

# **Submission to the Senate Economics References Committee**

## **Some Comments on Bank Regulation**

Everybody hates banks and they are popular whipping boys for politicians and the media. The current and previous Treasurer often used the bully-pulpit to hector the banks over their rate setting behaviour. Recently the Opposition called for regulation of bank interest rates. Banks are denounced for “not passing on rate reductions” or for “changing interest rates independently of the Reserve Bank”. They are also accused of anti-competitive behaviour although no evidence whatsoever has been produced to support this charge. There have been calls for banks to be punished or for revenge to be taken against them – punished for what, revenge for what? Extreme and inflammatory calls such as these should be backed up with fact based support. Recent irrational bank-bashing has reached such levels that it is hard to believe that Australian society would tolerate such abuse of any other minority group. It is also strange that we are so anxious to damage an industry which plays such a critical role in the functioning of the economy. This witch hunt generates a great deal of heat but no light. A review of the facts will provide more of the latter.

### **RBA Monetary Policy**

The Bank Board sets only one interest rate—the cash rate. This is the interbank rate, the rate at which deposits in the banks’ Exchange Settlement Accounts are traded. These deposits are usually of the order of \$1bn, a tiny percentage of total bank liabilities. The suggestion of the critics is that if the RBA reduces the cash rate, the banks have somehow received a benefit which they are selfishly refusing to pass on to their customers. In fact, they have received no benefit at all.

Of course, RBA cash rate decisions affect longer-term interest rates, but these are determined by market interest rate expectations. Market expectations depend on views on future RBA decisions, but market reactions vary from time to time. And it is these longer-term market rates which determine banks’ cost of funds and, therefore, the rates they can charge customers.

More precisely and, as pointed out in my article in the Australian Financial Review of 23 – 24 October 2010, banks' cost of funds is affected by three categories of market interest rates. The first is short-term money market rates such as the ninety day bank bill rate. This rate is very dependent on views about RBA decisions in the near future. However, the gap between the cash rate and the ninety day bill rate is not constant and can change without any RBA action because of changes in market expectations. In March 2010 the cash rate and the ninety day bank bill rate were about 10 basis points apart whereas at the moment they are about 30 – 40 basis points apart. In order to close this gap, the banks would need to increase their rates by more than any increase in the cash rate.

The second component of bank cost of funds is longer term rates such as bond rates. These are less affected by RBA policy decisions. The third component is rates on funds raised overseas. RBA decisions do not affect these rates at all.

All of these components can change without any change in the cash rate and if the cash rate is changed, the extent to which the components change varies from time to time. Moreover, the composition of bank funding will change whenever the banks decide that the existing composition of their funding is no longer optimal and change it. In other words, banks' cost of funds does not track the cash rate and can change without any change in the cash rate.

Therefore, there is no reason why banks should track changes in the cash rate or restrict changes in their lending rates to times when the cash rate is changed. If commentators tell you that banks are not passing on reductions in the cash rate or that they are changing their rates independently of the RBA ignore them. They know nothing about the subject.

## **Interest Rate Margins**

The gap between bank lending rates and their cost of funds is a measure of their interest rate margin which is often taken as a measure of the resources used up by banks in performing their functions. The RBA has looked at bank interest rate margins and failed to find any evidence of recent significant increases in them. However, we need to take a more detailed look at the ways in which bank decisions affect various sections of the community. Three such sections need to be considered.

The first is bank depositors. If banks cannot react to increases in their cost of funds by raising their lending rates, they will be forced to lower (or keep down) deposit rates. This would disadvantage savers, including such groups as self-funded retirees. It is not clear why we should be less concerned about this group than borrowers.

The second is shareholders. It is often forgotten that banks, like all companies, are fictional entities. They represent their shareholders and have an obligation to look after their interests. These shareholders are not bloated capitalists—they are us, mainly through our superannuation funds. They must earn an acceptable return on capital or they will not contribute it. This point is discussed below.

