

# Commonwealth Bank

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3 December 2010

The Secretary  
Senate Economics References Committee  
PO Box 6100  
Parliament House  
CANBERRA ACT 2600



Dear Sir

## **Competition within the Australian banking sector**

The Commonwealth Bank of Australia (“the Group”) is pleased to present the attached submission to assist the Committee in its deliberations on assessing competition within the Australian banking sector.

Australia has been well served by our stable, well regulated and prudently managed banking sector, particularly during recent episodes of severe turbulence in global financial markets. The strength of the sector has ensured a continuous supply of credit to business and personal customers that has helped sustain the Australian economy during a period when many other economies have faltered.

Importantly, the competitive nature of the sector has continued to provide depositors and borrowers with well priced products and services against a backdrop of declining bank fees, rising funding costs and a riskier world outlook.

The disruption to international capital markets caused by the Global Financial Crisis (GFC) has had significant impacts that have altered the competitive dynamic operating in the Australian banking sector. For the purposes of this Inquiry the three notable impacts are:

- The GFC has exposed the business models of some financial service providers as inappropriate. The resultant withdrawal from the market by some institutions has been perceived as a significant reduction in competition despite evidence that the Bank’s retail net interest margin (NIM<sup>1</sup>), an indicator of competition, has compressed.
- The rise of deposits as an important source of funding to counter the costs of increased volatility of international capital markets has increased competitive tension. This has also put pressure on bank funding costs.

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<sup>1</sup> Net interest margin (NIM) is defined as the difference between the average interest rate earned on assets minus the average interest rate paid on borrowings plus the benefit of interest free liabilities, provisions and equity.

- A structural shift in the way the banking sector is now funding itself.

This submission seeks to provide a clearer understanding of the current competitive landscape and will focus on:

- Funding costs and the impact on interest rates: Recent Reserve Bank of Australia (RBA) commentary confirms that bank funding costs are influenced by factors outside its cash rate. The impact of the GFC on international capital markets has resulted in a lift in costs that will not return to “normal” levels for the foreseeable future.
- Fees and NIMs: These measures reflect a competitive bank environment. Retail bank fees have fallen as a percentage of interest earning assets in recent years and retail bank NIM has also declined. It should be recognised that NIM in corporate and business lending had been reduced to unsustainable levels prior to the GFC when risk premiums were priced out of lending and encouraged poorer business models.
- Bank profitability: The magnitude of bank profits is often taken out of context with little regard for the size of the institution, the amount of assets deployed to generate income and the volume of transactions. Return on Equity (ROE) and Return on Assets (ROA) are market-recognised measures of profitability. The Group’s ROE and ROA are currently below the long term average return. Australian banks in 2010 generated ROE and ROA broadly in line with the thirty year average for the banking sector.
- Small business lending: The Bank has been a keen supporter of small businesses since the GFC began and has grown its market share well above system growth while repricing sensibly for risk and without changing lending standards.
- Government support for the financial system during the financial crisis: The Government’s decision to provide guarantees to support the economy and financial system, in line with those being made by the other developed economies, was a decisive and sensible policy response. It ensured that the impact on the Australian financial system and economy was limited. It also provided an alternative income source for the Government, with over \$5b in fees expected to be raised over the life of the wholesale funding guarantee from banks using that guarantee.

The Bank believes that the domestic banking sector is competitive, particularly so in the retail and small business segments. However, we acknowledge that continued access to funding at reasonable cost remains a fundamental issue facing all market participants and we encourage the Government to continue to consult with the industry to develop funding solutions that sustain Australia’s first class banking system.

There have been considerable regulatory changes applied to the industry in recent years and more are foreshadowed. Australian banks and their regulators are regarded as world class and have successfully protected depositors and borrowers from the worst impacts of the GFC. This submission argues that the sector is fundamentally sound and competitive and caution should be exercised in recommending additional regulatory changes.

Yours sincerely

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## 1.0 Introduction

The Commonwealth Bank is Australia's largest financial institution on most measures and is well placed to comment on aspects of the banking sector. The Group:

- Serves over 11 million Australian customers<sup>2</sup>
- Employs over 45,000 people
- Manages over 5 million transaction accounts, 1 million mortgages and almost 5 million personal savings accounts
- Operates the most branches<sup>3</sup> (over 1,000) and ATMs (3,400) of all the major banks
- Processes approximately 45% of Australia's daily electronic transactions
- Has assets in excess of \$600b on its balance sheet
- Manages or administers over \$200b in additional funds for investors as part of our wealth management operations
- Provided customers with \$100b in new lending in FY10
- Paid \$2.9b in taxes in FY10
- Distributes around three quarters of profits to shareholders, of which more than 80% are Australian investors and over half of which are retail investors (780,000)
- Is one of a very limited number of AA rated banks worldwide.

It is acknowledged that the combined amount of bank profits has been a catalyst for closer examination of bank funding, profitability and competition within the sector. The following sections will clarify the impact of increased funding costs on interest rates, the nature of bank profits and recent trends in net interest margins (NIMs). A summary of the distribution of the Group's income in FY10 is provided in Attachment 1.

## 2.0 Funding costs

### 2.1 How banks fund themselves

There are three main sources of bank funding, each highly competed for, comprising:

- deposits;
- borrowing from capital markets; and
- shareholder equity.

Deposits comprise a range of products, including transaction and saving accounts and term deposits.

Banks borrow from both domestic and international capital markets. The vast bulk of borrowing from domestic markets is short term (under one year maturity). Most of the offshore borrowing is long term (greater than one year maturity), reflecting the deeper capital markets that allow banks to borrow at longer maturities. Offshore capital markets also allow banks to diversify their investor base.

