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Banking Competition: The Rhetoric and the Reality

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Director's Note

Welcome to the thirty second issue of *Economic Issues*, a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of Economic Issues is intended to be broad, limited only to topical, applied economic issues of relevance to South Australia and Australia. Within the scope, the intention is to focus on key issues – public policy issues, economic trends, economic events – and present an authoritative, expert analysis which contributes to both public understanding and public debate. Papers will be published on a continuing basis, as topics present themselves and as resources allow.

This paper considers competition in the banking sector, recent consolidation in the banking sector and implications for customers and appropriate policy responses to drive competition in the banking sector. The paper is presented in two parts:

- a consideration of the issues in assessing banking competition and issues arising in the aftermath of the Global Financial Crisis (GFC); and
- policy responses to support the development of the fifth pillar to compete with the four major banks.

The author of this paper is Dr Penny Neal, Senior Lecturer, Flinders Business School and Senior Research Associate at the Centre. The views expressed in the report are the views of the author.

Michael O'Neil
Executive Director
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May 2011

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Banking Competition:
The Rhetoric and the Reality

Overview

Introduction

The decision by the Big 4 banks to raise home loan interest rates by substantially more than the 25 basis points increase in the Reserve Bank's cash rate on 4th November 2010 triggered widespread outrage across the community despite previous warnings by the banks that interest rates were going to have to rise faster than the cash rate due to the increase in funding costs that banks have faced since the onset of the GFC. The outrage was reflected in public comments made by members of both the Government and the Opposition and reflected the public perception that there has been inadequate competition within the Australian banking sector and that the level of competitiveness is deteriorating rather than improving.

Bank customers' anger over the perceived lack of competition in the banking sector, fuelled in particular by comments made by the Shadow Treasurer Joe Hockey, led to the Government adopting a package of reforms, its *Competitive and Sustainable Banking System* package (12 December, 2010). The Government also set up a Senate References Committee Inquiry into 'Competition within the Australian banking sector' (hereafter referred to as the Senate Inquiry) which is due to report by 27th April.

There was a degree of hysteria following the decision by the Big 4 to raise interest rates by as much as they did in November 2010. The aim of this paper is to take a more balanced view and look behind the rhetoric and populist responses engendered by the backlash against the major banks to examine whether the Australian banking sector has indeed become less competitive post the GFC. Further, the paper seeks to critically assess the proposed policy responses. The danger for the Government is that a knee jerk response to public anger may have unintended consequences that ultimately act against the best interests of bank customers.

An OECD report into competition in financial markets found that "... the benefits of full, effective competition in the banking sector are enhanced efficiency, the provision of better products to final consumers, greater innovation, lower prices and improved international competitiveness".[1] The challenge for the Government is to ensure its policy responses do indeed promote full, effective competition.

The real issues

The key points arising from the paper's discussion are as follows:

- There has been a substantial degree of consolidation in the Australian banking sector.
- Bank customers have had to pay both higher interest rates and higher spreads, small businesses more so than mortgage holders.

- Banks have faced higher funding costs across all types of funding.
- Despite higher funding costs, higher interest spreads have led to a rise in the net interest income of the Big 4 although net interest margins have not recovered their pre-GFC levels.
- Net interest income for the other domestic banks has not recovered its pre-GFC level.
- The securitisation market has all but collapsed making it more difficult for regional banks and other financial service providers which rely more heavily than the majors on the wholesale market to secure funding.
- Less funding at higher cost is making it more difficult for the regional banks and other financial service providers to compete with the four majors.
- Bank customers' perceptions are that it is difficult to switch banks and that there is no point in any case as 'banks are all the same'.

The sixth and seventh points are the most important in terms of increasing competition between the four major banks and the other lenders including the regional banks, mortgage originators and building societies. The smaller lenders had a much greater reliance on securitisation as a source of funding and it was the rapid growth of the securitisation market that enabled them to increase their market share in the years leading up to the GFC. Policy responses to support access by the regional banks and the mutual sector to the securitisation and wholesale markets are key to driving competition in the banking sector.

PART ONE
BANKING COMPETITION: THE ISSUES

1. Competition concerns (Public perceptions)

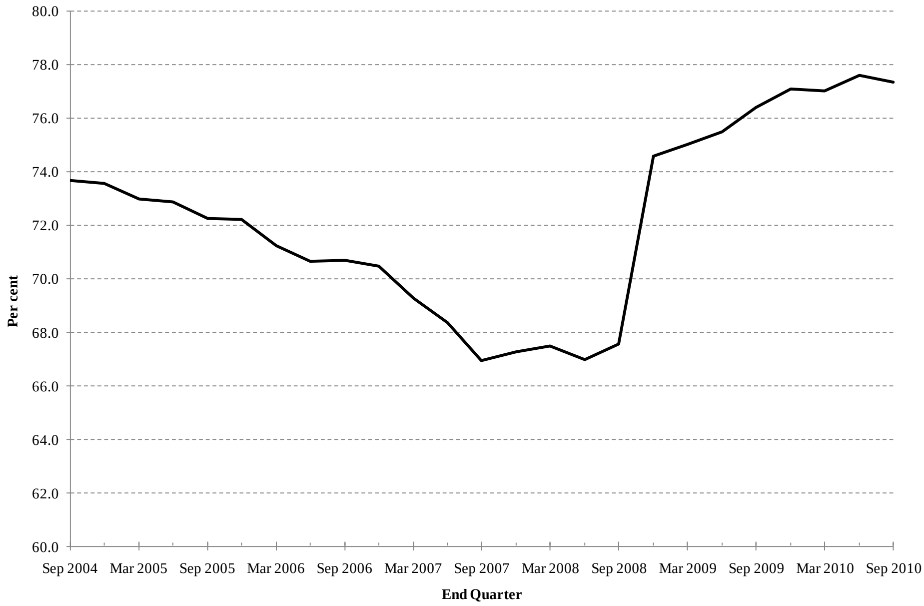
1.1 Consolidation and the Big 4: How big is too big?

The four major banks are amongst the largest firms in Australia. The four major banks accounted for 19.3 per cent of the *total* market capitalisation of the domestic stock market at the end of September 2010 and 56.3 per cent of the financial sector.[2]

A major concern arising from the aftermath of the GFC has been the extent to which the banks, and in particular, the major banks have gained market share at the expense of smaller banks and other financial services providers and the adverse impact that is perceived to have on competition in the banking sector.

The increasing dominance of the four major banks is illustrated in Figure 1 which charts the 4-firm concentration ratio (the percentage share of the assets of the 4 largest firms in an industry) for the Australian banking sector since the September 2004 quarter. The major banks' share of the total assets of all banks declined from 73.7 per cent in the September 2004 quarter to a low of 66.9 per cent in the September 2007 quarter when the market share of regional and foreign banks peaked at 33.1 per cent. The increase in the regional and foreign-owned banks' market share was seen as a sign of increasing competition between the major banks and other financial services providers and was assisted by the increasing use of securitisation as a funding source for the smaller banks.

Figure 1
Total assets of the major banks as a proportion of the total assets of all banks



Source: Derived from APRA, *Quarterly Bank Performance*, www.apra.gov.au

From the September 2007 quarter – which was the quarter in which the impact of the subprime mortgage crisis began to be felt in international financial markets – to the June 2010 quarter, the major banks' share of total banking assets rose more than 10 percentage points to 77.6 per cent. Contributing to the consolidation of the Big 4 were the acquisitions of St George by Westpac and BankWest by the Commonwealth Bank in 2008/09.

Concentration ratios are often criticised for not taking into account both the relative size and the distribution of all firms in the market. The Herfindahl-Hirschman Index (HHI) is regarded by many as a better indicator of industry concentration than *n*-firm concentration ratios. The HHI is used by the US Department of Justice and the Federal Trade Commission to assess merger applications by large firms in the US. It is calculated by summing the squared market share of each firm in the relevant market. The HHI increases as the number of firms in the market falls and as the disparity in the size between firms increases. An HHI of between 1000 and 1800 points is said to be an indicator of a moderately concentrated market and an HHI in excess of 1800 points indicates a highly concentrated market. An HHI of less than 1000 points indicates the market is not concentrated.

Table 1 shows the HHI since 2002 for banks operating in Australia. The market shares used in the calculation of the index are based on total resident assets of all banks operating in Australia at the given date.[3,4] The HHI suggests that the Australian banking industry has been moderately concentrated between 2002 and 2010. However, the HHI suggests there was a marked rise in concentration between 2009 and 2010 which almost certainly primarily reflects Westpac's acquisition of St George and the Commonwealth Bank's acquisition of BankWest in 2008-09 (also see Figure 1 on the 4-firm concentration ratio).

Table 1
Herfindahl-Hirschman Index
Based on total resident assets of all banks operating in Australia

End June	HHI
2002	1319
2003	1349
2004	1267
2005	1251
2006	1207
2007	1130
2008	1104
2009	1195
2010	1453
2010 (end December)	1448

Source: Derived from APRA, *Monthly Banking Statistics*, www.apra.gov.au

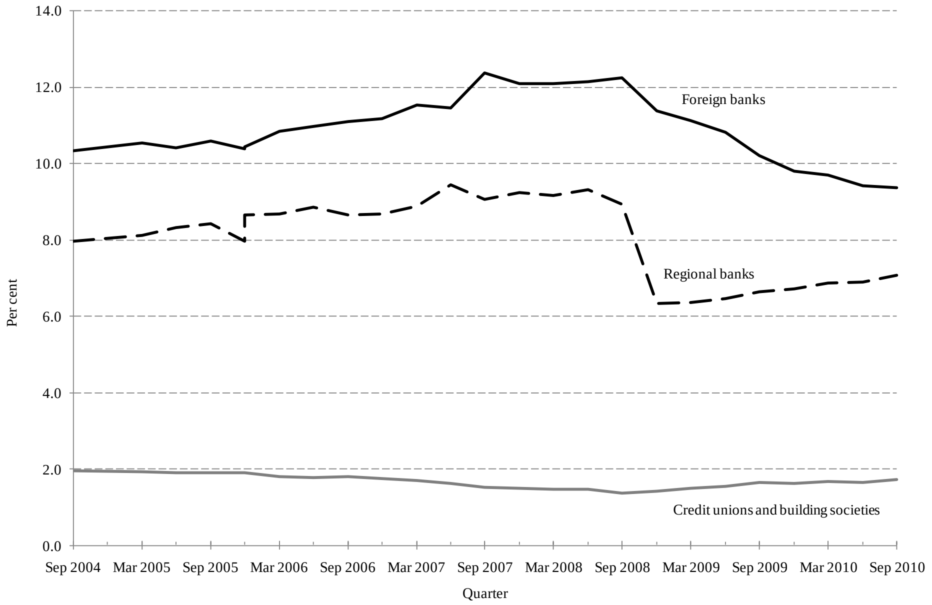
1.2 Contestability

Both the 4-firm concentration ratio and the Herfindahl-Hirschman Index show the Australian banking industry has been characterised by a rise in concentration since the GFC. Consolidation of the banking sector has also been characteristic of other countries' banking sectors. However, economists argue that it is contestability, not concentration, which is important to competition.[5] Contestability refers to the ease with which firms can enter and exit markets. Hence, low barriers to entry and exit are preconditions for a contestable market. A perfectly contestable market would have no barriers to entry or exit.

