

**Senate Economics Committee
Inquiry on Banking Competition
Written Questions received 28 December 2010**

Q1. The return on equity in the large Australian banks is similar to that for other large companies in Australia. But should the returns be *lower* given the relatively low risk of banking? (On a more technical note, is it *total risk* or *non-diversifiable risk* that is relevant?)

Treasury has not assessed whether banking involves similar risks to other sectors for the purpose of comparing returns on equity.

Q2 How important are economies of scale in retail banking, and in participating in international lending? Does this constitute a barrier to entry and a force for concentration?

The emergence of electronic banking methods (e.g. Internet banking, ATMs and EFTPOS) and alternative distribution channels (e.g. mortgage brokers) has helped to overcome the disadvantages that might otherwise be encountered by new market entrants due to the absence of well-established branch networks.

This has improved the ability of potential new entrants and smaller existing players to service Australian banking customers (e.g. by offering ‘online’ savings accounts or home loans that are applied for and administered over the Internet). These developments have been a key driver behind foreign banks’ renewed interest in Australia’s retail banking market in recent years.

Q3 Charts 6 and 7 in Treasury’s submission show bank interest margins gradually narrowing after deregulation but widening somewhat in recent times. Is this a statistical blip or does it reflect reduced competition since the GFC?

According to the major banks annual reports, net interest margins (NIMs) fell to a low of around 2¼ per cent in 2008, following a long period of decline that started in the 1980s. The financial crisis increased the banks’ cost of funds and banks responded by increasing their interest rates. NIMs returned to pre-crisis levels and have remained broadly flat over 2010.

NIMs are measured as net interest income (that is, interest revenue less interest expense) over the average interest earning assets of the bank. Positive NIMs suggest a bank can lend money at a higher rate than it can borrow.

Several factors impact NIMs. Primarily these are funding costs, such as the cost of banks accessing deposits, the wholesale debt market and short term money markets, relative to the rate banks charge retail borrowers, such as home loan rates and business loans.

Q4 From the viewpoint of the financial system as a whole rather than an individual issuer, what is the advantage of financial intermediaries securitising mortgages rather than issuing bonds to fund mortgage lending which remains on their balance sheet? Are there advantages in the organisation doing the credit assessment on housing loans continuing to bear the risk on them?

The IMF has identified two systemic benefits of securitisation. Firstly, it facilitates the mobilisation of illiquid assets (as loans are repacked into standardised securities that can be traded). Secondly it facilitates the transfer of credit risk from banks to a wider range of investors (*Global Financial Stability Report*, October 2009, Chapter II). Securitisation also played a significant role in boosting competition within the Australian financial system by allowing non-bank financial institutions to compete with banks.

The main advantage in the organisation doing the credit assessment on a housing loan continuing to bear the risk on the loan is that it gives it an incentive to exercise appropriate diligence in originating and monitoring the loans. This incentive can be weaker in a securitisation arrangement under which the originator transfers credit risk to other investors. While this was not a problem in Australia, where default rates on home loans have remained low, there is evidence that 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.

Q5 Some submissions have called for the immediate removal rather than the phasing-out of interest withholding tax. What impact would this have? How much would it cost?

In the 2010-11 Budget, the Government announced a phase down in interest withholding tax (IWT) for financial institutions to take effect from the 2013-14 income year. The benefits of the phase down are that it will: help support banking competition; reduce the extent to which financial institutions make funding choices based on tax rather than commercial considerations; and further develop Australia as a regional financial centre.

If this measure were to be brought forward - for example, were IWT to be abolished with effect from 1 July 2011, it would be expected to bring forward these benefits and give rise to additional costs to revenue. 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.

Q6 It has been put to us that mutuals are disadvantaged because they pay the same company tax as the banks, but the banks' shareholders received franking credits. Is this right? If the government wished to remove this, what options are open to them and what are the advantages and disadvantages of each option?

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 (with effect from 1 July 2002) 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 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.

Q7 Would allowing positive credit reporting stimulate competition?

On 14 October 2009, the Cabinet Secretary, Senator the Hon Joe Ludwig, released the Australian Government's First Stage Response to the Australian Law Reform Commission (ALRC) report, *For Your Information: Australian Privacy Law and Practice* (ALRC 108). The ALRC report recommends 295 changes to improve Australia's privacy framework. The recommendations include provisions relating to the regulation of credit reporting including the introduction of comprehensive credit reporting (positive credit reporting).