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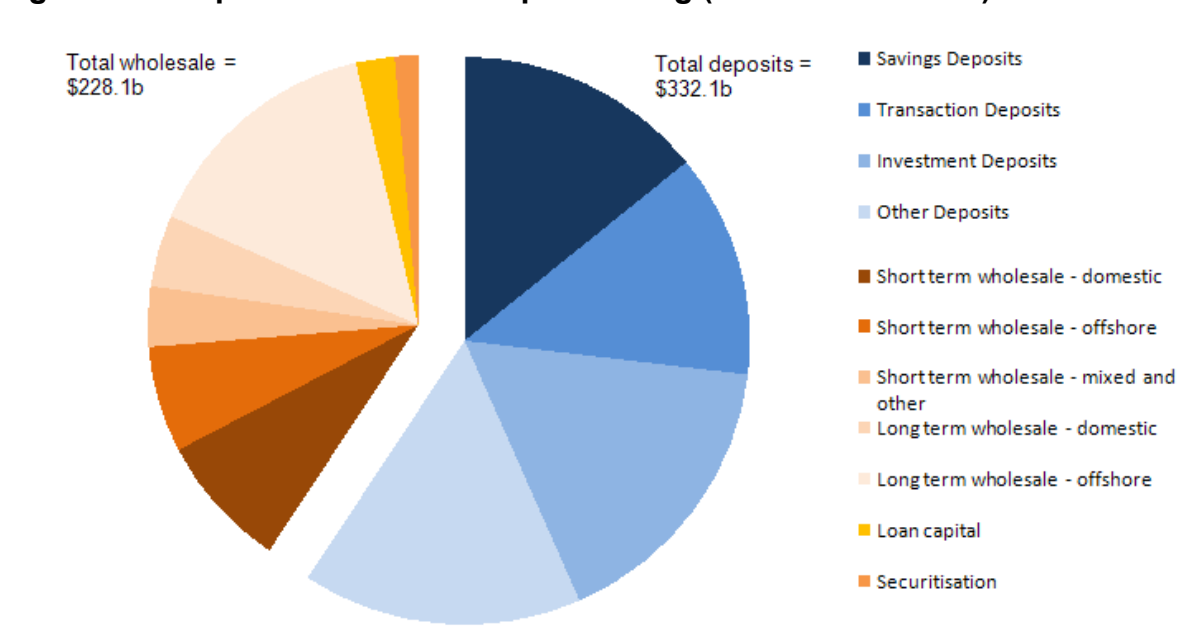
<sup>2</sup> Including Bankwest

<sup>3</sup> Based on proprietary (i.e. CBA) branded branch numbers

Securitisation is another form of borrowing from capital markets, where investors lend banks and other financial institutions funds secured directly against a collection of assets (e.g. home loans).

Figure 1 below illustrates the composition of the Group’s funding as at end October 2010.

**Figure 1: Composition of the Group’s funding (end October 2010)**



Source: CBA

Deposits comprise the most significant proportion of the Group’s funding (59%), with borrowing from capital markets also playing a significant role. Securitisation funds only a small part of the Group’s balance sheet, and has been used mainly to diversify funding sources. The composition of the Group’s funding has changed since the GFC (see Table 1 below). The Group’s funding now comprises a higher proportion of deposits, long-term funding and equity, with a notable decline in short-term funding. The Group has adapted to the lessons of the GFC, and to regulatory pressures, to make its funding structure stronger than previously.

**Table 1: Change in composition of the Group’s funding since October 2007**

	October 2007	October 2010
Deposits	\$194b (53%)	\$332b (59%)
Short term wholesale funding	\$106b (29%)	\$101b (18%)
Long term wholesale funding	\$65b (18%)	\$127b (23%)

Source: CBA

## 2.2 How bank costs have increased

Bank funding costs are driven by several factors, including the RBA cash rate as well as other factors. However, since the GFC the impact of those other factors has increased.

### **2.2.1 Deposit funding and competition for deposits**

One of the consequences of the GFC is that banks have increased the proportion of their funding sourced from Australian deposits taking into account the importance of diversifying away from the volatility of capital markets which exposed Northern Rock and other institutions. The result has been a significant increase in competition in the deposit market, leading to higher deposit rates.

The strong competition in the deposit market has been a significant benefit for savers. The Group, for example, has over 5 million depositors that have benefited from the significant rise in deposit rates above changes in the RBA cash rate.

The increase in deposit rates has been a significant driver of the increase in our funding costs. Since June 2007, the CBA Retail Bank's deposit funding costs have increased by around 140 basis points (bp) outside of changes in the RBA cash rate. The assessment of deposit funding costs reflects a variety of significant influences, including both headline and non-advertised "special" rates, and temporary bonus or honeymoon rates. The cost increase also reflects a material change in customer preferences towards high yield deposit accounts.

Competition in the deposit market is likely to remain structurally higher than prior to the GFC. One of the lessons from the GFC was that banks that relied upon the deposit market for a significant proportion of their funding were safer than banks that sourced a high proportion of their funding from the capital markets, particularly short-term and securitisation markets.

### **2.2.2 Rising short-term funding costs**

The majority of the Group's short term funding needs is sourced domestically. This mainly takes the form of bank bills and certificates of deposits. The short term bank debt market is the single largest debt market in Australia (\$360b as at September 2010), although the size of this market has shrunk by around 30% since its peak in early 2008.

For much of the time immediately prior to the GFC, the additional premium above the RBA cash rate that banks paid to borrow from wholesale markets was relatively steady at around 10bp. This meant that changes in bank funding costs in wholesale debt markets were essentially driven by expected changes in the RBA cash rate. The risk of changes in this additional premium is known as basis risk. The "BBSW–OIS spread"<sup>4</sup> is generally regarded as the cost of hedging this risk.

The GFC saw a substantial increase in the premium that banks needed to pay to borrow from this source as a result of the heightened volatility in financial markets and heightened concerns around bank credit-risk. At the peak of investor concern about banks, the cost paid by banks to hedge this additional premium rose from 10bp to around 90bp in late 2008. The increase in the cost paid by the Australian banks was less than that paid by offshore banks reflecting the stronger performance of Australian banks.

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<sup>4</sup> BBSW is the abbreviation for Bank Bill Swap rate, OIS is the abbreviation for Overnight Indexed Swap rate

Improvement in sentiment in global financial markets has seen such costs fall. Nonetheless, this premium cost is still around 20bp, compared to the 10bp paid prior to the GFC, although this amount changes daily.