Even a market dominated by four major firms may be contestable if there is a competitive fringe of firms for which entry and exit is not difficult if those firms compete with the four majors and place downward pressure on the prices offered by all firms in the market.

As part of its *Competitive and Sustainable Banking System package*, the Government is supporting the development of the smaller lenders, the regional banks, credit unions and building societies as a fifth pillar in the banking sector with a view to placing more competitive pressure on the four major banks. These smaller lenders found it particularly hard to rollover their funding during the GFC and are still having difficulties obtaining funds at reasonable cost. These difficulties have led to a decline in the loans they make and as a consequence their market share declined as did the market share of foreign banks (see Figure 2).

Figure 2
Smaller lenders: total assets as a share of the combined assets of all banks, credit unions and building societies



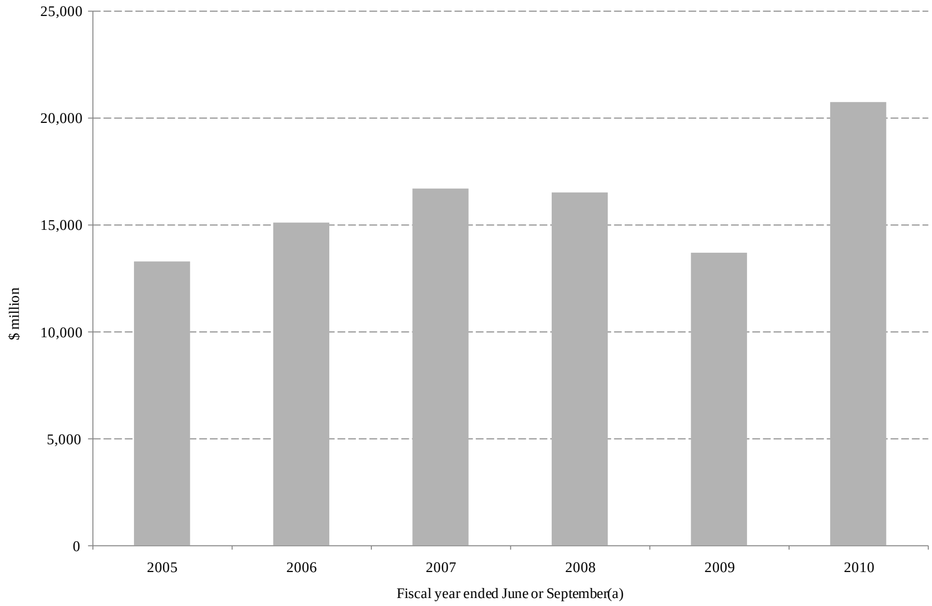
Source: Derived from APRA, *Quarterly Bank Performance* and *Quarterly Credit Union and Building Society Performance*, www.apra.gov.au

1.3 Super profits?

Contributing to adverse public perceptions about less competition as a result of the increasing dominance of the major banks is the absolute size of the profits that they make. Figure 3 shows the total after-tax profit of the four major banks exceeded $20 billion for the 2009/10 fiscal year. Profit before tax rose by 26 per cent from $22.5 billion in 2008/09 to a record $28.5 billion in 2009/10. The rise in profits reflected a marked reduction in loan impairments, an increase in margins from the repricing of risk in the banks' commercial and institutional portfolios and an increase in wealth management income.[6]

Subsequent to the full year results discussed above, several of the four majors announced record first half profits in February 2011. The announcements only added to the perception that the four majors don't face much competition and that bank customers are being 'ripped off' to benefit shareholders.

Figure 3
Total after-tax profits of the four major banks

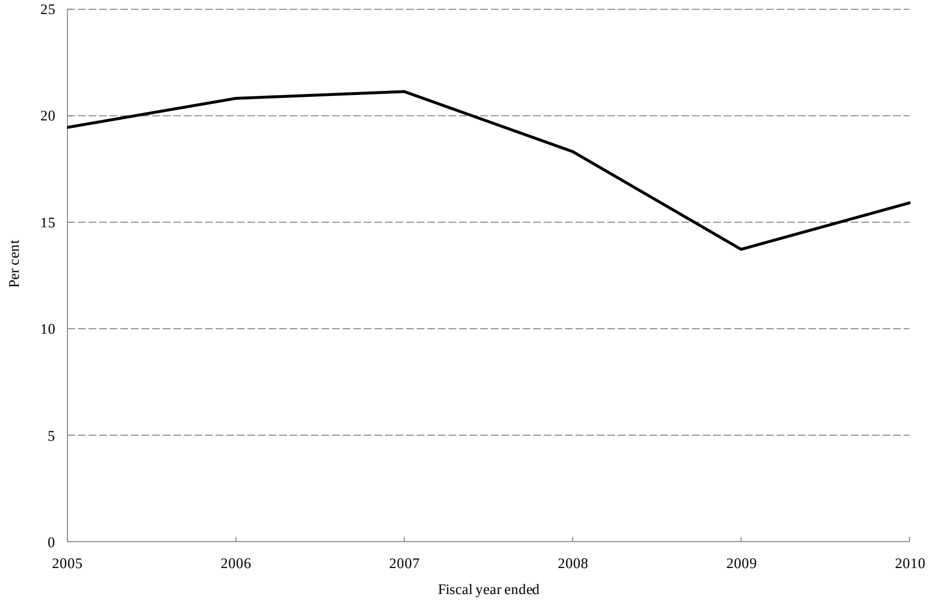


Note: The balance sheet date for the Commonwealth Bank is 30 June and for ANZ, NAB and Westpac, the balance sheet dates are 30 September.
Source: Derived from the annual reports of the four major banks.

Is it right to look at the so-called super profits that the big 4 banks make and argue that bank customers are being ripped off? In general, large firms make large profits because of their scale and, as noted earlier, the four major banks are amongst the largest firms in Australia. To make appropriate comparisons about profitability across firms of different sizes, one needs to examine the return on equity (ROE), a measure of the after-tax profits per dollar of the shareholders' equity invested in the firm. Investors require a reasonable ROE relative to other investments. If investors believe the ROE is too low, they will withdraw their equity which could have a devastating impact on the capital position of the banks and contribute to bank failure.

The GFC led to dramatic falls in the ROE for Australian banks. The ROE fell from around 20 per cent in the years before the GFC to 13.7 per cent for the fiscal year ended 2009. It has since recovered somewhat to 15.9 percent for the 2010 fiscal year as profitability rose for the reasons given earlier (see Figure 4).

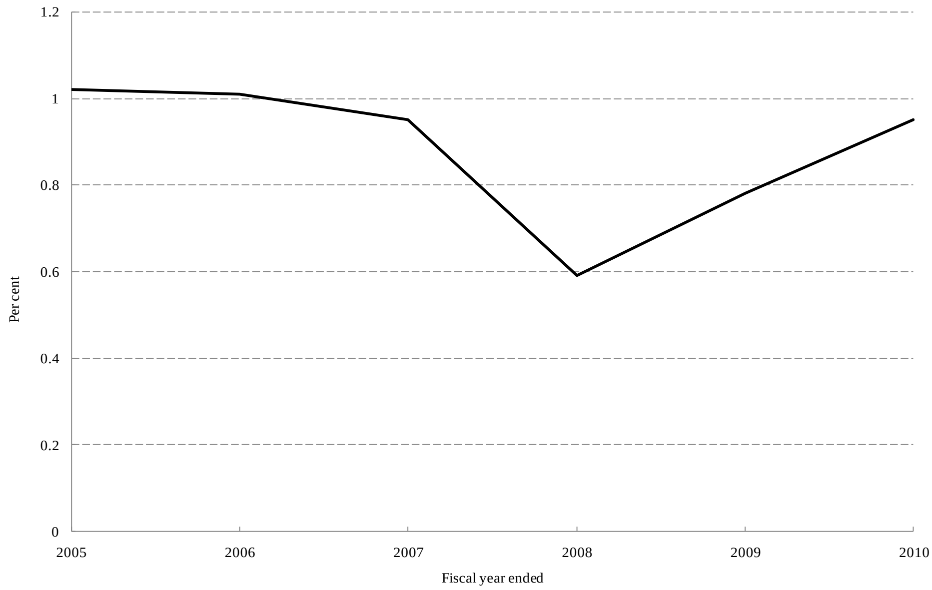
Figure 4
Return on equity: major banks



Source: KPMG, *Major Australian Banks, Year End: Financial Institutions Performance Summary*, www.kpmg.com.au

Another major performance indicator for banks is the return on assets (ROA) which is a measure of after-tax profits per dollar of assets held by the bank. The ROA is considered to be a measure of how efficient the banks are at using their assets to generate profits. For the major banks, the ROA fell from 1.1 per cent in 2005 to 0.6 per cent in 2008 before recovering somewhat to 0.9 per cent in 2010 (see Figure 5). The ROA fell most in 2008, driven mostly by a very substantial increase in credit impairment charges. The rise in 2010 was driven by a rise in profitability whilst the major banks held the level of their assets relatively constant.[7]

Figure 5
Return on assets: major banks



Source: Source: KPMG, *Major Australian Banks, Year End: Financial Institutions Performance Summary*, www.kpmg.com.au

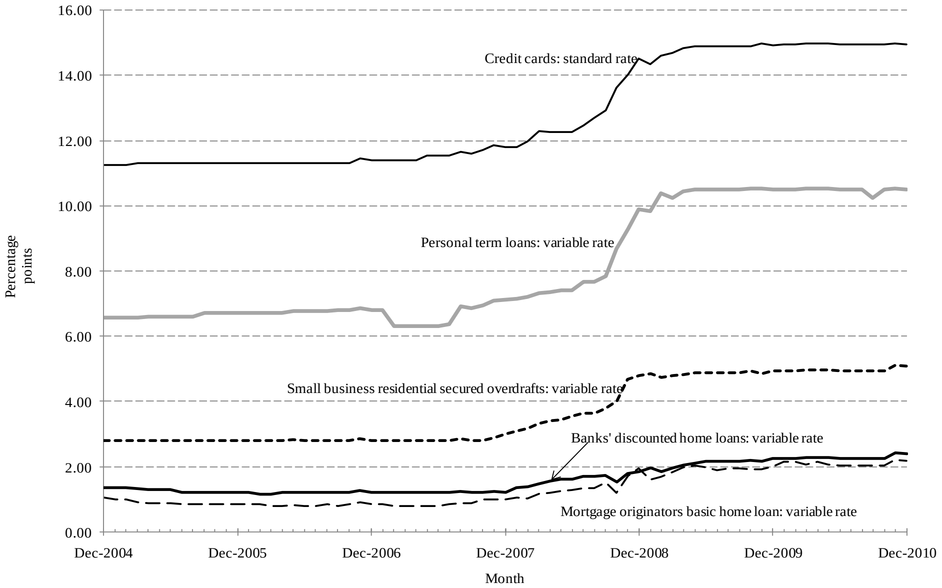
In contrast to the perception engendered by the absolute magnitude of bank profits, the fall in the ROE since 2007 and in the ROA since 2005 suggests that the profit performance of the banks has not been all that stellar in recent years. The Big 4 have massively stepped up the level of competition in the retail market since the Senate Inquiry was announced and the aggressive discounting that is currently occurring may put significant downward pressure on the ROE and ROA should it be maintained which may be of benefit to bank customers but will be of concern to shareholders.