The third is borrowers. There is a bizarre aspect of the political/media campaign to keep bank lending rates down. If the aim is to slow an overheated economy, higher interest rates must be allowed to have an effect. If we insulate borrowers against them, monetary policy will become ineffective. It is true that increasing interest rates mainly affect borrowers, but this is one reason why monetary policy is often described as a “blunt instrument”.

Moreover, there seems to be a push not only for lower lending rates but also for greater ease in obtaining finance. This view is strange, given that it is recognised that the GFC was caused by a sharp lowering of credit standards, particularly (but not only) in the USA. This is not a time to undermine credit standards and, more importantly, it is not in the interests of borrowers to lend them money that they cannot repay.

Note also that banks could react to a narrowing margin by raising fees on depositors or borrowers. In recent years the trend has been in the other direction and it would not be desirable to force banks to reverse this trend.

The minutes of the RBA Board meeting of 2 November included the following statement:

*Domestically, the most recent data showed a continuation of the trends in bank funding that had been apparent for some time. The shares of relatively high cost funds, such as domestic deposits and long-term debt, had continued to rise, while the share of short-term debt had continued to*

*fall. Members were briefed on developments in funding costs. Most banks had reported a small reduction in net interest margins in their most recent half-yearly accounts, though some had experienced an increase. Deposit competition appeared to have levelled off in recent months. In debt markets, spreads on short-term bank bills had narrowed to be not far above pre-crisis levels. Spreads on longer-term bank debt had stabilised at levels that were significantly higher than before the crisis. This was slowly adding to the banks' cost of funds as banks rolled over debt issued earlier at lower spreads. Members noted that there was a possibility that banks would increase interest rates on loans by more than any move in the cash rate.*

On the release of these minutes on 16 November, the orgy of bank bashing suddenly ceased. However, it would be desirable to develop policies which prevent such damaging and irrational outbreaks.

## **Looking at Bank Returns**

The question which should be asked is—have the banks expanded the margin between their lending rates and their cost of funds? Alternatively, we could ask—are the banks making an excessive return on their capital? Rather than looking at a series of individual changes, it would be better to attempt to answer one or both of these questions. The RBA did release a report on the behaviour of bank interest rate margins over the GFC which found that the banks had not exploited the situation. This report was greeted with massive silence from the politicians and media.

The basic test of whether banks are exploiting customers and abusing some monopoly power is whether they are earning a return above that necessary to keep them functioning. That is, whether they are earning above normal profits (i.e. super profits or economic rent). Too many commentators seem to believe that “super” simply means “large”. In fact, there is a well established methodology for determining the return which represents a normal return—the Capital Asset Pricing Model (CAPM). This model indicates that a normal return is equal to the risk – free rate plus a risk premium. The latter depends on:

- the market risk premium;
- the relationship between the return on bank shares and the market return.

If bank shares behave like average market shares, the normal or required return is equal to the market return. Over the period 1981 – 2009 this was 13.8% p.a. However, it is quite possible that as a result of the GFC, banks are currently rated as riskier than the average market share. For example, the Westpac return recently announced would be consistent with a beta of around 1.3. This is a reasonable value in the current circumstances.

I suggest that an appropriate entity (the RBA or perhaps APRA or the ACCC) release a regular report on this question. If it is found that banks are extracting an excessive return, actions should take the form of increasing competition in the banking industry. This would allow the discussion of monetary policy to focus on more important aspects of it. For example, appropriate targets for it and its effectiveness.

If the bank industry is competitive, any impositions on banks will lead to higher costs/lower returns being passed on to customers in some form. For example, there are already some suggestions that the focus on bank lending rates has led to lower deposit rates.

In addition, there are strong arguments for there to be regular inquiries into the financial system, similar to the Campbell, Martin and Wallis Committees. However, such an inquiry should be truly independent and not based on the Treasury.

The following are some comments on policies which have been canvassed in recent times.