In addition to the cost impacts outlined above, it is important to note that firstly, the cost of hedging this additional premium applies to both long term and short term wholesale funding; and secondly, the Group has sought to prudently extend the term of its short-term borrowings, which comes at an additional cost.

### ***2.2.3 Rising long-term funding costs***

Since the GFC, long-term funding costs have also increased reflecting the greater premium that investors are demanding for the higher risk associated with the uncertain economic and financial market outlook. For example, the margin for raising floating rate five-year debt from the domestic market is currently around 100bp higher than prior to the GFC, and the margin for raising this debt from offshore is between 100bp to 120bp higher than prior to the GFC, depending on the market from which the funding is sourced.

Since the start of the GFC, CBA has sourced more funding from offshore and the term of new wholesale funding transactions has been extended materially. For example, the Bank borrowed for 10 year terms in US and Europe for the first time in 2009 and 2010.

Spreads on long-term funding may narrow if the global economic and financial market backdrop moderates significantly, but spreads are unlikely to return to their pre-GFC lows any time soon. This is simply because investors are demanding a greater premium for risk and we have to pay the market price if we are to access this source of funds. Indeed, deterioration in the economic and financial market outlook may see long-term spreads widen again.

### ***2.2.4 Higher proportion of expensive long-term funding***

One of the consequences of the GFC is that banks have become more aware of liquidity risk, particularly following some of the collapses of major international banks. Consequently, the composition of Australian bank funding has been tilted towards more expensive funding sources that help reduce banks' liquidity risk (deposits, long-term funding and equity) and away from cheaper short-term funding.

At the same time, regulators are introducing new regulations to reduce liquidity risk. The final calibration of the new liquidity rules by APRA is yet to be determined. One of the implications from the new rules will be that a higher proportion of bank funding will come from equity, long-term funding and deposits and a higher proportion of low yielding liquid assets will need to be held. The benefit from these changes will be a safer financial system, but it will also mean higher bank funding costs.

Another result of the GFC is that there has been a change in the composition of investors that buy bank paper away from banks, special investment vehicles (SIVs) and hedge funds and towards long term investors such as fund managers, pension funds and insurance companies. To meet this change in demand by the investor base, banks have had to issue more expensive longer-dated bonds.

The impact of higher term wholesale funding will continue to impact the Bank's overall funding cost as we replace cheaper pre-GFC funding with new and currently more

expensive long term bonds. Over 2010, while the market cost of new term wholesale funding has moderated from the high levels of 2009, the average cost of our term wholesale debt portfolio has continued to increase as new, more expensive funding replaces older, cheaper funding.

### **2.2.5 Higher hedging costs**

The Group (along with the other Australian banks) hedges the foreign exchange risk from offshore borrowing in order to deliver AUD funding to its customer base. Implementing the hedge removes the risk that large swings in the AUD exchange rate can lead to potential significant losses on offshore borrowing.

Hedging the AUD exchange rate removes a significant risk to banks but comes at the expense of increasing bank funding costs. Indeed, hedging the currency risk of offshore borrowing neutralizes any optimal benefit of borrowing in a low interest rate currency (e.g. US dollar, Japanese yen). Typically the markets which banks used to hedge their foreign exchange risk have been liquid. But the volatility resulting from the GFC has led to these markets becoming less liquid. The result has been that the costs of hedging have risen for banks. Hedging costs are particularly relevant for Australian banks given their large offshore funding requirements.

### **Summary**

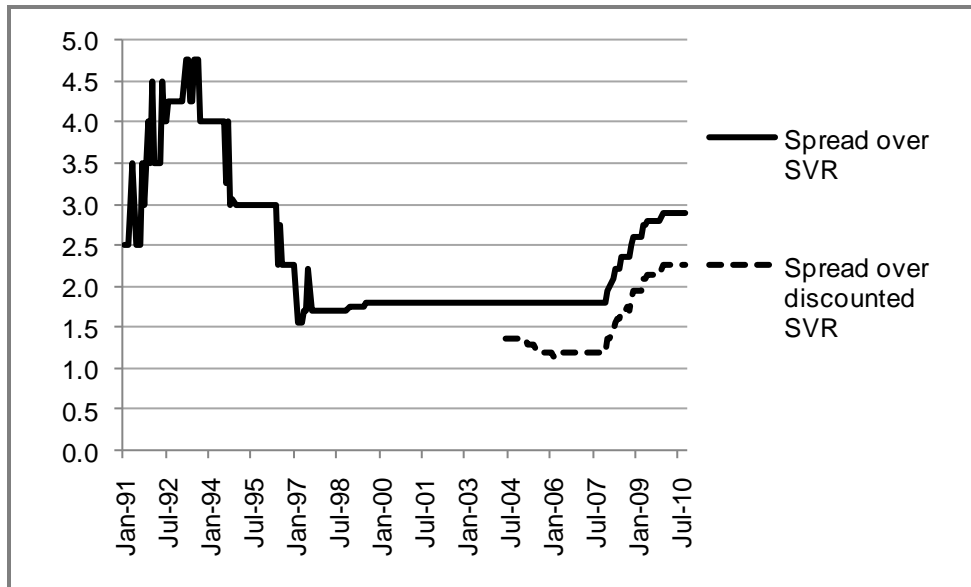
As noted above, there has been a sustained increase in the total funding cost for the Retail Bank, amounting to 1.35 per cent since the GFC commenced.

### **2.3 Bank funding costs and the cash rate**

The RBA noted in its June 2009 Bulletin article that, "*The relationship between the cash rate and the rate on standard housing loans was particularly close from 1999 to 2007, though in the longer sweep of history this period looks unusual.*" For example, using RBA data on the standard variable rate (SVR) mortgage and the cash rate indicated that the difference between the SVR and the cash rate widened in the early 1990s, before declining in the late 1990s.



**Figure 2: Spread between RBA cash rate target and standard variable rate mortgage (percentage points)**



Source: RBA

The observation that the cash rate and the SVR moved together between 1999 and 2007 hides a variety of factors.