2. Interest spreads: are banks gouging borrowers?

Symptomatic of the lack of competition in the Australian banking sector as far as borrowers are concerned has been the rise in the loan interest rates they pay relative to the cash rate. It is undoubtedly the case that borrowers are paying much higher spreads since the GFC than in the years just prior when the spreads between loan interest rates and the cash rate were relatively steady so that borrowers adjusted to expecting that loan rates would increase by around the same amount as the cash rate.

Figure 6 illustrates the spread between selected loan interest rates and the cash rate. For home loans, the banks' basic discounted variable rate increased from 135 basis points above the cash rate in December 2004 to 240 basis points in December 2010 and there was a similar rise in the spreads of mortgage originators. The spreads on small business variable rate loans secured by residential mortgages rose from 280 basis points to 510 basis points, an increase of 82 per cent in the size of the spread. There were also dramatic increases in the size of the spreads on standard credit cards (370 basis points, a 32 per cent increase) and on variable rate personal loans (395 basis points, a 60.3 per cent increase).

Figure 6
Loan spreads
Selected loan interest rates less the cash rate - Australia

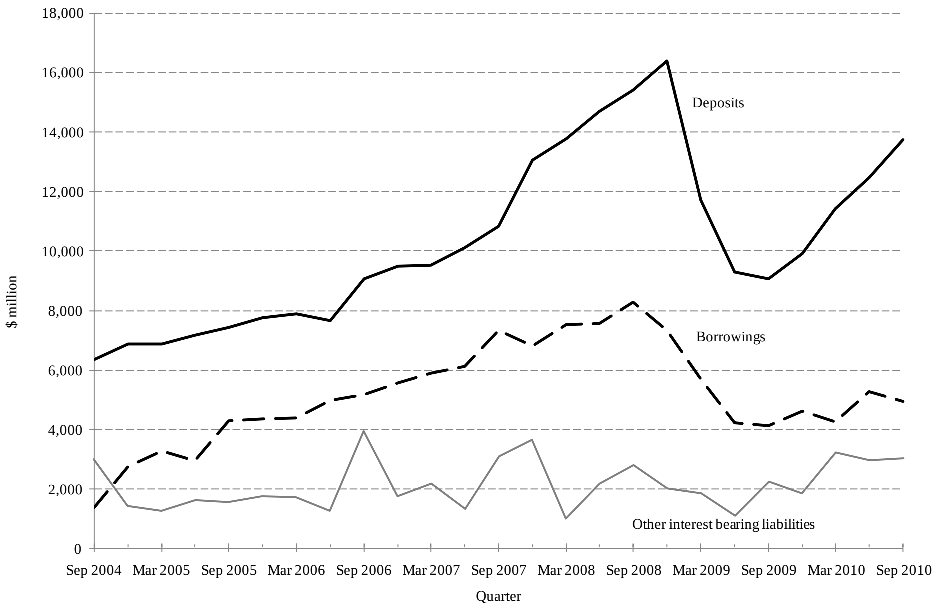


Source: RBA, Statistics, www.rba.gov.au

The public perception is that the banks are gouging bank borrowers by charging higher loan interest rates. The banks' justification for higher loan interest rates is that they themselves face higher funding costs as they compete with each other to attract deposits by offering higher term deposit rates and they convert some less expensive short-term funding raised in the capital markets to more expensive long-term funding to ensure more stable sources of funding. The composition and cost of bank funding will be considered further below.

All of the banks argue that they have had to increase the spreads on borrowers because of the rise in their own funding costs. Figure 7 which illustrates the interest expense of the four majors by category supports the argument that there has been a rise in funding costs. There has been a very marked rise in interest paid to depositors but also some increases in interest paid on borrowed funds and on other interest-bearing liabilities over the past several years.

Figure 7
Interest expense of major banks by category

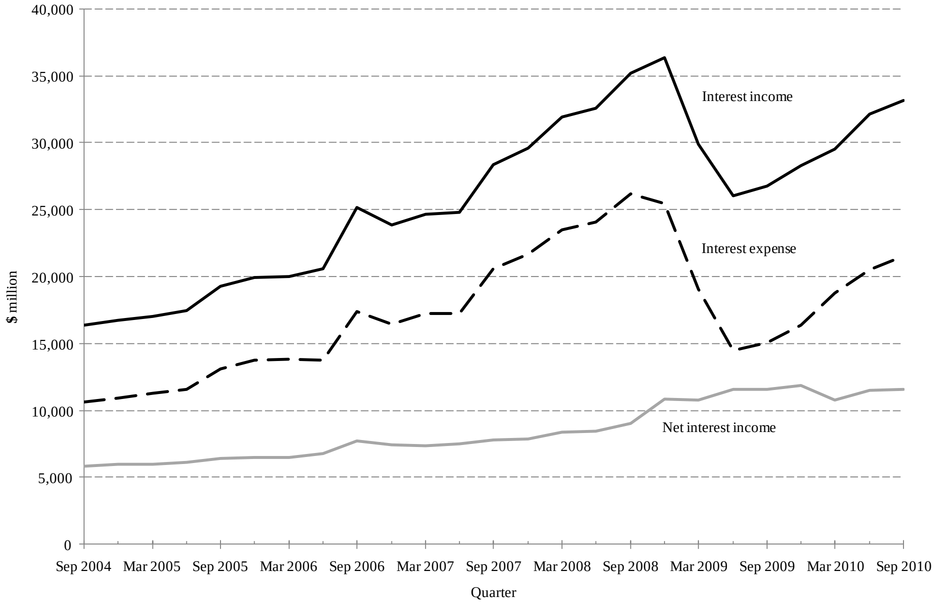


Source: APRA, *Quarterly Bank Performance*, www.apra.gov.au

Net interest income is the difference between the interest earned by making loans and investing in securities, and the interest that must be paid to secure the funding with which to make those loans. If it is the case that banks have been gouging borrowers in recent years, one would expect to observe a marked rise in net interest income earned by the banks. An increase in interest revenue matched by an increase in funding costs would lead to no change in net interest income, whereas if funding costs are rising faster than the interest income earned by the banks one would observe a fall in net interest income.

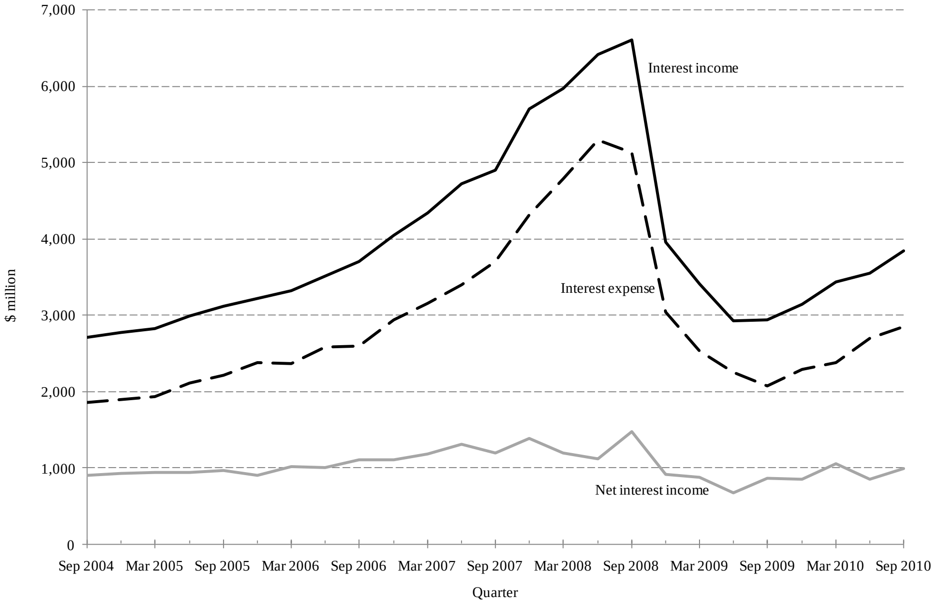
For the major banks, net interest income rose from $8,493 million in the June 2008 quarter to $11,546 million (a rise of 36 per cent) in the June 2010 quarter (see Figure 8). In contrast, Figure 9 shows net interest income for the other domestic banks fell from $1,467 million in the September 2008 quarter to $853 million in the June 2010 quarter (a fall of 42 per cent) but rose to $987 million in the September 2010 quarter (a rise of 15.7 per cent on the previous quarter but still 33 per cent below its peak).

Figure 8
Net interest income: major banks



Source: APRA, *Quarterly Bank Performance*, www.apra.gov.au

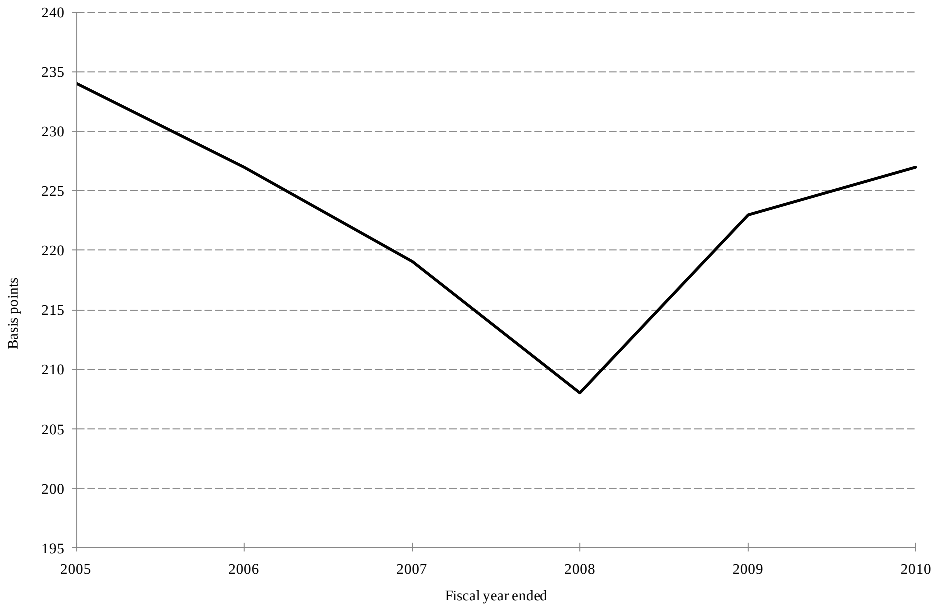
Figure 9
Net interest income: other domestic banks



Source: APRA, *Quarterly Bank Performance*, www.apra.gov.au

Despite the increase in interest expense, the major banks' net interest margin has risen since 2008[8] (see Figure 10). In the several years leading up to the GFC, net interest margins fell. KPMG reported the main factors driving the fall were more expensive funding, an asset mix with relatively lower margin products, and most importantly and the biggest driver of the fall, competition with interest rate spreads on credit cards, mortgages and business lending all coming under pressure. From 2008, the key contributor to the rise in the net interest margin was re-pricing for risk especially in the commercial and industrial portfolios tempered by increased competition in the market for retail deposits and the rise in funding costs as short-term debt was replaced by long-term debt in the wholesale market.