### **Switching Regulation**

It is often suggested that switching by bank customers be made easier. This could be done fairly easily with deposit accounts and it is not clear that there are any serious impediments to such switching at present. However, it will not be possible to make switching of loans as easy.

Any bank receiving an incoming loan would need to undertake a credit evaluation of that loan. That is, this proposal might increase competition in the deposit market but not the loan market. Is this unintended consequence desirable?

A related proposal is for customers to be given a transferable bank account number. One aspect of this proposal is that it could be regarded as a first step towards an identity card system (regarded as bad by some, good by others). However, as already noted, it is unnecessary because deposits can be switched easily.

The reason for mortgage exit fees is that setting up a mortgage account involves the lenders in costs which are recouped over the life of the mortgage. If the mortgage is terminated earlier, the costs can only be recouped through the exit fee. Sam Wylie, writing in the Australian Financial Review for 12 November 2010 argued that these costs should be recouped through an up front fee instead of being spread over the life of the mortgage. However, the downsides of this proposal are:

- many borrowers would prefer the fee to be spread over the life of the mortgage because they will be better off in the later stages of repayment; and
- it actually makes switching less attractive for borrowers because they will be faced with a new up front fee when they move to another bank.

## **Fixed Rate Mortgages**

In an article in the Australian Financial Review of 8 November 2010, Jeremy Cooper suggests that we should go over to long-term fixed rate mortgages. He asks “why can’t Australians choose to pass all the interest rate risk over to the lender at the onset?” the answer is—it can’t be done. The fixed rate borrower runs the risk of paying much more for their loan than a variable rate borrower. Also, it was this form of lending which led to the Savings and Loan debacle in the United States.

## **Signalling Regulation**

The claims about signalling are silly. Banks know each other's costs of funds because they raise money in the same markets on the same terms. Stopping some businesses discussing their decisions in public would be a remarkable interference with the flow of market information—but it is unlikely to change interest rate setting behaviour.

## **Government Banking Business**

Some commentators have suggested that the government allocate its business so as to influence bank behaviour. This is a very bad idea which could increase the incentives for corruption. However, in this case it is simply silly—the government banks with the RBA.

## **A Post Office Bank**

The idea of basing a bank on Australia Post (AP) persistently resurfaces although the details are very unclear. Is AP to act only as an agent? Then who would be the principal? Would a trained staff be available? It appears that this proposal could lead to a substantial deterioration in lending standards. There is already an excellent alternative available via Credit Unions. It is not easy to start a new bank and if this is the proposal, the new bank would probably need to be given some competitive advantages. Is such an interference in the competitiveness of banking justified? Any such proposal would need to take account of the problems which arose in the earlier publicly-owned banking sector, e.g. political interference and under-capitalisation.

## **Credit Cards**

One area in which reform could occur is in credit card lending. The accumulation of credit card debt is causing a great deal of concern, particularly amongst social workers. Two possible reforms meriting attention are:

- ensuring that the minimum monthly payment on credit cards at least covers the interest and other charges on it; and

- creating a clearing house which looks at the total exposure of each borrower. Limits could be imposed based on the income, assets, etc. of the borrower.

## **Deposit Guarantee**

During the GFC banks received an explicit deposit guarantee. This guarantee simply replaced the pre-existing implicit guarantee, i.e. it was believed in the market that the government would not allow a major bank to default. Such a guarantee is necessary because the payments system in an economy must be regarded as safe. The banks (i.e. their customers) paid for the explicit guarantee. This is reasonable in terms of maintaining competitive balance. The only policy question is – what is the appropriate fee? The temptation for politicians to obtain some kind of implicit and ill-defined fee (such as lower lending rates) must be resisted.

It should be noted that a guarantee is a benefit for depositors. It does not mean that shareholders or management are protected (i.e. that a failing bank should be bailed out). Whether or not it is desirable to extend the guarantee in this way is a question still to be considered.

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