- From the 1990s it became increasingly common for banks to offer discounts to new borrowers. With nearly 20% of mortgage borrowings being refinanced each year the increase in discounting has been passed to the bulk of home borrowers.
- Also, a growing composition of bank funding over that time period came from short-term debt markets and securitisation markets. In effect banks were reducing their cost of funding by taking on unsustainable levels of liquidity and funding risk – a practice that has now been reversed.
- Finally, banks were reducing their margins (as evidenced by declining NIMs), reflecting under-pricing of risk as many financial institutions expected strong economic growth and benign financial markets to continue.

### 3.0 Bank profitability

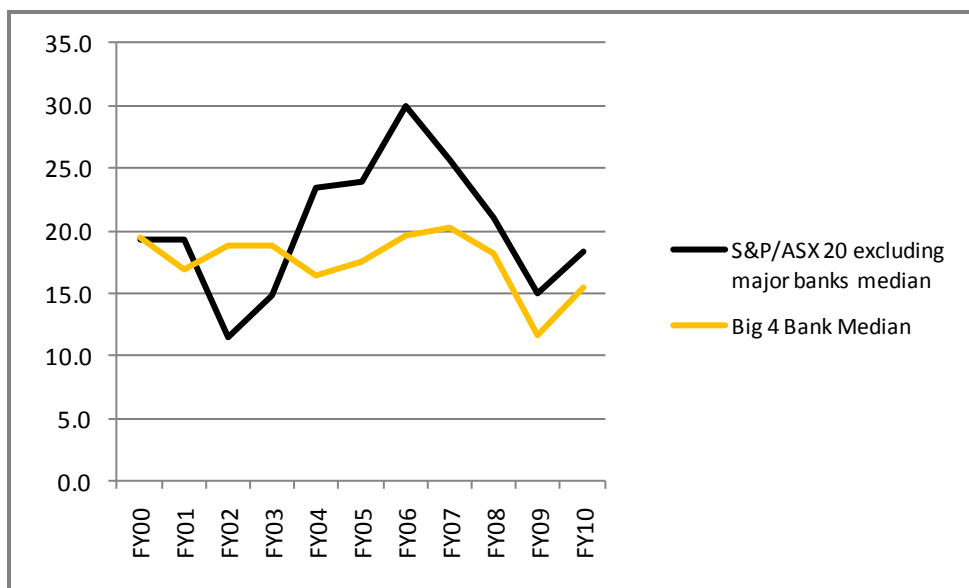
There has been much public commentary about bank profits. This commentary has tended to focus on either the size of the profit or the NIM. Focusing on either in isolation from other measures is misleading.

#### 3.1 Size of profit and how this translates to return on equity

The profit of the Group (and other Australian banks) is large. However, the Group operates on a very large asset base and competes for equity against other listed companies from within and outside the sector. Therefore a more rigorous measure of profitability is either Return on Equity (ROE) or Return on Assets (ROA).

Australian banks actually earn lower than average returns compared with other large, mature Australian companies. However, bank returns are more stable (Figure 3).

**Figure 3: Australian major banks have delivered a lower average, but more stable, return on common equity (%) compared with the S&P/ASX20 alternatives**



Source: Bloomberg, CBA

Note: Major banks defined as ANZ, CBA, NAB and WBC; S&P/ASX 20 average excluding major banks includes AMP, BHP Billiton, Brambles, CSL, Foster's, Macquarie Group, Newcrest Mining, Origin Energy, QBE Insurance, Rio Tinto, Suncorp-Metway, Telstra, Wesfarmers, Westfield Group, Woodside and Woolworths. Figures are normalised for major corporate restructures. For companies reporting with a December year end FY10 is an estimate

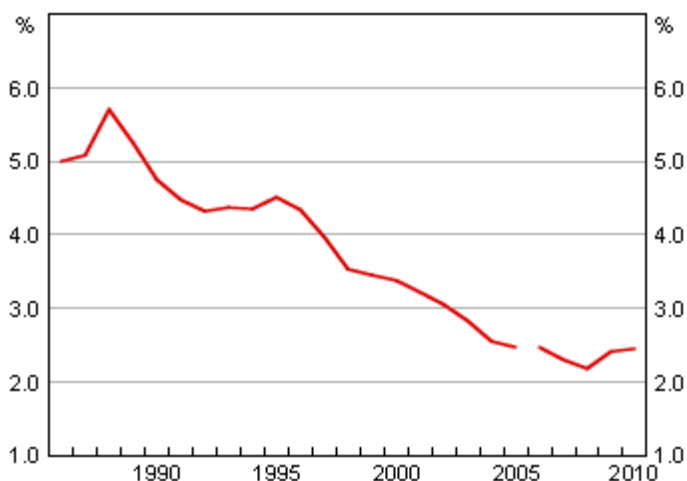
Another measure of profitability is return on assets (ROA). The Group's ROA on domestic banking is 0.7%-0.8%, which is low by Australian company standards.

It is therefore unwarranted to suggest that Australian major banks are earning excessive profits. Australian banks in 2010 generated ROE and ROA broadly in line with the thirty year average for the banking sector.

### 3.2 Net interest margins (NIMs)

Bank NIMs are defined as the difference between the average interest rate earned on assets minus the average interest rate paid on borrowings plus the benefit of interest free liabilities, provisions and equity. Below is a chart of major bank NIMs over the past 25 years (Figure 4).