Figure 10
Net interest margins: major banks



Note: Fiscal years ended 2005 & 2006 include St George amongst major banks.
Source: Source: KPMG, *Major Australian Banks, Year End: Financial Institutions Performance Summary*, www.kpmg.com.au

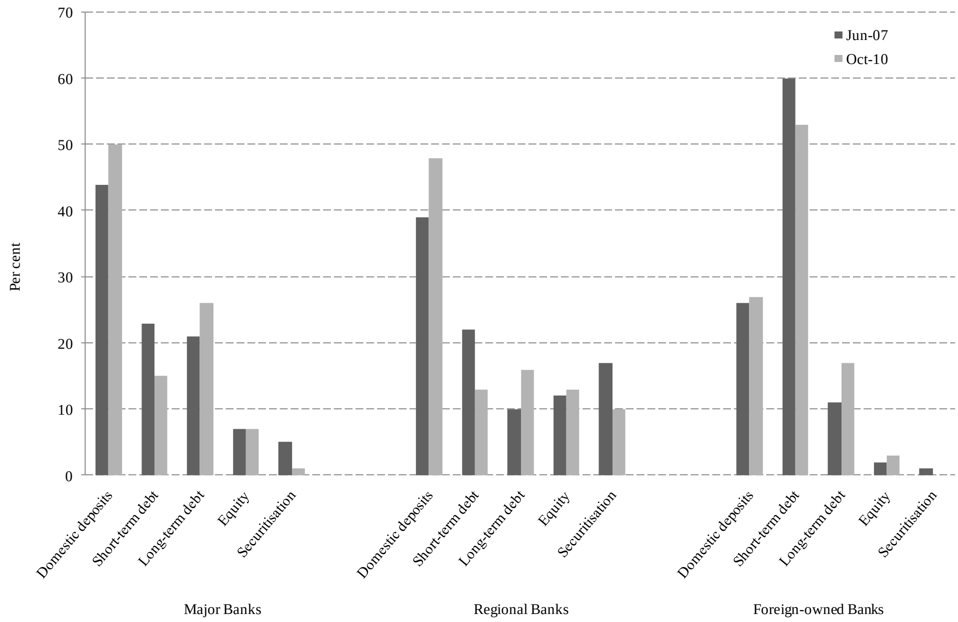
The four major banks have engaged in intensive price competition in relation to housing loans and business loans in recent months. As a consequence of this and because of higher funding costs, UBS has forecast the margins of the Big 4 to fall to 2.25 per cent in 2011 and to fall significantly further to 2.13 per cent in the next two years.[9]

3. Bank funding

3.1 Composition of bank funding

The banks' rationale for increasing interest rates more than the RBA cash rate has been that their funding costs have risen. Funding costs depend on the composition of bank funding and how much the banks have to pay for each source of funds. The majority of funding for the major banks and the regional banks comes from domestic deposits and Figure 11 shows the share of deposits from all sources of funding has increased between June 2007 and October 2010. Figure 11 also shows that prior to the GFC, more of the banks' funds were derived from short-term debt than from long-term debt, but post-crisis more funds are obtained by issuing long-term capital market liabilities rather than short-term.

Figure 11
Composition of bank funding by type of bank



Source: Table 2 of RBA Submission to Senate Economics References Committee Inquiry into Competition within the Australian Banking Sector.

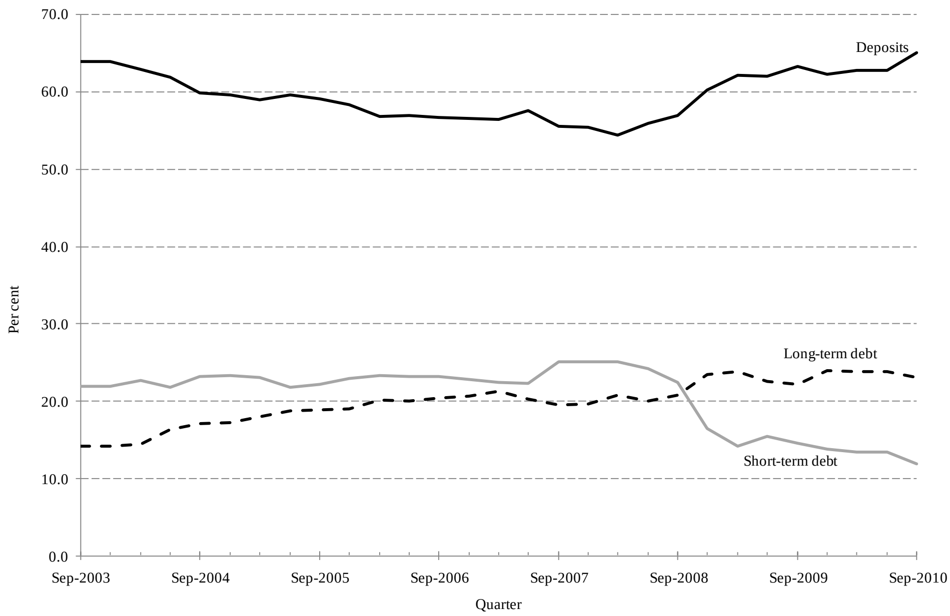
Banks also finance activities by securitising some of their assets and by raising equity. The share of equity in total funding for the major banks was little unchanged between June 2007 and October 2010 but increased slightly for the regional and foreign-owned banks (see Figure 11). Securitisation fell from 5 per cent to 1 per cent of total funding for the major banks and from 17 per cent to 10 per cent for the regional banks.

Figure 12 shows the composition of bank funding when equity and securitisations are excluded. At the end of the June quarter 2007, just prior to the turmoil in the capital markets caused by the sub-prime mortgage crisis, deposits comprised only 58 per cent of banks' funding compared with 65 per cent at the end of the September quarter 2010, short-term funding fell from 22 per cent to 12 per cent of total funding over the same timeframe whereas the proportion of long-term funding rose from 20 per cent to 23 per cent of total funding.

Deposits and long-term debt are more stable sources of funding than is short-term debt and the authorities have actively encouraged the banks to access a more stable funding base than was the case prior to the subprime mortgage and global financial crises. Figure 12 clearly illustrates the difficulties banks had in rolling over short-term debt following the onset of the GFC in 2008 and short-term debt as a proportion of total funding is continuing to decline albeit at a slower rate. From a cost perspective, however, deposits and long-term funds are more expensive for the banks to raise than are short-term funds.

Access to funding is vital to the stability of the Australian banking sector; long-term funding increases stability relative to short-term funding but long-term funding comes at higher costs which are then passed on to bank customers.

Figure 12
Composition of bank funding excluding equity and securitisations



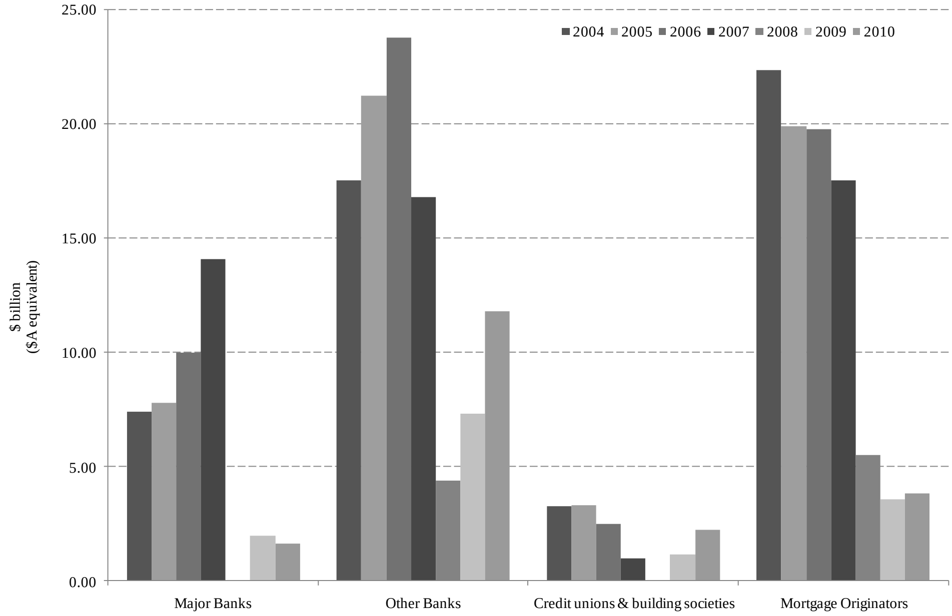
Source: ABS, *Financial Accounts, Australian National Accounts*, Cat. No. 5232.0, www.abs.gov.au

3.2 Securitisation

Prior to the GFC, the development of the securitisation market in Australia was a prime driver of competition between the large banks and other financial institutions, especially in the home loan market. Securitisation refers to the pooling and sale of loan assets by financial institutions which sell those loans to a special purpose vehicle (SPV) set up for the specific purpose of issuing securities (bonds) backed by the underlying loans into financial markets.

In Australia, most of the loan assets which are securitised are home loans. These are known as residential mortgage backed securities (RMBS) which give investors the right to the cash flows from the underlying mortgages plus interest. The regional banks and mortgage originators are much more heavily reliant than the major banks on the wholesale market and, in particular, securitisation as a source of funds (see Figure 13).

Figure 13
RMBS issuance by originator



Source: Data obtained on request from RBA.

Other types of loans including commercial property, automobile, and credit card loans can also be securitised. Securitised loans are more generally referred to as asset backed securities (ABS). Payments to investors in RMBS or other types of ABS depend on the underlying borrowers making their repayments as they fall due. [10] RMBS and other forms of ABS are amortising securities, i.e., repayments of both principal and interest are made to investors throughout the life of the security. Financial institutions of various kinds are the principal investors in securitised loans.

