[60]

3.59 Looking forward, their prediction was that:

> Increased levels of competition will return, but with the current financial climate groups are uncertain of how long it will take and whether it will be as effective as it was prior to 2007.[61]

3.60 A proposal to create a government-guaranteed 'AussieMac', based on the Canada Mortgage and Housing Corporation, to support the residential mortgage securitisation market was evaluated. The conclusion was that the:

> …proposal is not a suitable model for the Australian context.[62]

3.61 On competition law, the conclusion was:

> Both the ACCC and ASIC are constrained by their respective Acts which do not provide them with the power to independently investigate and report on issues of concern that relate to competition within the marketplace.[63]

3.62 Positive credit reporting was seen as helping smaller lenders compete with the major banks and the committee recommended:

> The committee supports the findings of the Australian Law Reform Commission's report and urges the government to implement the report's recommendations on reforming Australia's credit reporting system.[64]

3.63 Account switching was another focus and the committee noted that the switching rate for transaction accounts in Australia was below that in Europe. The committee noted the switching package introduced by the Government in November 2008 and recommended that the Government consider including card schemes in the package.[65] They further recommended that:

> …after 12 months in operation, the Treasury review the Account Switching Package with consideration being given to any areas in which it may be enhanced, including consideration of the costs and benefits of a more centralised account switching system, such as those in operation in the UK and the Netherlands.[66]

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60 House of Representatives Standing Committee on Economics, *Competition in the banking and non-banking sectors*, November 2008, p 21.

61 *Competition in the banking and non-banking sectors*, November 2008, p 24.

62 *Competition in the banking and non-banking sectors*, November 2008, p 39.

63 *Competition in the banking and non-banking sectors*, November 2008, p 52.

64 *Competition in the banking and non-banking sectors*, November 2008, p 56.

65 *Competition in the banking and non-banking sectors*, November 2008, p 56.

66 *Competition in the banking and non-banking sectors*, November 2008, p 74.

3.64 A lengthy discussion of the impact of exit fees on competition was somewhat inconclusive:

> The committee is uncertain whether there is a definite, across the board, negative impact on competition caused by the imposition of entry and exit fees on mortgage products…The Committee recommends that…the government consider mechanisms for making entry and exit fees more transparent and for addressing unfair entry and exit fees.[67]

3.65 The importance of improved financial literacy was recognised:

> The committee recommends that the Australian Securities and Investments Commission includes a glossary of standardised financial terms in simple language on its consumer website and also on the Financial Literacy Foundation's website.[68]

Bank mergers (2009)

3.66 This committee examined bank mergers in an earlier inquiry. A focus of the recommendations was improving the provision of information:

> The Committee recommends that the ACCC increase the transparency of their merger inquiries by publishing commissioned research and submissions unless the submitter explicitly asks that they be confidential…The Committee recommends that the Government request the ACCC, APRA and the Reserve Bank to provide a joint annual report to parliament on competition in the retail banking market in Australia, and the provision of affordable banking facilities to those on low incomes, but taking care not to increase unduly the reporting burden on financial institutions.[69]

3.67 It also was concerned about further increases in concentration in the banking industry:

> The Committee recommends that the Government retain the 'four pillars' policy of not allowing a merger between any of the four major banks…The Committee regards it as reasonable for the Treasurer to impose conditions on banks before approving a merger. Once conditions are imposed, there should be independent verification and appropriate penalties if the bank is not complying.[70]

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67 *Competition in the banking and non-banking sectors*, November 2008, p 86.

68 *Competition in the banking and non-banking sectors*, November 2008, p 98.

69 Senate Economics References Committee, *Report on Bank Mergers*, September 2009, pp 53-54.

70 Senate Economics References Committee, *Report on Bank Mergers*, pp 56 and 60.

Government funding guarantees (2009)

3.68 This committee examined the Government's two schemes to provide guarantees for bank deposits and other funding introduced in October 2008. (The schemes are discussed further in Chapter 12.) The Committee recommended changes to the premia charged for the scheme:

> The Committee recommends that, in view of the experience of markets not pricing all guaranteed debt identically, the Government review the need to apply differential premia for ADIs with different ratings for the wholesale funding guarantee (and hence also that applying to deposits over $1 million).[71]

3.69 Recognising the problems in the securitisation market, the Committee recommended that:

> …the Government introduce an appropriately designed guarantee scheme for residential mortgage-backed securities.[72]

3.70 Foreshadowing some of the issues faced in this inquiry, the Committee commented:

> During financial crises, the balance of concern tends to move from competition towards solvency. One manifestation of this is that the authorities tend to be more likely to allow mergers. The Committee regards it is appropriate for greater weight to be given to solvency concerns in a crisis. But a fine judgment is required as to how much the emphasis should shift, as it may be hard to revive competition once the crisis has passed.[73]

Bank accountability (2009)

3.71 The Senate Economics Legislation Committee examined a bill that would require a bank to explain to the Treasurer if it had moved interest rates contrary to movements in official interest rates and if the Treasurer regards the move as contrary to the public interest empower him to revoke the guarantee of the bank's deposits under the Financial Guarantee Scheme.

3.72 The Committee recommended against the bill as:

> … it is concerned that the bill may discourage banks from competing in reducing interest rates, could lead to higher bank fees and/or reduced lending to homebuyers, could raise doubts about the deposit guarantees and

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71 Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector – The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 19.

72 Senate Economics References Committee, *Government measures*, September 2009, p 34.

73 Senate Economics References Committee, *Government measures*, September 2009, p viii.

> so reduce confidence in the safety of bank deposits and could be perceived as politicising the setting of bank interest rates.[74]

3.73 Instead it argued for better disclosure of information around the cost of funds:

> The Committee recommends that the Reserve Bank and the Australian Prudential Regulation Authority regularly publish estimates of the costs of funds for the banking sector as a whole and bank interest margins.[75]

Access of Small Business to Finance (2010)

3.74 The Committee examined the availability of finance for small business. (This topic is discussed further in Chapter 6.) It reiterated earlier concerns about concentration in banking, recommending:

> …the Government retain the 'four pillars' policy of not allowing a merger between any of the four major banks…a moratorium be placed on approval of any further takeovers in the banking industry for one year, unless the bank being taken over is at imminent risk of failure…the *Trade Practices Act* be amended to inhibit firms achieving market power through takeovers or abusing market power and that 'market power' be expressly defined so that it is less than market dominance and does not require a firm to have unfettered power to set prices. A specific market share, such as, for example, one third (set based on international practice), could be presumed to confer market power unless there is strong evidence to the contrary.[76]

3.75 It viewed increasing competition as preferable to other suggestions for improving access by small business:

> The Committee notes the suggestion of a development bank but prefers to increase competition within the existing commercial banks…The Committee notes the suggestion of a guarantee for loans to small business but prefers to increase competition within the commercial banks rather than for a government entity to assume the risk.[77]

Access for Small and Medium Business to Finance (2011)

3.76 The Joint Committee on Corporations and Financial Services revisited the issue of the availability of finance in early 2011. Its main suggestion for improving competition was to strengthen the mutual sector and it recommended the government explore further means of doing this. It also recommended that minimum notice

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74 Senate Economics Legislation Committee, *Banking Amendment (Keeping Banks Accountable) Bill 2009*, November 2009, p 17.

75 Senate Economics Legislation Committee, *Banking Amendment*, November 2009, p 10.

76 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

77 Senate Economics References Committee, *Access of Small Business to Finance*, pp 60 and 68.

periods for adverse changes in terms and conditions of small business loans be added to the relevant codes of practice.

Calls for future banking inquiries

3.77 There have been some suggestions that in addition to this inquiry into *competition* in banking, there needs to be a broader inquiry into other aspects of the financial system. As Associate Professor Cornish notes, the five banking inquiries discussed above followed the depressions or recessions of the 1930s, 1970s, 1980s and 1990s, so:

> …it is not surprising that, following the Global Financial Crisis or Great Recession of 2007/09, calls have been made for a new inquiry; similar calls for inquiries have been made in other countries.[78]

3.78 A number of submitters and witnesses, particularly academics, made such a call:

> Following the lessons that have been learned during the global financial crisis, and the 12 years that have elapsed since the last such exercise, we believe that a broad-based inquiry into the integrity of Australia's financial system is now warranted.[79]
>
> …there are strong arguments for there to be regular inquiries into the financial system, similar to the Campbell, Martin and Wallis Committees.[80]
>
> Recommendation: Call a new enquiry to identify fundamental areas of concern in the wider banking industry – in particular, bank products and ways to regulate these products.[81]
>
> A complete and independent review of the Australian banking sector by the Productivity Commission is recommended.[82]
>
> A Royal Commission into the Banking sector is inevitable as there will be so many more vulnerable people losing their homes in the foreseeable future.[83]

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78 Associate Professor Selwyn Cornish, *Submission 9*, p 3.

79 Joshua Gans, Nicholas Gruen, Christopher Joye, Stephen King, John Quiggin and Sam Wylie, *Submission 103a*.

80 Dr Tom Valentine, *Submission 14*, p 5.

81 'Ren', *Submission 19*, p 1. Similar calls were made by Dr Brett Edgerton, *Submission 20*, p 2; Mr Terence Holmes, *Submission 3*, p 2; Mr Andrew Thomas, *Submission 73*, p 17; and Mr Lindsay Johnston, *Submission 97*, p 12.

82 WA Small Enterprise Network, *Submission 68*, p 3.

83 Banking and Finance Consumers Support Association, *Submission 112*, p 25.

> …what we probably need—looking at the terms of reference of your own committee—is a review that is broader than just thinking about competition. It is really thinking about our financial regulations…[84]

3.79 A survey of businesses in Queensland found that over 70 per cent supported a full review of the financial system.[85]

3.80 There were some in the banking community who supported a review but thought now was not the most propitious time:

> …although we support in principle the concept that regular reviews of the financial system are warranted, we believe that in all the circumstances currently before us, it would be appropriate to conduct such a wide-ranging inquiry when major international and domestic regulatory change has settled down over the next three to four years.[86]

3.81 Others thought it would be a mistake to wait for a 'more settled' time:

> I suspect it is going to be a long time before, for example, the sovereign debt crisis and the various adjustments in Europe play out. There is no guarantee that that resolution will come before the next financial crisis.…the likelihood is that we are not going to get a period of calm much better than the current one without running into the risk that we could see a severe financial shock. For example, a downturn in China, a collapse in the housing prices here or a number of factors could expose our system to severe stress.[87]

3.82 Some submitters saw an additional inquiry as unnecessary:

> …the FSU does not champion the notion that there is a need for a "son of Wallis" type inquiry…Rather, efforts ought to be made to implement the outcomes/recommendations from recent parliamentary reviews into the banking sector.[88]

3.83 Yet other witnesses were agnostic:

> I am not here to advocate another major inquiry into the Australian financial system at this time, nor am I saying that there should not be another inquiry.[89]

> Whether or not we require a further inquiry I think depends very much on the findings of this committee…[90]

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84 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 103.

85 Chamber of Commerce and Industry Queensland, *Submission 43*, p 16.

86 Westpac, *Submission 72*, p 39. See also Australian Bankers' Association, *Submission 76*, p 43.

87 Professor John Quiggin, *Proof Committee Hansard*, 4 March 2011, p 48.

88 Finance Sector Union, *Submission 80*, p 1.

89 Mr Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 112.

3.84 The Committee heard calls for decennial reviews of the banking system:

> I also recommend, and have done ever since I worked with the Campbell committee in the early eighties, that there be regular and independent inquiries into the financial services industry. We had an understanding then, which was continued into the Wallis committee, that there would be a review every 10 years. It is now 14 years since the Wallis committee. Consequently, I think it is probably time for another such review.[91]

3.85 The Wallis Report titled its overview section "Towards 2010", suggesting another review is due by now to chart the future direction.

3.86 Regular inquiries are the pattern in some other countries:

> In Canada, for example, it is well established now that they have a comprehensive review of the financial system every 10 years.[92]

3.87 On the possible focus of such an inquiry, Associate Professor Cornish notes:

> New methods and techniques of operation in the financial services industry were introduced over the preceding twenty years and some of them contributed no doubt to the recent financial and economic collapses around the world. The financial crisis itself has revealed weaknesses in regulatory procedures in some of the world’s preeminent financial centres, and there have been deficiencies in the way that some of these countries have conducted their monetary and financial policies.[93]

3.88 The Stephen Martin Committee identified a cyclical pattern in both bank behaviour and public inquiries:

> The people have also looked to governments to rein in the excesses of banks. Banks have been prone to overreact in both booms and busts. Imprudent lending fuelled the speculative mania of both the 1880s and the 1980s. Excessive contraction of credit worsened the slumps of the 1890s and 1930s. Many believe this pattern is repeating itself in the early 1990s. In many cases, changes in government controls over the financial system followed major public inquiries...Other steps include regulation. This has moved in a cycle.[94]

3.89 Some submitters requested further inquiries into specific aspects of competition in banking:

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90 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 133.

91 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 62.

92 Associate Professor Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 119.

93 Associate Professor Selwyn Cornish, *Submission 9*, p 3.

94 *A Pocket Full of Change: Banking and Deregulation*, p 35.

> In addition to this Senate inquiry process, the Government should commission the Productivity Commission to conduct an inquiry into examining the degree of competition in the provision of business finance. The study should examine:
>
> 1. The impact of an increasing/decreasing number of participants in lending markets;
> 2. The implication of repricing of risk to businesses;
> 3. The changes that have occurred in the cost and availability of finance to business, especially smaller enterprises, over time; and
> 4. International experiences in encouraging banking competition and their advantages and disadvantages if applied in Australia.[95]

> Master Builders recommends that the Productivity Commission conduct an independent inquiry into the banking system to improve competition within the Australian banking system.[96]

> At the risk of raising yet another inquiry, I think we need a far more fact based view on the sources of competitive advantage in banking. I think the merits of maintaining the current biases towards major bank regulations needs independent analysis.[97]

3.90 After the Committee had concluded its hearings, it emerged that Treasury was also an advocate of a broader inquiry into the financial system. In its 'Red Book' briefing to the re-elected government, released under Freedom of Information in March 2011, Treasury referred to:

> …initiating a comprehensive financial sector review in order to take stock of the lessons of the financial crisis and draw together the work currently being undertaken both here and internationally….Australia has not undertaken a comparable review since 1997 and we strongly urge you to make this a key priority in your second term… There is merit in establishing an inquiry that draws together the existing work streams and considers broader, more systemic issues. This includes considering the lessons from the GFC and the balance between the dual objects of stability and safety, and competition and efficiency. The best time for such an inquiry to commence is once markets have stabilised and G20 outcomes have become clear.[98]

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95 Australian Chamber of Commerce and Industry, *Submission 37*, pp v-vi.

96 Master Builders' Association, *Submission 38*, p 6.

97 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 15.

98 'Incoming Government Brief", pp 2-3 and 36. Available on Treasury website at http://www.treasury.gov.au/documents/1875/PDF/01_Overview.pdf.

Recommendation 1

3.91 The Committee recommends that a broad ranging inquiry into the Australian financial system be established, modelled on that conducted by the Campbell Committee. The terms of reference should be broad, covering the role of banks and other financial institutions in a post-GFC financial environment. The inquiry should be well resourced and have its own secretariat, independent of government departments.

Chapter 4

Assessing competition in the Australian banking market

Overview

4.1 The Committee agrees with Treasury that:

> Competition is the cornerstone of efficiency and productivity in any market. It promotes fair prices, enhances living standards and ensures that scarce resources are allocated to their highest value uses.[1]

4.2 The extent of competition in the Australian banking industry has been examined in two recent reports by the Senate Economics References Committee. Some observations from these reports are:

> The Australian banking market is dominated by four large banks, now accounting for around ¾ of the market. This has resulted from a series of mergers going back more than a century.[2]
>
> A consequence of these mergers has been a long-run tendency towards increased concentration within the Australian banking industry. There was a temporary reduction in concentration with the deregulation of the 1980s, mostly reflecting the entry of foreign banks and conversion of the larger building societies, but this has now been overwhelmed by the ongoing mergers. As a result the Australian banking market is now, by some criteria, the most concentrated it has been for more than a century…The Australian banking market is now quite concentrated by international standards. This is likely to be one reason it is more profitable, and has wider interest margins, than banks in most comparable countries…[3]

4.3 There are a number of metrics by which the state of competition can be assessed. As Treasury and NAB explained:

> These include market share, pricing, profitability, market contestability and product innovation. An assessment of the state of competition in banking requires consideration of all these indicators, and none of these indicators should be used individually as an exclusive and definitive indicator of the state of competition in the banking sector.[4]

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1 Treasury, *Submission 102*, p 1.

2 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 47.

3 Senate Economics References Committee, *Report on Bank Mergers*, September 2009, pp 5-6.

4 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 25.

> …two critical measures, and this is how our investors look at it: what is the return on the equity that our shareholders have put into the business and what is the return on assets?[5]

4.4 These and other indicators are assessed in this chapter.

Number of products available and competitors

4.5 The banks often defend the state of competition by pointing to the number of players and products.[6] It is true that there are a large number of lenders and deposit-takers in Australia:

> Australian banking customers are currently served by a wide range of providers. These include 12 Australian-owned banks; 9 foreign-owned bank subsidiaries; 35 foreign bank branches; 11 building societies and more than 100 credit unions. Further, there are currently around 111 providers of over 2,200 mortgage products; 66 providers of over 420 different credit cards; and 114 providers of over 992 different types of deposit account.[7]

4.6 This indicator, however, also shows a sharp decline in the number of providers and products available in recent years:

> In October 2007, the Australian mortgage market was serviced by over 150 financial institutions offering over 2,117 home loan products. In November 2010, this had fallen to 100 financial institutions offering 1,600 products.[8]

4.7 The more important point is that the number of competitors is not a good indicator of competition:

> …an industry with four participants…can be either a tightly organised cartel gouging customers or highly competitive; the number of participants in the industry is not the important thing.[9]

4.8 There are hundreds of corner stores competing with Coles and Woolworths but this does not mean that these two stores do not dominate grocery retailing. In the same way, the four major banks dominate the banking market, notwithstanding a long tail of small financial organisations.

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5 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 58.

6 See, for example, the Australian Bankers' Association, *Submission 76*, p 5.

7 Treasury, *Submission 102*, p 22.

8 NSW Business Chamber, *Submission 84*, p 5.

9 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 61. See also National Australia Bank, *Submission 91*, p 3.

Intensity of competition

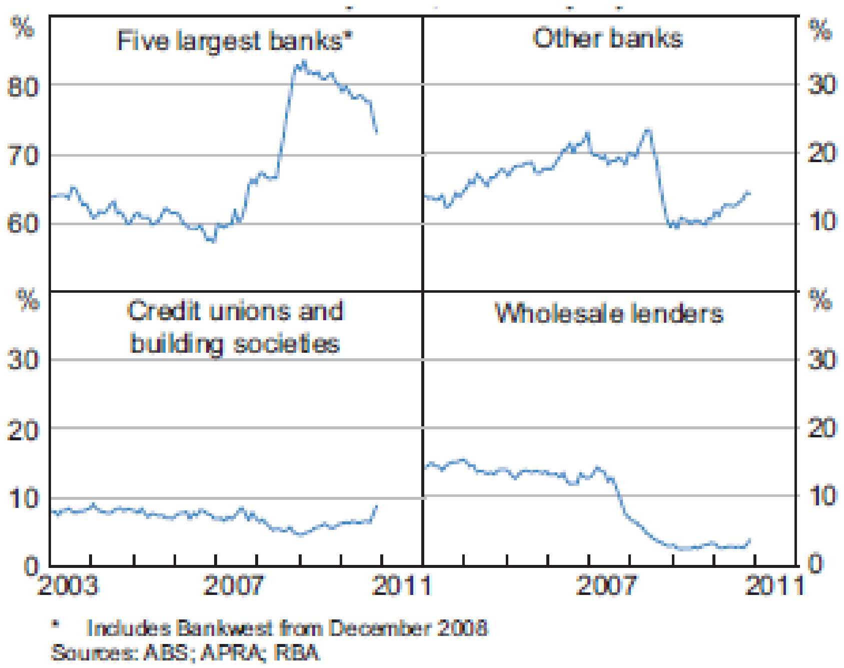
4.9 More relevant, but harder to quantify, is the intensity of competition between banks. As noted in earlier chapters, National Australia Bank has recently adopted a more competitive stance but only on certain products and it is unclear how long it will be sustained. Occasional bouts of heavily advertised 'competition' are not sufficient to demonstrate a truly deep-seated competitive ethos.

Measures of concentration in the Australian banking market

4.10 There are two common measures of market concentration. The first is simple; the market share of the largest three, four or five firms.

4.11 In Australia, the four major banks now dominate the Australian banking market, accounting for around three-quarters of deposits and assets and a larger share of home loans (Table 4.1, last row and Chart 4.1). One witness referred to the market as 'almost a quadropoly'.[10]

Chart 4.1: Share of owner-occupier housing loan approvals



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p 49; update of chart in their *Submission 41*, p. 5.

10 Mr Peter Strong, Executive Director, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, p 12.

4.12 The weakness of this measure is that it is rather arbitrary how many firms are included, and it can make a difference to the results. For example, Westpac's takeover of St George (then the fifth largest bank) added significantly to the market share of the 'four largest' banks, but had little effect on the share of the 'five largest'.

4.13 A preferable measure of concentration is the Herfindahl-Hirschman concentration Index (HHI). This is calculated by summing the squares of the market shares (expressed as proportions). This means the measure can vary from 0 representing perfect competition to 1 representing monopoly.[11] A market with X equally-sized competitors will have an index of 1/X.

4.14 Professor Sathye suggested 0.18 represents a 'red light', over which the index is indicating a worrying degree of concentration.[12] The ACCC uses 0.2 as a guide.[13]

Table 4.1: Measures of concentration in Australian banking market

	Assets		Deposits		Home loans	
	Share of 4 largest banks	HHI	Share of 4 largest banks	HHI	Share of 4 largest banks	HHI
1890	0.34	.06				
1913	0.38	.10				
1950	0.63	.14	0.64	.15		
1970	0.68	.16	0.68	.16	0.77[1]	.21[1]
1990	0.66	.12	0.65	.12	0.65	.13
Oct 2008 (pre-mergers)	0.65	.11	0.65	.12	0.74	.15
Oct 2008 (post-mergers[2])	0.73	.14	0.75	.15	0.86	.20
February 2011[2]	0.77[3]	.16[3]	0.78	.16	0.87	.21

[1] Assuming all owner-occupier housing loans were made by savings banks and accounted for all their loans. [2] Counting BankWest and St George as parts of Commonwealth and Westpac respectively. [3] Not consistent with previous statistics due to reclassification by ANZ and Commonwealth.

Source: Secretariat, calculated from data in APRA, *Monthly Banking Statistics*, October 2008, February 2011; *RBA Bulletin,* June 1990; Butlin et al (1971), White (1973).

11 The measure is sometimes calculated using *percentages* rather than *proportions*, in which case possible values range from 0 to 10,000. Professor Sathye's *Submission 28* is an example.

12 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 33. See also his *Submission 28*, pp 7 and 17.

13 Mr Brian Cassidy, Chief Executive Officer, ACCC, *Committee Hansard*, 25 January 2011, p 51.

4.15 The extent of concentration is attested to by some witnesses representing small business:

> Currently, the major banks are providing two thirds of business credit. SEN research shows that 90 per cent of WA small businesses have applied for finance from the big four banks.[14]

4.16 As illustrated by Charts 2.1 to 2.5, the major banks have essentially grown their market share over the past century by successively taking over the various banks and building societies established in the previous century.[15] This is reflected in a long-run tendency towards increased concentration (Table 4.1), only temporarily interrupted in the 1980s by the entry of foreign banks and conversion of the larger building societies. Australia's banking market is now, by some criteria, the most concentrated it has been for more than a century.

4.17 The Australian banking market is also now quite concentrated by international standards (Table 4.2, Chart 4.2).[16]

Table 4.2: Measures of concentration, 2008

	Concentration measures (based on assets)[1]	
	% share of 4 largest banks	HH index
Australia	84	.19
Canada	76	.17
France	82	.21
Germany	47	.10
Japan	57	.10
Netherlands	97	.33
Sweden	99	.30
Switzerland	82	.32
UK	84	.21
United States	<59	<.10

[1]Only includes domestically-headquartered banks which rank in the world's top 1000. In Australia this includes nine banks accounting for 80 per cent of the market.

Sources: Secretariat, calculated from data in *The Banker*, July 2009; Bank for International Settlements (2009, p 39). (Comparisons in 1980 and 1990 can be found in Senate Economics References Committee, *Report on bank mergers*, September 2009, p 7.)

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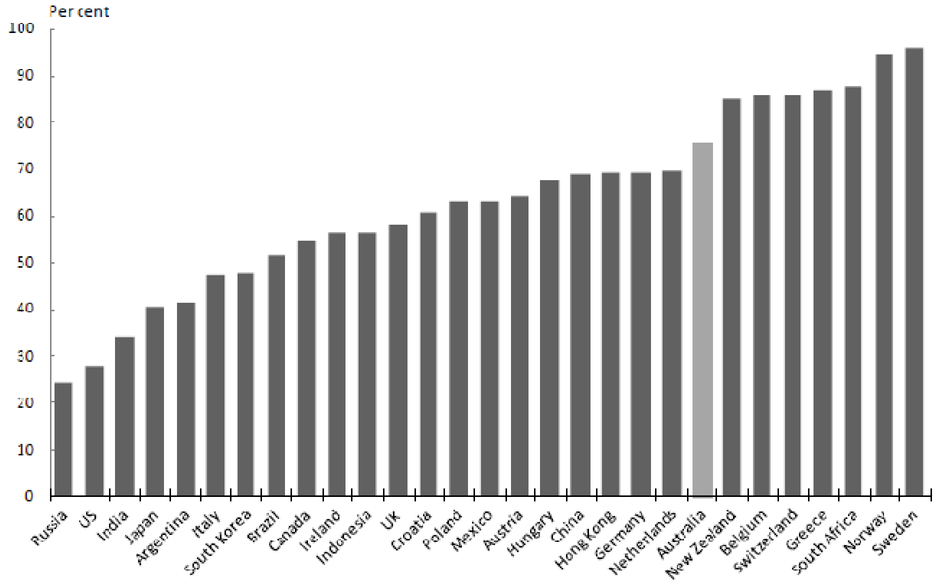
14 Mr Andrew Canion, Manager, Western Australian Small Enterprises Network, *Committee Hansard*, 21 January 2011, p 110.

15 With the exception of the Commonwealth Bank (only established in 1912), the increases in their market share are more than accounted for by their acquisitions; Senate Economics References Committee, *Report on bank mergers*, September 2009, p 5.

16 This conclusion is also reached by House of Representatives Standing Committee on Economics (2008, p 26).

Chart 4.2: Share of assets held by three largest banks (average 2000-2008)



Source: Treasury, *Submission 102*, p 13.

4.18 This is likely to be one reason the Australian banks are more profitable, and have wider interest margins, than banks in most comparable countries (Table 4.3), although this also partly reflects that it has fewer non-performing loans. Australian banks' operating costs are not especially low.[17]

4.19 The Australian banking market is commonly regarded as an oligopoly:

> The banking sector, like a number of other sectors in Australia—maybe because of size and population—have those tendencies of oligopolistic markets…we should continually keep such markets under surveillance or oversight to ensure that consumers get the best results or outcomes from those markets.[18]

17 Senate Economics References Committee, *Report on Bank Mergers*, September 2009, p 7. There are challenges in comparing the profitability of Australian banks with those overseas. As Martin and Hawkins (1991, p 3) comment; 'the structure of banking, economic conditions, the extent of off-balance sheet activity, the tax system, the importance of international operations, the regulatory regime and the mix of household and corporate lending varies greatly, as do accounting practices'.

18 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, pp 26-27.

Table 4.3: Profitability of banks (% to assets, 2009)

	Pre-tax profits	Net interest margin	Net gains from trading	Net fee income
Australia	0.9	1.9	0.1	0.5
Canada	0.7	1.7	0.1	0.9
France	0.2	1.1	0.3	0.4
Germany	-0.0	0.8	0.2	0.4
Japan	0.3	1.0	0.1	0.3
Netherlands	-0.1	1.2	0.0	0.4
Sweden	0.3	1.0	0.3	0.4
Switzerland	0.2	0.6	0.6	0.9
UK	-0.1	0.9	0.5	0.5
United States	0.4	2.7	0.3	0.7

Source: Bank for International Settlements (2010, p 29).

4.20 An oligopoly does not necessarily prevent strong competition but it does make it less likely:

> You could have one of the big banks providing intensive competition if they so chose, and to some degree NAB is providing some level of tension. However, in an oligopoly structure, there is little incentive for one of the players to be aggressive because, all that does is cut their profit margins over time. They simply fall into a cosy club arrangement. So what you need is those independent competitors who, for lack of a better word, disrupt the oligopoly… Even within an oligopoly structure, one of the oligopolists may engage in periodic bouts of competition or, as I describe it, the odd angry shot… but will that continue over time? [19]
>
> Competition can be strong in quite concentrated markets and weak in markets that are not highly concentrated. There is nevertheless a tendency, all else equal, for markets to be less competitive when more concentrated.[20]

Economies of scale in banking

4.21 Economies of scale can be a force promoting concentration in banking, and hence reducing competition. The Reserve Bank comment that:

> While a larger bank can, in principle, spread fixed costs across a greater range of activities, thereby taking advantage of economies of scale, larger

19 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 60.

20 United Kingdom Independent Commission on Banking, *Issues Paper: Call for Evidence*, September 2010, p 22; cited by Abacus, *Submission 53*, p 7.

> institutions also suffer some diseconomies of scale (e.g. difficulties associated with governance).[21]

4.22 Some submitters stressed the importance of economies of scale to differing extents:

> In order to survive in the long term, banks need a certain scale to dilute their fixed costs and they need effective diversification both of assets and liabilities to ride out the peaks and troughs of the business cycle. This becomes a virtuous circle, with large and diversified banks rewarded by better credit ratings that more enable them to expand further. A viable bank is naturally a big bank. As a result, banking is a natural oligopoly. Given the size of the Australian economy, four banks seems about right. It would not be wise to tinker with the current situation.[22]

> Economies of scale in retail banking are significant and constitute a substantial barrier to competition. Scale influences the underlying cost of a banking business in various ways including, but not limited to, its influence on an ADI's credit rating…the ability to spread the cost of complying with regulation…[and] funding infrastructure investment in branch networks and payments systems, purchasing/cross-selling power, IT synergies.[23]

> Scale lowers the cost of capital because of increased diversification (e.g. most smaller players operate in just a few asset classes with real estate security concentrated geographically)…economies of scale in retail banking derive from IT capabilities, branch network presence, discretionary overheads (risk, marketing, finance, etc) and the spreading of risk. But these are small proportion of cost base and are being attacked by falling IT costs/ new technology and shift in consumer towards internet vs branch. More important is cost of funding which ultimately depends on credit rating/quality of lending book.[24]

4.23 Empirical studies of economies of scale in banking were surveyed by the Reserve Bank. They summarise the results as:

> Studies of economies of scale in banking tend to be inconclusive. One study, which is now quite dated – Berger et al. (1999) – summarises that most estimates of maximum efficient size lie in the range of $100 million to $25 billion of assets. However, Wheelock and Wilson (2001) note that firm conclusions on economies of scale for larger banks are difficult as there are few institutions, and a recent review by the Committee on the Global Financial System (2010) of the empirical literature suggests that there is

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21 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 1.

22 Mr Nicholas Palmer, *Submission 22*, p 4.

23 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Responses to questions on notice, no 7*, 20 January 2011, p 1.

24 National Australia Bank, *Responses to questions on notice, no 11*, 31 January 2011, p 1.

> little evidence for the existence of scale or scope economies in international banking.[25]

4.24 The ANZ Bank's reading of the literature is even more agnostic:

> The literature on economies of scale in retail banking is inconclusive, reflecting conjecture about the point at which diseconomies occur and the diversity and uniqueness of the cases examined and the considerable variation in regulatory and operating environments across countries.[26]

4.25 A UK parliamentary committee recently examined the arguments on economies of scale, and were sceptical about claims that there were significant advantages to consumers from banks with significant market shares merging:

> The large banks have told us that ultimately consumers will benefit from lower prices resulting from the economies of scale and synergies provided by larger more diversified banks. We agree that there are economies of scale/minimum efficient scale in retail banking which will ultimately limit the total number of firms in the market. However, we question whether the need for economies of scale justifies banks having a 30% share of the market or whether such benefits, if they exist, will be passed onto consumers in a market where competition is deficient. Indeed, such economies of scale benefits are likely to be outweighed by the negative impact on competition by those providers who are perceived to be ‘too big to fail’.[27]

The profitability of banks in Australia

4.26 Profitability is another measure of competition:

> The best test of competitiveness…is to look at the outcomes—that is, are the banks making an excessive profit?[28]

4.27 Notwithstanding some increase in bad debts, the Australian banks' profitability held up during the global financial crisis and reached record levels in 2010 (Chart 4.3).

4.28 One component of this profits growth arising from banks persuading Australian households to take on more debt. Some of this has been of benefit to those households, allowing them to improve their education or their health. But much of it seems to have been spent on conspicuous consumption or in bidding up housing prices.

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25 Reserve Bank of Australia, *Responses to questions on notice, no 6*, 18 January 2011, p 1.

26 ANZ Bank, *Responses to questions on notice, no 11*, 31 January 2011, p 1.

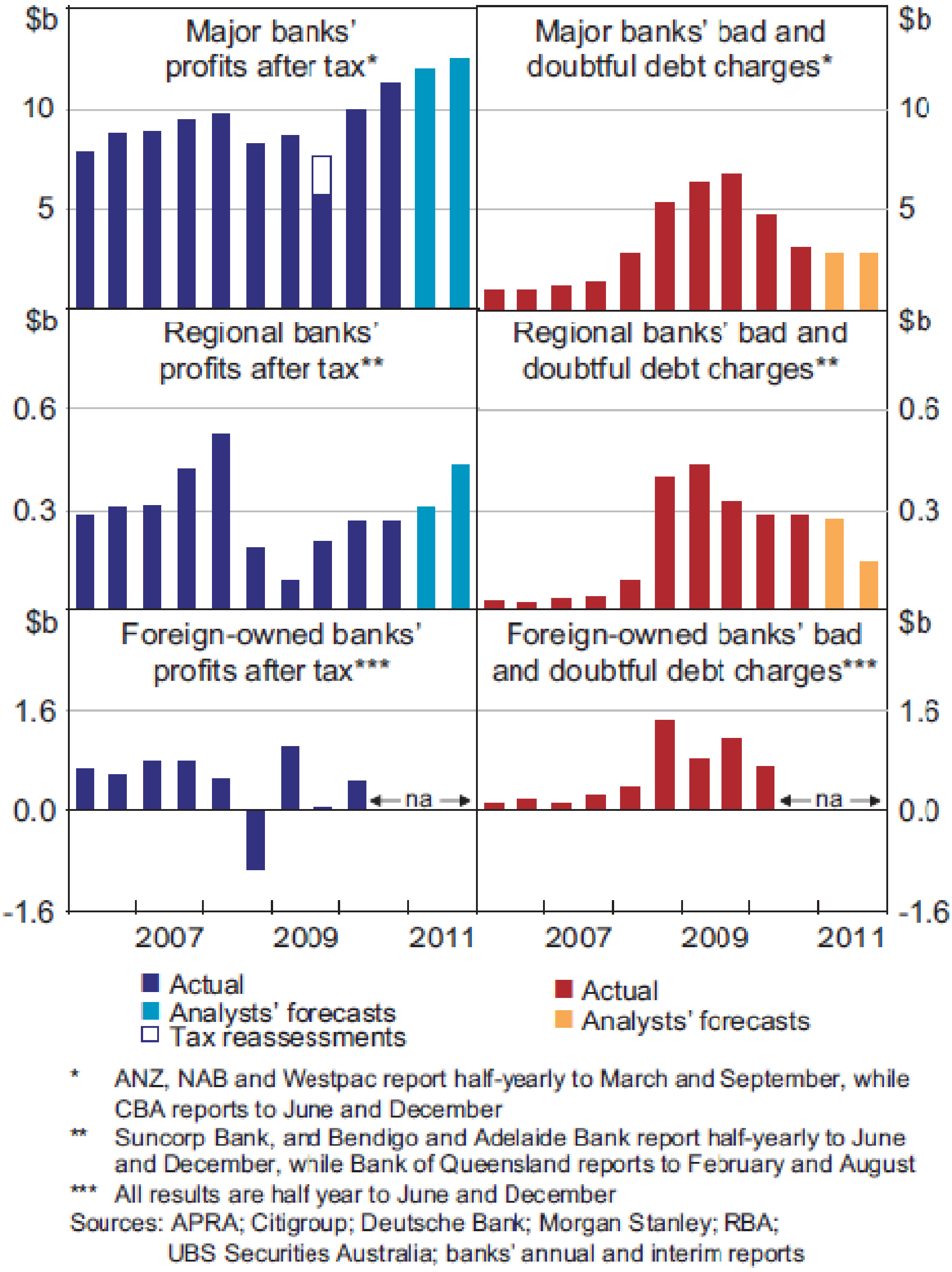
27 UK House of Commons Treasury Committee, *Competition and Choice in Retail Banking*, March 2011, p 23. The issue of banks being 'too big to fail' is discussed in Chapter 11.

28 Professor Tom Valentine, *Proof Committee Hansard*, 25 January 2011, p 60.

4.29 Professor Sathye's interpretation is that banks':

> …profit margins have gone up significantly. These statistics, which are calculated from APRA's statistics, show that there is not enough competition in the market.[29]

Chart 4.3: Profitability of banks operating in Australia

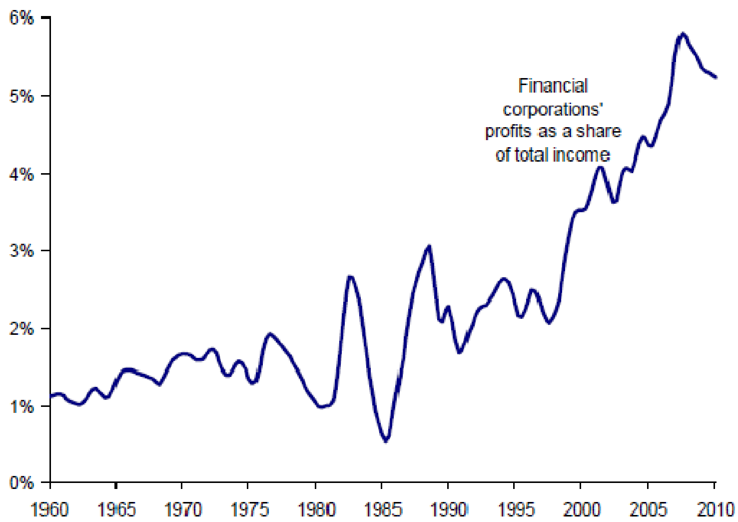


Source: Reserve Bank of Australia, *Financial Stability Review*, February 2011, p. 22.

29 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 33.

4.30 Over a longer period, it has been noted that the share of national income accounted for by financial institution profits has grown strongly (Chart 4.4).[30]

Chart 4.4: Financial corporations' profit share



Source: Australian Council of Trade Unions, *Submission 89*, p 5.

4.31 A former Reserve Bank governor has mused:

> I, like you, have often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia… They always were very profitable, let's face it. They were very profitable in the regulated phase, and some of us thought that those profit rates would go down in the deregulated phase, as competition heated up. So you can understand why people are very interested in profits and very surprised that profits or rates of return on equity have remained so high.[31]

4.32 Other submitters put the view probably held by a significant share of the public:

> And the only reason our banks are making such huge profits is because they are simply ripping us all off.[32]

> One does not have to be a rocket scientist to understand that in spite of banking costs rising (a little) for them to borrow, the banks are making Super profits at the expense of their customers.[33]

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30 The Bank for International Settlements (2010, p 77) show that the financial sector's share of total value added has also increased in other advanced economies but the increase in Australia has been unusually large.

31 Mr Ian Macfarlane, then Governor of the Reserve Bank, *House of Representatives Standing Committee on Economics, Finance and Public Administration Hansard*, 17 June 1999, p 77.

32 Mr Peter Higgins, *Submission 17*, p 4.

33 Mr Michael O'Connor, *Submission 125*, p 1.

4.33 Such comments struck Professor Valentine as unfair:

> …bank bashing had little justification…the media and politicians, from both parties I might say, have adopted the approach of the Queen of Hearts in *Alice*—first the verdict, then the trial. In other words, there is no proof to justify the abuse which has been heaped on the heads of bankers. I have said on a number of occasions in a light-hearted way that there seems to be an argument for antivilification laws to protect bankers.[34]

4.34 The banks justify high profits as necessary to maintain high credit ratings and thereby lower funding costs which they could pass on as lower loan interest rates:

> Bank performance measures are critical for a bank to retain a high credit rating – without a high credit rating, the cost to access money and capital markets is higher. If banks have to pay higher rates for money, then individuals and businesses will also pay higher rates to borrow from banks.[35]

4.35 Professor Sathye is not convinced:

> I do not agree with that analysis that more profits mean a better rating or that the credit rating of the banks will be affected if their profits are lower. As a matter of fact, the Canadian banks have lower profits than the Australian banks, but their rating is not affected; their rating is similar to that of Australian banks…a credit rating does not depend exclusively on the profits that the banks make. A credit rating takes into account a number of factors, and those factors are basically the prudential standards in Australia and the asset qualities of banks.[36]

4.36 Another perspective comes from comparing profits in the financial, resources and other sectors. Around 2005 these were broadly the same in aggregate. Now the resources and financial sectors' profits are well above the other sector (Chart 4.5).[37]

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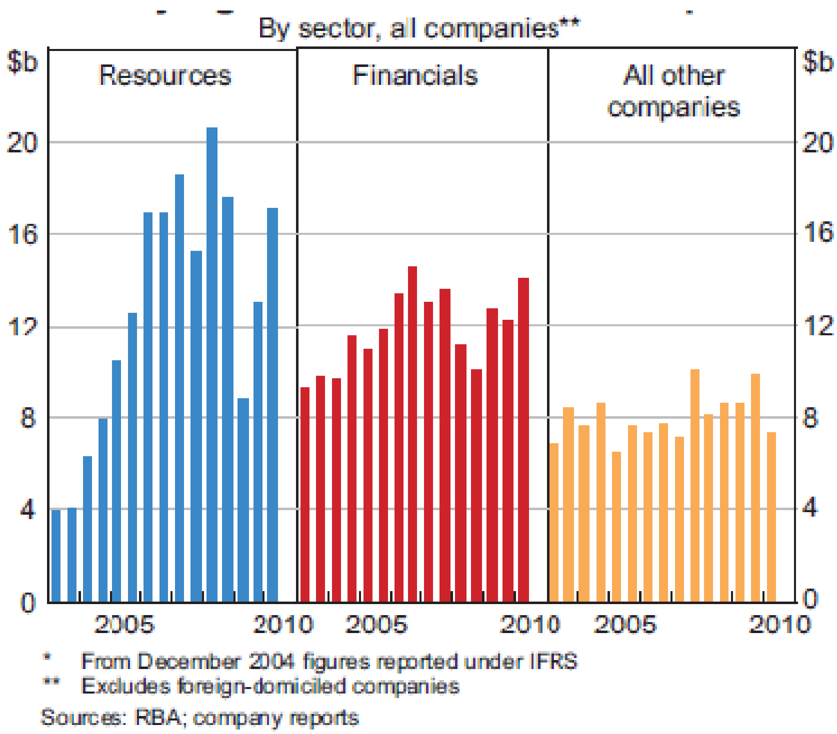
34 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 60.

35 Australian Bankers' Association, *Submission 76*, p 21.

36 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 39.

37 The Committee's attention was drawn to this chart by Mr Nick Behrens, General Manager, Policy, Chamber of Commerce and Industry Queensland, *Proof Committee Hansard*, 4 March 2011, p 61.

Chart 4.5: Underlying profits of ASX 200 Companies



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, November 2010, p 49.

Measures of return on equity

4.37 A related measure is banks' return on equity. The Governor of the Reserve Bank remarked to the Committee:

> I would assess the current state of profitability of the majors as good. They are earning quite a healthy rate of return on their equity…[38]

4.38 The Bank commented more recently:

> As the major banks' profits have recovered, their average return on equity has increased to near pre-crisis levels, at almost 15 per cent in 2010. Analysts are forecasting a further small rise in 2011.[39]

4.39 The Governor mused that this issue could become more telling in the future:

> There are arguments about whether in the fullness of time—in a new regulatory world where banks, particularly globally, hold a lot more capital and are inherently therefore less risky— equity holders ought to expect a

38 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 9.

39 Reserve Bank of Australia. *Financial Stability Review*, March 2011, p 22.

> lower rate of return because of a lower risk profile. That is quite an interesting question…[40]

4.40 A banking analyst pointed out that the Australian banks' return on equity in 2010, of 16 per cent, is the same as their average return on equity over the past thirty years, and lower than many other large Australian companies.[41] National Australia Bank said that the GFC had reduced its return on equity from around 16 per cent to 13 per cent and:

> …13 to 16 does not represent an excess by Australian return standards.[42]

> The returns on equity and returns on assets over the last 10 years of the "big 4" are substantially lower than, for example, those of Woolworths or Telstra. Yet, their businesses are much more risky and hence demand a higher level of return.[43]

4.41 One response to this is that the largest Australian non-bank companies include Telstra, the supermarket duopoly and large mining companies, all of which could be argued to be themselves operating in uncompetitive industries where supernormal profits may be earned.

4.42 Another response is to question the claim that banking is a risky business.[44] One indicator that banking in Australia is a relatively low-risk industry is that the major banks' return on equity has only once turned negative in the past thirty years and only twice dropped below 10 per cent (Chart 4.6). The explicit guarantees that government have provided (see Chapter 12) and the view that governments regard them as too big or important to be allowed to fail (see Chapter 11) are other factors that should lead investors to regard bank shares as lower risk.

4.43 In turn this low risk should imply that banks do not need to earn as high a return on equity as other companies to attract capital:

> Profit levels are very strong and have increased in the last year or so after benefiting from government support. The fact that the government reduces bank shareholder risk would suggest that earnings should be closer to say 10 per cent return on equity rather than the 15 to 20 per cent currently being achieved.[45]

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40 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 11.

41 Mr Jonathan Mott, Bank Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 144.

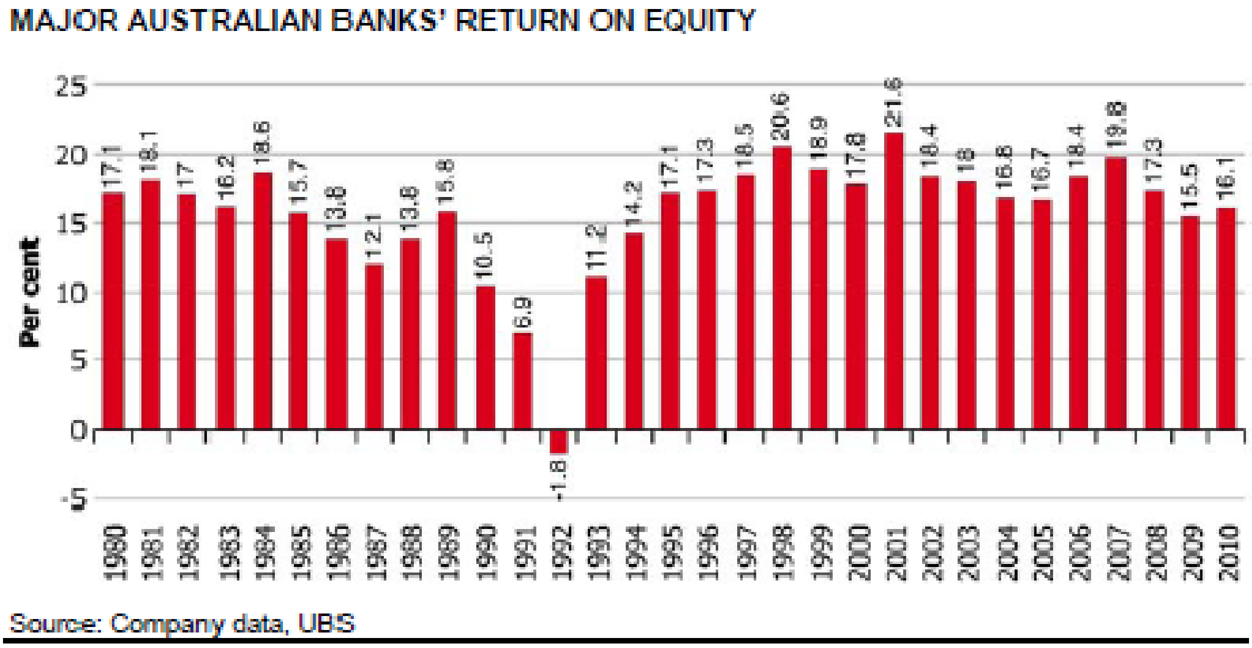
42 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard,* 13 December 2010, p 59.

43 Mr George Ivanov, *Submission 124*, p 2.

44 ANZ Bank claims that banking is risky as banks are highly-geared organisations; *Responses to questions on notice, no 11*, 31 January 2011, p 2.

45 Master Builders' Australia, *Submission 38,* p 6.

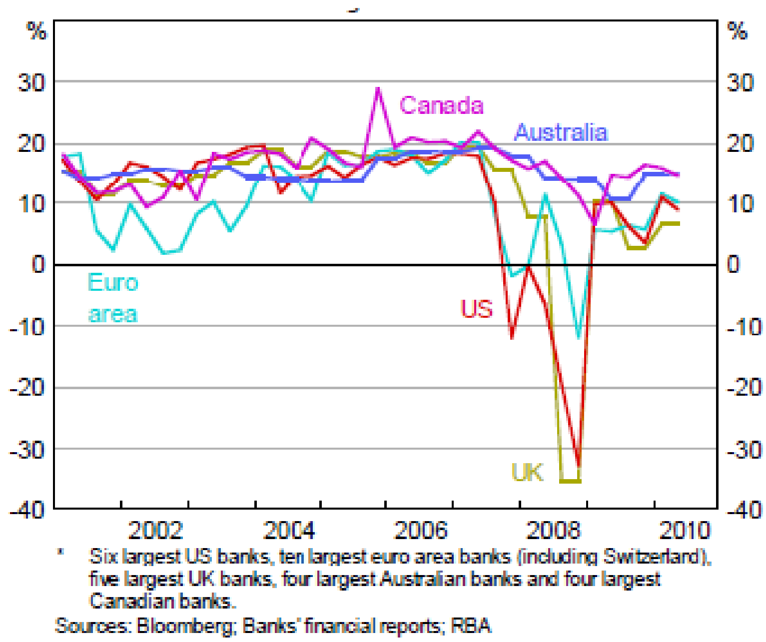
Chart 4.6: Major Australian banks' return on equity



Source: Westpac, *Submission 72*, p 27.

4.44 Australian banks' return on equity was similar to that in comparable countries in the years before the GFC. The difference since then has been that Australian (and Canadian) banks had only modest dips in returns, while European and US banks as a group incurred large losses (Chart 4.7).

Chart 4.7: Large banks' return on equity



Source: Reserve Bank of Australia, *Submission 41*, p 25.

4.45 Professor Sathye reports:

> If you look at the profit data of the banks, the average return to shareholders in Australia over the last five years has been something like 9.5 per cent, which is probably the highest in the OECD countries...[46]

4.46 Professor Valentine defended the returns earned by banks:

> …nobody I have seen has presented evidence of excess returns over any reasonable period of time.[47]

4.47 Treasury made a simple but telling observation on the adequacy of banks' returns:

> I do not see anyone withdrawing from the market because of lack of profitability.[48]

Interest margins

4.48 For a long time before the global financial crisis, banks' margins had been decreasing (Charts 4.8 to 4.11 and 5.1). The main forces driving down margins were the impact of deregulation and increasing competition from former building societies, foreign banks and non-bank mortgage lenders.

4.49 There were also some other forces at play:

> A large and efficient mortgage broker network had established itself. By the middle of the [1990s] decade, 30% of all housing loans were being originated through brokers. The second factor contributing to competition was the enhanced use of the Internet. The Internet reduced search costs for prospective housing loan borrowers, enabling them to more easily compare loan products online, including fees and charges…The third factor was greater focus by foreign-owned subsidiaries on Australia’s retail banking markets.[49]

> The sustained downward pressure on the net interest margin is one of the clearest, long-term economy-wide benefits of the deregulation of the Australian financial system…Competitive pressures from non-prudentially regulated lenders and new bank entrants in the period since 1995 also played a role in the fall in the net interest margin. New technologies that permitted a lowering of the industry's operational costs would also have played a part.[50]

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46 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 34.

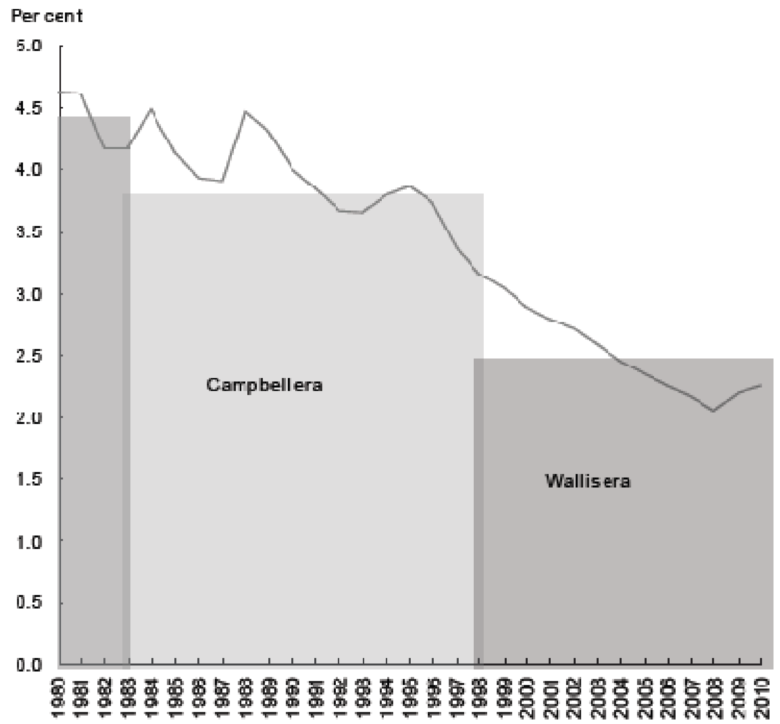
47 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 61.

48 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Proof Committee Hansard*, 9 March 2011, p 11.

49 Australian Bankers' Association, *Submission 76*, p 26.

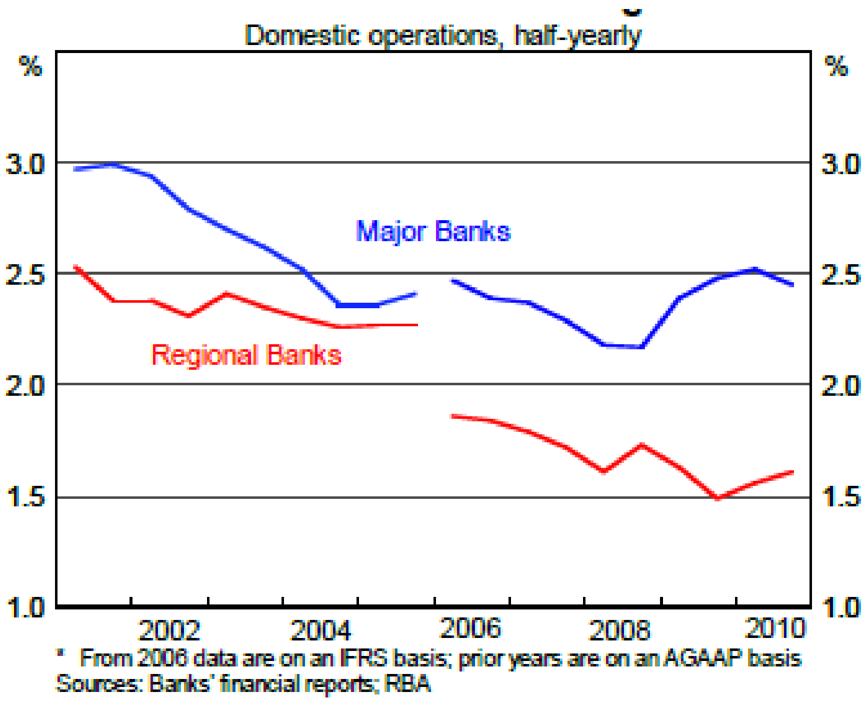
50 Then Treasury Secretary Dr Ken Henry (2011, p 21).

Chart 4.8: Bank net interest margins



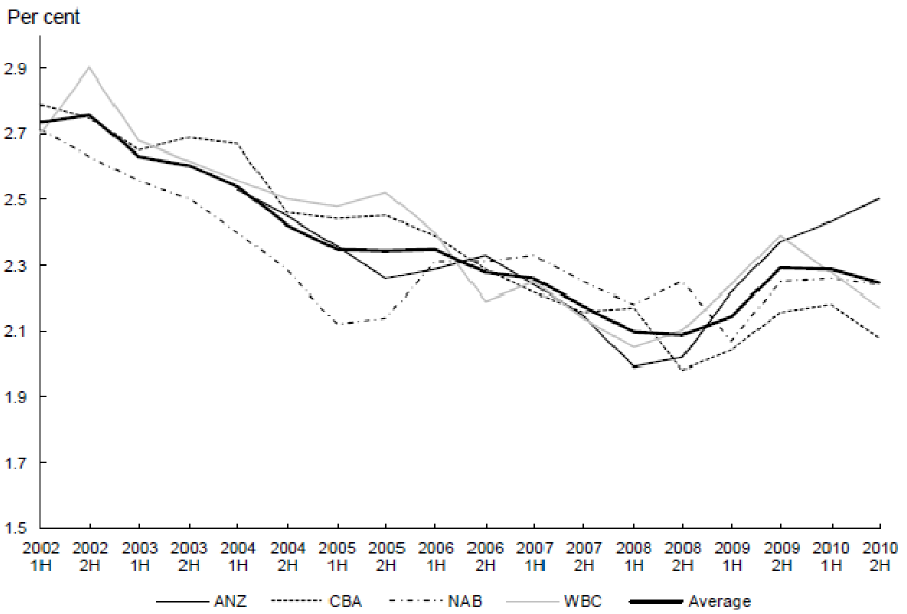
Source: Department of the Treasury, *Submission 102*, p 15.

Chart 4.9: Banks' net interest margin



Source: Reserve Bank of Australia, *Submission 41*, p 20.

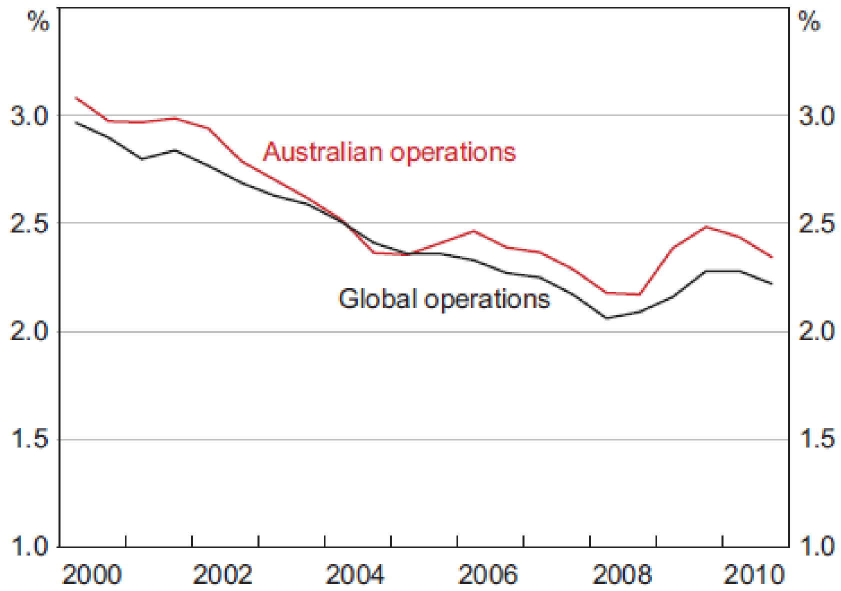
Chart 4.10: Net interest margins – four major banks



Source: Major banks' financial disclosure documents. Notes: Data is half yearly. Calculated as net interest income to average total interest earning assets on a group basis. ANZ data unavailable prior to 2004.

Source: Treasury, *Submission 102*, p 16.

Chart 4.11: Major banks' net interest margin



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
Sources: RBA; banks' annual and interim reports

Source: Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 23.

4.50 A recent econometric study by Kirkwood (2010) attempted to quantify the contributions to the reduction in margins, finding that about two-fifths was due to a decline in operating costs and one-fifth due to competition from mortgage originators.

4.51 Since the global financial crisis, however, the interest margins of the major banks in Australia have widened (Charts 4.9, 4.10 and 4.11). This broad pattern was common to all four major banks (Chart 4.10) and to both their domestic and foreign operations (Chart 4.11).

4.52 There are differing interpretations of this. One view is that there is just a bit of random variation in recent years and the underlying margins have been fairly steady for a number of years.[51]

4.53 An alternative interpretation is that margins have started to rise as competitive pressures have eased:

> The reduction in banking competition has enabled banks to increase their margins at the expense of both mortgage holders and business customers.[52]
>
> …the period between 2000 and 2007 when we had very intensive competition as demonstrated by the reduction of net interest margins during that period. We had St George, BankWest, Aussie Home Loans, RAMS and Wizard and those players provided intense competition that did keep the big four banks honest. With the removal of those competitors…you saw the ability of the four big banks to start increasing their net interest margins…[53]

4.54 A third interpretation, put by the banks themselves, is that:

> From the beginning of 2007 we saw wholesale funding, particularly international funding and short-term funding, increase in price significantly. For the first six months of that the banks absorbed that cost and that will have had an impact on their margins, so we have had a bit of a dip, if you like. Banks then started to pass some of those costs on, but they also started to reprice for risk, which will cause an increase in the net interest margin.[54]

4.55 APRA emphasised the latter factor:

> …it is generally agreed that risk was not being adequately priced in the global banking system in the lead-up to the global financial crisis so some repricing of assets (and hence widening of margins) was to be expected and was prudent.[55]

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51 See Australian Bankers' Association, *Submission 76*, p 16 and ANZ Bank, *Submission 94*, p 15.

52 Australian Chamber of Commerce and Industry, *Submission 37*, p iii.

53 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 52.

54 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 14 December 2010, p 94.

55 Australian Prudential Regulation Authority, *Responses to questions on notice*, no 6, 31 January 2011, p 1.

4.56 The Committee asked the Reserve Bank for their analysis. They replied that 'the early stages of the financial crisis saw funding costs rise more quickly than lending rates' and 'the small increase in margins following their trough in the financial crisis is likely partly to reflect the removal of those temporary factors'.[56]

4.57 They add that margins can be also be affected by other factors such as:

- higher risk margins on lending, which have been encouraged by supervisors, will have boosted net interest margins (given these do not adjust for either expected or actual losses of principal);
- an increase in the amount of equity funding is likely to have boosted banks' margins (equity is a non-interest bearing liability that increases a bank's interest earnings);
- derivatives to hedge interest rate risk can have a substantial effect on banks' margins over short periods of time; and
- some institutions may have shifted the balance between fee and interest income.[57]

4.58 The Treasury Secretary was more agnostic:

> Over the last two years, the net interest margin has increased from 2¼ percentage points to 2½ percentage points – back to 2005 or 2006 levels. It is too early to judge whether this post-GFC widening can be explained fully by a lessening of competition, but it does provide a case for close examination of the factors affecting competition.[58]

4.59 The interest margins are wider for the major banks than the regional banks (Chart 4.8). Asked about possible reasons for this, the Reserve Bank replied:

> The higher credit ratings of the major banks allow them to raise wholesale debt on less expensive terms than the regional banks.
>
> Differences in the composition of the different banking sectors' assets and funding liabilities.
>
> - While deposit liabilities comprise a greater share of the major banks' funding liabilities than they do for regional banks, relatively expensive term deposits make up a considerably greater share of regional banks' funding liabilities (28 per cent) compared with the major banks' funding liabilities (20 per cent). This would be offset, somewhat, by the fact that the regional banks have a greater share of equity funding.
> - Lower margin household lending makes up a greater share of the regional banks' assets than it does for the major banks' assets.

56 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 1.

57 Reserve Bank of Australia, *Responses to questions on notice, no 6*, 18 January 2011, p 2.

58 Then Treasury Secretary Dr Ken Henry (2011, pp 21-22).

> Likewise, regional banks are relatively underweight in the credit card market, a relatively high-risk and high-margin product.
>
> Moreover, different banks can offer customers different fee and interest rate combinations. Consequently, one institution might report a higher net interest margin but lower fee income than its competitors.[59]

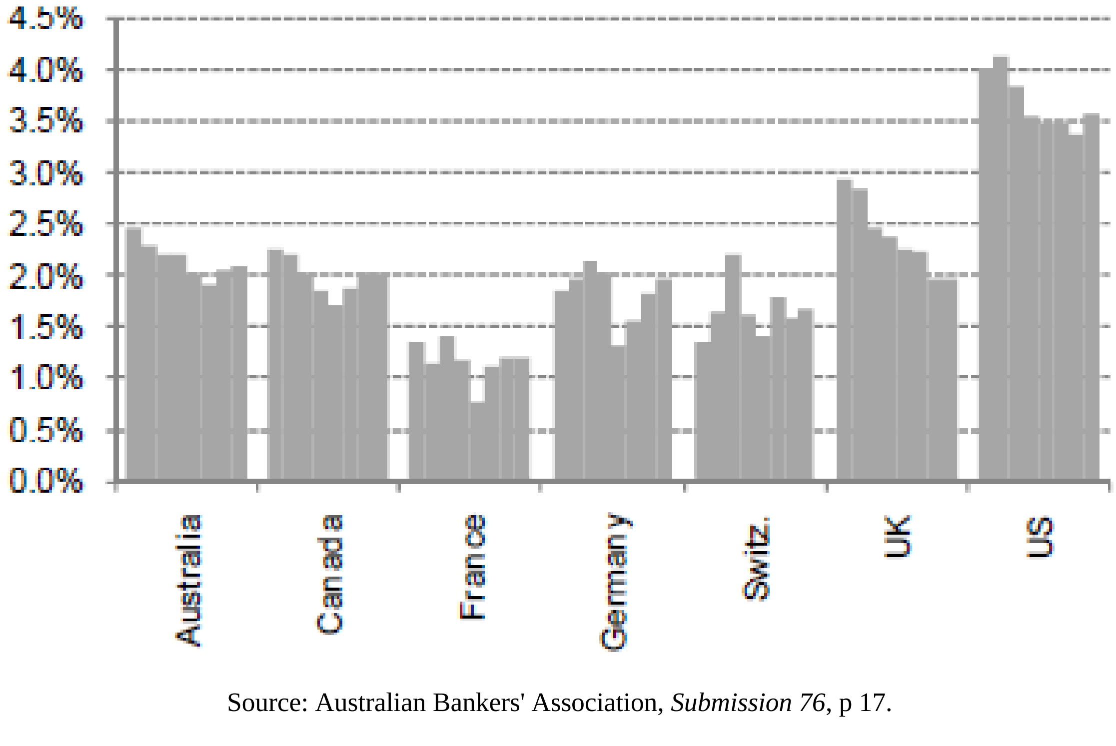
4.60 The ANZ's explanation was:

> …the relative dominance of higher yielding (and higher risk) business segment on the books of the majors…[and] the higher credit ratings of the major banks which affords lower wholesale funding costs.[60]

4.61 The Commonwealth Bank distinguished between margins on its household lending, which it claims have continued to shrink, and margins on business lending, which have expanded as risk is repriced.[61]

4.62 The net interest margins in Australia are within the range of comparable countries (Chart 4.12).

Chart 4.12: International bank net interest margins (2004-2010)



Source: Australian Bankers' Association, *Submission 76*, p 17.

59 Reserve Bank of Australia, *Responses to questions on notice, no 6*, 18 January 2011, p 2. See also Henry (2011, p 22).

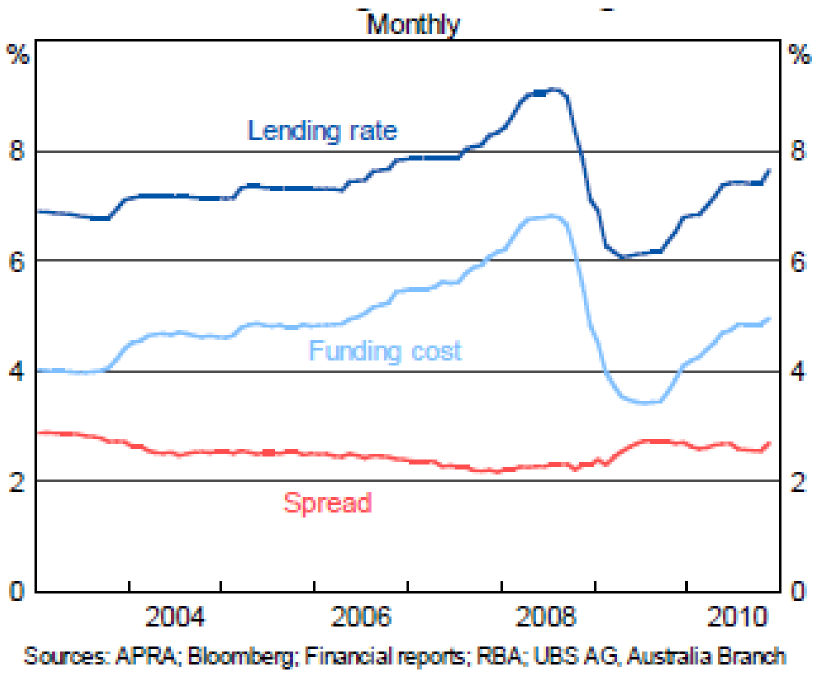
60 ANZ Bank, *Responses to questions on notice, no 11*, 31 January 2011, p 2.

61 Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 55.

Interest spreads

4.63 Closely related to the interest margin is the interest spread; the difference between average lending rates and average funding costs (Chart 4.13). On the Reserve Bank's calculations, this has also widened somewhat since the GFC after a long period of narrowing.

Chart 4.13: Major banks' interest spread



Source: Reserve Bank of Australia, *Submission 41*, p 21.

4.64 The differences between the margin and the spread reflect an increased share of liquid assets and the fall in interest on them compared to loans, increases in arrears and bad debts, derivatives transactions and increases in equity.

Bank fees

4.65 As well as interest margins, banks make profits from fees and so the size of these fees is also pertinent to considerations of competition. Banks' fee income from households rose to $5 billion in 2009, as higher fees on loan accounts more than offset a drop in fees on deposit accounts (partly reflecting the ATM fee reforms discussed in Chapter 14).

Table 4.4: Banks' fee income from households ($ billion)

	2007	2008	2009
Housing loans	1.0	1.1	1.2
Personal loans	0.4	0.5	0.6
Credit cards	1.2	1.3	1.4
Deposits	1.8	1.9	1.7
Other fees	0.1	0.1	0.1
Total	4.5	4.9	5.0

Source: Reserve Bank of Australia, 'Banking fees in Australia', *Reserve Bank Bulletin*, June quarter 2010, p. 33.

4.66 The Reserve Bank explained:

> One of the forces influencing the structure of bank fees was the increased competition from mortgage originators in the mid 1990s. As interest margins came under downward pressure, banks began to unwind the cross-subsidies that had existed between mortgage and deposit accounts. One specific outcome of this was that banks introduced periodic mortgage and account servicing fees. While, in aggregate, consumers of banking services benefited from this process, the consumers of the financial services that had previously been heavily subsidised were worse off…More recently, the financial crisis has had two opposing effects on bank fee income. First, more aggressive competition for deposit funding saw banks reduce and remove exception fees on deposit and transaction accounts for both business and personal customers. Second, there was a repricing of credit and liquidity risks on loans and bank bill facilities, which led to increased fees, particularly on undrawn loan facilities held by businesses. In particular, the total banking fee income reported by the major banks in their 2010 financial results indicated a 4 per cent decline in fee income.[62]

4.67 A widely cited estimate by Fujitsu Consulting is that:

> Australian households are likely to be paying close to $1,000 for their banking services, assuming they have a full range of products and services and typical transaction patterns, compared with $749 in the UK and $850 in the USA.[63]

4.68 The assumption that all households pay for a full range of services, however, is not realistic. The Reserve Bank data suggests that the average household pays about $500 -- half Fujitsu's estimate -- for bank fees (the $5 billion in Table 4.4 divided by

62 Reserve Bank of Australia, *Submission 41*, p 22.

63 Fujitsu Consulting, *Australian Bank Fee Survey 2009*, p. 6.

around 10 million households). Given this, not too much weight should be placed on Fujitsu's comparison between fees in Australia and overseas.

4.69 Bank fees may fall disproportionately on the poor:

> Wealthy consumers (people with mortgages, people with term deposits or other investments, and members of professional associations) all receive generous fee exemptions and no attempt is made to recover the costs of individual transactions from such customers. This means that poorer customers who do pay fees subsidise their wealthier counterparts on a per transaction basis, although the banks would argue that they still make more income from their wealthy customers through their other business with the bank, despite the lost fee revenue.[64]

Table 4.5: Unit fees on credit cards ($)

	2007	2008	2009
Annual fees for no-frills cards	48	49	52
Cash advance fee at own bank's ATM	1.4	1.4	1.2
Cash advance fee at other banks' ATM	1.6	1.6	1.4
Late payment fee	31	31	31
Over limit fee	30	30	30

Source: Reserve Bank of Australia, 'Banking fees in Australia', *Reserve Bank Bulletin*, June quarter 2010, p. 34.