**Figure 4: Major Banks' Net Interest Margin\* (Domestic operations, yearly)**

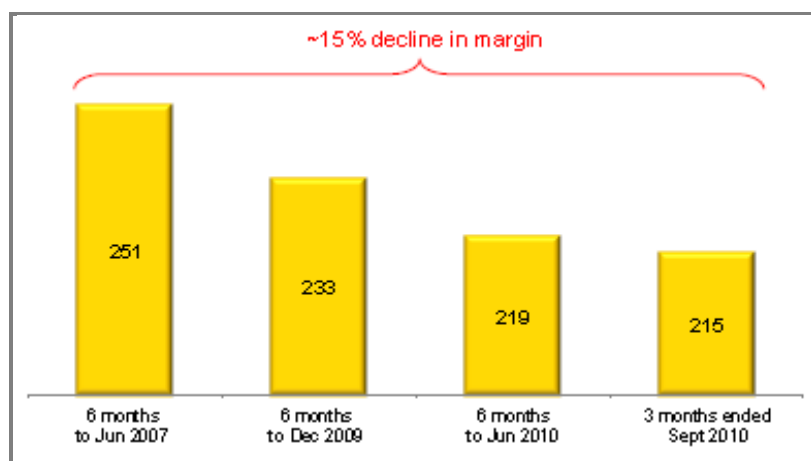


\* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis  
 Source: RBA

Bank NIMs have been on a long-term downward trend. While NIMs are now above the level prior to the GFC, the period immediately prior to the GFC is a poor standard of comparison since risk was not being properly priced then. Indeed the underpricing of risk globally was one of the causes of the GFC. From a broader perspective, NIMs are still nearly 100bp below the levels prevalent at the start of the last decade.

Retail banking NIM is an overall indicator of margins on personal banking products, across deposits and lending. Retail banking NIM has reduced by 15% between June 2007 and September 2010 (see Figure 5).

**Figure 5: CBA's Retail Banking NIM is 15% lower than pre-GFC levels**



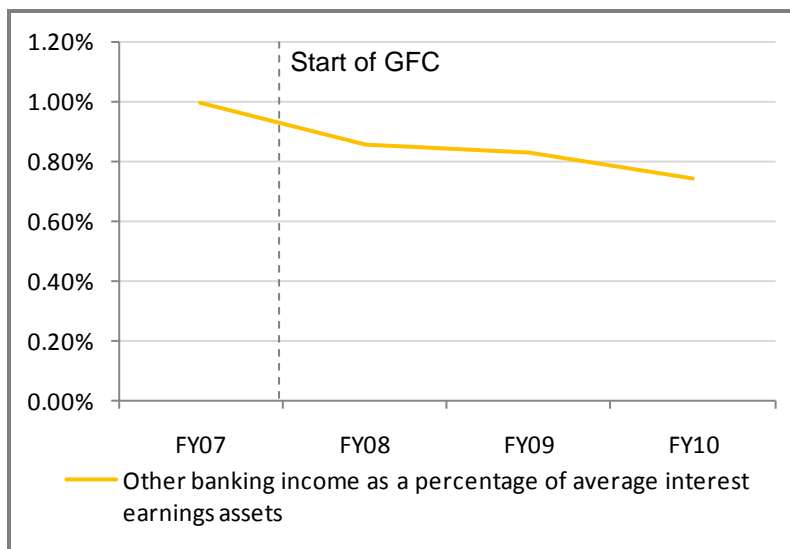
Source: CBA

### 3.3 Fees must also be considered in any discussion of profitability

Non-interest income is another important source of income for banks and must be considered as part of the picture of profits.

Within the Group's Retail Bank, other banking income (non-interest income or fees) as a proportion of assets has steadily decreased as we have continued to review and reduce the level of fees which we charge our customers.

**Figure 6: CBA's Retail Bank fee margin has also declined**



Source: CBA

As noted in Section 1, the Group waives monthly account keeping fees for just under 50% of our transaction account customers. We have also reduced exception and ATM usage fees to our retail and business customers by over \$200m in FY10.

## 4.0 Banking operates in highly competitive markets

Banks are a conduit or intermediary between savers and borrowers. Banks compete with a number of alternative intermediaries, including the stock exchange, superannuation and managed funds, and investment banks. As a result, there are strong competitive pressures in intermediation.

### 4.1 There is significant competition in both deposits and mortgages

On the saver side, the GFC sharply intensified competition. There was an initial flight of savings to banks (and exit of savings from, or slowing inflow into, the stock market and superannuation and managed funds) which, all other factors being equal, should have placed downward pressure on interest rates offered on deposits. However, intense competition amongst the banks for deposits as a funding source saw interest rates on deposits move up sharply (refer discussion in Section 2.2.1). Depositors have been significant beneficiaries from the GFC in terms of the margin received on their funds.

On the borrower side, it is worth making particular comment on factors driving the mortgage market as this market has attracted considerable attention in the lead up to this Inquiry.

There is significant evidence of strong competition in the mortgage market.

- There are around 100 mortgage providers (i.e. underwriters or manufacturers of the loans) currently operating in the market, extending well beyond the major banks. This number is well in excess of what most competition policy analysts would consider indicative of a competitive market.
- There is a wide variety of mortgage products from which customers can choose – variable or fixed rate, with a wide range of features from a basic account to offset accounts or redraw facilities.
- Reflecting the variety of products and providers there is a wide spread of interest rates and fees charged on mortgages. While a number of other mortgage providers have lower headline interest rates than CBA, they often also have significantly higher fees, especially deferred establishment fees which can run into the thousands of dollars.
- Brokers distribute about 40% of all new mortgages in the retail mortgage market. Their service proposition to customers is that they offer independent advice as to which mortgage would best fulfil the customer's needs across a range of mortgage providers. Brokers therefore add further competitive pressure to the retail mortgage market, directly benefiting customers.

The Committee should be aware that an assessment of price competition requires consideration of the discounting practices in this market. The vast majority of the Group's mortgage customers do not pay the headline standard variable rate (SVR), which is currently 7.81%. Many of our customers have their mortgage as part of the Group's Wealth Package, which ensures they receive a discount of up to 70bp off the SVR (reducing the interest rate to 7.11%). The Group also offers a basic variable product with an interest rate of 7.3% with a current introductory rate of 6.99% for the first 3 years.

The Bank is determined to be competitive in the mortgage market and when discounting is taken into account the Bank's price is well below that of many other financial institutions.<sup>5</sup> The Bank has offered a standard variable interest rate that has been consistently lower than the average of its major bank competitors and the lowest or second lowest standard variable interest rate amongst the majors.