Securitisation is an additional source of funding for banks and other financial institutions. By selling some of their loan assets they raise monies which can be used to make more loans. The GFC led to the near-collapse of the securitisation market so that the smaller banks, CUBS and mortgage originators have not been able to raise much funding through the issue of ABS since 2008 (see Figure 13). The money that has been raised has largely been with the support of the Australian Government.

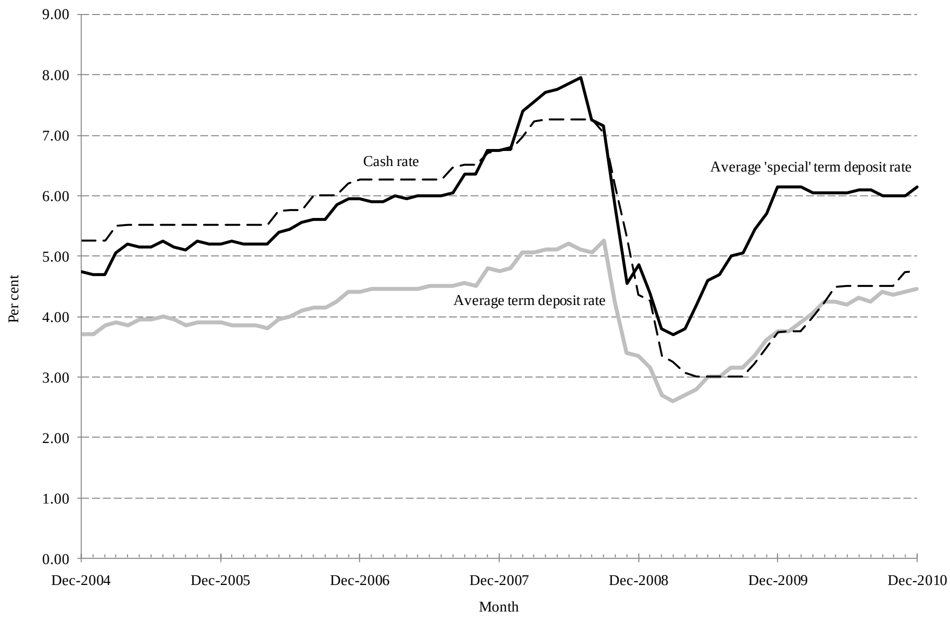
4. Funding costs

4.1 Deposits

Deposits are the major source of funding for the major banks and for the regional banks. The Australian Bankers' Association submission to the Senate Inquiry states that the more expensive savings, online and term deposits account for around 70 per cent of total balances and the typically low interest transaction accounts constitute approximately 30 per cent of total deposits.

The banks have been especially eager to attract term deposits since the onset of the subprime and global financial crises, and have competed with each other to do so by offering extremely attractive interest rates on term deposits. Up to 2007, interest rates on term deposits were below the cash rate. Since 2008, the interest rates offered on the banks' 'special' term deposit rates have been substantially higher than the cash rate, in the order of 140 basis points by the end of 2010 (see Figure 14).

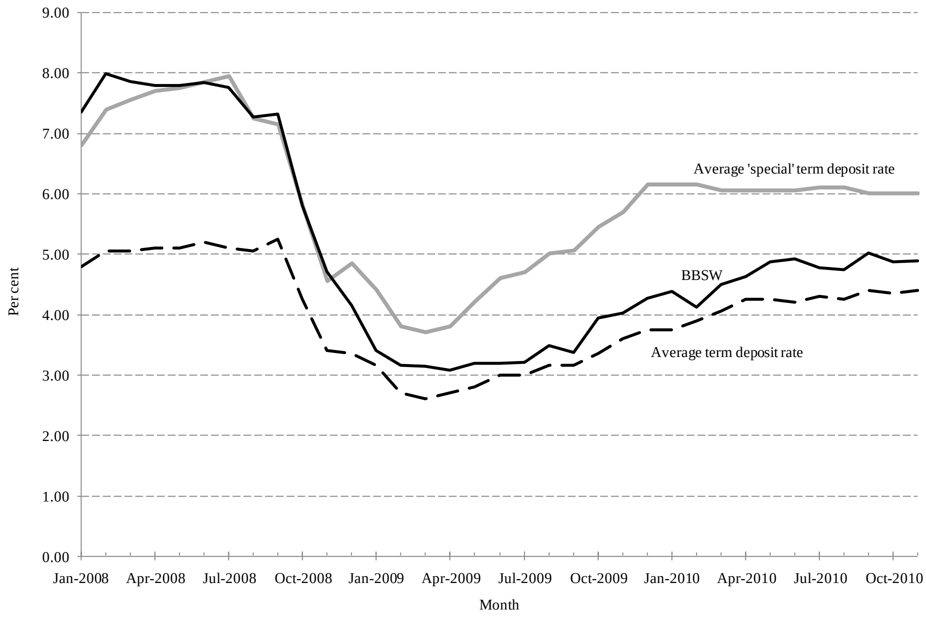
Figure 14
Term deposit rates and the cash rate



Source: RBA, Statistics, www.rba.gov.au

The banks themselves tend to use the bank bill swap rate (BBSW) as a benchmark measure or reference rate for the cost of funds, particularly for deposits and long-term debt.[11] Thus the interest rate paid on deposits would generally be less than the BBSW. Figure 15 shows that although this continues to be true for the average rate paid on all term deposits, the average 'special' rate paid to attract most term deposits since the onset of the GFC has been as much as 203 basis points higher than the BBSW and was still 110 basis points higher towards the end of 2010. The banks assertions that they have experienced a marked increase in funding costs associated with attracting deposits are correct. (Also see Figure 7 showing interest expense of major banks by category.)

Figure 15
BBSW and term deposit rates



Source: RBA, Statistics, www.rba.gov.au and Fiig Securities Ltd, www.fiig.com.au

4.2 Long-term debt

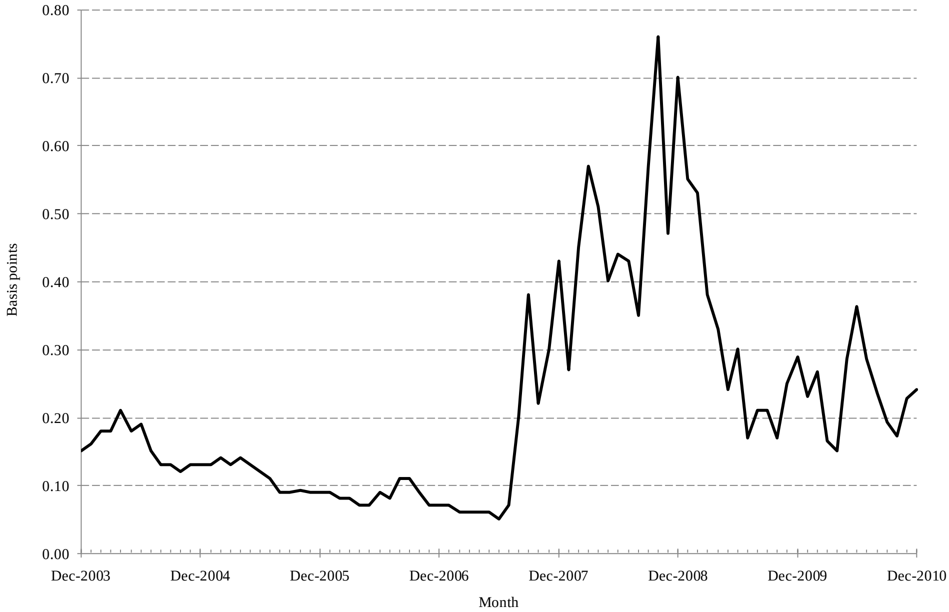
Prior to the GFC, the banks were able to issue 3 year bonds at around 12-15 basis points above the swap rate but that rose to 242 basis points in March 2009. By the second half of 2010, the spread was averaging around 100 basis points. [12] The RBA's submission to the Senate Inquiry suggested that as these spreads only affect *new* bond issuance, the average spread on the major banks' outstanding long-term debt is expected to increase by a further 15-20 basis points over 2011. The RBA estimates the rise in the spread will contribute around 5 basis points to the major banks' total funding costs as long-term debt represents around 25 per cent of major banks' overall funding.

The spreads on issuing long-term debt have increased more for the regional banks than they have for the majors because the regionals have lower credit ratings. Before the GFC, the regional banks were able to issue 3-year bonds at an estimated spread of about 40-50 basis points above the bank bill or swap rates, but this increased to 150-200 basis points by late 2010.[13]

4.3 Short-term debt

Short-term wholesale debt is priced mainly off bank bill rates. Prior to the onset of the subprime mortgage crisis in 2007, 90 day bank bill rates were less than 10 basis points above the overnight indexed swap rate (OIS). The OIS is an indicator of what participants in financial markets expect the cash rate will be. Following the onset of the crisis, the bank bill to OIS spread increased as short-term debt became more expensive (see Figure 16). The spread peaked in September 2008 as Lehman Bros collapsed and the GFC ensued. At the end of 2010, the spread was still double what it had been prior to the onset of the subprime and global financial crises.

Figure 16
90 day bank bill to OIS spread



Source: RBA, Statistics, www.rba.gov.au

4.4 Securitisation

An advantage of securitisation over outright borrowing in debt markets is that in many cases ABS can be issued into financial markets with a higher credit rating than the credit rating applied to new borrowings by the banks. This is because the credit rating on ABS is based on a limited subset of loans and thus the underlying borrowers' perceived capacity for repayment (or the value of the loan collateral in the event of default). In contrast, the credit rating applied to a conventional bond issue by banks is based on the bank's perceived capacity to make payments as they fall due. By issuing ABS with higher credit ratings, financial institutions can obtain additional long-term funds at lower cost than they could by borrowing through the issue of conventional bonds. Nevertheless, the cost of issuing long-term debt has risen as discussed above and so have the costs of issuing ABS, but the securitisation market remains a difficult market from which the banks and other lenders can source funds.

4.5 Overall funding costs

Taking into account the rising costs of deposits, and both short-term and long-term debt, the RBA submission to the Senate Inquiry (p. 14) estimated that from mid 2007 to the end of 2010, the average overall cost of the major banks' funding had risen about 90 to 100 basis points relative to the cash rate and that the overall increase in the regional banks' funding costs has been larger.

5. Small business finance

There have been concerns that small businesses are finding it difficult to access finance and that those difficulties may reflect inadequate competition in the banking sector particularly between the Big 4 banks. The CPA submission to the Senate Inquiry indicated that small business roundtables showed that the Big 4 were seen as the key source of debt financing. The Australian Bankers' Association (ABA) submission agreed that business surveys conducted in 2009 did show significant concern about access to bank finance for small businesses but the ABA attributed this to the exit of many non-bank lenders during the GFC so that small businesses became more reliant on banks than they had previously been to obtain finance.