4.70 National Australia Bank took a strategic decision to cut fees which were damaging its reputation:

> We were the first and only bank to completely abolish exception fees, which drove 50 per cent of complaints into the bank. We were the first and only bank to abolish account-keeping fees, which drove significant complaints into the bank. We have abolished mortgage exit fees.[65]

4.71 There are reasons to think that there will be insufficient competition leading to excessive charging of some kinds of fees.

> This is because consumers do not expect to pay penalty fees at the time they open an account or take out a loan or credit card, thus they do not negotiate over these terms (even if they are aware of them). Nor, for similar reasons,

64 Chris Connolly, Director, Financial Services Policy Centre, University of New South Wales, 'Do the Poor Pay More?', 2005.

65 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Proof Committee Hansard*, 13 December 2010, p 56.

> do they choose one financial product over another based on the amount of penalty fees.[66]

4.72 ASIC has indicated it is considering issuing a regulatory guide on unfair fees in general.[67] This is discussed further in Chapter 10.

Barriers to entry

Another indicator of the competitiveness of markets is whether there are significant barriers to entry. A number of factors have been suggested as impeding new entrants to the banking markets. From the 1940s to the 1980s there was a simple and decisive one; the government discouraged or would not allow it. But there remain other significant considerations.

Branch networks

4.73 Professor Sathye notes:

> …it will be hard, well-nigh impossible, for the new entrant to create a vast network of branches like that of the Big Four. These banks have already developed long-term relationship with customers and it would be hard to make inroads into this strength of the banks. Online financial service provision is a possible alternative and it is being used effectively in the deposit market by some of the banks such as the ING Direct.[68]

Low interest deposits

4.74 The existing banks, particularly the majors, have the advantage of a legacy of low or no interest deposits:

> Those wondering about the absence of competition in retail banking might consider the impossibility of any new player building a substantial transaction deposit base on which no interest is paid: it is just not on…[69]

4.75 The implicit bargain of low interest on deposits in exchange for free services has been very tax effective for banks and their customers (albeit paid for by taxpayers in general and by bank customers in the form of a less efficient banking system). One estimate puts the lost tax revenue at around $3 billion a year.[70]

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66 Consumer Action Law Centre, *Submission 87*, p 22.

67 *ASIC Consultation Paper*, no 135. ASIC has already issued *Regulatory Guide 220* on mortgage exit fees, discussed further in Chapter 7.

68 Professor Milind Sathye, *Submission 28*, p 11.

69 Mr Peter Mair, *Submission 2*, p 8.

70 Mr Peter Mair, *Submission 2a*, p 2.

4.76 It has also made it harder for new entrants to compete. This may be gradually changing as banks have to compete more for deposits and electronic transactions erode the value of free services.

Financial planners

4.77 A submitter argued:

> …the four major banks now control a significant share of the financial planning market. This market share is increasing through the banks offering consumers "free" financial plans. Over the years, I have seen a number of these plans prepared by various banks for my clients. They all have one feature in common: the products recommended are always those of the relevant bank or its associated insurance / managed funds arms.[71]

Bundling

4.78 Bundling of products may also be a problem:

> Banks also make it almost impossible to get a loan unless you have all your banking with that bank, and this reduces competition. There should be no coercion or otherwise to get a loan other than on its merits, and not whether you bank with them.[72]
>
> Bank providers can bundle housing loans, with personal loans, with credit cards, and transaction accounts, in such a way as to provide a strategic commercial advantage, whilst at the same time leveraging potential clients in relation to wealth management and personal risk insurances, as well as general insurances.[73]
>
> …if one financial institution chooses to bundle their account services together and give you a special rate on your mortgage because you take other accounts with them, for example. I think it has been indicated to the committee already that that is the kind of thing that is a brake on moving.[74]
>
> There should be a possibility for a mono-line new market entrant to compete in one segment.[75]
>
> Bank bundling of products and stickiness of relationship result in customers being less price sensitive. Customers who choose to have several transaction accounts or products with an institution have a greater propensity to stay with that institution.[76]

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71 Mr Suryan Chandrasegaran, *Submission 4*, p 3.

72 Mr Murray Withers, *Submission 99*, p 1.

73 Mr Mervin Reed, *Submission 5*, p 3.

74 Mr Christopher Hamilton, Chief Executive Officer, APCA, *Committee Hansard*, 21 January 2011, p 33.

75 Mr Jost Stollmann, Chief Executive Officer, Tyro Payments, *Committee Hansard*, 21 January 2011, p 39.

76 Aussie, *Submission 39*, p 3.

4.79 Westpac's CEO referred to bundling as a factor further limiting competition between their Westpac and St George brands:

> …typically, customers do not do that [bank with both Westpac and St George]…It may be that they have other products and services as well,… typically, people do not only move for price.[77]

Advertising

4.80 The sheer size of the major banks allows them to spend enormous amounts on advertising which most new entrants could never match. The four major banks spend over $1 billion a year on advertising.[78]

Perceived safety and size

4.81 A survey showed that 19 per cent of customers believe a larger bank is safer.[79] This may partly explain why 43 per cent of the customers of the big four banks have never even considered switching to a smaller bank or credit union.[80]

Attitude of ratings agencies

4.82 As discussed further in Chapter 9, the behaviour of ratings agencies, which exert an important influence on the cost of funds for financial intermediaries, may exacerbate the tendency for concentration by favouring larger entities.

Regulatory change

4.83 The major banks may be best placed to cope with regulatory change:

> Australia’s largest domestic banks once more have an advantage in their ability to find, in their domestic scale, immediate resources for the process changes, system changes, compliance and administration that new regulations may require. A recent example of legislation with the potential to inadvertently reduce competition in Australian financial services was the *National Consumer Credit Protection Act*, as it related to the provision of merchant point of sale credit. While fully supportive of the principles behind the reform, the burden of compliance requirements would have disproportionately disadvantaged HSBC and other affected credit card providers.[81]

> …increased regulation of the banking sector may have the unintended consequence of placing a higher burden of compliance and increased costs on the smaller banks in comparison to the major banks. It is often

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77 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 81.

78 Australia Institute, *Submission 46*, p 3.

79 Australia Institute, *Submission 46*, p 4.

80 Fear et al (2010, p 21).

81 HSBC, *Submission 107*, p 6.

> fundamentally more expensive for smaller players to comply with new legislation, if that compliance relies on system based solutions. The fixed cost of developing these solutions does not vary greatly in relation to the size of an institution, therefore the unit cost of compliance falls as the scale of business increases.[82]

Cross-subsidies

4.84 It has been suggested that the size and diversity of the four major banks allows them to cross-subsidise areas where competitive pressures arise to see off new entrants:

> The major banks have a massive ability to cross-subsidise one area for another.[83]

4.85 Cross-subsidising is undesirable on efficiency grounds as well as its implications for competition:

> …one segment of customers subsidising another…if sustained for long periods of time, … will impact on resource allocation in the different customer bases and therefore asset allocations in our economy.[84]

Credit reporting

4.86 Limitation on credit reporting under the *Privacy Act 1988* has been mentioned as an impediment to new entrants:

> Australia is one of only a handful of OECD countries restricting credit reports to negative information…Negative credit reporting gives established lenders a clear information advantage over new entrants when assessing lending risk. Their large existing customer base gives them broad insight into a consumer's ability to make repayments. In contrast a new lender, having to rely on the limited information available on credit reports, will have significantly less capacity to accurately differentiate high- and low-risk borrowers.[85]

Perceptions of competition

4.87 The Chamber of Commerce and Industry Queensland surveyed its members and almost 90 per cent agreed that there should be more competition in the Australian banking industry. Asked about their biggest concern relating to the banking industry,

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82 Bendigo and Adelaide Bank, *Submission 58*, p 2.

83 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 19.

84 Mr David Liddy, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 15.

85 Veda Advantage, *Submission 50*, p 3. A similar argument is put by HSBC, *Submission 107*, p 5 and Abacus, *Submission 53*, p 31.

'competition' was nominated by 12 per cent and 'difficulty in switching banks' by a further 5 per cent.[86] (This is not inconsistent with the earlier result; it just reflects many regarding competition as less of a concern than high interest rates and charges.)

4.88 Most Australians believe that the banking market is overly concentrated:

> 72 per cent of survey respondents said that the big four banks in Australia have too much market power.[87]

4.89 There are also perceptions of collusion:

> Additionally this style of advertising currently being deployed by the NAB Bank in saying they have broken up from the other Banks suggests historic collusion on how banks charge consumers fees and set interest rates.[88]

4.90 In some cases, suspicions about banks leads submitters to suggest a return to a policy widely advocated in the past (see Chapter 3) and nationalise the banks:

> Parliament could act upon this by nationalizing banks as they cannot be trusted.[89]

Overview of competition

4.91 Witnesses differed on their views of the adequacy of competition. It was unsurprising that the major banks themselves argued there was sufficient competition. Among more independent witnesses, there were some who seemed comfortable:

> I think there is a lot of competition in the market.[90]

4.92 The Governor of the Reserve Bank distinguished between competition in deposit and loan markets:

> Four years ago the competition was all in lending money. There was very intense competition to lend. But now there is very intense competition to raise money on the part of financial institutions.[91] Other things have happened as well that affect the competitive landscape, but this is a very fundamental change in the state of the world. That said, the market, I think, remains more competitive than it was in the mid-nineties and borrowers have access to a larger range of products than they once did. The overall

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86 Chamber of Commerce and Industry Queensland, *Submission 43*, pp 3 and 16.

87 Fear et al (2010, p iv).

88 Finance Brokers' Association of Australia, *Submission 133*, p 3.

89 Mrs Kay Robinson, *Submission 119*, p 3.

90 Associate Professor Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 116.

91 The Governor later explained that the increase in competition for domestic deposits is related to the increased cost of raising wholesale funding offshore; *Committee Hansard*, 13 December 2010, p 10.

availability of finance to purchase housing, in particular, seems to be adequate.[92]

4.93 A similar point was made by the CEO of ANZ Bank:

> …the nature of competition has changed. Competition in the deposit market has never been so intense. Deposit rates have been bid up as financial institutions compete for stable sources of funds.[93]

4.94 The Governor of the Reserve Bank referred to cycles in competition:

> Competition is cyclical, to some extent. Competition is at its most intense usually around the peak of the business cycle when the risk that everybody is taking on is actually much greater than they think. Subsequently, the nature of those risks become clearer and people retreat from risk taking and the competition to lend…abates considerably and the competition to raise funds and shore up balance sheets gets much stronger.[94]

Multi-brand banking

4.95 Perceptions of competition may be affected by multi-brand banking. Westpac explained their strategy:

> …our strategy is one of offering customers choice through our multi-brand model, our key retail brands being Westpac, St George, Bank SA and RAMS. Each designs and implements their own customer strategies and plans. They have different marketing approaches, and it has become increasingly clear to us that they attract different types of customers.[95]

4.96 At one point in her testimony, the Westpac CEO claimed the two brands are 'competing against each other for customers'.[96] But she had earlier conceded that the branches branded as St George do not compete with those branded as Westpac:

> …customers who choose St George are not the customers who would choose Westpac. There is very little overlap there.[97]

4.97 She claimed that St George caters for customers wanting a certain type of banking experience:

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92 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2.

93 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 117.

94 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, pp 9-10.

95 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 65.

96 Ms Gail Kelly, Westpac, *Committee Hansard*, 21 January 2011, p 81.

97 Ms Gail Kelly, Westpac, *Committee Hansard*, 21 January 2011, p 80.

> …they see it as warm and friendly. It is down to earth. It is straightforward. It is community orientated. It is local. It is very grassroots. It is people based. It has a human-touch element to it.[98]

4.98 This raises questions about what type of bank Westpac customers must be seeking.

4.99 Questioned about advantages to customers, the Westpac Group's CEO suggested:

> ...St George has the benefit of now being part of an AA-rated bank with a stronger capital base, which means that it can price products in an improved way...[99]

4.100 Having a AA rating undoubtedly allows a bank to raise wholesale funds more cheaply. Whether this is passed on to customers is much less clear. Before the merger, home loan interest rates from the higher rated Westpac were not less than those from the lower rated St George. Currently, the Committee observed that lower rated entities such as Credit Union Australia are offering home loans at lower interest rates than the higher rated major banks.[100]

4.101 It is important to note that among the conditions imposed by the Treasurer in approving Westpac's acquisition of St George in October 2008 was that Westpac would be required to retain all Westpac and St George retail banking brands including Bank SA, and maintain the existing number of Westpac and St George branches and ATMs, for a period of three years.[101]

4.102 A couple of months after her appearance before the Committee lauding the St George brand, Westpac's CEO announced that the St George branches in Victoria would be replaced by branches reviving the name of Bank of Melbourne.

4.103 Other submitters saw the multi-brand strategy as designed to 'create an illusion of more competition than actually exists'.[102]

4.104 Some submitters felt it was potentially misleading for large banks to market themselves under multiple brands, and called for:

> …the Government to make it a requirement for institutions that are wholly owned subsidiaries of other financial institutions to clearly articulate that ownership within all signage, advertising and marketing material.[103]

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98 Ms Gail Kelly, Westpac, *Committee Hansard*, 21 January 2011, p 80.

99 Ms Gail Kelly, Westpac, *Committee Hansard*, 21 January 2011, p 86.

100 Credit Union Australia, *Tabled document, no. 8*, 25 January 2011.

101 The Hon. Wayne Swan MP, 'Proposed acquisition of St George Bank Limited by Westpac Banking Corporation', *Media release*, 23 October 2008. See also Senate Economics References Committee, *Report on Bank Mergers*, September 2009, pp 57-60.

102 Abacus, *Submission 53*, p 7.

Banking competition in regional areas

4.105 Banks may not be competing to provide a good service in remote areas. One bank admitted:

> …the banks, 10 years ago, clearly broke a bond of trust with the community when they closed branches. There is no question about that; it was a mistake.[104]

4.106 Bendigo and Adelaide Bank, the only bank with headquarters outside a capital city, related the decline in regional representation to the impact of greater competition:

> …non-bank mortgage providers in the 1990s…entered the market because they identified that banks were subsidising their other activities by charging relatively higher rates on home loans. By competing on price in the home mortgage market alone, they were able to quickly gain material market share. The banks responded by competing with them on price. As a result…banks were forced to cut costs as revenue shrank. This resulted in bank job losses, branch closures and banking utility being withdrawn from individual communities—many of them based in rural Australia.[105]

4.107 They warned of the deleterious effects:

> Once a bank left town, people were forced to go to other places to do their banking and, pretty soon, they were doing their shopping in other towns as well. Before too long, most businesses in the towns that lost their banks closed…Some do not have banking services anymore and some do not have a meaningful business presence at all.[106]

Committee view

4.108 The Committee note that even during the period of the GFC when the real economy slowed markedly, the profits of the major banks held up well. The returns they offer investors more than match those from other industries, despite the explicit and implicit support they received which makes banking a less risky activity.

4.109 While the Committee prefers banks to be profitable rather than unprofitable, their very high profits are ultimately paid for by households and small businesses. They are also a reflection that competition is not as keen as it should be.

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103 Credit Union Australia, *Submission 85*, p 7.

104 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 56.

105 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 78.

106 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Proof Committee Hansard*, 15 December 2010, p 78.

4.110 The Committee commends the Reserve Bank for the information it publishes on bank profitability in its semi-annual *Financial Stability Review*. Further such information would help inform the public debate.

Recommendation 2

4.111 The Committee recommends that the Reserve Bank publish further regular information on banks' interest margins and returns on equity; and compare these to returns in other industries to allow an assessment of whether risk-adjusted returns in the banking sector are sufficiently high to suggest that competition is inadequate.

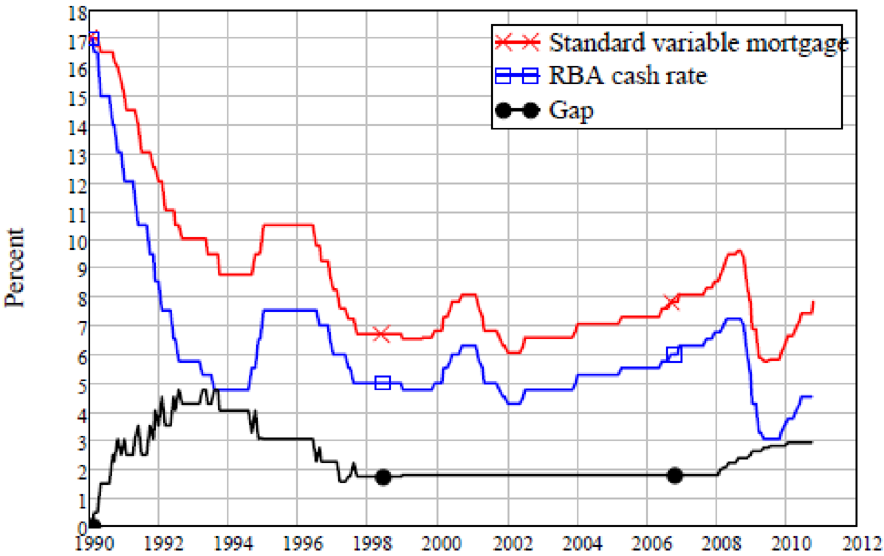
Chapter 5

Home loan interest rates

Introduction

5.1 There is a widespread belief that banks' lending rates should follow (and only follow) movements in the RBA's policy rate, the 'cash rate'. This belief is especially strong for home loans where it has been reinforced by the banks generally behaving in this way for a number of years (Chart 5.1[1]). (The view is also held for small business rates[2] although this attracts less attention.)

Chart 5.1: RBA cash rate and bank's variable home loan rate



Source: Associate Professor Steven Keen, *Submission 63*, p 3.

5.2 Some customers hold this view very strongly:

> As for the arrogance of banks that increase mortgage rates over and above the RBA... this is beyond belief.[3]

1 Similar charts appear in *Submissions 7, 8, 59* and *88.*

2 A survey of Queensland business found that 90 per cent did not believe increases in interest rates above the change in the official interest rate were justified; Chamber of Commerce and Industry Queensland, *Submission 43*, pp 8 and 16. Small business finance is discussed further in the following chapter.

3 Mr Michael O'Connor, *Submission 125*, p 2.

5.3 The increase in home loan rates beyond the Reserve Bank's latest 25 basis point increase in its 'cash rate' on Melbourne Cup Day 2010 attracted particular ire. A recent opinion poll showed that 79 per cent of respondents would support 'government regulation to limit bank interest charges to the level set by the RBA'.[4]

5.4 This belief of customers has developed as a result of the banks' actions over recent years:

> On one hand banks keep saying that there funding costs are disjointed from RBA cash rate as most of their funding is done through purchased funds in international and domestic market…banks however, invariably change their home lending rates as RBA cash rate changes.[5]

5.5 This pattern is, however, the result of an unusual amount of stability in financial conditions over that period rather than being an innate feature of banking operations. As the Reserve Bank Governor explained:

> …market funding costs do not move in this environment one-for-one with the cash rate. In fact, the period of time in which they did was historically rather unusual. It lasted 10 or 12 years. But if you went back prior to that period the association of mortgage rates with the cash rate was actually much looser.[6]

5.6 Some bank CEOs accepted that the banks had created this misperception by sheltering behind the RBA decisions when they raised interest rates on home loans:

> The banks have made a problem for themselves here by continually moving in line with the Reserve Bank… The reality is that that is not the driver of our funding but we have, for many, many years, created that perception in the public's mind, so we have got to face the fact that this is something we have created through our own poor communication on the issue...I certainly do not blame the public at the moment for being upset about moves they see as not in line with the RBA.[7]

> The fact that the banks have moved their interest rates in line with the RBA adjustments has led to the understanding of the public that there must be a connection, and that is quite understandable. So I think we have created that problem for ourselves...[8]

5.7 One bank CEO blamed the non-bank mortgage lenders:

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4 Cited in Finance Sector Union, *Submission 80*, p 7.

5 Professor Milind Sathye, *Responses to questions on notice*, p 3.

6 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 15.

7 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 51.

8 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 133.

> …the perception of a nexus between the RBA cash rate and housing loan rates needs to be broken…The perception came about as a result of non-bank lenders entering the home loan market. These lenders used the securitisation market to fund their loans and the securitisation market provided these funds based on…bank bill rates…[which] reflect the market expectation of the cash rate…Banks, erroneously in my view, elected to compete with these originators on price and were therefore led down the path of also changing pricing as official rates changed.[9]

5.8 The belief that home loan interest rates should be related to the RBA's cash rate led one submitter to suggest banks be required to justify any greater increases:

> A National Interest Rate Accord built on an annual National Interest Rate Case is the answer. If banks want to raise mortgage interest rates above and beyond the RBA's, they should be forced to justify one-off moves to an independent authority…Private health insurers, which just like the banks enjoy enormous protection and support from government policy, have to justify premium rises, although that process has been watered down far too much.[10]

Banks' cost of funds

5.9 The banks indeed argue that less than half of their costs of funds vary with the cash rate.[11] Large proportions of bank lending are funded by overseas borrowing. Almost a tenth of deposits pay no or low interest.[12] A significant proportion of funds is longer-term and so only very gradually adjusts to movements in short-term interest rates (Charts 5.2 and 5.3).

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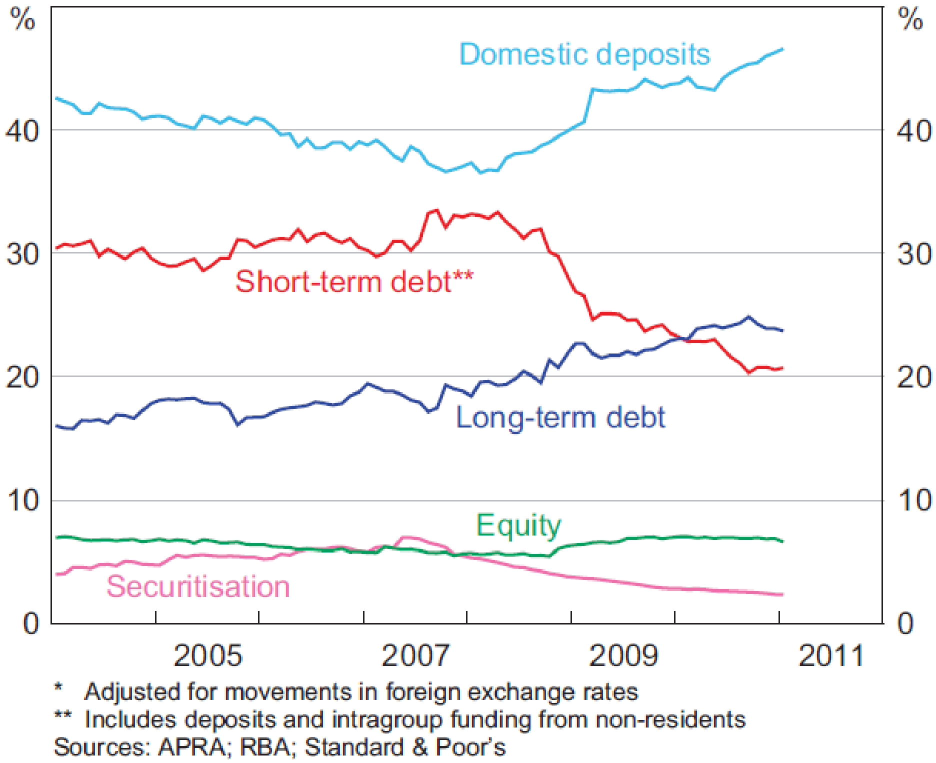
9 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Responses to questions on notice*, no 7, 20 January 2011, p 1. He adds 'the irony in all this is that the non-bank lenders…no longer exist because they didn't manage their liquidity through borrowing across a range of short and long term maturities'.

10 Mr Alan Stokes, *Submission 48*, p 1.

11 For example, Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 46.

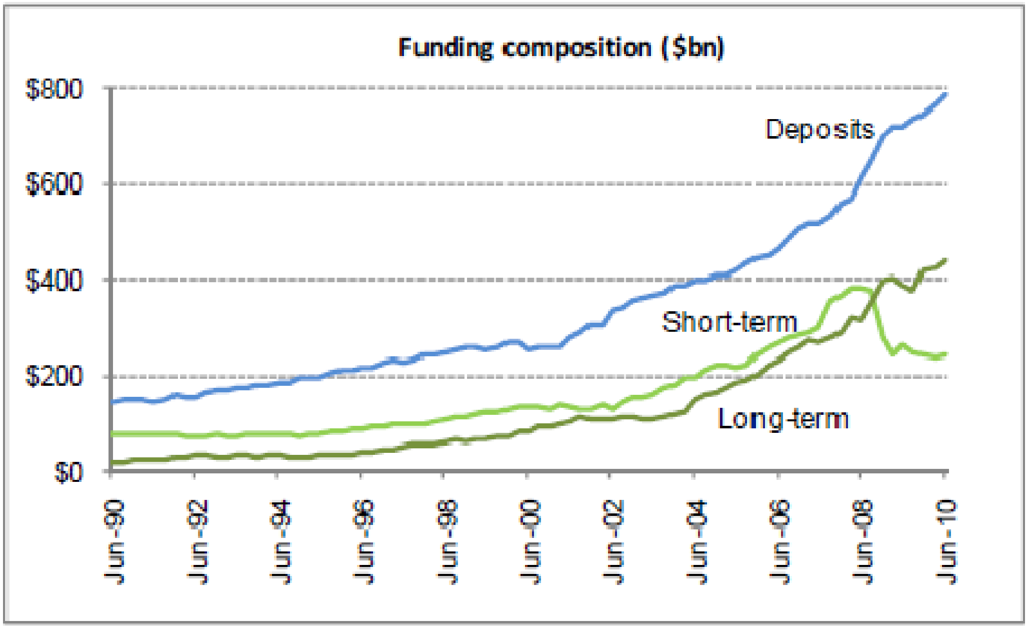
12 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 5.

Chart 5.2: Composition of Australian banks' funding (% of funding)



Source: Reserve Bank of Australia, *Financial Stability Review*, February 2011, p. 46. (Update of chart included in Heritage Building Society, *Submission 113*, p 2)

Chart 5.3: Composition of bank funding



Source: ABS Financial Accounts

Source: Australian Bankers' Association, *Submission 76*, p 82.

5.10 An academic witness stated at the hearing:

> There is no reason the banks should follow the Reserve Bank cash rate…[13]

5.11 In his submission he elaborated:

> The [Reserve] Bank Board sets only one interest rate—the cash rate. This is the interbank rate, the rate at which deposits in the banks' Exchange Settlement Accounts are traded. These deposits are usually of the order of $1bn, a tiny percentage of total bank liabilities. The suggestion of the critics is that if the RBA reduces the cash rate, the banks have somehow received a benefit which they are selfishly refusing to pass on to their customers. In fact, they have received no benefit at all. Of course, RBA cash rate decisions affect longer-term interest rates, but these are determined by market interest rate expectations…And it is these longer-term market rates which determine banks' cost of funds and, therefore, the rates they can charge customers.[14]

5.12 Since the GFC the banks have made increasing use of longer-term funding (Charts 5.2 and 5.3) which, given yield curves generally slope up, is usually more expensive.[15] In part this is a response to pressure from supervisors and ratings agencies:

> The announcement of new global standards for liquidity by the Basel Committee in December…has contributed to this. Banking institutions will need to have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. Increasing the share of funding from longer-term debt can reduce the size of the liquidity portfolio that needs to be held under that scenario.[16]

> These developments partly reflect a reassessment of risk in the post-GFC environment. They are also in anticipation of regulatory change in the post GFC environment, including new international standards on bank liquidity to be fully implemented by 2015.[17]

> …we have put in place far more longer-term funding. This has been done to protect the AA rating, which is so important for the banks, and also at the behest of APRA…[18]

5.13 But it also reflects changes in the banks' own thinking:

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13 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 61.

14 Professor Tom Valentine, *Submission 14*, p 1.

15 Australian Bankers' Association, *Submission 76*, pp 3 and 11.

16 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p 46.

17 Then Treasury Secretary Dr Ken Henry (2011, p 17).

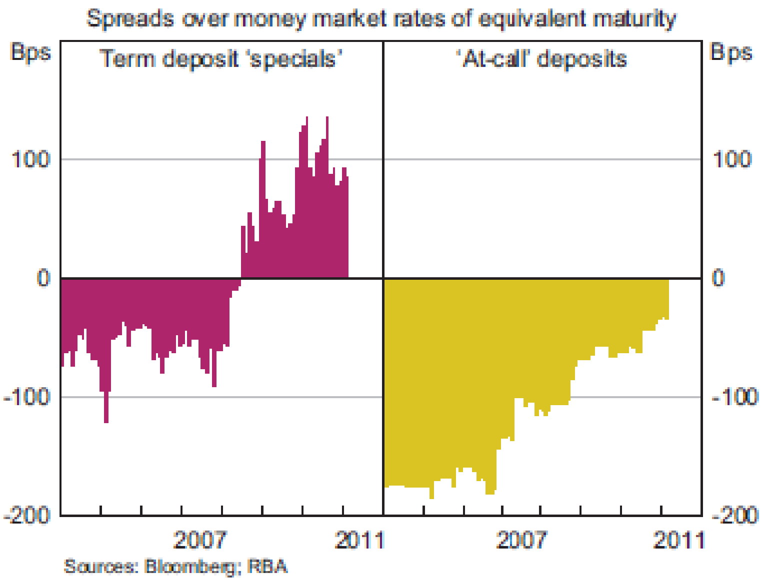
18 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 118.

> … our overall stance that we need to be more conservative, having learnt lessons from the GFC.[19]

5.14 The increased use of longer-term funding raised the average cost of funding. The banks have drawn attention in particular to the increased cost of term deposits, relative to the cash rate.[20] Chart 5.4 shows the large increase in 2009, which now appears to have stabilised:

> A consequence of the banks' efforts to change their funding patterns has been stronger competition in the deposit market in recent years. Deposit rates remain at or around historically high spreads to money market rates, although the intensity of competition for term deposits may have abated somewhat in the second half of 2010 as banks' funding pressures have eased; it might now be that much of the adjustment from lower-rate to higher rate deposit accounts has run its course.[21]

Chart 5.4: Major banks' deposit rates



Source: Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 28.

5.15 There has also been discussion about the impact of interest rates overseas. As offshore borrowings are hedged, however, the cost is not that different to that of domestic borrowing:

> The Group (along with the other Australian banks) hedges the foreign exchange risk from offshore borrowing in order to deliver AUD funding to

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19 Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 47.

20 Australian Bankers' Association, *Submission 76*, p 86.

21 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 28.

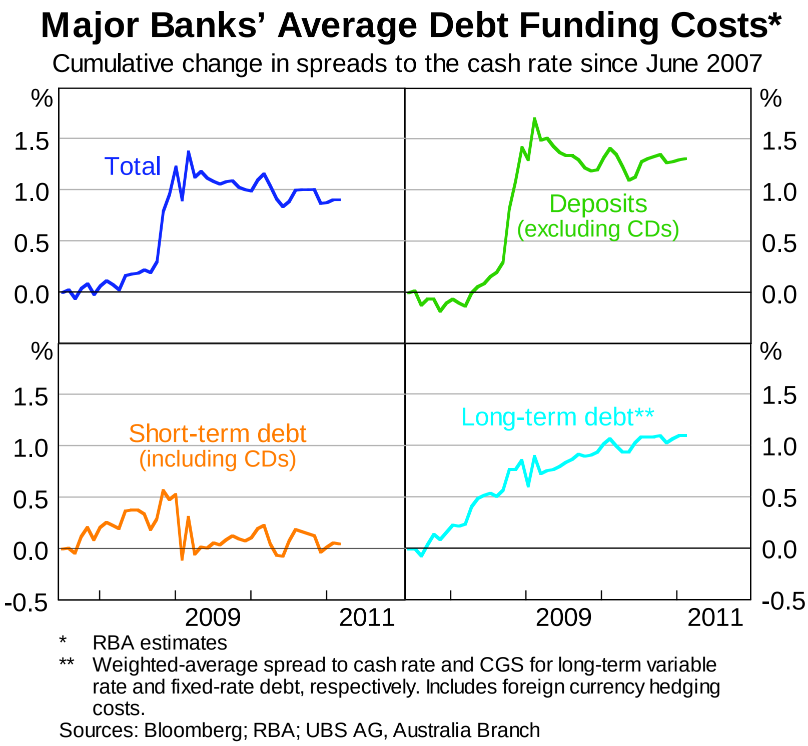
its customer base. Implementing the hedge removes the risk that large swings in the AUD exchange rate can lead to potential significant losses on offshore borrowing.[22]

Funds borrowed by Australian banks in offshore markets are either borrowed in Australian dollars or hedged into Australian dollar exposures using derivatives. In particular, the ABS's 2009 Foreign Currency Exposure release, undertaken on behalf of the RBA, showed that Australian banks hedged almost all of their foreign currency liabilities. The few unhedged liabilities were potentially fully hedged 'naturally' as they were more than offset by the banks' unhedged foreign currency debt assets and foreign equity investments…Hedging converts the interest rate on offshore debt back to an Australian dollar interest rate, which, if it were a floating rate, would be influenced not only by the cash rate but also by changes in the cost of hedging.[23]

The larger part of offshore borrowing is denominated in foreign currency with the foreign currency risk being hedged.[24]

5.16 The increase in the cost of various types of funding relative to the cash rate is shown in Chart 5.5.

Chart 5.5



Source: Reserve Bank of Australia, update of chart in *Submission 41*, p. 14.

22 Commonwealth Bank of Australia, *Submission 88*, p 5.

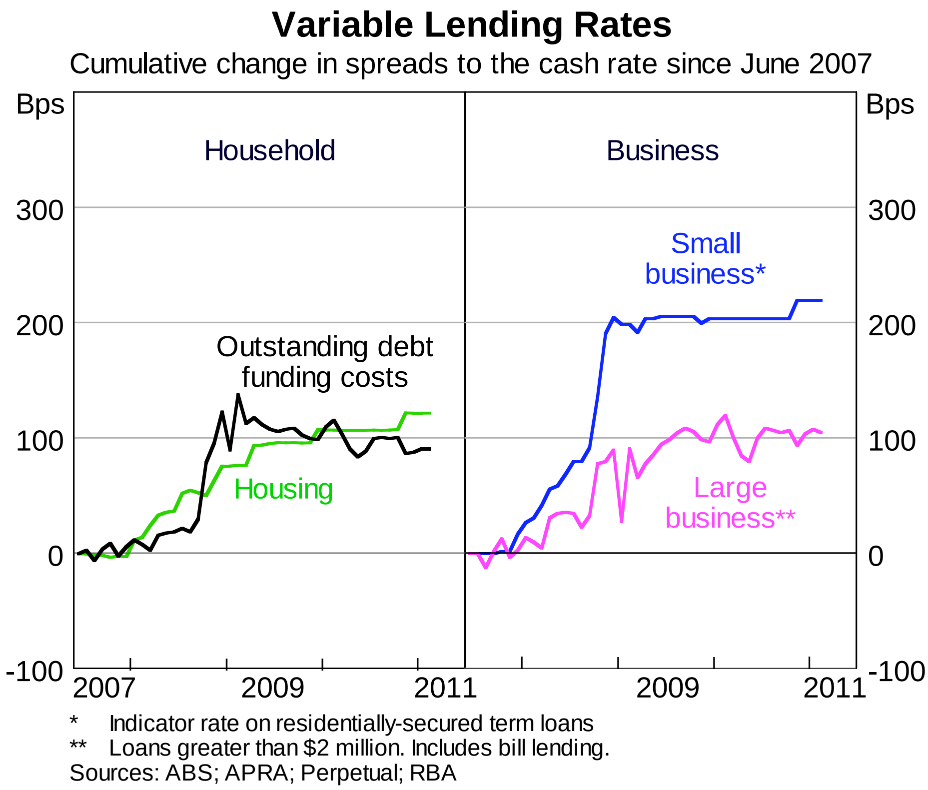
23 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 6.

24 APRA, *Responses to questions on notice*, no 10, 31 January 2011, p 3.

5.17 For the major banks, the increase in the cost of funds was around 100 basis points. One smaller bank estimated its comparable increase was 130-140 basis points.[25]

5.18 Chart 5.6 shows that after the GFC housing loan interest rates rose by less than the Reserve Bank's estimate of banks' cost of funds. By contrast business loan interest rates have been increased by more than the cost of funds. This suggests banks have become risk-averse and the relative safety of housing lending has become more attractive to them.

Chart 5.6



Source: Reserve Bank of Australia, update of chart in *Submission 41*, p. 15.

5.19 The major banks challenged the Reserve Bank's calculations, arguing that while 'spot rates have largely stabilised' the banks have to rollover longer-term funding at rates still well above pre-GFC levels:

> …the average cost of our funding book is rising because we are replacing cheap funding with more expensive funding—certainly, absolutely, very

25 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 87.

> pleasingly, funding that is below the peaks but still substantially above the pre-crisis levels.[26]
>
> In our own situation the average cost of funds continues to rise…and that is because…we are still replacing funds that we brought on board before the global financial crisis with funds that are now much more expensive.[27]

5.20 This does not explain any discrepancy with the Reserve Bank's calculations, however, as the RBA is well aware of the banks' need to roll over funds:

> …their funding costs on the offshore part of it, the long-term part, where you borrow at five years—so every year one-fifth of that funding is replaced; the cost of what you borrowed five years ago is 'down here'; the cost of what you are borrowing to replace it with is 'up here'.[28] So, as each month goes by, a little bit of the old stuff rolls off and the new stuff rolls on. How big a quantum that is is a matter of estimation—an empirical estimation, of course—but my guess is that one of the things that is in their mind is that this is happening each month and, as each month goes by, there is that small squeeze on their margins.[29]

5.21 As shown in Chart 5.5, the increase in the average cost of longer-term funding is more than offset by a reduced cost (relative to the cash rate) of short-term borrowing and deposits.

5.22 The Reserve Bank's charts refer to an average of the banks, so may not capture the experience of every individual bank, which may be the cause of the dispute.[30] There are differences in the cost of funds between banks:

> There is some variation in the cost of funding across the major banks. First, there are differences in funding composition across these banks. Second, there are some differences across the banks in the rates paid on particular funding sources; these differences can reflect factors such as timing of bond issuance, or how strongly a bank is competing for a particular type of deposit. The major banks' financial results show that for the 2010 financial year, the average interest rates on the interest-bearing liabilities of these

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26 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 61. Similar comments were made by Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 47; and Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 120.

27 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 72.

28 The reader will have to imagine the accompanying hand gestures.

29 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 15.

30 For example, the Commonwealth Bank say they have a more conservative funding mix than the industry average; *Responses to questions on notice*, no 8, 28 January 2011, p 1.

> banks' Australian operations was between about 4 and 4.7 per cent, a range of about 70 basis points.[31]

5.23 Credit Union Australia, the largest competitor from the mutual sector, reported a different recent experience and expectation for funding costs:

> …we are seeing funding costs at the moment largely flat over the last eight to 12 months or that kind of period. So perhaps we have been at the peak.[32]

Loan rates and the cost of funds

5.24 Professor Sathye suggests that in a competitive market banks' loan pricing would reflect their average cost of funds.[33] Asked about this, the Reserve Bank told the Committee:

> How banks reprice outstanding loans is likely to be a significant determinant of whether the bank sets its loan rates on a marginal cost or average cost basis. In Australia, an increase in the indicator rate increases rates for both new and existing variable-rate borrowers. On that basis, we would expect that rates would be set with average funding costs mainly in mind. In contrast, loans that did not reprice as interest rates move could be expected to be set with a view to the marginal cost of funding. Moreover, since the onset of the global financial crisis, banks have become more concerned about how they fund an increase in their balance sheets, thereby putting more emphasis on using a marginal funding cost benchmark to assess a loan proposal.[34]

5.25 The most recent increases to home loan interest rates by the major banks in excess of the Reserve Bank's adjustment to the cash rate, on Melbourne Cup Day 2010, continues to cause controversy. Treasury remains critical:

> Senator WILLIAMS—Mr Murphy, you were just saying that you recognise that the cost of funds for the banks has increased. Is that correct?
>
> Mr Murphy—Yes.
>
> Senator WILLIAMS—Does that justify their position to raise their interest rates outside the Reserve Bank cash rate movement?
>
> Mr Murphy—No, I do not think it does. The cost of funds has risen significantly from, say, pre GFC. It went up dramatically during the GFC

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31 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 6.

32 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 87.

33 Professor Milind Sathye, *Responses to questions on notice*, no 4, 14 January 2011.

34 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 5. The RBA's response is endorsed by APRA; *Responses to questions on notice*, no 10, 31 January 2011, p 3.

> and it has dropped back down. One of the issues is: what is the time frame in terms of when costs of funding should be looked at? [35]
>
> He [the Treasurer] has taken the view that it is unjustified. As I said, there is a range of factors, and I see it easy to come to that conclusion.[36]

5.26 But importantly the banks increasing their loan rates by more than the Reserve Bank's adjustment to its cash rate does ***not*** mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target. If the banks expand their margin over the cash rate, then the Reserve Bank will set a lower cash rate than they would otherwise have set.

5.27 The Governor of the Reserve Bank explained:

> But since the middle of 2007 there clearly has been an increase in their [the banks'] overall costs of funds relative to the cash rate. That has been reflected in the widening of the margins. It has also been reflected in the cash rate being roughly, I would say, about 100 points lower than it would have been, to take account of that margin change and roughly—not exactly in any given month but roughly speaking—offset it so that the loan rates in place in the economy are, roughly speaking, about where we think they ought to be for the macroeconomic management needs that we have. We cannot finetune this on a month-to-month basis; we could not claim to do that. But over time, in the broad sweep, the big amounts, roughly speaking, have been offset by different behaviour by us on the cash rate compared to what we would have done otherwise.[37]

5.28 The banks' actions may influence the home loan rate relative to other lending rates. The Reserve Bank does not regard the home loan rate as the *only* interest rate that influences economic activity and hence inflation. Higher interest rates on loans for business will lead them to scale back or defer their investment decisions. Higher interest rates on deposits encourage households to save more and so spend less. Higher interest rates on personal loans will also discourage some consumer spending. Higher interest rates also have a wealth effect as they reduce asset prices by more heavily discounting future cash flows. Higher interest rates tend to be associated with a higher exchange rate, weakening activity in exporting and import-competing industries.

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35 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 39.

36 Mr Jim Murphy, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 45.

37 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 13 December 2010, p 13.

5.29 Conceptually the Reserve Bank can be thought as being concerned with a weighted average interest rate charged by banks and other ADIs; with the weights reflecting the importance of the interest rate in influencing activity.[38]

5.30 Australian households have high levels of housing debt (compared to the past, and increasingly compared to international peers), predominantly at variable interest rates. This implies that the importance of the link between movements in the Reserve Bank's policy rate and the interest rate on home loans is more important now in Australia than in the past or in most other countries. The much greater media attention given to home loan interest rates amplifies their importance in influencing consumer sentiment.

5.31 The housing variable loan rate is therefore the most influential rate on economic activity in Australia and so the dominant influence on it will be the Reserve Bank's view on how monetary policy needs to be set to achieve the medium-term inflation target.

5.32 Treasury warn of the unintended consequences of regulating interest rates on housing loans or other bank loans:

> …calls for the Government to regulate lending rates on particular bank products are quite peculiar. The only certain outcome of any such regulation would be credit rationing, with some households and businesses finding it impossible to access credit on reasonable terms. Typically, such interventions have unsavourary distributional consequences…[39]

The repricing of risk

5.33 Since the GFC, banks have become more attuned to the differences in risk of different types of loans. As the Governor of the Reserve Bank explained:

> …risk has been repriced since early in 2007…Prior to then it was widely held, I think, that risk was underpriced—that it is to say, investors demanded relatively little compensation for risk in the returns that they required on investment. That meant the financial institutions of all types could get ample funding easily and cheaply… But investors changed their behaviour in 2007-08. The compensation that they require for taking risk now is higher.[40]

5.34 As a major bank CEO put it:

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38 Grenville (1995) and Lowe (1995) describe the monetary transmission mechanism in more detail.

39 Henry (2011, p 24).

40 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2.

> Yes, I think we all recognise that risk was mispriced, and that is one of the reasons we had a GFC.[41]

5.35 One implication of this underpricing of risk was that securitisation was unusually competitive for a period of time:

> Business models that took particular advantage of low-cost wholesale funding or securitisation were able to provide a very competitive edge to certain markets, particularly—though not only—markets for mortgage lending…wholesale funding and securitisation are [now] more expensive. In the case of securitisation, in addition costs have risen, in part because certain investors completely exited that market and are very unlikely to return.[42]

(Securitisation is discussed in more detail in Chapter 13.)

5.36 The Governor pointed out that the global reduction in the demand for risk made wholesale markets a less attractive funding source of banks:

> …the strong reliance that many of our institutions, including the major banks, had on wholesale funding—a lot of it from offshore—came to be seen as something of a vulnerability. They felt that themselves. They were under pressure also—from rating agencies and from supervisors and this is everywhere in the world, not just here—to have a higher share of the assets funded by deposits, many of which are thought to be more stable.[43]

5.37 The repricing of risk may also explain why banks have increased interest rates on small business loans by more than on housing loans, as illustrated by Chart 5.6 and Chart 6.3.

Measuring home loan interest rates

5.38 There are complications in measuring the average home loan interest rate.

'Discounts' on home loan rates

5.39 While attention focuses on the banks' advertised or posted indicator rates for home loans, there has been an increasing tendency for banks to offer some customers 'discounts' from these rates (Chart 5.7). As the Reserve Bank explains:

> …it has become commonplace for banks to offer borrowers discounts on indicator rates. Indeed, banks have been advertising these discounts for a

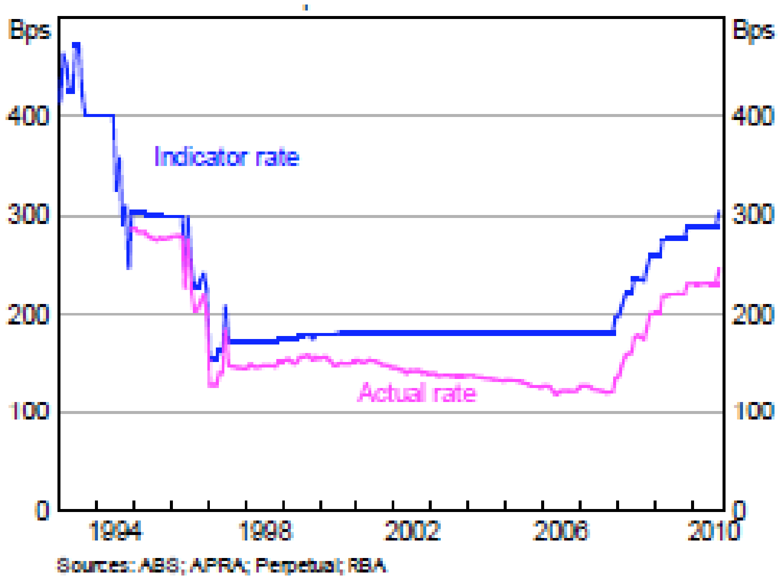
41 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 53.

42 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2.

43 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 10.

number of years, resulting in almost all borrowers obtaining a discount of some size. These discounts have increased over time and, on average, are currently around 60 to 70 basis points.[44] It has become more common over recent years for borrowers, particularly those taking out bigger loans, to negotiate larger discounts than those that are advertised.[45]

Chart 5.7: Variable housing lending rates (relative to cash rate)



Source: Reserve Bank of Australia, *Submission 41*, p 15.

5.40 Choice reported that some customers were able to get a better deal just by asking for it:

> …we did some research on this and we found that, with home loans and also with transaction accounts, when people asked their bank for a better deal they did get one. Some people even claimed to get a one per cent reduction in their home loan—not many, but a few claimed that they got that.[46]

5.41 The Reserve Bank commented:

> The discounts were used by the banks to compete for new business while minimising the foregone interest of lower effective interest rates on their existing housing loan portfolios.[47]
>
> Lenders finance a wide spectrum of credit risks so it is appropriate that borrowers with varying risk characteristics are charged different rates. The

44 They range up to around 90 basis points.

45 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 3.

46 Mr Christopher Zinn, Director, Communications, Choice, *Committee Hansard*, 14 December 2010, p 34.

47 Reserve Bank of Australia, *Submission 41*, p 15.

> size and prevalence of discounts will also reflect the profitability of the customer’s current and potential relationship with the lender, as well as credit conditions at the time of origination.[48]

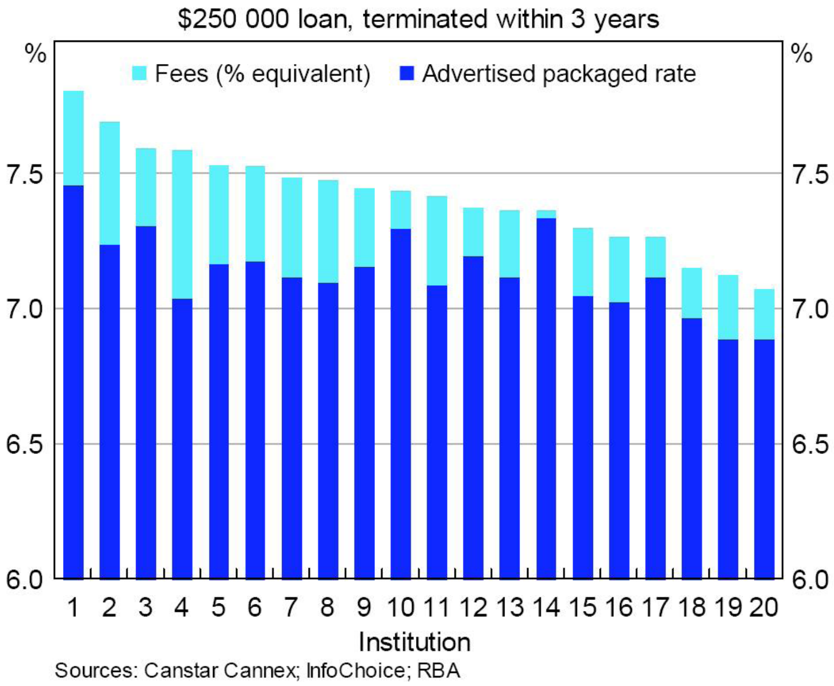
5.42 The variation between posted indicator rates and actual rates charged has the disadvantage of clouding price comparisons. It is not enough to compare the readily available information on indicator rates. It is also necessary to assess which lenders may be willing to make larger reductions in the negotiation process. Arguably this advantages borrowers who go through a broker rather than shop around for a loan themselves.

Effective variable mortgage rates

5.43 The interest rate is, of course, not the only relevant cost of a mortgage. Establishment, service and exit fees also need to be taken into account. The Reserve Bank estimates that 'on a $250 000 mortgage held for up to three years, for instance, these fees are estimated to add, on average, about 30 basis points a year'.

5.44 Chart 5.8 compares rates charged by various lenders including these fees.

Chart 5.8: Effective variable mortgage rates



Source: Reserve Bank of Australia, *Submission 41*, p 16.

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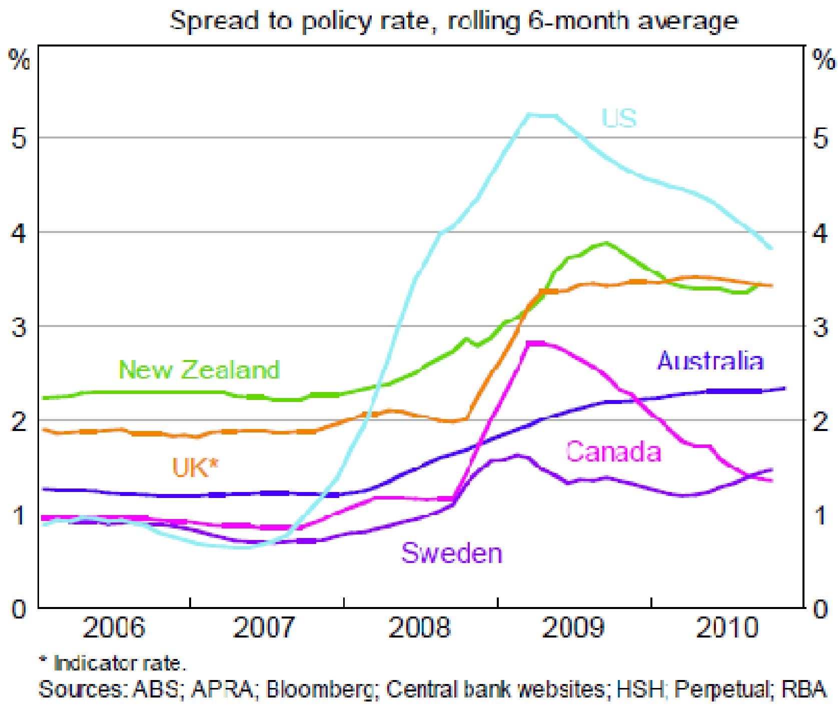
48 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 3.

International comparison

5.45 While there are always difficulties in obtaining exactly comparable data, the best measures available suggest that the margin of home loan interest rates over central bank policy rates in Australia is around the middle of the range of that in comparable countries (Chart 5.9)

Chart 5.9: Interest margins on variable rate mortgages



Source: Reserve Bank of Australia, *Submission 41*, p 16.

5.46 The ABA present data showing the gap between the central bank policy rate and the interest rate charged on five-year fixed interest home loans is between 2 and 3 per cent in Australia, Canada, New Zealand and the United Kingdom.[49]

Tying home loan interest rates to the Reserve Bank's policy rate

5.47 Professor Sathye has suggested that the interest rate on home loans should be a fixed margin over the Reserve Bank's official cash rate.[50] A problem with this idea is that in extreme market conditions, such as occurred during the global financial crisis,

49 Australian Bankers' Association, *Submission 76*, p 31.

50 Professor Milind Sathye, *Submission 1 to Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010*, (hereafter *'basic banking inquiry')*, p 7.

a bank's cost of funds may go well above the cash rate (Chart 5.5) and potentially they could be making a loss on the loans.

5.48 Professor Sathye's suggestion has some similarities with that proposed in the Banking Amendment (Keeping Banks Accountable) Bill 2009, which would have required that that if a bank moves interest rates contrary to movements in official interest rates, the treasurer could remove its access to government guarantees of its deposits. The Committee recommended that the Senate not pass that bill, as:

> …it is concerned that the bill may discourage banks from competing in reducing interest rates, could lead to higher bank fees and/or reduced lending to homebuyers, could raise doubts about the deposit guarantees and so reduce confidence in the safety of bank deposits and could be perceived as politicising the setting of bank interest rates.[51]

Variable versus fixed interest rate loans

5.49 Australia is unusual in having most of its home loans with interest rates variable at the bank's discretion.[52] Indeed, some submitters argued that banks should not be allowed to vary interest rates on home loans.[53]

5.50 More common are either fixed rates or adjustable rates tied to some market indicator interest rate.[54]

5.51 The Reserve Bank commented:

> The Australian housing loan market is characterised by relatively limited use of fixed-rate loans by international standards. Historically, more than three-quarters of housing loans have been written with a variable interest rate, and most of the remaining share have rates that are fixed for less than five years. While Australian households will, as a result of this behaviour, generally bear more interest rate risk on their mortgage debt compared to households in other countries, this is partly offset by providing households with greater flexibility. In particular, when interest rates fall to low levels, many households tend to take the opportunity to make additional principal repayments. In contrast to variable-rate loans, fixed rate loans almost always have restrictions on prepayments. The greater prevalence of variable-rate loans in Australia is, in part, likely to be influenced by the fact that these loans provide borrowers with greater flexibility in making prepayments, with Australian borrowers valuing this feature, given that owner-occupier interest payments are not tax deductible as they are in a number of other countries. Also, the greater prevalence of variable rate

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51 Senate Economics Legislation Committee, *Banking Amendment (Keeping Banks Accountable) Bill 2009*, November 2009, p. 17.

52 Professor Kevin Davis, *Proof Committee Hansard*, 25 January 2011, p 57.

53 Mr Peter Higgins, *Submission 17*, p 1.

54 Professor Kevin Davis, *Submission 8*, p 2. Some data are provided in APRA, *Responses to questions on notice*, no 6, 31 January 2011, p 5.

> loans increases the effectiveness of monetary policy, as the bulk of households is affected quickly by changes in interest rates. This means that, other things equal, the Reserve Bank needs to move the cash rate less than might otherwise be the case.[55]
>
> Were lenders to offer such products, they are likely to carry a slightly higher interest rate as compensation to the lender for taking on the risk that funding costs might rise more quickly than the cash rate (that is, the lender is providing the borrower with an option) .[56]

5.52 Reserve Bank economist Luci Ellis elaborates:

> Mortgage interest deductibility affects the capacity to service debt and the incentives to repay principal. This in turn affects incentives to take mortgages with fixed versus variable interest rates. When interest payments are not deductible, mortgage borrowers are effectively paying their mortgage out of post-tax income. This implies that the post-tax return to paying down the mortgage will generally exceed the post-tax return on investing in financial assets, providing an incentive to pay down the mortgage rapidly if possible. Such an incentive encourages the use of variable-rate mortgages, which are less likely to involve prepayment penalties.[57]

5.53 The reason for this prevalence of variable rate mortgages may just be inertia dating back to the days of controlled interest rates:

> …it goes back to the dim, dark ages of history when interest rates were controlled by government, and therefore to borrow you never had to bother about what interest rates were. You knew it would be at the ceiling set by the government. We removed that ceiling on housing loan interest rates but we did not ask whether the current institutional structure of loan contracts appropriate for the new environment.[58]

5.54 As a result of the use of variable rate mortgages in the Australian market, the risk of interest rate variability is borne by households rather than banks. It could well be argued that banks are better placed than households to bear this risk:

> …an interest rate which is variable at the lender's discretion…is also undesirable from a risk-sharing perspective in terms of who is better able to bear the risk of changes in banks' funding costs and in terms of the availability of information.[59]

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55 Reserve Bank of Australia, *Submission 41*, p 17.

56 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 2.

57 Ellis (2006) cited in Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, pp 4-5.

58 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, pp 68-69.

59 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 58.

'Fixed interest gap' or 'tracker' mortgages

5.55 A bill currently before Parliament requires banks to offer a 'fixed interest gap' (sometimes know as a 'tracker') mortgage product. This is a mortgage where the interest rate charged is adjusted to maintain a fixed percentage (set at the time of the loan) above the lender's cost of funds. Banks would be required to get the approval of APRA for the formula they use to calculate their costs of funds.

5.56 Senator Bob Brown explains the motivation:

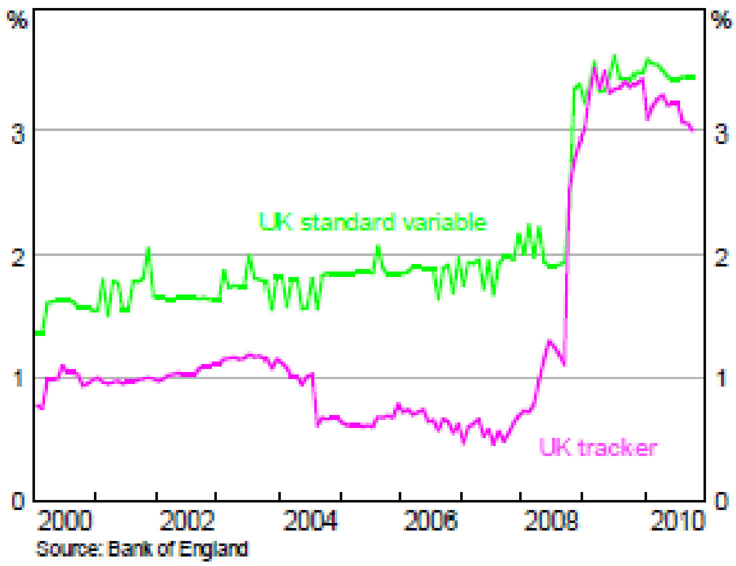
> These mortgages will protect customers from interest rate fluctuations that are not genuinely caused by changes to the bank's cost of funds…these mortgages will offer customers greater transparency and reassurance by behaving as customers expect variable rate mortgages to behave.[60]

5.57 The bill would not preclude banks also continuing to offer their current variable rate loans where they retain discretion to vary the rate charged.

5.58 Such 'tracker' products are offered in the United Kingdom. The Reserve Bank commented:

> While 'tracker' or benchmarked products can provide informational benefits for borrowers and potentially provide lenders with a smoother margin on their mortgage book, these products are not without limitations. In the United Kingdom, for example, the spread between new tracker rates and the policy rate has increased sharply, rising by more than the UK standard variable rate.[61]

Chart 5.10: UK variable housing lending rates (relative to cash rate equivalent)



Source: Reserve Bank of Australia, *Submission 41*, p 17.

60 Senator Bob Brown, *Senate Hansard*, 15 June 2010, p. 30.

61 Reserve Bank of Australia, *Submission 41*, p 17.

5.59 Some submitters want to go further than this bill. Professor Kevin Davis wants to:

> Prohibit loan contracts which give lenders absolute discretion to change the interest rate on existing loans.[62]

5.60 The Australian Bankers' Association reject the idea:

> …demand for such a product is unknown, yet banks and other ADIs would be subjected to additional costs in developing, launching and administering the product that would add cost to all lending. We note that there are a number of recent examples of policy driven products that have not proven to be commercial viable, or have not attracted consumer interest, or have subsequently been cancelled. If a commercially viable market existed in Australia for such a mortgage, we consider that one or more of the 111 institutions marketing home loans would have provided this product.[63]

5.61 The ABA is apparently unaware that there is (at least) one ADI offering such a product. Queensland Teachers Credit Union offer a 'tracker' mortgage loan where the applicable rate only moves in line with changes in the Reserve Bank's cash rate. They comment on it:

> This product creates certainty and surety for consumers and, at the same time, provides transparency. Not only does it provide demonstrable benefits for consumers, it conforms to the social and political objectives of the Government.[64]

5.62 They note that their ability to make the tracker loans is constrained by problems in the securitisation market:

> …due to current securitisation requirements in relation to the ability to reprice mortgage loans, this type of loan does not conform and is therefore ineligible for securitisation,…[65]

5.63 The ANZ Bank is currently considering how a tracker product might work in practice.[66]

5.64 Asked about any prudential concerns, APRA responded:

> In APRA's view, there is a substantial implicit interest rate risk in such a product, when ADI funding costs increase more than the reference rate. The problem was notable, among other examples, with United Kingdom 'tracker' loans during the global financial crisis. If home loan rates were to be tied to the cash rate or other rates not controlled by the lending

62 Professor Kevin Davis, *Submission 8*, p 5.

63 Australian Bankers' Association, *Submission 76*, p 45.

64 Queensland Teachers Credit Union, *Submission 122*, p 4.

65 Queensland Teachers Credit Union, *Submission 122*, p 4.

66 ANZ Bank, *Responses to questions on notice*, *no 11*, 31 January 2011, p 2.

institution, the ADI may be required to hold additional capital against the extra risks.[67]

Committee view

5.65 The Committee concludes that the Reserve Bank's policy rate is only one influence on banks' cost of funds. It is therefore not reasonable to expect that banks' variable interest rates on housing loans should always and only move in parallel with changes in the Reserve Bank's policy rate. It welcomes the initiative by some lenders to provide 'tracker loans' with such an explicit linkage for those borrowers who desire this certainty.

5.66 The Committee does not support regulatory controls on home loan interest rates, or interest rates in general, but instead suggests in following chapters measures that will increase competitive pressures.

67 APRA, *Responses to questions on notice, no 6*, 31 January 2011, p 2.

Chapter 6

Small business finance

6.1 While most public, and particularly media, attention on banking focuses on home loans, ensuring there is adequate competition in the provision of appropriate credit to small business is also important. Small businesses employ about half the Australian workforce and, unlike larger firms, are generally reliant on financing from domestic lenders.

6.2 As the Committee produced a report into access of small businesses to finance only in June 2010, and the Joint Committee on Corporations and Financial Services recently reported on its an inquiry into 'Access for Small and Medium Business to Finance'; this topic is not pursued in greater depth in this report.

6.3 Some witnesses and submitters believe that reduced competition in the banking market has hurt small business in particular:

> …the exit of non-bank lenders and foreign banks has meant that small business owners have had to adjust their business strategies. This has involved delaying plans for expansion, downsizing or, in some cases, closing an otherwise viable business. Many niche finance products, such as fit-out finance, which is relied on extensively in the retail sector, simply no longer exist...The question before this committee is whether... people who have credible cases for access to business finance are being denied because of risk rating by the institutions. Our concerns…are that businesses with a long history of relationships with their institutions are being denied applications for credit even in profitable circumstances…The overwhelming evidence is that banks have gone beyond what is reasonable…[1]

> In March 2010, CPA Australia ran four round table events with members involved with small business to gauge their views on small business access to finance. Many participants stated that they have seen a reduction in competition between lenders to small business since the beginning of the global financial crisis.[2]

6.4 In some cases it is claimed that healthy small businesses were suddenly subject to additional onerous requirements:

> In their minds they were meeting all of the criteria that were set by their lending institution. However, their loan arrangements have been reviewed by the bank and, accordingly, they have had to either turn an interest loan

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1 Mr Richard Holyman, Deputy President and Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Committee Hansard*, 15 December 2010, pp 108 and 113.

2 CPA Australia, *Submission 82*, p 3.

> into retiring principal amounts or they have had other aspects of the loan changed significantly to the detriment of their plans.[3]

6.5 This accords with the views the Committee heard during its inquiry last year:

> A strong consensus emerged from small businesses across industries that competition had declined and was now inadequate among lenders.[4]

6.6 Some submitters have suggested that credit was cut to small business in an unduly harsh way during the GFC:

> Through the GFC banks reacted negatively to SME Borrowers by reducing LVR parameters and at times without notice or little notice to existing SME borrowers even when an existing borrower had an unblemished credit history, and increased serviceability requirements for new SME borrowers and imposed much lower than historic LVRs to be geared... in some cases the reduction in the LVR meant that SME Borrower/s had to find significant amounts of cash to reduce debt or they would be placed into default without cause of a poor repayment history.[5]

6.7 There are suggestions that a fear of banks deterred small business from seeking finance after the GFC:

> …given the widespread perception as well that it is difficult to obtain finance, many small businesses stopped approaching their banks. One reason is they did not want their loan facilities re-rated and end up paying a higher margin. The more they can stay away from the bank the better.[6]

Availability of credit to small business

6.8 Lending to small business slowed since the GFC (Chart 6.1). The data do not suggest lenders have discriminated against small business. Credit to small business has been increasing, albeit at a slower rate, in recent years while there has been an absolute fall in credit provided to larger firms.[7]

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3 Mr Nick Behrens, General Manager, Policy, Chamber of Commerce and Industry Queensland, *Proof Committee Hansard*, 4 March 2011, p 60.

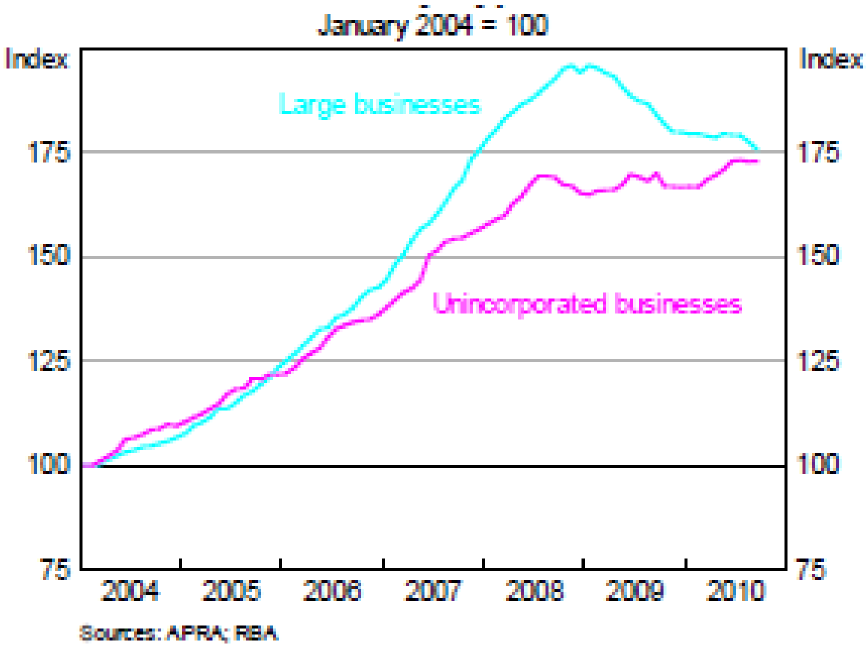
4 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 37.

5 Finance Brokers' Association of Australia, *Submission 133*, p 5.

6 Mr Greg Evans, Director of Economics and Industry Policy, Australian Chamber of Commerce and Industry, *Joint Committee on Corporations and Financial Services Hansard,* 2 March 2011, p 10.

7 This is consistent with the observation that while bank business loans of less than $2 million *slowed* during the GFC, there was a *fall* in the amount of larger business loans outstanding; Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 8.

Chart 6.1: Business credit by type of borrower



Source: Reserve Bank of Australia, *Submission 41*, p 7.

6.9 The Committee examined the reasons for this last year, concluding:

The slowdown in lending to small business appears to reflect a combination of demand factors such as;

- less demand for finance by small business in the wake of the global recession, as weaker sales mean that existing capacity is adequate and there is not the need to borrow for investment;
- less demand for finance by small business as reduced confidence leads to a more conservative attitude towards debt;

and supply factors such as;

- fewer small businesses being able to meet existing lending standards in the wake of the global recession;
- some tightening of lending standards by financial intermediaries. It is arguable that banks were tending towards recklessness in the preceding boom, and that some tightening of credit standards represents a prudent return to 'normal' practice, but there may also be cases where banks are over-reacting; and
- non-bank lenders having fewer funds available as securitisation and interbank lending markets dried up and/or interest rates in them became prohibitive.

Witnesses were reluctant to apportion the roles played by these various factors.[8]

8 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 1.

6.10 The Reserve Bank suggest:

> It appears unlikely that credit growth will return to the very high rates that were sustained in the pre-crisis period, since credit expansion during that period was significantly boosted by the one-time adjustment to financial deregulation and the shift to low inflation… There have been no notable changes in lending criteria at the smaller end of the business loan market.[9]

6.11 Another factor mentioned as possibly restraining lending to small business is the capital backing required to underpin it by rules set by APRA. These are discussed further in Chapter 11.

Sources of credit for small business

6.12 Small business is largely reliant on the major banks for its funding. Foreign banks and smaller lenders are unlikely to compensate for reduced competition between the major banks:

> …experience shows us that foreign lenders are mostly interested in corporate lending and lending to particular sectors such as commercial property development...Second tier lenders (smaller banks and credit unions) …without larger distribution networks and larger back office support…[are] unlikely…[to] become a major source of competition in small business lending.[10]

6.13 There may be scope for mutuals to lend more to small business, especially as mergers increase their size. Already, Credit Union Australia, the largest credit union, reports over 20,000 small business customers.[11]

6.14 The WA Small Enterprise Network was particularly concerned about the implications for young entrepreneurs of banks' reliance on mortgages on homes to secure small business loans:

> … the relative cost of a house measured against average weekly earnings is significantly greater than it has been in the past. As such, it is becoming more difficult and costly for the younger generation of Australians to enter into home ownership. As a result, it is possible that by the time future entrepreneurs have purchased a home and built up sufficient equity to act as collateral against a business loan, they will be on average older than is the case now. They may be past the current average age where people currently seek out finance to start their own businesses.[12]

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9 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 27.

10 CPA Australia, *Submission 82*, p 9.

11 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 88.

12 WA Small Enterprise Network, *Submission 68*, p 8.

The cost of credit for small business

6.15 Even if small business is able to access credit, a lack of competition may manifest in credit being unduly costly. Since the GFC, finance for small business has become more expensive, both absolutely and relative to housing loans (Charts 5.6, 6.2 and 6.3).

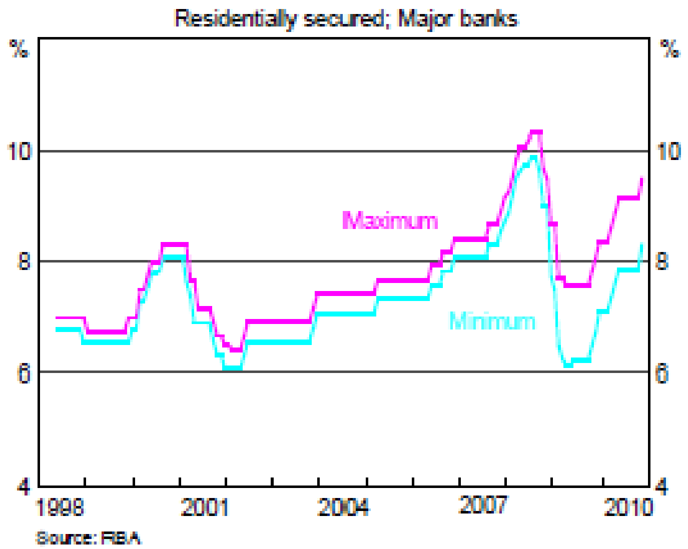
6.16 The banks offer three justifications:

> …(a) small business loans are riskier and so attract a higher risk-premium than residential housing loans; (b) the margins being charged before the GFC were too low and the higher margin today reflects a more appropriate rate, and (c) higher levels of capital are required for small business loans (compared to housing) as part of the prudential regulatory regime.[13]

6.17 As noted above, lenders are paying more attention to the risk in loans. This has led to a wider range of interest rates being charged to borrowers. (Chart 6.2). But while banks may be more cognisant of risks, this does not mean the riskiness of their small business loans has increased (compared to pre-GFC levels; risk certainly goes up during a recession). Indeed to the extent banks are being more selective in their lending the average risk of their loans should have been *lowered*:

> …if they are lending to the less risky businesses, the aggregate risk that they bear should have reduced and that should in turn result in them being able to lend at a lower cost than would otherwise be the case.[14]

Chart 6.2: Range of indicator rates for small business variable rate loans



Source: Reserve Bank of Australia, *Submission 41*, p 18.