#### **4.2 Barriers to entry to retail banking appear sufficiently low**

Another concept which is often used in analyses of competition is barriers to entry. These barriers appear to be sufficiently low in retail banking given the announced intention to enter or expand by a number of foreign banks (e.g. HSBC, Chinese and Indian banks which have access to offshore deposits) and the non-bank Yellow Brick Road.

The entry and expansion in the past decade by organisations such as ING Direct also suggests barriers to entry are sufficiently low.

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<sup>5</sup> A summary of all of CBA's mortgage products, and the terms and conditions, can be found at <http://www.commbank.com.au/personal/home-loans/home-loan-summary.aspx>

Rabobank is an important entrant in that it is a AAA-rated bank and is able to access the wholesale market more cheaply than the Group can as a AA-rated bank.

Most recently both AFG and Mortgage Choice have announced they will distribute their own mortgages.

#### **4.3 Mergers involving the Group during the GFC have ensured competition remains**

Other commentary leading up to this Inquiry has focused on the effect of banking mergers allowed during the GFC on the level of competition, such as the Group's acquisition of Bankwest (December 2008).

The Australian Competition and Consumer Commission (ACCC) considered the merger and concluded it was "unlikely to substantially lessen competition" in the relevant markets.

As part of the Treasurer's approval of the Bankwest acquisition (press release 18 December 2008), the Group is required to meet a number of conditions that support 'a strong and competitive Australian banking system' and, in particular, a requirement to maintain and grow the Bankwest brand.

Bankwest has shown it remains a competitive force in Australian banking and a clear alternative to the major banks since the Group's acquisition. No CBA or Bankwest branch or business centre in Western Australia has closed as a consequence of the acquisition. In fact, Bankwest has committed to an investment program to expand and refurbish its branch presence in Western Australia as well as on the east coast.

Bankwest has been able to continue to lend and offer competitive products and services to its customers, for example by launching the Bankwest Rate Cutter Home Loan which provides customers with a 0.4% p.a. discount off the standard variable rate and then an additional 0.1% p.a. discount each year for the next four years. Bankwest does not charge ATM disloyalty fees to its own customers for their use of other banks' ATMs.

Bankwest, like most Australian ADIs, relies on wholesale funding to supplement its retail deposit funding. Bankwest has been able to rely on the Group to fulfil that wholesale funding need, at the AA credit rating at which the Group can raise those funds.<sup>6</sup>

If the Group, or another institution, had not bought Bankwest the bank would almost certainly have collapsed and would not be in the market at all. This would have had a very negative impact on the entire Australian banking system, not the least in terms of perceptions of offshore investors.

#### **4.4 Account switching**

There is a perception that few customers switch banks. The reality, at least from the Group's experience, is different: a significant number of customers do switch.

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<sup>6</sup> Further information about the ACCC's merger assessment can be found in the Group's submission to the Senate Economics Committee's *Inquiry into Aspects of Bank Mergers* (refer to [http://www.apf.gov.au/Senate/committee/economics\\_ctte/bank\\_mergers\\_08/submissions/sub02.pdf](http://www.apf.gov.au/Senate/committee/economics_ctte/bank_mergers_08/submissions/sub02.pdf))

#### 4.4.1 Transaction and savings accounts

The Group opens and closes over 1 million personal transaction accounts a year, in the context of having over 5 million personal transaction accounts<sup>7</sup>. We open slightly more new accounts a year than we close.

The figures are even higher in relation to personal savings accounts. In the past year the Group has opened and closed over 1.7 million personal savings accounts, in the context of having nearly 5 million personal savings accounts.<sup>8</sup> Again, we open more accounts than we close.

It is not surprising that there is a higher level of account openings and closures for savings accounts than transaction accounts given the differing natures of the accounts. People tend to hold minimal balances in their transaction accounts and use their savings account to maximise interest earnings on any surplus deposit funds. The high degree of ease at which customers can, for example, shift funds into and out of online savings accounts enables them to move to the highest rate in the market.

These account opening and closure numbers show many customers change their personal bank accounts each year, contrary to popular opinion.

#### 4.4.2 Switching

Notwithstanding the fact significant switching already occurs, it is sometimes suggested that bank account numbers should be portable between financial institutions to enable greater switching activity. However, this is not possible under the current banking system infrastructure and changes to make account numbers portable would be extremely costly for business, government agencies and banks.

Account numbers are structured in such a way that it identifies the bank, branch and account number of the account held. This sequence of numbers is used for the processing of transactions between banks, domestically and well as internationally. The full set of numbers is required to ensure that payments are credited to, and debited from, the correct bank and account. (It is known, for example, that there can be the same account number at different banks belonging to different customers.)

The account number is also an integral part of how cheques and direct entry (credits and debits) are processed. The payments process in Australia does not have a centralised processing hub for direct entry which means that we have a multilateral payment processing service which is facilitated by the Australian Payments Clearing Association (APCA) called Bulk Electronic Clearing System (BECS).

As at June 2010, more than 254,000 organisations, ranging from government agencies and large corporations to small businesses, were registered as direct credit users, and over 19,000 organisations were registered as direct debit users. Over the last decade the

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<sup>7</sup> This comprises accounts closed due to customers moving their transaction account to another financial institution or accounts opened due to customers moving their transaction account to CBA (which together explain the majority of the over 1 million openings and closures), customers moving or returning overseas and ceasing to need to have an Australian ADI transaction account, and customers dying

<sup>8</sup> This comprises account openings and closures for the same reasons as transaction accounts and again the majority is due to customers switching from or to CBA

number of direct credit users has more than doubled and the number of direct debit users has more than tripled.

A change to the system of bank account numbers will undoubtedly result in extremely high costs for many of these users as they would have to change and retest their software for whatever changes were made to customer account numbers.

Sometimes calls for bank account number portability are likened to mobile phone number portability. However, there are important differences between the two sectors.