The Senate Inquiry on Small Business Finance which reported in 2010 found that:

> *"The slowdown in lending to small business appears to reflect a combination of demand factors....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...; and*
> - *Non-bank lenders having fewer funds available as securitisation and interbank lending markets dried up and/or interest rates in them became prohibitive."*[14]

A number of submissions to the Senate Inquiry (including, *inter alia*, ABA, CPA, Chamber of Commerce and Industry Queensland), agreed that banks had imposed tougher compliance requirements and that margins had increased for small business loans relative to the increase in margins between housing loan rates and the cash rate. (Also see Figure 6.) The ABA's submission (p.39) cited the reasons for this. Smaller business loans are riskier than housing loans and therefore incur higher risk premiums. Margins on business loans before the GFC were too low; today's margins more appropriately reflect risk; and the banks are required to hold higher levels of regulatory capital against business loans than is required against housing loans. This is so because default rates are higher on business loans than on housing loans. The CPA submission noted that roundtables showed that small businesses were not generally accepting of the increased reporting and stricter loan covenants imposed on them since the GFC.

It seems uncontroversial that small businesses are facing higher loan spreads and tougher compliance requirements. Nonetheless, some of the Big 4 banks have actively sought to attract small business borrowers in recent months through extensive advertising and attractive conditions.

6. Switching providers: Is it too difficult?

Competition is increased when consumers can easily switch providers. An issue for borrowers has been exit fees. The regional banks and mortgage originators compete with the major banks by offering lower upfront costs for borrowers but they charge higher exit fees.

Exit fees are otherwise known as deferred establishment fees and are intended to compensate lenders for not charging the full costs of establishing loans at the outset. Lenders expect to recoup some of their establishment costs from ongoing fees and interest rates charged on loans, but early prepayment on loans can leave lenders out of pocket. The Government is to ban exit fees on mortgages from 1 July 2011. Several of the four major banks have already abolished exit fees and another has offered to pay the exit fees of the other two should customers refinance their housing loans with it. Phil Naylor, mortgage brokers' association head, complained to the Senate Inquiry that "[t]he banning of exit fees will have the reverse effect [of increasing competition] by causing non-bank lenders to lose their most effective weapon in competition with banks".[15]

Although exit fees are unpopular with borrowers, it is probable that their abolition will lead to higher upfront costs, higher ongoing fees or higher interest rates as banks and other lenders attempt to recoup the cost of establishing loans. All of these outcomes are likely to be even more unpopular especially for those borrowers from lower socio-economic backgrounds who are currently more likely to seek loans with lower upfront costs from the regional banks and mortgage originators.

There is also a perception amongst bank customers that switching from one bank to another is not going to make any real difference to their choices. Abacus, the Association of Building Societies and Credit Unions, commissioned a poll in 2010 which suggested 40 per cent of respondents had considered changing their bank in the previous two years but two-thirds of this group hadn't because:

- 41 per cent said it was too difficult;
- 23 per cent said there were fees and charges attached to shifting; and
- 28 per cent said there was no point as all banks were the same.[16]

ANZ's submission to the Senate Inquiry (p. 28) refers to recent research by Choice which found 78.5 per cent of customers have not considered switching, 7.6 per cent had switched and 11.8 per cent had considered switching but had not done so; half of these had not switched because of the effort involved. ME Bank's submission referred to research by ASIC that suggested customers were reluctant to switch banks because of the complexity, particularly in relation to direct debits. Other research has made similar findings.

PART TWO
POLICY RESPONSES

1. Supporting alternatives to the Big 4

1.1 Supporting the development of the fifth pillar: the mutual sector

One of the planks in the *Competitive and Sustainable Banking System* package is to build a new pillar, the so-called fifth pillar, by supporting the mutual sector (credit unions and building societies or CUBS) to become 'banks' where eligible and by educating the public about the safety and competitiveness of mutual lenders. Credit unions and building societies are similar to banks in that they are authorised deposit-taking institutions (ADIs) and so are supervised by APRA, but differ in that they operate on a not-for-profit co-operative basis where depositors are members of the society or credit union to which they belong. In contrast, banks are in business to make profits and shareholders are not necessarily depositors in the banks in which they hold shares. All ADIs are supervised by APRA and deposits in banks and CUBS are protected under the Financial Claims Scheme.

APRA's submission to the Senate Inquiry (p. 3) notes there are currently five building societies and 20 credit unions that could seek approval to use the term 'bank' in their business name but have not chosen to do so to date. These building societies and credit unions are already authorised by APRA to carry on banking business and, in addition, have at least $50 million in Tier 1 capital, which is the minimum requirement set by APRA for an authorised deposit-taking institution (ADI) to seek approval to use the term, 'bank' in its business name.

Capital provides a buffer against unanticipated losses. It means the shareholders rather than the depositors absorb the losses (at least until capital is exhausted). One of the reasons no Australian bank failed during the GFC is that Australian banks were well capitalised relative to their overseas peers. Dilution of the capital requirement would mean that it is more likely less well capitalised banks or other financial institutions would fail in the future which could lead to contagion effects to other financial institutions and widespread instability in the financial sector. More highly capitalised institutions are better protected from failure.

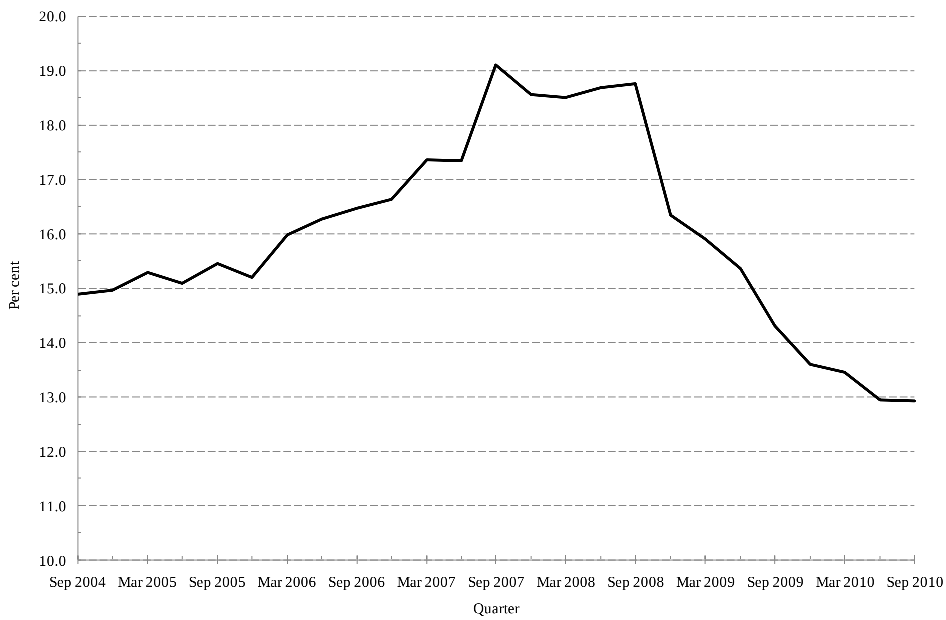
Most credit unions and building societies are not as safe as banks simply because they do not hold as much capital. However, depositors in the mutuals are protected by the Financial Claims Scheme and so their deposits are as safe as those in the banks. The push by some of the mutuals, e.g., CUA, to change the classification of Authorised Deposit Taking Institutions to Australian Banking Institutions would seem to send the wrong signal to consumers. Mutuals are regulated by APRA in a similar way to banks but it is less likely that the Government would bail-out a mutual that was failing simply because its failure would not have the same implications for financial stability as would the failure of one of the Big 4 which would be considered 'to be too big to fail', no matter what the authorities now say.

For the Government to suggest mutuals will become a fifth pillar in the banking system any time soon is misleading. Between 2004 and 2010, the total assets of all building societies and credit unions as proportion of the combined assets of banks and CUBS never exceeded 2.7 per cent. However, the origins of many mutuals lay in providing home loans to their members but even on this measure the mutuals' share of the total value of housing loans provided by banks and the CUBs has not exceeded 5 per cent since 2004. The *Competitive and Sustainable Banking System* package (p. 17) states that mutuals account for around 9 per cent of *new* home loans and offer discounts up to 1 percentage point lower than the standard rates offered by the major banks, but without noting that most of the new home loans offered by the major banks are also at substantial discounts to their standard variable rates.

1.2 Supporting the growth of foreign banks in Australia

The GFC led to a decline in the presence of foreign banks in Australia. After rising from a 14.9 per cent share in the second half of 2004, the total combined assets of foreign bank branches and subsidiaries located in Australia fell from a peak of 19.1 in the September 2007 quarter to 12.9 per cent in the September 2010 quarter (see Figure 17). Several submissions to the Senate Inquiry (e.g., Australian Bankers Association, Chamber of Commerce & Industry Queensland, HSBC, ING Direct) have advocated both the immediate abolition of interest withholding tax and the LIBOR cap as measures that could provide a more level playing field for foreign banks operating in Australia and therefore bring more competitive pressure to bear on the domestic banks.

Figure 17
Foreign bank assets as a share of total assets of banks operating in Australia



Source: APRA, *Quarterly Bank Performance*, www.apra.gov.au

Subsidiaries of foreign banks operating in Australia are currently required to pay 10 per cent interest withholding tax (IWT) on the interest they pay for funds borrowed from their parents or non-resident affiliated banks and Australian branches of overseas banks are required to pay 5 per cent IWT. Any bank operating in Australia which takes retail deposits from offshore depositors and on-lends those deposits in Australia is also required to pay 10 per cent IWT. The purpose of the IWT is to collect tax on Australian sourced income from non-residents but it also increases the funding costs for the foreign banks which source at least part of their funding from affiliated banks overseas relative to domestic banks.

In response to several reviews (the Henry Report and the Johnson Report) which recommended the abolition of the IWT, the Australian Government in the 2010/11 Budget announced a phasing-down of the IWT from 2013. However, there is a case for more immediate action. The submissions to the Inquiry noted above suggested the IWT is discouraging foreign branches and subsidiaries from borrowing from their overseas parents which have surplus funds to fund their loan books in Australia. The HSBC submission goes as far as saying: "...it [the IWT] has to date been the key impediment to the growth of foreign banks in Australia". The Australian Bankers' Association submission (p. 54) suggests abolition of the IWT could:

> *"... 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. Furthermore, these reforms would increase the total deposits in the Australian economy providing a balance against the superannuation guarantee and diversify banks' funding sources by creating an inflow of offshore retail funds (not just wholesale funds)."*

We agree with the ABA's views. Abolition of the IWT would seem to be a relatively simple measure that could promote competition in Australia between the domestic banks and the foreign banks. The impact on Government budget revenue should be relatively neutral because the abolition of the IWT would increase the profits of the foreign banks domiciled in Australia and so they would pay more company tax.

Another measure to support competition coming from foreign banks would be to abolish the LIBOR cap. The LIBOR cap limits the tax deductibility of interest expense paid by foreign bank branches domiciled in Australia on borrowings from their parent banks to the London Interbank Offered Rate (LIBOR). If branches of foreign banks borrow from their parents at higher rates than LIBOR, the difference between the actual interest rates paid and LIBOR is not tax deductible. LIBOR rates are only quoted for loans with a maximum term to maturity of 12 months so more expensive longer-term borrowings are capped at the 12 month LIBOR rate.