13 Australian Bankers' Association, *Submission 76*, p 39.

14 Mr Micah Green, Economist, New South Wales Business Chamber, *Committee Hansard*, 21 January 2011, p 56.

6.18 The Committee heard that small business is increasingly reliant on expensive credit cards for financing:

> …63 per cent of small and medium business owners are now using their credit card facility as a form of business finance. That is extremely high by international standards…[they are paying] extremely high rates…[15]

> Increasingly for small business their primary means of finance is through credit card facilities.[16]

6.19 Banks have been criticised for charging more for a small business loan secured against a residential property than for a home loan secured against the same property:

> We can see no reason why a fully secured business loan should attract a higher interest rate than a housing loan similarly secured. We suggest that one way of addressing this issue would be to add a properly drafted anti-price discrimination clause to the *Trade Practices Act* which could, among other things, prohibit differential pricing of loans and other financial services unless it can be demonstrated that costs or risks attached to these are different.[17]

> So it is very difficult to justify an interest price premium when the ultimate asset that is being used to balance it is the same.[18]

> The loan of funds for use in the operation of small businesses is unjustifiably subjected to higher rates of interest and more arduous conditions than loans made to other customers who provide the same security…Given that this practice is common across all banks it has the appearance of being collusive behaviour.[19]

6.20 The banks responded:

> …you have to look through the security. The security is not something you should be relying on. The security is there and it is an important component, but you have to look through that to the underlying fundamentals of the business, particularly the ability to service the debt… It is timeliness as well. In a business situation it could take quite a bit of time to unwind security, or you have to have a business plan prepared to see whether the business can trade through and so you might be working against a couple of scenarios for a while. So there is a timeliness element to it, and then there is cost of recovery…The long-run loss profile on those

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15 Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Committee Hansard*, 15 December 2010, p 111. CPA Australia provide further information and show this is a higher proportion by international standards; *Submission 82*, p 5.

16 Chamber of Commerce and Industry Queensland, *Submission 43*, p 9.

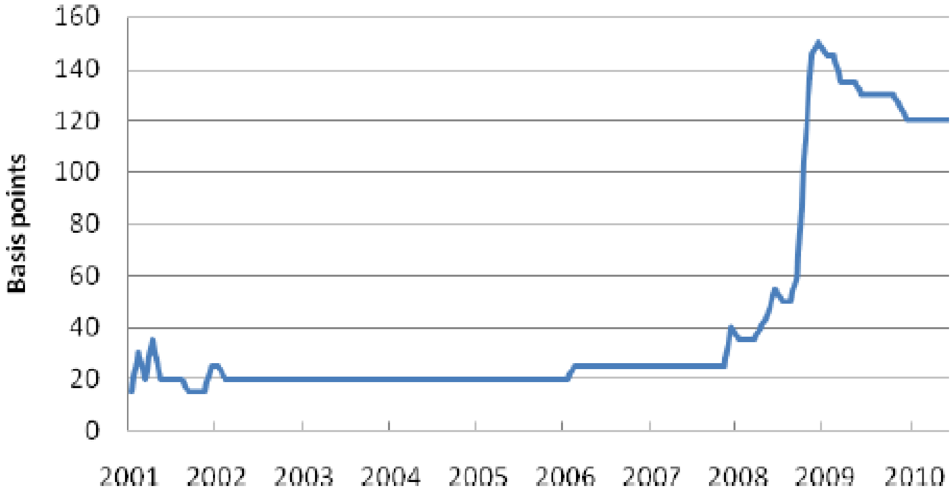
17 National Association of Retail Grocers of Australia, *Submission 54*, p 2.

18 Mr Andrew Canion, Manager, Western Australian Small Enterprises Network, *Committee Hansard*, 21 January 2011, p 115.

19 Council of Small Business of Australia, *Submission 90*, p 3.

loans is higher than normal residential secure mortgages, and that will drive the risk profile, that will drive the cost.[20]

Chart 6.3: Spread between small business and home loan rates



Source: NSW Business Chamber, *Submission 84*, p 10.[21]

6.21 The Australian Prudential Regulation Authority supported the banks' view:

> The underlying default rates and arrears rates on owner occupied homes and investor lending is a lot lower than it is for small and medium sized enterprise loans that are secured against the residential mortgage. They have a far higher likelihood of what they call 'probability of default rates' and 'loss given default' than do the normal residential mortgages.[22]

6.22 The Reserve Bank quantified these differences:

> The interest rate must cover the expected loss of making a particular loan. The expected loss is, in turn, largely determined by a borrower's *probability of default* and the *loss given default*. In the first case, rough estimates suggest that small business borrowers are more than twice as likely as standard mortgage customers to default [Chart 6.4]. In the second case, once a default has occurred, APRA statistics suggest that a lender is

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20 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, pp 53-54 and 67. A similar argument was made by Mr Peter Hanlon, Group Executive, People and Transformation, Westpac, *Proof Committee Hansard*, 21 January 2011, p 87.

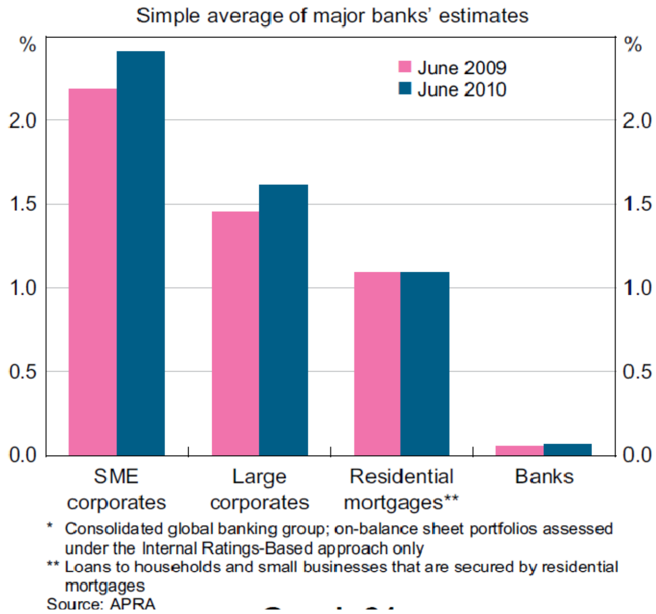
21 A longer run version of this chart is given in Westpac, *Responses to questions on notice, no 16*, 7 March 2011, p 3.

22 Mr Graeme Johnson, General Manager, Supervisory Support Services, APRA, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 19.

likely to lose close to 30 per cent of the small business loan's value, compared with 20 per cent for housing loans.[23]

6.23 As the default rate on home mortgages is around 1 per cent, this would imply the interest rate on small business loans should be around 50 basis points higher than for housing loans.[24] This is more than the difference in interest rates charged had been for most of the past decade but less than the current difference (Chart 6.3).

Chart 6.4: Probabilities of default



Source: Reserve Bank of Australia, *Financial Stability Review*, September 2010, p 22.

6.24 This is consistent with the response when Westpac was challenged about why the differential was previously so much lower:

> …we have seen banks losing more money than they would like to on small business because of the mispricing for risk.[25]

6.25 The inquiry by the Joint Committee on Corporations and Financial Services reported last month that:

> On the basis of the evidence submitted to the committee, it appears there are sound reasons for the higher interest rates for SME loans compared to residential loans, and the increased cost of SME lending that resulted from the GFC.[26]

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23 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 8.

24 The difference between the required margin on housing loans of 1 per cent x 0.2 = 20 basis point and 2.4 per cent x 0.3 = 72 basis points.

25 Mr Peter Hanlon, Group Executive, People and Transformation, Westpac, *Proof Committee Hansard*, 21 January 2011, p 87.

26 Joint Committee on Corporations and Financial Services (2011, p 30).

Loan guarantees for small business

6.26 The Australian Chamber of Commerce and Industry recommended the Government explore the feasibility of a temporary small business loan guarantee:

> There are schemes of this nature in a number of other industrialised nations— Canada, the United States, the United Kingdom—that are worthy of some serious assessment at the very least. What governments in those jurisdictions have done is to provide some mechanisms for government to provide some guarantees on small business loans where there is some clearly demonstrated market failure that is not being met by the market.[27]

6.27 This was supported by other small business representatives:

> We would absolutely, totally support it.[28]

> Master Builders recommends that government extend guarantees to small business loans.[29]

6.28 The NSW Business Chamber is concerned about the design of such a scheme, and argues it should involve a price for the guarantee and should not cover 100 per cent of the value of the loan to ensure banks retain an incentive to consider loan applications carefully.[30] They also argue that not all a bank's loans should be covered:

> For instance, if a bank had, say, 100 loans to small businesses all covered by the guarantee, you could put a cap on to say that only 10 per cent of those loans can ever be claimed against the government guarantee. So if all 100 went belly up, you would get financing back for only ten.[31]

6.29 Treasury does not support such schemes:

> The majority of OECD countries have implemented or expanded existing guarantee schemes for small business loans since the onset of the global financial crisis. However, these schemes have generally been unsuccessful in stimulating credit to small businesses. According to the OECD, such guarantee schemes and extensions have not produced the desired results, and 'the stagnation in lending is true even of banks in countries where…credit guarantee schemes exist.[32]

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27 Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Committee Hansard*, 15 December 2010, p 110.

28 Mr Peter Strong, Executive Director, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, p 12.

29 Master Builders' Association, *Submission 38*, p 6.

30 NSW Business Chamber, *Submission 84*, p 4.

31 Mr Micah Green, Economist, New South Wales Business Chamber, *Committee Hansard*, 21 January 2011, p 57.

32 Treasury, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 66.

International examples of such schemes

6.30 Some small business representatives gave the following examples of such schemes overseas:

> Most OECD countries have small business loan guarantee programs, with the exception of Australia and New Zealand.[33]
>
> Other countries have introduced guarantees on small business loans to assist with alleviating small business credit constraints:
>
> - In the United Kingdom, the Enterprise Finance Guarantee, managed by the Department for Business Innovation and Skills, provides a loan guarantee scheme to facilitate business lending to SMEs.
> - Under Canada's small business financing program, the Canadian government guarantees 85 per cent of eligible small business loans. The guarantee is provided to the small business in exchange for a fee, and in this way, the scheme is self financing.
> - In the United States, the Small Business Administration (SBA) guarantees loans made to small businesses by financial institutions.[34]

6.31 The Reserve Bank provided comparative information on overseas schemes to the Committee last year.[35]

6.32 A survey by some World Bank economists made the following observations:

> Many countries around the world have therefore made Partial Credit Guarantee (PCG) funds a central part of their strategy to alleviate SMEs financing constraints. Multi- and bilateral donors have supported the set-up of such schemes around the developing world. These schemes seek to expand lending to SMEs, sometimes focusing on specific regions or sectors through reducing lending risk. Specifically, a PCG fund is a risk transfer and risk diversification mechanism; it lowers the risk to the lender by substituting part of the risk of the counterparty by that of the issuer of the PCG…PCG funds (and full credit guarantee funds) have existed at least since the beginning of the 20th century[36] and have become more popular over the past decades. In spite of their recent growth and initial evidence suggesting success of some of these funds, there is a dearth of analysis to systematically inform the process of design of PCG funds, pricing of their guarantees, their regulation, and the implication that PCG fund

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33 Master Builders' Association, *Submission 38*, p 6.

34 Chamber of Commerce and Industry Queensland, *Submission 43*, p 19; New South Wales Business Chamber, *Submission 84*, p 3.

35 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, pp 69-74.

36 Uruguay established a scheme in 1896!

characteristics have with respect to the prudential regulation of banking portfolios covered by such guarantees.[37]

6.33 Their analysis leads them to conclude:

> Our survey shows an important role of government in partial credit guarantee schemes around the world, but mostly limited to funding and management, and much less in credit risk assessment and recovery. This might be for the better, as we also find that where government is involved in credit risk assessment and recovery, default rates are typically higher. Older schemes are also more likely to be government funded and managed and also have higher loan losses, consistent with the notion that the costs and liabilities of a PCG fund become obvious only after some time. We find a surprisingly low incidence of risk-based pricing and limited use of risk management mechanisms.[38]

Committee view

6.34 Last year the Committee concluded:

> The Committee notes the suggestion of a guarantee for loans to small business but prefers to increase competition within the commercial banks rather than for a government entity to assume the risk.[39]

Banks' service to small business customers

6.35 In last year's inquiry into banks and small business, the Committee observed that:

> A number of submissions referred to customer dissatisfaction with banks' services to small businesses, including claims about unreasonable increases in interest rates, poor communication and changes to loan conditions made unilaterally without notice.[40]
>
> There are suggestions that as banks become larger the quality of service to small business may decline, particularly if duplicate branches are closed and local managers moved.[41]

6.36 There was also concern that branch bank managers no longer had the experience and familiarity with local business conditions to make well-informed credit decisions and sometimes lacked the authority to take such decisions.[42]

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37 Beck, Klapper and Mendoza (2008, pp 2-3).

38 Beck, Klapper and Mendoza (2008, p 25).

39 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 68.

40 Economics References Committee, *Access of Small Business to Finance*, June 2010, p 62.

41 Economics References Committee, *Access of Small Business to Finance*, June 2010, p 63.

> …as much as the banks have tried to present the view that they are becoming more locally focused, we are not seeing that in practice yet. What we are seeing is that a risk factor is applied to businesses fitting a certain profile across the nation, irrespective of the different business conditions. [43]

6.37 Even one of the major banks conceded there were virtues in:

> ...doing business with customers you can see from the local church spire.[44]

Code of conduct

6.38 Small business believes:

> …it is inappropriate that small business are excluded from coverage under the Uniform Consumer Credit Code…[45]

6.39 The banks have a general code of conduct but some submitters thought they ought to develop a code specifically relating to small business:

> Bank and bank client relationships have also been strained. One initiative that may contribute to improving relationships between banks and small business and reduce the possibility of this relationship being damaged again in the future, is for the Australian Bankers' Association (ABA) to consider expanding its existing Code of Banking Practice to include a code of conduct on small business lending.[46]

> …such a code is the only process by which small businesses –and other bank customers – can engage on reasonably even terms in negotiating dispute resolution. The inordinate, indeed overwhelming power of the banks and their huge financial resources simply precludes the use of the courts for all but the wealthiest of the bank's customers.[47]

6.40 Some submitters would like to see Australian banks adopt international practice in this area:

> …the UK, Canada and Ireland have specific codes of conduct relating to lending to small to medium sized enterprises and that such a Code would therefore bring Australian banking into line with best practice.[48]

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42 See, for example, CPA Australia, *Submission 82*, pp 16-18.

43 Mr Andrew Canion, Manager, Western Australian Small Enterprise Network, *Committee Hansard*, 21 January 2011, p 115.

44 Mr Joseph Healy, National Australia Bank, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 54.

45 Council of Small Business Organisations, *Submission 90*, p 7.

46 CPA Australia, *Submission 82*, p 1.

47 Council of Small Business Organisations, *Submission 90*, p 7.

48 CPA Australia, *Submission 82*, p 10. CPA provided the Committee with more information about the codes in Canada and Ireland last year; see Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, pp 78-79.

6.41 The Committee called for such a code last year.[49] A further discussion of the codes of practice developed by the banks and mutuals, and lists of those intermediaries subscribing to them, are available in the report by the Joint Committee on Corporations and Financial Services (2011).

Recommendation 3

6.42 The Committee recommends that the Australian Bankers' Association meet with small business representatives to develop a code of practice specifically relating to lending to small business.

Bank mergers and small business lending

6.43 Small business may suffer disproportionately from further mergers within the banking system. A survey of the economics literature by the Committee last year found that:

> As banks become larger they are more able to make large loans to large companies. It has been suggested that this may lead to them being less interested in lending to small business. Overseas studies have found some empirical evidence that larger banks make a smaller proportion of their loans to small business.[50]

6.44 The Australian Prudential Regulation Authority observed that:

> Regional banks as a group tend to have a relatively high share of small business loans to total loans.[51]

6.45 Bank mergers are discussed further in Chapter 9.

Better information about the sector

6.46 The Committee called last year for better information about the small business credit market:

> The Committee recommends that the Government request the ACCC, APRA and the Reserve Bank to provide a joint annual report to parliament on competition in the retail banking market in Australia, and the provision

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49 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 80.

50 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 50. Among studies cited were Berger, Demsetz and Strahan (1999); Carletti, Hartmann and Spagnolo (2002); Group of Ten (2001); and Hawkins and Mihaljek (2001).

51 Senate Economics References Committee, Access of Small Business to Finance inquiry; APRA, *responses to questions on notice*.no. 3, p 1.

> of finance to small business, but taking care not to increase unduly the reporting burden on financial institutions.[52]

6.47 This view was echoed by some submitters to this inquiry:

> CPA Australia recommends that the government (or its agencies) introduce a Bank Lending Survey measuring changes in demand for debt finance by business (categorised by business size) as perceived by senior bankers. Such a survey would assist government, regulators and the business community understand trends in business lending.[53]

6.48 This is the practice in some comparable economies:

> The governments or their agencies of a number of major economies (including US, UK and Canada) produce a regular Bank Lending Survey.[54]
>
> Currently, Australia does not have a dedicated senior loan officer survey to determine the supply and demand conditions prevailing in the small and medium-sized enterprise (SME) lending market. Such lending surveys currently exist in a number of countries including the United States of America (US), the United Kingdom, Europe and Japan, and have been useful in researching the lending demand and supply dynamics for both SMEs and large firms. For example, the US Federal Reserve issues the 'Senior Loan Officer Opinion Survey on Bank Lending Practices'.[55]

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52 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

53 CPA Australia, *Submission 82*, p 10.

54 CPA Australia, *Submission 82*, p 10.

55 Australian Securities and Investments Commission, cited in Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 23.

Chapter 7

Moving between banks

7.1 The costs and other impediments to moving between banks are important factors with the potential to weaken competition significantly:

> …consumer switching costs (whether real or perceived) are widespread and our analysis suggests that the resulting welfare losses may be substantial: switching costs generally raise prices and create deadweight losses…in a closed oligopoly…public policy should discourage activities that increase consumer switching costs (such as airlines' frequent-flyer programmes) and encourage activities that reduce them (such as standardisation that enhances compatibility and reduces costs of switching, and quality regulation and information sources that reduce consumer uncertainty about untested brands).[1]
>
> Changing banks is too hard and unduly complicated.[2]

7.2 National Australia Bank's CEO concedes this:

> The two key drivers of competition are search cost, so how long does it take in terms of time and what is the cost to find a deal—this applies to any industry—and, secondly, what is a switching in time and cost? They are the key drivers.[3]

7.3 A survey of Queensland businesses found that those banking with regional banks are more satisfied than those banking with the majors.[4] The failure of this to translate into increased market share for the regional banks suggests some barriers to customers moving between banks.

7.4 The same survey found that of businesses that had not switched banks, only about a third said this was because they were satisfied with their bank. A third said they thought all banks were the same and a third said it was too difficult and expensive to change banks. Almost half the businesses that switched banks found the process difficult or extremely difficult, and that it cost over $5,000.[5]

7.5 There are not just explicit costs to moving between financial intermediaries. There is also an inherent inertia. One submitter wrote of the 'fear of the unknown' as a deterrent:

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1 Klemperer (1995, p 536), cited in Consumer Action Law Centre, *Submission 87*, p 5.

2 Council of Small Business Organisations of Australia, *Submission 90*, p 10.

3 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 63.

4 Chamber of Commerce and Industry Queensland, *Submission 43*, pp 7 and 13.

5 Chamber of Commerce and Industry Queensland, *Submission 43*, pp 14-15.

> If you've been with your lender for a period of time…You're familiar with their internet and phone banking. You know where the branches and ATMs are located…What if you move to a new lender and find out that it's a lot more difficult to get things done or the products don't work like you would expect? Sometimes it's better to deal with the devil you know.[6]

7.6 Mrs Amanda Watson put the blame more on the consumer:

> It is my belief that many Australians are somewhat apathetic in regards to their banking choices and while I note that there is a fair level of 'bank bashing' most people appear to choose not to switch in order to find a better product for their needs.[7]

7.7 This chapter discusses the factors which may deter customers from moving between banks, including mortgage exit fees, financial illiteracy and mortgage insurance, and considers possible improvements in this area.

Mortgage exit fees

7.8 Banks charge a variety of fees if customers repay a loan early. In the case of *fixed rate* loans a large exit fee may be quite reasonable. A prudent bank offering a fixed rate loan will fund it through fixed rate borrowing. If interest rates fall, and customers are free to repay loans early and take out new loans at a lower rate, the bank will be caught still paying a high interest rate but earning a low rate. The rest of this section is concerned with the case of *variable rate* loans, where there is not this justification.

7.9 Some exit fees are modest administrative fees, or mortgage discharge fees, as would be paid at the maturity of a loan. But some lenders charge large 'early repayment' fees or have 'deferred establishment' fees which may be waived if a loan is maintained until maturity. Both of these may not be clearly disclosed at the time the loan is taken out and both can act to impede competition by locking customers into their current bank even when a rival offers a lower interest rate.

7.10 Some examples of exit fees are given in Tables 7.1 and 7.2. The fees are generally high for non-conventional lenders and low for building societies and credit unions.

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6 ProSolution Private Clients, *Submission 30*, p 1.

7 Mrs Amanda Watson, *Submission 64*, p 1.

Table 7.1: Exit fees after three years on $300,000 owner-occupied home loan ($)

	Upfront fees	Exit fees
ANZ simplicity Plus	600	160
NAB base variable rate home loan	600	150
Westpac flexi first option home loan	600	950
Commonwealth Bank economiser	600	1050
St George basic home loan	100	1500
Bendigo residential variable home loan	730	250
Bank of Queensland standard variable	595	1450
Aussie Classic	600	1215
Mortgage House basic home loan	569	5250
Homestar No Fee	0	3600
AIMS gold standard variable home loan	660	4230
Community CPS Credit Union basic variable	595	0
Mecu Credit Union basic home loan	595	100
Greater Building Society great rate	0	0
Heritage Building Society standard variable	600	0

Source: Infochoice website (www.infochoice.com.au) as at 23 March 2011.

Table 7.2

Average Fees on Variable Housing Loan Products

$250 000 owner-occupier loan, terminated within 3 years

	Setup Fee $	Service Fee $	Discharge Fee $	Exit Fee $	Total $
Current					
Credit unions and building societies	595	122	106	364	1,187
Major banks	431	513	229	462	1,635
Other banks	459	468	271	676	1,874
Non-ADI	584	254	363	2,066	3,266
Change since 2008					
Credit unions and building societies	13	10	14	-37	0
Major banks	-23	203	115	-620	-324
Other banks	36	113	43	-28	165
Non-ADI	-149	38	133	121	143

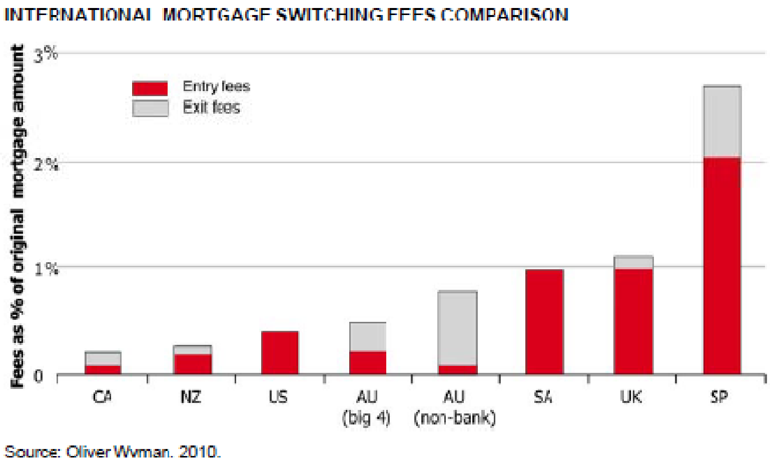
Sources: ASIC; Canstar Cannex; InfoChoice; RBA

Source: Reserve Bank of Australia, *Submission 41*, p 24.

7.11 Westpac do not charge an exit fee if the customer remains for more than four years.[8] Presumably the argument is that the interest charged has covered the upfront costs by then. This seems inconsistent, however, with the argument that the fee is necessary to recover the costs of establishing the loan. These costs would be fixed rather than varying with the size of the loan, and so if recouped from interest would be recovered more quickly for larger loans. Nor do interest rates drop for ongoing borrowers after four years.[9]

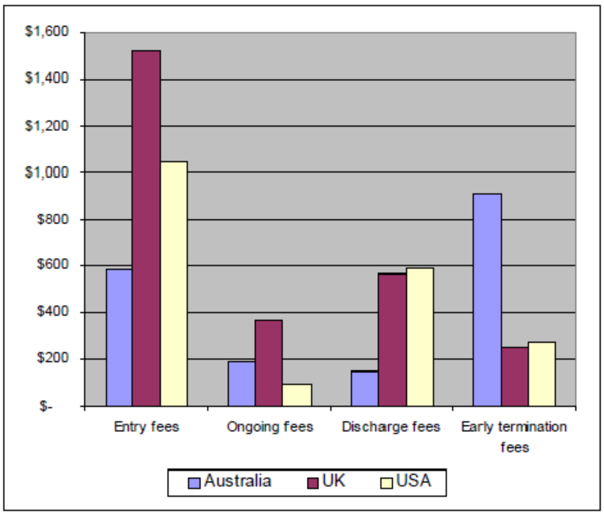
7.12 Exit fees for mortgages in Australia are higher than in most comparable countries (Charts 7.1 and 7.2).

Chart 7.1: Mortgage switching fees



Source: Westpac, *Submission 72*, p 36.

Chart 7.2: Comparison of selected bank fees



Source: ASIC, 'Review of mortgage entry and exit fees', *Report no. 125*, April 2008, p 11.

8 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 92.

9 Ms Nicole Rich, Director, Policy and Campaigns, Consumer Action Law Centre, *Proof Committee Hansard*, 25 January 2011, p 17.

The case against excessive exit fees

7.13 There is considerable support for action to limit exit fees, particularly but not exclusively in relation to home mortgages:

> Consumers of mortgage products dissatisfied with the product or service they receive from their bank or mortgage provider feel trapped by the exit fee, which discourages them from switching.[10]
>
> Lenders should only be allowed to charge loan exit fees on a cost recovery basis…[11]
>
> …excessive and unjustified early exit fees represent a serious barrier to switching in the mortgage market, inhibiting competition...Across the market more broadly, this reduces the pressure on lenders to provide better and more competitive products.[12]

7.14 Exit fees differ from other bank charges in that there is no incentive for an individual bank manager to waive or lower these charges in an attempt to retain a valued customer, as they are only relevant to a customer who has decided to move their custom elsewhere. It was suggested that if establishment fees are being deferred due to the borrower's cash flow constraints, it would be more transparent just to add the fee to the loan amount.[13] When comparing potential lenders, a borrower is unlikely to pay much attention to differences in exit fees as they are likely to be focused on the purchase of their current home, not thinking about when they will sell it to buy their next.

7.15 One example of the anti-competitive impact of excessive exit fees was the following:

> …our client chose a variable rate home loan based on representations that the product‘s interest rate would remain competitive, but after several rate rises over approximately an 18 month period, her home loan rate was considerably higher than other rates in the market, but she felt unable to switch because she faced an early exit fee of over $12,000.[14]

The case for exit fees

7.16 The main opposition to restrictions on exit fees comes from some non-bank lenders. They are unable to raise funds as cheaply as the major banks, so may rely on fees to offer competitive interest rates:

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10 Redfern Legal Centre, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 2*, p. 2.

11 Australian Chamber of Commerce and Industry, *Submission 37*, p 28.

12 Consumer Action Law Centre, *Submission 87*, p 13.

13 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 59; *Submission 8*, pp 8-9.

14 Consumer Action Law Centre, *Submission 87*, p 13.

> The offer that they [some non-bank lenders] make to consumers is: ‘We can offer you an interest rate which is at the moment around 0.7 per cent less than the banks, but to come on board with us we want some assurance that you are going to stay with us for a reasonable amount of time. Also, to make it attractive, we won’t change you any upfront fees, any establishment fees. But if you leave us within three years—or five years, depending on who the non-bank lender is—we will then ask you to pay those establishment fees; thus the term ‘deferred establishment fees’…I know that there has been a focus on non-bank lenders charging $7,000 as a deferred establishment fee, and I suppose people always tend to look at the worse possible example to prove their point. Yes, that could happen, but it would only happen if someone had a pretty high loan—about $700,000—and they switched within the first 12 months of the loan.[15]

> There is a real tangible cost to ‘writing a loan’ which has a commercial impact, as does the manufacturing production and sale of any product. This commercial cost cannot be ignored, and should not be hidden elsewhere. Removing the same will have an impact which most likely will not be to the benefit of the consumer borrower as it has the potential to significantly increase the cost up front to obtain a loan.[16]

> Exit fees *per se* (apart from questions of scale) are a reasonable charge.[17]

> The proposed removal of exit fees is not a measure we believe will enhance competition. It is the smaller, non-bank lenders that will be hurt most by this. For the majority of banks, the deferred establishment fee was put in place as a competitive response to reduce the upfront albeit legitimate costs of taking on a new mortgage.[18]

7.17 The Australian Bankers' Association commented:

> …exit fees do reflect genuine costs incurred by banks and others. To the extent that they are genuine costs, removing the ability to recover those costs is likely to hit smaller lenders disproportionately compared to larger lenders.[19]

7.18 Asked about any prudential concerns, APRA responded:

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15 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 71.

16 Finance Brokers' Association of Australia, *Submission 133*, p 2. See also Mortgage House of Australia, *Submission 115*, pp 1-2.

17 Dr Evan Jones, *Submission 81*, p 7.

18 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2.

19 Mr Steven Münchenberg, Australian Bankers' Association, *Committee Hansard*, 14 December 2010, p 83.

> …it is important that ADIs are able to cover and/or recoup their legitimate costs in originating, managing and closing out a mortgage.[20]

7.19 The Committee heard claims that banning exit fees would lead to a corresponding increase in establishment fees or interest rates, which would be paid by all borrowers:

> If you ban exit fees you will push costs to up-front…[21]

7.20 Furthermore, as exit fees are only charged to those customers repaying early, this provides an advantage for those customers who stay with the lender. Aussie noted that:

> Regulation or banning of exit fees would result in cross subsidisation by the stable customers of those customers who routinely move between financiers.[22]

ASIC action on unfair exit fees

7.21 As described in Chapter 10, some provisions of the National Credit Code under the *National Consumer Credit Protection Act 2009* relate to exit fees. These provisions came into effect in July 2010 and from this date borrowers have been able to challenge the validity of early termination fees they think are 'unconscionable' or 'unfair'. Borrowers may also complain to ASIC or to an external dispute resolution scheme; the borrower or ASIC can seek review of fees by a court.[23]

7.22 ASIC have explained their stance as:

> Mortgage exit fees are acceptable provided they reflect—and are limited to—the lender's losses which can be directly connected to the borrower exiting the loan early.[24]

7.23 This statement has been interpreted as implying:

> Under the Australian Consumer law, an unfair contract term that includes payment of early exit fees can be declared void.[25]

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20 APRA, *Responses to questions on notice*, no 6, 31 January 2011, p 3.

21 Mr Peter White, National President, Finance Brokers Association of Australia, *Proof Committee Hansard*, 4 March 2011, p 4. This possibility is also raised by Professor Milind Sathye, *Submission 28*, p 8; and Australian Chamber of Commerce and Industry, *Submission 37*, p 24.

22 Aussie, *Submission 39*, p 2.

23 Dr Peter Boxall, Commissioner, ASIC, *Committee Hansard*, 21 January 2011, p 3.

24 Mr Tony D'Aloisio, Chairman, ASIC, *Herald-Sun*, 19 November 2010, confirmed by Mr Greg Kirk, Senior Executive Leader, ASIC, *Committee Hansard*, 21 January 2011, p 5. A similar view is put by ACCC and ASIC in 'A guide to the unfair contract terms law', p 16.

25 Care Financial Counselling Service, *Submission 3 to basic banking inquiry*, p 3.

7.24 The Consumer Action Law Centre advocated a narrow or literal reading of this which would make the permissible fees quite small:

> …if you section out exit costs that apply whenever the exit occurs and simply focus down on the costs attaching to early exit, we think that the numerical value of that cost would be very small.[26]

The Government's December 2010 package

7.25 The Government announced in its package that from July 2011 exit fees would be banned on new variable rate mortgage loans.[27]

7.26 The measures which came into force in July 2010 relating to unconscionable exit fees would continue to apply to existing mortgages. The reason the new measures do not apply to existing loans is constitutional:

> …that would be an acquisition of property. The property is the property of the financial institution. We took legal advice on that.[28]

7.27 Treasury clarified that the ban refers to a fee 'triggered by the consumer's action to pay out the mortgage early, which would not ordinarily happen.'[29]

7.28 Perhaps trying to make a virtue of necessity[30], two of the major banks have abolished exit fees ahead of the ban.

7.29 On 23 March 2011, the Government amended the National Consumer Credit Protection Regulations 2010 to prohibit exit fees.

Committee view

7.30 The Committee regards the Government's decision to ban exit fees as a kneejerk reaction. The new consumer protection provisions which would restrict exit fees to reasonable amounts only came into effect a few months ago and are not well known. They should be given a chance to work. Exit fees should be limited to underlying costs and a reasonable profit margin, rather than banned.

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26 Ms Catriona Lowe, Co-Chief Executive Officer, Consumer Action Law Centre, *Committee Hansard*, 25 January 2011, p 15.

27 The ban will be implemented through amendments to the National Credit Code; Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 7.

28 Mr Jim Murphy, Executive Director, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 41.

29 Mr John Lonsdale, General Manager, Financial System Division, Department of the Treasury, *Proof Committee Hansard*, 9 March 2011, p 7.

30 As Treasury's Jim Murphy explained: 'Put yourself in their position—you are facing a ban on something you have been doing so you may as well adapt and get some credit points out of it.'; *Proof Committee Hansard*, 9 March 2011, p 5.

7.31 The Committee notes the importance of fees in underpinning the business models of non-bank lenders which bring competitive pressures to the market.

7.32 The Committee believes that banning exit fees will lead to higher upfront fees, including for borrowers who never incur exit fees. It is notable that the only financial intermediaries that accepted the abolition of exit fees were the major banks.

7.33 It is important, however, that borrowers are made aware of the extent of exit fees at the time they take out their loans.

Recommendation 4

7.34 The Committee recommends that the Government reconsider its decision to ban exit fees, before the amended regulations come into effect, with a view to allowing enough time for the effectiveness of the existing ban on unfair and unconscionable exit fees (as implemented through ASIC Regulatory Guide 220) to be assessed. If it proceeds with the ban, it should only apply to authorised deposit-taking institutions.

Recommendation 5

7.35 The Committee recommends that lenders be required to inform borrowers when they take out a loan of the provisions of the *National Consumer Credit Protection Act 2009* which relate to unconscionable charges.

Recommendation 6

7.36 The Committee recommends that borrowers be required to sign off on a form clearly disclosing any exit fees applicable to their home or small business loan before making any commitment.

Recommendation 7

7.37 The Committee recommends that lenders charging exit fees be required to explain on their website how the exit fee relates to relevant costs.

Other factors influencing inhibiting customers moving between mortgage providers

7.38 In addition to costs and related impediments, a number of other issues affecting decisions to move between banks were raised during the inquiry.

Lenders mortgage insurance

7.39 Lenders mortgage insurance (LMI) is a product intended to protect lenders by covering any shortfall if a property has to be sold as a result of the borrower defaulting on their loan and realises less than the outstanding balance of the loan.[31] It became evident during this inquiry that LMI can represent a significant cost for borrowers:

> But the biggest inhibitor of switching—in over half the cases we see, probably 70 per cent—is not the exit fee; it is the duplicating cost of mortgage insurance. If you borrow over 80 per cent of the value of your property, you have got to obtain mortgage insurance. That can cost you anything. It can cost you $10,000 or $7,000...That is something that the Treasurer said he was going to have a look at, and I think that is a great thing. To have a look and do something about it would be fantastic.[32]

> The real deterrent in the LMI premium, as the policy is not portable from one bank to another. As a result a customer wishing to move a mortgage from one bank to another will need to pay LMI twice…LMI policies should be made portable…[33]

> …that is a problem for consumers in terms of the initial insurance premium being a sunk cost and if they switch they have to pay another one…the premium for a lender’s mortgage insurance policy is in the thousands of dollars…[34]

> …if the loan is discharged early there is regularly no premium rebate to the borrower albeit in some cases it is ‘partially’ available for the first 2 or 3 years of the loan only (and note the premium is paid based on the total loan term not just 2 or 3 years) this rebate is not on a pro-rata or proportional basis given the total period covered in some cases if you don’t ask for a rebate/refund on the premium you won’t get it as only some LMI Providers have an automatic system to do this – others do not. Colloquially if you don’t know you don’t get, and you can’t ask for something you don’t know about…[35]

> Mortgage insurance is typically required for loans which are 80% or more of the property value (i.e. loan-to-valuation ratio of at least 80%). It is not portable. The cost of mortgage insurance varies with loan size and, like

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31 LMI is not to be confused with mortgage protection insurance, which covers borrowers to allow them to maintain mortgage payments in the event of illness or unemployment.

32 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, pp 111 and 128.

33 Mr Dinesh Warusavitharana, *Submission 98*, pp 2 and 4. Credit Union Australia, *Submission 85*, p 10 also calls for improvements to the portability of mortgage insurance.

34 Mr Greg Kirk, Senior Executive Leader, ASIC, *Committee Hansard*, 21 January 2011, pp 12-13. Concerns were also expressed by Ms Nicole Rich, Director, Policy and Campaigns, Consumer Action Law Centre, *Committee Hansard*, 25 January 2011, p 23, and Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 88; Abacus, *Submission 53*, p 24; and Mr Peter White, National President, Finance Brokers Association of Australia, *Proof Committee Hansard*, 4 March 2011, p 2.

35 Finance Brokers' Association of Australia, *Submission 133*, p 4.

legal fees and State government taxes and charges, can run into the thousands of dollars.[36]

7.40 LMI is usually paid by the borrower but the benefit accrues to the lender. If the borrower repays early, they will only sometimes get any refund for the premium paid for the remainder of the loan:

> Generally speaking, there is somewhere between a 12- to 24-month window. If you discharge your mortgage in that period of time, you are possibly eligible for a rebate of up to about only 40 per cent of that premium only, remembering the premium covers the lender for right of recourse for 20 to 30 years. But the consumer is the one who has paid for it and the consumer is the one who only gets a rebate if they ask for it.[37]

7.41 Treasury commented:

> Lenders' mortgage insurance is one thing that, when it is raised, is an impediment to people moving forward to seek to switch their accounts. We are working on that at the moment and looking at a process whereby lenders' mortgage insurance could be portable—could go with the mortgage. We have not finalised it yet but it is the clear intention of the government to introduce such a system.[38]

7.42 The Insurance Council of Australia defended the current arrangements:

> While the cost of LMI protecting the lender is typically borne by the borrower, the borrower obtains significant benefit from the use of LMI by the lender. LMI provides greater access to home ownership, particularly for low income, low equity or higher risk borrowers who would otherwise have difficulty obtaining a home loan. These borrowers are able to obtain a loan that would otherwise not be available, or to obtain a loan much earlier than they would be able to if they had to save for a full (20%) deposit.[39]

7.43 The Insurance Council also observed:

> Importantly, with LMI, lenders do not have to charge a higher interest rate to cover the increased risk a low deposit borrower presents. The cost of the once only up front LMI premium borne by a borrower is significantly less than higher risk based interest pricing that would apply to a higher risk borrower over the life of the mortgage loan.[40]

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36 Commonwealth Bank of Australia, *Submission 88*, p 14.

37 Mr Peter White, National President, Finance Brokers Association of Australia, *Proof Committee Hansard*, 4 March 2011, p 2.

38 Mr Jim Murphy, Executive Director, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 34.

39 Insurance Council of Australia, *Submission 137*, p 2.

40 Insurance Council of Australia, *Submission 137*, p 2. No reason was given why a lender would charge more to a customer in increased interest than an insurer would charge as a premium for offsetting the same risk.

7.44 Genworth Financial, a provider of LMI insurance, claims that LMI is not an impediment to borrowers switching:

> ...LMI is typically only required on HLTV [high loan-to-value] loans (above 80%). If a consumer does take out a high LTV loan and looks to switch to another lender, our analysis shows that the consumer is unlikely to be asked to pay LMI again if they switch after two to three years, given the LTV for the new loan is likely to be below 80% given long run home price appreciation assumptions.[41]

7.45 The Government has indicated its intention to make LMI transferable between lenders, perhaps through a clearing house, or refundable, and consultations are underway with key insurers.[42]

7.46 If the market for LMI is competitive, these additional requirements will push up its cost. As with exit fees, this would mean that those borrowers who stick with their lender will be paying more to assist borrowers who switch lender.

7.47 There were doubts raised, however, about whether the LMI market is very competitive, with some submitters arguing it was opaque and concentrated:

> If you go back in history, there was a government mortgage loss insurer and there were four or five at one stage. We are down to two…it is important that we keep competition in that market…because that is an input into making sure that the securitisation market operates effectively and efficiently, which means players like us can provide that competition to make sure that mortgage spreads do not increase.[43]

> Currently lenders mortgage insurance is a duopoly market…The Federal Government agency, the Housing Loans Insurance Corporation (HLIC), operated from the early 1960s before being sold to GE Capital in 1999. The sell off of HLIC has greatly reduced competition and exacerbated the competitive disadvantage suffered by securitisers relative to banks funding on balance sheet.[44]

> There is also a lack of disclosure of commissions (if any) paid to banks/lender for the sale of LMI…[45]

7.48 The borrower will generally be required to pay an LMI provider nominated by the lender, often an entity owned by that lender, and cannot shop around for a cheaper

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41 Genworth Financial Mortgage Insurance, *Submission 136*, p 5.

42 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 9; Mr Jim Murphy and Mr John Lonsdale, Department of the Treasury, *Proof Committee Hansard*, 9 March 2011, pp 9-10 and 14.

43 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 112.

44 Members Equity Bank, *Submission 77*, p 3.

45 Finance Brokers' Association of Australia, *Submission 133*, p 4.

LMI provider. As the premium is paid in a lump sum at the time the loan is taken out, it is equivalent to an additional 'establishment fee' but is often excluded from comparisons of interest rates and fees charged by different lenders. There are also concerns that there is no product disclosure statement on lenders mortgage insurance.[46]

Recommendation 8

7.49 The Committee recommends that lenders mortgage insurance always be made either pro-rata refundable or transferable and that this be made clear to borrowers.

7.50 As an alternative, lenders mortgage insurance should be payable by instalments (eg. monthly, quarterly or annually) rather than as an upfront lump sum payment (as occurs in other jurisdictions).

Interest rate disclosure

7.51 There have been calls for a standardised annual percentage interest rate to be prominently displayed, to avoid confusion over compounding.[47]

7.52 Ideally the single standardised interest rate would also include fees:

> I would like to see all fees (excluding fixed rate break costs) converted into the interest rate, including any deferred establishment or exit fees, so that the true cost of the facility at any point in time is known and borrowers are not hoodwinked about how much they are really paying…[48]
>
> …banks should be required to…publish comparison rates for business loans;…[49]
>
> Suggestion: A regulated central comparison website across all financial products, by type & features with full disclosure of fees & charges.[50]

7.53 The Financial Ombudsman Service commends the one-page disclosure statement required in the United States (see following page).

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46 Finance Brokers' Association of Australia, *Submission 133*, p 4.

47 Mr Alan Mills, *Submission 15*, p 1.

48 Mrs Maria Rigoni, *Submission 86*, p 1.

49 Mr Andrew Canion, Manager, Western Australian Small Enterprise Network, *Committee Hansard*, 21 January 2011, p 110.

50 Mr John O'Brien, *Submission 117*, p 2.

FEDERAL TRUTH-IN-LENDING DISCLOSURE STATEMENT
THIS IS NEITHER A CONTRACT NOR A COMMITMENT TO

Loan Number: **(Insert Alpha-Numeric – TO BE ADDED)** Date: **(Month Date,Year –TO BE ADDED)**
Creditor: **(Insert Corporate Name – TO BE ADDED)**
Address: **(Insert full address, city, state and zip – TO BE ADDED)**

Borrower(s): **(Insert borrorer(s) full names – TO BE ADDED)**

Address: **(Insert full street address, city, state, zip – TO BE ADDED)**

Lines containing an "x" are applicable:

ANNUAL PERCENTAGE RATE The cost of your credit as A yearly rate	FINANCE CHARGE The dollar amount the credit will cost you.	Amount Financed The amount of credit provided to you or on your behalf	Total of Payments The amount you will have paid after you have made all payments as scheduled.	☐ Total Sale Price The total cost of your purchase on credit including your down-payment of
(Insert Perc.Rate – TO BE ADDED) %	$ (Insert Finance Amount – TO BE ADDED)	$(Insert Total Amount Financed – TO BE ADDED	$(Insert total dollar amount of payments	$(Insert Amt. TO BE ADDED) $(Insert Amt. TO BE ADDED)

PAYMENT: Your payment schedule will be:

Number of Payments	Amount of Payments **	When Payments Are Due	Number of Payments	Amount of Payments **	When Payments Are Due	Number of Payments	Amount of Payments **	When Payments Are Due
		Monthly Beginning			Monthly Beginning			Monthly beginning

(Insert Number of Payments – TO BE ADDED) (Insert Amount of Payment – TO BE ADDED) (Insert Month/Date/Year – TO BE ADDED)

____DEMAND FEATURE: This obligation has a demand feature.
____VARIABLE RATE FEATURE: Your loan contains a variable rate feature. Disclosure about the variable rate feature have been provided to you earlier

INSURANCE: The following insurance is required to obtain credit:
___Credit life insurance and credit disability ____ Property Insurance ____Flood Insurance ____Mortgage Insurance
You may obtain property insurance from any insurer that is acceptable to the Lender.
SECURITY: You are giving a security interest in: (Insert full property address – TO BE ADDED)
____The goods or property being purchased ____Real property you already own
FILING FEES: $(Insert numerical amount w/decimal – TO BE ADDED)
LATE CHARGE: If payment is more than (Insert number of days – TO BE ADDED) days late, you will be charged (Insert percentage amount – TO BE ADDED)% of the payment.
PREPAYMENT: If you pay off early, you
____may ____will not have to pay a penalty.
____may ____will not be entitled to a refund of part of the finance charge.
ASSUMPTION: Someone buying your property.
____may ____may, subject to conditions ____may not assume the remainder of your loan on the original terms.
See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date and prepayment refunds and penalties.
____"e" means an estimate all dates and numerical disclosures except the late payment disclosures are estimates.

Each of the undersigned acknowledge receipt of a complete copy of this disclosure. The disclosure does not constitute a contract or a commitment to lend.

Applicant	Date	Applicant	Date
Applicant	Date	Applicant	Date
Applicant	Date	Applicant	Date

**NOTE: Payments shown above do not include reserve deposits for taxes, assessments, and property or flood insurance.

7.54 The Consumer Action Law Centre advised that better disclosure would help:

> We would certainly support disclosure that occurs pre-contractually that enables consumers to visit a number of institutions, obtain a range of information and make a carefully considered decision rather than quickly being provided with disclosure at the point of contract. We would say it needs to be of standard form and key terminology.[51]

7.55 A lacuna is a site where financial products can be readily compared:

> A consumer would be better informed by a transparent price mechanism. A better informed customer can then make a decision to switch if the price differential is found attractive. Currently, there is no official website/data resource where such information could be available at one place.[52]

> Competition would be enhanced by increasing the information available to the public so that they could more easily compare different banking products from different institutions.[53]

7.56 One bank had found that simplifying charges benefited the bank as well as customers:

> One of the positive learnings from the last 18 months is that the abolition of a number fees and changes in process around this has removed a number of complexities in our business. This simplification of our offers means that we are able to better explain our products and services to our staff and customers, and do so at a reduced cost.[54]

Better information to assist moving between banks

7.57 The movement of customers between banks is facilitated if information about different offers is easy to compare. The Consumer Action Law Centre warned:

> It is also in the interests of industry participants to do the opposite, making it harder to compare deals by producing more complex products and information about those products, and attempting to differentiate products on a basis other than price, even where products are essentially commoditised or homogenous goods. In Australia, the telecommunications market provides an excellent example of this phenomenon in action – we believe it is currently impossible for consumers to undertake an effective comparison of mobile phone plans and choose the best deal for their usage pattern.[55]

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51 Ms Catriona Lowe, Co-Chief Executive Officer, Consumer Action Law Centre, *Committee Hansard*, 25 January 2011, p 13.

52 Professor Milind Sathye, *Submission 28*, p 15.

53 Name withheld, *Submission 52*, p 2.

54 National Australia Bank, *Submission 91*, p 10.

55 Consumer Action Law Centre, *Submission 87*, p 17.

7.58 The Reserve Bank and the Australian Prudential Regulation Authority already receive a lot of information from ADIs about their products. For example, the Reserve Bank is able to calculate a measure of the cost of mortgages, including both interest and (establishment, service and exit) fees. The Reserve Bank provided an example of this in a chart in their submission (reproduced as Chart 5.8) but did not identify the individual lenders. Providing such information, with the names of the credit providers, would be very useful to consumers.

7.59 Another impediment to consumers comparing across accounts is confusing differences in product names:

> A valuable way of rectifying the information asymmetry that fosters the current anticompetitive environment in respect of exception fees is to require all financial institutions to adopt equivalent nomenclature and terminology when describing exception fees, in order to enable consumers to genuinely compare banking products with ease.[56]

> …banks should be required to standardise banking terminology, to help business customers make easier product comparisons…We believe some simple changes would be helpful, such as requiring standardised terminology to be used and cutting out some of the more confusing lingo.[57]

7.60 Another submitter refers to:

> …extensive product suites with complex pros and cons. The resulting consumer confusion allows the banks to harvest greater revenues through inefficient selection.[58]

7.61 A small business representative referred to a major bank which gave them a document about terms and conditions which ran to 75 pages.[59]

7.62 The Commonwealth Bank itself cast doubt on the usefulness of advertised interest rates for comparing between banks (see further discussion in Chapter 5):

> The vast majority of the Group's mortgage customers do not pay the headline standard variable rate…[60]

7.63 Behavioural economics warns of 'decision paralysis'; an increasing number of options may not lead to a better choice being made, it may lead to a reversion to a default option.[61]

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56 Maurice Blackburn, *Submission 31*, p 7.

57 Mr Andrew Canion, Manager, Western Australian Small Enterprise Network, *Committee Hansard*, 21 January 2011, pp 110 and 117.

58 Accounts4Life, *Submission 128*, p 3.

59 WA Small Enterprise Network, *Responses to questions on notice, no 13*, 1 February 2011, p 1.

60 Commonwealth Bank of Australia, *Submission 88*, p 10.

61 Heath and Heath (2010, p 50).

7.64 One component of the Government's December 2010 package is a uniform mandatory key fact sheet for new home loan customers, which will show consumers how much they will pay every month and over the life of their loan (see next two pages).[62] Treasury's Jim Murphy is particularly enthusiastic about it:

> If you wish to go and shop around, this will enable you in terms of what deal you can get. This is a simple document which would give you the terms and conditions for that loan. To me that is a huge advance.[63]

7.65 ASIC released an online mortgage-switching calculator in 2010, which allows consumers to work out how long it would take them to gain in interest savings what it costs to switch mortgage providers. It is part of the new personal finance website (www.moneysmart.gov.au), which replaced ASIC's previous FIDO website.

7.66 Choice expounded their initiative to provide customers with better information:

> One of the reasons Choice launched its Compare, Ditch and Switch website—and we have had tens of thousands of Australians using that tool since we launched it a few days ago—is to make it easier for people to compare products in the market and easier for people to use our data comparison to match one product against another. But, for lots and lots of consumers, the complexity of the information about products, the speed with which the market sometimes changes and the speed with which you need to be able to transfer, for example, your direct debits and direct credits to a different transaction account is just too much, and we have to recognise that.[64]

7.67 The Brotherhood of St Laurence shared with the Committee results from their research:

> …over 70 per cent of low-income clients surveyed were not aware of basic bank accounts and had not taken them up, leaving many paying bank fees unnecessarily. The analysis also shows that banks are not promoting these products and that information about them is difficult to find or unnecessarily complex.[65]

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62 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 10.

63 Mr Jim Murphy, Executive Director, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 33.

64 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 33.

65 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 3.

CONSULTATION DRAFT

This information sheet is an Australian Government requirement under the *National Consumer Credit Protection Act 2009*

KEY FACTS ABOUT THIS HOME LOAN

Personalised for: John Smith Date produced: 1 December 2010	[Mortgage provider logo]

What you have told us	
Loan Amount: $300,000 Term of the mortgage: 30 years Repayment method: Principal and interest	Value of the property: $400,000 Loan to valuation ratio (LVR): 75%

HOW DOES THIS HOME LOAN COMPARE?

Description of this home loan	
Mortgage Lender	XYZ Mortgages
Product name	Variable Rate Package
Interest rate	7.16%
All-in rate: (including fees)	7.33%
Product features	0.70% discount off standard variable rate, interest off-set account, repayment redraw, free transaction account and free credit card.

Cost of the XYZ Mortgages Variable Rate Package	
Total amount to be paid back (including the loan amount and fees)[1]	**$742,019**
This means you will pay back	**$2.43 for every $1 borrowed**
Repayment per month (including fees)	**$2063**
Repayment per year (including fees)[2]	**$24,756**

[1] Based on minimum monthly payments over the full term of the loan at the current interest rate and current fees and charges
[2] Based on current interest rates.

What fees will you have to pay on the XYZ Mortages home loan?[3]	Fee Amount
Total establishment fees	$0
Ongoing fees (per year)	$395
There may be circumstances in which you have to pay other fees (for example, if you ask for extra statements or miss a repayment).	

[3] On 20 days notice, the fees may change and new fees may be imposed. Additional government charges may require payment and these have not been included. Stamp duty on transfer of land has not been included.

What happens if interest rates increase?
This is a **variable rate product.** If your interest rate was to increase by one per cent, your monthly repayment would increase by around **$208.**

Where can you shop around for better deals?
There may be better deals available. Ensure that you obtain Key Facts sheets like this one from other home loan providers to compare this mortgage with deals from other lenders. For more information about home loans visit the ASIC financial tips website: www.fido.gov.au. For information on other lenders and their products, visit: betterbanking.choice.com.au, www.canstar.com.au, www.infochoice.com.au, www.ratecity.com.au or www.mozo.com.au.

CONSULTATION DRAFT

This information sheet is an Australian Government requirement under the *National Consumer Credit Protection Act 2009*

IMPORTANT INFORMATION

This is not a legally binding mortgage offer and it does not oblige XYZ Mortgages to provide you with the mortgage described in this key facts sheet.

You will need to satisfy the lending criteria to qualify for this loan.

This key facts sheet is an Australian Government requirement.

To help you compare and select the most appropriate product, you must be provided with a key facts sheet before you can apply for a home loan.
All firms selling mortgages are required to give you a key facts sheet like this one, that contain similar information presented in the same way.

Ensure that you obtain key facts sheets from other home loan providers to compare this mortgage with deals from other lenders.

It is important to shop around and compare interest rates, fees and features before you apply for a home loan. Choosing the home loan that is most appropriate for you can save you tens of thousands of dollars. You'll see many different types of home loans advertised, with a range of fees and terms. While they have some features in common, interest rates and repayment options vary, so choosing a home loan that suits your needs takes time and involves shopping around.

You may have to pay other fees and charges in addition to any fees shown in this key facts sheet.

Ask your mortgage provider for a list of all fees that apply to this mortgage.

Some features may be appropriate for your situation and result in savings over the life of the loan.

- Loans may vary depending on:
- fees (establishment, ongoing);
- interest type (variable/fixed);
- loan term (including term of any fixed portion);
- repayment type (interest only or principal and interest);
- loan amount;
- purpose (owner occupy, investment property);
- ability to transfer mortgage property;
- ability to split;
- ability to make extra repayments, redraw, or offset;
- access (e.g. phone, online);
- linked accounts (credit card, cheque/savings); and
- Loan to Value Ratio (LVR).

For more information about home loans

Visit the ASIC financial tips website: **www.fido.gov.au**
Websites that compare home loan products include:
betterbanking.choice.com.au
www.canstar.com.au
www.infochoice.com.au
www.ratecity.com.au
www.mozo.com.au

7.68 Choice argued that even when impediments to moving between banks are removed, there may be a need for education before consumers make the most of the opportunities. They spoke of the need:

> …to encourage people to change their behaviour and move accounts, move mortgages and so on, because we have had centuries, if you like, of consumer inertia, and it does not just change overnight. So there is a period of time where it will take efforts on all of our parts, really, to encourage the market to work better than it has worked before, even with those new mechanisms.[66]

Recommendation 9

7.69 The Committee recommends that the Reserve Bank and the Australian Prudential Regulation Authority draw on their data collections to publish regular information about the total cost of home loans (based on standardised assumptions on the average size and term) for the twenty largest ADI home mortgage lenders.

Recommendation 10

7.70 The Committee recommends that a working group be set up including Treasury, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Australian Competition and Consumer Commission, the Reserve Bank, the Financial Ombudsman Service, the Australian Bankers' Association, Abacus, consumer representatives and relevant academics to develop standardised words for financial products and their characteristics to allow consumers to more readily compare offers from different financial intermediaries.

Psychological or privacy barriers

7.71 There is a natural reluctance of borrowers about revealing to bank officers personal details about their income, their regular expenses, and the value of their home and other assets. Having to repeat this process when moving between lenders inhibits customers moving.

7.72 A possible means of overcoming this problem would be personal credit ratings. An agency could make an assessment of a customer's creditworthiness and give them a certificate they could give to a lender. Part of the assessment process could involve positive credit reporting. If the customer wishes to change to a new lender they could show the same certificate to the new lender rather than having to repeat the disclosure process.

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66 Mr Nick Stace, Chief Executive Officer, Choice, *Committee Hansard*, 14 December 2010, p 39.

Recommendation 11

7.73 The Committee recommends that the Government ask Treasury to investigate the feasibility of personal credit ratings to facilitate borrowers moving between lenders.

Financial literacy

7.74 There were a number of calls from witnesses and submitters for improved financial literacy:

> There does not seem to be a large amount of switching between transaction account providers in the general population. I guess that those with lower financial literacy might have greater reticence.[67]

> …for any banking reform to be successful it needs to include better consumer education…[68]

7.75 The Governor of the Reserve Bank remarked:

> It is a hard balance to strike, isn't it? As you say, you do not want to say to people in some overly nanny state sort of way, 'You can't have this loan.' You certainly do not want them to be in a position where they have taken on a commitment without fully realising what is actually involved. That is the balance to strike.[69]

7.76 The banks indicated their contribution to improving financial literacy:

> …the banking industry is committed to a long-term strategic priority of helping improve Australians' financial literacy. Australia's banks have a strong tradition of free education in financial skills and have in place a wide range of financial literacy, financial inclusion and capacity and enterprise building programs. In the year to June 2010, it is estimated these programs also received over $36 million of direct support from the main retail banks. Program contributions include building understanding in the areas of managing money, finance and banking, developing budgets, managing debt, building basic investment, insurance and superannuation knowledge, planning for life stages, including home ownership and retirement. These programs target efforts to assist the most vulnerable parts of the community.[70]

> The Federal Government should enhance levels of financial literacy of all Australians by developing and publishing a "National Strategy on Financial

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67 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 7.

68 Mr Ken Longshaw, *Submission 134*, p 1.

69 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 9.

70 Australian Bankers' Association, *Submission 76*, p 43.

> Literacy" …[and] provide additional funding to ASIC so that dedicated efforts on financial literacy can be implemented…[71]

7.77 The CEO of ANZ Bank also emphasised the role of financial literacy in his opening remarks:

> Turning to customer empowerment: active, well informed customers help lift competition…The idea of the proposed mortgage fact sheet is to provide a simple statement which will help consumers compare the costs and features of mortgages. Financial institutions can also assist here by providing simple, transparent products. In the longer term, more financially literate and informed customers will grow competition in the market. ANZ has made a significant investment in understanding the issues related to low levels of financial literacy, and which groups in the community are most affected, and in developing programs aimed at building the skills of the more vulnerable in the community. Our programs are delivered in partnership with the government and community organisations such as the Brotherhood of St Lawrence.[72]

7.78 Yellow Brick Road believes:

> …additional investment in financial education must be made, and that the Australian consumer should be encouraged to seek financial advice by making these services tax deductible.[73]

7.79 Treasury commented:

> If we are looking at competitive and sustainable banking, a major thrust is to better inform consumers as to the nature of the banking system and how they should invest their money—to empower them to increase their financial literacy.[74]

7.80 It was suggested the improvement in financial literacy needed to start in schools:

> Improve Australia's educational system to facilitate informed discussion about topics such as inter-bank competition.[75]

7.81 Regrettably, in 2008 the Government significantly cut funding from the financial literacy programme introduced by the Howard Government.

7.82 The Government recently announced some initiatives:

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71 Australian Bankers' Association, *Submission 76*, pp 60-61.

72 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 118.

73 Yellow Brick Road, *Submission 101*, pp 15-16.

74 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 30.

75 Mr David Allen, *Submission 126*, p 10.

> The Government will also launch a new, interactive consumer website with ASIC to help people boost their understanding of money matters through access to high-quality and independent online, personalised financial guidance that is free and readily accessible.[76]
>
> From 2011, the national school curriculum for Maths will contain a strong focus on the practical financial skills that students need…[77]

7.83 The National Financial Literacy Strategy was released by the Government on 15 March 2011. The Strategy includes four key elements:

- using educational pathways to build financial literacy for all Australians;
- providing Australians with trusted and independent information, tools and ongoing support;
- recognising the limits of education and information, and developing additional innovative solutions to drive improved financial wellbeing and behavioural change; and
- working in partnership and promoting best practice.[78]

7.84 Partly due to a lack of financial literacy many customers rely on advisers to select banking products. This raises the issue of 'Quis custodiet ipsos custodes?' Is it any easier to choose a good adviser than a good product? This is particularly problematic when advisers receive much of their income from commissions from the product providers rather than just being paid by the consumer.

7.85 After the Committee had completed its hearings, the Government released information on its 'Future of Financial Advice' reforms. These represent the Government's response to the Joint Committee on Corporations and Financial Services' report into financial products and services, which was set up in the wake of collapses such as Storm Financial and Opes Prime. The Minister characterised the reforms as designed to:

> …focus on improving the quality of financial advice and expanding the availability of more affordable forms of advice…The key reforms include a ban on conflicted remuneration structures, including commissions and volume payments, a requirement for advisers to obtain client agreement to ongoing advice fees every two years and the expansion of limited advice.[79]

7.86 It remains to be seen whether the aims of these reforms can be implemented successfully without undermining access to relevant financial advice by Australians,

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76 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 14.

77 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 14.

78 Australian Securities and Investments Commission, Report 229: *National Financial Literacy Strategy*, March 2011, p 6.

79 'Future of Financial Advice' information pack, foreward by The Hon Bill Shorten MP, Assistant Treasurer and Minister for Financial Services and Superannuation, 28 April 2011.

particularly those on lower incomes. Finance brokers and other financial advisers do play a useful role is helping households find the best deal on a home loan. They thereby contribute to improving competition in this market. A poorly thought out or implemented FOFA could limit the reach of that role. It is important to balance ensuring that advisers are not conflicted by commission arrangements with not preventing the impartial advisers being able to do their work effectively and in an accessible manner. The CEO of the Mortgage and Finance Association of Australia noted:

> ...there are conditions imposed on brokers, such as clawback provisions. If the customer decides to switch, the broker gets penalised by having their commission taken off them within a certain period of time. Some lenders have volume hurdles that say, 'We won't let you deal with us unless you produce so much business to us.' Those sorts of things make the broker's role more difficult. At the edge of the market, brokers who cannot comply with those conditions find it difficult to continue. As I have said, brokers are part of the competitive force in the market because they provide the retail face to the competition. A lot of the stuff we have been talking about is behind the scenes, the funding, but brokers provide the retail face.[80]

Committee comment

7.87 The Committee supports the renewed attention being paid to financial literacy. This is an important component of a more competitive financial system. The Committee is concerned, however, that the Government's approach may be too simplistic and prevent some customers gaining the benefit of informed and impartial advice.

Term deposits

7.88 There are odd spikes in the rates banks offer retail customers on term deposits; 'specials' as the banks term them. For example, they may offer 6 per cent for a seven month maturity but only around 3 per cent for six months or eight months. This disadvantages customers who just allow term deposits to roll over automatically on maturity.

7.89 Westpac were rather vague about the motivations:

> …all banks have specials at various points…it could be for seven months or 12 months and it fits in with your maturity profile—and there is also a little bit of a marketing element to it and a tracked and incentivised business element as well.[81]

7.90 Westpac also downplayed the extent to which less sophisticated investors ending up being rolled over into low interest terms:

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80 Mr Phil Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 76.

81 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 76.

> …customers do pay a lot of attention to the rates that they receive and, indeed, that was even intensified further through the global financial crisis with this intensity of preciousness of retail deposits. Customers do pay attention to that. We personally write to every customer, or communicate directly with every customer, when that term deposit is maturing and have a conversation with that customer about the options. We are not rolling over very attractive rates to much lower rates. That is simply not part of our philosophy or our style…[82]

7.91 Asked about this the Reserve Bank observed that the large majority of customers who initially invest in a term deposit at a 'special' rate roll over their deposit into a new 'special' (possibly for a different term).[83]

7.92 In 2009, ASIC conducted a review of the marketing and disclosure of term deposits by ADIs. ASIC noted that seven of the eight ADIs reviewed had dual pricing (i.e. they offer both high and low interest rates based on the term of investment, with significant differences between these rates), but none of the ADIs reviewed 'disclose the existence of dual pricing or the risk of rollover at a lower interest rate'.[84] The report recommended improvements to advertising practices and the disclosure of dual pricing, interest rates and grace periods.

Recommendation 12

7.93 The Committee recommends that banks should be required to contact customers before the expiry of term deposits advising them of the rate that will apply if they are automatically renewed and the current 'special' rates available.

Delays

7.94 Some bank customers are critical of the delays in banks effecting transfers of mortgages:

> Banks are able to settle properties for purchase readily in normal commercial time, but when they are receiving the settlement from outgoing customer this becomes in the main a painful exercise for the customer. It should be regulated that a bank is required to settle the transfer of a mortgage from one bank to another, within a maximum of 21 days of the date notified by the customer that they are transferring to another bank. There is no system impediment to this occurring. Mostly titles for properties exist both electronically and on paper and the exiting customer bank holding the title should be readily able to produce the physical title document, match it with the transfer signed by the customer, and transfer the title to the new lender within this period. If the bank cannot produce the title within 21 days and affect the transfer for the customer a penalty of

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82 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 76.

83 Reserve Bank of Australia, *Responses to questions on notice, no 6*, 18 January 2011, p 6.

84 Australian Securities and Investments Commission, *Report 185: Review of Term Deposits*, February 2010, p 6.

> perhaps one month's interest expense for each day's delay by the bank be paid to the customer as compensation.[85]
>
> Abacus member ADIs have pointed to two factors that could be improved for borrowers wanting to switch lenders…long delays in discharge and settlement by the current lender.[86]

7.95 Brokers were also critical of delays:

> The actual processes employed by the banks internal departments which handle Discharge Documents and Payout Figures etc, use erroneously long delaying tactics which hinder and frustrates consumers and industry participants when trying to refinance a mortgage and or discharge the same,..[87]

Stamp duties

7.96 State stamp duties on mortgages will remain a barrier to shifting mortgages:

> Discharge fees of a mortgage—and that is where you get stamp duty—would still be applicable. That is a matter of state government regulation.[88]
>
> For those borrowers who live in jurisdictions where stamp duty is payable on mortgages, there is a significant barrier in switching as previously paid mortgage stamp duties are not transferable…[89]
>
> In some States and in some situations mortgage stamp duty can be charged on refinanced loans. This can be quite substantial. Also, the titles office charges mortgage registration and deregistration fees (which range from $180 to $260).[90]

7.97 Under the *Intergovernmental Agreement on Federal Financial Relations*, stamp duties on mortgages are scheduled to be abolished before 1 July 2013.[91]

7.98 The Government is examining the possible introduction of a central repository to hold all mortgages so as to avoid mortgage discharge and re-establishment fees.[92]

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85 Mr Mervin Reed, *Submission 5*, p 7.

86 Abacus, *Submission 53*, p 24.

87 Finance Brokers' Association of Australia, *Submission 133*, p 3.

88 Mr Jim Murphy, Executive Director, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 36.

89 Bendigo and Adelaide Bank, *Responses to questions on notice*, no 7, 20 January 2011, p 1.

90 ProSolution, *Submission 30*, p 3.

91 *Report on Australia's Future Tax System*, December 2009, p 479.

92 Treasury, *Submission 102*, p 28; Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 9.

Recommendation 13

7.99 The Committee recommends that the abolition of stamp duties on refinancing of mortgages be placed on the agenda for the forthcoming tax forum and that the agreement on their abolition be implemented.

Account portability

7.100 The Government has observed that impediments to deposit account portability (discussed below) may also inhibit movements of mortgages:

> Many bank customers hold their savings in a deposit account with the same bank as they have their home loan, so the inconvenience of moving their deposit account also acts as a significant barrier to moving their mortgage.[93]

Electronic conveyancing

7.101 The Bendigo and Adelaide Bank told the Committee:

> …there is currently a project about electronic or e-conveyancing. If the industry could get together and for the 80 per cent of people who just need a standard, everyday mortgage agree to the terms of what an industry mortgage might look like, we can put that into an e-conveyancing project. So if you wanted to swap from Westpac to us it would simply be a matter of it happening in a central electronic register. This reduces an enormous amount of the cost in the industry…[94]

7.102 The Australian Bankers' Association added:

> The National Electronic Conveyancing Development Ltd (NECDL) was established in January 2010 by the New South Wales, Queensland and Victorian Governments, following a Council of Australian Government's decision to develop the national electronic conveyancing system. We support this as an important initiative for national micro-economic reform and as being key to greater efficiency and convenience in conveyancing for consumers, practitioners and financiers... A national system will provide greater certainty of settlement date, delays associated with making appointments for settlement will be significantly reduced and the electronic settlement of transactions will obviate the need for bank cheques on settlement.[95]

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93 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 8.

94 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 90.

95 Australian Bankers' Association, *Submission 76*, p 65.

Deposit account number portability

7.103 Many consumers and small businesses find the process of moving between banks cumbersome as it involves telling large numbers of organisations or customers about a new account number. This is more burdensome for consumers now that many bills are paid using direct debits from accounts.

7.104 A recent survey commissioned by CHOICE showed that the most common reasons for not switching between ADIs were beliefs there was too much paperwork (50 per cent), not having enough time to research the best deal (48 per cent) and not believing they would be better off (44 per cent).[96]

7.105 The rate of transaction account switching appears lower in Australia than in the UK.[97] And the UK is considering measures to facilitate account switching there:

> …it may be possible to introduce greatly improved means of switching at reasonable cost, in which case the industry should be required to do this within a short timescale…[98]

7.106 As well as being a hassle for individuals, it is burdensome for small business:

> …at the moment in business if I need to change my account I have to go and tell all my customers my new account numbers. It happens to me, because I have suppliers. I will get an email, a letter, a phone call or whatever saying: 'Here's the new BSB and account number. Please change it.'... Most small businesses do not do it because it is difficult. It is not so much that they do not want to do it; it takes a lot of time and effort… you have your bank details on your stationery.[99]

7.107 Some bankers acknowledge the problem:

> When people switch banks, what they generally struggle with administratively is changing all of their direct debits and various other things, and that is obviously a barrier to people taking advantage of portability.[100]

> … direct debits and credits serve the purpose of tentacles for banks to hold onto customers by restricting them from moving to another provider. Unfortunately, for the Account Switching package to work effectively,

96 CHOICE, *Submission 70*, p 9.

97 About 9 per cent of customers moved in a year in the UK, compared to under 8 per cent over two years in Australia; CHOICE, *Submission 70*, p 9.

98 Independent Commission on Banking (2011, p 5)

99 Mr Peter Strong, Executive Director, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, pp 8-9. Similar issues were raised by the WA Small Enterprise Network, *Submission 68*, p 9.

100 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 65.

changes are required under the Bulk Electronic Clearing System ("BECS') rules. Currently consumers do not find the package convenient or user friendly and are reluctant to initiate switching to other banks even when they are not happy with the service provided to them by their current bank. Since the customer has to open a new account number and then take the responsibility to actually transfer the credits and debits over, there is reluctance on the part of consumers to initiate a change.[101]

7.108 Other banks and the Australian Payments Clearing Association regard the problem as overstated:

> Based on local data on account "churn" and overseas comparisons as well as RBA analysis of deposit account competition, there is substantial and effective competition in transactional banking services. If the challenges of switching transaction accounts are a barrier to competition, they are not a strong one – millions of Australians change provider every year.[102]
>
> The [Commonwealth Bank] Group opens and closes over 1 million personal transaction accounts a year, in the context of having over 5 million personal transaction accounts...These account opening and closure numbers show many customers change their personal bank accounts each year, contrary to popular opinion.[103]

7.109 Improving portability is welcomed by a number of witnesses and submitters:

> Bank account portability is very important…it should be pursued vigorously.[104]
>
> …portable account numbers would take the hassle out of moving from one FSP [financial service provider] to another, by eliminating the need to advise multiple parties of new account details…[105]

7.110 The Australian Bankers' Association is sceptical about the idea:

> …account portability, as frequently proposed, where a bank account number can be moved from financial institution to financial institution, would require significant investment, especially for smaller providers as well as other businesses and government departments. Furthermore, the benefits of account portability have not been demonstrated.[106]

7.111 Some submitters called for action to mandate improving account portability:

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101 ING Bank, *Submission 35*, p 4.

102 Australian Payments Clearing Association, *Submission 49*, p 1. APCA provide estimates of churn rates in pp 5-6 of the submission.