- When mobile phone number portability was introduced there were only a small number of mobile phone carriers, in comparison to there being well over 100 financial institutions.
- Those telecommunication companies had much newer technology systems (which could be more easily adapted) than do many financial institutions. Many of the financial institution systems have been integrated into a complex payment system for 20 years or more.<sup>9</sup>
- Payment systems are also far more highly integrated into a range of other systems throughout the economy than telecommunications systems.
- Prior to the introduction of portability of mobile phone numbers, all telecommunication carriers issued numbers in the same format of 04XX XXX XXX. Financial institutions use a wide variety of account number formats and check digit routines, some of which may be incompatible with the IT systems of other financial institutions.
- Requiring financial institutions to relinquish control of their accounts to other institutions would attract significant fraud risk, including systemic fraud by criminal organisations.

The submission by APCA provides a detailed discussion on these issues.

#### **4.4.3 Mortgages**

The Group opens and closes over 400,000 mortgage accounts a year, in the context of having over 1.4 million mortgage accounts.

The average length of time a customer holds their mortgage with their financial institution is currently 4-5 years. This suggests that many Australians reconsider their mortgage provider at least a few times, if not more, during their lifetime.

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<sup>9</sup> Telecommunications carriers' more modern systems had only two relatively simple functions, being to switch phone calls and SMS messages, with relatively low risk, and with no need to change processes for the sender or receiver of phone calls or SMS messages. In contrast, payments processing involves multiple systems with a wider range of complex processes and various payment messages used for cheque, Direct Entry and Real Time Gross Settlement transactions. The complexity and risk of simultaneously changing all of those payment systems and processes is not comparable to the experience of telecommunications carriers



There are many factors which influence the average length of time a customer has their mortgage with their financial institution. It is very important to note that brokers are extremely active in the secondary market for mortgages (i.e. refinancing).

The existence of mortgage early exit fees (or deferred establishment fees) is one commonly cited factor. We note ASIC's recent Regulatory Guide on these fees to ensure the fees are not "unconscionable" and not "unfair". The Group also notes the legitimate role mortgage early exit fees can play. They:

- compensate mortgage providers for the usually waived loan establishment fee, which represents a significant cost to financial institutions; and
- ensure mortgage providers are not exposed to the cost of any unanticipated asset-liability mismatch which can arise if a customer repays their loan early.

In this way mortgage early exit fees can be a responsible business practice. The Group's fee of \$700 (which is payable for the first four years only) is towards the lower end of the market.

Other reasons why customers switch mortgage providers fewer times than say their savings account provider are:

- the significant legal fees and State government taxes and charges which can be involved (and can run into the thousands of dollars);
- the need to complete a new credit assessment when a new loan is established. Mortgagees may be reluctant to do this, especially if, for example, their income has decreased or their property value has decreased; and
- the potential need to take out a new mortgage insurance policy at the provider they switch to. Mortgage insurance is typically required for loans which are 80% or more of the property value (i.e. loan-to-valuation ratio of at least 80%). It is not portable. The cost of mortgage insurance varies with loan size and, like legal fees and State government taxes and charges, can run into the thousands of dollars.

## **5.0 Competition in small business lending and deposits**

Business banking has been an area of growth and competition for the banking sector with most banks having grown their services to, and staff in, business banking. Business banking is one of the Group's five key strategic priorities and it is the only priority that is specific to a line of business.<sup>10</sup>

The Bank has invested significantly in business banking by:

- providing our customers with over 60 business banking centres across Australia with the full range of financing, working capital, transactional and merchant solutions;

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<sup>10</sup> The other strategic priorities include: Customer service; Technology and operational excellence; Trust and team spirit; and Profitable growth. Further information about each of these strategies can be found at <http://www.commbank.com.au/about-us/>

- locating business banking specialists in 23 new business banking centres;
- placing more than 170 business bankers in local branches;
- continuing to identify opportunities to re-locate and/or decentralise business banking resources within the existing branch network; and
- providing businesses with 24 hour/7 day access to business bankers, who are located Australia-wide, through a market leading telephony platform.

Along with our business banking focus, the Bank's highest priority is to ensure that our customers experience excellent service during their interactions with us. Since 2006, we have achieved the fastest growth rate of the major banks in business customer satisfaction.<sup>11</sup> We have also achieved and maintained equal first position in business customer satisfaction among the four major banks.<sup>12</sup>

### **5.1 CBA is a strong lender to small businesses**

The Commonwealth Bank has lent, and continues to lend, to credit-worthy small businesses, with lending growth well in excess of the market. The Bank has over 130,000 small business customers and is a major provider of small business loans with \$26.8b outstanding in loans and asset finance facilities.<sup>13</sup> New business lending remains strong with CBA advancing \$7.7b to small sized businesses in the year to 30 June 2010.<sup>14</sup> The Bank increased its total outstanding loan balances to small business customers by 13% from July 2008 to June 2010. During the same period, bank lending to businesses has contracted by 2.5% for loans under \$2m per APRA/RBA reporting.

Importantly, the Bank has not made any material changes to its lending policies for small businesses since the financial crisis commenced. Our business lending approval rates have not changed before, during nor after the financial crisis. This is despite other competitors exiting or scaling back their lending to the small business market.

### **5.2 CBA pricing is competitive**

The strength in the Bank's lending to small businesses and commitment to this sector can be demonstrated by the Bank reducing small business interest rates more than any other major bank.

The Bank's residentially secured business loan reference rate – the product that is most comparable to the retail home lending product – is currently at 8.31%.<sup>15</sup>

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<sup>11</sup> According to the TNS Business Finance Monitor, April 2006 - April 2010

<sup>12</sup> According to DBM Business Financial Services Monitor, March - October 2010

<sup>13</sup> As at 30 June 2010. Small business loans are defined consistently with the APRA monthly reporting (i.e. client loan balances less than \$2m). Asset finance includes asset finance provided to small businesses in our Local Business Banking and Regional & Agribusiness segments

<sup>14</sup> This includes business loans and asset finance facilities. Small business loans are defined consistent with RBA and Australian Prudential Regulation Authority (APRA) monthly reporting (i.e. client loan balances less than \$2m). Asset finance includes asset finance provided to small businesses in our Local Business Banking and Regional & Agribusiness segments

<sup>15</sup> As at 15 November 2010

This reference rate has been the most competitive rate among the big four banks for the year to October 2010, with the Bank actively advertising this rate within the community in national and metropolitan newspapers. Even after the November 2010 rate changes, and notwithstanding the fact that one of our competitors has not announced a change to their comparable rate at the time of preparing this submission, our rate remains second lowest in the market. Since the RBA's cash rate peaked in July 2008 and taking into account recent increases, CBA has reduced its residentially secured business reference rate by a net 1.58 percentage points. Over the same period, comparative rates by other major banks have reduced by an average of only 0.94 percentage points.<sup>16</sup>

Small business customers have benefited from the Bank's interest rate decisions as we have limited any increase in the cost of funds to small businesses. This is despite the Bank facing continual pressure on its cost of funds since the credit crisis commenced (as discussed in section 2).