The LIBOR cap artificially inflates funding costs, especially longer-term funding costs for branches of foreign banks which source some of their funds from parent banks relative to the funding costs for domestic banks. Interest expenses are fully tax deductible for domestic banks but not for foreign banks domiciled in Australia because of the LIBOR cap.

Abolition of IWT and removal of the LIBOR cap would put funding costs for foreign banks on a more level playing field with domestic banks and hence increase competitive pressure in the Australian banking market.

1.3 Legislate the four pillars policy

Some submissions to the Senate Inquiry expressed concern about the consolidation of the Big 4 that occurred as a result of the acquisitions of BankWest by the Commonwealth Bank and St George Bank by Westpac in 2008/09. These mergers almost certainly contributed to the stability of the Australian banking sector at what was a very difficult time but the feeling is that they would not have been approved under more normal circumstances. Section 50 of the Trade Practices Act 1974 Act prohibits an acquisition if it would be likely to have the effect of substantially lessening competition in a market.

Concerns were also raised about the four pillars policy which bans mergers between any of the Big 4 banks. A number of submissions suggested the four pillars policy should be legislated to prevent further consolidation of the Big 4 into the Big 3 or even the Big 2 should the Government agree, as the Big 4 would like, that the Australian Competition and Consumer Commission can assess and perhaps approve merger applications between any of the Big 4 banks.

Another issue raised was the lack of transparency about the branding of banks as a result of acquisitions. For example, even though St George was acquired by Westpac, Westpac operates St George as a distinct retail brand so that many St George customers and customers at other banks (including Westpac) that might think of switching are unaware that St George is owned by Westpac. Suggestions were made to the effect that where a bank was acquired by another bank, its ownership should be clearly apparent to retail customers through its branding.

1.4 Financial Claims Scheme

In response to the haemorrhaging of deposits to offshore banks during the GFC, the Australian Government instated the Financial Claims Scheme which currently guarantees deposits of Australian depositors up to $1 million. As part of its *Competitive and Sustainable Banking System* package, the Government confirmed the deposit guarantee would become permanent although the $1 million cap is to be reviewed and the cap arising from the review will be in place from October 2011. The deposit guarantee is available to depositors in banks, credit unions and building societies. The public perception that mutual organisations are not as safe as banks is to be addressed by a campaign to increase awareness that deposits in mutuals are guaranteed in the same way as bank deposits and that the bank regulator, APRA, also regulates banks. The Government hopes that the advertising campaign will attract depositors to the mutual sector which will increase deposits as a source of funding for the sector which can then use them to compete against the Big 4 banks in making loans.

2. Supporting access to funding

2.1 Government support for securitisation provided through the Australian Office of Financial Management

The Treasurer has directed on several occasions that the Australian Office of Financial Management (AOFM) invest in RMBS in an effort to revive the securitisation market.[17] On 12 December 2010, the Treasurer announced as part of the *Competitive and Sustainable Banking System* package that he would be directing the AOFM to invest up to a further $4 billion in RMBS issued by the smaller banks and other financial institutions with the particular objective of supporting lending to small business. This funding would not be available to support securitisation by the major banks. Although support of the RMBS market in this way has been welcomed by smaller lenders, their long-term viability and therefore their ability to act as a competitive force against the Big 4 banks over the long-term is contingent on the securitisation market losing its current dependence on government-injected funds.

2.2 Government guarantee or provision of mortgage default insurance

Government provided mortgage default insurance to mortgage lenders was suggested by a number of submissions (including Australian Bankers' Association and Bendigo and Adelaide Bank) to the Senate Inquiry as a means to increase securitisation of residential mortgages. Mortgage default insurance would enhance the credit quality of the RMBS. The guarantee would insure lenders against default on mortgages where the mortgagees hold less than 20 per cent equity in their homes. Government provided insurance would improve access to funding for the regional banks, mortgage originators and CUBS in particular. Increasing access to funding for these institutions is by far the most important way that the Government can stimulate competition in the banking sector. Providing mortgage default insurance is also a practical solution to moving away from direct injections of taxpayers' funds into RMBS through the purchase of RMBS by the AOFM to a more market-oriented solution.

2.3 Bullet RMBS

In an effort to increase access to finance by regional banks, credit unions and building societies, the Government announced that it would accelerate the development of the bullet RMBS market for smaller lenders. Traditional RMBS are amortising securities that make repayments of principal and interest over the life of the security. In contrast, bullet RMBS more closely resemble (non-amortising) conventional bonds in that investors receive interest payments according to a fixed schedule throughout the life of the security but the repayment of principal is made in a lump-sum on the security's maturity date (at the end of the life of the security). This means that the issuer (the borrower) has access to the borrowed monies for a longer period than if they had issued traditional RMBS.

Whether the issuance of bullet bonds will favour regional banks and the non-bank deposit-taking institutions is a moot point. As noted in the *Competitive and Sustainable Banking System* document, the Australian Office of Financial Management has supported the first bullet RMBS issuance by a smaller lender (Bendigo and Adelaide Bank) but a recent Commonwealth Bank issuance also included a bullet tranche. Part of the additional $4 billion dollar support by the Government through the AOFM for RMBS is to be made available where required for investment in bullet RMBS. For the regional banks, credit unions and building societies, the longer-term success of bullet RMBS will depend on the ability to attract investors other than the Australian Government through the AOFM.

2.4 Covered bonds

The Government announced as part of its *Competitive and Sustainable Banking System* package that it would permit Australian banks, credit unions and building societies to issue covered bonds with the objective of increasing the access of Australian financial institutions to cheaper longer-term funding.

Covered bonds are similar to asset backed securities in that the bonds are backed or 'covered' by a pool of segregated assets such as housing loans. The principal difference between ABS and covered bonds is that, in contrast to securitisation, covered bonds must be retained on the issuing institution's balance sheet so that, in fact, covered bonds are dual recourse bonds with investors having recourse both to the issuer and to the pool of assets backing the bond in the event of default by the issuer.

To date, the issue of covered bonds by domestic financial institutions has not been permitted in Australia because the Banking Act gives first claim on a bank's assets to depositors. In contravention of the Banking Act, covered bonds give first claim to the segregated pool of assets backing the bonds to investors. The Government announced its intention to change the Banking Act in order to permit the issuance of covered bonds together with its intention to make the Financial Claims Scheme permanent. The Government is of the view that the Financial Claims Scheme provides sufficient protection to depositors should investors in covered bonds have the senior claim over a bank's assets in the event of bank failure.

The Government intends to cap the issue of covered bonds by financial institutions to 8 per cent of an issuer's total Australian assets. This should provide further protection to depositors as it means they would still have first claim over 92 per cent of a bank's assets.

Covered bonds can be issued with a higher credit rating than the credit rating of the issuer. Thus the major banks with their AA credit ratings are likely to be able to issue covered bonds backed by housing loans with a higher AAA credit rating. The higher credit rating means that the banks will be able to obtain longer-term and thus more stable funding, typically in the 5- to 10-year range,[18] at lower interest rates than they would be able to through the issue of conventional bonds. A recent ANZ study estimates that 3-year debt could become 35-45 basis points cheaper and 10 year debt could be reduced by 40-50 basis points.[19] Lower funding costs should feed into lower loan interest rates and help ease out of cycle rate rises.

The issue of covered bonds is also a way by which financial institutions can diversify their funding sources. It is hoped that domestic superannuation funds will find the AAA rated covered bonds issued by domestic financial institutions an attractive investment which would improve the liquidity of the fixed-income market in Australia.

It is doubtful, however, whether the ability to issue covered bonds will improve banking competition. Global investor appetite is greatest for AAA rated bonds. The push to issue covered bonds has come from the AA rated major banks which will not have much difficulty in issuing AAA rated covered bonds. It will be much more difficult for lower-rated regional banks, building societies and credit unions to issue AAA rated bonds because of the feature that investors have recourse to the (less highly rated) institution and so face a higher perceived probability of default. It seems that investors in the stock market perceived the potential issue of covered bonds as benefiting the four major banks at the expense of the regional banks as the share prices of the Big 4 rose the day following the announcement of the *Competitive and Sustainable Banking System* package in contrast to the share prices of the regional banks which fell. Bank of Queensland Chief Executive David Liddy made public his view that covered bonds would benefit the big banks and '… put back the cause for a fifth pillar based on regional banks by 15 years'.[20]

Although the large banks are those that are likely to be advantaged by the issue of covered bonds, in part because of the higher quality of their residential mortgage books, the cap on their issue should limit the extent to which the Big 4 gain a competitive advantage over the regional banks, credit unions and building societies as a result of their issue.

2.5 Reduce the fee for the Government guarantee on wholesale funding for non-AA rated institutions

In 2008, the Government introduced a guarantee on wholesale funding with a tiered fee structure that depends on the institutions' credit rating: 70 basis points for an AA rated ADI (i.e., the Big 4), 100 basis points for an A-rated ADI and 150 basis points for BBB and unrated ADIs. A number of submissions to the Senate Inquiry from the regional banks and the mutuals sector are critical of the differential fees because, even though the guarantee is no longer available on new debt, it is still payable on debt that was issued under the guarantee.

The regional banks and the smaller lenders are calling for an immediate reduction in the fee to 70 basis points for all lenders. They argue that the higher fees imposed on them increase the wholesale funding margins between them and the Big 4 banks by 65 to 70 basis points and that "[t]his 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"[21] so that a non-AA rated ADI had to pay both a higher interest rate to the market than any of the Big 4 banks on top of a higher fee to the Government.

The consequence of the wholesale funding guarantee was to give the Big 4 banks a competitive advantage in the form of lower wholesale funding costs that they still enjoy today and which makes it difficult for the smaller lenders to compete on pricing without impacting their net interest margins. If the Government is serious about promoting the development of the regional banks and CUBs as a fifth pillar of the banking sector, it should seriously consider the prompt reduction of the fee for the wholesale funding guarantee on existing outstanding debt for non-AA rated institutions to 70 basis points as the market is already pricing in for higher risk on debt issued by institutions with lower credit ratings.