103 Commonwealth Bank of Australia, *Submission 88*, p 12.

104 Dr Richard Denniss, Executive Director, Australia Institute, *Committee Hansard*, 15 December 2010, p 31.

105 Financial Ombudsman Service, *Submission 78*, p 5.

106 Australian Bankers' Association, *Submission 76*, p 64.

> …the Federal Government needs to make switching banks as easy and as seamless as possible. Within this context, the best outcome for bank customers would be to have an ability to simply go the new bank, sign an authority to allow the new bank to move the customer's dealings over to the new bank and have the new bank do all the work with the old bank.[107]

> The other method used by banks to limit competition between themselves is the archaic bank state branch identifying numbering system, which together with the account number, supposedly drives the payment system. This antique framework was originally designed for the cheque clearance system specifically for Micra Ink readable cheques. It is readily easily replaced by each customer having a bank account number that becomes the universal number for that person. In other words each Australian citizen can have a number of bank accounts, each with a separate and unique identifying number solely for that person. The payments system for interbank clearances is readily adaptable to this identifier which would fully replace the bank state branch system of numbering, and thus make it very simple for a client to move banks whilst retaining their account numbers. Of course the banks will oppose this and provide significant reasons why this can't be done, but it can simply be legislated for with 12 months notice of compliance.[108]

7.112 The banks in general, however, expressed caution about the idea, whether through dislike for improved competition or genuine concern about technical problems:

> We are dealing with very complex and ageing infrastructure in the banking environment, so we would have to look into the time taken.[109]

> …this account portability and the fact that this is going to go out for further consultation is quite an important thing. The actual logistics and difficulties of doing this and the cost of it would be so huge.[110]

7.113 Some other parties were also wary:

> Bank account number portability may have limited benefits for small business lending, and may impose significant costs upon the banking sector.[111]

> Account number portability is an idea that should be examined, but the legal and compliance hurdles, along with their associated costs, are likely to be considerable, particularly for smaller mutual institutions.[112]

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107 Associate Professor Frank Zumbo, *Submission 56*, p 6.

108 Mr Mervin Reed, *Submission 5*, p 8.

109 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 65.

110 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 126.

111 WA Small Enterprise Network, *Submission 68*, p 3.

An attempt to force an artificial addressing constraint to support account switching would tend to dampen this competitive evolution.[113]

…we would have to replace the BSB number system with a different arrangement if we were to move to account number portability.[114]

7.114 A banking analyst was also wary on technical and cost grounds:

… the proposal to have account number portability will be very difficult. When we look at this, a lot of banks have the BSB number and the account number; the various banks have different numbers. Remember that some of the IT technology and the core banking processes go back to the 1960s and that there are more than 100 ADIs in Australia. Every bank has to try to redo their IT systems. Some of the banks that we have spoken to over the last couple of days and previously have suggested that it will cost the major banks several hundred million dollars each to implement this account number portability.[115]

7.115 He also raised a prudential concern:

Northern Rock is a classic example. When there was a run on a financial institution, the IT system spontaneously crashed. That was convenient but it meant that not as many people could go online and transfer their savings across. The queues went out the door and there were not that many tellers there. That slowed the run on the bank, and it eventually failed anyway. If you have account number portability, in the event that rumours go around that there could be a financial institution under stress, it will lead to instability… If you think about the Basel committee's reforms on liquidity, we want sticky deposits and we want term funding. With account number portability, it is diametrically opposed to sticky deposits because, by definition, deposits will become less sticky.[116]

7.116 This concern was not thought likely to be a problem by a major bank:

…if a customer had issues with a particular institution then they might just withdraw their money and then put it in somewhere else much more quickly rather than try to switch accounts like that.[117]

7.117 The Committee asked APRA about this and APRA responded that:

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112 Abacus, *Submission* 53, p 24.

113 Australian Payments Clearing Association, *Submission 49*, p 8.

114 Mr Christopher Hamilton, Chief Executive Officer, Australian Payments Clearing Association, *Committee Hansard*, 21 January 2011, p 31.

115 Mr Jonathan Mott, Bank Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, pp 146-7.

116 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 147. A similar concern was raised by Mr Nicholas Palmer, *Submission 22*, pp 3-4.

117 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, pp 131-2.

> From a prudential perspective, portability would expose ADIs to greater liquidity management pressures and would be likely to require them to hold higher levels of liquid assets to compensate for increased customer movement.[118]

The September 2008 package

7.118 The Government announced a package of measures in September 2008 aimed at facilitating movement between financial intermediaries. A key part of the package was the requirement for ADIs to provide their customers, if they wanted to switch, with a list of direct debit and credit payments going back 13 months.

7.119 It appears to have had a limited impact so far:

> Usage of the switching package has been low…In the year to September 2010, 2541 lists of regular payment arrangements were issued to consumers at their request.[119]

> …consumer awareness of this is relatively low and CUA's experience has been that very few consumers have taken advantage of the legislation.[120]

> A recent internal ASIC survey reportedly showed '40% of 1,207 respondents couldn't be bothered switching banks because of the hassle, 10% said there was no point changing because all banks are the same and 10% found switching too hard a process'.[121]

7.120 ASIC conducted a review of the initiative and its report was later released under Freedom of Information. ASIC summarised the results for the Committee:

> …implementation had happened consistent with the requirements. But there was a relatively low level of usage at that point—this is probably going back two years—though consumers who had used the new procedures generally reported a better experience switching than those who had not. We identified that one of the problems in the situation is making sure consumers are aware of this possibility of the service. It is very difficult to compel an institution to advertise to its customers that it will give them help to leave, and that is probably too much to expect from institutions… there was a relatively low level of understanding or knowledge of this facility by consumers.[122]

7.121 The Government attributes the limited take-up so far to the GFC:

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118 APRA, *Responses to questions on notice,* no 6, 31 January 2011, p 3.

119 Australian Payments Clearing Association, *Submission 49,* p 5.

120 Credit Union Australia, *Submission 85,* p 10.

121 Maurice Blackburn Pty Ltd, *Submission 31,* p 6.

122 Mr Greg Kirk, Senior Executive Leader, ASIC, *Committee Hansard,* 21 January 2011, pp 10-11.

> During the turbulence of the global financial crisis it is understandable that many savers would have had a preference for the stability of their existing institution…more consumers will utilise the account switching service as competition returns to the banking sector and the benefits of the package become more widely known.[123]

Alternative approaches

7.122 The Committee received evidence on possible alternative approaches to full deposit account number portability:

> You might be in a situation where you could have a user interface that allowed you, if you had multiple bank accounts, for example, to redirect a direct debit from one banking institution to another. That would require you to have accounts in other banks, but if you had an account with bank A and you decided you preferred the deal with bank B then you could redirect direct debits from A to B. There are things that can be explored that may not be as complex or timely as total account portability.[124]

> I am not sure that we need an expensive, high-tech solution. We see in some other countries that there is a process where you tell the new bank that you want to leave the old banking institution and they have a positive obligation to provide standard information in a set time frame and a way of verifying that it is the right person.[125]

> There are solutions that have been tried in Europe. There is a solution short of portable bank account numbers which we have supported, which is to require the new bank to take the hassle out of switching for you as a customer by authorising them to deal with your old bank within a clear time frame and transfer your direct debits and direct credits across.[126]

> …there are a number of other mechanisms significantly beyond what we currently have in Australia in other jurisdictions such as New Zealand, Europe and the Netherlands which stop short of actual account number portability but still enable a significantly more effective switching by consumers than we currently have in Australia.[127]

7.123 The European Union has recently introduced measures, falling short of full account portability, but which sound like they would facilitate account switching. They provide that:

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123 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 9.

124 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 65.

125 Ms Louise Petschler, Chief Executive Officer, Abacus, *Committee Hansard*, 13 December 2010, p 89.

126 Mr Richard Lloyd, International Policy Adviser, Choice, *Proof Committee Hansard*, 14 December 2010, pp 33-34. He later (p 35) referred to the Netherlands as a specific example.

127 Ms Catrinoa Lowe, Co-Chief Executive Officer, Consumer Action Law Centre, *Committee Hansard*, 25 January 2011, p 14.

- banks must provide consumers with a switching guide explaining what steps need to be taken in the switching process, by whom and within which timeframe;
- if the consumer chooses, their new bank must act as a complete intermediary between the consumer and their old bank as well as third parties, by which we mean that the new bank (not the consumer) performs all the relevant steps, including obtaining the necessary information about the consumer‘s recurrent payments from their old bank, reinstalling these payments on the new account, asking the old bank to cancel these payments on the old account, and informing third parties about the consumer‘s new account details;
- the new bank must assist the consumer to request that their old bank close their old account and transfer the remaining balance;
- there are clear timeframes that must be followed, including that the old bank must provide the information about recurrent payments within seven banking days of receiving the request to do so and the new bank must set up the recurrent payments on the new account within seven days of receiving this information; and
- the information provided by the consumer's old bank and the closure of their old bank account should generally be free of charge.[128]

7.124 The Netherlands system works as follows:

> Once a consumer (or a small business) applies to use the switching service, for 13 months their new bank ensures that their old bank reroutes direct credits to the new account and as direct debits hit the old account, they are also rerouted and the creditor is informed of the new account and to change their details for future debits. (The consumer must inform their employer and other parties that direct credit their account about their change in account sometime within the 13 months – they receive a notification of the impending end of their switching service one month before it ends.) Rerouted transactions are separately noted on the consumer‘s bank account statements.[129]

7.125 A European entrant to the Australian market believes the Netherlands approach is a successful model:

> We understand the Dutch system has resulted in around 100,000 customers shifting each year as a result of that. It really did shift the dial.[130]

7.126 ING Bank refers to a new scheme in New Zealand:

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128 Consumer Action Law Centre, *Submission 87*, p 9.

129 Consumer Action Law Centre, *Submission 87*, p 9. See also Choice, *Response to questions on notice*, no 5, 17 December 2011.

130 Mr Matt Baxby, Managing Director, Virgin Money Australia, *Proof Committee Hansard*, 4 March 2011, p 29.

> …a new company called 'Payments NZ' owned by ANZ, Westpac, ASB, BNZ, Kiwibank, HSBC TSB and Citibank, has been established. Our understanding is that Payments NZ, will be taking over the New Zealand Bankers' Association's Electronic Credit System Code and the Direct Debit Systems Code, which documents the operational agreements and arrangements among member banks for clearing electronic credits and direct debits. Under this proposed model, the customers will fill out a form authorising the incoming bank to get all the customer's information relating to direct debits and credits linked to their existing account from the outgoing bank and the incoming bank will organise the entire switching process and have the direct debits and credits linked to the new account number with the incoming bank.[131]

7.127 The Consumer Action Law Centre contrasts the EU and Netherlands schemes with that developed in Australia. Among the deficiencies of the Australian scheme they highlight are that it only requires the old bank to produce a paper list of payments and the customer must then sort through these and notify the parties involved, it excludes credit card accounts and there is no restriction on customers being charged a fee by the old bank.[132]

7.128 The Centre concludes:

> …the Australian listing and switching service compares poorly with overseas practice and strongly recommend that it be improved.[133]

7.129 Choice referred to research suggesting 80 per cent of bank customers have not considered moving. Responding to a suggestion that this may be an indication of their satisfaction with their current bank, Choice had the following rejoinder:

> Our annual consumer satisfaction survey across the board for ADIs shows that the banks with the largest market share consistently have the lowest customer satisfaction ratings…You would think that, if they were competing genuinely on price and quality, that would not be the case… there were very clear reasons given by those who considered switching but did not switch in the last two years: the paperwork, the hassle of researching the market and the belief, rightly or wrongly, in the case of individual products that there is not a better alternative out there in the marketplace.[134]

7.130 The Government has announced a feasibility study of introducing full account number portability to report by June 2011. The study will be conducted by former Treasury secretary and Reserve Bank governor Bernie Fraser, and assess the current

131 ING Bank, *Submission 35*, p 4.

132 Consumer Action Law Centre, *Submission 87*, pp 10-11.

133 Consumer Action Law Centre, *Submission 87*, p 11.

134 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 33.

technology, privacy issues, the potential need for a central account registry and the costs, benefits and risks of introducing account portability on various timelines.[135]

Recommendation 14

7.131 The Committee recommends that a scheme based on those in Europe be introduced requiring a bank, upon being advised that a customer has left for a new bank, to reroute all direct debits and credits for 13 months and provide the new bank with details of those direct debits and credits.

135 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 8.

Chapter 8

Price signalling

> *People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary.*[1]

8.1 In the recent public debate on banking competition in Australia, the issue of anti-competitive price signalling has been raised as a possible area of legislative reform. Anti-competitive price signalling refers to a corporation conveying to its rivals its future price intentions. By so doing, the corporation eliminates uncertainty about the price of its goods or services, thereby reducing the risks of competition and impeding the functioning of a competitive market.

8.2 Price signalling has been a significant issue in this inquiry. Various witnesses have put differing views on the nature and harm of this conduct and several have offered comment on the legislative proposals. The Committee has also kept abreast of the broader public debate on the issue. Since the Senate referred this inquiry:

- both the Government and the Coalition have proposed legislation to address price signalling;[2]
- the Government has called for, and received submissions on its Exposure Draft Bill and has subsequently introduced a bill into the parliament to address price signalling;
- the House of Representatives Standing Committee on Economics has received submissions and held a public hearing into the Coalition's bill;[3]

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1 Adam Smith, *The Wealth of Nations*, first published 1776–8, Book 1, Chapter 10, paragraph 82.

2 The Coalition's bill—the Competition and Consumer (Price Signalling) Amendment Bill (No. 1) 2010—was introduced into the House of Representatives on 22 November 2010. The Government released an exposure draft of its bill on 12 December 2010 and conducted a consultation process. Following this, the Government's bill—the Competition and Consumer Amendment Bill (No. 1) 2011—was introduced into the House of Representatives on 24 March 2011.

3 House Standing Committee on Economics, *Inquiry into the Competition and Consumer (Price Signalling) Amendment Bill 2010*, http://www.aph.gov.au/house/Committee/economics/1BillPriceSignalling/hearings.htm (accessed 1 March 2011).

- several bank chief executives and the Treasurer have commented on the issue of price signalling;[4] and
- several academic articles[5], newspaper articles[6] and analyses by law firms[7] have been published.

8.3 This chapter examines the current debate, the legislative proposals and the Committee's view on price signalling. It is divided into three sections which:

- define 'price signalling' and present the main arguments as to whether it is a problem;
- discuss the current provisions of the *Competition and Consumer Act 2010* on contracts, arrangements or understandings that restrict or affect competition. It then considers the ramifications of the Australian Competition and Consumer Commission's (ACCC) recent petrol cases for the legal interpretation of an 'understanding' under section 45(2); and
- compare the Government's proposed legislation to prohibit price signalling with the Coalition's proposal and concludes with the Committee's view on these bills.

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4 The Hon. Wayne Swan MP, Interview with Lyndal Curtis, *ABC Radio, AM Program*, 13 December 2011; The Hon. Wayne Swan, Interview with Kieran Gilbert, *Sky News Channel*, 13 December 2010. Mr Ralph Norris, *Commonwealth Bank of Australia Profit Statement*, 9 February 2011.

5 Baxt, Kiratzis and Eglezoz, (2011, p 6); Smith, Duke and Round (2009, pp 26–27); Noble (2010); and Fisse and Caron Beaton-Wells (2011).

6 Patrick Durkin, 'Banks irate over price signalling', *Australian Financial Review*, 4 January 2011, p 3; John Durie, 'Price signalling plans cast too wide a net', *The Australian*, 13 January 2011; Matthew Drummond, 'Proposed price signalling law 'just does not work', *Australian Financial Review*, 8 February 2011, p 54; Katja Buhrer and Jason Murphy, 'ACCC adamant on price signalling', *Australian Financial Review*, 27 January 2011, p 37; John Kehoe, 'Broader fears on price signalling clamp', *Australian Financial Review*, 9 February 2011, p 53; Josh Gordon, 'Petrol, groceries in consumer law push', *Sydney Morning Herald*, 9 January 2011; Michael Jacobs and Bill Reid, 'Price-signalling laws fraught with danger', *Australian Financial Review*, 1 March 2011, p 63; Terry McCrann, 'Zumbo and Samuel, a strange tag team', *Herald Sun*, 15 December 2010.

7 Mallesons Stephen Jaques, 'Price signalling - two Bills compared, neither needed', 21 January 2011; Allens Arthur Robinson, 'Client Update: Prohibiting Price Signalling', 13 December 2010; Freehills, 'Price signalling "Take 2"—the government's turn', 16 December 2010; Johnson Winter & Slattery, 'ACCC power to prosecute anti-competitive price signalling', December 2010; Mallesons Stephen Jaques, 'Government releases Exposure Draft Bill to outlaw price signalling', 12 December 2010; MinterEllison, 'Anti-competitive price signalling— implications beyond the banking sector', 15 December 2010.

What is price signalling?

8.4 Defining 'price signalling' is not straightforward. The term is often used pejoratively, denoting an anti-competitive conduct, but not all price signalling will have an anti-competitive intent or outcome. Indeed, public disclosure of price information is essential to efficient markets. As this chapter discusses, there is a complex legal debate as to what should be classed as illegal 'price signalling'. This debate relates to various factors including whether there is a 'commitment' to act on the information passed, whether the pricing information is relayed publicly or privately between competitors, and whether the competitor relaying the information has the purpose as well as the effect of 'substantially lessening competition'.

8.5 Notwithstanding this complexity, a working definition of price signalling is useful. In broad terms, it refers to one competitor relaying its future pricing information to another competitor. For example, Bank A announces on its website that effective from a future date, it may increase its interest rate for home mortgage loans by one per cent. This is price signalling. Should Bank B note this information and announce in response that it will either change its rate or keep it unchanged, this is also price signalling.

8.6 Australian academics Dr Rhonda Smith, Mr Arlen Duke and Professor David Round identify three facets of price signalling. First, it is a form of communication that is indirect: it is not stating an actual price but indicating to the market the capacity of a firm to price. They give the example of a retailer advertising that it will better by 10 per cent a lower price for an equivalent product found at another store by a customer. Second, the signal may be intended to convey broad messages beyond consumers to actual and potential rivals. Signalling does not necessarily involve reciprocity from the recipient of the signal, although it is expected to achieve a particular outcome. Third, a firm's conduct may be a signal if it has a track record of responding in a particular way.

8.7 Dr Smith, Mr Duke and Professor Round define signalling as:

> ...the conveying of information about one or more aspects of the market to actual or potential market participants (including consumers) through 'one-off' acts or as a result of establishing a pattern of behaviour. Signalling as a means of coordination may be directly about prices or it may be indirect, for example, by indicating how the signaller will react in certain circumstances to the conduct of one or more rivals with the aim of causing rivals to respond in a way that is mutually profit-enhancing.[8]

8 Smith, Duke and Round (2009, p 24).

8.8 Price signalling is often identified on a spectrum of coordinated conduct.[9] At one extreme is collusion whereby firms enter into an oral or written agreement in relation to pricing, market sharing or bidding for contracts. Collusion is a per se illegal offence in Australia.[10] At the other end of the spectrum is conduct known as 'conscious parallelism' whereby profit maximising firms in an oligopolistic market take into account the expected reactions of their rivals. In this market, the firms are interdependent and act unilaterally in response to similar cost and demand factors.[11] 'Conscious parallelism' is not illegal.

8.9 Between these extremes is conduct termed 'tacit collusion'. This form of conduct involves no oral or written communication between competitors but does involve deliberate behaviour intended to coordinate the decision-making of competitors. Price signalling falls within this category. However, the nature and effect of price signalling may differ markedly: it may itself be placed on a spectrum. It can include:

- providing information that enables consumers to make better choices, thereby increasing consumer welfare and encouraging competition;
- deliberately limiting the information available to consumers thereby raising consumers' search costs and reducing competition;
- deliberately restricting output or allocating market shares, thereby increasing firms' capacity to raise prices and narrow competition;[12] and
- coordinating a move from one consensus price to another by signalling planned price increases on the internet or in press statements, and thereby lessening competitive tension in the market.[13]

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9 See Beaton-Wells and Fisse, (2010, p 83), Smith, Duke and Round (2009, pp 26-27) and Noble (2010). The coordination spectrum was also noted by ACCC Commissioner Dr Jill Walker at a public hearing; *Proof Committee Hansard*, 25 January 2011, p 39.

10 The Part IV per se prohibitions are in sections 44ZZRF, 44ZZRG, 44ZZRJ and 44ZZRK relating to cartel provisions, section 45(2) relating to exclusionary conduct, sections 47(6) and (7) relating to third line forcing and section 48 relating to resale price maintenance.

11 Noble (2010, p 1).

12 Mr Brian Cassidy, Chief Executive Officer of the ACCC, gave the House of Representatives Standing Committee on Economics the example of a company signalling that the following week it would concentrate on supplying a certain segment of the market. This signal says to its competitors that the company will be vacating the other segments they operate in and that could establish a market-sharing arrangement. One competitor says, ‘Well, in that case, I’m going to concentrate on this segment,’ and another competitor says, ‘Well, I’ll concentrate on that segment.’ With this arrangement in place, the company is free to increase its prices in the segment of market it has signalled it is going to concentrate on without any worry about its competitors taking away market share.; *House of Representative Standing Committee on Economics Hansard*, 18 February 2011, p 21.

13 Smith, Duke and Round (2009, pp 27-28).

The banks' understanding of 'price signalling'

8.10 The Committee sought the views of the major banks on the issue of price signalling. The following comments give a sense of what the banks understand by 'price signalling', whether they believe it occurs in the banking sector and whether it should be explicitly prohibited by law. (The banks' views on the proposed price signalling legislation are discussed later in the chapter.)

8.11 Mr Ralph Norris, Chief Executive Officer of the Commonwealth Bank, was asked whether he understood price signalling to mean 'merely making predictive statements about possible future movements in rates'. He responded: 'I do not see that as being price signalling'.[14] Another Commonwealth Bank officer was adamant: 'we do not price-signal, and we absolutely have not had private discussions between banks about pricing'.[15]

8.12 Westpac CEO Ms Gail Kelly told the Committee that price signalling was not occurring in the Australian banking industry and that Westpac was 'clearly' against any kind of price collusion or any sort of price signalling.[16]

8.13 ANZ CEO Mr Mike Smith broadly defended his right to talk on interest rates and pricing issues. He made no distinction, however, between general commentary on these matters and public statements about the bank's pricing intentions, nor did he distinguish between current pricing and future pricing statements. Mr Smith did emphasise that the public comments he might make on pricing matters are not intended to be price signalling. As he told the Committee:

> It is right to be able to have an opinion on these things. Any of these comments, certainly from my perspective, were not meant to be price signalling. I do not care what the other banks do as long as we can remain competitive.[17]

Why is price signalling a problem?

8.14 What is the 'mischief' in price signalling? In other words, where should the line be drawn between a healthy disclosure of information to the market and anti-competitive conduct? These are fundamental, yet vexed questions.[18] Mr Brent Fisse argued that 'distinguishing between oligopolistic interdependence and unjustified coordination of market activity by competitors is probably the toughest

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14 Mr Ralph Norris, *Committee Hansard*, 15 December 2010, p 72.

15 Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 65.

16 Ms Gail Kelly, *Committee Hansard*, 21 January 2011, p 71.

17 Mr Mike Smith, *Committee Hansard*, 15 December 2010, p 141.

18 The issue has also been the subject of recent legal and academic debate. See footnotes 6 and 8.

challenge in competition law'. He added: 'satisfactory approaches have yet to emerge anywhere in the world'.[19]

Mr Smith's comment

8.15 A significant point of reference for the Committee in terms of identifying price signalling and why it is can be harmful was a comment reported in *The Australian* in November 2009 by Mr Smith. He was reported as saying that while he would be 'reluctant' to increase home loan rates above the Reserve Bank's rates, if other banks moved their rates outside moves by the RBA, he would not be 'stuck on my own'.[20] The question the Committee put to some witnesses was whether this statement constituted 'price signalling' and whether legislation is needed to prohibit this type of statement.

8.16 The ACCC identified Mr Smith's comment as an example of price signalling but noted that it is not prohibited under the current law.[21] The ACCC Chairman, Mr Graeme Samuel, told the Committee that the type of comment made by Mr Smith constitutes a 'softening up' of the market: it effectively signals to ANZ's competitors that if they increased their rates, they would not have to worry about losing market share to ANZ. Mr Samuel argued that this conduct removes the uncertainty associated with true competitive tension and should therefore be prohibited. He observed that while information on prices in advance of time can in one sense be seen to be useful, in most cases 'the vast value of its usefulness is in allowing competitors to know what you intend to do'.[22] A pertinent question is:

> Why would someone say what was said, other than for the purpose of signalling perhaps to their competitors what their behaviour was going to be in relation to increases in bank housing loan interest rates?[23]

8.17 Other witnesses were more circumspect about Mr Smith's intent and the need to prohibit this type of comment. Ms Sharon Henrick, a partner at Mallesons Stephens Jaques, believed that Mr Smith's purpose and intent in making the comment is unclear.[24] Mr Brent Fisse told the Committee that in his view, it is 'very marginal' as to whether the type of comment made by Mr Smith should be prohibited. Moreover, he queried:

> ...whether in any event it should be a matter of priority for the ACCC to be taking enforcement action in that kind of case, particularly given that the

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19 Mr Brent Fisse, *Submission 67*, p 1.

20 Richard Gluyas, 'ANZ shift on plan to stick with RBA', *The Australian*, 4 November 2009, p 5.

21 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 40.

22 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 42.

23 Mr Brian Cassidy, Chief Executive Officer, ACCC, *House of Representatives Standing Committee on Economics Hansard*, 18 February 2011, p. 12. While Mr Cassidy's remark did not explicitly mention Mr Smith's comment, it is likely he had this comment in mind.

24 Ms Sharon Henrick, *Committee Hansard*, 25 January 2011, p 100.

same outcome could be achieved in other ways—for example, by making a continuous disclosure statement in a rather more skilful way than was made by the CEO on that particular occasion, as reported by *The Australian* in 2009. It is a marginal case. The ACCC should focus much more obviously on stark cases of price fixing, of which there are still many recorded instances in the Australian economy.[25]

8.18 Associate Professor Frank Zumbo identified price signalling as a symptom of the lack of 'real, quality, intensive competition'. He elaborated:

> The underlying problem is the greater concentration of the market that we have seen, the increasing concentration we have seen. Where you have a highly concentrated market you do have a problem with price-signalling, but the price-signalling is a reflection of the highly concentrated market.[26]

8.19 Nonetheless, in an oligopolistic market, Associate Professor Zumbo recognised the potential anti-competitive effect of price signalling. He identified the harm as a form of collusion:

> I believe the evil in relation to price signalling is that you have one competitor basically telling another competitor in a variety of ways that if that other competitor behaves in a particular way on price, the competitor making the comment will also behave in a particular way. That is why price-signalling legislation has to be highly targeted to the particular mischief that we are concerned with.[27]

8.20 Other witnesses argued that the debate on price signalling is misguided. Professor Tom Valentine, notably, described the 'whole discussion' on signalling as 'ridiculous' given that the banks already know what each others' funding costs are. He told the Committee:

> They know what they are going to charge, roughly, and I do not see why we should stop consumers getting important information which might be useful to them in deciding, for example, what size mortgage they should be applying for. Let’s face it: the Reserve Bank was able to predict what was going to happen to the banks’ cost of funds and therefore to the charges. It expected that they would put up their rates by more than the increase the bank made in the cash rate. Consequently, we would not be surprised if the other banks had that sort of information.[28]

8.21 The Committee notes that while Professor Valentine may well be correct that the banks have access to each others' funding information, his observation misses the point. The concern with price signalling as a form of anti-competitive conduct is not

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25 Mr Brent Fisse, Adjunct Professor of Law at the University of Sydney, *Committee Hansard*, 25 January 2011, p 100.

26 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 59.

27 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 59.

28 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 62.

whether the banks are aware of each others' cost of funds, but the message that specific comments about a competitor's future pricing intentions may have on competitive tension in the market. Further, Mr Smith's comment was not a general reference to his competitors' higher funding costs but a specific observation about where he would position his bank on interest rates should his competitors move theirs.

The need for the banks to provide economic commentary

8.22 Various submitters and witnesses emphasised that the banks (as with other companies) have a legitimate and important role in informing the market about their pricing. They extended this defence by arguing that tighter prohibitions on price signalling would effectively end banks' public comments on their prices and strategies.

8.23 The Commonwealth Bank's CEO was questioned over a comment he reportedly made in August 2010 that the Commonwealth Bank was likely to raise its interest rates above any Reserve Bank cash movements. He responded that the comment was not intended as price signalling and that all bank chief executives have made public statements about their funding costs. He told the Committee that there are legitimate reasons to offer this type of economic commentary about interest rate outlooks.[29]

8.24 One of his colleagues argued that restrictive price signalling provisions would prevent the banks from explaining their pricing structures and the cost of their funds:

> We are all competing for funds in the same market and the costs are going up. Everybody has got different funding structures, and you will note that the different banks put up their rates by different amounts presumably because their funding costs are a little different, but at the end of the day all that we have tried to explain—and interestingly I think you have done a very good job of pointing this out as well—is that our costs are going up. There is a risk clearly with this legislation that we will not be able to explain that as clearly in the future because it will be seen to be price signalling. But from our investor point of view and our continuous disclosure point of view we think it is important that we are able to explain what is happening with our business, and obviously you believe that as well from the point of view of the Australian public understanding these costs.[30]

8.25 Mr Smith also defended the banks' public statements about interest rates. He reasoned that:

> It would be rather unusual if I were asked my views on interest rates, or the likely movement of interest rates, or the interest rate environment or foreign

29 Mr Ralph Norris, *Committee Hansard*, 15 December 2010, pp 60 and 72.

30 Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 72.

> exchange—what is the Aussie dollar doing?—unless I could actually see exactly what I could and could not say.[31]

8.26 Suncorp Bank's CEO was another to express his concern at the possible impact of legislation to prohibit price signalling on the capacity of the banks to provide information to the market. He told the Committee:

> ...the proposed legislation against price collusion stops the industry commentating and commenting on interest rate and market movements, preventing education of the community about interest rates and the factors that go into product pricing and exacerbating a one-sided debate.[32]

8.27 The Australian Bankers' Association (ABA) has argued that not only would tighter legislation on price signalling stop the flow of information to the market, it could lead to consumers making bad decisions regarding their product or loan choices. The banks would not be able to correct misinformation and provide facts about banking services and markets.

8.28 The ABA noted that individual banks and the Association 'are constantly facing inquiries from journalists, politicians and bank customers seeking a response to comments, allegations or analysis regarding banks' funding costs and other pricing-related issues'. Further, it observed that many of these inquiries stem from comments or analysis from parties other than the banks themselves, such as the RBA Board Meeting minutes and comments from politicians, media commentators and academics.[33]

The ACCC's response

8.29 The ACCC took issue with what it saw as some of the more 'outrageous' comments that legislation to prohibit price signalling would stop the banks from making any public comment. Mr Samuel emphasised the distinction between forecasting by individual banks of what they intend to do with their interest rates on the one hand, and discussing interest rates and economic conditions in general terms on the other.[34] He drew the Committee's attention to the following three scenarios:

> One is an after-the event commentary and discussion as to why it is that bank A has moved its interest rates. We have done so because there are prospectuses et cetera and therefore we have had to move our interest rates in accordance with what has just been announced. That is perfectly legitimate. The second is to discuss beforehand where, generally, economic conditions may be, how bank economists and even bank CEOs say, ‘Look, we think that economic conditions are such that we think that the cash rate might move in certain directions.’ That again would appear to be perfectly

31 Mr Mike Smith, ANZ Bank, *Committee Hansard*, 15 December 2010, p 131.

32 Mr David Foster, *Committee Hansard*, 9 February 2011, p 2.

33 Australian Bankers' Association, *Submission 76*, p 41.

34 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p. 41.

> legitimate. Where we get into some difficulties is when a bank CEO or others within the bank say, 'We are not sure what the Reserve Bank will do next week, but we are saying now, ahead of time, "If the Reserve Bank moves by 25 basis points, it is almost certain we are going to move beyond that.'"[35]

8.30 The Committee finds these distinctions very useful. They have not been recognised in the recent commentary expressing concern that signalling prohibitions may muzzle the banks from making any public comment on funding and interest rates. The precise form of the legislation and the courts' subsequent interpretation of the provisions are another matter (see below). Nonetheless, the ACCC's comments on the issue have been important to highlight the nature of comments that, in its opinion, should fall foul of the law.

Can price signalling be pro-competitive?

8.31 There has also been some comment that signalling can have a pro-competitive effect. Professor Michael Jacobs and Mr Bill Reid recently presented a scenario involving four banks.[36] Bank A publicises that it will increase its interest rate for mortgage loans by 50 basis points. Bank B learns of this but makes an announcement that it has no intention of raising its rates. Banks C and D subsequently announce that they will also keep their rates unchanged. Finally, Bank A announces that it has changed its mind about the contemplated increases and will also keep its rates on hold.

8.32 Professor Jacobs and Mr Reid make the following points in defence of the banks' conduct in this case:

- the signalling of price intentions was required by Bank A to inform customers of rate changes 'per its prevailing standard form loan agreements';
- the signalling by Banks B, C and D may have been intended to win customers from Bank A—a 'legitimate and desirable outcome';
- the signalling exposed disagreement among the banks, suggesting that each was acting independently of the others; and
- when the signalling ended, the banks' rates remained at the pre-signalling level—had Banks B, C and D remained silent, they could have increased their rates under the cover of Bank A's initial announcement.

8.33 This hypothetical example assumes Bank A is contractually obliged to inform customers of rate increases it is contemplating but then does not actually do, which would be rather unusual. And if Bank B had instead responded to Bank A's signal by saying it too would increase interest rates by 50 basis points, then Banks C and D may well have jumped on the bandwagon and customers would have been worse off. Contrast to the case where price signalling is not allowed. Bank A would then be more

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35 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p. 41.

36 *Australian Financial Review*, 'Price-signalling laws fraught with danger', 1 March 2011.

reluctant to announce an increase in its rate. If Banks B, C and D did not follow, it would lose customers and likely be forced to lower its rate back down.

8.34 Mr Cassidy was asked whether price signalling could be competitive if a bank signalled an increase in its interest rates by less than what it anticipated the Reserve Bank's was going to move. Mr Cassidy responded:

> That can be just as deleterious to consumers. It may be in a context where several of the banks are worrying about market shares and contemplating not increasing their interest rates by as much as the Reserve Bank. Again that could be an attempt by that particular bank to, if you like, limit the extent to which their competitors hold their rates down. So it can work on the down that way just as much as on the up.[37]

The current law: a contract, arrangement or understanding

8.35 Section 45(2) of the *Competition and Consumer Act* (formerly the *Trade Practices Act 1974*) states that a corporation shall not make a contract or arrangement, or arrive at an understanding if it has the purpose, or would have or be likely to have the effect, of substantially lessening competition. The starting point for the ACCC in prosecuting a case under this section is to show that a contract, arrangement or understanding has been entered into. However, in the past six years, there have been two significant decisions of the Full Federal Court that have, at least in the ACCC's view, raised the required proof that an 'understanding' has been made.

The Apco case

8.36 The 2005 Ballarat petrol case *Apco Service Stations Pty Ltd v ACCC*[38] was significant in defining an 'understanding' for purposes of section 45(2) of the *Trade Practices Act*. The ACCC's case relied heavily on circumstantial evidence involving records of telephone conversations between the parties, and correlations between these calls and the timing of petrol price rises. The ACCC instituted proceedings against sixteen respondents—eight corporations and eight individuals—for price fixing conduct in the Ballarat retail petrol market over an eighteen month period from June 1999 to December 2000. Of these, four corporations and five individuals either admitted or did not contest the ACCC's claims and proceeded to penalty hearings before the Federal Court. The remaining four corporation-34s and three individuals proceeded to trial before Justice Merkel.[39]

8.37 Justice Merkel found there was no expectation by the initiating respondents that Apco's readiness to receive calls meant it would match price increases advised by

37 Mr Brian Cassidy, *Committee Hansard*, 25 January 2011, p 53.

38 [2005] FCAFC 161.

39 Marshall (2008, p 2).

the initiating respondents.[40] The Full Court said there was no more than a hope or factual expectation that Apco would act in a particular way, and that fell short of an understanding.[41] The Full Court thereby ruled that a commitment by a party to a particular course of action or inaction is necessary to establish an 'understanding' within the meaning of section 45(2) of the *Trade Practices Act*. The ACCC's case failed because it did not prove the requisite commitment.[42]

8.38 The ACCC sought special leave to appeal the Full Court decision to the High Court, however this application was dismissed.[43]

Geelong petrol case

8.39 In *ACCC v Leahy Petroleum Pty Ltd & Ors*,[44] Justice Gray found that alleged price fixing arrangements arising out of disclosures of information between petrol retailers in the Geelong area did not constitute an 'understanding'. He noted that parallel conduct, even where conscious, lay outside the scope of an understanding.[45]

8.40 The ACCC told the Committee that in the Geelong petrol case:

> ...a group of petrol companies and petrol retailers in the Geelong region were passing on to one another their pricing intentions. They were not innocent discussions talking about the footy and the weather and saying, ‘Oh, by the way, I’m increasing my price to $1.45 a litre this afternoon,’ because they were using code in these discussions. Admittedly the discussions then looked a bit odd but nonetheless they were using code in the discussions...and yet the court ruled. We took legal advice on whether we had grounds to appeal, and the legal advice we had was that we had no grounds to appeal following the Apco decision; the court ruled that that behaviour was not unlawful.[46]

Is the current law adequate to prohibit price signalling?

8.41 The Committee received some evidence that section 45(2) of the *Competition and Consumer Act* is adequate to deal with anti-competitive signalling. The legal firm Mallesons Stephen Jaques told the Committee that in their opinion, the current wording of the Act is sufficient for the ACCC to prosecute one or more competitors

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40 ACCC (2007, p 228).

41 ACCC (2007, p 228).

42 Beaton-Wells and Fisse (2010, p 75).

43 Australian Competition and Consumer Commission, "High Court dismisses ACCC – APCO special leave application", *Media release*, MR 112/06, 5 June 2006.

44 [2007] FCA 794.

45 Law Council of Australia, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011.

46 Mr Brian Cassidy, *Committee Hansard*, 25 January 2011, pp 33-34.

for exchanging information about a future price. What needs to be proven, they argue, is that:

(i) one or more competitors was attempting to arrive at an understanding that had the purpose or likely effect of fixing, controlling or maintaining a price or a component of a price; or

(ii) or one or more of the competitors was attempting to arrive at an understanding to exchange information about future prices and the understanding had the purpose, or would be likely to have the effect of substantially lessening competition in a market; or

(iii) two or more competitors had arrived at an understanding to exchange pricing information, and the understanding to exchange the pricing information had the purpose or would have likely effect of substantially lessening competition in a market; or

(iv) two or more competitors had arrived at an understanding that had the purpose or likely effect of fixing, controlling or maintaining a price or a component of a price.[47]

8.42 Mallesons' submission notes that in the first two of the above cases (i and ii), the current 'law of attempts' requires both an intention to signal a price and an express or implied suggestion that the recipient of the information might act on the information that has been signalled. In the last two cases—an understanding to exchange information (iii and iv)—the submission notes that under current law, 'a mere expectation on the part of the party who signals the price is not enough to establish a commitment to act'.[48]

8.43 The ACCC disagreed with Mallesons' analysis, arguing that there is conduct that goes beyond the four scenarios which should be capable of being subject to the law. Their Chairman elaborated:

> The problem is the requirement of a commitment as summarised in Apco and as affirmed by the High Court. Let me take the example of a group of competitors sitting around a table when one of them says, ‘You know it would be really useful if we were to let each other know what we’re doing in our prices,’ and the others say, ‘Yes, that would be a useful exercise,’ but that is as far as they go. That does not amount to a commitment. Indeed it may be that in those circumstances they go away and they do exchange prices as a matter of process but on the few occasions they just do not cooperate; they do not do it. That, if you like, creates the perception that there was in effect no commitment but there is a wink and a nod. That is not a commitment that is sufficient to be covered by the current law.[49]

47 Mallesons Stephen Jaques, *Submission 60*, p 6.

48 Mallesons Stephen Jaques, *Submission 60*, p 6.

49 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 33.

8.44 In relation to the Apco case, Mallesons' submission queried whether the finding demonstrates a current gap in the law, 'or whether the judgment was due to the way the ACCC pleaded its case'.[50] Ms Sharon Henrick, a partner and convenor of the Competition Law Group at Mallesons, told the Committee:

> Without wishing to criticise the Commission for the way it pleaded the Apco case, we considered that if the Commission had pleaded that case differently it would have been able to succeed against Apco and Apco’s managing director who received the information about future prices. In particular, we believe that if the Commission had pleaded an understanding to exchange information or to give and receive information with an anticompetitive purpose or with an anticompetitive effect—so either of those things—it should have won the case against Apco and Apco’s managing director.[51]

8.45 In evidence to the Committee, Mr Brent Fisse argued that in his view, and that of Ms Henrick, not enough work has been done to examine the reasons that the ACCC enforcement actions in cases such as Apco and Leahy did not succeed. He queried whether or not the evidence that was put forward by the ACCC was done so in a way that corresponded adequately to the relevant theory of the case.[52]

8.46 Unsurprisingly, the ACCC disagreed. Mr Samuel told the Committee that as a result of the Apco case, a finding of price signalling in contravention with the current law would only be in a case:

> ...where Banker A and Banker B agree that they will not only exchange information but that they will also say to each other, ‘I’m lifting mine by 45 basis points next week, will you do the same?’ and the other says, ‘Yes, I’ll do the same.’[53]

The ACCC's 2007 proposed amendment

8.47 The ACCC has argued since these rulings that the requirement to prove a commitment makes it difficult to show there is a contract, arrangement or understanding within the meaning of the cartel provisions of the *Trade Practices Act*. It noted that some of its investigations into alleged cartel conduct could not be taken further where the parties have denied a commitment, notwithstanding their acknowledgement to have met and exchanged information on prices.[54] In its 2007 report on petrol prices, the ACCC expressed concern that these findings:

> ...disclose a subtle but significant shift in the nature of the commitment that must be found to establish the existence of an understanding. Earlier

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50 Mallesons Stephen Jaques, *Submission 60*, p 6.

51 Ms Sharon Henrick, *Committee Hansard*, 25 January 2011, p 91.

52 Mr Brent Fisse, *Committee Hansard*, 25 January 2011, p 93.

53 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 43.

54 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 27.

> decisions of the Federal Court interpreted the term to include an expectation regarding future conduct consciously or intentionally engendered in one person by the words or conduct of another person. However, the more recent decisions suggest that an understanding will not be regarded as having been reached in those circumstances; rather, there is a need for at least one of the parties to give or accept a commitment, obligation, undertaking or assurance that they will act in a certain way.[55]

8.48 In the petrol prices report, the ACCC proposed an amendment to section 45 of the *Trade Practices Act* to clarify the meaning of the term 'understanding'. It sets out a number of factual matters the court may take into account in determining whether an understanding has been arrived at and specifically provides that it is not a necessary element of an understanding that the parties to the understanding be committed to giving effect to it.[56]

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55 ACCC (2007, p 228).

56 ACCC (2007, p 230). Specifically, the ACCC's proposed amendment stated:

(a) The court may determine that a corporation has arrived at an understanding notwithstanding that:

> (i) the understanding is ascertainable only by inference from any factual matters the court considers appropriate
>
> (ii) the corporation, or any other parties to the alleged understanding, are not committed to giving effect to the understanding.

(b) The factual matters the court may consider in determining whether a corporation has arrived at an understanding include but are not limited to:

> (i) the conduct of the corporation or of any other person, including other parties to the alleged understanding
>
> (ii) the extent to which one party intentionally aroused in other parties an expectation that the first party would act in a particular way in relation to the subject of the alleged understanding
>
> (iii) the extent to which the corporation was acting in concert with others in relation to the subject matter of the alleged understanding
>
> (iv) any dealings between the corporation and any other parties to the alleged understanding before the time at which the understanding is alleged to have been arrived at
>
> (v) the provision by the corporation to a competitor, or the receipt by the corporation from a competitor, of information concerning the price at which or conditions on which, goods or services are supplied or acquired, or are to be supplied or acquired, by any of the parties to the alleged understanding or by any bodies corporate that are related to any of them, in competition with each other
>
> (vi) whether the information referred to in (v) above is also provided to the market generally at the same time
>
> (vii) the characteristics of the market
>
> (viii) the likelihood of the information referred to in (v) above being useful to the recipient of the information for any purpose other than fixing or maintaining prices;
>
> (ix) the extent to which, if at all, the communication referred to in (v) above was secret or intended by the parties to the communication to be secret.

Treasury's discussion paper

8.49 In January 2009, Treasury released a discussion paper and called for submissions on the meaning of 'understanding' in section 45 of the *Trade Practices Act*. The discussion paper asked, among other matters, whether the current judicial approach to the interpretation of 'understanding' limits the ability of the *Trade Practices Act* to address properly anticompetitive practices and if so, whether there is a need to clarify or define the meaning of 'understanding'.[57]

8.50 A submission of particular note to the Treasury inquiry was made by Dr Caron Beaton-Wells and Mr Brent Fisse. Their submission argued that case law has failed to provide a clear conceptual definition of the conduct that should be caught by the requirement of a 'contract, arrangement or understanding' under section 45 of the *Trade Practices Act*. It also noted that economic theory provides guidance on where the line should be drawn conceptually between legal and illegal coordination between competitors. The submission claimed that in interpreting the word 'understanding' in section 45 of the *Trade Practices Act* consideration should be given to the approach in the United States and the European Community, particularly the concept of 'concerted practice' under EC law.[58]

A 'concerted' practice'

8.51 A 'concerted practice' is harmful to competition because it enables competitors to determine a coordinated course of action…and to ensure its success by eliminating any uncertainty as to its competitors' conduct.[59] It is not a recognised concept in Australian competition law.

8.52 Dr Beaton-Wells and Mr Fisse's submission to Treasury's inquiry noted that under Article 81(1) of the European Community Treaty, there is a distinction between 'concerted practices' and an 'agreement'. The aim of this provision is to prevent firms from evading the application of the law by colluding in a manner that falls short of an agreement.[60] The submission observed that in general, the standard required to establish a 'concerted practice' is much less demanding than that required to establish

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57 Department of the Treasury, *Discussion Paper: The meaning of 'understanding' in the Trade Practices Act 1974*, http://www.treasury.gov.au/contentitem.asp?NavId=014&ContentID=1459 (accessed 25 February 2011).

58 Dr Caron Beaton-Wells and Mr Brent Fisse, *Submission*, Treasury inquiry into the meaning of 'understanding' in the Trade Practices Act, April 2009 http://www.treasury.gov.au/documents/1511/PDF/Beaton-Wells_and_Fisse.pdf (accessed 25 February 2011).

59 Imperial Chemical Industries Ltd v Commission [1972] ECR 619, [118].

60 Dr Caron Beaton-Wells and Mr Brent Fisse, *Submission*, Treasury inquiry into the meaning of 'understanding' in the Trade Practices Act, April 2009, p 12 http://www.treasury.gov.au/documents/1511/PDF/Beaton-Wells_and_Fisse.pdf (accessed 25 February 2011).

an 'agreement'. A 'concerted practice' does not require any element of commitment'. Rather, what needs to be shown is:

(a) some form of contact between competitors (which may be indirect or weak as, for example, contact via a publicly announced price increase);

(b) a meeting of minds or consensus in relation to cooperation which may be inferred from mere receipt of information; and

(c) a relationship of cause and effect between the concertation and the subsequent market conduct.[61]

8.53 Dr Beaton-Wells and Mr Fisse emphasise that the EC law concept of 'concerted practice' is intended specifically to catch tacit collusion or facilitating practices. Significantly, they contend that it is likely that the EC concept of a 'concerted practice' would catch the behaviour alleged to constitute an 'understanding' in the Apco and Leahy cases. Specifically, they note that in these cases:

> ...there would be no need to establish commitment on the part of the respondents to increase prices in accordance with the signals provided. Nor would it be necessary to show that there was a reciprocal or two way exchange of information – the concept of ‘concerted practice’ covers the situation where one party is active in disclosing information and another is passive in receiving or accepting it. Thus, for the purposes of finding those respondents who conveyed the information about changes in petrol prices liable, it would be sufficient to show that they did so with the purpose of influencing their competitors to follow the signalled price rise (even if in some cases, they failed to achieve the desired effect). For the purposes of finding the recipients of the information liable, it would be sufficient to show that their conduct was influenced even if merely by aiding their decisions as to whether or not to follow the signalled price.[62]

8.54 Treasury has not as yet responded to the submissions to its discussion paper. Some have argued that it should do so before proceeding with legislation to address price signalling.[63] In their submission to the Government's Exposure Draft, Dr Rhonda Smith, Mr Arlen Duke and Professor David Round argue that the government should not rush to introduce price signalling laws before considering other options such as those raised by the discussion paper. They also maintain that the proposals to lower the bar to prove an 'understanding' and the proposal to introduce price signalling laws should be introduced together.[64]

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61 Dr Caron Beaton-Wells and Mr Brent Fisse, *Submission*, Treasury inquiry into the meaning of 'understanding' in the *Trade Practices Act*, April 2009, p 12 http://www.treasury.gov.au/documents/1511/PDF/Beaton-Wells_and_Fisse.pdf (accessed 25 February 2011).

62 Dr Caron Beaton-Wells and Mr Brent Fisse, *Submission*, Treasury inquiry into the meaning of 'understanding' in the *Trade Practices Act*, April 2009, pp 13-14.

63 See Mr Brent Fisse, *Submission 67*, p 3.

64 See also Smith, Duke and Round (2009, pp 22-42).

The ACCC's current view on price signalling prohibitions

8.55 The ACCC told the Committee that signalling may involve no underlying contract, arrangement or understanding but can, nonetheless, have exactly the same outcome as the more traditional cartel type behaviour.[65] It thereby argued that in terms of addressing signalling, clarifying the meaning of the word 'understanding' in section 45 is not the key. As Mr Cassidy explained to the Committee:

> ...there is a class of conduct—a not insignificant class of conduct—that we simply cannot get to with the law as it currently stands but which is unlawful in other jurisdictions.[66]

8.56 In terms of addressing signalling, the ACCC appears to have shifted its focus from a clearer definition of 'understanding' in the context of section 45(2) of the *Competition and Consumer Act* to an EC-style provision on concerted practices. Mr Samuel noted in his evidence that the ACCC had 'had another look' at the issue of signalling and considered the concerted practices approach recommended by Dr Beaton-Wells and Mr Fisse.[67] In this context, Mr Cassidy contrasted Australian provisions with those currently operating in the EC and the UK:

> We particularly look at the EC and the UK, where there is a solution, we believe, and the solution has been in existence ever since the EC was formed. It is in the original article 81 of the treaty which formed the EC. The sky has not fallen in in the EC or the UK because of this particular piece of law. Nonetheless, it is operative. We have very recent cases that we can go to which...are unlawful in the UK and unlawful in the EC but would not be unlawful here. We believe there is a way of...getting at this sort of behaviour, this sort of conduct, without affecting legitimate market conduct. It is an area where you need to be careful, admittedly, because there are some fine lines between what you might call questionable conduct and quite legitimate conduct, but nonetheless we believe it can be done.[68]

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65 Mr Brian Cassidy, *Committee Hansard*, 25 January 2011, p 29.

66 Mr Brian Cassidy, *Committee Hansard*, 25 January 2011, p 28.

67 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 28. This shift was earlier acknowledged by ACCC Commissioner Dr Jill Walker in a speech to the Law Council of Australia's annual Trade Practices Workshop in August 2010; http://www.accc.gov.au/content/item.phtml?itemId=944183&nodeId=3a77a169d2335c5403d1052290e9407e&fn=20100821_Walker_Law%20Council%20AgreementsFacPracFinal.pdf (accessed 27 March 2011).

68 Mr Brian Cassidy, *Committee Hansard*, 25 January 2011, p 30. Mr Cassidy also told the Committee of a recent UK case involving the Royal Bank of Scotland and Barclays. The Royal Bank of Scotland was found to have passed on specific price information to Barclays and—even in the absence of an underlying agreement—was fined £328.5 million.

The proposals for reform

8.57 As noted earlier, both the Opposition and the Government have proposed legislative reforms to address price signalling. In November 2010, the Opposition competition spokesman, the Hon. Bruce Billson MP, introduced the Competition and Consumer (Price Signalling) Amendment Bill 2010 to make anti-competitive price signalling unlawful. On 12 December 2010, the Government published the Competition and Consumer Amendment Bill (No. 1) 2011 as an Exposure Draft for comment by 14 January 2011. This section looks at these proposals and some of the commentary on their merits and shortcomings.

The Government's Exposure Draft Bill

8.58 The Government's Exposure Draft Bill contains two strict liability (or 'per se') prohibitions. It contains a proposed prohibition on making a private disclosure of pricing information (which includes pricing information in the public domain) to an actual or potential competitor.[69] In terms of public disclosure and/or disclosure of information beyond pricing, the bill prohibits disclosing information about prices, capacity or strategy for the purpose of substantially lessening competition (SLC).[70]

8.59 This second prohibition, the SLC prohibition[71], clarifies that a corporation's purpose may be inferred from surrounding circumstances. The Court may have regard to a non-exhaustive list of factors for the purposes of determining whether a corporation had the requisite purpose of SLC when making a disclosure. These factors are: whether the disclosure was a private disclosure to competitors; the degree of specificity of the information; whether the information relates to past, current or future activities; how readily available the information is to the public; and whether the disclosure is part of a pattern of similar disclosures by the corporation.

8.60 The Explanatory Note accompanying the Exposure Draft bill described private disclosure of pricing information as 'most readily distinguishable from benign or pro-competitive forms of conduct'. It noted that it is difficult to ascertain a rationale for disclosing pricing information to competitors in a private manner, other than to seek to facilitate prices above a competitive level. The Government also argues that this prohibition will eliminate a key element of the communications required for setting up, monitoring and sustaining cartel behaviour.[72]

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69 Proposed section 44ZZW.

70 Proposed section 44ZZX.

71 Some have referred to this prohibition as 'the signalling prohibition'. See Law Council of Australia, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011.

72 Department of the Treasury, Competition and Consumer Amendment Bill (No. 1) 2010, *Explanatory Note*, http://www.treasury.gov.au/documents/1918/PDF/Explanatory_Material_CCAB.pdf (accessed 10 March 2010).

8.61 The SLC prohibition captures a range of disclosures beyond those relating to pricing information and recognises the possibility that anti-competitive pricing and information disclosures can be made in public. The Government has justified the prohibition on the basis that the disclosure of a broader range of strategic business information can lead to anti-competitive outcomes. It justifies the 'purpose test' on the basis that it will 'limit the possibility of capturing pro-competitive information disclosures'.[73] The Government has stated that:

> The Government has received independent legal advice that considers it would not be appropriate to ban the communication of pricing intentions that have the effect or likely effect of substantially lessening competition, as opposed to the purpose. Such a prohibition would create substantial uncertainty, because market participants could not know in advance how their competitors will react to their public statements, and therefore what the effect or likely effect would be.[74]

Proposed amendments to the Exposure Draft Bill

8.62 In March 2011, Treasury told the Committee that the Government was considering introducing an authorisation and notification regime to accompany the Exposure Draft Bill's prohibitions. Banks will not be subject to the prohibitions when they join together to lend money to large businesses and during corporate workouts when companies are unable to repay debts. A notification regime is proposed to allow banks to seek approval from the ACCC to share their pricing with their competitors if they believe there is a net public benefit in the information being exchanged (see paragraph 8.80).[75]

Criticism of the government's bill—the per se prohibitions

8.63 The central criticism of the Government's draft bill is that it risks prohibiting legitimate commercial activity. Various critiques of the bill refer to the potential for 'overreach' and 'unintended consequences' from the per se prohibitions. As Mr Fisse told the Committee:

> There is no requirement of proof of an agreement or an understanding—there is no requirement of proof of collusion, in other words—and that is the fundamental tack that has been taken in the exposure draft provisions. That approach, in our view, is fundamentally mistaken, because once one moves away from a requirement of collusion, deliberate coordination or, under the current law, contract arrangement or understanding, and focuses merely on information disclosure, it is inevitable that the prohibitions are going to suffer from extreme reach—in our view, unjustified overreach.[76]

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73 Department of the Treasury, Competition and Consumer Amendment Bill (No. 1) 2010, *Explanatory Note*, p 4.

74 Australian Government, *Competitive and sustainable banking system*, 2010, p 11.

75 Mr Jim Murphy, Treasury, *Proof Committee Hansard*, 9 March 2011, p 7.

76 Mr Brent Fisse, *Committee Hansard*, 25 January 2011, p 93.

8.64 In their submission to the Treasury inquiry, Dr Beaton-Wells and Mr Fisse describe the prohibitions in the Exposure Draft as 'novel' and note that they depart 'radically' from the law in other jurisdictions. They criticise the narrowness of the bill, arguing that prohibiting a specific form of conduct (price signalling) in a specific sector (banking) runs the risk that courts will not focus on the legislative intent of the provision.[77] In their view, both the per se prohibitions require clarification. The private disclosure prohibition must include distinctions on whether the information relates to past, current or future behaviour, whether it is confidential, whether it involves commitment, whether it is verifiable and whether it involves aggregated or disaggregated data. The SLC prohibition should focus on whether or not a competitor is acting strategically to coordinate market conduct with a competitor.[78]

8.65 The Law Council of Australia has argued that the private disclosure prohibition requires significant amendments to avoid unintended consequences. It recommended prohibiting disclosures that are made to competitors for the 'purpose of, or with the effect or likely effect of, substantially lessening competition'. It also it emphasised the need for a defence of legitimate business justification.[79]

8.66 Ms Henrick of Mallesons Stephen Jaques also warned the Committee of the unintended consequences of the Government's legislation. She argued that the proposed legislation would pose 'significant and unnecessary' risks for the way alliances and consortiums operate given they exchange information about prices. Further, vertically integrated businesses supplying goods or services to their competitors routinely need to discuss prices, but they are not protected by the bill's proposed exemptions. Ms Henrick also noted that the Government's bill would pose unnecessary risks for many information vendors, such as firms that provide estimates of market shares.[80]

8.67 Another criticism of the Government's proposed legislation is that the SLC test is too difficult to satisfy. Mr Fisse argued that there are practical concerns with the SLC test. Apart from being 'notoriously vague', he emphasised that the test would require proof of a direct link between the signalling and the effect on the market. In the case of a bank announcing a future mortgage rate increase, the SLC test would not be passed if it is likely that the information about the future price would have become known to the market in other ways. He also noted that the 'purpose' test of the

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77 Dr Caron-Beaton-Wells and Mr Brent Fisse, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011, p 2.

78 Mr Brent Fisse and Dr Caron-Beaton-Wells, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011, p 4.

79 Law Council of Australia, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011, p 2.

80 Ms Sharon Henrick, *Committee Hansard*, 25 January 2011, p 92.

prohibition can be avoided by the defendant drawing a distinction between the purpose of the disclosure and the purpose of the conduct to which it related.[81]

8.68 Dr Smith, Mr Duke and Professor Round have also criticised the per se prohibitions in the Draft Exposure Bill. In their submission to Treasury, they recommend that the bill be amended to accompany the prohibitions with an anti-competitive effects test through a requirement that the conduct has the effect or likely effect of substantially lessening competition. They note that as signalling conduct can have both positive and negative effects on competition, it is important that the effect of competition is recognised to guard against overreach.[82]

8.69 The academics also insist that an authorisation is not an adequate check on per se prohibitions. Not only do authorisations take time, but they are:

> ...not intended to permit policy makers to adopt overly broad laws knowing that a party who is inappropriately caught by such a law is able to escape the imposition of unreasonably [sic] penalties by lodging a costly authorisation application with the ACCC.[83]

8.70 The Law Council of Australia has also argued that reliance on an authorisation process is inappropriate to ensure that legitimate information disclosures do not breach the prohibitions.[84] It also cited the cost and time associated with the process.

8.71 The Committee received some comment that the legislation should be applied to all sectors of the economy, not just the banking sector. The ACCC, notably, told the Committee that:

> The general principle of the *Trade Practices Act*...is that it should apply with very rare exceptions, such as telecommunications, across all sectors of industry and commerce. We consider that this is an issue that will affect a variety of sectors in industry and commerce in Australia and ought to apply across the board.[85]

8.72 While the ACCC's preference is for economy-wide legislation on signalling, given the proposed legislation focuses on the banking sector, it supports expansion to other sectors through regulation:

> ...we would think it should apply more broadly, but equally if there is going to be some sort of phased mechanism for coverage we think a process of

81 Mr Brent Fisse and Dr Caron-Beaton-Wells, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011, p 5.

82 Dr Rhonda Smith, Mr Arlen Duke and Professor David Round, *Submission to Treasury*, p 2.

83 Dr Rhonda Smith, Mr Arlen Duke and Professor David Round, *Submission to Treasury*, p 8.

84 Law Council of Australia, *Submission to Treasury*, Competition and Consumer Amendment Bill (No. 1) 2011 (Exposure draft), January 2011.

85 Mr Graeme Samuel, *Committee Hansard*, 25 January 2011, p 31.

> regulation going through both houses of parliament is a preferable approach because it does give us clarity as to exactly what the law is and who it applies to at a particular point in time.[86]

8.73 A further criticism of the Government's Draft Bill is that it will be easily circumvented. Mr Fisse argued in his submission to this inquiry that the narrow focus of the bill creates opportunities for companies to sidestep the provisions. The prohibition against public notification by a competitor of a future price increase (the SLC prohibition) could be avoided by notifying customers privately and leaving it to the media to report the information. Moreover, the focus on price signalling may force companies to examine other facilitating practices such as price matching or use of non-price terms and conditions.[87]

8.74 Before being appointed an ACCC Commissioner, Dr Jill Walker wrote that the problem with making the private exchange of pricing information a per se prohibition is that it:

> ...seems likely to simply result in the modification of conduct to publicise the price exchanges, thereby lifting the conduct out of the per se category, because it would be too difficult to draw a bright line between those public actions which should be condemned per se and those which should not.[88]

Committee view

8.75 The Committee strongly supports these critiques. It believes that the per se prohibitions in the Government's Exposure Draft Bill run the risk that legitimate communication of pricing information that is not anti-competitive in its intent or its effect will be captured. The Committee argues that it is better for a bank engaging in anti-competitive price signalling to go undetected than it is for a bank conducting legitimate communications to be inappropriately penalised. In this vein, the Committee also contends that the government's over-reliance on the proposed new ACCC notification regime as a solution to the problems in the bill is likely to be cumbersome and restrictive for the banks, as well as a burden on the ACCC. The far better alternative is to replace the prohibitions with a competition test that applies to both public and private communications.

The Government's bill

8.76 In March 2011, the government introduced into the House of Representatives its bill on price signalling. The EM accompanying the bill noted that many stakeholder concerns relating to the draft bill had been considered and addressed.[89] The main changes to the bill from the Exposure Draft are some new exceptions to the

86 Mr Brian Cassidy, *Committee Hansard*, 25 January 2011, p 31.

87 Mr Brent Fisse, *Submission 67*, p 2.

88 Dr Jill Walker, LECG, Memo dated 5 May 2009, p 9.

89 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, p. 67.

prohibitions as well as a notification process to enable parties to obtain immunity from the *per se* prohibition.

8.77 However, the bill does not abolish the per se prohibition as several stakeholders had recommended. The government bill retains (from the Exposure Draft) the SLC prohibition. The EM responded to stakeholder concerns that this prohibition should be limited to confidential and prospective pricing information by noting that disclosures will only be prohibited if a business has the requisite (substantial) purpose of substantially lessening competition in making the disclosure.[90]

8.78 The EM also recognised stakeholder concerns that the SLC prohibition does not contain the requirement that the conduct has 'the effect, or likely effect of substantially lessening competition'. It claimed that an effects test is 'unwarranted at this time'. It added: 'that the disclosure must be made for the purpose of SLC recognises that there may be legitimate and pro-competitive reasons to make such disclosures'.[91]

Defences

8.79 The EM to the government's bill states that a number of exceptions to the prohibitions will be made available. In terms of the *per se* prohibition, disclosures relating to pricing information regarding goods or services will be exempt if the information relates to goods or services supplied or likely to be supplied, acquired, or likely to be acquired by the corporation from the recipient. In terms of exceptions applying to both the prohibitions, the bill amends the Exposure Draft by adding three new exceptions:

- disclosures made for the purpose of complying with the continuous disclosure obligations within the *Corporations Act 2001*;
- disclosures made in the course of engaging in conduct that is covered by an authorisation; and
- disclosures made in relation to a collective bargaining notice, if the disclosure is made to one of the contracting parties.[92]

Notification

8.80 As flagged with the Committee (see paragraph 8.62), the Government's bill expands the existing notification process to allow parties to notify for conduct which falls under the *per se* prohibition. It will allow parties to obtain immunity through the lodgement of a notification of the conduct with the ACCC which has 14 days to assess the notice before immunity commences. The notification process will operate

90 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, p. 71.

91 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, p. 72.

92 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, p. 72.

alongside the authorisation process, which will enable business to obtain immunity from both prohibitions.[93]

Regulations

8.81 The EM clarifies that in the first instance, a regulation 'should be made to proscribe banks to the prohibitions'. There is capacity for the regulations to be made to apply to prohibitions to other sectors after further review.[94] The EM noted that the use of regulations to give effect to the sector specific application of the prohibitions gives greater flexibility in applying the prohibitions to other sectors in the future. All the regulations will be disallowable instruments and therefore subject to Parliamentary oversight.[95]

The Coalition's bill

8.82 In his Second Reading Speech on the Competition and Consumer (Price Signalling) Amendment Bill (No. 1) 2010, the Hon. Bruce Billson MP told Parliament that the bill addresses a gap in the current law. He added that this 'gap' has assumed 'particular salience' in light of the current vigorous debate about the state of competition in the banking sector and interest rate movements.[96]

8.83 Mr Billson explained that the bill's key elements—a purpose and effects test and the yardstick of 'substantially lessening competition'—are important to focus on the anticompetitive conduct. In terms of determining the purpose of the conduct, he noted that:

> The bill makes it possible for a court to infer purpose on the basis of the conduct. This is the ‘if it looks like, walks like, squawks like and hangs out with ducks, it is fair enough for the court to infer that it is a duck’ reasoning.[97]

8.84 In terms of the 'substantially lessening competition test', Mr Billson noted that it is a recognised threshold in the *Trade Practices Act* and was selected to ensure that the anticompetitive effects manifested in identical prices or parallel price movements are captured.[98]

8.85 The Coalition's bill differs from the government's proposed legislation in three key respects:

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93 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, pp 75-76.

94 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, p. 68.

95 Competition and Consumer Amendment Bill (No. 1) 2011, *Explanatory Memorandum*, p. 69.

96 Mr Bruce Billson, Second Reading Speech, *House of Representatives Hansard*, 22 November 2010, p 3118.

97 Mr Bruce Billson, *House of Representatives Hansard*, 22 November 2010, p 3118.

98 Mr Bruce Billson, *House of Representatives Hansard*, 22 November 2010, p 3118.

- first, whereas the Government's bill has a per se prohibition on private disclosures of pricing information to competitors, the Coalition's bill states that the illegality of these private disclosures is dependent on the purpose of the corporation in making the disclosure;
- second, the Government's bill also prohibits disclosure of information about prices, capacity or strategy for the purpose of substantially lessening competition. With no effects test, it would be possible to breach both the prohibitions even if the disclosure has no discernable effect on competition. The Coalition's bill has both a 'purpose' and 'effect' test: it prohibits communication of price related information to a competitor for the purpose of inducing or encouraging the competitor to vary a price, *and* which is likely to have the effect of substantially lessening competition in the market for the goods or services in question; and
- third, the prohibitions in the Government's bill relate to information about pricing, capacity and commercial strategy, whereas the Coalition's bill relates only to pricing.

8.86 The Coalition's bill therefore sets a higher threshold than the Government's proposed legislation. Not only does it not apply a per se prohibition on private disclosures, but the proof for an offence for a public disclosure is that it has both the purpose and the effect (or likely effect) of substantially lessening competition. This provision guards against the risk—distinct in the Government's bill—that signalling with a pro-competitive effect could be prosecuted.

Criticisms of the Coalition's bill

8.87 In evidence to the House of Representatives Standing Committee on Economics, the ACCC outlined its objections to the Coalition's legislation. Mr Cassidy told the Committee that three aspects of the legislation concerned the ACCC:

- first, the bill relates only to price signalling and not to quantity based offences such as market sharing or collusive tendering;
- second, the bill requires both purpose and effect to be shown, 'whereas the more normal competition provisions...are couched in terms of purpose and/or effect'. Mr Cassidy explained that the ACCC would normally proceed 'on one or the other' and the bill thereby establishes a fairly high burden of proof; and
- third, as per the Government's proposed legislation, some signalling conduct should be subject to a per se prohibition. Mr Cassidy argued that where competitors privately pass between themselves their future pricing intentions, a per se prohibition should apply.[99]

99 Mr Brian Cassidy, *House of Representatives Standing Committee on Economics Hansard*, 18 February 2011, p 11.

8.88 The Australian Bankers' Association (ABA) has cautioned that the Opposition's bill could have unintended consequences if it is not carefully considered. It noted that banks are required to communicate their funding costs and other price related issues as part of their liaison with the media, the parliament and their customers. Mr Steven Münchenberg, Chief Executive of the ABA, has argued that the banks need to comment in the public debate and any attempt to constrain this participation will mean that the media and other commentators will be unable to present a balanced view.

8.89 The ABA also criticised the Coalition's bill on the basis that it is out of step with the prohibitions in EU and US anti-trust laws. It argued in its submission to the House inquiry that the bill's prohibition on unilateral disclosures (rather than 'concerted' practices) with no requirement of concerted action or coordination with a competitor is 'unprecedented'.[100] Mr Münchenberg told the House Committee that it is 'a very, very low threshold' for an offence 'by just putting out a communication that others may or may not respond to'.[101]

8.90 The ABA disputed the Explanatory Memorandum's claim that 'the Bill will have no financial impact'. It claimed that this ignores 'significant costs' that may be incurred due to the ACCC's power to investigate through section 155 of the Competition and Consumer Act. Its submission noted that:

> ...given the breadth of the proposed prohibition, the ACCC’s investigation powers would be significantly broadened with the potential for legitimate disclosures by competitors to be misinterpreted and then investigated by the regulator on the basis of mere suspicions or allegations, notwithstanding that the communications were procompetitive, legitimate business practice.[102]

Committee view

8.91 On the basis of the proceeding discussion, the Committee makes the following observations. The first is to reiterate that legislating to prohibit anti-competitive price signalling is a difficult and complex matter. Fundamentally, however, it is important that any proposed legislation recognises that not all price signalling—whether publicly or privately communicated—will have an anti-competitive intent or effect. It is important that the banks do not feel constrained to speak publicly in general terms about the future direction of the market.

100 Australian Bankers' Association, *Submission 4*, House of Representatives Standing Committee on Economics, p 3.

101 Mr Stephen Münchenberg, *House of Representatives Standing Committee on Economics Hansard*, 18 February 2011, p 36.

102 Australian Bankers' Association, *Submission 4*, House of Representatives Standing Committee on Economics, p 4.

8.92 The second point is that the Committee believes that there is a need to address price signalling through an amendment to the *Competition and Consumer Act*. It agrees with the ACCC that the Act is currently inadequate to prohibit statements of the type made by ANZ CEO Mr Smith. This type of statement, which relays to the market the future pricing intentions of a company, should be addressed by the ACCC. The Committee agrees with the ACCC that the courts have ruled in Apco and Leahy that an 'understanding' for purposes of section 45(2) constitutes more than what is necessary to prosecute a case of 'price signalling'. Regardless of whether the ACCC might have been able to plead more effectively in the case, this is where the current understanding of the law stands.

8.93 Thirdly, and following from these points, the Committee believes that the Government's Draft Exposure Bill is poorly drafted and should not contain per se prohibitions. The Committee contends that a new provision addressing price signalling in the banking sector must contain a competition test in language that is familiar to the *Competition and Consumer Act*. Accordingly, the Committee recommends that the Government amend its proposed draft legislation to prohibit price signalling with 'the purpose, effect or likely effect of substantially lessening competition in the market'.

8.94 Fourth, the Committee requests that the Government release the independent legal advice it received that it would not be appropriate to ban the communication of pricing intentions that have the effect or likely effect of substantially lessening competition, as opposed to purpose. It queries why the provision could not be couched in terms familiar with the Act; namely, 'the purpose and/or effect or likely effect of substantially lessening competition'.

Recommendation 15

8.95 Subject to the release of the Government's independent legal advice, the Committee recommends that the *Competition and Consumer Act 2010* be amended to include a provision which states that a corporation engages in price signalling if it communicates future price-related information to a competitor, and the communication of that information has the purpose, or has or is likely to have the effect, of substantially lessening competition.

8.96 Finally, the Committee notes that the banks' understanding of price signalling, and the reason why it should be subject to a competition test, is quite limited. It is important that any legislation is accompanied by clear explanations providing examples of signalling that would be in breach of the law and assurances on the types of statements that remain legal.

Recommendation 16

8.97 The Committee recommends that an amendment to the *Competition and Consumer Act 2010* to introduce a price signalling provision should be accompanied by ACCC guidelines providing:

- **examples of the type of communication that would fall foul of this provision;**
- **examples of the type of communication that would not fall foul of this provision; and**
- **the protection offered by the exemptions.**

Chapter 9

Bank mergers and new competitors in the banking market

Merger policies generally

9.1 The Senate Economics Committees have examined mergers policy in a variety of contexts in recent years. They have generally concluded that the current regime is excessively permissive of mergers and has allowed undesirable concentrations of market power in a number of sectors. Some conclusions from those earlier reports are:

> The Committee believes concerns about the impact of 'creeping acquisitions' on competition are valid. It agrees that the current provisions of section 50 of the *Trade Practices Act* are insufficient to address the problem adequately.[1]
>
> The Committee recommends that the Government retain the 'four pillars' policy of not allowing a merger between any of the four major banks.[2]
>
> The Committee recommends that a moratorium be placed on approval of any further takeovers in the banking industry for one year, unless the bank being taken over is at imminent risk of failure.[3]
>
> The Committee reiterates its recommendation that the *Trade Practices Act* be amended to inhibit firms achieving market power through takeovers or abusing market power and that 'market power' be expressly defined so that it is less than market dominance and does not require a firm to have unfettered power to set prices. A specific market share, such as, for example, one third (set based on international practice), could be presumed to confer market power unless there is strong evidence to the contrary.[4]

ACCC approval of mergers

9.2 Section 50 of the *Competition and Consumer Act 2010* (formerly the *Trade Practices Act 1974*) states that mergers which have the effect of 'substantially

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1 Standing Committee on Economics, *Trade Practices (Creeping Acquisitions) Amendment Bill 2007 [2008]*, August 2008, p 9.