Comprehensive credit reporting will expand on the current regime which is only based on negative credit reporting, such as default information. The reforms will allow provision of information about a borrower's current credit accounts and repayment history.

Comprehensive credit reporting has the potential to support competition by providing better information on which lenders can base their lending decisions. More detailed information can lead to more efficient pricing and a wider range of credit products.

Q8 Some submitters have called on Australia to establish its own version of the Canada Mortgage and Housing Corporation. What do you see as the advantages and disadvantages of this suggestion?

The Treasury provided analysis on the merits of establishing a version of the Canadian Mortgage and Housing Corporation in its submission to the 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.

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, or that the benefits of the proposal would outweigh the associated risks and costs.

A copy of the submission may be found at:

<http://www.aph.gov.au/house/committee/itrdlg/financialcrisis/subs/sub167.pdf>.

The Government considers the current investment program by the Australian Office of Financial Management (AOFM) a more appropriate way to support the securitisation market in Australia. The Deputy Prime Minister announced an extension of this program by \$4 billion, to \$20 billion, as part of the *Competitive and Sustainable Banking Package*. This program involves AOFM investing in AAA-rated Australian residential mortgage-backed securities (RMBS) to support the funding of smaller lenders who are able to exert competitive pressures on larger financial institutions.

Q9 ABACUS suggests "the Government should update the GST RITC item 'Credit Union Services' to cover mutual building societies". Do you see any problem in treating building societies the same way as credit unions?

Financial institutions are not entitled to recover the GST included in the price of their acquisitions where these are used in making financial supplies. The GST RITC is designed to address the potential competitive disadvantage for those financial institutions that are required to out-source more of these services; such as smaller banking institutions. The GST RITC allows for a reduced input tax credit on a limited range of acquisitions (reduced credit acquisitions or RCAs) that are used in making financial supplies. RCA item 16 covers supplies to a credit union by an entity that is wholly owned by 2 or more credit unions. This item effectively allows credit unions to partially recover GST on all their acquisitions even where these could not otherwise have been out-sourced, in contrast to any other type of financial institution, including building societies.

The extension of RCA item 16 to other financial entities was considered as part of Treasury's 2009 Review of GST Financial Supply Provisions. The Government considered the findings of the review in early 2010 and announced the findings of that review in the 2010-2011 Budget. The Government's announcement did not include an extension to the existing RCA item 16. An extension to RCA item 16 would result in a reduction to the GST base and require the agreement of all the States and Territories and would be at odds with the policy rationale underlying the RITC regime.

Credit unions and building societies continue to be able to benefit from other RCA items available to financial institutions generally. Access to RCA items potentially benefit smaller financial institutions like credit unions and building societies more as they generally rely on out-sourcing to a greater extent than larger banking institutions.

Q10 Do you have any comments on proposals to crack down on 'price signalling' by banks? What do you understand by the term? Some proposals are to prohibit price signalling where it 'substantially lessens competition' or where it is 'for the purpose of inducing a competitor to vary a price'; would these be hard to prove? Do you agree with critics of the proposals, when they argue that a prohibition would lead to a less informed and less competitive market? Could a prohibition on public announcements be sidestepped by notifying customers privately and letting the media report it?

On 12 December 2010, as part of its Competitive and Sustainable Banking System package, the Government stated its intention to address anti-competitive price signalling and information disclosures. In doing so, the Government recognised that any proposal to address anti-competitive price signalling and information disclosures will need to carefully balance the potential anti-competitive impacts of particular information disclosures with the benign and pro-competitive effects of other information disclosures.

The Government also released exposure draft legislation on price signalling. Interested parties were invited to express their views on the Bill before 14 January 2011. To assist with this consultation process, an explanatory note on the Bill was made available on the Treasury website. The views of respondents will be considered by the Government in the process of finalising its legislation to address anti-competitive price signalling and information disclosures.

Q11 Why are Australian home loans predominantly at variable rates whereas in many comparable countries fixed rates are more common?

Around three-quarters of housing loans in Australia are variable.

The predominance of variable rate mortgages in Australia reflects, in part, consumer demand and the characteristics of banks' funding sources.

Banks take a risk by pricing fixed rate mortgages for durations that are longer than their sources of funding. The average maturity of a banks' source of funding is around 3.25 years on average. Pricing a fixed rate mortgage for long durations, for example, several decades, would mean banks need to factor in different costs and risks. As a consequence, rates for fixed rate loans are generally more likely to be higher than rates on variable rate loans.