3. Supporting mortgage holders and small business borrowers

3.1 Adjustable rate mortgages (ARMs)

Much of the public opprobrium to the perceived lack of competition amongst banks has arisen in response to the widening gap between home loan interest rates and the cash rate. The spread between the banks' discounted variable home loan rates and the cash rate doubled from 120 basis points at the end of 2007 (around which it had fluctuated for some years beforehand) to 240 basis points in December 2010 (see Figure 6). Rightly or wrongly, the public perception is that the banks are gouging home loan customers by raising loan interest rates faster than the cash rate in order to increase their already massive (as perceived by the general public) profits. It is as though borrowers see the margin between the cash rate and the variable home loan interest rate at the inception of their home loans as an appropriate margin to be retained throughout the life of the loan. Encouraging or mandating the use of adjustable rate mortgages would go some way towards addressing public concern over rising spreads.[22]

Adjustable rate mortgages (ARMs) are mortgages where the interest rate charged to the borrower is explicitly linked to some benchmark interest rate which itself is linked to the banks' cost of funds. In Australia, it would most likely be the bank bill swap rate (BBSW) but the banks could choose any indicator rate they view as appropriate to their circumstances including the cash rate. The loan interest rates in ARMs are generally set equal to the benchmark interest rate plus some specified margin where the loan interest rate is reset at pre-specified intervals in line with changes in the benchmark interest rate. This has the advantages for borrowers of limiting the rise in their home loan rates to the rise in the benchmark interest rate, i.e., borrowers know what the margin on their home loan will be from the outset, and they have advance knowledge of when their loan interest rates are likely to be changed. Caps can be applied to ARMs which limit the frequency of changes in interest rates, limit the size of any increase in interest rates and limit the total change in the interest rate over the life of the loan.

Some banks and policy analysts may be wary of introducing and promoting ARMs in Australia because the majority of sub-prime loans in the US that led to the GFC were of this type. However, the fault did not lie with the use of ARMs *per se*. The fault lay with the woefully inadequate assessment of the creditworthiness of prospective borrowers and the lack of transparency surrounding the securitisation and issue of RMBS that followed. In contrast, Australian lenders applied stricter credit criteria to loan applicants, perhaps partly in response to ‘jawboning’ by the Reserve Bank when it became concerned that some lenders were making too many ‘low-doc’ loans (similar to subprime loans in the United States). Thus, although loan defaults rose during the GFC in Australia, they remained only a very small proportion of lenders’ loan books.

Although ARMs have not been proposed as an alternative to standard variable or fixed rate loans, it might be a worthwhile exercise for the Government or the Reserve Bank to undertake some research into whether the banks should be encouraged to offer these types of loans in Australia given their popularity in overseas markets.

3.2 Small business loan guarantee

A proposal to increase small businesses’ access to finance has been proposed in several submissions to the Senate Inquiry (NSW Business Chamber, Chamber of Commerce & Industry Queensland) which have advocated a government provided guarantee on loans to small business. The guarantee would be similar to schemes already operating in the United Kingdom, Canada and the United States. Small businesses would be charged for the guarantee and so would only use it if they could not secure non-guaranteed funding. The revenue raised would go some way to offsetting the costs to the Government of calls on the guarantee. Banks would still be responsible for the assessment of loans to small business but would take on loans they otherwise wouldn’t as a consequence of the guarantee being in place. To ensure that banks undertake appropriate risk assessments, the guarantee would cover less than 100 per cent of the loan amount, typically 75 to 85 per cent in the countries with small business loan guarantees in place. As access to small finance for business improves over time, the use of the guarantee would naturally decline.

The Reserve Bank is not in favour of a small business loan guarantee. The RBA's Assistant Governor, Guy Debelle, and the head of the RBA's domestic markets operations, John Broadbent, told the Senate Inquiry the RBA had examined the schemes operating overseas and found they had achieved only mixed success because the fees imposed on small business led to a low take-up rate.[23] The RBA is also concerned that lenders will take greater risks with a loan guarantee in place.

Despite the moral hazard issue, the proposal to offer a government guarantee on small business loans appears to us to have merit in increasing small business access to finance without imposing unreasonable costs on taxpayers given that the guarantee would cover less than 100 per cent of the loan amount which should provide sufficient incentive for lenders to properly assess the creditworthiness of potential borrowers.

3.3 Make switching banks easier

In 2008, the Government announced a number of measures to make it easier for customers to switch banks that included a listing and switching service that requires banks to provide their customers with accurate information on all direct debits and credits to take to a new bank for easier transferral, a consumer complaints hotline and consumer education providing advice on how to switch. Consumer take-up, and perhaps consumer awareness of these measures has been low which suggests an improved education campaign to raise consumer awareness of this assistance could increase the level of switching and hence increase the level of competition between banks and between banks and other financial service providers.

As one element of its *Competitive and Sustainable Banking System* package, the Government is banning exit fees for new home loans from 1 July this year. Several of the Big 4 have already abolished exit fees and so have less to lose from this change. In terms of increasing competition between providers, the abolition of exit fees favours the large banks which charge lower exit fees in any case. In the absence of exit fees, regional banks and mortgage originators will most likely charge higher upfront costs for establishing loans or attempt to recoup the establishment costs by imposing higher loan rates on borrowers.

The Government has also appointed a former Governor of the Reserve Bank, Bernie Fraser, to examine the feasibility of implementing full account portability so that banking customers can easily switch both their deposit and loan accounts. Full account portability would require changing the current BSB (Bank, State and Branch) account numbering and specific account number convention. As the ANZ submission to the Senate Inquiry notes (p. 27), changing this protocol would be costly and would apply only to transaction accounts which are relevant for cash payments and direct entry payments, whereas two-thirds of non-cash retail payments rely on Card Scheme numbers and other references developed by BPAY and PayPal. Similarly to ANZ, Westpac has concerns about account portability relating to the BSB code and the unique account identifier. As its submission (p. 35) notes:

> 'All payment, routing, settlement and existing systems infrastructure is built on this fundamental unit of identification.
>
> Industry-wide systems and mechanisms, including payment schemes, clearing houses, government bodies and APCA [the Australian Payments Clearing Association which is responsible for clearing cheques], are affected.'

Although it may prove both technically difficult and very expensive to implement full account portability, the major banks have been exploring a BPAY-based account portability option for several years, MAMBO, (Me at My Bank Online). Customers would register for their own BPAY code which could then be transferred from bank to bank without the need for re-establishing direct debits or credits.[24,25] Westpac made reference to its active participation in the MAMBO project in its submission to the Senate Inquiry (p. 34). The other major banks made no reference in their submissions which suggests there may be some tensions about the MAMBO project.

Further proposals made in submissions to the Senate Inquiry in relation to switching suggest either making mortgages themselves portable or improving the portability of lenders' mortgage insurance on existing debt.

References

Baumol, W., J.C. Panzar and R.D. Willig (1982), *Contestable Markets and the Theory of Industry Structure*, New York: Harcourt Brace Jovanovich.

Chan, D., Schumacher, C. and Tripe, D. (2007), Bank Competition in New Zealand and Australia, Paper presented to the 12th Finsia-Melbourne Centre for Financial Studies Banking and Finance Conference, Melbourne, 24-25 September.

End Notes

[1] OECD (2009), Competition and Financial Markets, www.oecd.org, p. 8.

[2] Derived from Australian Securities Exchange, Financial Sector Profile and Historical Market Statistics, www.asx.com.au.

[3] APRA defines total resident assets as all assets on the banks' domestic books that are due from residents. APRA and the RBA no longer publish total assets for the individual banks. Data on individual banks is required to calculate the market shares. In any case, using data on resident assets places the focus squarely on the activities of the banks in the domestic market.

[4] Chan, Schumacher and Tripe (2007) calculated index values for the Australian banking market from 1996 to 2005 based on the total assets of all banks which ranged between a minimum of 1125 and a maximum of 1248 which are not dissimilar to those presented in Table 1.

[5] The concept of contestability is due to William Baumol (1982).

[6] KPMG (2010), *Major Australian Banks, Year End 2010: Financial Institutions Performance Summary*, www.kpmg.com.au

[7] *Ibid*, p. 25.

[8] The net interest margin is calculated as net interest income divided by earning assets. KPMG calculates the net interest margin as the simple average of the net interest margin of the major banks.

[9] Quoted in Murdoch, Scott (2010), 'Banks face margin squeeze from retail price war', *The Australian*, March 2, p. 23.

[10] The issue of RMBS which were backed by housing loans made to uncreditworthy borrowers in the US was the proximate cause of the subprime mortgage crisis which ultimately became the global financial crisis. Defaults on housing loans meant that investors in many RMBS securities could not be paid out. As various types of financial institutions had invested heavily in RMBS and other ABS, the marked fall in the value of their assets led to a domino effect in financial markets where many institutions just could not raise the capital they needed to continue in business.

[11] The bank bill swap rate (BBSW) is a reference rate which is defined by the Australian Financial Markets Association (AFMA) as 'the average mid rate, for Australian Dollar bills of exchange, accepted by an approved bank, having a tenor with a designated maturity, that appears on an approved information vendor's service (e.g. Thomson Reuters Screen BBSW page) at approximately 10.08am AEST, on the reset date.' (www.afam.com.au)

[12] Australia Bankers' Association submission to the Senate Inquiry into Competition within the Australian Banking Sector, p. 90 and RBA submission, p.12.

[13] RBA submission to the Senate Inquiry into Competition within the Banking Sector, p. 12.

[14] Senate Economics References Committee. Access of Small Business to Finance, June 2010. Quoted in Australian Bankers' Association submission into the Senate Inquiry into Competition within the Australian banking sector, pp. 36-37.

[15] Quoted in Stutchbury, Michael (2010), 'Banking reform 'on the run' propels us headlong into disaster', *The Weekend Australian*, December 18-19, p.11.

[16] Abacus – Australian Mutuals Limited, Submission to the Senate Economics References Committee's Inquiry into Competition within the Australian banking sector, p. 24.

[17] To 17 December 2010, the AOFM had invested a total of $12.537 billion across 42 transactions, supporting 14 issuers. (www.aofm.gov.au)

[18] Australian Securitisation Forum submission to the Senate Inquiry into banking competition, p. 4.

[19] Quoted in Murdoch, Scott (2011), 'Covered bonds to cut big banks' debt costs', *The Weekend Australian*, February 5-6, p. 27.

[20] Stutchbury, Michael (2010), drawing on quotes from David Liddy in 'Banking reform 'on the run' propels us headlong into disaster', *The Weekend Australian*, December 18-19, p. 11.

[21] BOQ Submission to the Senate Economics References Committee, Inquiry into competition within the Australian banking sector, pp. 4-5.

[22] Kevin Davis suggests the use of adjustable rate mortgages in his submission, 'Housing Mortgage Contact Design and Banking Sector Competition' to the Senate Economic Committee Enquiry, 'Competition within the Australian banking sector', http://www.aph.gov.au/Senate/committee/economics_ctte/banking_comp_2010/submissions.htm

[23] Reported in Uren, D. (2011), 'Reserve Bank of Australia rejects call for loan guarantee', *The Australian*, March 12.

[24] Palmer, Chris (2010), 'Bankers dance to Mambo, http://www.bankingreview.com.au/2010/10/bankers-dance-to-mambo.html

[25] Palmer, Chris (2010), 'Portability is possible, getting big four agreement a lot harder, http://www.bankingreview.com.au/2010/12/portability-is-possible-getting-agreement-from-the-big-four-a-lot-harder.html