2 Senate Economics References Committee, *Aspects of Bank Mergers*, September 2009, pp 15-16.

3 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

4 *Access of Small Business to Finance*, June 2010, p 56. A similar recommendation appears in Senate Economics References Committee, *Milking it for all it's worth – Competition and pricing in the Australian dairy industry*, May 2010, p 60.

lessening competition' are prohibited unless the Australian Competition Tribunal authorises them on the grounds that they give rise to a public benefit. The ACCC's position is that a lessening of competition is substantial if it creates or confers an increase in market power on the merged firm and/or other firms in the relevant market that is significant and sustainable.[5]

Reviews of mergers

9.3 A review of previous merger decisions may lead to improved outcomes. At a hearing, an academic expert on competition, Professor King, saw considerable merit in this suggestion:

> …one of the things that would be desirable is an ex post review of mergers more generally in Australia…That sort of exercise would allow us to, in a sense, check that our laws are appropriate. We have a particular set of tests in Australia relating to a substantial lessening of competition in a market. Is that the appropriate test? The best way of working that out is to look at the decisions that have been made.[6]

9.4 Reflecting later, he added:

> This type of retrospective study represents best regulatory practice. The U.S. antitrust authorities have carried out this type of study….The benefits of such a study are clear. It allows feedback to both the regulators and the legislature about our competition laws and their implementation. If the federal government made the resources available to do this exercise (and required relevant businesses to provide relevant data, such as retail scan data) then this would be a good outcome.[7]

Mergers among banks

9.5 As noted in Chapter 2, and illustrated by the 'family tree' diagrams there, the current market situation is the result of a large number of bank mergers in Australia. The Chairman of the Australian Prudential Regulatory Authority (APRA), Dr Laker told the Committee:

> There certainly has been a narrowing in the number of authorised deposit-taking institutions in Australia over the course of the last 20 years. That consolidation has mainly taken place at the smaller end of the market through the merger and exit of credit unions; that has been a pronounced downward trend.[8]

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5 ACCC, Submission to Senate inquiry into Aspects of Bank Mergers, *Submission 4*, p 3.

6 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 109.

7 Professor Stephen King, 'Retrospective merger analysis', *Core Economics Blog*, 22 January 2011, http://economics.com.au/?p=6638 (accessed 27 March 2011).

8 Dr John Laker, *Committee Hansard*, 14 December 2010, pp 11–12.

9.6 The Committee found in its 2009 report into bank mergers that there are essentially four main views about the motivations for bank mergers:

- the first is that it is about improving the efficiency of banking by realising economies of scale and economies of scope or allowing banks to meet the borrowing needs of increasingly large corporations;
- the second is that it is motivated by increasing market power (and hence profits), which will be reflected in lower interest rates on deposits and/or higher interest rates on loans;
- the third motivation is that banks may seek to merge in order to reach a size at which they are 'too-big-to-(be-allowed-to)-fail'. There is evidence that ratings agencies and markets believe that large banks are more likely to be assisted in a crisis than small banks; and
- the final view is that mergers are largely ego-driven, with bank management seeking the greater prestige and salaries that come from running a larger organisation. (There are also defensive advantages in getting larger. It makes the bank less likely to become a takeover target itself, thereby protecting the CEO's position.)[9]

9.7 The Committee noted that it is only if the first reason is dominant that mergers may be in the public interest rather than just in the interests of the bankers.

9.8 The Finance Union of Australia argued the need for tighter merger regulations in the banking sector governed by a stricter public interest test.[10] In the case of the Westpac takeover of St George:

> We had very vigorous exchanges with the ACCC around that, particularly the St George merger. We made it crystal clear to everybody we spoke to and particularly the ACCC that if they green-lit that merger they would essentially end competition against the big four... We had a fifth pillar; it was called St George, and Westpac were allowed to purchase it. We think that the ACCC completely went missing at a time when they needed to stand up...A thousand people lost their jobs as a result of that merger, and there are probably 2,000 or 3,000 more people who are going to lose their jobs. With the fall of St George, we have lost the only genuine competitor to the big four...No-one has won out of that.[11]

9.9 Other witnesses shared this view that the takeover of St George represented a significant diminution of competition:

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9 Senate Economics References Committee, *Aspects of Bank Mergers*, September 2009, pp 15-16.

10 Mr Leon Carter, Secretary, Finance Union of Australia, *Committee Hansard*, 14 December 2010, p 44.

11 Mr Leon Carter, *Committee Hansard*, 14 December 2010, p 50.

> There is absolutely no doubt in my mind that the St George acquisition by Westpac was a huge mistake. It was the beginning of the end. It was the tipping point. St George was an intensive competitor, particularly in relation to small businesses.…the four big banks basically took out one significant threat to them overnight. [12]

9.10 Even mergers with a smaller national footprint can have a significant effect in the relevant state:

> Senator PRATT—…I am interested to know whether there was any perceivable difference in the small- to medium enterprise sector in Western Australia on banking competition when BankWest was taken over by the Commonwealth.
>
> Mr Canion—We were particularly disappointed by the outcome that that has delivered for the competitiveness of the sector. It has again reduced the options available to small business. There was a discernible effect, I would say, on the ability of businesses to get loans at a good price.[13]

9.11 The impact of merger activity is felt by a range of companies, including mortgage brokers. The Mortgage Finance Association told the Committee:

> The mergers that have taken place certainly have not been good from a mortgage broker point of view...The offer that the mortgage broker makes to the consumer is: 'Come to me. I can go through a whole range of different lenders and a whole range of products and find the most appropriate deal for you.' So the fewer lenders there are in the marketplace lessens the attraction of the broker and the pressure they can bring in terms of competitive forces in the industry.[14]

9.12 A number of submitters wanted the major banks to be prohibited from making further takeovers of smaller banks:

> …there should be rules governing takeovers of smaller competitive financial institutions, which the big banks continually do to get rid of their competition. There has been an increase in takeovers in recent times, and enables the big banks get even bigger…[15]
>
> …the Government should rule out any significant future merger and acquisition activity in the Australian retail banking system and the wider

12 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, pp 60-61.

13 Mr Andrew Canion, Manager, Western Australian Small Enterprise Network, *Committee Hansard*, 21 January 2011, pp 114-115.

14 Phillip Naylor, Chief Executive, Mortgage Finance Association of Australia, *Committee Hansard*, 14 December 2010, pp 75–76.

15 Mr Murray Withers, *Submission 99*, p 1.

> financial services sector which would consolidate the dominance of any one of the four major banks.[16]

Four pillars

9.13 For two decades, there has been bipartisan opposition to a merger between the four major banks. In 1990, the Treasurer the Hon. Paul Keating announced the 'six pillars' policy opposing any mergers between the four largest banks and two largest insurance companies.[17]

9.14 Some witnesses expressed concern that while the four pillars policy is what currently prevents mergers among the four major banks, it is only a policy and is not enshrined in any legislation.

> …if there were not a four-pillar policy, the four major banks would seek to merge with one another… My deep concern is that it is only a policy. It could at any point in time be changed at the whim of a particular government in power, the suggestion being that the particular government may justify the removal of a specific four-pillar policy by simply saying that there are competition laws that would prevent mergers between the four major banks. I have a lack of confidence in those competition laws…[18]

> If companies are run by people whose objective is to maximise the financial interest of their shareholders… it is inevitable that it would tend towards monopoly, because of the enormous economies of scale and the enormous profits that come from a combination of economies of scale and market power.[19]

9.15 The four pillars policy seems well supported, by both business and trade unions:

> The NSW Business Chamber supports the current four pillars policy, and is concerned about the potential for further mergers to reduce the number of second tier and regional banks. While acknowledging that some consolidation of the banking sector was necessary to stabilise balance sheets during the global financial crisis, further consolidation of market power within the major banks should not be allowed in the current environment.[20]

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16 Australian Chamber of Commerce and Industry, *Submission 37*, p iv. A similar view was expressed by the Chamber of Commerce and Industry Queensland: *Submission 43*, p 19.

17 Fear et al (2010, p 13).

18 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 58.

19 Dr Richard Denniss, Executive Director, Australia Institute, *Committee Hansard*, 15 December 2010, p 24.

20 NSW Business Chamber, *Submission 84*, p 11.

> …the Australian Government must continue to ban any merger between the big four banks. It is significant that the overwhelming majority of commentators, policy makers, academics and regulators now credit the maintenance of the 'four pillar' policy, at least in part, as having contributed to Australia's banking sector avoiding the worst ravages of the Global Financial Crisis.[21]

9.16 There are two means by which mergers between the four majors may be stopped. Section 50 of the *Competition and Consumer Act* prohibits any acquisition of shares or assets which is likely to have the effect of substantially lessening competition in the market. It would be a matter for the ACCC and courts to determine whether a merger between two of the four major banks would have such an effect.[22]

9.17 Secondly, there is the *Financial Sector (Shareholdings) Act 1998*, which requires the Treasurer's consent for any acquisition of shares in a financial institution beyond the order of 15 per cent. This Act allows governments to maintain the 'four pillars' policy.

9.18 Last year the Committee made the following observation:

> The Committee is concerned that takeovers of regional banks by major banks are not only reducing the number of competitors but are specifically removing those banks most interested in lending to small business. Given the evidence it has seen in other inquiries, most recently into the dairy industry, the Committee is concerned that the existing provisions of the *Trade Practices Act 1974* may be insufficient to prevent further undesirable takeovers in the banking industry. [23]

Divestiture

9.19 The issue of divesture has been raised as a possible option to strengthen competition in the banking sector. Certainly the natural tendency of the sector has been to consolidate, as the charts in Chapter 2 illustrate. One witness considered that this might be reversed:

> …an oligopoly might change its mind and embrace new entrants, as we have seen in other industries like the pharmaceutical industry. The fact of the matter is that new companies and new entrants bring the really new ideas and the really new business models. There can be a model in an

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21 Finance Sector Union, *Submission 80*, p 4.

22 The ACCC were understandably reluctant to express a view at the hearing; Mr Graeme Samuel, Chairman, ACCC, *Committee Hansard*, 25 January 2011, p 34.

23 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

> industry where the bigger institutions actually benefit from that instigation to innovation.[24]

9.20 The more common view is that direct action may be needed to force change on the oligopoly. Some witnesses called for the ACCC to be given greater powers to force divestiture, and pointed out it exists overseas:

> Where we see a major concentration in the market—for example, with particular superannuation and other investment platforms—we would think that the ACCC should be able to continually assess how the market is working where those levels of concentrations are and, where it is required, seek that there be divestiture by the parent body. [25]

9.21 Virgin Money Australia told the Committee that:

> Australia is a polarised market. The major banks have more than 80 per cent of the market share and the rest of the market is in the balance. I think that was reinforced during the global financial crisis with the acquisition of a number of challengers, including BankWest and St George. As a result of that it is more difficult for new entrants and regionals to acquire scale. One of the recommendations we have put forward is that it is worth considering requiring the major banks to divest some of those assets now that we are through the GFC. That is as simple as, 'Would those transactions have been approved in a stable economic environment?' The answer to that is no. Overall we think that is a measure that would shift the dial. It probably sounds extreme, but we think these are extreme times.[26]

9.22 Currently the ACCC has only a very limited divestiture power: within three years of a merger it can force a reversal if it can establish that it was deliberately misled when initially reviewing the merger.[27]

9.23 The Finance Sector Union of Australia has recommended that the ACCC be given divestiture powers. It told the Committee:

> Where we see a major concentration in the market—for example, with particular superannuation and other investment platforms—we would think that the ACCC should be able to continually assess how the market is

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24 Mr Jost Stollmann, Chief Executive Officer, Tyro Payments, *Committee Hansard*, 21 January 2011, p 38.

25 Mr Leon Carter, National Secretary, Finance Sector Union, *Committee Hansard,* 14 December 2010, p 51.

26 Mr Matt Baxby, Managing Director, Virgin Money Australia, *Proof Committee Hansard*, 4 March 2011, p 29.

27 Mr Graeme Samuel, Chairman, and Mr Brian Cassidy, Chief Executive Officer, ACCC, *Committee Hansard*, 25 January 2011, p 37.

> working where those levels of concentrations are and, where it is required, seek that there be divestiture by the parent body.[28]

9.24 Professor Milind Saythe also supported the introduction of divestiture powers. He noted that measures to break banks up have been suggested in the US and in the UK and 'Australia too needs to ensure that the financial system does not develop pockets of dangerous concentration'. He told the Committee that while:

> It would be a radical move...there is nothing in place at the moment which really can work as a sort of deterrent to the major banks acting against the interests of the community and producing suboptimal outcomes.[29]

9.25 It is worth noting that the recent interim report of the UK's Independent Commission into Banking, released in April 2011, has recommended further divestiture of assets of Lloyds TSB, which is already under an EU requirement to divest 600 branches.[30]

9.26 Associate Professor Frank Zumbo argued the need for Australia's regulators to have a divestiture power similar to those available in the United States and the United Kingdom. He recommended that, as a practical way forward:

> The Senate Economics Committee request within 3 months of the date of the request a report pursuant to s 29(3) of the *Trade Practices Act* as to circumstances under which the ACCC would apply for a divestiture order pursuant to s 81 of the *Trade Practices Act*.[31]

9.27 However, the ACCC noted that the divestiture power in the United States targets a specific form of anti-competitive conduct:

> Divestiture is not a remedy in relation to cartel conduct in the US. It is a remedy for monopolisation.[32]

9.28 Virgin Money told the Committee that the banks should divest some of the assets they accrued during the global financial crisis (GFC). It noted that given the high concentration of market share between the majors and the other banks, which was reinforced during the GFC, the majors should be forced to divest.[33]

9.29 Others queried the need for a divestiture power. Treasury told the Committee that mergers in Australia have in fact supported the stability of the financial system. It

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28 Mr Rodney Masson, Director, Policy and Communications, Finance Sector Union of Australia, *Committee Hansard*, 14 December 2010, p 51.

29 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 41.

30 Independent Commission on Banking (2011, p 5).

31 Associate Professor Frank Zumbo, *Submission 56*, p 14.

32 Mr Brian Cassidy, Chief Executive Officer, ACCC, *Committee Hansard*, 25 January 2011, p 56.

33 Mr Matt Baxby, *Proof Committee Hansard*, 4 March 2010, p 30.

noted that it is a basic strategy for governments to merge entities which are faltering so that consumers do not lose out, and there is no contagion in the system. Accordingly, Treasury argued that:

> ...it would be better to get more competitive competition into the system so that we benefit from having a stable financial system, we benefit from having that stable platform which the four majors give us. Whether there would be a fifth pillar or not, what we want to get back to is a stable platform and a competitive system. I do not know whether divestiture is the way to go or is it to actually try to get others to be more competitive.[34]

9.30 As has been noted elsewhere in this report, the Committee considers that there is a need to consider the appropriate balance between stability and competition. There is no question that a monopoly bank would tend to be very stable. But it would also likely fail to deliver the most attractive options for consumers. As such, Treasury is right to argue mergers are likely to increase stability. The question is their impact on competitive outcomes.

Encouraging new entrants

9.30 Another issue raised during this inquiry was whether the 1980s reforms to open the Australian market to foreign banks were of lasting competitive effect. The Committee asked the Governor of the Reserve Bank what had gone wrong since these reforms. He responded:

> ...we did have very intense competition in the system in the eighties mainly chasing corporate lending. Some of that came to grief with the excesses of the late-eighties. A number of the foreign lenders were, in fact, disproportionately represented amongst the group that lent to the entrepreneurs who subsequently came to grief. In the nineties and 2000s there was some resumption of that kind of competition in the business space and the competition to lend to some of the more highly geared entities that came to grief two or three years back involved foreign lenders as well.[35]

9.31 The Governor added:

> It was always going to be a tall ask for foreign institutions to come in and compete with the size of that branch structure. That said, there are today some foreign institutions that offer retail products—Citibank and ING, for example. But were there prohibitions put on various things? I do not know. Not that I am aware of, but that was 25 years ago.[36]

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34 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 40.

35 Mr Glenn Stevens, *Committee Hansard*, 13 December 2010, p 10.

36 Mr Glenn Stevens, *Committee Hansard*, 13 December 2010, p. 20.

9.32 Professor Sinclair Davidson argued that the signal for a foreign bank to enter the Australian market is where Australian banks are earning supernormal profits. He added:

> So if banks in Australia are not turning supernormal profits there is no incentive for foreign banks to enter. If foreign banks are not entering into Australia that is because they are not perceiving there to be unusually high profits in Australia. So our banking system is profitable, sure, but it is not what economists might call a supernormal profit.[37]

9.33 However, other submitters identified systemic barriers to foreign banks competing in the Australian market. Most notably, foreign banks that come into Australia as branches are not allowed to compete for retail deposits of an initial balance below $250,000.[38] This restriction does not apply to subsidiaries.

9.34 This prohibition reflects Australia's unusual system of depositor protection which, instead of explicit deposit insurance, has relied on depositors having priority over other claimants and the ability of the Reserve Bank to direct the operations of a bank in a crisis. These protections are much more effective with a bank that is separately incorporated in Australia rather than operating as a branch.

9.35 Another discouragement to foreign bank entry is interest withholding tax on banks borrowing from foreign parents. This issue is discussed in more detail in Chapter 15.

9.36 Treasury noted that the global financial crisis had had an effect on the foreign bank market in Australia. It told the committee that the GFC:

> ...made it more difficult for them to raise funding and to conduct their businesses. Also, we saw a withdrawal of some foreign banks from Australia and a reduction in their banking, and just the general restriction on credit availability across international markets made it that those who may have been more dominant going into the crisis could exercise more market power during the times when others had to withdraw their services.[39]

9.37 One submitter believed the division of responsibilities between regulatory agencies was not conducive to encouraging new competitors:

> APRA are the regulator but seem only interested in the prudential health of the industry, not competition. The ACCC handle competition but will only act where a breach of the *Trade Practices Act* occurs; they do not proactively pursue a competitive banking environment. The Australian Payments Clearing Association (APCA) run the majority of payments

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37 Professor Sinclair Davidson, *Committee Hansard*, 25 January 2011, p. 65.

38 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 63.

39 Mr Jim Murphy, Executive Director, Markets Group, *Committee Hansard*, 13 December 2010, p 27.

> systems and are effectively an industry collective making their own rules. The RBA espouse goals of decreased barriers to entry and increased competition (for the benefit of the Australian people) but seem limited in their ability to tangibly support new entrants. Treasury actually have a 'Bank Competition Unit' but, while being supportive of new ideas, are limited by a need to remain neutral. Then there's the ABA who valiantly espouse the benefits of competition yet are unable to point to any active or past initiatives on the topic.[40]

Mutuals as a 'fifth pillar'

9.38 There are around ten building societies and over 100 credit unions, collectively known as 'mutuals', which have 4.5 million members across Australia and collectively account for around a tenth of household deposits and home loans.[41] As their industry body explains:

> Mutuals offer consumers a different model of banking - a model where the customers own the credit union or building society. This allows credit unions and building societies to put their customers first, without the conflict that listed banking institutions face in providing shareholders with dividends at the expense of customers….Customer-owned banking institutions are not motivated to maximise profits or engage in irresponsible lending to drive up returns to shareholders.[42]

9.39 Suncorp Bank advocated a multi-tiered structure to compete with the major four banks. It told the Committee:

> Our belief is that a strong multi-tiered banking system is the right model for the country. It provides a good competitive dynamic, good choice for consumers and business customers and good options for investors in terms of choice of different institutions. So, across a whole number of bands, we believe that a multi-tiered structure provides the best balanced outcome across the board. By supporting a fifth pillar alone, whilst there would be some benefits for that organisation in the near term, recreating the competitive environment that existed prior to the GFC, a multi-tiered structure would achieve that.[43]

9.40 Yellow Brick Road Wealth Management was guarded about the prospect of a fifth pillar to rival the major four banks. It argued that in the current environment in Australia, it is:

> ...very difficult to build a fifth pillar today. You might have the opportunity to bring a big foreign bank in to do something like that but I would say big

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40 Accounts4Life, *Submission 128*, p 2.

41 Abacus, *Submission 53*, p 6; Australian Prudential Regulation Authority, *Submission 57*, p 3.

42 Abacus, *Submission 53*, pp 3 and 6.

43 Mr David Foster, Chief Executive Officer, Suncorp, *Committee Hansard*, 9 February 2011, p 6.

> foreign banks would not want to come here to take on Australian banks today in this environment.[44]

9.41 Mr Bouris noted that a large foreign bank would 'just become part of the oligopoly' in Australia. Rather, he envisaged that a fifth pillar might be:

> ...a collective of smaller to medium players. I do not mean 120; we are talking about 20 or 25 medium-sized players who could all, in an ideal world, have one per cent each of the market share. An 80-20 split would be about the right percentage between the big banks and the smaller collective because that is enough to make the banks consider market share instead of profitability. When they think of market share, they start to reduce their margins and try to attract more borrowers. That reduction in margin ultimately is where we want to be because that flows on to the consumer as the better interest-rate price.[45]

9.42 Mr John Symond of Aussie Home Loans dismissed the idea of the mutuals forming a fifth pillar. He told the Committee:

> …to suggest that the mutuals can become the fifth force in banking, quite frankly, is a joke. They are small corner stores, they do not have infrastructure, they do not have technology, they do not have the clout and reach.[46]

9.43 The Committee is aware that a particular challenge for the mutuals is growing their capital base to underpin an expansion of market share. As Mr Jonathon Mott, a banking sector analyst, told the Committee:

> ...if they go from around four per cent to 10 per cent market share, which is what the government is intending, the amount of capital in the system for the building societies and the mutuals would need to rise from $6 billion to around $10 billion to $12 billion, and maybe even a bit more. A couple of things worth remembering are, firstly, that mutuals do not have access to the capital markets, by definition. If a bank needed that they could go to shareholders and raise equity. Secondly, the return on equity in the mutuals is about eight per cent versus around 16 per cent in the major banks, so they do not generate enough capital organically to be able to do that. The only alternative would be to go to their members and ask them for capital. If you are a member of a building society or a credit union, I do not think you will be too happy…[47]

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44 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 111.

45 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 111.

46 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, p 108.

47 Mr Jonathan Mott, Bank Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 148.

Credit rating agencies

9.44 Institutional investors and international banks are familiar with the major Australian banks and can easily form a view about the quality of their paper or the risk involved in having them as a counterparty. (As discussed further in Chapter 11, the perception that governments regard them as 'too big to fail' means they are perceived as very low risk). Life is harder for most ADIs which have a smaller profile. They are more dependent on assessments by credit rating agencies.

9.45 Unfortunately for the mutual ADIs, the rating agencies appear to accord too much attention to size and not enough to the underlying quality of assets:

> This reliance we have on the rating agencies is a little interesting, if I can put it that way. That was one of the core components of the GFC: the very poor underwriting standards globally, specifically in the US. These bonds were rated AAA, and we all know how that panned out. Therefore, it is curious that, on the one hand, we say that the rating agencies did not coat themselves in glory and, on the other hand, we base a whole system around validating the rating agencies' methodology.[48]

> Local councils trusted the opinions of credit rating agencies rather than Australia's prudential regulatory system and chose to invest in AAA-rated exotic securities when they would have been better off depositing funds in an unrated mutual ADI.[49]

> This [US financial] crisis could not have happened without the rating agencies.[50]

> I do not think the rating agencies' methodology has covered itself in glory. There is a good argument that turns around and says: some of the simpler organisations that borrow funds from their local community, invest in their local community, know their local community and invest in solid assets called housing are very, very safe institutions because they are not buying CDOs and they are not trading foreign exchange…If you ask me: 'Do I think there is a bias against smaller organisations?' yes, I do, because the answer keeps coming back to your capital base…I disagree with that. I think what you need to do is understand the underlying risks of the business and make sure your capital supports the underlying risks of the business. I would say that some credit unions are very, very safe organisations.[51]

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48 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 114.

49 Abacus, cited in Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector—The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 18.

50 National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, 2011, p xxv.

51 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 115.

> It is not clear that a small institution with a diversified portfolio of financial assets would have a higher risk than a large banking institution.[52]

> I can very easily mount a case that a $50 million credit union is not as risky as the Commonwealth Bank: they do not invest in CDOs, they do not have international operations, they do not have business banking. But they will never be able to get a AA rating because they are simply not big enough...[53]

Proposals for a new government bank

9.46 A number of submitters essentially called for a new bank along the lines that the original Commonwealth Bank was established around a century ago:

> Create an Australia Bank, owed 100% by the people of Australia through the Government of the day…Australia Bank…will be owned by the people …Centrelink benefits…will be paid directly into it the Australia Bank and will not have any fees for deposits or withdrawals. The Australia Bank will have a Home Loan rate set at a maximum, of 5% and be competitive against any other financial institution for business and investment. It will be the benchmark competitor that others will have to rise to the occasion, thereby creating 'real' competition.[54]

> …the government simply introducing a new bank offering low fees and reasonable interest rates. This new bank would be need to be government-owned…Its charter would prohibit the bank from charging interest rates greater than 2% above the then prevailing Reserve Bank rates, with any shortfall in funds (not funded by retail deposits) to be borrowed from the Reserve Bank. This should guarantee a reasonable profit for the bank, which can be used to fund expansions to the bank network, with the excess to be paid to consolidated revenue. In residential lending, the bank should be a specialist bank which only lends to owner-occupiers (i.e. for people buying their own homes) but not investors. With business lending, it should only lend to small business.[55]

> It is time the federal government and the Opposition stopped talking about how they might tackle the banks ripping of their customers and to act to reduce their power. How? By setting up another government-owned bank to act as a brake to the soaring interest rates, excessive profits earned by banks, egregious fees and the excessive remuneration packages paid to our bank CEOs…There’s only one way to create serious competition to such a strong banking cartel: do what Prime Minister Andrew Fisher did in 1911

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52 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 100.

53 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 80.

54 Mr Mal McCullough, *Submission 10*, p 1.

55 Mr Suryan Chandrasegaran, *Submission 4*, pp 4-5.

> when he set up the Commonwealth Bank of Australia as a government-owned competitor. We need to set up another similar bank.[56]

> …it makes sense to consider policy action to promote access to safe and convenient basic banking. To ensure that guaranteed low-risk banking services are universally available, government should consider the establishment of a publicly-owned savings bank similar to the New Zealand Kiwibank.[57]

> It is recommended that Government consider the establishment of a Development Bank or SME Bank either as a Government Owned Bank or a Government and Private Enterprise Joint Venture, so to support appropriate styles of borrowing structures as needed for SMEs to maintain and grow their businesses, and so to be able to continue to employ our consumer borrowers.[58]

9.47 A related suggestion was for the Reserve Bank to provide basic banking accounts for individuals.[59]

9.48 A survey of Queensland businesses found that almost half supported the government setting up a new bank to promote competition.[60]

9.49 Another view was that it was at least an idea worthy of further consideration:

> …a public bank is something that is worth looking at. Do I have a strong argument in favour of a public bank? No, but it is something that an inquiry could consider.[61]

9.50 Further parallels were drawn with the New Zealand government-owned 'Kiwibank':

> The bank is both successful and popular, and continues to fulfil its mandate of making banking services accessible to members of the public at reasonable rates.[62]

Australia Post

9.51 There have been calls for Australia Post to form the basis for a strong competitor to the major banks:

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56 Mr Richard Talbot, *Submission 51*, p 1.

57 Professor John Quiggin, *Submission 103*, p 6.

58 Finance Brokers' Association of Australia, *Submission 133*, p 5.

59 Mr Chris Webbe, *Submission 11*, p 1.

60 30 per cent of respondents disagreed with the idea. Chamber of Commerce and Industry Queensland, *Submission 43*, p 16.

61 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 106.

62 Mr Suryan Chandrasegaran, *Submission 4*, p 5.

> Australia Post already has substantial and permanent distribution outlets that handle a wide variety of financial services transactions presently, and with little modification could handle banking business in open style shopfronts.[63]
>
> The most obvious opportunity is for Australia Post to follow the German example and set up a PostBank, purely focusing on retail consumer banking. This will [be] the most efficient and effective way to stimulate competition [in] the banking industry.[64]

9.52 Associate Professor Zumbo argued that the government should explore opportunities for Australia Post to offer basic banking services using its extensive branch network. He noted that this could involve asking the Productivity Commission to undertake a feasibility study into Australia Post offering basic banking services and to review the overseas experience with national postal services offering banking services.[65]

9.53 A survey of Queensland businesses found that 45 per cent supported Australia Post being used as a distribution channel for smaller lenders.[66] However, other submitters were less enthusiastic:

> …the idea has drawbacks. Though the availability of multiple outlets has appeal, one can't readily graft a bank onto a post office. It would be a savings bank at best, and there are already adequate options in the savings bank domain.[67]

9.54 While APRA were not asked specifically about Australia Post, their general requirements to allow an organisation to become an ADI were set out as follows:

> It needs to have adequate capital for the sort of business that it wants to take on. It needs to have a strong and robust board if it is coming into Australia and we are presuming it is here already but wants to be a locally incorporated ADI. It has to have strong risk management systems and strong personnel that can run those systems…It is a tough test to get past.[68]

9.55 However, the Australian Bankers' Association points out that Australia Post already plays a role in providing:

> …agency facilities for banking transactions for at least 100 years and already acts as a distribution point for more than 70 banks and other

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63 Mr Mervin Reed, *Submission 5*, p 11.

64 Mr Dinesh Warusavitharana, *Submission 98*, p 3.

65 Associate Professor Frank Zumbo, *Submission 56*, p 8.

66 About 15 per cent of respondents disagreed with the idea. Chamber of Commerce and Industry Queensland, *Submission 43*, p 16.

67 Dr Evan Jones, *Submission 81*, p 6.

68 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 9.

> financial service providers. It is open for other financial service providers to form the same commercial relationship.[69]

9.56 Australia Post described themselves as 'an enabler of banking services' and referred to their current activities:

> Australia Post operates Bank@Post, a trusted neutral intermediary service for the banking industry processing 125 million transactions per annum in the wider payments industry; Bank@Post provides personal and business banking services (deposit, withdrawal and enquiry) on behalf of 70 financial institutions…over 1,470 of our rural and remote outlets support Bank@Post providing accessibility for customers of financial institutions in all parts of the country, irrespective of whether a financial institution has a local presence or not.[70]

9.57 Australia Post explained the role played by post offices overseas in banking:

> Internationally, postal organisations are active in the provision of financial services. Some have been moving further into the space (New Zealand Post), whilst others have created new entities out of their banking operations (Deutsche Post). The models of operation vary greatly; for instance Japan Post (Post Bank) and New Zealand Post (Kiwi Bank) operate banks in their own right, whilst Post Italienne and Swiss Post operate as integrators of financial services. Other entities, such as Post Norden, have a similar set-up to Australia Post where they operate as an agent and aggregator of financial services for many providers.[71]

Development bank

9.58 Another option to help farmers and other small businesses is to resurrect an organisation like the Commonwealth Development Bank or the Primary Industry Bank. The Council of Small Business Organisations of Australia has argued the need for a small business development fund operated through a government agency.[72]

9.59 The Committee has considered similar proposals in an earlier inquiry. Some witnesses to that inquiry suggested that competition from the development bank might lead the commercial banks to compete more aggressively in the small business market. Others noted that a development bank could also fill the gap during recessions through keeping credit flowing to businesses, farmers and for mortgages, should the commercial banks be forced to restrict lending.

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69 Australian Bankers' Association, *Submission 76*, p 42.

70 Australia Post, *Submission 120*, pp 3-4. The Bank@Post arrangements are described in further detail at http://auspost.com.au/personal/personal-banking-at-australia-post.html.

71 Australia Post, *Submission 120*, p 7.

72 Mr Peter Strong, Executive Director, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, p 12.

9.60 However, Treasury warned that unless there is a specific market gap, such as that met by the Export Finance and Insurance Corporation, a development bank can lead to market distortions. Specifically, the development bank could assist lenders rather than borrowers by providing a cheap source of funding that can be lent onwards at normal market rates. It could also stimulate lending to borrowers who would not meet standard credit conditions, and who are not in a position to repay their loans. Business representatives also doubted the effectiveness of a development bank, noting that its creation would be a permanent solution to what is not expected to be long-term problem.[73]

Committee view

9.61 Noting the evidence presented in Chapter 4 about the highly concentrated state of the Australian banking market, and the likelihood that it leads to bank customers paying more for banking services, the Committee would be concerned if there were any further increase in concentration. The Committee therefore strongly supports the retention of the 'four pillars' policy preventing any merger between the four major banks. It also urges the ACCC to take a strongly sceptical view towards any proposal for one of the four major banks to take over one of the remaining regional banks.

9.62 The Committee regards forced divestiture as a major intervention in a free market and regards it as a 'last resort' approach to increasing competition. Instead it seeks other means of increasing the number of players in the market. With the change to an explicit form of deposit insurance, the preference for foreign banks to operate as subsidiaries rather than branches could be reviewed as part of the broader review of the financial system called for in Chapter 3. This same review could also examine means whereby current non-ADIs could more directly compete with ADIs. This could include an examination of the restrictions on ownership arrangements for ADIs.

9.63 There is also scope for a removal of some restrictions which are currently impeding mutual ADIs from competing strongly with banks. These are discussed in following chapters.

In 2010, the Committee concluded that the best way forward is to increase competition within the existing commercial banks rather than pursue a development or rural bank or to convert Australia Post into a bank.[74] The Committee still holds this view. It appreciates Australia Post's role in delivering banking services to some rural and regional areas. It is commendable that it provides services on behalf of a number of ADIs and thereby promotes competition. It should continue to seek opportunities to improve the community's access to financial services.

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73 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 59.

74 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 3.

Chapter 10

Unfair contract terms

10.1 This chapter examines how competition affects unfair terms that may be included in banking contracts.

10.2 In 2009, the Senate Economics Legislation Committee inquired into the provisions of the first tranche of the Australian Consumer Law (ACL). A key provision of this bill was the banning of unfair terms in standard form business-to-consumer contracts. Standard form contracts are contracts that are not individually negotiated: they are often 'take it or leave it' contracts.

10.3 The ACL provides that a term in a consumer contract will be considered 'unfair' if:

(a) it causes a significant imbalance in the parties' rights and responsibilities;

(b) it is not 'reasonably necessary' to protect the 'legitimate interests' of the supplier; and

(c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

10.4 A term is likely to be considered unfair if a supplier can vary any term without the consumer's consent or if a supplier can cancel a contract without a corresponding right for the consumer. If a term is found to be unfair, it is void but the rest of the contract remains in effect.[1]

10.5 The ACL's unfair contract terms provisions covers banking and financial services contracts as well as utility service contracts, internet and telephone contracts and gym memberships.

10.6 The ACL's unfair contract terms provisions were introduced in July 2010 and are a schedule within the *Competition and Consumer Act 2010*. The provisions relevant to financial products and services are legislated in the *Australian Securities and Investments Commission Act 2001*.

10.7 The Senate Economics Legislation Committee's report into the unfair contract provisions noted that the banking sector criticised the bill's impact on business certainty and business costs. The Australian Bankers' Association told that committee:

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1 Senate Economics Legislation Committee, *Trade Practices Amendment (Australian Consumer Law) Bill 2009 [Provisions]*, September 2009, p 1.

> Central to our concerns is that the regime will create uncertainty for banks…In practice the operation of this legislation is likely to see customers agreeing on the terms and conditions for their banking services before the customer accepts a financial product, only to later seek to avoid their obligations by claiming a particular term is unfair.[2]

Competition and unfair contract terms

10.8 In theory, the more competitive the banking market is, the less likely that the banks will offer 'unfair' standard form banking contracts. A healthy, competitive banking market will lead to competitive and 'fair' standard form contracts. After examining the issue of unfair contract terms in 2008, the Productivity Commission noted:

> If consumers value fair play by firms the question arises as to why firms would not organise themselves to exploit the market advantages that this behaviour would bestow.[3]

10.9 Another view was put by the Banking and Finance Consumer Support Association. It argued that an over-supply of competitors can foster unfair terms to be included in contracts and impact unfairly on the consumer, the taxpayer, the shareholder and investors. The Association noted that if left unchecked, as in low doc lending, the market becomes 'flooded with unacceptable contracts and conduct which may take years to repair the damage'.[4]

10.10 The Financial Ombudsman Service argued that competition will only have a limited impact on unfair terms in a contract. It noted that most products are sold on the basis of price and that an unfair term is not likely to be brought to the consumer's attention by the selling institution. The effect of competition on unfair contract terms was therefore only likely to occur where a competitor draws customers' attention to an institution's unfair term. Even in this event, however, it argued that this publicity was most likely to be focussed on the fee attached to the unfair term, which underlines that competition is typically based on price.[5]

10.11 Choice noted that competition alone often does not guarantee the elimination of unfair contract terms because they are routinely not adequately disclosed and

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2 Mr David Bell, *Senate Economics Legislation Committee Hansard*, Trade Practices Amendment (Australian Consumer Law) Bill 2009 [Provisions], 26 August 2009, p 35.

3 Productivity Commission, *Review of Australia's Consumer Policy Framework*, April 2008, volume 2, pp 414-5. The Productivity Commission report includes a detailed discussion of issues related to unfair contract terms (pp 403-441), and gives an example of how competitive pressure from consumers against unfair contract terms in software end-user licence agreements has led to a reduction in the use of these unfair terms (p 427).

4 Banking and Finance Consumer Support Association, *Submission 112*, p 22.

5 Financial Ombudsman Service, *Submission 78*, p 3.

therefore not considered by consumers at the time of making purchase or service decisions. It argued that while the application of the unfair contract term provisions will provide significant benefits for consumers, it is not a complete solution. Specifically, Choice observed that:

- the regime only applies to consumer contracts;
- there remains some ambiguity in applying the regime as to when a term will be considered 'unfair', particularly when applying the second limb of the unfairness test—whether it is 'reasonably necessary in order to protect the legitimate interests' of the bank;
- similarly there will be some doubt about whether particular terms are part of the 'upfront price' (and therefore not covered by the regime) in the context of a banking service
- the regime does not prohibit particular unfair terms until such time as a court has determined the term is unfair.[6]

10.12 Choice argued that the issue most likely to cause the most difficulty for both consumers and the industry is the level at which terms should be considered 'unfair'. It believes that the obvious and fair rule would be that all fees should be based on the bank's cost of providing the service to which the fee relates or the loss that is incurred as a result of a default. Choice claimed that this is likely to enhance competition because it will make it more difficult for institutions to offer artificially attractive interest rates which are supplemented by fee income.[7]

10.13 The Committee received some evidence expressing concern that the recent diminution of competition in the Australian banking sector will not protect consumers from unfair contract terms and fees. Associate Professor Frank Zumbo wrote in his submission to the Committee that:

> ...consumers are currently, and will continue to, face higher interest rates and unfair contract terms and fees as a direct result of the substantial reduction in the independent competition previously provided by St George, BankWest, RAMS, Aussie Home Loans and Wizard.[8]

10.14 As a corollary of this argument, Associate Professor Zumbo claimed that the threshold for enforcing the unfair contract terms provisions is too high. He noted that while the threshold was not as high as 'unconscionable conduct', it will nonetheless be difficult to prove and hard to enforce.[9]

6 Choice, *Submission 70*, pp 7-8.

7 Choice, *Submission 70*, p 8.

8 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 55.

9 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 55.

Mortgage early exit fees and unfair contract terms

10.15 ASIC published a review of entry and exit fees applying to home mortgages in April 2008, prepared at the request of the Treasurer. Following from this, the *National Consumer Credit Protection Act 2009* came into force in July 2010. The National Credit Code, which is contained in Schedule 1 of that Act, contains provisions, administered by ASIC, to the effect that the courts may review and annul unconscionable interest and other charges such as exit fees.[10]

10.16 ASIC explained:

> Under this legislation borrowers can challenge the validity of early termination fees they think are unconscionable or unfair. Borrowers may also complain to ASIC or to an external dispute resolution scheme. The borrower or ASIC can seek review of fees by a court.[11]

10.17 While it might be unlikely that an individual consumer would undertake the expense and risk of taking a bank to court to try to vary an exit fee, the Code also allows for ASIC to bring such a case in the public interest.[12]

10.18 ASIC also noted that after a period of consultation, in November 2010 they published guidance for lenders about how ASIC proposed to administer the unfair contract terms provisions in relation to exit fees:

> The guidance spells out ASIC's view on such matters as what types of costs and losses might be included in an exit fee, the types of losses that might not be recovered through exit fees and the limited circumstances under which a lender might vary exit fees during the life of a mortgage.[13]

10.19 This document noted that ASIC no longer viewed ongoing loan administration as a legitimate interest. It argued that ongoing loan administration costs were recovered through other fees and charges, such as account keeping fees, and do not

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10 Section 78(1) of the National Credit Code provides that 'The court may, if satisfied on the application of a debtor or guarantor that:… a fee or charge payable on early termination of a credit contract… is unconscionable, annul or reduce the change or fee or charge and may make ancillary or consequential orders.' Section 78(4) expands on this, saying ' For the purposes of this section, a fee or charge payable on early termination of the contract or a prepayment of an amount under the credit contract is unconscionable if and only if it appears to the court that it exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment, including the credit provider's average reasonable administrative costs in respect of such a termination or prepayment'.

11 Dr Peter Boxall, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 21 January 2011, p 3.

12 Section 79(2) of the National Credit Code provides that 'ASIC may make an application under this Division and has standing to represent the public interest' and Section 79(3) adds 'The application…may apply to all or any class of credit contracts entered into by a credit provider during a specified period…'

13 Dr Peter Boxall, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 21 January 2011, p 3.

need to be recovered through early exit fees. ASIC also noted that it does not agree that it is legitimate for lenders to seek to recover product and business development costs in an early exit fee. It argued that it is more appropriate to recover these through other fees and charges (such as ongoing fees or in a lender's margin on lending).[14]

10.20 There are doubts that the ASIC approach will prove effective:

> While we do have laws dealing with unfair fees, I have to say that ASIC has been very slow to enforce those laws, and suggestions that individual consumers can go to ASIC and that that will lead to an investigation are, I believe, once again naive. The reality is that agencies like APRA and the ACCC have limited resources. If a single consumer were to raise an issue, they would be likely to get back a form letter saying that it is not a priority area, it is just an isolated instance and the consumer has the ability to pursue private actions.[15]

10.21 The Consumer Action Law Centre noted in its submission that ASIC's formal guidance on the issue of exit fees and 'deferred establishment fees':

> ...makes it clear that ASIC does consider that these fees could fall foul of the new laws in certain circumstances and that ASIC could potentially take action to enforce the new laws in the future if it considered doing so was in the public interest.[16]

10.22 The Centre observed that given a policy goal of preventing the negative effect of exit fees on competition in financial services markets, the need for regulatory intervention was 'inevitable'.[17] Nonetheless, it argued that the regulatory framework could be extended to 'clamp down' on these fees.

10.23 The Centre noted the United Kingdom's lead of imposing disclosure obligations on lenders in relation to these fees. This requires lenders to disclose early exit fees upfront using easy to understand cash amounts. All lenders are required to call this type of fee by the same name, so that consumers do not have to compare the costs of early termination fees as opposed to deferred establishment fees.

10.24 The Centre argued that the unfair contract terms provisions are important to protect consumers once they have entered into a contract. Disclosure is not protection against unfair or excessively high fee levels. Accordingly, the Centre recommended that the unfair contract and consumer credit law provisions be amended to clarify that that only costs directly related to early termination can be recovered in an early exit

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14 Australian Securities and Investments Commission, *Response to submissions on CP 135 Mortgage exit fees: unconscionable fees and unfair contract terms*, November 2010, p 12.

15 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 55.

16 Consumer Action Law Centre, *Submission 87*, p 14.

17 Consumer Action Law Centre, *Submission 87*, p 14.

fee. It noted that in Victoria, there is already a model for regulating early termination fees in this way.[18]

Unfair fees

10.25 An unfair fee might broadly be described as one where the fee payable materially exceeds the reasonable cost to the financial institution of undertaking the activity to which the fee relates.[19] The ability of a bank to charge an 'unfair' fee reflects, in part, a lack of competitive tension in the market. As Choice noted in its submission:

> ...unfair fees and charges are a symptom of an uncompetitive market in Australia. CHOICE has welcomed the Government's recent moves against excessive mortgage exit fees and unfair credit card terms. But it is notable that consumers have been driven to taking collective legal action to recover unfair fees.[20]

10.26 The Committee received some comment on the need for a tougher legislative stance on banks' unfair fees. In his submission, Associate Professor Zumbo recommended amending the definition of unfair term under the ACL to expressly deal with unfair fees. He suggested amending the meaning of 'unfair' in section 24(2) of the ACL[21] to state that:

> (2) In determining whether a term of a consumer contract is unfair under subsection (1), a court may take into account such matters as it thinks relevant, but must take into account the following:
>
> ...in relation to a fee payable in connection with a financial product, whether the fee materially exceeds the reasonable cost to the financial institution of undertaking the activity to which the fee relates.[22]

10.27 The Consumer Action Law Centre argued that as the national unfair contract terms laws have only recently been introduced and are specifically designed to target unfair contractual terms, 'they should now be given a chance to work' and 'regulators should be given an opportunity to monitor the market and enforce the law'.[23]

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18 Consumer Action Law Centre, *Submission 87*, pp 16–17.

19 Associate Professor Frank Zumbo, *Submission 56*, p 7.

20 Choice, *Submission 70*, p 4.

21 A corresponding amendment to section 12BG of the *Australian Securities and Investments Act 2001* is also likely to be required.

22 Associate Professor Frank Zumbo, *Submission 56*, p 7.

23 Consumer Action Law Centre, *Submission 87*, p 20.

Bank selling practices

10.28 The trade union covering bank workers is critical of some selling practices:

> It is common practice throughout the banking industry for significant numbers of employees to have their wages and conditions outcomes and in some cases their employment predicated on employer imposed sales targets associated with the sale of products, very much including credit products…this encourages a culture of product pushing onto consumers, with little regard for whether it is the right product for consumers or their ability to afford it.[24]

10.29 A recent opinion poll showed that 59 per cent of customers were 'unaware of bank workers' salaries being tied to the selling of debt products' and 79 per cent 'want sales targets of credit products delinked from wages for bank workers'.[25]

10.30 Among the bank workers themselves, 43 per cent reported 'being placed under pressure to sell credit/debit products to customers regardless of their ability to afford them' and 81 per cent say such targets were not adjusted during periods of economic difficulty.[26]

Committee view

10.31 The Committee believes that more intense competition will lead to fewer rather than more instances of contracts with unfair terms. There is still a role for some regulation to supplement the benefits of improving competition. Regulations governing clear, simple and comparable disclosure would certainly assist consumers in determining whether or not to sign a contract. As discussed in Chapter 7, the Committee believes that bank exit fees should be allowed but they should be related to the costs incurred by the lender, not set at a prohibitive level where they act as a barrier to competition. As the unfair contract term provisions have been in operation for less than a year, the Committee believes it is prudent to wait to reserve judgment on their effectiveness.

10.32 As the Committee has noted in Chapter 7, public education to improve financial literacy is an important component of ensuring that the full benefits of a competitive financial system are available to all consumers.

Recommendation 17

10.33 The Committee recommends that the Government introduce regulation of mortgage early exit fees (including deferred establishment fees), requiring disclosure of these fees upfront in a simplified and comparable format.

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24 Finance Sector Union, *Submission 80*, p 10.

25 Cited in Finance Sector Union, *Submission 80*, p 7.

26 Cited in Finance Sector Union, *Submission 80*, p 8.

Chapter 11

The prudential supervision of financial intermediaries and their social obligations

11.1 There seems to be a broad consensus that good supervision played an important role in Australian financial intermediaries coming through the GFC without the need for the government bailouts and takeovers seen in many other countries. There are questions, however, about whether current or prospective supervisory rules could inhibit competition.

11.2 The Australian Prudential Regulation Authority (APRA) described its role in the financial system as follows:

> Our mandate is to promote the sound and prudent management of the institutions we supervise so that, in the case of deposit taking, the institutions meet their promises to depositors under all reasonable circumstances.[1]

11.3 Institutions wishing to raise deposits from the public require authorisation from APRA. They are hence known as 'authorised deposit-taking institutions' (ADIs). They comprise banks (domestic banks and subsidiaries and branches of foreign banks), building societies and credit unions.[2]

11.4 In general, the prudential framework does not raise issues of competitive neutrality between different types of ADIs:

> …the prudential framework in Australia applies with few exceptions to banks, building societies and credit unions equally. Where it does not, there are prudential policy considerations—long-standing in one case—that justify a degree of differentiation. Overall, APRA does not consider that the prudential framework or its risk based approach to supervision acts as an impediment to a competitive banking system in Australia.[3]
>
> In sum, APRA does not consider that its prudential framework for ADIs or its supervisory approach is a material factor in the competitive balance between different types of ADIs.[4]

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1 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 2.

2 There are a handful of 'other ADIs'; specialist credit card providers and purchased payment facilities providers.

3 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 2.

4 Australian Prudential Regulation Authority, *Submission 57*, p 10.

Competition and stability

11.5 A claim frequently made during the inquiry was that the goals of stability and competition are conflicting. One stark example was the Westpac CEO's statement:

> There is a trade-off between competition and stability, and getting that balance right is crucial.[5]

11.6 Yet not a minute before, she had claimed:

> …the Australian banking sector is highly competitive. It is also strong and stable.[6]

11.7 Asked to elaborate, she postulated:

> There are examples one can look at where a heightened competitive environment has led to some very poor practice and some very poor underpricing of risk, which has led to instability.[7]

11.8 A perhaps more nuanced version was offered by some prominent academic economists:

> …in the US…that intensity of competition, together with some issues of regulation, could be argued as a major cause of the global financial crisis.[8]

> …the whole point of financial regulation is to achieve an appropriate balance between competitive efficiency and system stability.[9]

> Increased competition can also increase moral hazard incentives for banks to take on more risk. Declining profitability as a result of increased competition could tip the incentives of bankers towards assuming greater risk in an effort to maintain former profit levels.[10]

11.9 At one extreme, there is a trade-off between competition and stability:

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5 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 65. This claim is also made repeatedly by the Australian Bankers' Association head in S Münchenberg, 'Balancing bank stability and competition', *The Australian*, 17 January 2011, p 32.

6 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 65.

7 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 97.

8 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 108.

9 Professor Ian Harper, cited in Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector – The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 43.

10 Mishkin (2004, p 269), a well-known textbook by an economics professor formerly on the Federal Reserve Board.

> …a monopoly bank would be very profitable, and therefore robust in a crisis, but would be unlikely to provide low-cost or innovative products to its customers.[11]

11.10 Treasury warned that competition concerns need to be balanced with concerns about stability:

> …there is going to be a trade-off there between ensuring a safe, secure and stable financial system versus competition.[12]

11.11 This seems somewhat at odds with their earlier view that:

> Stability and confidence are important underpinnings for efficient, competitive markets.[13]

11.12 The competition authority's view is that:

> It is the prudential requirements that bring about stability, not the adjusting up or down of the competition level.[14]

11.13 A British consultant not only claimed there was a trade-off between competition and stability but purported to quantify it (Chart 11.1):

> Bain & Company calculates that the cost borne by taxpayers from an unstable banking industry is more than £1,000 per annum per head—mainly as a result of reduced output and higher unemployment. By contrast, regulators inclined to view the UK banking market as insufficiently competitive would be hard pressed to identify the cost of this to customers as more than £200 per annum per head. Those taxpayers and customers are, broadly speaking, one and the same.[15]

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11 Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector – The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 19.

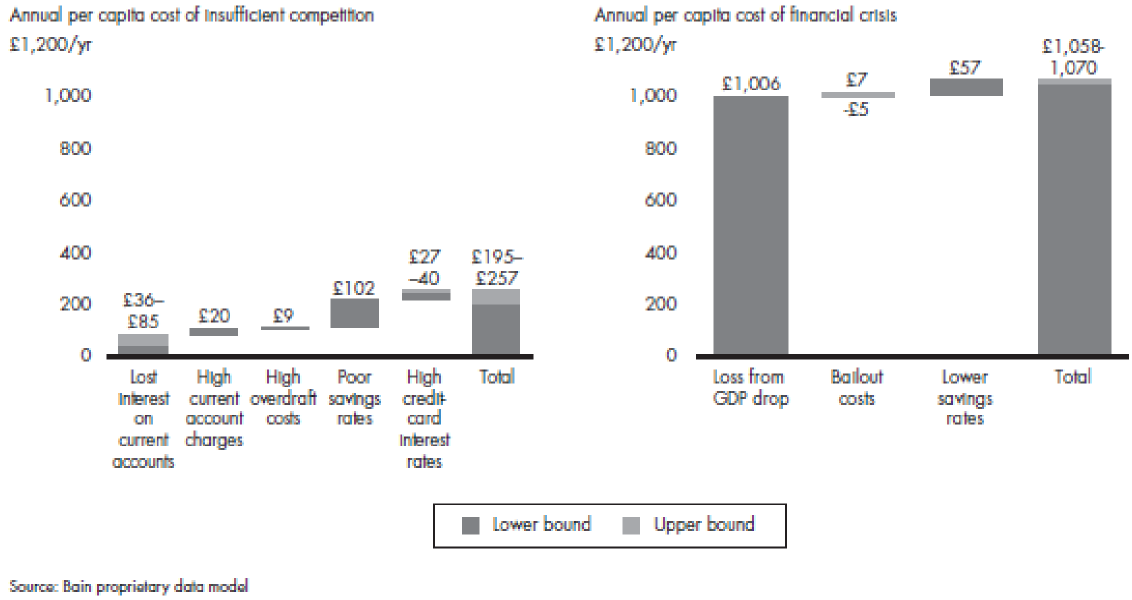
12 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 27.

13 Department of the Treasury, cited in Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector—The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 37.

14 Mr Graeme Samuel, Chairman, ACCC, *Committee Hansard*, 25 January 2011, p 56.

15 Bain & Co, ' Getting bank competition right post-crisis', provided by the Commonwealth Bank of Australia, *Additional information no. 7*, 23 December 2010, pp 1-2.

Chart 11.1: Costs of instability versus suboptimal competition



Source: Bain & Co, 'Getting bank competition right post-crisis', provided by Commonwealth Bank of Australia, *Additional information no. 7*, 23 December 2010.

11.14 Choice opined:

> … financial stability does not have to be pursued at the expense of competition or to the detriment of consumers.[16]

11.15 A new market entrant suggested:

> … stability is fundamental to a properly functioning banking system, but that is not mutually exclusive with conditions which foster competition.[17]

11.16 APRA's perspective is that:

> We are required under our legislation to balance this objective of financial safety with efficiency, competition, contestability and competitive neutrality. Beyond that, we do not have any specific responsibility for competition in the deposit-taking sector. Of course, having prudently managed and well capitalised deposit-taking institutions surely lays the foundations for sustainable competition. Unless APRA are overzealous—and I do not believe we have been—there need be no difficult trade-offs between financial safety and competition over the longer term.[18]

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16 CHOICE, *Submission 70*, p 11.

17 Mr Matt Baxby, Managing Director, Virgin Money Australia, *Proof Committee Hansard*, 4 March 2011, p 29.

18 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 2.

11.17 The reference APRA make to *sustainable* competition is important. The type of competition, such as lending on very thin margins, that occasionally arises and causes problems for stability is *unsustainable* competition. It is this unsustainable competition which regulators such as APRA seek to avoid occurring. As APRA remarked:

> …in the period 2002-03 we did see quite strong competition in housing lending which took the form of a dilution of credit standards, and that was a form of competition which we were uncomfortable with… there was just a competitive pressure to meet the customer by finessing, overriding or changing strong credit standards in some cases and it was an issue that we were vocal about at the time. That is competition which does raise prudential concerns. And of course if you look at the subprime experience in United States, you will see that whole problem writ very large.[19]

Are the major banks 'too big to fail'?

11.18 There is a common view around the world that large banks are 'too big to fail'. Usually regulators avoid explicit statements to this effect, but in the US, following the insolvency of Continental Illinois in 1984, the Comptroller of the Currency testified to Congress that the 11 largest banks were 'too large to fail' and would be bailed out so that no depositor or creditor would face a loss.[20]

11.19 In Australia the major banks appear to be regarded as 'too big to fail', or more accurately 'too big for the authorities to allow them to fail'.

> I do believe that the four big banks are too big to fail. There is no government that I could ever anticipate letting one of those big major banks fail. The devastation to the economy would be so great that no government could tolerate that. So that does give those four big banks an implicit advantage—a considerable implicit advantage.[21]

> …no big bank will ever be allowed to fail to meet any liability to its depositors or anyone else…[22]

> …whatever the government might say, financial markets perceive each of the Big Four to be too big to fail and so protected by an (implicit) government guarantee.[23]

> …they are systemically important and too big to fail.[24]

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19 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 7.

20 Mishkin (2004, p 263).

21 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 62.

22 Mr Peter Mair, *Submission 2*, p 4.

23 Dr Nicholas Gruen, *Submission 21*, p 1.

> The big four banks are able to raise funds much more cheaply on international wholesale markets. This is, in large part, due to the perception that the banks are 'too big to fail' and therefore ultimately supported by the Commonwealth Government. This situation entrenches the market power of the dominant oligopolistic firms, and they are able to extract significant returns which are then largely distributed to shareholders and senior executives.[25]

11.20 The recent report by the UK's Independent Commission on Banking highlighted the problems caused by banks too big to fail:

> Banks ought to face market disciplines without any prospect of taxpayer support, but systemically important banks have had and still enjoy some degree of implicit government guarantee. This is the 'too big to fail' problem. Unless contained, it gives the banks concerned an unwarranted competitive advantage over other institutions, and will encourage too much risk taking once market conditions normalise. It also puts the UK's public finances at further risk, especially given the size of the banks in relation to the UK economy. On top of the taxpayer risk from bank bail-outs, banking crises damage the public finances because of their effects on output and employment. Indeed the problem could arise in future that the banks are 'too big to save'.[26]

11.21 Similarly a UK parliamentary committee, inquiring concurrently into banking competition there, warned:

> We believe effective competition cannot take place in an environment where firms which are perceived as 'too important to fail' are both protected from the discipline of the market place and derive tangible benefits from this status.[27]

11.22 If banks are indeed too big to fail, this represents a, potentially very large, contingent liability for the budget and hence the taxpayer:

> The pre-GFC thinking was that banks should consolidate and become big because there is an advantage in being big. But the GFC very well demonstrated that a larger size is no longer a desirable thing. As a matter of fact, larger sized banks can become a permanent headache for the taxpayer because we do not know when these guys are going to stuff it up and come back to the taxpayer. So I have some concerns about the size of Australian banks.[28]

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24 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 15.

25 Australian Council of Trade Unions, *Submission 89*, p 3.

26 Independent Commission on Banking (2011, p 2).

27 UK House of Commons Treasury Committee, *Competition and Choice in Retail Banking*, March 2011, p 5.

28 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 33.

11.23 The Commonwealth Bank rejected this argument:

> …we are a bank that does not take that view. We are a bank that is run on the basis that we will not fail and the 'too big to fail' part does not come into it.[29]

11.24 Of course, the large banks overseas that failed would have also said this could never happen.

11.25 There have also been references to banks being 'too interconnected to fail'[30]:

> …what led to the unravelling in the UK banking market was not initially a large bank. It was Northern Rock, which was a relatively small bank but had a significant systemic impact on the UK economy…The issue does not really come down to the size of the bank. I think any banking situation where a bank fails has the potential to have flow-on impacts.[31]

11.26 These implicit guarantees may even be stronger now than before the GFC:

> Lehman Brothers—a small bank in the US—was allowed to fail, and I do not think there is any doubt that, with the benefit of hindsight, the US regulators and US government would have bailed out Lehman Brothers had they realised what a psychological impact it would have on the market for a relatively small bank to collapse.[32]

11.27 Asked whether the major banks had become 'too big to fail', APRA responded:

> We never ever confess that any institution is too large to fail. There is a marketplace at work there and we have seen institutions around the globe that were household names that have moved into government ownership in other markets. What we seek to do is to minimise the risk that that will happen with any institution of any size.[33]

Capital requirements presently

11.28 APRA has broadly adopted the internationally agreed capital adequacy rules, under which ADIs must hold capital equivalent to at least eight per cent of risk-weighted assets. The rules are developed by the Basel Committee on Banking

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29 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 68.

30 Professor John Quiggin, *Proof Committee Hansard*, 4 March 2011, p 45.

31 Mr Ralph Norris, Commonwealth Bank, *Committee Hansard*, 15 December 2010, p 68.

32 Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 68.

33 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 12.

Supervision, at which APRA represents Australia. The current set of rules, known as Basel II, provide for capital requirements to be calculated using whichever is more appropriate of a default 'standardised' approach or a more complex, 'advanced' approach.[34]

11.29 It is sometimes claimed that the capital requirements discriminate against smaller banks and mutual financial intermediaries because the large banks are able to use the 'advanced' approach rather than the 'standardised' approach to calculating required capital and so need to hold less capital against home loans:

> …we have to hold twice as much capital to support a mortgage as what the major banks do because of the different approaches we have to measuring our capital adequacy.[35]
>
> Under Basel II the risk weighting given to mortgages held by small ADIs is around twice that of the big four banks…[36]

11.30 APRA responded:

> To be able to use the advanced status you need to have very sophisticated risk modelling, robust risk management and quite deep extensive databases and then you can manage housing-lending portfolios using a much more rigorous method. There is a complete overlay of governance and controls on top of that. You need to do that not just for your lending to housing but for how you manage operational risk and how you manage interest rate risk on the banking books. So to be called an advanced bank requires a very comprehensive set of requirements… when we look at how it all washes out, with all the various changes, it is not clear from our evidence that there is a major difference in the impact of Basel II between the advanced and standardised banks when you put it all together.[37]
>
> …approval is based on the ADI's capabilities rather than its size.[38]

11.31 There are additional imposts involved with the advanced approach too, not just benefits:

> …advanced ADIs are subject to other capital requirements that are not applied to ADIs adopting the standardised approaches. For example, APRA requires advanced ADIs to hold capital against interest rate risk in the

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34 In Australia only the four major banks and Macquarie Bank currently have approval to use the advanced approaches.

35 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 86. Similar remarks were made by Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16. See also Members Equity Bank, *Submission 77*, p 4.

36 Heritage Building Society, *Submission 113*, p 7.

37 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, pp 12-13.

38 Australian Prudential Regulation Authority, *Submission 57*, p 5.

> banking book. APRA also currently requires advanced ADIs to hold at least 90 per cent of the amount of regulatory capital that was required under the original Basel regime; standardised ADIs are not subject to such a limitation.[39]

11.32 In practice, the major banks as a group do not appear to have gained a significant competitive advantage from being able to use the advanced approach:

> Broadly speaking, the implementation of Basel II resulted in reductions of capital for advanced ADIs of between zero and ten per cent, and averaged around five per cent for standardised ADIs.[40]

11.33 Notwithstanding such assurances, Heritage, Australia's largest building society, would like the current arrangements changed:

> Given that mutual building societies and credit unions typically have significantly lower arrears rates for their mortgages than those of the big banks, it is recommended that the risk weighting for mortgages held by mutual building societies and credit unions be aligned with that of the big four banks. This initiative levels the playing field for smaller ADIs. It also frees capital to allow mutual building societies and credit unions to grow their share of the retail mortgage market more aggressively in competition with the banks.[41]

11.34 There were also claims that the capital rules are unduly harsh on small business loans:

> …the Australian Prudential Regulation Authority (APRA) should explore whether the risk-weightings on business loans secured by residential properties are punitive. Currently, APRA requires the banks to apply a risk weighting of 50-70 per cent for small business whereas regional banks have to apply a risk weighting of 100 per cent for small business.[42]

11.35 As was noted in Chapter 6 (see Chart 6.4), small business lending incurs larger losses than do housing loans and so it is justified for there to be a correspondingly higher amount of capital held against small business loans than the concessional amount required for housing loans. The Reserve Bank provides some quantitative estimates:

> …small business borrowers are more than twice as likely as standard mortgage customers to default…once a default has occurred, APRA statistics suggest that a lender is likely to lose close to 30 per cent of the small business loan's value, compared with 20 per cent for housing loans.[43]

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39 Australian Prudential Regulation Authority, *Submission 57*, p 7.

40 Australian Prudential Regulation Authority, *Submission 57*, p 6.

41 Heritage Building Society, *Submission 113*, p 7.

42 Master Builders' Association, *Submission 38*, p 6.

43 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 8.

Other current prudential requirements

11.36 APRA also require ADIs to have an adequate liquidity management strategy. Some smaller ADIs are exempted from the more complex aspects of this.[44] The mutual ADIs benefit from this. If they regard the simpler rules are more costly, they can just not apply for the exemption.

11.37 APRA also have prudential requirements covering governance, risk management, fitness and propriety, large exposures, associations with related entities, outsourcing and business continuity management; all of which apply equally to banks and mutual ADIs.[45]

The new Basel III capital and liquidity requirements

11.38 The international community has responded to the global financial crisis by tightening the global prudential standards governing capital and liquidity. The new measures are known as 'Basel III' and will be phased in from 2013.[46]

11.39 APRA explained the benefits of these reforms:

> Basel III is underpinning the capital of the banking system globally and it is also strengthening capital and liquidity buffers in the global system. We are participants in the global system.[47]

11.40 APRA does not expect the rules to be unduly onerous for Australian intermediaries:

> …APRA does not expect that the more stringent global capital regime will have significant implications for ADIs in Australia, which remained well-capitalised throughout the global financial crisis…the main impact of the Basel III capital reforms will fall on the larger ADIs due to (i) their higher usage of structured capital instruments that will no longer be eligible as regulatory capital, and (ii) a larger impact from the tighter definition of capital deductions. Overall, APRA does not anticipate standardised ADIs being materially affected by the capital reforms.[48]

11.41 Westpac explain their concerns about the new Liquidity Coverage Rules (LCR) as follows:

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44 Australian Prudential Regulation Authority, *Submission 57*, pp 7-8.

45 Australian Prudential Regulation Authority, *Submission 57*, p 8.

46 Further information about them can be found at Australian Prudential Regulation Authority, *Submission 57*, Attachment B.

47 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 8.

48 Australian Prudential Regulation Authority, *Submission 57*, p 9. See also Dr John Laker, Chairman, APRA, *Committee Hansard*, 14 December 2010, p 8.

> Banks will also need to establish capacity to survive a "run" on deposits for a month, rather than a week which applied under the old standards. This will require them to hold more liquid assets, which may limit funds available for lending to customers and add to overall costs.[49]

11.42 APRA comment about these new requirements:

> There is no doubt that there are challenges for our banks in meeting that standard but also it is not as though our banks sailed through the crisis without any liquidity issues. We know they needed the wholesale guarantee for offshore funding and the deposit guarantee. There were various sorts of assistance that were given to the banking system to help it through the crisis and to help make sure that it was able to continue to operate in an orderly fashion during the crisis. What the Basel III liquidity requirements are about is trying to lessen the need for that public sector support next time around. So it is not as though our banks were as robust on the liquidity front as they might have been or could say, 'We don't need any reform whatsoever on that side of things.'[50]

11.43 The Basel III rules are designed to restore confidence in global banking systems. In the longer term they should reduce the cost of funds for Australian banks from those prevailing since the GFC:

> Over time when these new capital reforms are bedded down globally if that underpins more confidence in global banking systems you might like to think that some of those more extreme risk premiums can come down.[51]

The challenge posed by the shortage of government bonds

11.44 There is a problem that as Australian governments have been running surpluses and smaller deficits than most other economies represented on the Basel Committee, banks will struggle to find enough bonds to meet the liquidity requirements.

11.45 One response would be to allow highly rated RMBS to be counted as liquid assets. Unsurprisingly, this idea appealed to the Australian Securitisation Forum and the banks:

> …we would put that if residential mortgage backed securities and certainly the higher rated tranches could be held as eligible assets under the liquidity tests that Basel III will introduce for Australian banks.[52]

49 Westpac, *Submission 72*, p 30.

50 Mr Wayne Byres, Executive General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 8.

51 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 8. The risk premia are unlikely to drop back to where they were immediately before the GFC as the risk premia then had been unrealistically low.

> …by accepting third party AAA RMBS paper (currently eligible securities for repurchase transactions by the RBA) as an asset under the new liquidity rules, this reform would not only assist in rebuilding the primary and secondary securitisation markets in Australia, but would also assist banks to meet their obligations under the pending Basel III regulations…[53]

11.46 The problem with this idea is that in the GFC the RMBS proved *not* to be liquid.[54] This was conceded by the Forum and a regional bank:

> …there is good liquidity when market conditions are stable and favourable, and when markets become stressed and disrupted that liquidity vanishes.[55]

> Basel III has outlawed securitisation in terms of being available for liquidity but you can understand why that would be the case, because the performance of securitisation in offshore markets has been abysmal.[56]

11.47 The best they could offer was the hope that by APRA:

> …deeming them to be acceptable as eligible securities that then can create the liquidity perception that aids the market.[57]

11.48 Another approach would be for the Reserve Bank to issue its own paper to create a riskless liquid security which banks could hold. Asked about this, the Reserve Bank responded:

> Any debt issued by the RBA would be very similar to that issued by the Government. If the RBA were to issue its own paper to provide banks with additional liquid assets, the RBA would need to consider which assets to purchase with the proceeds of that debt issue. This would likely involve purchasing private securities on an outright basis, thereby permanently increasing the credit risk that the RBA it is facing. In contrast, accepting private securities (including RMBS), on a repo basis provides an extra degree of protection for the RBA. This is why counting RMBS as an eligible liquid asset in the commercial banks' portfolios is a less risky option than the RBA holding the paper outright.[58]

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52 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 20. Members Equity Bank also argued for this; *Submission 77*, p 4, as did Aussie, *Submission 39*, p 5.

53 Australian Bankers' Association, *Submission 76*, p 57.

54 APRA, *Responses to questions on notice*, no 10, 31 January 2011, p 3.

55 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 20.

56 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 87.

57 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 20.

58 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 1.

11.49 In the event, there has been an alternative arrangement put in place by APRA and the Reserve Bank to deal with the problem:

> The Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA) have agreed on an approach that will meet the global liquidity standard. Under this approach, an authorised deposit-taking institution (ADI) will be able to establish a committed secured liquidity facility with the RBA, sufficient in size to cover any shortfall between the ADI's holdings of high-quality liquid assets and the LCR requirement. Qualifying collateral for the facility will comprise all assets eligible for repurchase transactions with the RBA under normal market operations. In return for the committed facility, the RBA will charge a market-based commitment fee.[59]

11.50 The size of the fee is yet to be determined, but the Reserve Bank have described the principles underlying it:

> The fee is intended to leave participating ADIs with broadly the same set of incentives to prudently manage their liquidity as their counterparts in jurisdictions where there is an ample supply of high-quality liquid assets in their domestic currency. A single fee will apply to all institutions accessing the facility.[60]

Banking 'licences'

11.51 Within ADIs only those with APRA's approval are allowed to have 'bank' in their name. The main impediment to building societies and credit unions being allowed to call themselves 'banks' is now the $50 million minimum capital size that APRA requires before giving this approval. (Prior to 1998 they also had to relinquish their mutual status).[61]

11.52 There are currently 25 mutual ADIs—five building societies and twenty credit unions—that have sufficient capital to meet this requirement but have not applied to APRA for approval to style themselves as banks.[62]

11.53 Abacus suggested there may be more applications:

> I think now that some of our institutions will consider asking APRA to consider their application for a bank licence.[63]

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59 'Australian Implementation of Global Liquidity Standards', *Reserve Bank of Australia and APRA Joint Media Release*, 17 December 2010.

60 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 61.

61 Abacus, *Submission 53*, p 23.

62 Australian Prudential Regulation Authority, *Submission 57*, p 3.

63 Mr Mark Degotardi, Head of Public Affairs, Abacus, *Committee Hansard*, 13 December 2010, p 86.

11.54 APRA explained the policy rationale as:

> …a test of substance, that the community has a view that banks are intended to be strong, durable financial institutions...The term does have a cachet of durability and strength.[64]

11.55 The Government has asked APRA to review guidelines around use of the term 'bank', and report to the Government in March 2011.[65] APRA's chairman explained:

> …we have said to the government that we will review the policy, and I will go into that review with an open mind and see what the issues are. There are a number of complex issues involved here, including, most importantly, financial stability impacts and customer understanding impacts. It will need careful consideration, and we will do that…The Productivity Commission also reviewed this issue this year when it was revisiting some of the regulatory impacts and its report argued, in a sense, for maintaining the status quo. It could not see a policy reason for changing that.[66]

11.56 Asked about the value of their banking licence, the Commonwealth Bank initially replied:

> Our business would have very little value if we did not have a licence. It is not valued in our books, though.[67]

11.57 Perhaps sensing that the questioning was going towards a possible charge for the licence, the Commonwealth Bank then sought to downplay its importance:

> Senator CORMANN—So, essentially, in a comprehensive sense, your Australian banking licence contributes to a lowering of, to a downward pressure on, your cost of funds?
>
> Mr Norris—No, it is that the business is assessed by the rating agencies as to the strength of the business, and they have a number of criteria that they will look at. The fact that we operate in Australia is one part of that, from looking at the economic situation, but certainly the major issues around rating are the resilience of the organisation, its sustainability and its ability to continue to generate reasonable returns and profits; those are the factors that are most relevant.[68]

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64 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 5.