While Australian households will generally bear more interest rate risk on their variable mortgage debt compared to other households with fixed rate mortgages, this is partly offset by providing Australian households with greater flexibility on their variable mortgage prepayments. Fixed rate loans tend to almost always have restrictions on such prepayments.

Countries such as New Zealand, Canada and the United Kingdom share mortgage market characteristics more akin to Australia than the US. Countries such as the US, that offer long-term fixed rate mortgages, exhibit a range of different regulatory characteristics. For example, US mortgage providers generally do not impose penalties on pre-payments for fixed rate mortgages – the merits of which are being re-examined in light of the recent crisis.

Q12 Conceptually, in a competitive banking market, would you expect bank lending variable interest rates to follow movements in the banks' average or marginal cost of funds? And should the interest rate on loans be moving with costs for the average bank or the lowest-cost bank?

Interest rates charged by banks are commercial decisions. The individual rates charged by banks will reflect the particular circumstances and funding mix of banks, the loan portfolio of banks, how loans are repriced, as well as the competitive positions of the lowest-cost (and highest-cost) bank. However, rates will also reflect things like corporate strategy and the cyclical conditions associated with the business cycle.

A bank's decision to alter its variable lending rates will reflect both marginal and average cost of funds across its loan portfolio. The average duration of a bank's liabilities will also determine, in part, what interest rates are required to afford to roll over debt, and afford repayments on other liabilities as they mature.

Q13 Should a small business loan secured by a mortgage over a house bear the same interest rate as a home loan secured over the same house? Is it price discrimination if they do not?

The loan market is not homogeneous and, as a result, price differences between different segments should be expected.

Different borrower segments have different credit risk and this should be reflected in loan pricing. Credit risk is a function of both the likelihood that a borrower defaults and the expected recovery value of a loan's collateral. Historically, residentially-secured small business loans have higher default rates than residential purpose loans. For this reason, in general, small business loans secured by residential property can be expected to have higher interest rate in a competitive market.

Senate Economics References Committee
Inquiry into Competition within the Australian Banking Sector
Treasury response to Question on Notice – ATM Fees
Transcript 13 December 2010 (E47)

Senator CAMERON — On this one-third of Australians who do not use their own bank's ATMs, do you have any idea how much the banks are skimming off on fees from this 30 per cent?

Mr Murphy—Right. We will find that out. The Payments System Board may have that information. We could find that out for you.

Answer

The Reserve Bank of Australia (RBA) estimates that the total of all direct charges on ATM withdrawals in the first 12 months following the implementation of the March 2009 reforms was \$540 million. This includes ATMs owned by authorised deposit-taking institutions as well as those owned by independent deployers. The RBA has estimated that aggregate fees paid by consumers in relation to ATM withdrawals fell by around \$120 million in the 12 month period following March 2009 reforms.

Senate Economics References Committee

Inquiry into Competition within the Australian Banking Sector

Treasury response to Question on Notice – ATM Fees

Transcript 13 December 2010 (E48)

Senator XENOPHON—Further to Senator Cameron’s line of questioning, one of the complaints that have been made is that many people, particularly those on low incomes, simply want to access the ATM not to make a withdrawal but to see what their account balance is—

Mr Murphy—Yes, and they get charged for it.

Senator XENOPHON—Should there be a differential cost for those who simply want to access their bank account balance?

Mr Murphy—Okay. We will take that on board. We may have to refer those to Reserve Bank, because they have responsibility for the Payments System Board—but we can look at those, yes.

Answer

Currently, the cost structures for ATM fees are driven by the market. In considering whether ATM providers should be required to cost different services differently it is necessary to determine whether there is a case for Government intervention.

The majority of ATM transactions do not incur a direct charge because they are made at ATMs owned by the customer’s financial institution, or on a network for which the financial institution has negotiated charge-free access. Where a direct charge is incurred, in the majority of cases it is the same for both withdrawals and balance enquiries. Nonetheless, in around 30 per cent of cases the balance enquiry charge is lower than the withdrawal charge – typically \$0.50 to \$1.25, compared with a typical withdrawal fee of \$2.00.

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 independently owned ATMs (where nearly all transactions are charged), only 6 per cent of transactions are balance enquiries.

As part of the Government’s *Competitive and Sustainable Banking System* package, Treasury and the Reserve Bank of Australia (RBA) are monitoring the implementation of the RBA’s reforms to the ATM system. In June 2011 this taskforce will report on whether any further reforms are required.