65 Department of the Treasury, *Submission 102*, p 30.

66 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 5. See also *Competitive and Sustainable Banking System*, Australian Government, December 2010, p 17.

67 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 66.

68 Mr Ralph Norris, Commonwealth Bank, *Committee Hansard*, 15 December 2010, p 67.

11.58 Credit Union Australia have enough capital that they could apply for a banking licence, but have chosen not to do so. Asked why, they responded:

> …we would no longer be a credit union, which is also a protected term. We would then be a bank instead of being a credit union…we very much want to position ourselves as an alternative, so calling ourselves a bank we believe detracts from that as well as diminishes from our heritage as a credit union. Our desire is nonetheless to be able to very clearly represent that we are in the business of banking, and that is really what we are seeking.[69]

11.59 A banking licence is related to having an exchange settlement account (ESA) with the Reserve Bank. Abacus comment:

> …smaller banking institutions, such as credit unions and building societies, do not need to hold an ESA with the RBA because they can access settlement services and the payments system through central ADIs owned by the sector with specialist expertise such as Cuscal, Indue and ASL. However, a number of Abacus member banking institutions have exercised their option to become ESA holders.[70]

Bank shareholding restrictions

11.60 One possible means of increasing the number of banks would be to ease the requirements in the *Bank Shareholders Act* limiting the stake of any single shareholder in a bank.

11.61 The Vic Martin report favoured retaining limits on bank shareholdings but put the arguments on both sides:

> A wide dispersion of shareholders is regarded as offering the following advantages:
>
> - avoids dominance of control of a bank by one or few interests;
> - provides protection to depositors against a risk that a bank might be operated to serve the needs of shareholders;
> - avoids the interdependence of a bank's viability with that of a dominant shareholder;
> - ensures reasonable independence and continuity of management; and
> - may enhance the bank's capacity to raise any additional capital required.
>
> Against the above, the following points can be argued:
>
> - a requirement limiting shareholdings inhibits entry and hence tends to increase concentration in the banking industry;

69 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 84.

70 Abacus, *Submission 53*, p 21. The mutual ADIs with ESAs are Greater Building Society, Heritage Building Society, IMB Ltd, and Police Department Employees Credit Union.

- at least eleven unrelated shareholders (each of appropriate standing) are required in order to form a bank. This can be very difficult and a wasteful use of scarce, suitable domestic participants;
- a body interested in sponsoring a new bank is not able, under current administration of the *Banks (Shareholdings) Act*, to hold a substantial shareholding (ie 10 per cent or above) in a bank and this is a disincentive to sponsorship;
- a requirement for a wide dispersion of ownership effectively removes any likelihood of bank takeovers and may shift power too far in favour of management. The security of tenure for management may inhibit efficiency and innovation; and
- a few large shareholders may more readily be able to reach agreement on and to provide capital injections than a large number of shareholders.[71]

11.62 The Stephen Martin Committee cast the arguments as follows:

> …a dominant shareholder poses the risk that a bank's deposits might be used for the benefit of such a shareholder, or that public confidence in the bank would be compromised by business problems experienced by the dominant shareholder…The main argument against the ownership rules is that they remove an important market discipline, by making it more difficult for an inefficient bank to be taken over…[and] reduce the capacity of banks to benefit from economies of scale. On the question of efficiency, it is important to note that while the ownership rules limit the potential for banks to be subject to takeover, they do not restrict more efficient banks from taking away an inefficient bank's market share.[72]

Mutual ADIs and banks

11.63 Notwithstanding that APRA supervises mutual ADIs to the same standard as bank ADIs, this may not be the public perception. As one building society explained:

> Research conducted by Heritage indicates that, irrespective of their dislike for the big banks, customers perceive them to be more secure than the alternatives. This belief relates both to the size of the banks and to a common belief that they have an explicit government guarantee that the building societies and credit unions do not.[73]

11.64 Some mutual ADIs would prefer the term 'authorised deposit-taking institutions' be changed to 'authorised banking institutions':

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71 Australian Financial System Review Group, *Report*, pp 56-57.

72 House of Representatives Standing Committee on Finance and Public Administration (1991, p 129).

73 Heritage Building Society, *Submission 113*, p 5.

> …to reassure consumers that we are regulated in the same way as banks and to reinforce our core function, which is banking.[74]

11.65 Rather than being referred to as 'non-banks', with a possible misinterpretation that they are not as secure or well-supervised as banks, some mutual ADIs would prefer to be known as 'customer-owned financial institutions'.[75]

11.66 Their industry body argued:

> APRA should allow all ADIs the non-compulsory option of marketing themselves as “banks”. This would enable Abacus members to exercise the option of marketing themselves as “mutual banks” to the market generally or to market segments where the terms “credit union” or “building society” are less effective.[76]

11.67 The Productivity Commission concluded:

> It would seem, prima facie, that there is little beyond the name ‘bank’ to distinguish some credit unions and building societies from banks. It would be useful to remove any unnecessary restrictions which limit the ability of building societies and credit unions to compete with banks on a level playing field. The current restrictions on the use of terms such as ‘bank’ by other ADIs could be reconsidered.[77]

11.68 Mutual ADIs are also disadvantaged relative to banks by institutional investors being less familiar with them:

> …the banking sector is a known quantity in the investment community as opposed to credit unions. A fund manager cannot invest in a credit union today, so they have not been examining them, whereas of course they have a very strong view on the banking sector.[78]

11.69 Credit Union Australia has consistently charged less for home loans than the major banks. Asked how they can do this, they responded:

> Firstly, we do not have to generate profit at the same levels. We need to generate sufficient profits to maintain strong reserves and to fund the growth and development of the organisation, but that is the limit of our profit requirements. Anything in excess of that is returned through better pricing. The fact that a shareholder based institution would be paying out

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74 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 82. See also their *Submission 84*, p 3. A similar view was put by Heritage Building Society, *Submission 113*, p 6 and Abacus, *Submission 53*, p 22.

75 Credit Union Australia, *Submission 85*, p 5.

76 Abacus, *Submission 53*, p 22.

77 Productivity Commission *Annual Review of Regulatory Burdens on Business: Business and Consumer Services.* August 2010 Research Report, cited in Abacus, *Submission 53*, p 23.

78 Mr John Brogden, Chief Executive Officer, Financial Services Council, *Committee Hansard*, 21 January 2011, p 21.

> something like 60 per cent of its profits in dividends does give us a significant pricing advantage—or, looked at another way, we return dividends to our shareholders, who are our customers, through lower prices rather than in the form of a separate dividend. It does support that model. We are aided by the fact that we have a relatively simple business. It is a pure consumer business. It does not have the volatility of business and corporate banking, which obviously varies enormously with the economic cycle. Our intention is to keep it a simple and low-cost business as well.[79]

Recent initiatives

11.70 The Treasurer's December 2010 package foreshadows the introduction of a 'government protected' logo for ADIs which is intended to build confidence in mutual ADIs and smaller banks.

11.71 Abacus, the peak body for building societies and credit unions, welcomed the recent announcements, although they do not go as far as Abacus hoped:

> [based on] …18 months worth of market research on the barriers that people have to switching to credit unions and building societies. We constantly find the view that the big banks are covered by a separate and better regulatory system, and that is a barrier to change. So we see the idea of the protected deposits seal and that link back to government regulation as a very pro-competitive reform.[80]
>
> …the government protected deposit seal, and that certainly will go some way to improving the awareness of consumers around regulated institutions.[81]

11.72 It also attracted praise in other circles:

> So an education awareness program funded by government around the safety of mutuals is very welcome.[82]
>
> It will encourage competition coming through there, so I think that measure will be successful.[83]

79 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 86.

80 Ms Louise Petschler, Chief Executive Officer, Abacus, *Committee Hansard*, 13 December 2010, p 83.

81 Mr Mark Degotardi, Head of Public Affairs, Abacus, *Committee Hansard*, 13 December 2010, p 86.

82 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 97.

83 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 146.

Recommendation 18

11.73 The Committee recommends that mutual financial intermediaries be allowed to refer to themselves as a 'mutual bank' or 'approved banking institution' and use terms such as 'credit union bank' in their name.

Other financial institutions

11.74 ASIC explained the difference between the prudential supervision by APRA of authorised deposit-taking institutions (ADIs) and those financial institutions which raise money in wholesale markets or by offering a stake more like equity than a deposit:

> The issue about which institutions are subject to prudential regulation is a government decision, and the government has decided that the deposit-taking institutions should be prudentially regulated by APRA. All institutions, both the ones that are regulated by APRA and the ones that are not regulated by APRA, have to have a licence, and that is where we come in. One of the conditions of having a licence is certain issues which go to the financial management of the institution, so to that extent there is some form of monitoring of the financial situation of these institutions. The government has made a decision that there is greater prudential risk for institutions which accept deposits and lend money than there is with institutions which just borrow money on the wholesale market and lend the money.[84]

11.75 Some non-ADIs felt they were subject to excessively harsh requirements. In particular there was concern expressed over ASIC's RG156 rule related to the issue of debentures:

> This required that all the advertisements for debentures should include a prominent statement to the effect that investors ‘risk losing some or all of their principal and interest’.[85]

11.76 Some non-ADIs also objected to how they are required to characterise the bonds they issue:

> The changing of the naming of the from 'debentures' to 'unsecured notes' will undoubtedly put further doubt in the investor's minds with respect to the level of risk…[86]

11.77 The regulators have a delicate balancing act between avoiding terminology that may overstate the riskiness of investing with unsupervised financial intermediaries (and so reduce the competitive pressure they can exert on the ADIs)

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84 Dr Peter Boxall, Commissioner, ASIC, *Committee Hansard*, 21 January 2011, p 13.

85 Provic Group, *Submission 123*, p 5.

86 Provic Group, *Submission 123*, p 6.

and ensuring that unsophisticated investors realise that the unsupervised entities are riskier than ADIs. The Government's introduction of a 'government protected' logo may give an opportunity to allow the non-ADIs to apply less critical language.

Recommendation 19

11.78 The Committee recommends that financial intermediaries not supervised by the Australian Prudential Regulation Authority be required to state clearly that funds placed with them are 'not guaranteed by government' but otherwise should not be prohibited from applying familiar terms such as 'debenture' where this would not be misleading.

Bank holding companies and the 'narrow banking' model

11.79 Professor Davis noted:

> …there may be some scope in a proposal that I have seen from the OECD that says you should get banks to change to a non-operating holding company structure where one part of it is sort of the standard banking—taking deposits; making simple loans—and the other subsidiary part of the nonoperating holding company is the investment bank.[87]

11.80 Professor Valentine observed:

> …as a matter of history, at the Campbell committee we looked closely at the holding company concept and, at that stage—and that was 30 years ago—it seemed to us that there was a lot in it.[88]

11.81 Suncorp Group has recently adopted a holding company structure to separate its banking and insurance operations:

> …it was about transparency and simplicity to be able to explain the operations of each of our businesses more clearly.[89]

11.82 The separation of banking and other operations was also suggested:

> …one could start with the divestment of insurance / wealth management from the Big 4, the fusion of which no defensible argument has ever been mounted. Share-broking subsidiaries could readily be hived off. And so on.[90]

11.83 It is noted that in April 2011, the Independent Commission on Banking in the UK, in its interim report, recommended the ring fencing of banks' retail activities to

87 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 77.

88 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 77.

89 Mr Anthony Rose, Chief Financial Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 8.

90 Confidential, *Submission 81*, p 19.

minimise the possibility of losses from the riskier investment bank activities infecting a bank's retail business:

> …a focus of the Commission's work is the question of whether there should be a form of separation between UK retail banking and wholesale and investment banking. Ring-fencing a bank's UK retail banking activities could have several advantages. It would make it easier and less costly to sort out banks if they got into trouble, by allowing different parts of the bank to be treated in different ways. Vital retail operations could be kept running while commercial solutions – reorganisation or wind-down – were found for other operations…The Commission is therefore considering forms of retail ring-fencing under which retail banking operations would be carried out by a separate subsidiary within a wider group.[91]

11.84 Some leading academic economists have become increasingly vocal supporters of such an approach since the GFC:

> …a specific, but serious, problem arises from the ability of conglomerate financial institutions to use retail deposits which are implicitly or explicitly guaranteed by government as collateral for their other activities and particularly for proprietary trading. The use of the deposit base in this way encourages irresponsible risk-taking, creates major distortions of competition and imposes unacceptable burdens on taxpayers. Such activity can only be blocked by establishing a firewall between retail deposits and other liabilities of banks.[92]

11.85 A harsher version of the approach of separating riskier activities into a distinct part of a banking group is banning banks from any involvement in riskier activities. Such an approach was considered (but not favoured) by the Independent Commission on Banking in the United Kingdom in its recent report:

> Banks must have greater loss-absorbing capacity and/or simpler and safer structures. One policy approach would be structural radicalism – for example to require retail banking and wholesale and investment banking to be in wholly separate firms.[93]

11.86 The ACTU supports 'narrow banking' as a response to the problem of banks being 'too big to fail':

> A regulatory regime should be considered in which Australian banks are regulated as public utilities and forbidden from expanding into risky asset classes and/or jurisdictions while they enjoy a Government guarantee (explicit or implicit) of their liabilities…The Australian Government should make it clear that it will not act to ensure the continued viability of

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91 Independent Commission on Banking (2011, pp 3-4).

92 Kay (2010, pp 225-226).

93 Independent Commission on Banking (2011, p 2).

> non-deposit taking institutions that pursue excessively risky investments…[94]

Committee view

11.87 The Committee believes that APRA effectively ensures that Australian banks do not pursue excessively risky investments. This is an area, however, that could be usefully addressed by the broader inquiry into the financial system for which the Committee has called.

Social obligations of banks

11.88 Banks have a special status. For businesses, 93 per cent of respondents to a recent survey indicated their banking relationship is important or critically important.[95] They provide what could nowadays be regarded as an essential service:

> …when I first started my working life I received my wages in a little yellow envelope in cash and it was my choice if I placed some or all of that money into a bank account. Today Australian people are forced to accept their wages electronically into a bank account, we have no choice and are then charged a fee by the banks to access our own money.[96]

> Australians do not have the day to day capacity to simply opt out of the banking system. Banking is connected and integrated into our ability as citizens to function and exist in modern society.[97]

> A bank account is a necessity for effective participation in modern Australian economic life, and should therefore be regarded as an essential service.[98]

> Banks…do have a unique role in our community…Banks have a special place in our society. They are the lifeblood of liquidity… Technology and national security laws have ensured that participation in the banking system has become a mandatory feature of modern life. The banking system's crucial role in supplying the economy's financial arteries and transforming savings into investment makes it different from most other industries.[99]

> Everyone knows the financial system—and that is why the government is concerned—is such an important part of everyone's life. Post GFC, international debate has raged: are these just private sector profit-making

94 Australian Council of Trade Unions, *Submission 89*, p 3.

95 Chamber of Commerce and Industry Queensland, *Submission 43*, p 5.

96 Mr Peter Higgins, *Submission 17*, p 2.

97 Finance Sector Union, *Submission 80*, p 11.

98 Australian Council of Trade Unions, *Submission 89*, p 2.

99 The Hon. Joe Hockey MP, 'Address to the Australian Industry Group Annual National Forum, Canberra, 25 October 2010.

> entities, as we view them in Australia, or are they a hybrid, providing an essential service to the community?[100]

11.89 Many would regard banks as having social obligations in exchange for the privileges they enjoy:

> Nevertheless banks protected by government insurance of small deposits have some responsibility to return to the community a level of service and a responsible level of profit-taking...Bank management, and most particularly local bank managers, have responsibilities to the community.[101]
>
> Ultimately financial institutions must have a broader responsibility for economic development in Australia.[102]
>
> The Brotherhood [of St Laurence] believes that all Australians have a right to fair and affordable access to basic services, including banking services. Fair and affordable access to essential services helps disadvantaged and low-income people by enabling them to be part of Australia's mainstream society, and by ensuring corporate, government and community sectors all take responsibility for addressing social problems.[103]
>
> The government has recognised the special place of banks, and it grants banks privileges and benefits that are not afforded to other sectors…The banks may occasionally chafe under the restrictions, but they must concede the system of prudential supervision imparts tremendous benefits to their operations…I want a Social Compact between our Taxpayer guaranteed banks, their shareholders and our Government and our Parliament. This must define the relationship and must include direction on competition, expansion, expectations of credit and savings, community service obligations, risks and rates.[104]
>
> The social contract should provide at a minimum, access to “fee free” credit accounts for wage earners and for people on regular low incomes, portability of credit accounts, exit fee free discharges from loans and cost free access to ADR for individuals and small businesses and a mediation process…[105]
>
> …our banking system has a social obligation to the Australian community in addition to their economic and commercial role…we need them to enter into a social and economic contract for the benefit of all

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100 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Proof Committee Hansard*, 9 March 2011, p 11.

101 Mr Andrew Oliver, *Submission 1*, pp 2-3.

102 Chamber of Commerce and Industry Queensland, *Submission 43*, p 3.

103 Brotherhood of St Laurence, *Submission 29*, p 3.

104 The Hon. Joe Hockey MP, 'Address to the Australian Industry Group Annual National Forum, Canberra, 25 October 2010.

105 Mr Lindsay Johnston, *Submission 97*, p 10.

> Australians...Australia's financial service should function in an accessible, affordable and fair manner reflecting its status as an essential service.[106]

11.90 Some suggested a competitive banking system may still not meet all social obligations:

> …competition alone is not enough to address the significant problem of financial exclusion for low-income and vulnerable Australians.[107]

11.91 Westpac considered banks were just like any other company, except for the fact their deposit taking function required regulation:

> …a bank is a company like any other company… we are a regulated industry. We have depositors' funds and that is why we have the level of regulation that is required...[108]

11.92 As noted in Chapter 14, concerns have been raised about changes to the products the banks offer more vulnerable individuals, such as bank customers being pushed into credit cards instead of being able to access small personal loans.[109]

11.93 Other countries monitor banks' performance on these matters:

> …in the United Kingdom and the United States, performance monitoring has become widespread in creating accountability among financial institutions to develop affordable, appropriate products to address financial exclusion. In the United Kingdom and elsewhere, competition regulators have powers to conduct market studies to determine whether competition is benefiting all consumers.[110]

11.94 A desire to find innovative means of competing with the major banks has led one smaller bank to offer a deposit account which pays only minimal interest but instead offers a prize draw of $20,000 a month.[111] This has been criticised as encouraging savers to instead become gamblers.

11.95 The Brotherhood of St Laurence note:

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106 Finance Sector Union, *Submission 80*, pp 1- 3.

107 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 2.

108 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, pp 78-79.

109 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, pp 2 and 5.

110 Mr Gerard Brody, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 3.

111 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 21. Mr Liddy stated that while the lottery account was unique in Australia similar products were offered in New Zealand and the United Kingdom.

> On community service obligations: further regulation can be used to ensure that financial institutions provide accessible basic services to all customers. This can be necessary in markets where policymakers recognise conflict between the profit motive of firms and the social policy goals of the industry. For example, in privatised telecommunications, gas or electricity markets, companies are not able to deny access to less profitable rural or low income customers.[112]

11.96 The banks reject the idea that they should be obliged to provide basic banking products:

> …the proposal to mandate that banks, as distinct from other ADIs, offer a free transaction account to all account holders in Australia, whatever their legal and financial status, is anti-competitive, and therefore would distort the provision of retail banking services in Australia…no other business in Australia is required to provide its services free of charge.[113]

11.97 Even where banks provide a basic banking product, it may not be taken up by those customers who could most benefit:

> Especially with our clients, it takes some time to work with them to ensure that they are thinking about their finances and their money management issues and to build their financial literacy so that they are making the decisions that are in their own best interests.[114]

> We think that the banks could do more in promoting those products and identifying customers who would be eligible for such products—even make it a default option that they get put on those sorts of accounts…Generally, those accounts are available to those who have some form of Centrelink income or have access to a healthcare card or a pensioner concession card, for example. Banks generally know if that is the case with their clients, particularly around Centrelink income because it is deposited into their accounts.[115]

11.98 Bankers have played a trusted role as financial advisers in the community, but are increasingly in a conflict of interest:

> When people are asked to make financial decisions that they do not fully understand, they often rely on other people for help, particularly people that they regard as better qualified or informed. In the case of bank products, people often rely on the advice they receive from bank workers. What is not well understood is that bank workers in Australia are often paid commissions to sell their bank's products. The more products they sell—in other words, the more debt they convince customers to take on—the more

112 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, pp 3-4.

113 Australian Bankers' Association, *Submission 76*, p 44.

114 Mr Gerard Brody, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 11.

115 Mr Gerard Brody, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 7.

> money they make. In fact, encouraging bank tellers and call-centre workers to sell debt products is an integral part of a bank's marketing strategy. Consumers can no longer be confident that the advice they receive from bank workers is objective rather than conflicted.[116]

Committee view

11.99 The Committee recognises that banks are accorded a special status and given special privileges. In exchange they have social obligations to provide banking services to the broad community. These are obligations that the banks should meet voluntarily rather than compulsorily. In areas where there are unmet demands for basic banking services which the government believes on social grounds should be provided to disadvantaged members of the community, the government should invite banks to tender to provide the services and the government pay to ensure they are provided.

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116 Australia Institute, *Submission 46*, p 3.

Chapter 12

Government guarantees and support

Government guarantees for bank funding

12.1 During the global financial crisis the Government took unusual action, quickly introducing in October 2008[1] two schemes—the Financial Claims Scheme (FCS) and the Guarantee Scheme for Large Deposits and Wholesale Funding (Funding Guarantee Scheme)—to guarantee bank funding:

> At the time of the guarantees…it virtually was a time of emergency. As the governor commented, the No. 1 priority was the stability of the financial system. The financial system affects everyone's daily life. It would very much be a matter of great concern to governments if there was a shock to the financial system. The wholesale funding guarantee and the deposit guarantee ensured that that did not happen in Australia.[2]

12.2 At least in part the schemes were a response to similar measures taken overseas:

> …circumstances had reached a point in Australia—particularly because of decisions that had been taken the week earlier by the United Kingdom government and steps that we understood might have been under consideration more broadly in Europe and also in the United States—where a failure to act in a timely way in Australia could have had severe implications for the ability of Australian financial institutions to access wholesale term funding in international markets.[3]

12.3 Yet compared with other countries, the Australian guarantees had a very broad coverage:

> The duration announced was three years (longer than that announced by several other countries), amount of coverage was without limit and 100 percent (several countries had put limits on amount and percentage insured), and it included both retail and wholesale deposits at all banks

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1 The Bank for International Settlements identified September–November 2008 as the most severe stage of the global financial crisis; BIS (2009, p 16).

2 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 27.

3 Dr Ken Henry, Secretary, Department of the Treasury, cited in Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector – The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 11. APRA expressed a similar view.

> (several countries restricted it to retail deposits and certain institutions only) and was fee free (several countries had fee in place).[4]
>
> The Australian arrangements share many common features with those introduced in other countries although, on balance, the range of parameters are generally at the more supportive end of those internationally.[5]

Financial Claims Scheme

12.4 From early 2008 the Government had been developing a deposit guarantee scheme with a $20,000 cap. The Opposition called on them to raise this to $100,000 and the Government went even further. Under the FCS all deposits under $1 million with locally-incorporated ADIs are automatically guaranteed by the Government, with no fee payable. The FCS will remain in place in this form until October 2011.

12.5 In the event of failure, the Government would provide initial funds to depositors and then recover funds through the wind up process, with the option of an industry levy if there is a shortfall.

12.6 The Australian Bankers' Association's interpretation is:

> In the unlikely event that a bank or other ADI fails and there is not enough money for depositors, the legislation in place providing the guarantee authorises the Government to recover any money used for the guarantee from banks and other ADIs. (In other words, should a bank or other ADI fail, the scheme is actually underwritten by the banking industry, not taxpayers.)[6]

12.7 The wording in the legislation, however, gives the government the right but not the obligation—it says 'they may'—to ask other ADIs to help out in the event of a failure. The Commonwealth Bank thought 'it is a right that may well be exercised' but (apparently) do not regard it was a contingent liability for which provision should be made in their balance sheet.[7]

Funding Guarantee Scheme

12.8 Under the Funding Guarantee Scheme, the Government provides a guarantee, for a fee, on deposits greater than $1 million, and wholesale funding with maturity out

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4 Professor Milind Sathye, cited in Senate Economics References Committee, *Government measures*, p 19.

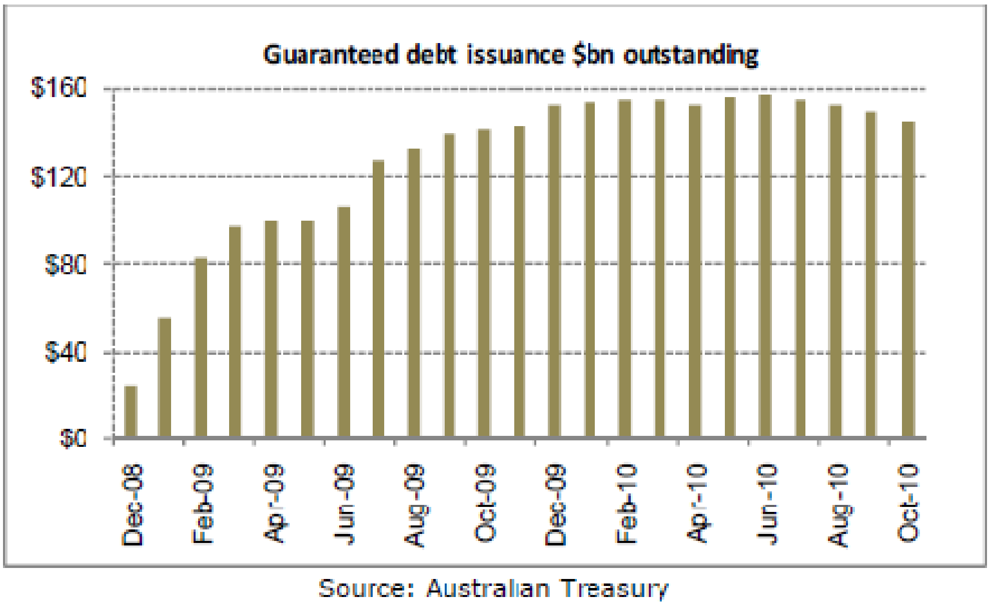
5 Reserve Bank of Australia and Australian Prudential Regulation Authority, cited in Senate Economics References Committee, *Government measures*, p 9. A table with an international comparison is also given in that report.

6 Australian Bankers' Association, *Submission 76*, p 12.

7 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, was asked twice about provisioning but did not answer; *Committee Hansard*, 15 December 2010, p 69.

to five years.[8] At its peak in mid-2010, the amount of guaranteed debt was almost $160 billion (Chart 12.1).

Chart 12.1: Government guaranteed bank debt



Source: Australian Bankers' Association, *Submission 76*, p 92.

12.9 The scheme was hailed by some smaller banks:

> It was the saviour for the Australian financial services market…[9]

12.10 Sometimes neglected in the discussion of the wholesale guarantees is that the banks paid for them:

> While banks have used the government's wholesale funding guarantee, they have paid for that privilege. In the case of the Commonwealth Bank, we expect to pay the government almost $1 billion for the use of this guarantee.[10]
>
> For this guarantee, Australia's banks are currently paying $100 million a month to the Government. So far, Australia's banks have paid over $2 billion, and are expected to pay a further $3.5 billion by the end of the scheme.[11]

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8 Unlike the FCS, the Funding Guarantee Scheme also guarantees, with some restrictions, issuance by foreign-bank branches.

9 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 19.

10 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 43.

11 Australian Bankers' Association, *Submission 76*, p 12.

> Around $5.5 billion will be paid by banks to the government for credit enhancement by the time the last of the guaranteed wholesale funding expires.[12]

12.11 On 7 February 2010, the Government announced that the Funding Guarantee Scheme would close to new borrowing from 31 March 2010, though debt previously issued under the Scheme continues to be covered until it matures.

Impact of the schemes

12.12 The Reserve Bank views these measures as successful in meeting their goal:

> The announcement of the FCS, and the arrangements for large deposits and wholesale borrowing, helped to maintain public confidence in the Australian banking sector.[13]

12.13 As one major bank put it:

> …banks in Australia would have survived without the scheme. However, they would have found it difficult to maintain an adequate supply of affordable credit in the economy. This could have had significant ramifications for the Australian economy and may have delayed the economic recovery.[14]

12.14 The GFC was accompanied by a move of deposits to the major banks, both from smaller banks and from non-ADIs. Some have suggested this was caused, or accentuated, by the guarantees:

> CHAIR—…I think the decision by the government to guarantee deposits of only ADIs reinforced that flight to quality. Do you agree with that? I see you nodding, for the benefit of the Hansard.
>
> Mr Lloyd—We would completely agree with that and would go further: the guarantee in the way it is structured, particularly now that we have four ADIs that everyone knows will not be allowed to fail, has given those very large ADIs an extra competitive advantage courtesy of the government and the taxpayer.[15]
>
> The failure to include BDAs [bank deposit alternatives][16] in the deposit guarantee served to significantly widen the gap with regards to the

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12 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 117. See also Australian Bankers' Association, *Submission 76*, p 23.

13 Reserve Bank of Australia, *Submission 41*, p 26.

14 ANZ Bank, *Submission 94*, p 7.

15 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 29.

16 As defined by the Financial Services Council, these include cash management trusts, mortgage trusts and certain bond funds.

perception of the underlying risk between bank deposits and BDAs…it effectively discourages investors from investing in BDAs.[17]

…there is no doubt that at the time they [deposit guarantees] had a detrimental effect on the non-bank savings sector, the non-ADI savings sector. That was probably most obviously felt with the requirement of mortgage trusts within our sector to freeze redemptions.[18]

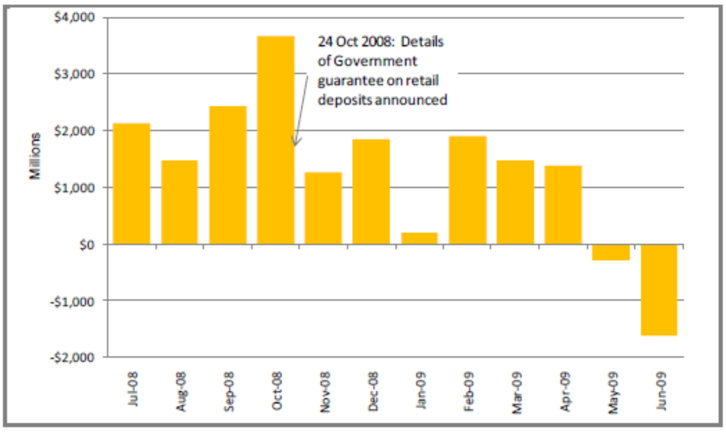
The members of the Provic Group saw the average deposits in their companies fall from $118 million in 2008, to $75 million in 2009 as a result of the global financial crisis and being excluded from the government guarantee…[19]

12.15 The evidence from Treasury is that:

…a drift of money back into the ADIs, deposit-wise, from other forms of holding investments was happening before the deposit guarantee was actually put in place...the introduction of the guarantee just reinforced that...[20]

12.16 The Commonwealth Bank presented data suggesting that, rather than accelerating it, the guarantee halted the flight of funds to the major banks (Chart 12.2).

Chart 12.2: Change in Commonwealth Bank retail deposits



Note: The growth in Dec 2008 and then again in Feb, March and April 2009 was influenced by the Government stimulus payments which were made in these months and largely spent in the following months. Retail deposits are household deposits as defined by APRA

Source: Commonwealth Bank of Australia, *Submission 88*, p 18.

17 Financial Services Council, *Submission 121*, p 4.

18 Mr John Brogden, Chief Executive Officer, Financial Services Council, *Committee Hansard*, 21 January 2011, p 19. See also Aussie, *Submission 39*, p 5.

19 Provic Group, *Submission 123*, p 6.

20 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 28. The Reserve Bank expressed a similar view; Senate Economics References Committee, *Government measures*, p 30.

12.17 This was also the view of the other major banks:

> The majors [banks] contend that the flight to quality during the GFC meant that, inevitably, lenders would prefer them over lower-rated, smaller institutions but that the government guarantee particularly of deposits stemmed the extent of this flight to them.[21]

12.18 Some non-ADIs believe Australia should have extended the guarantees more broadly as they argued occurred in some other countries:

> …the broader guarantee offered by the New Zealand Government to their financial institutions including debenture issuing companies.[22]

12.19 It is inevitable that, whenever a somewhat arbitrary decision is made to help institutions of a certain type, institutions just outside the boundary will feel aggrieved. The Governor of the Reserve Bank commented:

> The question really is: can you guarantee everything?...My view would be that you cannot. In a situation such as the one that we faced in October 2008, I would argue for stabilising the core of the system…And that is essentially what was done, and I think it was right.[23]

12.20 This view is supported by Treasury:

> The issue is…whether the guarantee should have been extended to finance companies and other mortgage providers. The governor said that they needed to draw the line somewhere and his primary aim was the financial system. We agree with that and that was the thinking behind it.[24]

12.21 APRA was asked what smaller companies would need to do to become ADIs and therefore be covered by the scheme. APRA replied:

> It needs to have adequate capital for the sort of business that it wants to take on. It needs to have a strong and robust board if it is coming into Australia and we are presuming it is here already but wants to be a locally incorporated ADI. It has to have strong risk management systems and strong personnel that can run those systems…It is a tough test to get past.[25]

12.22 A large building society recounted how, to their surprise, the guarantees were used by smaller ADIs:

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21 Australian Securitisation Forum, *Submission 74*, p 11.

22 Provic Group, *Submission 123*, p 6.

23 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 13.

24 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 28.

25 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 9.

> Given their preferential treatment in the pricing of the wholesale guarantee it is logical to assume that the big banks would have made most use of the facility. In fact, while major banks were significant issuers in the early stages of the GFC, ongoing difficulties within securitisation markets forced some smaller, lower rated banks to continue to utilise guaranteed wholesale funding even though the cost was much higher relative to the big banks because of the increased guarantee fee and the additional premium demanded by investors because of perceived risks associated with lower rated ADIs…Since the wholesale guarantee was removed in March 2010 only one senior debt wholesale markets transaction has been completed by an ADI with a credit rating below A (long term). Heritage believes the Government needs to level the playing field in relation to access to funding at cost effective levels by reintroducing the wholesale guarantee for smaller ADIs.[26]

Pricing of the guarantees

12.23 The Reserve Bank explained the considerations behind the average level of the fees:

> In setting the premiums on the guarantee the Government considered a range of factors, including international settings and the need to ensure that the arrangements did not continue indefinitely. The fees were set at a level between the then current risk spreads – the product of very stressed conditions – and spreads that were considered likely to prevail in more normal market conditions. This was designed to act as a natural exit mechanism, so that when pricing of risk improved, the yield spread between unguaranteed and guaranteed debt would narrow to below the guarantee fee and it would become cost-effective for issuers to return to unguaranteed issuance.[27]

12.24 Controversially, the fees charged for the wholesale guarantees differed between ADIs. The fees were set in relation to credit ratings, as an indication of the risk involved. ADIs rated AAA to AA- were charged 70 basis points, those rated A+ to A- were charged 100 basis points and others were charged 150 basis points.

12.25 The differential charges were strongly criticised by Abacus, the smaller banks and others:

> …during the GFC the largest banks accessed a wholesale government guarantee that we were not able to access because of the differential pricing on that guarantee. The cost for us therefore was too expensive. And that did put us at a disadvantage.[28]

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26 Heritage Building Society, *Submission 113*, pp 3-5.

27 Reserve Bank of Australia, *Submission 41*, p 27.

28 Mr Mark Degotardi, Head of Public Affairs, Abacus, *Committee Hansard*, 13 December 2010, p 92.

> There are differences of guarantee and differences in the price of guarantee, which has disproportionately benefited the major banks.[29]
>
> Entities in the Australian marketplace which are regulated by the one entity, APRA, are subject to the same prudential standards…I do not believe the 150 basis points that we were charged was reasonable.[30]
>
> …if you equalise the cost arrangements in respect of the wholesale funding guarantee, that is going to be a direct advantage to those second-tier institutions, and they would have the capacity to flow that through…it certainly would allow them to compete more actively on price.[31]

12.26 The differential charges for the guarantees were defended by the Governor of the Reserve Bank:

> The government was going to provide effectively a guarantee on wholesale obligations. The question is: should that be done without any regard to the rating of those entities or not? The decision was taken—in my view, correctly—that the fees should be related to the strength of the institution. We used publicly available credit ratings in order to do that. I think that was appropriate. It is still the case that, even for those institutions that are paying the higher fee, they have been able to borrow using the guarantee and paying the fee more cheaply than they otherwise would have.[32]

12.27 While it is true that the lower–rated intermediaries were able to borrow, as the borrowings cost them more than the big banks there was an adverse impact on their ability to compete.

12.28 The pricing structure was similar to that in many but not all comparable countries:

> The fees charged for the government guarantees on wholesale funding are typically based on the credit rating of the issuer (Australia, Canada and New Zealand), or credit default swap premiums (France, the Netherlands, Spain and the United Kingdom). In contrast, in the United States the fee charged is dependent on the term of the instrument but not the rating of the issuer. The fee structure adopted in the Netherlands and New Zealand also depends partly on the term of issuance.[33]

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29 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 31.

30 Mr John Minz, Chief Executive Officer, Heritage Building Society, *Proof Committee Hansard*, 4 March 2011, p 13. See also Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 11.

31 Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, provide effectively*Committee Hansard*, 15 December 2010, p 114. See also Chamber of Commerce and Industry Queensland, *Submission 43*, p 19.

32 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 17.

33 Reserve Bank of Australia, *Financial Stability Review*, March 2009, p 46.

12.29 The Australian scheme used a relatively simple fee structure. This may have been a good thing. The Bank for International Settlements noted that in overseas countries 'the take-up under government debt guarantee programmes was slower than expected as issuers were deterred by the terms and the costs…the complexity of these guarantee programmes and the varying treatment across jurisdictions deterred some investors'.[34]

12.30 The problem was that, surprisingly[35], investors seemed to ignore the guarantee when deciding what interest rate they would demand on the guaranteed bonds from smaller banks:

> The unintended consequence around that is essentially that the assumption was that everyone would be priced off the sovereign curve for the pricing; however, the market looked through that and essentially priced against the credit ratings of the various institutions, and on top of that was a fee differential.[36]
>
> This fee structure had an unintended consequence of a ‘double dip’ on any non-AA rated ADI, as the credit markets ‘looked through’ the guarantee to the issuer’s underlying credit rating anyway – for example, BOQ on its first issuance paid 150bps to the Government for the fee on top of 115bps to the market. By comparison, the major banks were paying ~75bps to the market and only 70bps as the fee to the Government for the guarantee.[37]

12.31 The Bank of Queensland quantified the impact:

> If the government guarantee on wholesale funding were flattened to the fee that the major banks pay for all remaining payments, BOQ would be able to immediately reduce our variable mortgage rate by 20 basis points.[38]

12.32 The Reserve Bank noted that:

> The fee applicable to AA-rated institutions under the Australian Guarantee Scheme (70 basis points per annum) was at the low end of the international range for schemes with this structure…The differential between institutions with different credit ratings under the Australian Guarantee Scheme was, however, relatively large by international standards…[39]

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34 BIS (2009, p 106).

35 The CEO of the Australian Bankers' Association said '…at the time of that announcement perhaps no-one could have anticipated this looking-through issue'; cited in Senate Economics References Committee, *Government measures*, p 17.

36 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 10.

37 Bank of Queensland, *Submission 44*, pp 4-5.

38 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16.

39 Schwartz, (2010, p 20), cited by Abacus, *Submission 53*, p 8.

12.33 With the benefit of hindsight, there are some alternatives that would have avoided relying on credit rating agencies but not involved the government underwriting unduly risky institutions, and would have been pro-competitive:

> Heritage recommends a flat fee be applied and, to manage the Government's total exposure, suggests that the guarantee only be made available to smaller ADIs that satisfy key balance sheet metrics.[40]
>
> …a better outcome would have been achieved by pricing the guarantee exactly the same for all ADIs whilst limiting the amount each ADI could raise under the guarantee. This would have preserved the existing market dynamic and avoided the outcome of the major banks using the artificial pricing advantage that emerged to make significant grabs for market share.[41]

12.34 The Committee examined the guarantee in 2009 and concluded:

> The Committee recommends that, in view of the experience of markets not pricing all guaranteed debt identically, the Government review the need to apply differential premia for ADIs with different ratings for the wholesale funding guarantee (and hence also that applying to deposits over $1 million).[42]

12.35 Unfortunately the Government has either not conducted such a review or not released the results. While the guarantee no longer applies to new borrowings, it still applies to a significant amount of longer-term debt and the resulting additional imposts on lower rated ADIs impedes their ability to compete.

Recommendation 20

12.36 The Committee recommends that, to increase the competitiveness of smaller lenders, the Government immediately standardise the fee for all borrowers under the wholesale funding guarantee to a uniform rate of 70 basis points.

Permanent deposit insurance or guarantee scheme

12.37 Abacus, the peak body representing building societies and credit unions, believes a permanent deposit insurance or guarantee scheme would be pro-competitive as it would reduce the advantage the major banks have from being perceived as 'too big to fail'[43]:

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40 Heritage Building Society, *Submission 113*, p 5.

41 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 78.

42 Senate Economics References Committee, *Government measures*, p 19.

43 The notion that the major banks are 'too big to fail' is discussed in Chapter 11.

> The FCS [Financial Claims Scheme] levels the playing field for large and small banking institutions and is a procompetitive factor. Any reduction in the FCS cap from $1 million will benefit the four major banks to the competitive detriment of other regulated banking institutions. Rather than being seen as a risk to the taxpayer, the FCS should be seen for what it is – an early access facility for depositors' funds in the event of an institution failing.[44]

The threshold

12.38 While the $1 million threshold was an essentially arbitrary choice, it did seem to succeed in retaining confidence in bank deposits. As Professor Harper commented:

> …could they have done that with a guarantee of $250,000 or $500,000 or $100,000? I do not know the answer to that. In a sense, what I am saying is that I would far rather that the government erred on the side of too big a hit than too small a hit, because you only get one chance to do that in those circumstances. Fortunately, the government's intervention worked and I do not know if it would have worked at $500,000 or $250,000. If it had not worked, the chances of a second round working would have been much lower and we would have been in a much more difficult situation.[45]

12.39 Contrary to a view that bank runs result from small, less sophisticated and informed, investors (whose concerns could be addressed by a relatively small threshold), Professor Harper argued:

> These things start in the wholesale markets. The irrationality that you are talking about was amongst wholesale investment funds. Frankly, the banks, including our major banks, stopped lending to each other…you are not talking about ordinary Herald Sun-reading folk on the train…The ones who ought to have known better were frightened to the point of closing their balance sheets, not lending and hoarding cash—the whole lot. That is why, in my view, the best thing to do was to convince people who had a lot of money that it was all safe rather than the mums and dads with not that much.[46]

12.40 Abacus argues for the retention of the $1 million ceiling:

> …the retail deposit guarantee at a level of $1 million helps us compensate for some of the lack of community understanding of the fact that we operate under the same regulatory system... you should not move from the $1 million, that people understand it, that it is simple, that it gives the vast

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44 Abacus, *Submission 53,* p 12.

45 Professor Ian Harper, cited in Senate Economics References Committee, *Government measures,* p 7.

46 Professor Ian Harper, cited in Senate Economics References Committee, *Government measures,* p 7.

majority of retail depositors comfort in dealing with a smaller bank or a credit union or a building society.[47]

12.41 Abacus note that in comparable international jurisdictions:

> All US credit union members are protected by a government backed 'share insurance' scheme of $250,000 per member [and] many Canadian credit unions are covered by unlimited government guarantees explicitly designed to support their growth and competitiveness…[48]

12.42 An international comparison done by the Committee for an earlier report suggested the Australian threshold is well above the global norm.[49]

12.43 An opinion poll conducted in June 2009 suggested the public still wanted the deposit guarantee in place then:

> Only 30 per cent of those surveyed said they would be comfortable keeping money in the bank with no guarantee. A guarantee of deposits up to $50,000 would satisfy 50 per cent of the population. A $100,000 guarantee finds two-thirds public support, while a $500,000 guarantee brings in 80 per cent.[50]

12.44 One suggestion to build competition to the major banks was to only apply deposit insurance to some of their rivals:

> Credit unions and building societies have in the past been a valuable alternative to banks. We submit that the government create further assistance in making the mutual segment a more attractive place to deposit your moneys, by guaranteeing Australian depositors exclusively in relation to mutuals.[51]

> …the government needs to take actions that are decidedly in the favour of smaller financial institutions. The smaller financial institutions, the cooperatives, the mutuals, need to be given some kind of favourable financial institution status. If the deposit guarantee is restricted to the smaller players then that will clear the competition for the majors…I would suggest that that wholesale funding guarantee should be reinstated for the smaller financial institutions.[52]

12.45 The banks are happy to see the FCS continue as a permanent scheme:

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47 Ms Louise Petschler, Chief Executive Officer, Abacus, *Committee Hansard*, 13 December 2010, pp 83 and 88. This argument is supported by Credit Union Australia, *Submission 85*, p 11 and Heritage Building Society, *Submission 113*, p 5.

48 Abacus, *Submission 53*, p 32.

49 Senate Economics References Committee, *Government measures*, pp 50-51.

50 The poll was conducted for IFSA. *Australian Financial Review*, 7 August 2009, p 56.

51 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 96.

52 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 40.

> The Federal Government should retain the Financial Claims Scheme (FCS) and consultation should be conducted to ensure an orderly transition and to avoid anti-competitive effects.[53]

12.46 A permanent form of deposit insurance seems to be generally welcomed, although some felt the banks should be paying for it:

> …we welcome the confirmation of the permanency of the Financial Claims Scheme…[54]

> …there is one proposal to make the government guarantee on retail deposits permanent using the government protected deposit slogan. Again, I do not disagree with this policy. The government must acknowledge that there is risk transfer here. Eventually an ADI in Australia will fail—it is inevitable at some stage; this will happen—and I believe that ADIs should pay a premium for this taxpayer guarantee, similar to the FDIC in the United States. Such a levy would help protect taxpayers in the inevitable event of an ADI failing.[55]

> …where we need to move to improve competition in the Australian banking system is to make the federal government insurance of the banking system explicit…as the insurer, the government (1) should correctly work out the actuarial risk associated with banking activities and charge the banks an insurance premium and (2) should take an active role in preventing the banks from engaging in activities that create too much risk.[56]

12.47 The banks could either pay through an annual fee, or a one-off levy when a bank fails. The problem with the latter is:

> …in the event that one financial institution falls, it is likely that the others are going to be under stress. That is the time that they are least able to do it. So it is not an easy solution, because all these other financial institutions are probably under the same stress and inevitably it will be in a recession.[57]

12.48 The industry body for mutuals argues:

> The deposit guarantee poses no risk to the taxpayer because:
>
> 1. the prudential regulatory framework ensures that it is highly likely that the remaining assets of a failed institution will be sufficient to recover funds paid out under the FCS to depositors; and

53 Australian Bankers' Association, *Submission 76*, p 51.

54 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 16.

55 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

56 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 99.

57 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 160.

> 2. in the unlikely event of there being a shortfall, regulated banking institutions will be levied to make up the difference.[58]

12.49 In deciding which intermediaries should be covered by an insurance scheme, Professor King suggests:

> The obvious starting point is the deposit-taking institutions that we have already.[59]

12.50 Yellow Brick Road argues that it should be restricted to those ADIs that need it and that:

> …the Government should limit future retail deposit guarantees for the Major Banks and their subsidiaries, both in duration and value per deposit account, as their need for this support has declined.[60]

12.51 These are the organisations covered by APRA's prudential supervision. This accords with the, admittedly not disinterested, view of Abacus:

> Non-ADI industry bodies have argued that financial products that are “close substitutes” to deposits are disadvantaged by being outside the FCS. However, such products are not direct competitors with deposits if issuers of such products are not subject to prudential supervision and requirements on capital, liquidity, risk-management, reporting, auditing and governance.[61]

The Government's decision

12.52 The Government confirmed that the FCS would be a permanent feature of the financial system in December 2010, with a permanent cap set from October 2011.[62]

Recommendation 21

12.53 The Committee recommends that the financial claims scheme should be retained in its current form pending the outcome of a full inquiry into a deposit insurance scheme, possibly charging risk-related premia. The inquiry should also examine the issue of guaranteeing non-ADI products that are close substitutes for deposits, with a view to being better placed to provide such a guarantee as future need arises.

58 Abacus, *Submission 53*, p 12.

59 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 101.

60 Yellow Brick Road, *Submission 101*, p 9.

61 Abacus, *Submission 53*, pp 13-14.

62 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 18.

Other government support for competitors to the major banks

12.54 As discussed in other chapters of this report, the Government has encouraged mutuals to apply to use the term 'bank', and has instructed Treasury to accelerate work on designing the most appropriate structure for bullet RMBS issuance by smaller institutions.

12.55 The Government also plans an information campaign to promote competitors to the major banks:

> We'll put our mutual credit unions and building societies, together with our regional and other smaller banks, right at the centre of this awareness campaign, to properly inform consumers about the safe and competitive alternatives they offer to the big banks.[63]

12.56 A tangible manifestation of this is the introduction of a new 'Government Protected Deposit' symbol.[64]

12.57 A more direct way for the government to create stronger competitors to the four major banks would be by capital injections into competitors:

> If for example the Federal Government wished to engender competition, it could simply do so by purchasing a substantial shareholding in the smaller banks by way of a designed share issue, so as to increase their shareholder capital, and thus increase their capacity to lend into the market by way of credit creation using existing bank capital.[65]

Committee view

12.58 The Committee supports the introduction of the 'Government Protected Deposit' symbol as a means of allowing mutual and smaller ADIs to compete on a more equal footing.

12.59 The Committee notes that, unlike in many other comparable countries, the Australian government did not have to take equity stakes in banks during the GFC and regards such stakes as a practice to be avoided.

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63 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 14.

64 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 14.

65 Mr Mervin Reed, *Submission 5*, p 11.

Chapter 13

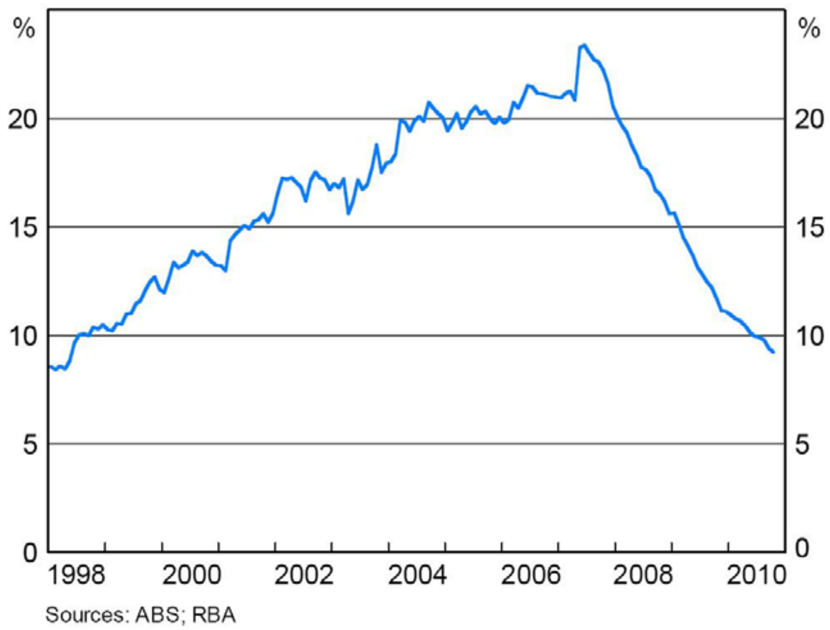
Bonds: a key funding source

13.1 While the traditional source of funds for banks is deposits, in Australia a significant amount of funds have been raised by banks issuing bonds. From the 1990s these bonds have been supplemented by a new class of bonds issued by some non-bank lenders who essentially fund new loans by selling off old ones. The loans are bundled up and bonds giving a claim on the cash flows from them are sold. The process is known as 'securitisation' and the resulting bonds are known as 'asset backed securities' (ABS). In Australia this process has predominantly been applied to home loans with the resultant securities being known as 'residential mortgage backed securities' (RMBS). This technique allows a financial institution to expand its lending much faster than would be possible were it relying on setting up a branch network to raise retail deposits. In the 1990s new organisations which utilised wholesale funding by securitisation such as Aussie Home Loans, RAMS and Wizard quickly became household names. Some non-bank ADIs also tapped this new funding source to expand their lending. This increased the competition in the housing loan market markedly.

Securitisation

13.2 Banks, and even more particularly non-bank mortgage originators, made increasing use of securitisation prior to the GFC. At its peak in 2007, securitisation accounted for over a fifth of new housing loans (Chart 13.1).

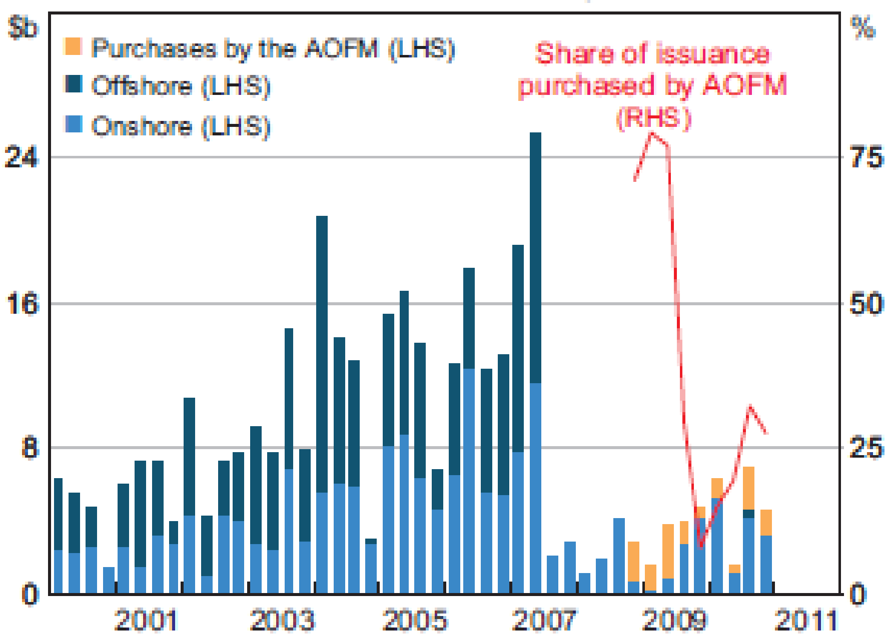
Chart 13.1: Share of housing credit funded by securitisation (monthly)



Source: Reserve Bank of Australia, *Submission 41*, p 3.

13.3 The expansion in securitisation in Australia was part of a global phenomenon. By 2006 the value of asset-backed securities issued in the US and Europe had reached $4 trillion, comparable to that of all corporate bonds. The GFC saw a collapse in the securitisation market, with issuance down to $1 trillion in 2009 and 'securitisation and the new intermediation model blamed for financial instability'.[1] The subsequent collapse in the Australian market for residential mortgage-backed securities (RMBS) is illustrated by Charts 13.1 and 13.2.

Chart 13.2: Australian RMBS issuance



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p 48. (Update of chart included in Heritage Building Society, *Submission 113*, p 3)

13.4 The Reserve Bank described the collapse and why they think it is unlikely it will be (entirely) reversed:

> The securitisation market was particularly adversely affected by the financial crisis. The contraction in securitisation markets was not unique to Australia, but was a world-wide trend driven by changes in global markets. The business models of some of the Australian lenders reliant on it were no longer viable and they either ceased lending or were bought by a larger institution.[2]
>
> …a large part—probably half—of the flow of investment prior to the crisis was by foreign investors, many of whom were SIVs[3] and conduits and so

1 Albertazzi et al (2011, p 1).

2 Reserve Bank of Australia, *Submission 41*, p 4.

3 Structured investment vehicles. Laminar Group also suggests SIVs bought about half the RMBS; *Submission 34*, p 8.

> on. Those people actually had a very risky business model, which we all know now. Those people are not coming back, so we are not going to see that sort of investor demand from offshore again virtually at any price, I would say.[4]

13.5 The Reserve Bank believes that the securitisation market is now close to its 'normal' size. This differs from some submitters who call for support 'until normality returns to the securitisation market'.[5]

13.6 Some other participants concurred with the Reserve Bank:

> …vehicles such as the structured investment vehicles, SIVs, and some of the hedge funds are probably unlikely to come back. Certainly the SIV is a not a business model that is sustainable post-crisis.[6]

> …the securitisation market is unlikely to return in either volume or pricing to where it was pre-GFC.[7]

13.7 A more critical note was sounded by a bank analyst:

> …many organisations' business models came under intense pressure when the securitisation market froze in 2007. It could be argued that many of these business models were flawed as they were too heavily reliant on a single source of funding which was only available at economic levels during a boom or a bull market.[8]

13.8 Yellow Brick Road were a bit more optimistic, suggesting that some of the overseas investors had 'gone into hibernation' with the implication they will in time wake up.[9]

13.9 There were also those somewhat agnostic about the prospects of a return to pre-GFC securitisation levels:

> …financial experts are not predicting an early end to the effects of the GFC on global markets and economies, with some analysts suggesting it will take another two years to see market conditions stabilise. Furthermore, there is still uncertainty over whether or not funding costs will then return to the lower levels seen in the years preceding the GFC.[10]

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4 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, pp 3-4.

5 Australian Chamber of Commerce and Industry, *Submission 37*, p v.

6 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 18.

7 Heritage Building Society, *Submission 113*, p 6.

8 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

9 Mr Owen Williams, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 102.

10 Australian Bankers' Association, *Submission 76*, p 66.

13.10 It has been noted that the whole RMBS market has been tarred by the excesses overseas and their reputation damaged:

> …as an asset class globally, mortgage backed securities have had a severe reputational hit. It is certainly true that the ones sold in this country are of fabulous quality but, as an asset class as a whole, unfortunately, there has been a reputational hit which will take time to be worked off.[11]
>
> Our assessment of the reason that there is not sufficient liquidity today in the RMBS market is more about market perception of asset qualities and liquidity.[12]

13.11 The Australian Office of Financial Management (AOFM) was questioned about the basis for securitisation:

> Senator PRATT—I want to ask from the perspective of our financial system as a whole rather than from the point of view of individual issuers what the advantage is of having financial intermediators securitising mortgages rather than issuing bonds to fund mortgage lending which remains on balance sheets?
>
> Mr Bath—It tends to be more cost-effective. Because mortgages are such a safe investment, by issuing debt that is backed by those mortgages the overall cost of funds for a financial intermediary can be reduced significantly.[13]

13.12 There are flaws, however, in the securitisation market, which have led regulators in some countries to rethink whether it is desirable for there to be no recourse to lenders once they have securitised loans :

> The RMBS market is resource dependent, overly complex and creates an ongoing operational burden for issuers due to the requirements created by external stakeholders such as credit rating agencies. In addition, changes in external stakeholder views or a shift in risk appetite, as well as the punitive regulatory changes insisted on by APRA (often applied retrospectively), reduce the efficiency of this channel from a capital and operational perspective. …there is an over-reliance on mortgage insurers (another oligopoly within Australia) to support RMBS structures…[14]
>
> In theory, securitisation should result in risk being passed to those agents best placed/most willing to manage it. However, the global financial crisis has showed that, because of the complexity and opacity of securitised products, investors did not understand the risk they were bearing and,

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11 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 4.

12 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 97.

13 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 106.

14 Heritage Building Society, *Submission 113*, p 5.

> hence, credit was misallocated. As a result, global regulators are proposing that banks retain 'skin in the game': that is, retain an exposure to the underlying assets within the securitisation pool and hence to the quality of their original credit assessment. These proposals are yet to be fully developed but capital requirements will inevitably reflect the residual risk that an ADI retains.[15]

> The basic issue with securitization is the role of asymmetric information. In particular, banks rely on soft information to grant and manage loans. Since this information cannot be credibly transmitted to the market when loans are securitized, banks might lack incentives to screen borrowers at origination or to keep monitoring them once the lending has been securitised... The evidence on the whole supports the thesis that the rise of subprime mortgages was accompanied by a decline in lending standards.[16]

> …mortgage originators in some countries failed to exercise appropriate diligence in undertaking credit assessments. Asset retention policies are one way in which other countries have sought to address this issue. By requiring issuers to retain some 'skin in the game', these policies are intended to incentivise mortgage originators to maintain appropriate underwriting standards.[17]

13.13 The UK experience was cited as a cautionary tale of how securitisation can lead to problems:

> …in the UK, with the Northern Rock example, such steady, available and cheap funds through the securitisation market meant that they had an unstable model and they fell over.[18]

> Between 1919 and 2000 the five (then four) UK major clearing banks controlled ~85% of the deposit market. However, following the Cruickshank Report into bank competition in 2000 and the substantial increase in funding availability that coincided (via securitisation) the UK banking environment changed substantially. Lending underwriting standards were loosened by newcomers, first in mortgages then in commercial property, leverage increased and asset prices rose sharply. Eventually the large banks followed to protect their position. Then the Global Financial Crisis (GFC) hit. We believe the short-term gains consumers enjoyed from competition appear more than offset by tax payer bail-outs and the recession.[19]

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15 Australian Prudential Regulation Authority, *Responses to questions on notice*, *no 6*, 31 January 2011, pp 3-4.

16 Albertazzi et al (2011, pp 2-3). Their own study casts some doubt on this for the case of Italian banks.

17 Department of the Treasury, *Responses to questions on notice*, *no 14*, 4 February 2011, p 2.

18 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 97.

19 Mr Jonathan Mott, Analyst, UBS, *Tabled document no. 5*, 14 December 2010, p 1.

13.14 As discussed further below, the Government provided some temporary support to the securitisation market during and just after the GFC. The ABA called for more work to identify other means to rebuild the securitisation market:

> Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to rebuild the securitisation market in Australia.[20]

13.15 There is a concern that, as a result of the flaws in the securitisation market having been exposed, it is unlikely ever to regain its former size. Arguments that the government should support the market until this happens may therefore effectively be calls for the government to prop up the market indefinitely. The Governor of the Reserve Bank warned that:

> …the taxpayer is being asked to shoulder more risk, one way or another, in order to facilitate the provision of private finance.[21]

13.16 Specifically addressing support for the RMBS market, the Governor counselled caution:

> One idea that one sees around is the extension of guarantees for mortgage-backed securities by the government, which is done in some other countries. Various people put forward arguments why that may be a good idea, and it may be. But if one were inclined to go down that track one would want to do it with great care because, when you think about extensive public intervention in housing markets, we do not need to look any further than the United States of America to see that that can go wrong if you are not very careful about the way incentives are designed.[22]

13.17 Treasury was among other witnesses who sympathised with the Governor's view:

> …caution as to how far governments should get involved in private market practices. Treasury is very much in agreement with the governor on that…[23]
>
> I become concerned when taxpayer money is used to artificially support markets and results in a risk transfer from the private sector to the taxpayer.[24]

13.18 While supportive of measures to invigorate the securitisation market, even the Australian Bankers' Association was hesitant about permanent support:

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20 Australian Bankers' Association, *Submission 76*, p 56.

21 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2. He elaborated somewhat on p 6.

22 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 6.

23 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 36.

24 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

> A countervailing argument and one of importance is that we also do not want to create a situation where certain markets or certain participants require permanent government support, because that situation would be a problem if it arose.[25]

13.19 One alternative suggested that the cost of supporting the RMBS market be borne by the banks:

> We do not expect the government to fund this sort of initiative. We do submit that if it cannot be funded through consolidated revenue that a social licence fee on major banks, subject to conditions including capacity and other things, be used as a levy to fund the initiative in the early stages.[26]
>
> …by introducing a fee-based facility for offering Government support for the payment of principal and interest on the securities, this reform could provide an opportunity for improving liquidity in the secondary market, but also encourage investment in primary issuance.[27]

Committee view

13.20 The Committee notes the important role the securitisation market played in injecting competitive vigour into the home loan market (and lending markets more broadly) before the GFC. It hopes that such vigour can be regained. It accepts that the taxpayer should not be expected to underwrite the market indefinitely as this is likely to delay restructuring of the market and discourage innovation. But it calls for support for the rebuilding of the securitisation market.

Bullet bonds

13.21 A 'bullet' RMBS returns the principal to the investor in a single lump sum upon maturity, with regular interest payments over the term of the security. This contrasts with traditional RMBS where the principal is repaid progressively over the term of the security.

13.22 One attraction of bullet bonds is that they may be eligible for inclusion in bond market indices. As many institutional investors try to replicate such indices, this increases demand for the bonds.[28]

13.23 The AOFM has facilitated issue of a bullet bond by a smaller bank and the Government is encouraging Treasury and AOFM to accelerate this work.[29]

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25 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 14 December 2010, p 104.

26 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 98.

27 Australian Bankers' Association, *Submission 76*, p 57.

28 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 21.

29 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 21.

13.24 The Australian Securitisation Forum commented:

> We are particularly supportive of and encouraged by the interest of the government in promoting and facilitating the evolution of bullet style residential mortgage backed securities.[30]

13.25 They explained the attractions as follows:

> …those that are less sophisticated in evaluating prepayment speeds and the pass-through principle that is a characteristic of RMBS might be attracted to buy a bullet security where they know they can invest in $10 million today and get $10 million back in three years time and treat it more like a standard bond…bullet style of RMBS will help the market go back to the international community because they will be able to source a currency swap at a cheaper price than they would if they had to put in place a specialised or tailored currency swap to account for the prepayments of principle that you can expect comes through on the underlying portfolio of assets.[31]

13.26 Others added about the attraction of bullet bonds:

> There are coupon or interest payments over the life of the transaction and then at what we call maturity you get back all of your principle and the final coupon. Mortgage backed securities that we have been investing in by and large until recently…have been amortising pass through structures. These are less attractive to investors because not only do they get their principle back in dribs and drabs over time but they also do not know exactly when they will get it back. There are two types of risk—or features that investors are not particularly attracted to—that the bullet structure removes. One is the long-term dribs and drabs return of their capital and one is the unknown rate at which the capital will come back. So the bullet structure is attractive to investors.[32]

> …a bullet bond structure is something we do support. It is something that makes a currency swap cheaper and more efficient to be able to raise those funds.[33]

> We therefore welcome the support for the development of bullet RMBS securities as a step toward satisfying the requirements of the broader fixed interest market…[it would] facilitate superannuation fund investment through incorporation in the fixed income index.[34]

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30 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 16.

31 Mr Dalton, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 19.

32 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 96.

33 Mr James Austin, Chief Financial Officer, FirstMac Group, *Proof Committee Hansard*, 4 March 2011, p 20.

34 Mortgage House of Australia, *Submission 115*, p 2. See also FirstMac Group, *Submission 26*, p 5 and Australian Bankers' Association, *Submission 76*, p 58.

13.27 The Australian Securitisation Forum suggested:

> …a more efficient way of achieving a bullet RMBS is to allow for substitution of assets and to permit an ADI to buy-back the performing assets at maturity – this eliminates negative drag and reduces extension risk for investors. However, the ASF notes that the current prudential and regulatory framework does not allow APRA (or any other relevant regulator) to assess and administer such structures in a way that is efficient from a capital and liquidity perspective for an ADI. It requires a more specific direction from Government, from a policy perspective, to allow such structures.[35]

Committee view

13.28 The Committee is keen to encourage the securitisation market as a means of promoting competition. Facilitating the issuance of bullet bonds would make a contribution to this.

Recommendation 22

13.29 The Committee recommends that the Government ask the Australian Prudential Regulation Authority to review aspects of its prudential framework to ensure that there are no inadvertent impediments to the issuance and trading of bullet bonds.

Treatment of securitisation

13.30 As noted above, views differ about whether it is desirable for securitisation to remove totally the risk exposure from the originating lender, or whether they should retain some exposure; some 'skin in the game' as it is known.

13.31 The International Organization of Securities Commissions (of which ASIC is a member) issued a report in 2009 which recommended the following regulatory responses to the problems that had arisen due to securitisation:

> 1. Consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation in order to appropriately align interests in the securitisation value chain;
>
> 2. Require enhanced transparency through disclosure by issuers to investors of all verification and risk assurance practices that have been performed or undertaken by the underwriter, sponsor, and/or originator;
>
> 3. Require independence of service providers engaged by, or on behalf of, an issuer, where an opinion or service provided by a service provider may influence an investor's decision to acquire a securitised product; and

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35 Australian Securitisation Forum, *Submission 122*, p 15.

4. Require service providers to issuers to maintain the currency of reports, where appropriate, over the life of the securitised product.[36]

13.32 The Australian Securitisation Forum commented:

> …the securitiser, whether that is the seller of the assets or the originator of the assets, should retain an interest that reflects the level of risk in the underlying assets…something modest for prime pristine pools of mortgages or it could be something higher for non-conforming mortgages, equipment leases or credit card receivables…[37]

13.33 The Reserve Bank Governor stressed the need to maintain the quality of RMBS:

> …underwriting standards in Australia remain pretty good. You have to keep that, obviously, for the quality of the securities to remain high. In fact, one of the thrusts of the global regulatory work that people are working on has been how to restart securitisation globally but on a basis which keeps the standards up, which keeps the incentives of the underwriters correctly aligned, and that is not easy to do. But that is the key thing: to keep the underwriting standards high. Most people seem to feel that one component of doing that is for the originator to keep a stake in the outcome rather than being able to shift all the risk away to the end investor, because if they are able to totally shift the risk then their incentive to keep the standards up is obviously weakened…we probably will be, over time, heading to a world in the global regulatory architecture where it will be expected that the originating lender retains some so-called 'skin in the game' as a way of keeping the incentives correct.[38]

13.34 Some other witnesses shared this view:

> …it is very important that we look at the recourse of a mortgage origination and that we do not move to an originate-to-sell model, which was one of the primary causes of the US subprime crisis. If we learn one thing from the GFC, it is that the writer of the loan must retain the majority of the risk; otherwise, bad lending practices will develop.[39]

> …there is a need for some degree of skin in the game…[40]

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36 International Organization of Securities Commissions, *Unregulated Financial Markets and Products: Final Report*, September 2009, p 21.

37 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 21.

38 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 7.

39 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

40 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 106.

13.35 While supportive of the approach, one of the world's leading authorities on financial supervision, Professor Charles Goodhart, warned it may constrain the revival of the securitisation market:

> ...[securitisation] largely depended on trust that credit qualities were guaranteed by the ratings agencies, by due diligence undertaken by the originators and by the liquidity enhancement and support of the parent bank. Without that trust, the duplication of information can be horrendously expensive. The attempt to restore trust…by requiring banks to hold a share of all tranches in a securitized product can make the whole exercise less attractive to potential originators. So, the market for securitization remains becalmed.[41]

13.36 Mr Mark Bouris, an active participant in the RMBS market through his former organisation Wizard and now with Yellow Brick Road, also supported the idea of originators maintaining a stake:

> …we are requiring issuers to put equity into the particular issues—which is somewhat similar to the Canadian model, which shows that they are not just buying their assets or originating assets and then loading the risk off to somebody else—that they maintain equity in there; that there are minimum standards of quality in relation to not only the performance of the pool but how the pool is created; there is credit scoring and transparency; and that they have capped LVRs.[42]

13.37 APRA's regulation APS120 requires an ADI, if they are to get capital relief, to satisfy APRA that there has been absolute transfer of the credit risk to third-party investors. If ADIs are required to retain some 'skin in the game', either by allowing some recourse from buyers of the ABS or more simply by just holding some of the ABS on their balance sheet, they will therefore have to hold additional capital consistent with the additional risk to which they will be exposed. This will, of course, make securitisation somewhat less attractive as holding additional capital represents an increased cost. It may be more of an issue for small lenders with small capital bases who rely on securitisation to enable them to originate more mortgages than they could support on their balance sheet.

Recommendation 23

13.38 The Committee recommends that, in order to retain incentives for careful credit assessment, an authorised deposit-taking institution which securitises a loan portfolio be required to keep a proportion of the resultant asset-backed securities on its balance sheet and hold appropriate levels of capital. The proportion should be set by the Australian Prudential Regulation Authority in consultation with the Australian Securities and Investments Commission to

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41 Goodhart (2010, p 165).

42 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 97.

balance incentives to maintain credit standards with the desirability of encouraging the recovery of the securitisation market.

The Reserve Bank's repo operations

13.39 Another area where smaller ADIs are, perhaps inadvertently, disadvantaged arises from the Reserve Bank's rules on what securities they accept in their repurchase arrangements:

> The RBA's definition of eligibility for repurchase agreements… unreservedly favour the major banks, in that the existing definition only provides 'repo' eligibility for long term debt issued by ADIs that are rated above A.[43]

13.40 A change is suggested:

> …the current RBA definition relies too heavily on credit rating opinions and does not give weight to the strong regulatory environment under which all ADIs operate. A relaxation of the RBA definition to incorporate all investment grade issuance would enhance the market for senior debt issuance for smaller ADIs by providing access to a more diversified investor base and reduce the need for smaller ADIs to rely predominantly on securitisation.[44]
>
> RBA repo eligibility criteria should be adjusted to include all ADIs regardless of their rating (including unrated entities) and RMBS.[45]

13.41 Concerns about the reliability of credit ratings have been noted in Chapter 9.

Recommendation 24

13.42 The Committee, having more confidence in the Australian Prudential Regulation Authority's oversight than in the opinions of credit rating agencies, recommends that the Reserve Bank accept as eligible paper for repurchase agreements long term debt issued by any authorised deposit-taking institution rather than just those rated above A.

The Australian Office of Financial Management programme

13.43 The Government has supported smaller lenders by instructing the AOFM to purchase AAA-rated RMBS. The measure had bipartisan support—indeed it was argued whether the idea had first been proposed by the Government or the Opposition.

43 Heritage Building Society, *Submission 113*, p 7.

44 Heritage Building Society, *Submission 113*, p 8.

45 Bendigo and Adelaide Bank, *Submission 58*, p 6.

13.44 The programme had three phases; $8 billion just after the GFC in September 2008, a further $8 billion in October 2009 and the Government foreshadowed a further $4 billion in its December 2010 statement which it initiated in April 2010.[46]

13.45 The Australian Securitisation Forum views the three phases as having differing natures:

> The first $8 billion was probably almost a lifeline to keep the sector going and particularly to provide funding to the smaller institutions…The second tranche I think the AOFM played a more expanding role to encourage investment by buying into the longer-dated tranches in the transactions. …With the last phase of the $4 billion there is the preparedness for it to be used in ways that could aid, for example, the evolution of the bullet-style residential mortgage backed securities.[47]

13.46 The Reserve Bank pointed to a number of advantages of the programme relative to alternatives:

> …it can be directly tailored to help specific types of institutions; the support can be phased out easily; the likelihood that the Government loses money on its investment is very small; and there is no ongoing contingent liability to the Government from the support.[48]

13.47 The Governor added at the hearing:

> The taxpayer takes on some risk. Doing it this way it is confined, the securities are being managed by people who have got expertise, so I do not have a problem with that; I think it was a sensible trade-off.[49]

13.48 Treasury believe the AOFM programme has been effective:

> It has been significant and, realistically, it has kept some of the smaller players in the game.[50]

13.49 The Government asserts:

> The Government's $16 billion RMBS investment continues to put downward pressure on borrowing costs for households and small business.[51]

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46 Australian Government, *Competitive and Sustainable Banking System*, December 2010, pp 19-20; 'More support for a competitive lending market', *Treasurer's media release* no 031, 8 April 2011.

47 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 24.

48 Reserve Bank of Australia, *Submission 41*, p 6.

49 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 18.

50 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 43.

51 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 19.

13.50 As argued in Chapter 5, with borrowing costs effectively determined by the Reserve Bank, any impact is likely to be marginal. It may have increased the supply of credit to some borrowers. The AOFM estimates that about a tenth of funds have been lent to small business.[52]

13.51 The AOFM programme is also supported by a number of market players:

> We also welcome the government's announcement of a further tranche of AOFM's RMBS investments because the recovery of the securitisation market and better pricing for smaller banking institutions will help regional banks, us and non-bank lenders to deliver tighter pricing and put more competitive pressure on the banks.[53]
>
> …the AOFM has played an important role in both fundamentally sustaining the businesses of some of the smaller players through the worst aspects of the crisis and providing important signals to the investment markets that the government sees that securitisation is an important sector of the financing of the Australian economy and that the government has an interest in seeing that the sector recovers. [54]
>
> The government support for securitisation through the AOFM has been vital to rebuilding confidence in that market.[55]
>
> …of the 13 Western economies and banking systems considered by the KPMG review…in 2008 only two, Australia and the UK, had no government involvement in the mortgage market.[56]

13.52 Associate Professor Zumbo, bringing the perspective of a competition policy academic rather than a financier, also called for some government support:

> There needs to be a role for government to promote that confidence in that securitisation market.[57]

13.53 But some thought it did not go far enough, either in the amount of funding or in being restricted to higher-rated bonds or in its focus on residential loans:

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52 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 19.

53 Ms Louise Petschler, Chief Executive Officer, Abacus, *Committee Hansard*, 13 December 2010, p 84.

54 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 17.

55 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Proof Committee Hansard*, 14 December 2010, p 79. See also Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2; Members Equity Bank, *Submission 77*, p 2; and ING Bank, *Submission 35*, p 2.

56 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 67.

57 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 54.

… the injection of $16 billion of funds through the AOFM and the promise of another $4 billion in the banking reform package. While that is welcomed, it will not be sufficient to revive the securitisation market….[58]

It will not hit the sides…that [additional $4 billion] is two days of funding…Chickenfeed… If the government want to make a difference and promote competition, they would have to invest at least $30 billion to $40 billion a year, and that is only a small amount.[59]

…support has been restricted due to the AOFM's current investment mandate that only allows it to invest in A rated notes. While investors have been returning to the higher rated notes, lower rated notes in securitisation issues remain difficult to sell at reasonable margins and it would greatly assist if the investment mandate was expanded to provide the AOFM with the ability to invest in these notes.[60]

The AOFM mandate should be expanded to permit the purchase of these lower [class B] subordinated tranches….[61]

There is support amongst some (but not all) industry participants for the investment programme of the AOFM to be broadened to include the lower tranches of RMBS as these classes are proving the hardest to sell to investors…[62]

…housing loans in Australia are $1 trillion. So even a below average growth rate of, say, seven per cent will require $70 billion in funding. So doubling the RMBS investment by another $16 billion would be meaningful to competition.[63]

13.54 Others cautioned about taking it further:

Substantial amounts of taxpayer money are now being used to artificially stimulate these markets. At present, the risks taken are low, given taxpayer money is only invested in the AAA tranches of RMBS. However, I would be very cautious over any moves to use taxpayer money to go further down the capital structure of RMBS to the subordinated tranches such as BBB or

58 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 66.

59 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, pp 117-8.

60 Credit Union Australia, *Submission 85*, p 8. At the hearing CUA's CEO added that the amount 'is unlikely to be sufficient to support anticipated demand from the credit unions and building societies movement if competition in banking is indeed to increase to meaningful levels'; Mr Chris Whitehead, *Committee Hansard*, 25 January 2011, p 82. See also Abacus, *Submission 53*, p 16.

61 Members Equity Bank, *Submission 77*, p 3. See also Think Tank Property Finance, *Submission 61*, p 5.

62 Australian Securitisation Forum, *Submission 74*, p 12.

63 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16.

> equity or any proposals to have a government guarantee on those issues. This would lead to a material risk transfer from the originator of the mortgages to the taxpayer, especially at a time when household leverage in Australia is the highest in the world and everyone acknowledges that housing is unaffordable.[64]

13.55 The purpose of the programme is to support smaller lenders who would otherwise have difficulty attracting funding. For this reason the AOFM has not bought bonds issued by the major banks. It has also not bought bonds issued by entities in which the major banks have large stakes, as these would presumably be more able to attract funds from the major banks themselves.

13.56 This proved controversial in the case of Aussie, which is 33 per cent owned by the Commonwealth Bank, but regards itself as acting independently.[65]

Committee view

13.57 The Committee welcomes the programme of AOFM purchases of RMBS, which it would like to see continue. While the initial motivation was preventing the Australian financial system seizing up during the global financial crisis, the focus now should be on helping smaller lenders attract the funding they need to compete in the market with the four major banks. With this new focus on competition, the AOFM should now be allowed to invest in a wider range of securities.

Recommendation 25

13.58 The Committee recommends that the Australian Office of Financial Management programme be expanded to include asset-backed securities based on assets other than home mortgages and to include securities rated AA or A (rather than just AAA) or issued by a financial intermediary supervised by the Australian Prudential Regulation Authority.

Recommendation 26

13.59 The Committee recommends that the Australian Office of Financial Management be given the discretion to purchase residential mortgage-backed securities issued by entities with a substantial bank shareholding where it judges this would promote a more competitive market.

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64 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

65 *Proof Committee Hansards*, 14 December 2010, pp 114-6; 15 December 2010, pp 58-59, 97-103; and 9 March 2011, p 15.

Other proposals for government support of securitisation

13.60 Mr Bouris believes areas where government support may be needed initially is in establishing a secondary market for trading RMBS so that they have the liquidity needed to give investors (in particular Australian superannuation funds) confidence in holding them. This suggestion did not appeal to the banks:

> The ABA does not believe that the establishment of an exchange would be of benefit to the securitisation market, and by itself would not create or enhance liquidity. We consider that the additional transaction costs associated with pre and post-trade infrastructure would likely have an adverse impact on the desirability of securitised products.[66]

13.61 Mr Bouris also suggested conducting a survey of potential demand for types of RMBS. The Australian Securitisation Forum described this proposal as:

> …a useful thing for us to consider. [67]

13.62 Mr Bouris would also like RMBS to be based on specific classes of mortgages. For example:

> 'Australian backed mortgages which have this credit score and have been rated by their agency, and lend money to everyone in Sydney who is earning over $70,000,' or something like that.[68]

13.63 He recommended various forms of standardisation:

> …to support securitisation the Government should sponsor the establishment of an industry standard for disclosure of information concerning marketable pools of Australian mortgages…[and] for credit scoring of applications for Australian mortgages, and require disclosure of the distribution of such credit scores within each Standardised Australian Mortgage Securities.[69]

13.64 The banks were not attracted to this idea:

> The ABA believes that independent benchmarks might stifle innovation.[70]

13.65 Mr Bouris' concept is somewhat similar to the new category of preferred securities being proposed in the US. The Committee acknowledges that such well defined securities that have characteristics meeting certain parameters will make investment in such products more attractive, but would correspondingly, render all

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66 Australian Bankers' Association, *Responses to questions on notice, no 15,* 8 February 2011, p 3.

67 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 19.

68 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 99. This is elaborated in *Submission 101*, p 10.

69 Yellow Brick Road, *Submission 101*, pp 11-13.

70 Australian Bankers' Association, *Responses to questions on notice, no 15,* 8 February 2011, p 3.

other securities less attractive, as well as lower the average quality of those securities not meeting the defined parameters. As such, in a market such as Australia's, which does have some activity, it could limit the market as much as improve it.

13.66 Abacus called for a government repurchase programme to improve liquidity:

> Currently some investors are unwilling to invest in Australian RMBS because of doubts about the ability to resell that investment before the expiry of the investment term. The presence of the Government as a repurchaser (in circumstances to be controlled and prescribed) would provide greater certainty to investors thus stimulating demand in the market.[71]

13.67 The ABA thought liquidity support could be restricted to certain types of RMBS:

> Furthermore, this reform could restructure the securitisation market and achieve broader regulatory objectives by identifying those securities that qualify for liquidity support. For example, certain market attributes and credit quality standards could include setting minimum loan-to-value ratios, imposing loan servicing criteria, improving transparency of data about issuances/tranches, imposing a retention (or capital) requirement, requiring credit quality enhancements or insurance, and establishing origination standards by requiring APRA licensing.[72]

13.68 One market player felt the regulation of the securitisation market needs to be improved:

> There is a pressing need for improved alignment and dialogue between policy makers (Treasury), regulators (APRA/RBA) and industry to ensure that the policy objectives of improved competition (via securitisation) is not frustrated by unnecessary or unintended regulatory conduct. Measures to improve the quality, efficacy, and coordination of engagement between relevant parties would be of material assistance in improving policy outcomes.[73]

The Canadian model

13.69 A number of submissions referred to the Canada Mortgage Bond programme which was introduced there in 2001. The AOFM provided the Committee with a description of the Canadian model:

> …the Canadian model has two components to it. One is a government intervention in what I would call the lenders mortgage insurance market, so it guarantees credit performance…on the underlying mortgages…In Australia in the 1960s or 1970s, the Australian government had a mortgage

71 Abacus, *Submission 53*, p 17.

72 Australian Bankers' Association, *Submission 76*, p 57.

73 Members Equity Bank, *Submission 77*, p 4.

> insurer. However, as the market was opened up to the private sector and competition, the government of the day stood back and now there are private sector providers of lenders mortgage insurance…The other aspect of it is that you have a facility that essentially guarantees the creation of a bullet structure…There are coupon or interest payments over the life of the transaction and then at what we call maturity you get back all of your principle and the final coupon.[74]

13.70 The Canadian programme is widely used there:

> …the large Canadian lenders all access the CMB program. In fact, 83 per cent of all issuances come from them. There is a good reason for that: pre-GFC the funding cost advantage of a Canadian mortgage bond versus the next cheapest alternative source of funding was 23 basis points. In early 2008, when the impact of the GFC had hit, the cost advantage was 105 basis points.[75]

> If you look at the Canadian model, 30 per cent of all their mortgages are securitised through the national scheme.[76]

13.71 Some witnesses regarded the Canadian Mortgage Bonds Program as a model which could be adopted here:

> …what was needed was not a temporary or a bandaid fix but a permanent system whereby lenders could be assured of access to funds, irrespective of the economic environment. We pointed to the Canadian model of a good example of what can be achieved by a government.[77]

> …the government should look at a system similar to the Canadian system, where the government—with a similar population— over five years have stood behind $300 billion in mortgage backed securities.[78]

> …that [Canadian mortgage] model has proven to be very resilient during the global financial crisis. You would think if anyone was going to be impacted by issues around securitisation it would have been Canada because they are right next door to where the major securitisation issues were. Yet it got through that period very well and continues to do well.[79]

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74 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 96.

75 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 67.

76 Mr Phillip Naylor, MFAA, *Proof Committee Hansard*, 14 December 2010, p 73.

77 Mr Phillip Naylor, MFAA, *Proof Committee Hansard*, 14 December 2010, p 67.

78 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, p 111.

79 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, pp 86-87. See also Virgin Money Australia, *Submission 62*, p 4 and Associate Professor Frank Zumbo, *Submission 56*, p 10.

> One option, similar to that in the Canadian system, would be to enable banks to access government guarantee for RMBS issuance for a fee, effectively creating a new class of security which would be seen by investors as an Aussie government guaranteed mortgage bond.[80]

13.72 It could be argued, however, that the Canadian model is popular there because it addresses problems that had arisen in North America but these problems have not arisen in Australia:

> Do you set up a permanent institution to guarantee credit performance? Arguably, credit has not ever been an issue on mortgage backed securities that have been issued in Australia. There has never been a credit loss on a rated mortgage backed security in Australia, so why do you need the government to guarantee something that does not need a guarantee?... The other aspect of it is: do you want to set up a permanent institution that will enable the ratio of bullet securities to the total amount of mortgages being financed to be increased further? That is a separate question to whether a government should be guaranteeing mortgage backed securities.[81]

13.73 Some supporters of the AOFM programme do not want a permanent government agency:

> The Agency model is the securitisation of mortgage backed securities by Government agencies…ME Bank does not support the agency model as it does not result in a market led approach, instead relying upon a Government intermediary interposing with the market, restricting investor choice. This also disconnects each issuer from a direct relationship with investors creating concentration risk.[82]

13.74 When Treasury was asked for their opinion, they referred the Committee to their submission to an earlier inquiry. The submission concluded:

> A Canadian-style program of support to the RMBS market, under which the Government guaranteed RMBS issued by lenders or purchased such RMBS outright using proceeds from the issuance of government-backed debt securities, could potentially enhance smaller lenders' access to funds. However, it is not clear that such an intervention would necessarily result in substantially greater choice and lower interest rates for mortgage borrowers,

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80 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2. See also Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16.

81 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 97.

82 Members Equity Bank, *Submission 77*, p 3.

> or that the benefits of the proposal would outweigh the associated risks and costs.[83]

Committee comment

13.75 The Committee believes that enhancing the securitisation market would facilitate smaller organisations providing competitive pressure to the major banks. It therefore believes that proposals suggested by market players should at the least be investigated further. It does not at this time favour the introduction of a programme of government support such as that in Canada. It would, however, like to see some more research done into how the Canadian model could be applied in Australia so that a scheme is in the 'bottom drawer' of the authorities ready to be implemented quickly if circumstances warrant it.

Recommendation 27

13.76 The Committee recommends that the Government commission a survey of potential demand for types of asset backed securities.

Recommendation 28

13.77 The Committee recommends that the broader inquiry into the financial system investigate ideas that may further the participation of smaller lenders in the securitisation market, such as greater standardisation and disclosure, liquidity support for securities issued by mutual ADIs meeting certain quality standards and better co-ordination between regulators.

Recommendation 29

13.78 The Committee recommends that Treasury develop a plan to introduce a support programme for RMBS similar to that operating in Canada in case a future deterioration in the securitisation market requires its introduction.

Covered bonds

13.79 The Government announced in its December 2010 package that it will amend the *Banking Act 1959* to allow Australian ADIs to issue covered bonds.[84] These are

83 Treasury, *Submission 167* to House of Representatives Standing Committee on Infrastructure, Transport, Regional Development and Local Government for its 2009 inquiry into the impact of the global financial crisis on regional Australia, cited in Treasury, *Responses to questions on notice*, *no 14*, 4 February 2011, pp 3-4.

bonds giving the holder a preferred claim on a specific group of assets on a bank's balance sheet. They differ from RMBS in that the assets stay on the banks' balance sheet but are 'ring-fenced' to give investors priority over depositors and other creditors in the event of the issuer going bankrupt.

13.80 Covered bonds offer 'dual recourse' as:

> If the cover assets are not sufficient to meet the bond payments in full, covered bondholders also have an unsecured claim on the issuer to recover any shortfall. In that case they would stand on an equal footing with the issuer's other unsecured creditors.[85]

13.81 Treasury comment:

> This initiative is designed to strengthen and diversify the financial system's access to cheaper, more stable and longer duration funding in domestic and offshore wholesale capital markets.[86]

13.82 The attraction of covered bonds for the issuer is that they should be able to be issued with a lower interest rate:

> It will be cheaper because our wholesale funding is AA rated and covered bonds are typically AAA rated.[87]
>
> ING Direct, for example, has a long term rating of A+ from Standard and Poor's but could issue a covered bond with a AAA rating.[88]

13.83 One caveat on this is that, as described in Chapter 12, government-guaranteed bonds were also expected to be issued at lower yields but, for reasons still not clear, the market priced them instead at the issuer's rating.

13.84 Proposals to allow the issuance of covered bonds are welcomed by a number of submitters:

> …it is another important step in diversifying funding and we would like to take advantage of it.[89]
>
> …covered bonds have a role in expanding and widening the investor base and in diversifying the funding base of ADIs.[90]

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84 As part of this commitment, on 24 March 2011 Treasury released an exposure draft of the Banking Amendment (Covered Bonds) Bill (No.1) 2011 for consultation.

85 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 17.

86 Department of the Treasury, *Submission 102*, p 30.

87 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 13 December 2010, p 64.

88 ING Bank, *Submission 35*, p 2.

89 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 64.

> I believe that covered bonds are a good move. That will improve the funding position of all the players.[91]
>
> …covered bonds are priced considerably cheaper than the bank can borrow funds in its own name, and that will have a benefit for us in terms of reducing the overall cost of funding to the industry.[92]

13.85 Covered bonds are commonly used in a number of countries:

> …they have been around in Germany, for instance, for about 150 years. The structure is fairly well established as to how they work…[93]
>
> They are used in many other markets. We [NAB] have issued them ourselves out of our New Zealand bank.[94]
>
> The covered bond market is large, with a total global amount outstanding of about €2.2 trillion in 2010. Around 300 institutions in over 30 countries have issued covered bonds. The bulk of covered bonds, around 90 per cent, have been issued by countries in the euro area…[95]
>
> In more than twenty nations, covered bonds perform a critical role on the liability and asset sides of bank balance sheets.[96]

13.86 Australia's depositor protection arranged had prevented their issue here:

> Under the *Banking Act 1959*…depositors must stand first in the queue in the event that a bank or deposit-taking institution is put into liquidation. That section in the *Banking Act* has always precluded the introduction of covered bonds in Australia.[97]

13.87 This has changed with the introduction of new arrangements for depositor protection:

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90 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 16.

91 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 35.

92 Mr Philip Coffey, Chief Financial Officer, Westpac, *Committee Hansard*, 21 January 2011, p 94.

93 Dr Guy Debelle, Assistant Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 8.

94 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 64.

95 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 17.

96 Australian Securitisation Forum, *Submission 122*, p 15. The countries are Austria, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, South Korea, Spain, Sweden, Switzerland, United Kingdom, U.S.A. and Ukraine.

97 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 2. See also Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 17.

> The Government's position is that the introduction of the Financial Claims Scheme has opened the door for Australian institutions to have covered bonds.[98]

13.88 It seems to be generally accepted that, at least initially, covered bonds will help the major banks but may be of limited use for smaller competitors such as the mutuals:

> Abacus strongly rejects however the notion that covered bonds are pro-competitive. There is little doubt that the major banks will be able to source additional lower cost funding through covered bonds, however it is unlikely that many smaller regional banks, credit unions or building societies would be able to access funding through such an instrument.[99]
>
> …covered bonds. I think that is an obvious help to the major banks.[100]
>
> …covered bond market…will not be an option for any bank under an AA rating in the short term (ie. it will only provide a benefit to the major banks).[101]

13.89 The main reason is that it is generally regarded that the minimum viable size for an issue of covered bonds is a few hundred million dollars.[102]

13.90 The major banks suggested the smaller lenders could issue covered bonds by pooling their operations:

> …if there are willing issuers and there are buyers out there the market will find a way to package or structure that so that the smaller banks can benefit from that market. I have no doubt that will happen.[103]

13.91 A warning was sounded by one submitter:

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98 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 36.

99 Abacus, *Submission 53*, p 17. See also Mr John Minz, Chief Executive Officer, Heritage Building Society, *Committee Hansard*, 4 March 2011, p 15.

100 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 149. See also Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 36; Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, pp 55-56; and Dr Evan Jones, *Submission 81*, p 6.

101 Bank of Queensland, *Submission 44*, p 4. See also Bendigo and Adelaide Bank, *Submission 58*, p 5; Heritage Building Society, *Submission 113*, p 7; Mr David Foster, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2;

102 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Proof Committee Hansard*, 14 December 2010, p 150. A survey by the Australian Securitisation Forum suggests there is some investor interest in smaller issuance sizes of $100 million to $200 million; see their *Submission 74*, p 16.

103 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 125. A similar view was put by Mr Philip Coffey, Chief Financial Officer, Westpac, *Committee Hansard*, 21 January 2011, pp 70-71.

> The impression their backers give is that they minimise risk. In reality they simply redistribute risk, so that the bond holders are exposed to less risk and the depositors, including the "mums and dads", are exposed to more risk then they would otherwise be.[104]

13.92 One way of limiting this problem is the common international practice of capping the amount of covered bonds that can be issued to around 5 per cent of the loans.[105] As the Reserve Bank describe:

> Countries that have only recently begun to permit covered bonds have tended to manage the subordination of depositors and other creditors by setting limits on the issuance of covered bonds. Regulations in Canada and rules proposed in the US Covered Bond Act limit covered bond issuance to 4 per cent of a deposit-taker's assets (in Canada) or liabilities (in the United States).[106]

13.93 This has also been suggested as a response to concerns here:

> …there is a limit on the proportion of the ADI's assets that can be encumbered for covered bond holders instead of deposit holders, so that the latter still sufficient recourse to an issuer's assets in the event of insolvency.[107]

13.94 Especially given the strong capitalisation of Australian banks and the very low chance of one defaulting, this would ensure that the issue of covered bonds does not pose any risk to depositors, or the taxpayers guaranteeing them.

13.95 The covered bond market proved more resilient than did that for RMBS during the GFC, although the Reserve Bank caution that:

> …despite providing more safety to investors, covered bond issuers' access to debt markets became seriously disrupted during the crisis, suggesting that the robustness of covered bonds should not be overstated.[108]

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104 Mr George Ivanov, *Submission 124*, p 6.

105 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Proof Committee Hansard*, 14 December 2010, p 151.

106 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 18.

107 Australian Securitisation Forum, *Submission 74*, p 17.

108 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 18.

Fixed interest markets more generally

13.96 The weakness in the RMBS market is viewed by some as part of a generally underdeveloped market for fixed interest securities:

> …we do need a big increase in domestic appetite for fixed interest. Our fixed interest market relative to our equity market is quite small on international standards. That is the case even though we have got a terrific savings pool in superannuation. Unless we can get a domestic fixed interest market of substance up and running, we are going to remain hostage to offshore investors, we are going to be reasonably inefficient as an economy because there will be more going into equity and we will not be leveraging to the appropriate amount we should, and there will be some restriction on funding for lower rated institutions...[109]

13.97 The Government aims to boost the vibrancy of bond markets by further streamlining disclosure requirements and prospectus liability regulations, and facilitating the trading of government bonds on securities exchanges to provide a more visible benchmark yield.[110]

Tapping superannuation

13.98 As noted above, the Government links the issue of covered bonds to accessing funds in superannuation:

> A deep and liquid covered bond market will help to channel Australia's national superannuation through the financial system into productive investment in all sectors of our economy.[111]

13.99 Some submitters want superannuation funds to be encouraged or required to provide more funding to ADIs.[112]

> …the Government needs to clearly investigate if the funds invested in Superannuation can be diversified in such a way that it could assist with funding of the banking system… There is a need to bridge the gap between superannuation funds sending much of their funds offshore and the needs of the Australian community, which is made up of the members they serve. Legislation could easily be drafted to support this public interest…Leaving the superannuation funds (and other institutional investors) to direct

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109 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 82.

110 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 24.

111 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 23.

112 Mr Rob Paton and Mr Ismar Tuzovic, *Submission 13*.

investment according to the market system contributed to the global financial crisis.[113]

No fund manager will look at a BBB ADI but (they) are happy to invest 20 per cent of their portfolios in offshore or emerging markets equities. This is not sensible for banking competition…If the Government wants to promote RMBS, the market needs to develop a link to a more significant investor base, i.e. the Australian superannuation funding pool.[114]

…investment and superannuation funds (both wholesale and retail) have an asset allocation that is over-weight equities and under-weight fixed income securities.[115]

…there are also some other opportunities to support competition…via further superannuation reform to encourage a greater proportion of fixed interest investments by superannuation funds…[116]

13.100 The ABA suggested:

The Federal Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to promote investment in deposits and fixed income assets within superannuation and retirement income products.[117]

…the Federal Government, in partnership with the banking industry, should conduct…a research exercise as part of responding to the 'Cooper Review' should look at conducting thorough analysis of the drivers and barriers for saving, thereby identifying how best to target savings messages. Understanding the factors that influence individuals' decisions about money, savings, investment, superannuation, debt and lifestyle choices will be important for determining how best to encourage greater personal superannuation contributions and private savings.[118]

13.101 The ABA, clarified, however, that they are not looking for regulations:

Prescribing investment options or mandating asset allocations is likely to have unintended and adverse consequences for superannuation fund trustees acting in the best interests of all members in their fund.[119]

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113 ING Bank, *Submission 35*, p 3.

114 A mutual ADI, cited by Abacus, *Submission 53*, p 14.

115 Australian Securitisation Forum, *Submission 74*, p 18.

116 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2. See also Bendigo and Adelaide Bank, *Submission 58*, p 6; Mr Michael Murphy, Chief Executive Officer, Queensland Teachers Credit Union, *Proof Committee Hansard*, 4 March 2011 and Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 80.

117 Australian Bankers' Association, *Submission 76*, p 58.

118 Australian Bankers' Association, *Submission 76*, p 59.

119 Australian Bankers' Association, *Submission 76*, p 59.

13.102 One argument is that this would just be restoring the ability of banks to fund their lending from deposits to the situation prevailing before superannuation funds gained more favourable tax treatment:

> It wasn't until the early 1990s when the Hawke/Keating Government introduced compulsory superannuation laws and tax incentives for voluntary superannuation contributions, that a gap emerged between the level of deposits and the funding needed for loan growth. Compulsory superannuation drew deposits away from banks and into superannuation trusts.[120]

13.103 The superannuation funds themselves, however, reject the approach of requiring them to direct funds to the banks:

> Changing the allocation of superannuation investments through government intervention would move funds away from the optimal allocation determined by trustees. The net result of such action would be to reduce superannuation fund returns and ultimately deliver lower retirement incomes.[121]
>
> …we strongly oppose any suggestion that the superannuation sector should in fact be treated as a cash cow for the ADI sector.[122]

13.104 The superannuation funds cite the recent Superannuation Review's recommendation that:

> …government should not mandate that superannuation fund trustees participate in any particular investment class or vehicle.[123]

13.105 Professor Valentine also opposes the suggestion:

> …superannuation funds through the last 10 years have made a deplorable return, and to compel them to hold low-yielding assets so people can have low-yielding mortgages would mean that they would make an even lower return. That is not a particularly desirable result.[124]

Committee comment

13.106 The Committee believes that superannuation trustees should continue to have the sole purpose of maximising the (risk-adjusted) returns to their members. It does not favour measures to direct them to invest in bank securities or any other asset class. The Committee does support, however, removing any artificial barriers or

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120 Australian Bankers' Association, *Submission 76*, p 58.

121 Financial Services Council, *Submission 121*, p 3. The FSC argues that population aging will lead to greater amounts invested in fixed income securities without any intervention.

122 Mr John Brogden, Chief Executive Officer, Financial Services Council, *Committee Hansard*, 21 January 2011, p 18.

123 Cited in Financial Services Council, *Submission 121*, p 3.

124 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 62.

discouragements to superannuation funds investing in securities such as ABS or covered bonds issued by banks.

Recommendation 30

13.107 The Committee recommends that the Government establish a working group with an independent chair, representatives from Treasury, the Australian Prudential Regulation Authority, the Reserve Bank, and the banking and superannuation industries, and also including academic experts, to explore and assess options that could promote investment in deposits and fixed income assets by superannuation funds and other funds managers.

Chapter 14

Competition in the payments system

14.1 There are many aspects of the payments system about which concerns have been raised concerning competition. The Committee heard that the payments system may be a significant barrier to entry, due to the dominant role of the major banks:

> …some non-ADIs have approached us and said they have found significant obstacles—for example, in accessing the payments clearance system…[1]

> APCA [Australian Payments Clearing Association] is governed by the big four banks and the big two credit card companies, that they set the rules of the game and that in a sense there is really a disincentive for them to set rules that would make it easy for new entrants to come into the market.[2]

> If you think about the financial sector, it is a bit like a triangle, with the Reserve Bank at the top, then the banks and then everybody else—and everybody else in the financial sector is dependent upon the banks for access to ultimate liquidity, which does put the banks in a very powerful position in that area.[3]

Background

14.2 The main supervisor of the payments system, and catalyst for improved competition within it, is the Payments System Board of the Reserve Board. This is an additional board to the more familiar board with responsibility for monetary policy decisions. It is chaired by the Governor of the Reserve Bank and includes the Chair of the Australian Prudential Regulation Authority (APRA) and some independent experts.

14.3 Another key role in the payments system is played by the Australian Payments Clearing Association (APCA), a private self-regulatory body, owned by organisations active in one or more of the five payments clearing systems that it administers. APCA told the Committee that it:

> …believes that promoting competition is the best means to ensure the payment services deliver what Australian citizens and businesses need over the long term.[4]

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1 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 29.

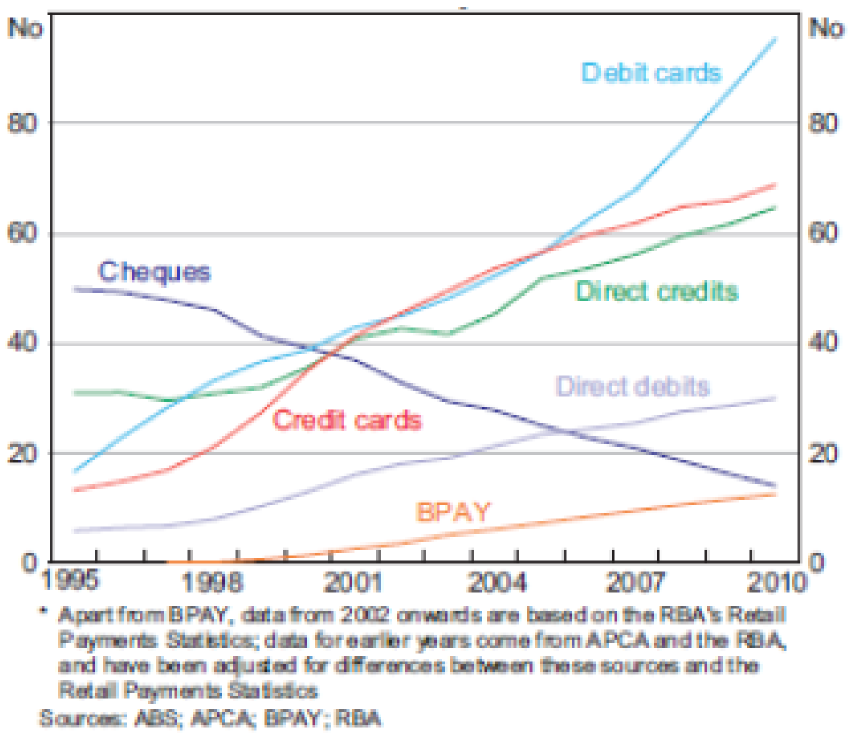
2 Mr Nick Stace, Chief Executive Officer, Choice, *Committee Hansard*, 14 December 2010, p 29.

3 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 74.

4 Mr Christopher Hamilton, Australian Payments Clearing Association, *Committee Hansard*, 21 January 2011, p 30.

14.4 From being dominated by cash and cheques there are now a number of different electronic systems that enable payments to be made (Chart 14.1).

Chart 14.1: Non-cash payments per capita

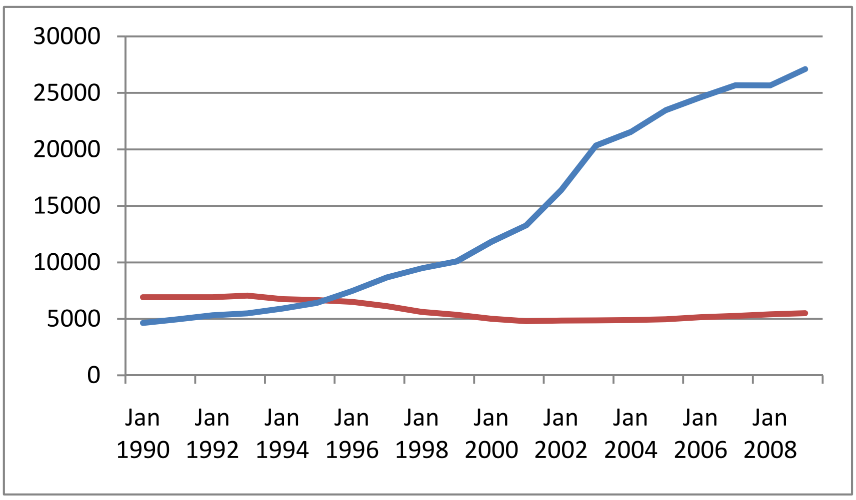


Source: Australian Payments Clearing Association, *Submission 49*, p 3.

ATM fees and access

14.5 ATM fees have become more important as banks close physical branches and ATM networks expand (lower and upper lines respectively in Chart 14.2).

Chart 14.2: Bank branches and total ATMs



Source: Secretariat, based on data from Reserve Bank of Australia.

14.6 A significant, albeit declining, proportion of ATM transactions may incur a fee. A relatively high estimate made last year was:

> …almost half of all ATM cash withdrawals are made outside of a bank or credit union’s own ATM network.[5]

14.7 A survey in late 2010 showed that less than a quarter of ATM withdrawals incurred a direct fee.[6] Younger people and those outside major cities are more likely to pay, although those in remote areas appear to make more use of EFTPOS cash-outs to avoid ATM fees.[7]

14.8 Some submissions are critical of ATM fees:

> A $2.00 charge for a $50.00 withdrawal contains an explicit finance charge of 4% daily (the Annual Percentage Rate is harsh and unconscionable). A fair warning disclosing the implied finance rate would be more responsible rather than the small dollar value. The majority of clients incurring such fees do not have the financial skills to calculate the finance rate.[8]

14.9 ATM fees have a disproportionate effect on poorer people as it is harder for them to use ATMs from their own bank, they are more likely to withdraw smaller sums and a fixed charge is a larger proportion of their income. The Redfern Legal Centre refers to:

> …the elderly and people with disabilities, who in our experience are more likely to experience difficulty in travelling in order to access fee-free ATMs. They are also often less able to afford the fees. Consumers living in areas that are under-serviced by banks (often due to branch closures in rural, regional and remote areas) have little choice between banks or ability to travel in order to avoid ATM fees. Accordingly, the imposition of ATM fees has a greater impact on people living in non-urban areas. Given that there are generally higher levels of unemployment and lower average incomes in such areas, ATM fees are hardest to avoid by the people who are least able to afford them.[9]

14.10 Similarly, the Brotherhood of St Laurence commented:

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5 Care Financial Counselling Service, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 3*, p 6.

6 Flood, Hancock and Smith (2011, p 44). The authors point out that 'it is possible that the survey respondents may have modified their behaviour during the course of the survey as a result of making a record of the direct charges incurred'.

7 Flood, Hancock and Smith (2011, p 45).

8 John O'Brien, *Submission 117*, p 5.

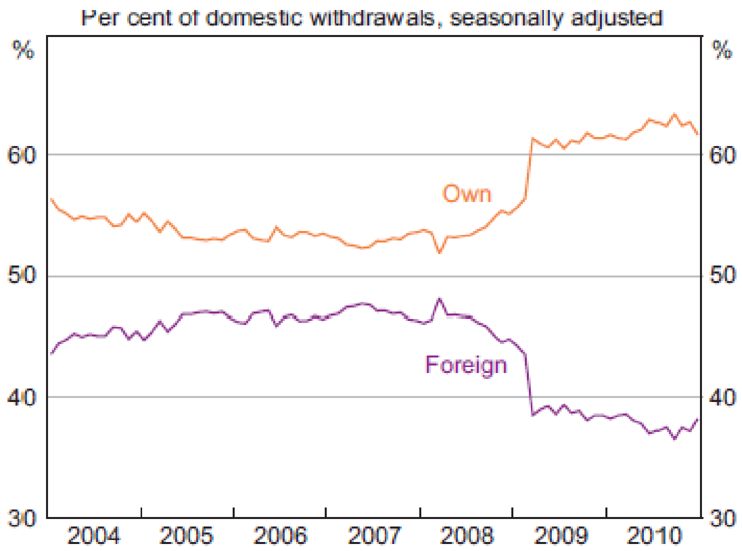
9 Redfern Legal Centre, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 2*, p 2.

> While some banks offer free ATM transactions, if you are constrained or disabled then the cheapest ATM may not be convenient.[10]

14.11 ATM fees were reformed by the Reserve Bank in March 2009. The most visible element was abolishing fees charged by banks to their customers for use of other banks' ATMs and their replacement by direct charges. Under the previous system the owner of an ATM charged the bank of the customer using the ATM an 'interchange fee'. The bank then passed on this fee, or sometimes more than passed it on, to the customer as a 'foreign fee', which the customer would only become aware of when they received their next bank statement. Now the ATM owner directly charges the customer at the time of the transaction but has to display the charge before the transaction is completed. The customer must be given the opportunity to cancel the transaction without cost if they do not wish to proceed.

14.12 These reforms saw a shift in transactions towards use of ATMs owned by cardholders' own banks away from those owned by other banks (Chart 14.3), an increase in average withdrawal size when using other banks' ATMs, and increased use of (typically free) EFTPOS cash-outs, all of which reduce the amount of transaction fees.[11] The Reserve Bank estimates that this has saved bank customers around $120 million a year in cash withdrawal fees.[12]

Chart 14.3: Composition of ATM withdrawals



Source: Flood, Hancock and Smith (2011, p 44); update of Reserve Bank of Australia, *Submission 41*, p 23.

10 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 3.

11 Filipovski and Flood (2010, pp 40-41) and Flood, Hancock and Smith (2011). Similar responses were observed in the US: see McAndrews (1998, p 3).

12 Dr Christopher Kent, Head, Payments Policy Department, Reserve Bank of Australia, *Proof Committee Hansard*, 4 March 2011, pp 35-36.

14.13 The reforms have been hailed in some quarters:

> …the reforms introduced in 2009 by the Reserve Bank of Australia, which aimed to make fees transparent, improve consumer choice and increase competition and the supply of ATMs in Australia, have been successful.[13]
>
> We were very supportive of moving to the direct charging regime….[14]

14.14 One smaller bank witness was less enthusiastic:

> …if we looked at what the consumer is paying in a quantum, whether it is in a transaction fee or a direct charge, my thought would be that it has not changed much over the last 10 years. Whilst there is more visibility, I am not sure whether the consumers are better off…… in America, when they brought in the [direct charging] regime that there are short-term changes of behaviour but it does not persist.[15]

14.15 Fortunately, the Australian experience has not followed this pattern. As shown in Chart 14.3, Australian bank customers have increasingly avoided incurring foreign ATM fees. Banks can choose to increase the number of ATMs their customers can use without charge by reciprocal agreements or by agreeing to make payments to owners of other ATM networks. Many banks have done so.[16]

14.16 Most banks charged 'foreign fees' of $2, and so far this is also the most common direct charge for use of an ATM (Chart 14.4).

14.17 An exception is National Australia Bank:

> Since the introduction of direct charge our pricing has been $1.50 per withdrawal and $0.50 per balance enquiry. This pricing is consistent across our entire network and no differentiation is applied for either location or time of day, selected locations apply no direct charge on any withdrawal or balance enquiries.[17]

14.18 The Reserve Bank told the Committee that:

> A small number of ATMs owned by independent deployers apply even lower charges, including some for which no direct charge is levied at all, with the cost of the transaction being met by the site owner.[18]

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13 ATM Industry Reference Group, *Submission 79*, p 2.

14 Ms Nicole Rich, Director, Policy and Campaigns, Consumer Action Law Centre, *Committee Hansard*, 25 January 2011, p 19. See also Brotherhood of St Laurence, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 5*, p 4.

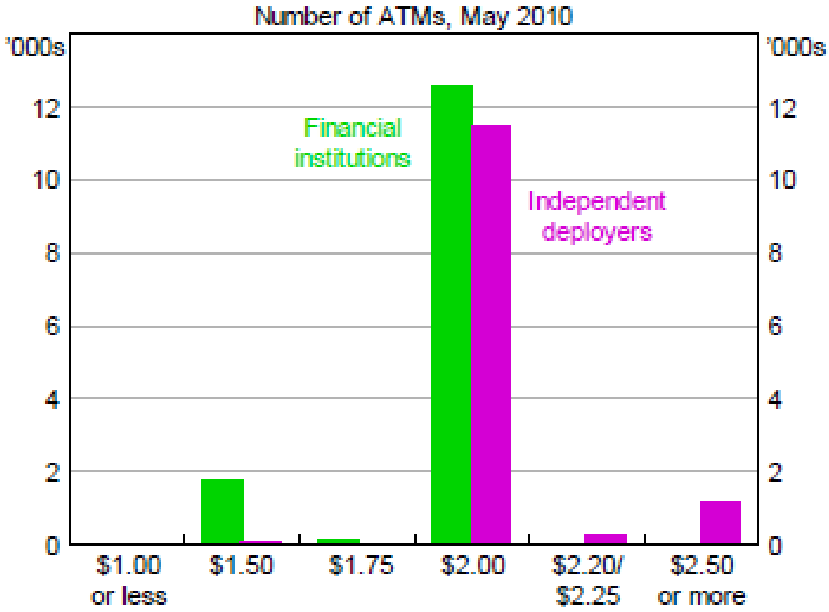
15 Mr John Minz, Chief Executive Officer, Heritage Building Society, *Proof Committee Hansard*, 4 March 2011, pp 16-17.

16 Filipovski and Flood (2010, p 42).

17 National Australia Bank, *Submission 91*, p 9.

18 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 1.

Chart 14.4: Direct charges for withdrawals



Source: Reserve Bank of Australia, *Submission 41*, p 23.

14.19 It is disappointing that so far the greater price transparency has not led to competitive pressures driving down the price of ATM transactions. Two Reserve Bank officials surmise that:

> It is possible that this reflects the fact that cardholders typically need to proceed some way through the transaction process at the ATM before the direct charge is displayed. This may make it difficult to compare prices, particularly where cardholders are unfamiliar with the ATMs in a particular location. While cardholders might avoid an ATM if they see that it applies a direct charge higher than they think is reasonable, there is little incentive for ATM owners to lower fees if it is not obvious to potential customers that they have done so. As a consequence, relatively little price competition among ATM owners appears to have developed to date. An obvious response is for ATM owners with a low direct charge to advertise the charge prominently so as to attract additional throughput and higher fee revenue. There is nothing to prevent owners from doing this, although the strategy requires the general public to understand pricing sufficiently to react accordingly. To date, advertising of prices has occurred only in isolated cases…[19]

19 Filipovski and Flood (2010, p 43). A similar tale is told by Choice, *Response to questions on notice*, no 5, 17 January 2011.

14.20 The Reserve Bank remains optimistic that greater price competition is 'the next stage that may well be in prospect'.[20]

14.21 The Commonwealth Bank stated:

> Currently, almost all of our ATMs do not cover their costs through the ATM direct charge… The cost of any ATM is a complex mix of rent and transaction mix (which drives servicing costs, cash replenishment costs etc). One main driver of difference is whether the ATM is in a branch or in a non-branch location. Non-branch sites are more expensive (by an additional 50%) due to the floor space rental costs.[21]

14.22 A 2007 Reserve Bank study estimated the average cost of an ATM transaction to a bank at around 75 cents, well below the current predominant charge of $2.[22] With fees charged on only about a third or less of withdrawals, the average direct charge across all withdrawals is a little below the average cost.[23]

14.23 The 2007 study suggested that the solely cash-related costs were around 25 cents, so the cost for a balance enquiry was around 50 cents.[24] In around a third of cases the charge for a balance enquiry is lower than for a cash withdrawal, being typically 50 cents to $1.25, but in other cases it is the same.[25]

14.24 Treasury commented:

> There are a number of alternatives to ATM balance enquiries, including internet and phone banking. A customer is also informed of their account balance in the course of making a withdrawal. If a transaction is declined because the customer has insufficient funds, ATM providers are prohibited by industry rules from making a direct charge. As a consequence, relatively few customers make balance enquiries for which they are charged. Data collected by Edgar Dunn & Company indicate that for bank ATMs (where many transactions are made charge-free by the bank's own customers) around 23 per cent of transactions are balance enquiries. However for

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20 Dr Christopher Kent, Head, Payments Policy Department, Reserve Bank of Australia, *Proof Committee Hansard*, 4 March 2011, p 36.

21 Commonwealth Bank, *Responses to questions on notice*, no 8, 15 December 2010, p 2.

22 Schwartz et al (2007, pp 100-101). The main components of the cost are the ATM equipment (18 cents), cash handling and storage (14 cents), ATM owner centre management (9 cents) and rental (12 cents). The cost is now likely to be significantly higher, at least for some ATMs as site rents have increased and ATMs are now deployed in sites where servicing costs are higher or transactions volumes lower; Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 10. Cash restocking costs may vary significantly from site to site, depending on whether the ATM is stocked by the site owner with recirculated cash, or externally by the ATM provider.

23 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 9.

24 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 10.

25 Treasury, *Responses to questions on notice, no 14*, 4 February 2011, p 8.

> independently owned ATMs (where nearly all transactions are charged), only 6 per cent of transactions are balance enquiries.[26]

14.25 There have been proposals to limit ATM charges to the cost of providing the service in the United States, where the typical direct charge for using an ATM is US$1-2, but there are also interchange fees which are passed onto customers.[27] There was a varied response in the US to the introduction of direct charging, with the states of Connecticut and Iowa banning them while fifteen states passed laws outlawing agreements *not* to impose them. At a national level, in 1997 a Republican Senator sought unsuccessfully to have direct charges banned while in 2010 a Democrat senator sought to limit the charge to 50 cents and ensure that ATM fees bear a 'reasonable relation to the cost of processing the transaction', which he estimated at 36 cents.[28]

14.26 The Salvation Army supports regulation of ATM fees:

> The regulation of ATM fees provides a fairer service when a customers ‘own-branded’ ATM is not available, which will particularly benefit rural / remote, elderly and disabled customers who depend on ATM use.[29]

14.27 Unsurprisingly, the Australian Bankers' Association oppose such regulation. Their then chief executive argued:

> Senator Brown's anti-competitive proposal against bank customers could result in fees being paid by customers to use their own-bank ATMs because non-customers of the bank would be able to use the ATM service for free.[30]

14.28 The Committee is aware of reports of people in remote indigenous communities paying up to $10 per ATM transaction. This is especially a problem for people do not like to carry large amounts of cash with them so make frequent withdrawals and to avoid overdrawn account fees need to check account balances before making withdrawals. This means that they can pay large amounts of ATM fees relative to their account balances.

14.29 The Reserve Bank has been investigating these reports, including by travelling to the Alice Springs region to check the veracity of reports of ATMs charging $10 fees. They described how:

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26 Treasury*, Responses to questions on notice, no 14*, 4 February 2011, p 8.

27 McAndrews (1998, p 2).

28 Senator Tom Harkin's amendment no 3812, co-sponsored by Senator Charles Schumer, to S. 3712, the *Restoring American Financial Stability Act*. The 1997 initiative was by Senator Alfonse D'Amato, then chair of the Senate Banking Committee.

29 Salvation Army, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 6*, p 2.

30 Mr David Bell, *ABA Media Release*, 3 March 2010.

> We asked for those who were reporting them to come to us. We tracked them down. They may have been charging $10 in the past. We did not find any current evidence anywhere in Australia of a store in a remote community charging $10 on an ATM.[31]

14.30 Consumer groups were also cognisant of the need to retain incentives for ATM owners to provide machines in remote areas:

> We do not want to see a situation where there are no ATMs available in certain communities because there is regulation that prevents operators from making a sufficient return on the machines to actually run them.[32]

14.31 Professor Sathye suggests a possible compromise of restricting the availability of accounts with no ATM fees to socio-economically vulnerable consumers.[33]

14.32 The Brotherhood of St Laurence want to distinguish between use of ATMs to check balances and (the more costly) use to withdraw cash:

> …many of our clients wish to use an ATM to check their account balance so that they do not overdraw the account. Many of these clients do not have access to internet banking or some other system to check balances. For some accounts, even checking the account balance via the ATM incurs a fee, making it difficult for consumers to then use their account in a way that minimises fees.[34]

14.33 This concern was shared by a parliamentary committee which recommended that consideration be given:

> …to ensuring that the price of obtaining an account balance is kept to and at the very least is in alignment with the costs associated with delivering the service.[35]

14.34 The Brotherhood of St Laurence recommends that:

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31 Dr Christopher Kent, Head, Payments Policy Department, Reserve Bank of Australia, *Proof Committee Hansard*, 4 March 2011, p 42. Flood, Hancock and Smith (2011, p 47) report that 'the highest direct charge that the Bank is aware of in any location is $5.00 for a cash withdrawal at a specialised venue'.

32 Ms Nicole Rich, Director, Policy and Campaigns, Consumer Action Law Centre, *Committee Hansard*, 25 January 2011, p 19.

33 Professor Milind Sathye, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 1* p 6.

34 Brotherhood of St Laurence, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 5*, p 4.

35 Joint Committee on Corporations and Financial Services, *Report on the ATM Fee Structure*, January 2004, p 24.

> …appropriate regulators be tasked with monitoring the level of ATM fees to ensure that they are not excessive, and empowered to regulate such fees should this be necessary.[36]

14.35 Another suggestion is that:

> …the RBA require the industry to amend its payment system clearing rules, to require a real-time warning to be given to consumers on ATM screens where a penalty fee will be imposed if a particular transaction goes ahead.[37]

Impact on ATM availability

14.36 Liaison by the Reserve Bank suggests that the move to direct charging has meant that:

> …some of these ATMs have been deployed in locations that might otherwise have not been viable – including in rural, regional and remote areas. It is also becoming more common to see ATMs in relatively low-usage locations and temporary ATMs at public events. Such ATMs tend to apply above-average direct charges, but would most likely not have been available under the previous regime.[38]

14.37 Professor Sathye warns that in the UK the number of ATMs provided has stagnated, while it has increased in Canada and the US where charging is allowed, and therefore 'removal of direct charging may have adverse consequences for consumer welfare in terms of higher transaction costs'.[39]

14.38 A US study of direct charging for ATM use concluded that the charges:

> …encourage the deployment of ATMs to areas that are too expensive for interchange fees alone to support, such as airports, casinos, football stadiums, and ski resorts.[40]

14.39 Two French academics argue:

> Nowadays, the USA and Canada have many more ATMs per inhabitant than countries in which surcharging [ie direct charges] is not applied.[41]

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36 Brotherhood of St Laurence, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 5* p 4.

37 Consumer Action Law Centre, *Submission 87*, p 23.

38 Filipovski and Flood (2010, p 44).

39 Professor Milind Sathye, Senate Economics Legislation Committee inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010, *Submission 1*, pp 4-5.

40 McAndrews (1998, p 2).

41 Donze and Dubec (2009, p 584).

14.40 The ATM Industry Reference Group, which represents three companies who together provide almost half the ATMs operating across Australia,[42] warn that they rely on direct charges. They warn:

> …any externally imposed control on the level of the current free market of ATM direct charges, even if this only related to one sector of the industry, could artificially distort the level of competition in the setting of ATM direct charges with potential unintended consequences that could ultimately lead to a lower level of ATM service across the nation.[43]

14.41 A similar view is put by the international ATM Industry Association:

> Direct Charging fees have allowed ATMs to be economically viable in both urban and rural areas, providing universal access to cash where there may be no or little alternative. The removal or capping of ATM fees may restrict the ability to deploy in rural or other low volume locations reducing both the growth and potentially the number of ATM locations in rural areas…[44]

14.42 The Government has foreshadowed further reforms, announcing:

> The joint Treasury/Reserve Bank Taskforce will report to the Government in June 2011 on the need for further action…[45]

Socially responsible location of ATMs

14.43 The National Australia Bank explained:

> There has been a growing concern over the supply of the availability of ATMs in gaming venues as this is believed to exacerbate problem gambling. NAB does not locate any ATMs in gaming venues, nor does our affiliated rediATM network – we were quite explicit about this when we negotiated our agreement.[46]

Committee comment

14.44 The Committee commends the Reserve Bank for requiring ATMs to display fees before the customer completes the transaction. The Committee hopes this will in time lead to greater competition and ATM providers will advertise machines with lower fees. Measures to cap ATM fees would be counterproductive as they would lead to ATMs being removed from some remote locations. NAB are to be commended for

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42 Banktech, Customers Ltd and First Data International (Cashcard Australia).

43 ATM Industry Reference Group, *Submission 79*, p 1.

44 ATM Industry Association, *Submission 71*, p 2.

45 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 15. The Taskforce has provided an interim report to the Government on the impact of ATM charges on indigenous communities; Mr John Lonsdale, General Manager, Financial System Division, *Proof Committee Hansard*, 9 March 2011, p 12.

46 National Australia Bank, *Submission 91*, p 9.

not locating ATMs in gaming venues and the Committee would like to see other ATM providers follow their lead.

Recommendation 31

14.45 The Committee recommends that the Australian Payments Clearing Association and the Australian Bankers' Association encourage their members to have their ATMs screens display a real-time warning to consumers where a penalty fee will be imposed if a particular transaction goes ahead.

Recommendation 32

14.46 The Committee recommends that the government deal with the problem of excessive ATM fees in remote indigenous communities by tendering for an ATM provider to install a network of ATMs in these areas which make specified minimal charges for balance enquiries and low charges for cash withdrawals.

Competition in credit card markets

14.47 Interest rates on credit cards in Australia can exceed 21 per cent. The average rate is 16 per cent. These represent very large margins above the cost of funds and rates charged on other types of loans.

14.48 A concern for social welfare organisations is bank customers being pushed into credit cards:

> …small-amount consumer credit, which is required by households to smooth expenditure, particularly related to things like education costs, whitegoods or vehicles. Over the past years, the banks have shied away from providing small amount personal loans, instead pushing many onto credit cards or simply refusing to offer service. For many on low incomes, credit cards can be a debt trap designed to induce immediate spending without an affordable, planned repayment schedule…Things like the lowest value personal loan have increased. Some years it was a smaller amount, maybe only $1,000 or $2,000. Generally the large banks lend $5,000 or $7,000 for the lowest-value personal loan.[47]

14.49 There are some pilot programmes catering for low income households:

> Some banks, such as ANZ and the National Australia Bank, are offering small-amount affordable loans in partnership with community agencies. This is very welcome. These programs have demonstrated that, when

47 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, pp 2 and 5.

> provided with opportunity and support, low-income earners can pay back debt.[48]

14.50 A former Reserve Bank officer is very critical of the structure of the credit card market:

> A moment's reflection reveals the 'credit card' to be simply a 'debit card' to which a line of credit is attached. The deception is about linking the illusion of free-credit (for 55 days on purchases) and 'flyer rewards' to the imposition of excessive charges on retailers, part of which – called an interchange fee – is paid to the bank issuing the credit card, supposedly to fund the 'free credit' and 'rewards'. There is no accounting for the actual cost to banks of either net 'free credit' given to bank customers or the 'rewards' actually redeemed. Deeming to be taxable income the gross value of these concessions would quickly expose the deception.[49]

14.51 Even an academic whose submission generally opposed interference in the banking market sees room for improvement in the credit card market:

> …the credit card issue. It appears to me that there are still restrictions on entry to that part of the payment system—that is, it is not entirely contestable, interest rates seem to be very high and there is an additional problem of credit card debt that many of the social services organisations are worried about.[50]

> Two possible reforms meriting attention are ensuring that the minimum monthly payment on credit cards at least covers the interest and other charges on it and creating a clearing house which looks at the total exposure of each borrower. Limits could be imposed based on the income, assets, etc. of the borrower.[51]

14.52 Another submitter was also critical of the lack of competition between card systems:

> MasterCard and Visa have a virtual monopoly…[there should be] investigation of the fees and charges imposed by credit card providers on both merchants and consumers.[52]

14.53 Visa responded that it:

> …requests internet acquirers to reach a minimum capital standard before they are permitted to become part of our network…Visa understands there has been suggestions made to the inquiry that regulation may be needed to

48 Mr Gerard Brody, Senior Manager, Financial Inclusion, Brotherhood of St Laurence, *Committee Hansard*, 25 January 2011, p 2.

49 Mr Peter Mair, *Submission 2*, p 8.

50 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 62.

51 Professor Tom Valentine, *Submission 14*, pp 7-8.

52 Ms Carolyn Currie, *Submission 114*, p 2.

> reduce these minimum collateral standards…Visa thinks it would be extraordinary in the immediate post-GFC environment to seek to put in place any form of regulatory intervention that would actually *reduce* the level of financial system security and stability.[53]

14.54 A possible reason for the apparent lack of competition and high interest rates on credit cards is that many customers intend to always pay off their balances in full each month and thereby not pay interest. While it is likely that many in fact do not exercise this much discipline, it nonetheless means that they do not shop around for low interest rates. This explanation was supported for the US market in a detailed study by Ausubel.[54] In Australia, only 15 per cent of credit card holders apply for a 'low rate' card and only around 40 per cent say they sometimes pay interest.[55]

14.55 There have been criticisms that the minimum monthly repayments set for credit cards are too low. Choice gave an example of how high interest rates, annual fees and low minimum repayments could mean an outstanding balance would not be paid off after fifty years.[56] Stating a minimum repayment may influence people not to pay off more than that amount.[57]

14.56 At one level, offers of initial low interest rates on credit card balances transferred from one bank to another are a welcome example of competition. There are, however, some aspects of these offers which are undesirable for customers not reading the fine print:

> Moving the balance is fine, as long as you’re not tempted to make a purchase on the new card. Any minimum monthly payment is taken from the low interest debt first (the balance transfer) while the high interest debt is left to compound. Not paying the full balance at the end of the month (which *includes* the balance transfer amount) leads to a loss of the interest free period (on new purchases) and further compounding of the high interest debt.[58]

14.57 As foreshadowed in its December 2010 announcement, on 24 March 2011 the Government introduced legislation[59] to force credit card lenders to allocate

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53 Visa, *Submission 127*, p 3.

54 Ausubel (1991) examined the US credit card market, which also shows high and 'sticky' interest rates, and found that credit card lending earned a much higher rate of return that other banking activities, and this could not explained by the higher bad debts during recessions. His calculations suggest the interest rate was around 5 percentage points above the competitive rate.

55 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 7.

56 *Sydney Morning Herald*, 6 April 2011, p 6.

57 Study by the University of Warwick, cited in *Sydney Morning Herald*, 6 April 2011, p 6.

58 Accounts4Life, *Submission 128*, p 3.

59 National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Bill 2011.

repayments to higher interest debts first,[60] prevent lenders from charging over-limit fees unless consumers specifically agree that their account can go over the limit, ban unsolicited credit extension offers unless pre-agreed to by the consumer and give consumers more say over their credit limits. The legislation would also introduce a requirement for lenders to provide a Key Facts Sheet for credit card contracts that provides a clear summary of the standard terms applicable, including minimum repayments required to be made, annual percentage rates and fees.

14.58 The Consumer Credit Legal Centre have criticised the bill for only applying to new rather than existing cards.[61]

Committee view

14.59 The Committee regards the reforms put forward by the Government as reasonable. It would not support bans on fees but measures to ensure customers are better informed about the implications of making only the minimum repayment are welcome.

Other aspects of the payments system

14.60 Some submitters drew attention to the payments system:

> …the real areas in which competition is low and super-profits earned by the banks are in payment systems, including credit card transaction processing. These areas, in which fees are by international standards very high, are the principal reason that the underlying profits of the Big Four banks represent almost 3% of Australia's GDP.[62]

14.61 A former Reserve Bank officer is very critical of what he terms:

> …the failure to deal with the institutionalized cartel arrangements and related price fixing for credit card, debit card and BPay transactions.[63]

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60 The Government gave the following example: 'the Johnson family may have a credit card balance of $5,000, consisting of a $2,500 balance transfer from a previous lender on which they are now paying interest at a special rate of 1.9% per annum, and another $2,500 which they have spent using a credit card from their new lender on which they are paying interest at 19.9% per annum. If the Johnson family were able to make a $2,000 payment towards their credit card balance, most lenders would seek to use this to pay off $2,000 of the debt which is only costing 1.9% per annum. The Government will legislate to ensure that the lender must instead use the $2,000 to pay down some of the debt on which interest is owed at the much higher rate of 19.9%, saving the Johnson family around $360 a year.' Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 13.

61 Ms Karen Cox, Co-ordinator, Consumer Credit Legal Centre, *Sydney Morning Herald*, 6 April 2011, p 6.

62 Professor Ross Buckley, *Submission 32*, p 3.

63 Mr Peter Mair, *Submission 2*, p 7.

14.62 Other submitters also saw the payments system as key to competition:

> The biggest single regulatory mechanism used to hindering competition within the banking sector is the control by the four major banks of the payments system.[64]

14.63 The Reserve Bank acknowledges the challenge that:

> …the incumbents in a payment system will have a natural tendency to keep new entrants out and often might use risk as a justification for that.[65]

14.64 Direct access to the payments system is denied to most non-banks:

> …non-bank providers are effectively locked out of the electronic funds transmission system, and are unable to settle electronically, and have to deal with their competition being the banks when providing data for settlements.[66]

> APCA owns the BSB number range and will only release new numbers to Authorised Deposit-taking Institutions (ADIs). Accounts4Life has a business model that requires a BSB, yet does not constitute "banking business" and therefore does not need an ADI licence…the Big 4 can squash any attempt to allow a new entrant to operate independently and increase competition.[67]

14.65 Tyro Payments, a specialist banking institution supervised by APRA which provides EFTPOS and some other payment services but does not take deposits or make loans, comments:

> Due to its network nature, the payment industry requires a strong set of standards and rules to protect the integrity and stability of the system. However, the standards and rules must also enable innovation and competition.[68]

14.66 Tyro submits that it is the only non-bank acquirer to have applied for a specialised banking licence since the concept was introduced. Tyro is a tier one member of the Australian clearing and settlement system. It identifies a number of areas where it faced barriers to entry.[69]

14.67 A new entrant wanting to process credit card transactions is unlikely to have a rating from an agency and Visa and Mastercard then demand the entrant has

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64 Mr Mervin Reed, *Submission 5*, p 9.

65 Mr Darren Flood, Deputy Head, Payments Policy Department, Reserve Bank of Australia, *Proof Committee Hansard*, 4 March 2011, p 36.

66 Mr Mervin Reed, *Submission 5*, p 2.

67 Accounts4Life, *Submission 128*, p 2.

68 Tyro Payments. *Submission 36*, p 2.

69 The following paragraphs draw on Tyro Payments, *Submission 36.*

additional capital. Tyro argues that they should be satisfied if the entrant is licensed by the Reserve Bank and supervised by APRA.

14.68 New entrants to the EFTPOS debit card network are required to connect to all members bilaterally which Tyro does not regard as commercially viable.

14.69 Tyro noted that the two major supermarket chains 'benefit from interchange fees that can be up to one half of what merchants in general are charged'.[70]

14.70 The domestic debit card (EFTPOS) system is governed by EFTPOS Payments Australia Limited (EPAL) which Tyro claims is dominated by card issuers and the major retailers. This leads to concerns that interchange fees charged to smaller retailers will be pushed up. The system is also lagging behind overseas schemes in its technical capacity, lacking features such as 'tap and go'.

14.71 Tyro has long aspired to gain access to the private health fund claiming market but this is dominated by a major bank.

14.72 The Electronic Funds Transfer Code of Conduct is a voluntary code that provides protection for consumers who use electronic means for making payments, including ATMs, EFTPOS, credit cards, online payments, internet banking and eBay. The code provides key consumer protections in the case of fraud and on unauthorised transactions.

14.73 Tyro is concerned about EFTPOS interchange fees:

> …we are focused on acquiring only so we do not have the conflict of interest that the major banks have to maximise their interchange revenue at the expense of the merchants. Thus, it does not come as a surprise that we are the only ADI that questions the looming reversal and increase of the EFTPOS interchange fee that threatens the small and medium enterprise community with an additional burden of up to $¼ billion.[71]

14.74 Tyro also called for real-time settlements to make payments systems more efficient and less risky:

> …the industry should move to real-time settlement; it is unnecessary risk. When we aspired to membership of BECS, some of the banks refused to accept us, claiming we were a risk to the system given our modest balance sheet. So we would argue: why don't you use intelligent processes and information technology so that you can mitigate and eliminate the risk?[72]

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70 Tyro Payments. *Submission 36*, p 9.

71 Mr Jost Stollmann, Chief Executive Officer, Tyro Payments, *Committee Hansard*, 21 January 2011, p 34.

72 Mr Jost Stollmann, Tyro Payments, *Committee Hansard*, 21 January 2011, p 36.

14.75 A new entrant specialising in some aspect of the payments system may struggle against the major banks who cross-subsidise activities through bundling:

> …when a major bank settles its merchants a day earlier than our merchants, it means that it bundles the acquiring function with the transaction account. There is a bank that offers same-day settlement to its merchants if they have the transaction account and the acquiring relationship with them. They can do this because they do not go through your systems—the batch systems.[73]

14.76 Banks try to ensure merchants have all their banking relationships with the one bank, rather than just providing loans or just providing payment services:

> We certainly have customers who only utilise merchant facilities within our base. But, obviously, a key objective of ours is to deepen the relationships that we have with our customers and therefore provide broader services.[74]

14.77 A concern raised by small business as an example of banks colluding to maintain a poor service, concerns the payments system:

> …the behaviour by the major banks not to provide daily settlement of EFTPOS transactions by way of credits to merchants' accounts. It appears to be a concrete example of anticompetitive behaviour. The banks choose only to settle EFTPOS transactions on five days each week in a seven day commercial market. This unreasonably denies merchants access to their money.[75]

14.78 A specific shortcoming raised was the delay between when funds are debited from a customer's account and when the proceeds of the transaction are credited to the retailer's account. This generally takes a day, and for smaller retailers can take several days. This appears to be a result of the banks not agreeing to undertake the expense of installing better technology and agreeing protocols for its use:

> It is an historical thing and it needs further development to do that and there is the question of what is the cost of doing that and what is the best way of doing that…a problem that is common in this area, that what you often need to do to get the network to provide better functionality is to have everybody who is part of that network to move towards the same goal and often times you need a degree of coordination…[76]

14.79 There is an understandable suspicion that the bank is gaining from the delay, perhaps being able to earn interest on the short-term money market for the period the payment is in transit.

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73 Mr Jost Stollmann, Tyro Payments, *Committee Hansard*, 21 January 2011, p 45.

74 Mr David Foster, Chief Executive, Suncorp Bank, *Committee Hansard*, 9 February 2011, 9 February 2011, p 8.

75 Council of Small Business of Australia, *Submission 90*, p 5.

76 Dr Christopher Kent, Head, Payments Policy Department, Reserve Bank of Australia, *Proof Committee Hansard*, 4 March 2011, p 40.

14.80 The Reserve Bank assured the Committee that this is not the case:

> The funds are moved from one customer's account to another customer's account through this system and there might be some delay between when a payment instruction is sent and when that money is finally available at the other end for the receiving customer to take those funds out of their account if they so choose, but there is a point in time which is part of the arrangement where the exchange is deemed to have occurred and that is the point at which interest is calculated if any is being paid.[77]

Committee view

14.81 The Committee is concerned about claims that the payments system operates like a closed shop and would like to see more new entrants to it and greater competition in the provision of payments, clearing and settlement services. It believes this would accelerate the adoption of world class technology and real time settlement systems, to the benefit of bank customers.

Recommendation 33

14.82 The Committee recommends that the Government direct the Australian Competition and Consumer Commission to conduct an examination of barriers to competition in the Australian payments system and publicly report by the end of 2011 on any legislative or other reforms that would enhance competition and efficiency in the provision of payment, clearing and settlement systems.

77 Dr Christopher Kent, RBA, *Proof Committee Hansard*, 4 March 2011, p 39.

Chapter 15

Taxation issues and related matters

15.1 There were a number of issues raised during the inquiry relating to current taxation arrangements that restrict competition in the banking industry and possible changes to taxation arrangements that could promote greater competition. These include interest withholding tax, tax concessions on interest from household saving, GST input taxing, franking credits, debt write-offs, the Libor cap, Retirement Savings Accounts, First Home Saver Accounts and proposals to increase taxes on banking.

Interest withholding tax

15.2 Interest withholding tax (IWT) is levied on interest paid to a non-resident lender.

15.3 ING Bank regard IWT as one of the four key barriers to competition.[1] It is of relevance to foreign bank subsidiaries (but not branches). Its abolition was recommended by the Henry Tax Review and the Johnson report.[2]

15.4 The Government announced changes to IWT in the 2010-11 Budget:

- The tax on borrowings by local financial intermediaries from their overseas parents will drop, from 10 per cent to 7.5 percent from 1 July 2013 and to 5 per cent from 1 July 2014;
- The tax on borrowings by any Australian branch of a foreign bank from its overseas head office will drop from 5 per cent to 2.5 per cent from 1 July 2013 and then be abolished from 1 July 2014; and
- The tax applying to any financial institution that borrows from offshore retail deposits which they on-lend in Australia will be cut from 10 per cent to 7.5 per cent from 1 July 2013 and then to 5 per cent from 1 July 2014.[3]

15.5 Treasury explained the justification:

> The benefits of the phase down are that it will: help support banking competition; reduce the extent to which financial institutions make funding

1 Mr Don Koch, Chief Executive Officer, ING Direct, *Proof Committee Hansard*, 14 December 2010, p 135.

2 The 2009 *Report on Australia's Future Tax System* and the Australian Financial Centre Forum's 2010 report *Australia as a financial services centre: Building on our strengths.*

3 The Hon. Wayne Swan MP, 'Phasing down interest withholding tax on financial institutions to support banking competition', *Media release*, 11 May 2011.

> choices based on tax rather than commercial considerations; and further develop Australia as a regional financial centre.[4]

15.6 ING Bank believe IWT should be cut further:

> In Australia, we have nearly twice as much in loans as we do in savings. That is pretty consistent for the Australian industry…Elsewhere there is typically an excess of savings over loans. Most European countries and the North American countries have an excess of savings over loans. What we as a group would like to be able to do is take some of that excess and bring it to Australia and put it into Australian mortgages, because across the world Australian mortgages are now recognised as a very attractive investment…For our whole group, that makes a lot of sense because we are not going out to the markets and borrowing money to fund mortgages; we are taking it from related companies. It makes a lot of sense for the bank here in Australia and it means that, in the end, we will fund more Australian mortgages. What stops us from doing that is interest withholding tax.[5]

15.7 The Australian Bankers' Association claim that:

> …these reforms [abolishing IWT] would promote more efficient capital flows, cheaper cost of funds, greater diversification of funding sources for Australia's banks (not just Australian major banks, but potentially Australian regional banks) and provide potential benefits for bank liquidity and lower interest rates for Australian borrowers…. It should be noted that the Government will broadly recoup lost IWT revenue from increased company tax earnings. The ABA notes that this reform provides opportunities for banks to diversify their funding sources, contribute to more efficient global capital flows and promote Australia as a financial services centre, especially in the Asian region.[6]

15.8 Asked about the cost involved, Treasury replied:

> If IWT for financial institutions were to be removed with effect from 1 July 2011 (apart from IWT on non-resident retail deposits), it would result in an additional cost to revenue in the order of $750 million over the forward estimates.[7]

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4 Treasury, *Responses to questions on notice, no 14*, 4 February 2011, p 2.

5 Mr Mark Mullington, Chief Financial Officer, ING Direct, *Committee Hansard*, 14 December 2010, p 138. See also their *Submission 35*, pp 3-4. Similar views are put by Citi, *Submission 116*, p 2; Chamber of Commerce and Industry Quuensland, *Submission 43*, p 19; Dr Bob Such MP, *Submission 6*, p 2; and Australian Chamber of Commerce and Industry, *Submission 37*, pp 22-23. The tax was also noted as a barrier to competition by Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 63.

6 Australian Bankers' Association, *Submission 76*, p 54.

7 Department of the Treasury, *Responses to questions on notice, no 14*, 4 February 2011, p 2.

Committee comment

15.9 The Committee agrees with Treasury's argument for reducing IWT. The same reasoning, however, argues that rather than just phasing it down, it would be better to abolish it immediately. Treasury's estimates of the first round cost overstate the ultimate cost as the reform generates increased trading and employment in the finance sector and these costs should be outweighed by the benefits to other sectors from greater competition and narrower interest margins.

Recommendation 34

15.10 The Committee recommends that interest withholding tax be abolished as budgetary circumstances permit to increase the ability of foreign banks to compete in the Australian market.

Tax concessions on deposit interest income

15.11 The Henry Review found that real returns on ADI deposit accounts were subject to high rates of marginal tax:

> Interest has the least favourable tax treatment. The entire return, including inflationary gains, is included annually in taxable income, generating an effective marginal tax rate on the real return greater than the statutory marginal personal tax rate.[8]

15.12 The Government announced in the 2010-11 Budget a 50 per cent tax discount on up to $1,000 of interest earned by individuals, to commence on 1 July 2011. The measure was later delayed to July 2012 and the cap lowered to $500 for the first year.

15.13 The banks do not regard this as going far enough:

> While this reform will address some of the tax anomalies between interest bearing investments and other investments or asset classes (including shares, managed investments, property), it has been proposed in a manner that only applies in a limited way. In the absence of further reform, this is unlikely to provide tax incentives adequate enough to significantly influence consumers' savings and investment decisions, and therefore is unlikely to substantially shift the pool of domestic savings towards interest bearing deposits.[9]
>
> …there are also some other opportunities to support competition through taxation reform to increase or eliminate the cap on concessional taxation

8 *Report on Australia's Future Tax System,* Part One, December 2009, pp 32-33.

9 Australian Bankers' Association, *Submission 76,* p 53.

> treatment for bank deposits—where, currently, above the cap, depositors pay tax on the inflation component of their return…[10]

15.14 Taking an illustrative interest rate of 5 per cent, a depositor would need a deposit of $20,000 to gain the full benefit from the concession. Only about a tenth of household deposits are held in amounts of over $20,000.[11]

15.15 The banks called for the concession to be brought forward and/or the cap lifted:

> …by accelerating the introduction of the tax discount and removing the proposed $20,000 threshold for individuals to receive a 50% tax discount, this reform would address the imbalances within the current tax arrangements for deposits and provide an incentive for individuals to increase their savings using deposit accounts.[12]

> …we recommend that the Government reconsider its decision to delay the implementation of this tax concession on savings.[13]

Committee view

15.16 The Committee notes with approval that households have been saving more in recent years. This prudence should be encouraged. As well as giving households healthier balance sheets, encouraging savings in bank deposits would provide a more stable source of funds for banks and reduce their reliance on foreign borrowings.

15.17 The Committee notes the Henry Review's conclusions about the high marginal tax rates on the real return on bank deposits which makes it harder for ADIs to compete for household savings. The tax concessions for bank deposits are a step in the right direction but do not go far enough.

Recommendation 35

15.18 The Committee recommends the taxation arrangements applied to bank deposits and mutual ADI deposits should be reviewed by the inquiry into the financial system.

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10 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2.

11 Australian Bankers' Association, *Submission 76*, p 53.

12 Australian Bankers' Association, *Submission 76*, p 53.

13 ING Bank, *Submission 35*, p 4.

GST input taxing

15.19 GST input taxing refers to situations where there is no tax payable on the supply of input-taxed goods, but the tax previously paid in the supply chain is not refunded.[14]

15.20 The Henry Review observed that GST 'input taxation' of financial services advantages larger, vertically integrated companies. Many small credit unions rely on the industry body to provide services such as government and regulator relations, media representation, regulatory compliance systems and support, legal advice, business advisory services, research and market intelligence and systems to fight fraud and financial crime.[15]

15.21 Abacus claim that:

> Credit unions and building societies rely on outsourcing to obtain economies of scale and therefore carry a heavier GST burden than the major banks.[16]

15.22 This problem has been partly addressed by GST reduced input tax credits, but these refer only to credit unions not to mutual building societies.

Committee view

15.23 The Committee notes the concerns raised that the GST input taxing arrangements disadvantage mutual ADIs. It did not receive sufficient evidence to come to a definitive conclusion on this matter.

Recommendation 36

15.24 The Committee recommends that the Government require Treasury to review the GST input tax arrangements for mutual financial intermediaries having regard to the comments in the Henry Tax Review.

Franking credits

15.25 Franking credits arose from the introduction of dividend imputation. They are an 'organisation's share of tax paid by a company on the profits from which the organisation's dividends or distributions are paid'.[17]

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14 *Report on Australia's Future Tax System*, Part Two, December 2009, p 286.

15 Abacus, *Submission 53*, p 28.

16 Abacus, *Submission 53*, p 28.

17 Australian Taxation Office, *Refund of franking credits—frequently asked questions*, www.ato.gov.au/nonprofit/content.asp?doc=/content/17149.htm&page=3&H3 (accessed 21 March 2011).

15.26 Abacus note that while banks make a return to their shareholders in the form of dividends, mutuals make a return to their 'shareholders' (who are also their customers) in the form of lower loan interest rates, higher rates on deposits, low or no fees and better service. This places them at a competitive disadvantage in being unable to make use of franking credits:

> Mutual ADIs pay company tax just like listed banks but mutuals do not have the same capacity to distribute franking credits.[18]

15.27 One building society added that the stockpile of unusable franking credits could make it more vulnerable to takeover:

> These accumulated franking credits could be used against a mutual ADI in the event of a predatory takeover attempt by a listed entity. Such a predator could offer to pay a dividend that incorporates Heritage's accumulated franking credits as an incentive to encourage members to accept their unsolicited offer of acquisition. In real terms this enables a predator to use the funds of members to help finance an attempted takeover.[19]

15.28 Abacus go on to suggest Treasury explore some way of allowing mutuals to distribute a kind of franking credit.[20]

15.29 An alternative is to:

> …lower the amount of tax customer-owned financial institutions are required to pay by the equivalent amount of the franking credit.[21]

15.30 Asked about Abacus' comment, Treasury replied:

> Credit unions and mutual building societies that pay company tax and distribute profits to members can choose to have the same access to franking credits as other taxpayers (including banks). Credit unions and building societies that are liable to pay company tax are taxed as co-operative companies. The income tax law was amended in 2003…to make it easier for co-operative companies that distribute profits to members to frank those distributions. As a result of those amendments, co-operative companies can choose to frank distributions to members. Alternatively, they can make unfranked distributions and obtain a deduction for amounts distributed to members. The effect of these changes was to give co-operative companies that distribute profits to members the same access to franking credits as other companies (including banks), while maintaining the long standing benefit of a deduction for unfranked dividends. Where

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18 Abacus, *Submission 53*, p 27. Similar points are made by the Heritage Building Society: *Submission 113*, p 8.

19 Heritage Building Society, *Submission 113*, p 8.

20 Abacus, *Submission 53*, p 27. A similar argument is made by Credit Union Australia: *Submission 85*, p 11.

21 Credit Union Australia, *Submission 85*, p 11. Again, a similar argument is made by Heritage Building Society, *Submission 113*, p 8.

> profits are not distributed to members due to legal, practical or other reasons franking credits are retained in the co-operative. If these franking credits were to be distributed to members (in the absence of a dividend), co-operative companies would obtain an advantage over other companies.[22]

15.31 Abacus responded:

> All credit unions and building societies, except for a handful of very small credit unions, are liable to pay company tax but Abacus is unaware of any credit unions or building societies that are taxed as co-operative companies. It is the case that credit unions and building societies may be able to elect, from year to year, to be taxed as co-operative companies, but to do so they would have to satisfy certain criteria. The fact that most, if not all, credit unions and building societies do not elect to be taxed as cooperative companies indicates there are significant barriers to doing so. Despite paying company tax like our listed bank competitors, credit unions and building societies are unable to provide franked returns to their owners. For example, should a mutual choose to pay a cash dividend, the level and type of dividend is tightly constrained by ASIC Regulatory Guide 147. The result is that credit unions and building societies continue to accumulate franking credits but cannot pass on the benefits.[23]

Committee view

15.32 The Committee agrees with the mutual ADIs that they are being disadvantaged by the current arrangements governing franking credits.

Recommendation 37

15.33 The Committee recommends that the Government require Treasury to review the treatment of building societies and credit unions in the franking credit arrangements and report publicly on the advantages and disadvantages of various options.

LIBOR Cap

15.34 A foreign bank drew attention to the foreign bank branch rules of the *Income Tax Assessment Act 1936*, under which the tax deductibility of interest paid by a branch on borrowings from its parent is limited to the London Interbank Offered Rates (LIBOR). When funds are provided at a rate in excess of the applicable LIBOR rate, the excess is denied a tax deduction:

> In response to the GFC, banks have been had to seek longer term funding (3 years or longer) throughout the last few years. This will continue into the future as a consequence of current requirements by APRA as well as their

22 Department of the Treasury, *Responses to questions on notice, no 14*, 4 February 2011, pp 2-3.

23 Abacus, *Supplementary Submission 53a*, p 2.

> intended future adoption of the recently published Basel liquidity pronouncements. LIBOR does not prescribe any rates for lending terms of greater than 12 months. Hence, the tax deductibility of borrowing costs of longer than 12 months is artificially capped at the LIBOR 12 month rate.[24]

15.35 The ABA also supported this:

> …removing the LIBOR cap on deductibility of interest paid on branch/head office (which includes branch-branch) funding, this reform will address tax constraints related to offshore borrowings. Under the foreign bank branch rules of the income tax law, deductibility for interest paid by the Australian branches of foreign banks on funds borrowed from their offshore branches/head office is limited to the London Interbank Offered Rate (LIBOR). Funds provided at a rate above LIBOR are denied a deduction for those amounts. During the GFC, the difference between LIBOR and commercial rates significantly widened. This reform would ensure that banks operating in Australia have access to alternative funding sources at competitive rates.[25]

15.36 Both the Johnson Report and the Henry Review recommended the abolition of this cap.

Recommendation 38

15.37 The Committee recommends that the Government require Treasury to review the abolition of the LIBOR cap to the tax deductibility of interest paid by a foreign bank branch on borrowings from its parent bank.

Retirement Savings Accounts

15.38 Retirement Savings Accounts (RSAs) are a capital guaranteed product offered by licensed ADIs, life insurance companies and prescribed financial institutions for retirement savings as a low risk/low income accumulation account.[26]

15.39 The Cooper Superannuation Review recommended they be phased out:

> RSAs have generally not been a success because they are a capital guaranteed product and there is currently no scope in the RSA framework for adding a market-linked investment where the risk of loss is borne by the holder. RSAs are thus suitable only for individuals with an extremely low risk tolerance, and are essentially unsuitable for much of the accumulation phase of retirement saving.[27]

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24 Citi, *Submission 116*, p 3. A similar argument is put by HSBC, *Submission 107*, p 4.

25 Australian Bankers' Association, *Submission 76*, p 54.

26 *Super System Review: Final Report*, June 2010, part 1, p 115.

27 *Super System Review: Final Report*, June 2010, part 2, pp 321-2.

15.40 Abacus takes issue with the Cooper Review's opinion that RSAs 'seem not to meet the low-cost objective for which they were originally intended':

> …in fact credit union RSAs are very low cost, with very few fees and very low fees.[28]

15.41 Abacus argue that with only one bank having shown interest in providing RSAs, it is an area where mutuals are filling a gap in the market and promoting competition.[29]

Committee view

15.42 The Committee supports the retention of retirement savings accounts. They offer mutual ADIs a useful avenue for competing with the banks.

First Home Saver Accounts

15.43 First Home Saver Accounts (FHSAs) were established in 2008 to assist first home buyers save a deposit. An individual who makes a contribution of $5,500 to their FHSA will be eligible for a Government contribution of $935 and FHSA earnings are taxed at a concessional 15 per cent.

15.44 The Government estimated in 2008 that by 2012 they would hold savings of $6,500 million, but by mid-2010 there was only $114 million in 22,600 accounts.

15.45 Only 19 ADIs offer the accounts.[30] It is generally thought that the reason they have not become more popular is that they require savings to be locked up for four years.

15.46 Abacus suggest means by which competition in this part of the deposit market could be invigorated:

> We have no doubt that the key problem with FHSAs is the four-year minimum qualifying period. The most consistent issue that appears in feedback to Abacus from credit unions and building societies about FHSAs is that the four-year 'lock-up' requirement is too long and is the single most important disincentive for savers. Abacus recommends removal or reduction of the period of time during which savings in FHSAs can't be withdrawn. The Government contribution is incentive enough to ensure that savers contribute over a number of years. A minimum period is an

28 Abacus, *Submission 53*, p 18.

29 Abacus, *Submission 53*, p 18.

30 Abacus, *Submission 53*, p 19.

> unnecessary disincentive and penalises savers who have the opportunity to buy a house within the 'lock-up' period.[31]

Committee view

15.47 Given the purpose of the First Home Saver Accounts scheme, the Committee regards it as appropriate for the savings to be locked up for four years.

Recommendation 39

15.48 The Committee recommends that the Government require Treasury to review the operation of the First Home Savers Accounts scheme and report publicly on the advantages and disadvantages of various options.

Increasing taxation on banking

15.49 As noted above, it is at least arguable that banks make larger profits because of their market power and implicit or explicit government backing. This has therefore led to calls for higher taxes to capture more of the excess profits for the people:

> …if the parliament is unable or unwilling to regulate to drive either actual competitive outcomes or price restrictions, we should consider a super profits tax on banks. We have just surveyed the public about the upcoming tax summit next year, and 81 per cent of Australians support the tax summit considering the introduction of a super profits tax on banks.[32]

> …banks make enormous profits not necessarily because they are particularly good at what they do but because they have the privilege of owning a bank license, have a large customer base and so have access to the clearing system and the cheap funds as part of their role in the payments system.[33]

> … implicit Social Licence to operate as facilitators of transactions, deposits and lending, should not be provided for free. The major Banks can rely on support from the Government, including from a regulatory and funding point of view…the implicit Social Licence held by the Major Banks [should] be made explicit in a fee calculated as a percentage on assets (ie. Loan portfolio), and paid by the Major Banks to the Government…a reasonable level would be one (1) basis point, payable per annum on total assets, by profitable Major Banks. For the Banks that are most profitable, measured in terms of return on equity, a higher rate should apply.[34]

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31 Abacus, *Submission 53*, p 19.

32 Dr Richard Denniss, Executive Director, Australia Institute, *Committee Hansard*, 15 December 2010, p 29.

33 Australia Institute, *Submission 46*, p 7.

34 Yellow Brick Road, *Submission 101*, p

15.50 Professor Buckley argues that the taxpayer should be compensated for the support to banks that will not be allowed to fail:

> Yet if Australian taxpayers are, in effect, standing behind our banks, and the banks' credibility in the marketplace is thereby strengthened and their cost of funds correspondingly reduced (for which there is considerable evidence), there is a very strong equity argument for a levy on bank assets.[35]

15.51 Other submitters opposed this suggestion:

> Banks are not analogous to mining companies – they are not depleting non-renewable resources and should not have a super profits tax imposed on them.[36]

> The fact that banks make large profits is another charge made against them, but the question is, 'Are these what are called "super profits"?' This term was introduced in the discussion of the resources rental tax. Super profits are profits above those necessary to keep the shareholders happy. Economists also call super profits 'rent'. Unfortunately, too many commentators assume that any profits at all are super profits and should be taxed away, taken away or regulated away.[37]

Committee view

15.52 The Committee notes that banks pay large amounts of company tax, which rises as their profits increase. It does not support calls for increased taxation on banks. Rather it wishes, through the earlier recommendations in this report, to increase the amount of competition in banking which will drive down bank profits to a normal level commensurate with their size and the riskiness of their activities.

Senator David Bushby
Chair, Banking Competition Sub-Committee

Senator Alan Eggleston

35 Professor Ross Buckley, *Submission 32*, p 5.

36 Dr Carolyn Currie, *Submission 114*, p 3.

37 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p. 61.

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Government Senators' Minority Report

OVERVIEW

1.1 The government senators commend this report as a good overview of the current environment of Australian banking and banking competition. However we note that many of the recommendations of the report have been acted upon by the government already or are already under review. This minority report will focus on key findings that will benefit customers and increase competition within the banking sector. The government senators believe that the majority report recommendations focus on assisting smaller banking institutions. This will increase competition and provide benefits to customers in the long term. However the majority report overlooks the interests of bank customers and taxpayers in its views on exit fees and acceptance of lower rated financial instruments.

1.2 The majority report is a large document of over 300 pages, and in the time the Government senators have had to consider the report, and form this minority report, not every aspect of the report could be addressed.

Exit Fees

1.3 The government senators were surprised by the back down on exit fees in the majority report. Banning exit fees was previously recommended by the Senate Economics References Committee and was endorsed and supported by Coalition Senators, but this changed upon the announcement of the Governments reform package.

1.4 A major factor in the initiation of this hearing was the call for consumers to get better outcomes in a competitive banking sector. During the committee hearings it was established that exit fees are a major barrier for consumers in switching to more competitive deals.

1.5 The government senators cannot support the Coalition's majority report recommendation to keep exit fees in place. Exit fees for new customers only reinforce the barrier to switching, and weaken the power of customers.

Recommendation 1: Government senators recommends the banning of exit fees is essential in demolishing the significant barrier to switching, and supports the Government's measure to ban exit fees to increase competition and allow new customers to switch.

Price Signalling

1.6 The majority report recognises the problem of anticompetitive price signalling by banks but restricts its recommendation to actions that would "substantially lessen competition." Government senators with the view expressed by the ACCC that this form of words would limit their ability to act.

Recommendation 2: The Government senators reject the Coalition's amendments to price signalling. However Government senators support the

Government's amendments to the Competition and Consumer Act as the only rational measure in tackling price signalling, which will ban anti-competitive price signalling, while ensuring that banks can continue with all legitimate business activities.

Funding Sources

1.7 The government Senators recognise the important role of the Government's $16 billion investment in the RMBS market during the GFC, and the additional $4 billion announced in December, totalling $20 billion in investments. This is a significant measure of support for smaller lenders to access funding, allowing them to put competitive pressure on the major banks.

Recommendation 3: Government senators endorse the additional $4 billion investment in the RMBS markets, providing funding for smaller lenders, and consider that it is in the taxpayer's interest that the government should continue to only invest in high quality AAA rated RMBS, so taxpayers are not exposed to significant credit risk.

1.8 The government Senators have also recognised the importance for smaller lenders of access to cheaper funding and a diverse range of funding to allow those smaller lenders greater capacity to compete with the major banks. One key finding from the hearings was the support for the Government's development of bullet bonds, which is recognised as a desirable market for investors.

Recommendation 4: The government senators recommend the Government continues to work in developing the market for bullet RMBS as an alternative to traditional RMBS. This will help smaller lenders diversify and broaden their funding and access cheaper funding to compete more effectively.

1.9 Another measure which will benefit the banking sector in accessing cheaper funding is the development of the covered bond market. Covered bonds will help secure the long term safety and sustainability of the financial system, providing reasonably priced credit to households and small business.

Recommendation 5: The government Senators recommend that the Government's commitment to allow banks and mutuals to issue covered bonds should remain a priority of the Government.

Customer Information

1.10 The ability for customers to obtain a fact sheet comparing one home loan to another was a measure commended during the hearings. This measure gives customers greater power in assessing the offer of the bank, and comparing it to the banks competitors.

Recommendation 6: The government senators support the boost for greater customer information through the Government's announcement of a simple bank fee fact sheet, allowing customers to have a document detailing the fees involved, and comparing it to other home loans.

Financial System Inquiry

1.11 The majority report calls for a major inquiry into the financial system, however the ALP Senators did not find that evidence during the hearings clearly supported this. Key figures stated that the current issues are not systemic problems, but are structural issues that can be addressed. These very issues were addressed in the Government's banking reform package, without the need of a major inquiry.

Action Taken

1.12 There are a whole host of recommendations that have been already implemented by the Government or have been already dealt with. In fact 14 recommendations out of 39 have been covered. These recommendations that are endorsing the government's actions are:

Recommendation 8 relating to Lenders Mortgage insurance, the Government had announced in December that there will be a review taking place, looking at the options for making Lenders Mortgage Insurance more transferable, thus avoiding consumers losing value of the insurance when switching.

Recommendation 14. There is a review currently taking place addressing this recommendation with the former RBA Governor Bernie Fraser, who is conducting a comprehensive feasibility study options on account portability.

Recommendation 10 in the majority report is simply supporting the Government's reform package in regards to a single page, simple to use fact sheet, allowing consumers to easily compare deals side by side in a language simple for potential home buyers to read.

Recommendation 12 fails to account that for the fact that ASIC has already conducted a review, and will continue to supervise the actions of the banks.

Recommendation 18 in the majority report had already been announced by the Government in December.

Recommendation 37 in the majority report does not account for the fact that a mutual has no shareholders receiving dividends, so there is no shareholder that needs to be protected from double taxation.

Recommendation 34 relates to interest withholding tax and the Government has already announced plans to cut the IWT rate to 5% in 2014-2015 for local subsidiaries of overseas parents. Additionally, the IWT rate applying to borrowings by any bank branch from its overseas head office will be reduced from 5% to zero by 2014-2015.

Recommendation 33 in the majority report has already been recently addressed by government in asking the Council of Financial Regulators to establish a working group to consider the issues surrounding Australia's clearing and settlement systems.

Recommendation 22 should have recognised that Bendigo and Adelaide Bank were facilitated to complete such a deal. The Government announced that it would continue to support the development of the bullet RMBS for smaller lenders.

Recommendation 23 in the majority reports has also been addressed with APRA already having published guidance to issuers on levels of capital required to be held in relation to issuance of RMBS, and which has been reduced since APRA's previous guidance.

Recommendation 24 is a matter for the RBA to address.

Recommendation 30. The government senators would like to reiterate that Government has already announced reforms to help develop a deep and liquid corporate bond market, including trading Commonwealth Government Securities on a securities exchange and reviewing disclosure and prospectus liability requirements.

Recommendation 21 again the government senators would like to restate that the Government has already made this commitment in December that the Financial Claims Scheme will be a permanent element of the Australian system.

Recommendation 32 in the majority report is also being dealt with through a joint treasury/RBA taskforce that was due on February 2011. Government senators would commend this initiative.

Exit fees

1.13 The ALP senators are surprised that the majority of the Committee oppose the banning of exit fees. Only last year the Committee's view was that:

> Exit fees are not the only factor reducing switching between banks, but this is no justification for maintaining this impediment to competition. While there are valid arguments for some exit fees on fixed-rate loans, no convincing justification has been put forward for exit fees on variable-rate loans. It is not a sufficient response to say that excessive exit fees may be challenged in the courts.[1]

1.14 The Committee accordingly then recommended that:

> … banks abolish exit fees on variable-rate loans. If banks do not do so by the end of 2010, then guidelines or regulations, or if necessary new legislation, should be used to compel them to do so.[2]

1.15 Even major bank CEOs concede that impediments to switching between credit providers – such as exit fees – are a barrier to competition:

> The two key drivers of competition are search cost, so how long does it take in terms of time and what is the cost to find a deal—this applies to any industry—and, secondly, what is a switching in time and cost? They are the key drivers.[3]

1.16 Indeed, rather than viewing a ban on exit fees as an unfair impost, the major banks have been removing them ahead of any legislation. This appears to be already increasing competition in the mortgage market:

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1 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 44.

2 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 44.

3 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 63.

> …one of the major banks [has] told us that they had a significant loss of business since they removed exit fees…it has had a competitive impact.[4]

1.17 The majority report cites the Finance Brokers Association of Australia as claiming that banning exit fees would push up establishment fees. This was put to ANZ Bank:

> Senator PRATT—Will the ANZ be charging other fees to make up for the removal of exit fees in any way?
>
> Mr Smith—No.[5]

1.18 Similarly, a major bank was asked about the interrelation between exit fees and interest rates and replied:

> Our exit fees are not something we consider when we are looking at setting our standard variable rate,..[6]

As the Government has pointed out:

> If any bank seeks to simply re-badge their current exit fees as upfront entry fees – or recover exit fees through any other type of fee – ASIC has the power to pursue the bank if it appears that the fee is 'unconscionable' under the Government's new National Credit Code…[7]

1.19 If there is a degree of competition in the banking industry, and especially if there is good comparative information, banks will not be able to replace exit fees with an equivalent increase in establishment fees. As banks are likely to be setting other charges at their profit-maximising levels, there is no reason to think these would change if the exit fees were banned.

Differential treatment for non-ADIs?

1.20 The majority report recommends that any ban on exit fees 'should only apply to authorised deposit-taking institutions'. It is not clear why it is more acceptable for non-ADIs to behave in an anti-competitive way than for banks. Furthermore, it would likely cause confusion if customers think that exit fees have been banned for all lenders and then they are charged a fee by a non-ADI lender. It is not obvious that this would even help non-ADIs if this is the intention:

> The government has given an indication that exit fees would be prohibited. If you tried to differentiate the market, I think you would find that

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4 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Proof Committee Hansard*, 9 March 2011, p 5.

5 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Proof Committee Hansard*, 15 December 2010, p 137.

6 Mr Philip Coffey, Chief Financial Officer, Westpac, *Proof Committee Hansard*, 21 January 2011, p 96.

7 *Competitive and Sustainable Banking System*, Australian Government, 2011, p 7.

> consumers would discriminate against nonbank lenders if they had exit fees. So I think you have to have one rule for everyone.[8]
>
> I do not think you can have a hybrid half and half. If I [FirstMac, a non-ADI] have suddenly got exit fees and the banks do not, that is all the banks are just going to advertise all day long.[9]

Lack of price competition on exit fees

1.21 When comparing potential lenders, a borrower is unlikely to pay much attention to differences in exit fees as they are unlikely to be contemplating their house purchase after next.

1.22 Behavioural economics provides some insights. Consumers suffer from 'positive illusion'; just as the vast majority of people consider themselves to be above-average drivers and the majority of people consider themselves above-average in many other ways (including ironically in their assessment of their own self-awareness), they are likely to understate the likelihood of life changes that may trigger an early repayment of a home loan such as a relationship break-up or loss of a job.[10] Customers are also unlikely to contemplate that they will regret their choice of lender and wish to switch:

> …we know about the cognitive bias that humans have: they tend to be a bit overoptimistic about these things and to assume that contingent events will not apply to them and that they will not have to refinance within the first three years of the loan.[11]
>
> Nobody that signs up a home loan with us on day one expects to leave in the first five years.[12]

1.23 These factors all mean that customers will not pay adequate attention to exit fees when comparing loan offers. There is therefore not much competitive pressure on lenders to keep exit fees low:

> …the problem with those fees is that they are not part of the consumer's competitive assessment, if we can put it that way, in choosing a product in the first place…Therefore that competitive discipline that would otherwise keep them at a cost-reflective level is simply not there.[13]

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8 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Proof Committee Hansard*, 9 March 2011, p 18.

9 Mr Kim Cannon, Managing Director, FirstMac, *Proof Committee Hansard*, 4 March 2011, p 25.

10 Heath and Heath (2010, p 114).

11 Ms Nicole Rich, Director, Policy and Campaigns, Consumer Action Law Centre, *Proof Committee Hansard*, 25 January 2011, p 18.

12 Mr Kim Cannon, Managing Director, FirstMac Group, *Proof Committee Hansard*, 4 March 2011, p 24.

13 Ms Nicole Rich, Director, Policy and Campaigns and Ms Catriona Lowe, Co-Chief Executive Officer, Consumer Action Law Centre, *Proof Committee Hansard*, 25 January 2011, p 16.

Recommendation 1: Government senators recommends the banning of exit fees is essential in demolishing the significant barrier to switching, and supports the Government's measure to ban exit fees to increase competition and allow new customers to switch.

Price Signalling

1.24 The ACCC are clear that, in their view, a prohibition on price signalling is required:

> CHAIR—...The first point I take out of all of that is that the ACCC does consider that there is a mischief that needs to be addressed in terms of price signalling and that that has potential anticompetitive outcomes for consumers in Australia. For the purposes of Hansard, I see you are nodding, Mr Cassidy. Secondly, you do not believe that the current legislative powers granted to the ACCC in view of the Federal and the High Court decisions gives you sufficient power to adequately address that mischief.
>
> Mr Samuel—That is correct.[14]
>
> Senator HURLEY—There was an article in the Australian in 2009 which reported comments by the ANZ CEO, Mike Smith. He said that, while reluctant to increase home loan rates over and above the Reserve Bank's rates, if other banks moved their rates outside moves by the RBA he would not be 'stuck on his own'. That is precisely the kind of comment you are talking about.
>
> Mr Samuel—Yes, and we could not deal with that sort of comment under the law as it currently stands.
>
> Mr Cassidy—The problem with that sort of comment—the evil of it, if you like—is that it says to the competitors, 'If you increase your interest rates I will follow,' which means you are signalling to the competitor that if they increased their interest rates they would not need to worry about being stuck out there on their own and losing market share.[15]

1.25 While the majority report calls for a law to deal with price signalling to be introduced, it recommends that it be limited to conduct that has the purpose, or has or is likely to have the effect, of substantially lessening competition. The ACCC, who would have to enforce such a law, have been critical of proposals for all price signalling conduct to be subject to a substantial lessening of competition test. When questioned about the price signalling bill introduced by the Opposition, which would subject all price signalling conduct to a substantially lessening of competition test, the ACCC stated:

> When you think about the range of behaviour which the bill potentially covers, you would wonder whether some of that behaviour is so offensive and so unredeeming in its character as to whether it should not simply be a

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14 Mr Graeme Samuel, Chairman, Australian Competition and Consumer Commission, *Proof Committee Hansard*, 25 January 2011, p. 29.

15 Mr Graeme Samuel, Chairman; Mr Brian Cassidy, Chief Executive Officer, Australian Competition and Consumer Commission, *Proof Committee Hansard*, 25 January 2011, p. 40.

> per se offence. You can have a debate about how you would define, and there are different criteria that you can use when you are talking about signalling behaviour. As we have already said, there are criteria about whether it is price or other information. There are criteria about whether the information passes between competitors in secret or whether it passes between competitors in a more public sort of way. There are also criteria about whether the information is about future conduct, future prices and future strategy or whether it is about current prices and strategy. But if you go to what we might call the very worst end of the spectrum and you were to consider something like competitors passing between themselves their future pricing intentions and doing it in secret—using those criteria, that is about the worst end of the spectrum—you would wonder whether that sort of conduct perhaps should not be simply a per se offence because it of its unredeeming character rather than being subject to a substantial lessening-of-competition test.[16]

1.26 The ACCC also considered that such a proposal would be out of step with other key jurisdictions that have laws dealing with anti-competitive price signalling, such as the United Kingdom and the European Union:

> In the UK, as in the EC—because the UK law, the Competition Act, mirrors Article 101 of the European treaty—it is basically per se, in the sense that they refer to object and/or effect rather than purpose and/or effect. And if you look at the guidance material from the EC it basically says that, in relation to what they call concerted practices—the signalling behaviour—they are to be taken as having the object of substantially impairing competition. So, in other words, there is, if you like, an ex ante assumption that that sort of behaviour has the object of impairing competition and therefore runs foul of the European and UK law.[17]

Recommendation 2: The Government senators reject the Coalition's amendments to price signalling. However Government senators support the Government's amendments to the Competition and Consumer Act as the only rational measure in tackling price signalling, which will ban anti-competitive price signalling, while ensuring that banks can continue with all legitimate business activities.

RMBS

1.27 The ALP senators recognise the historic importance of this market, but due to the GFC smaller financial institutions suffered from a drop in confidence in this

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16 Mr Brian Cassidy, Chief Executive Officer, Australian Competition and Consumer Commission, *House of Representatives Standing Committee on Economics Hansard*, 18 February 2011, pp. 11-12.

17 Mr Brian Cassidy, Chief Executive Officer, Australian Competition and Consumer Commission, *House of Representatives Standing Committee on Economics Hansard*, 18 February 2011, p. 13.

market. This highlighted the importance of the Government's intervention investing $16 billion into the market. The Australian Bankers Association explains the situation:

> The competitive dynamics in the housing finance market was changed materially in mid-2007 with the commencement of the GFC. Housing finance was particularly impacted early on as the GFC trigger was high default rates on securitised US housing loans and, specifically, sub-prime loans similar in nature to 'non-conforming' loans in Australia. The crisis badly damaged investor confidence in all securitised housing assets and, indeed, other asset-backed securities, even though Australian RMBS continued to perform well. It became obvious by late 2007 that mortgage originators were having trouble finding investors to fund securitised loans and that this would impede mortgage originators' and other institutions reliant on securitisation to compete.
>
> Without adequate funding, mortgage originators and other lenders were forced to find new and stable sources of funding. Some managed to secure lines from Australian banks. Some closed their doors and sold their assets to banks and credit unions. Others merged with banks.
>
> The funding difficulties of mortgage originators and smaller lenders led the Australian Government to commit to invest $16 billion in RMBS. The investment is based on the stated policy rationale of improving competition.[18]

1.28 ME Bank described the effect of the GFC on the RMBS market and the Government's response as follows:

> ...due to poor underwriting standards for home loans in many countries, the securitisation markets around the globe stopped functioning as investors became nervous about the quality of the assets they were investing in. The market did not discriminate between countries in the respective quality of the securitisation issues but simply threw the baby out with the bathwater. In Australia, the closing of the securitisation markets made it difficult for many of the smaller players to remain competitive. If this market failure had been due to poor lending practices within the Australian banking system then I believe there should be no cause for complaint, as the industry would have brought it upon itself and should have to deal with the consequences. It was not the case that it was simply a failure of the overall system. Consequently, I strongly believe that government intervention in working towards ensuring the RMBS market was able to operate somewhat effectively again was entirely appropriate.[19]

1.29 In December the Government announced that a further $4 billion was to be invested in the RMBS market providing greater support to the smaller lenders. This further investment was widely supported:

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18 Australian Bankers' Association, *Submission 76*, pp 26-7.

19 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Proof Committee Hansard*, 25 January 2011, pp 106-7.

> We also welcome the government's announcement of a further tranche of AOFM's RMBS investments because the recovery of the securitisation market and better pricing for smaller banking institutions will help regional banks, us and non-bank lenders to deliver tighter pricing and put more competitive pressure on the banks.[20]

> We certainly endorse the decision to invest further in the RMBS market. It will help to support lenders who rely on this source of finance but really the emphasis has been on consumer banking and the mortgage sector with limited support for small business lending.[21]

1.30 This further $4billion investment will equate to $20 billion in total, but there has been a significant leverage from this investment:

> Senator PRATT—The government, as I understand it, put in $8 billion initially to support that market and then a further—

> Mr Murphy—Eight.

> Senator PRATT—...And the recent announcement is for a further $4 billion. That is based on the fact that what was done in the past has worked and is strengthening investment. What kind of leverage are we seeing in terms of that investment? That is $20 billion worth of investment—

> Mr Murphy—About $26 billion of leverage off that total figure. It has been significant and, realistically, it has kept some of the smaller players in the game.[22]

Recommendation 3: Government senators endorse the additional $4 billion investment in the RMBS markets, providing funding for smaller lenders, and consider that it is in the taxpayer's interest that the government should continue to only invest in high quality AAA rated RMBS, so taxpayers are not exposed to significant credit risk.

Support for bullet bond markets

1.31 The ALP senators agree with the majority report that supporting the development of a bullet bonds market is desirable. A number of witnesses supported it:

> the bullet structure is attractive to investors.[23]

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20 Ms Louise Petschler, Chief Executive Officer, Abacus, *Proof Committee Hansard*, 13 December 2011, p 84.

21 Mr Paul Orton, Director, Policy and Advocacy, New South Wales Business Chamber, *Proof Committee Hansard*, 21 January 2011, p 55.

22 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Proof Committee Hansard*, 13 December 2011, p 43.

23 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Proof Committee Hansard*, 15 December 2010, p 96.

> We think it can be one of the ways that the securitisation market can lift off a bit more.[24]
>
> The reason we are doing that [issuing bullet bonds] is that we feel that it will open up those people who are prepared to invest in RMBS because they do not have the prepayment risk or the tail risk associated with traditional structures.[25]
>
> What we are encouraged about is the government interest and support with respect to bullet securities because we think that could widen the investor base here in Australia…[26]
>
> The ABA believes that by developing a "bullet" RMBS security which enables efficient recycling of mortgages and removes the prepayment risk inherent in pass-through RMBS instruments, this reform would not only assist in rebuilding the securitisation market in Australia, but assuming a degree of government support, it would also assist banks to meet their obligations under the pending Basel III regulations.[27]
>
> …a bullet bond structure is something we do support. It is something that makes a currency swap cheaper and more efficient to be able to raise those funds.[28]
>
> We therefore welcome the support for the development of bullet RMBS securities as a step toward satisfying the requirements of the broader fixed interest market…[it would] facilitate superannuation fund investment through incorporation in the fixed income index.[29]

Recommendation 4: The government senators recommend the Government continues to work in developing the market for bullet RMBS as an alternative to traditional RMBS. This will help smaller lenders diversify and broaden their funding and access cheaper funding to compete more effectively.

Covered Bonds

1.32 The diversification of funding is an important aspect that is supported throughout the banking sector. The support of covered bonds is highlighted by witnesses:

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24 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 44.

25 Mr Michael Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 84.

26 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 19.

27 Australian Bankers' Association, *Submission 76*, p 58.

28 Mr James Austin, Chief Financial Officer, FirstMac Group, *Proof Committee Hansard,* 4 March 2011, p 20.

29 Mortgage House of Australia, *Submission 115*, p 2.

> If we have covered bonds and institutions can tap into international markets or, alternatively, domestic investors such as superannuation funds find covered bonds more attractive, it is another way of getting more funding into the financial system.[30]

> Yes, we will be [interested in using covered bonds]. I think that is a positive development. They are used in many other markets. We have issued them ourselves out of our New Zealand bank. We have done two covered bond issues out of Bank of New Zealand. We are planning at some point in the future to do one out of our UK bank. We have seen other offshore banks issue into this market in recent times, at lower cost. It is not the be-all and end-all but it is another important step in diversifying funding and we would like to take advantage of it.[31]

> It will be cheaper because our wholesale funding is AA rated and covered bonds are typically AAA rated. So we would be borrowing almost at the sovereign rate.[32]

> The proposals from the government have addressed that by stating that they will seek to amend the Banking Act to allow for the introduction of covered bonds. That opens that possibility up. We look forward to working with the government on a legislative framework that will allow covered bonds to be introduced into Australia while at the same time balancing the interests of depositors. We look forward to working with the government on that.[33]

Recommendation 5: The government Senators recommend that the Government's commitment to allow banks and mutuals to issue covered bonds should remain a priority of the Government.

Bank fees fact sheet

1.33 The majority report acknowledges that one component of the Government's December 2010 package is a uniform mandatory key fact sheet for new home loan customers, which will show consumers how much they will pay every month and over the life of their loan.[34] The ALP senators agree with the enthusiasm shown by witnesses for this advance:

> We are big fans of simplified disclosure in a one-pager…[35]

> If you wish to go and shop around, this will enable you in terms of what deal you can get. This is a simple document which would give you the terms and conditions for that loan. To me that is a huge advance.[36]

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30 Jim Murphy, Treasury, *Proof Committee Hansard* , 13 December 2010. p. 26.

31 Cameron Clyne, CEO National Australia Bank, *Proof Committee Hansard*,13 December 2010, p. 64

32 Mr Joiner, NAB, *Proof Committee Hansard* , 13 December 2010, p. 64

33 Dr John Laker, Chairman, APRA, *Proof Committee Hansard*, 14 December 2010, p. 3

34 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 10.

35 Ms Nicole Rich, Director, Policy and Campaigns, Consumer Action Law Centre, *Proof Committee Hansard*, 25 January 2011, p 18.

Recommendation 6: The government senators support the boost for greater customer information through the Government's announcement of a simple bank fee fact sheet, allowing customers to have a document detailing the fees involved, and comparing it to other home loans.

Other Bank Competition Issues

1.34 The majority report called for a review of payment, clearing and settlement systems in the wider financial system by the ACCC. The government senators were also alert to the allegations of barriers to competition in these systems that provide for EFTPOS, credit and debit card transfers and general payment transfers. Government senators are concerned about the implications of these relatively low fees but high volume transactions not being subject to sufficient competition.

1.35 Government senators acknowledge that the Reserve Bank of Australia has been monitoring this system closely and has made recent significant amendments that have improved competition. The government has recently asked the Council of Financial Regulators to establish a working group to consider the issues surrounding Australia's clearing and settlement systems. Government senators commend this work and look forward to the outcome.

1.36 The majority report also addressed ATM fees and the government senators concur with many of the comments but note that in December 2010 the government commissioned a joint Treasury/RBA taskforce to review issues affecting indigenous and other remote communities and the government is currently considering the report.

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[36] Mr Jim Murphy, Executive Director, Department of the Treasury, *Proof Committee Hansard*, 13 December 2010, p 33.

Financial System Inquiry

1.37 As stated in the Summary the government senators did not gain from the witnesses a pressing need or enthusiasm for a Financial System Inquiry, and feel this is more a desire of the Coalition rather than an indication of widespread support.

1.38 The current issues that are arising are not systemic problems, but structural issues that can be addressed, without the need of a major inquiry:

> The difficulty with a broader Wallis style inquiry is simply that they tend to take an enormous amount of time because the scope of those inquiries covers so much ground. What we are trying to do here is to identify the fact that there are certain specific matters that do warrant some further consideration.[37]

Other Recommendations

1.39 The majority report makes a number of other recommendations that relate to providing more market information (eg recommendation 2 on RBA and 9 on RBA and APRA). The government senators in most cases are not confident that the information suggested is warranted or feasible, and rely on these independent entities to provide timely and useful market information as required.

1.40 In other cases, government senators do not believe we heard sufficient evidence during the hearings to comment on recommendations, for example recommendation 38 on the abolition of the LIBOR cap, or the feasibility of a real time notification of a penalty rate warning in recommendation 31.

Conclusion

1.41 The Global Financial Crisis clearly had a major impact on world financial systems and a consequent impact on the Australian financial system. It is widely acknowledged that the Australian economy was sound at the time of the crisis, and its financial markets well monitored by the relevant regulators and the Reserve Bank of Australia.

1.42 Nevertheless, Australia was not immune from the GFC, it resulted in a shake up of the Australian financial markets. There was a bank merger, as well as a loss of smaller lenders and several foreign banks. This led to concern about competition in the financial sector.

1.43 One of the factors at play was a limited availability of wholesale funding and that has been a significant hurdle for the complete recovery of Australia's banking system. It was pointed out many times during this enquiry that it would not be desirable to fully return to the easy availability of finance experienced during the 1990s. Although it enabled new financing and brokerage sources and put downward

37 Mr Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 15 December 2010, p. 112

pressure on interest rates, the ultimate supply of finance came from the ready international flow of money deriving from asset growth and the questionable structuring of financial instruments that contributed to the GFC.

1.44 A stable, sustainable and equitable market is the objective.

1.45 The government senators commend the government's response in these circumstances. We believe the government acted swiftly and followed up appropriately.

1.46 The financial markets, like any other, are dynamic. The government, the Reserve Bank and the regulatory bodies will have to continually adjust to changing domestic and global situations to assist the functioning of our financial organisations.

1.47 Government senators also emphasise the critical importance of banking customers in this scenario. Some important changes have been made to consumer protection legislation generally, but we believe the government must continue to focus on the rights and needs of consumers in the financial markets. In taking out home mortgages in particular, borrowers are making major financial decisions. Of course it is important to ensure that smaller banking institutions are supported and the major banks are stable, but government senators believe that the interests of consumers should be equally important, and that also that taxpayers should never be exposed to unnecessary risk.

Senator Annette Hurley **Senator Louise Pratt**

Deputy Chair

Additional comments
Senator John Williams

Further to the majority report, Senator John Williams proposes the two following recommendations:

Recommendation 1

That the Australian Securities and Investments Commission (ASIC) has a title for non authorised deposit-taking institutions (ADIs) that lend money with real security and issue 'secured notes'.

Recommendation 2

That these companies with an average loan to valuation ratio (LVR) of 70 or less be covered by the Financial Claims Scheme from the Federal Government for deposits up to $100 000;

That these companies report to ASIC every six months detailing their average LVR for their lending. If their average LVR exceeds 70, the government should remove their Financial Claims Scheme assistance; and

That valuations for these companies must be carried out by a licensed valuer.

Senator John Williams
National Party Senator for New South Wales

Additional Comments by Senator Xenophon

1.1 With the four major banks holding around three quarters of Australia's deposits and assets, and 87 percent of home loans, the lack of choice between financial institutions for consumers effectively means that the "big four" have free reign to do as they please.

1.2 Over the years, Australia's banking sector has significantly shrunk.

> "In October 2007, the Australian mortgage market was serviced by over 150 financial institutions offering 2,117 home loan products. In November 2010, this had fallen to 100 financial institutions offering 1,600 products."[1]

1.3 In a survey conducted by the Chamber of Commerce and Industry Queensland, almost 90 percent of respondents agreed that there should be more competition in the banking industry.[2] A separate survey found 72 percent of Australians thought the big four banks in Australia have too much market power.[3]

Bank profits up, but so are interest rates

1.4 During the recent global financial crisis, Australian consumers had to reduce their spending, yet it seemed the profits of Australia's big four banks were as high as ever.

1.5 An online poll conducted by Fairfax newspapers in October 2010 asked:

> Do you think commercial banks would be justified in either moving early to raise rates or lifting them by more than the Reserve Bank when it moves?

Yes, banks are paying more for their money so borrowers should expect to pick up the tab	16%
No, banks are earning huge profits and can afford to absorb the extra costs	80%
Too hard to tell	4%

1.6 Then, on Melbourne Cup Day in November 2010, Australians were outraged when the Reserve Bank increased interest rates by 25 basis points but the big four banks increased their standard home loan rates, on average, by 40 basis points.

1.7 This followed the Commonwealth Bank posting a net profit for the full year ending 30 June 2009 of $4.7 billion, ANZ, $4.5 billion, National Australia Bank $3.8 billion, and Westpac, $4.6 billion.

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1 Treasury, *Submission 102*, Pg 22

2 Chamber of Commerce and Industry Queensland, *Submission 43*, Pgs 3 and 16

3 Fear et all, 2010, Pg iv

1.8 (And, in the first week of May 2011, ANZ and Westpac announced record half-year profits – ANZ, $2.66 billion, up 38 percent and Westpac, almost $3.2 billion for the half-year, up 7 percent.)

1.9 During the Committee Inquiry, the CEOs of the major banks explained to the Committee that their cost of wholesale funds had increased, hence the rise in interest rates.

1.10 However this has been a bitter pill to swallow for Australian consumers who have only watched the banks celebrate record profits while they have had to tighten their belts.

1.11 Greater transparency by the banks around the decision making process for increasing interest rates would better inform consumers. Each month, banks should be required to publish on their websites specific reasons for increasing or decreasing their standard home loan rates, whether in line with, outside of or above, the RBA's cash rate.

1.12 Furthermore, any time delay between the RBA's decisions and the banks' change in rates should be explained, especially where the RBA has lowered the cash rate and the bank has not followed suit.

1.13 This additional information will enable consumers to better assess their banks and have greater awareness for their justification for increasing interest rates and will help consumer more easily identify, at least on this issue, which bank they prefer.

The need for a 'fifth pillar'

1.14 In 2008, Westpac acquired St George Bank, then Australia's fifth largest bank. The loss of competition by this move attracted a lot of commentary during the Inquiry.

> **Mr Carter**—We had very vigorous exchanges with the ACCC around that, particularly the St George merger. We made it crystal clear to everybody we spoke to and particularly the ACCC that if they green-lit that merger they would essentially end competition against the big four... We had a fifth pillar; it was called St George, and Westpac were allowed to purchase it. We think that the ACCC completely went missing at a time when they needed to stand up...A thousand people lost their jobs as a result of that merger, and there are probably 2,000 or 3,000 more people who are going to lose their jobs. With the fall of St George, we have lost the only genuine competitor to the big four...No-one has won out of that."[4]

> **Associate Professor Zumbo**—There is absolutely no doubt in my mind that the St George acquisition by Westpac was a huge mistake. It was the beginning of the end. It was the tipping point. St George was an intensive competitor, particularly in relation to small businesses.…the four big banks basically took out one significant threat to them overnight. [5]

[4] Mr Leon Carter, Finance Sector Union, *Proof Committee Hansard*, 14 December 2010, Pg 45

[5] Associate Professor Frank Zumbo, *Proof Committee Hansard*, 14 December 2010, Pgs 61-62

1.15 Indeed, it has become apparent that whenever a 'smaller' bank or lending institution has emerged as a potential competitor in the sector, it has promptly been acquired by one of the major four banks.

1.16 For example, the Commonwealth Bank acquired West Australian bank, Bankwest, in 2008 for $2.1 billion, making the Commonwealth Bank the clear market leader in that state.

1.17 The BankWest deal gave the Commonwealth Bank $55 billion in loans, $37 billion in customer deposits and 148 branches.[6]

1.18 Although these banks continue to have their own branding and operate individually at a retail front, there is a false sense of there being more competition than really exists at a consumer level, given that the umbrella owners are in fact one and the same.

1.19 The ability for banks to acquire emerging threats to their dominance should therefore be prohibited through legislative amendment to Competition and Consumer Act 2010. Similarly, Australia's 'four pillar' policy should never be reduced.

1.20 Unfortunately, mutuals, credit unions and smaller banks have struggled to effectively compete against the major four banks, and the global financial crisis and the Government's Wholesale Funding Guarantee Scheme, while necessary and beneficial in some regards, only compounded the market domination of the big four banks.

1.21 During the global financial crisis, the Australian Government guaranteed Australian Deposit-Taking Institutions (ADIs) with credit ratings of AAA to AA- at 70 basis points per annum, while those with credit ratings of A+ to A- were charged 100 basis points and others 150 basis points.

1.22 The double cost of this to smaller financial institutions compared to the major banks made it relatively onerous for them to access the guarantee and therefore more and more customers flocked to the major banks rather than supporting smaller lenders.

> **Mr Degotardi—**…during the GFC the largest banks accessed a wholesale government guarantee that we were not able to access because of the differential pricing on that guarantee. The cost for us therefore was too expensive. And that did put us at a disadvantage.[7]
>
> **Mr Lloyd—**There are differences of guarantee and differences in the price of guarantee, which has disproportionately benefited the major banks.[8]
>
> **Mr Minz—**Entities in the Australian marketplace which are regulated by the one entity, APRA, are subject to the same prudential standards…I do not believe the 150 basis points that we were charged was reasonable.[9]

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[6] Commonwealth steals BankWest, http://www.intelligentinvestor.com.au/articles/Commonwealth-Bank-CBA/Commonwealth-steals-BankWest.cfm?articleID=817412, 9 October 2008

[7] Mr Mark Degotardi, Head of Public Affairs, Abacus, *Proof Committee Hansard*, 13 December 2010, Pg 93

[8] Mr Richard Lloyd, International Policy Adviser, Choice, *Proof Committee Hansard*, 14 December 2010, Pg 31

[9] Mr John Minz, Chief Executive Officer, Heritage Building Society, *Proof Committee Hansard*, 4 March 2011, Pg 13. See also Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Proof Committee Hansard*, 25 January 2011, Pg 11

> **Mr Anderson—**…if you equalise the cost arrangements in respect of the wholesale funding guarantee, that is going to be a direct advantage to those second-tier institutions, and they would have the capacity to flow that through…it certainly would allow them to compete more actively on price.[10]

1.23 The Committee's recommendation to reduce the guarantee permia to 70 basis points for all ADIs (Recommendation 12.1) is a positive measure and will work to even out the imbalance that currently exists.

1.24 It is crucial that financial institutions which could be potential fifth pillars in the banking sector be able to thrive and by making the guarantee more affordable for smaller ADIs, they will be able to compete against the big four and offer alternative banking choices to Australian consumers.

1.25 The Committee also heard that it was difficult for some of the smaller banks and credit unions to attract small and medium business loan customers due to the dominance of the major four banks.

1.26 CPA Australia told the Committee:

> Second tier lenders (smaller banks and credit unions) …without larger distribution networks and larger back office support…[are] unlikely…[to] become a major source of competition in small business lending.[11]

1.27 These second tier lenders should be better supported by the Government to enable them to provide alternative choice for consumers and increase competition in the small business market.

1.28 The Australian Office of Financial Management currently offers Residential Mortgage-Backed Securities and a similar scheme to support small business lending should be considered for second tier lenders only.

1.29 It was also put to the Committee that a distribution channel for smaller lenders should be established (such as through Australia Post) which would alleviate significant costs and provide better access to consumers across Australia.

1.30 A survey of Queensland businesses found that 45 per cent supported this proposal[12] and this was also encouraged by CHOICE.

> **Mr Stace—**Smaller banks need a hand up and that may also be through access to a branch network including, for example, working with Australia Post.[13]

1.31 Associate Professor Frank Zumbo suggested that the Productivity Commission undertake a feasibility study into this proposal, and Australia Post

[10] Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 15 December 2010, Pg 114. See also Chamber of Commerce and Industry Queensland, *Submission 43*, Pg 19

[11] CPA Australia, *Submission 82*, Pg 9

[12] Chamber of Commerce and Industry Queensland, *Submission 43*, Pg 16

[13] Mr Nick Stace, CHOICE, Proof Committee Hansard, 14 December 2010, Pg 28

offering basic banking services and to review the overseas experience with national postal services offering banking services.[14]

‘At Treasury, we won't save you’

1.32 In March 2010, Aussie Home Loans received an in principle 'go ahead' from the Australian Office of Financial Management that it would be able to acquire Residential Mortgage-Backed Securities.

1.33 This would have enabled Aussie Home Loans to provide approximately $1 billion in mortgages to its customers at interest rates below that of the banks.

1.34 However, on 3 December 2010, just days before the Treasurer, the Hon Wayne Swan MP, was due to announce the Government's banking reform agenda, Aussie Home Loans received an email stating that:

> "…contrary to previous advice, the AOFM is not going to be in a position to support the transaction, based on CBA's ownership of AHL.

Specifically,

> the Treasurer has clarified his expectation that the RMBS program not support the major banks, or their subsidiaries (whether fully or partially owned); and
>
> in light of this clarification, the AOFM will not be in a position to support the AHL transaction at this time."[15]

1.35 As a result of this decision, Mr Symond told the Committee Aussie Home Loan customers could face a 0.1 per cent increase, which would add about $350 a year to a $500,000 home loan.[16]

1.36 However, Aussie Home Loans is not a subsidiary of the Commonwealth Bank. In universally-accepted business terms, a 'subsidiary' is understood to be an entity that is controlled by a higher entity or parent company which owns more than 50 percent of the company.

1.37 Only 33 percent of Aussie Home Loans’ shares are owned by the Commonwealth Bank and although it holds 2 seats on the Board, Mr Symond has repeatedly stated that Aussie Home Loans maintains operational independence from CBA.

1.38 Ultimately, Australia's banking sector should comprise of as many players where possible, to provide consumers with greater choice and thereby creating more competition between the financial corporations.

1.39 Financial institutions which can be an effective alternative to the major four banks need to be supported and the Government has significantly erred in this area by

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[14] Associate Professor Frank Zumbo, *Submission 56*, Pg 8

[15] Document tabled by Mr John Symond at a public hearing in Sydney on 14 December 2010; email correspondence between Michael Bath and Ernest Baisi

[16] Daily Telegraph, Aussie John Symond slams Wayne Swan's bank reforms, http://www.dailytelegraph.com.au/news/national/aussie-john-symond-slams-wayne-swans-bank-reforms/story-e6freuzr-1225971171836, 15 December 2011

choosing not to support Aussie Home Loans which would have seen it provide competition to the mortgage sector.

1.40 Aussie Home Loans is 'market maker' in that it has been the impetus for competition in the home loan market ever since it was established in 1992, providing an alternative to the big four banks and spurring competition in the sector thereby saving Australian consumers hundreds of millions of dollars.

1.41 The Treasurer's decision not to provide Aussie Home Loans access to the RMBS program will have the paradoxical effect of reducing competition in the mortgage market with negative consequences for consumers, despite the fact that the Government's banking reform package is intended to "empower consumers to get a better deal in the banking system, to support our smaller lenders so they can put more competitive pressure on the big banks"[17].

1.42 The Committee’s recommendation that the Australian Office of Financial Management be able to exercise its discretion to purchase residential mortgage-backed securities issued by entities with a substantial bank shareholding where it judges this would promote a more competitive market (Recommendation 13.5) is logical and should have been applied by the AOFM and the Treasurer in the case of Aussie Home Loans. It was a missed opportunity.

Recommendations

Recommendation 1
That banks be required to publish on their websites specific reasons for increasing or decreasing their standard home loan rates each month, and any time delay between the RBA’s decisions and the banks’ change in rates be disclosed and explanation given, especially where the RBA has lowered the cash rate and the bank has not followed suit.

Recommendation 2
That the Competition and Consumer Act 2010 be amended so that the big four banks be prohibited from acquiring any further second tier financial institutions.

Recommendation 3
That the Productivity Commission conduct a feasibility study into Australia Post becoming a distribution channel for smaller banks, credit unions and mutuals.

Recommendation4
That the Government introduce a scheme through the AOFM to assist second tier lenders only to facilitate small and medium business loans.

[17] Competitive and Sustainable Banking, http://www.treasury.gov.au/banking/content/report/report_01.htm

NICK XENOPHON

Independent Senator for South Australia

Appendix 1

Submissions Received

Submission Number	Submitter
1	Mr Andrew Oliver
2	Mr Peter Mair
•	Supplementary Submission
3	Mr Terence Holmes
4	Mr Suryan Chandrasegaran
5	Mr Mervin Reed
6	Dr Bob Such MP, Member for Fisher
7	Mr Simeneh Makonnen
8	Prof Kevin Davis
9	Mr Selwyn Cornish, College of Business and Economics, Australian National University
10	Mr Mal McCullough
11	Mr Chris Webbe
12	Mr Robert Gay
13	Mr Rob Paton, Ismar Tuzovic
14	Mr Tom Valentine
15	Mr Alan Mills
16	Name Withheld
17	Mr Peter Higgins
18	Mr Richard Wright, Barbara Ann Wright
19	Name Withheld
20	Dr Brett Edgerton
21	Dr Nicholas Gruen, Whitlam Institute, University of Western Sydney
22	Mr Nicholas Palmer
23	Mortgage and Finance Association of Australia
24	Real Estate Institute of Australia (REIA)
25	Mr Geoffrey Hodgkinson
26	FirstMac Group
27	SLM Group Limited
28	Prof Milind Sathye, University of Canberra
29	Brotherhood of St Laurence

30		ProSolution Private Clients
31		Maurice Blackburn Pty Limited
32		Prof Ross Buckley
33		Mr Leigh Harkness
34		Laminar Group
35		ING Direct
	•	Supplementary Submission
36		Tyro Payments Limited
	•	Supplementary Submission
37		Australian Chamber of Commerce and Industry (ACCI)
38		Master Builders Australia Ltd
39		Aussie
40		Australian Industry Group (AIG)
41		Reserve Bank of Australia (RBA)
42		Urban Taskforce Australia Ltd
43		Chamber of Commerce and Industry Queensland
44		Bank of Queensland Limited
45		Suncorp Bank
46		Australia Institute
47		Office of Senator Bob Brown
48		Mr Alan Stokes
49		Australian Payments Clearing Association (APCA)
50		Veda Advantage DL
51		Mr Richard Talbot
52		Name Withheld
53		Abacus - Australian Mutuals Limited
	•	Supplementary Submission
54		National Association of Retail Grocers of Australia (NARGA)
55		Financial Redress
56		Prof Frank Zumbo
57		Australian Prudential Regulation Authority (APRA)
58		Bendigo and Adelaide Bank
59		Institute of Public Affairs
60		Mallesons Stephen Jaques
61		Think Tank Property Finance
62		Virgin Money Australia
63		Associate Professor Steve Keen

64	Mrs Amanda Watson
65	Mr Andrew Selby Smith
66	Australian Finance Conference
67	Brent Fisse Lawyers
	• Supplementary Submission
68	WA Small Enterprise Network
69	Mr Greg Bloomfield
70	CHOICE
	• Supplementary Submission
71	ATM Industry Association (ATMIA)
72	The Westpac Group
73	Mr Andrew Thomas
74	The Australian Securitisation Forum, Inc.
75	Mr Andrew Macken
76	Australian Bankers' Association Inc
77	ME Bank (Members Equity Bank Pty Ltd)
78	Financial Ombudsman Service Limited
79	ATM Industry Reference Group
80	Finance Sector Union of Australia
81	Confidential
82	CPA Australia
83	Dr Steven Kates
84	NSW Business Chamber
85	Credit Union Australia (CUA)
86	Mrs Maria Rigoni
	• Supplementary Submission
	• Supplementary Submission
87	Consumer Action Law Centre
88	Commonwealth Bank of Australia
89	Australian Council of Trade Unions
90	Council of Small Business of Australia (COSBOA)
91	National Australia Bank
92	Mr John McAuley
93	Mr John Turner
94	ANZ Banking Group Ltd
	• Supplementary Submission
95	Australian Financial Markets Association

96	Business Council of Australia
97	Mr Lindsay Johnston
98	Confidential
99	Confidential
100	Confidential
101	Yellow Brick Road Wealth Management Pty Ltd
102	The Treasury
103	Professor John Quiggin, School of Economics and School of Political Science and International Studies, University of Queensland
104	Mr Leonard Clampett
105	Mr Paul Myers
106	Mr Michael Woodford
107	HSBC Bank Australia
108	Commercial Asset Finance Brokers Association of Australia Limited (CAFBA)
109	Mr Archer Field
110	Australian Financial Integrity Network (AusFIN)
111	Confidential
112	Banking and Finance Consumers Support Association Inc
113	Heritage Building Society
114	Dr Carolyn Currie
115	Mortgage House of Australia Pty Ltd
116	Citi Australia
117	Mr John O'Brien
118	Confidential
119	Mrs Kay Robinson
120	Australia Post
121	Financial Services Council
122	Queensland Teachers' Credit Union Ltd
123	PROVIC Group Inc
124	Mr George Ivanov
125	Mr Michael O'Connor
126	Mr David Allen
127	Visa AP (Australia) Pty Ltd
128	Accounts4Life
129	Name Withheld • Supplementary Submission
130	Exposing Unacceptable Financial Activities (EUFA NZ)

131 Confidential

132 Mr Mark J. Cohen

133 Finance Brokers Association of Australia Limited (FBAA)

134 Mr Ken Longshaw

135 Mr Graham Keen

136 Genworth Financial Mortgage Insurance Pty Ltd

137 Insurance Council of Australia

Additional Information Received

- Additional information provided by the Commonwealth Bank of Australia on 23 December 2010; Bain and Co. report 'Getting bank competition right post-crisis'
- Received from the Reserve Bank of Australia on 20 December 2010, answers to Questions on Notice taken at a public hearing in Sydney on 13 December 2010
- Received from the ANZ Bank on 31 December 2010, answers to Questions on Notice taken at a public hearing in Canberra on 15 December 2010
- Received from the Treasury on 11 January 2011, answers to Questions on Notice taken at a public hearing in Canberra on 15 December 2010
- Received from Professor Milind Sathye on 14 January 201, answers to Questions on Notice taken at a public hearing in Canberra on 15 December 2010
- Received from CHOICE on 17 January 2011, answers to Questions on Notice taken at a public hearing in Sydney on 14 December 2010
- Received from the Reserve Bank of Australia on 18 January 2011, answers to Questions on Notice taken at a public hearing in Sydney on 13 December 2010
- Received from Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, on 20 January 2011, answers to senators' questions following the public hearing in Canberra on 15 December 2010
- Received from the Commonwealth Bank of Australia on 28 January 2011, answers to supplementary questions from the public hearing in Sydney on 15 December 2010
- Received from APRA on 31 January 2011, answers to Questions on Notice taken at a public hearing in Sydney on 14 December 2010
- Received from the ANZ Bank on 31 January 2011, answers to written Questions on Notice from the Committee
- Received from the National Australia Bank on 27 January and 1 February 2011, answers to Questions on Notice taken at a public hearing in Sydney on 13 December 2010

- Received from WA Small Enterprise Network on 1 February 2011, answers to Questions on Notice taken at a public hearing in Sydney on 21 January 2011
- Received from the Department of the Treasury on 4 February 2011, answers to written questions and answers to Questions on Notice taken at a public hearing in Sydney on 13 December 2010
- Received from the Australian Bankers' Association Inc on 8 February 2011, answers to Questions on Notice taken at a public hearing in Sydney on 14 December 2010
- Received from Westpac on 7 March 2011, answers to Questions on Notice taken at a public hearing in Sydney on 21 January 2011
- Received from the Treasury on 23 March 2011, answers to Questions on Notice taken at a public hearing in Sydney on 9 March 2011
- Received from the Reserve Bank of Australia on 18 March 2011, answers to Questions on Notice taken at a public hearing in Brisbane on 4 March 2011

TABLED DOCUMENTS

SYDNEY, 14 December 2010

- Document tabled by Mr John Symond; email correspondence between Michael Bath and Ernest Baisi
- Document tabled by Prof Frank Zumbo; 'Interest Rates and Margins' graph
- Document tabled by Mr Phil Nayor; tables (December 2010)
- Document tabled by Mr Jonathon Mott; UBS Investment Research - Australian Banking Sector Update

CANBERRA, 15 December 2010

- Document tabled by the Australia Institute; bank funding costs, 2009 and 2010

MELBOURNE, 25 January 2011

- Document tabled by Credit Union Australia; 'CUA vs Average Big 4 Standard Variable 2010' graph

Appendix 2

Public Hearings and Witnesses

SYDNEY, 13 DECEMBER 2010

BECKETT, Mr Ian, Principal Adviser, Banking, Financial Systems Division,
Department of the Treasury

BOURIS, Mr Mark Leigh, Executive Chairman,
Yellow Brick Road Wealth Management

CLYNE, Mr Cameron, Managing Director and Chief Executive Officer,
National Australia Bank

CORNISH, Associate Professor Selwyn, Research School of Economics,
Australian National University

DEBELLE, Dr Guy Lawrence Geoffrey, Assistant Governor (Financial Markets),
Reserve Bank of Australia

DEGOTARDI, Mr Mark, Head of Public Affairs,
Abacus

DIETZ, Mr Andrew, Manager, Infrastructure, Competition and Consumer Division,
Department of the Treasury

DOUGLAS, Mr Justin, Principal Adviser, Financial System Division,
Department of the Treasury

JOINER, Mr Mark, Executive Director, Finance,
National Australia Bank

LOAN, Mr Nick, Banking Competition Unit, Financial System Division,
Department of the Treasury

McINERNEY, Mr Dallas, Group Manager, Government Affairs and Public Policy,
National Australia Bank

MURPHY, Mr Jim, Executive Director, Markets Group,
Department of the Treasury

NICHOLSON, Mr Bryn Conway, Chief Operating Officer,
Yellow Brick Road Wealth Management

PETSCHLER, Ms Louise, Chief Executive Officer,
Abacus

STEVENS, Mr Glenn Robert, Governor,
Reserve Bank of Australia

WILLIAMS, Mr Owen Francis, Non-Executive Director,
Yellow Brick Road Wealth Management

SYDNEY, 14 DECEMBER 2010

BYRES, Mr Wayne, Executive General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority

CARTER, Mr Leon, National Secretary, Finance Sector Union of Australia

DALTON, Mr Chris, Chief Executive Officer, Australian Securitisation Forum

KHOO, Mr Brandon, Executive General Manager, Specialised Institutions Division, Australian Prudential Regulation Authority

KOCH, Mr Don, Chief Executive Officer, ING Direct

LAKER, Dr John Francis, Chairman, Australian Prudential Regulation Authority

LLOYD, Mr Richard, International Policy Adviser, Choice

MASSON, Mr Rodney, Director, Policy and Communication, Finance Sector Union of Australia

MOTT, Mr Jonathan, Bank Analyst, UBS Securities Australia

MULLINGTON, Mr Mark, Chief Financial Officer, ING Direct

MUNCHENBERG, Mr Steven, Chief Executive Officer, Australian Bankers Association

NAYLOR, Mr Phillip Gordon, Chief Executive Officer, Mortgage and Finance Association of Australia

SELL, Mr Alex, Chief Operating Officer, Australian Securitisation Forum

STACE, Mr Nicholas, Chief Executive Officer, Choice

STAMOLIS, Mr John, Statistics Director, Australian Bankers Association

SYMOND, Mr John, Executive Chairman, Aussie Home Loans

TATE, Ms Diane, Policy Director, Australian Bankers Association

ZINN, Mr Christopher, Director, Communications, Choice

ZUMBO, Associate Professor Frank, School of Business Law and Taxation, University of New South Wales

CANBERRA, 15 DECEMBER 2010

ANDERSON, Mr Peter, Chief Executive,
Australian Chamber of Commerce and Industry

BATH, Mr Michael Paul, Acting Chief Executive Officer,
Australian Office of Financial Management

CRAIG, Mr David Paul, Chief Financial Officer,
Commonwealth Bank of Australia

DENNISS, Dr Richard, Executive Director,
The Australia Institute

EVANS, Mr Greg, Director, Economics and Industry Policy,
Australian Chamber of Commerce and Industry

HIRST, Mr Michael John, Managing Director,
Bendigo and Adelaide Bank

HODGES, Mr Graham, Deputy Chief Executive Officer,
ANZ Banking Group Ltd

HOLYMAN, Mr Richard, Deputy President,
Australian Chamber of Commerce and Industry

McEWAN, Mr Ross Maxwell, Group Executive, Retail Banking Services,
Commonwealth Bank of Australia

NAREV, Mr Ian Mark, Group Executive, Business and Private Banking,
Commonwealth Bank of Australia

NASH, Ms Jane, Head of Government and Regulatory Affairs,
ANZ Banking Group Ltd

NORRIS, Mr Ralph James, Chief Executive Officer,
Commonwealth Bank of Australia

RICHARDSON, Mr David, Senior Research Fellow,
The Australia Institute

SATHYE, Professor Milind, Professor of Banking and Finance,
University of Canberra

SCOBIE, Mr Andrew, Board Director,
Australian Chamber of Commerce and Industry

SMITH, Mr Michael, Chief Executive Officer,
ANZ Banking Group Ltd

STRONG, Mr Peter James, Executive Director,
Council of Small Business Organisations of Australia

SYDNEY, 21 JANUARY 2011

BOND, Mr James, Economist,
Financial Services Council

BOXALL, Dr Peter, AO, Commissioner,
Australian Securities and Investments Commission

BROGDEN, Mr John, Chief Executive Officer,
Financial Services Council

CANION, Mr Andrew, Manager,
Western Australian Small Enterprise Network

CODINA, Mr Martin, Director of Policy,
Financial Services Council

COFFEY, Mr Philip, Chief Financial Officer,
Westpac

GREEN, Mr Micah, Economist,
New South Wales Business Chamber

HAMILTON, Mr Christopher, Chief Executive Officer,
Australian Payments Clearing Association Ltd

HANLON, Mr Peter, Group Executive, People and Transformation,
Westpac

KELLY, Mrs Gail, Chief Executive Officer,
Westpac

KING, Professor Stephen,
Private capacity

KIRK, Mr Greg, Senior Executive Leader,
Australian Securities and Investments Commission

LARBEY, Mr Miles, Senior Manager,
Australian Securities and Investments Commission

ORTON, Mr Paul, Director, Policy and Advocacy,
New South Wales Business Chamber

PRAGNELL, Dr Brad, Head of Industry Policy,
Australian Payments Clearing Association Ltd

STOLLMANN, Mr Jost, Chief Executive Officer,
Tyro Payments Ltd

MELBOURNE, 25 JANUARY 2011

BEZZI, Mr Marcus, Executive General Manager, Enforcement and Compliance Division, Australian Competition and Consumer Commission

BRODY, Mr Gerard Gavan, Senior Manager, Financial Inclusion,
Brotherhood of St Laurence

CASSIDY, Mr Brian, Chief Executive Officer,
Australian Competition and Consumer Commission

DAVIDSON, Professor Sinclair,
Private capacity

DAVIS, Professor Kevin Thomas,
Private capacity

FISSE, Mr Warren Brent,
Private capacity

GREISS, Mr Rami, General Manager, Investigations Branch, Mergers and Acquisitions Group, Australian Competition and Consumer Commission

HENRICK, Ms Sharon Louise, Partner and Convenor of the Competition Law Group, Mallesons Stephen Jaques

LOWE, Ms Catriona, Co-Chief Executive Officer,
Consumer Action Law Centre

McPHEE, Mr James Lachlan, Chief Executive Officer,
Members Equity Bank

PRICE, Mr Rob, Head of Strategy,
Credit Union Australia

RICH, Ms Nicole, Director, Policy and Campaigns,
Consumer Action Law Centre

SAMUEL, Mr Graeme, Chairman,
Australian Competition and Consumer Commission

VALENTINE, Professor Thomas,
Private capacity

WALKER, Dr Jill, Commissioner,
Australian Competition and Consumer Commission

WHITEHEAD, Mr Chris, Chief Executive Officer,
Credit Union Australia

CANBERRA, 9 FEBRUARY 2011

FOSTER, Mr David, Chief Executive Officer,
Suncorp Bank

LIDDY, Mr David, Chief Executive Officer,
Bank of Queensland

McMULLEN, Ms Tarryn, Head of MD's Office,
Bank of Queensland

ROSE, Mr Anthony, Chief Financial Officer,
Suncorp Bank

BRISBANE, 4 MARCH 2011

AUSTIN, Mr James Neil, Chief Financial Officer,
FirstMac Group

BAXBY, Mr Matt, Managing Director,
Virgin Money Australia

BEHRENS, Mr Nick, General Manager, Policy,
Chamber of Commerce and Industry Queensland

BOYLE, Mr Greg, Strategy Director,
Virgin Money Australia

CANNON, Mr Kim David, Managing Director,
FirstMac Group

FLOOD, Mr Darren, Deputy Head, Payments Policy Department,
Reserve Bank of Australia

KENT, Dr Christopher John, Head, Payments Policy Department,
Reserve Bank of Australia

MINZ, Mr John Francis, Chief Executive Officer,
Heritage Building Society Limited

MURPHY, Mr Michael Charles, Chief Executive Officer,
Queensland Teachers Credit Union

QUIGGIN, Professor John,
Private capacity

WHITE, Mr Peter, National President and Chairman of the Board of Directors,
Finance Brokers Association of Australia Ltd

WILLIAMS, Mr Paul Leo, Treasurer,
Heritage Building Society Limited

SYDNEY, 9 MARCH 2011

DEITZ, Mr Andrew, Manager, Infrastructure, Competition and Consumer Division, The Treasury

DOUGLAS, Mr Justin, Principal Advisor, Banking, Financial System Division, The Treasury

LONSDALE, Mr John, General Manager, Financial System Division, The Treasury

MURPHY, Mr Jim, Executive Director, Markets Group, The Treasury