In the case of commercially-secured small business lending, it is more difficult to compare pricing amongst the major banks because approximately 95% of customers are individually risk-rated and priced at a margin above or below the published reference rate. The reference rate in isolation is therefore not a very meaningful basis for comparing competitive pricing for commercially-secured loans. It is relevant, however, to compare the relative changes to reference rates because all loans linked to that rate will experience the same change in their pricing. In this regard, CBA believes our recent pricing decisions to undercut major competitors underlines the Group's commitment to the small business sector.

A view has been expressed that price competition is weak in the small business sector. CBA does not believe this to be the case and points to some of the Bank's advertising campaigns since the GFC which have been very specifically price-based. These campaigns were very significant and the Bank has spent a total of over \$2m in lending campaigns over the last 12 months. This kind of price-led above-the-line advertising is not typical of an industry with weak competition.

Furthermore, competitive forces in the industry have systematically eroded risk premiums and returns on capital. The Bank's margins for commercial lending have shown a long-term declining trend, with a 23% reduction in margins from the peak in 2002 to 2007. One of the key outcomes of the GFC was to highlight the true costs and risks inherent in lending, which drove up the cost of liquidity and capital.

Since 2007, commercial lending margins have increased by 11% as the Bank has priced risk more appropriately. Despite this increase, margins remain well below the levels of the early 2000s as competition remains strong. Also, as noted earlier, the period immediately prior to the GFC is a poor comparison since pricing was not sustainable in that period.

### **5.3 There is significant competition in small business deposits**

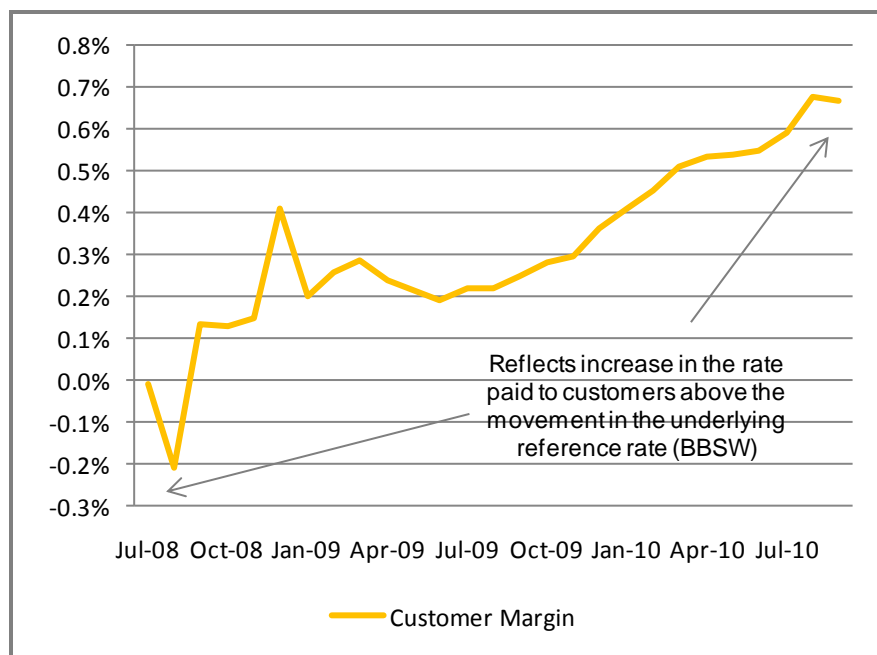
On the deposit side (transaction banking, savings and term deposits), competition continues to be strong.

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<sup>16</sup> To enable a consistent historical comparison, comparative rates for other banks are based on the residentially secured products offered from July 2008; some of these have recently been closed for new business

The margin paid to customers (that is, the difference between our funding costs and the deposit rate offered to our customers) on our business term deposit product (Cash Deposit Accounts) has grown significantly in the period from July 2008 to October 2010, as shown in Figure 7.

**Figure 7: Margin paid to SME deposit customers**



Source: CBA

The competition for transaction accounts has been intense and has been delivered via increased functionality and bundling of prices across multiple products. The Bank has competed aggressively in this area, having run advertising campaigns since the GFC on small business deposits to over \$3m over the last 12 months.

The merchant acquiring market is also highly commoditised, with margin compression increasingly prevalent. The RBA has reported average merchant service fees fell 59bp from 2003 to 2010.

#### 5.4 CBA supports small businesses in many ways

The Bank launched a range of initiatives to further support small businesses in the midst of the financial crisis. These initiatives included the business 'health check', the Small Business Investment Package, asset financing stimulus and risk management solutions. Further information regarding the Bank's initiatives is contained in our submission to this year's Senate Inquiry *Access of Small Business to Finance*.

We have also significantly invested in online and systems enhancements (CommBiz and NetBank online channels) and continue to invest in replacing our core banking platforms.

The investment in on-line capability has enabled small business and other clients to take advantage of more cost effective and timely processing. It also empowers small business people to transact with the Bank outside core business hours, freeing up time to invest in their business.

As of 31 October 2010 the Bank has installed 16,425 contactless payment readers across Australia almost exclusively in small to medium sized businesses. The readers have been installed free of charge by the Bank with all costs, approximately \$2m, met by the Bank on behalf of the small and medium business sector. The benefits of contactless payments to the recipient businesses include faster transaction processing and reduced cash handling expenses.

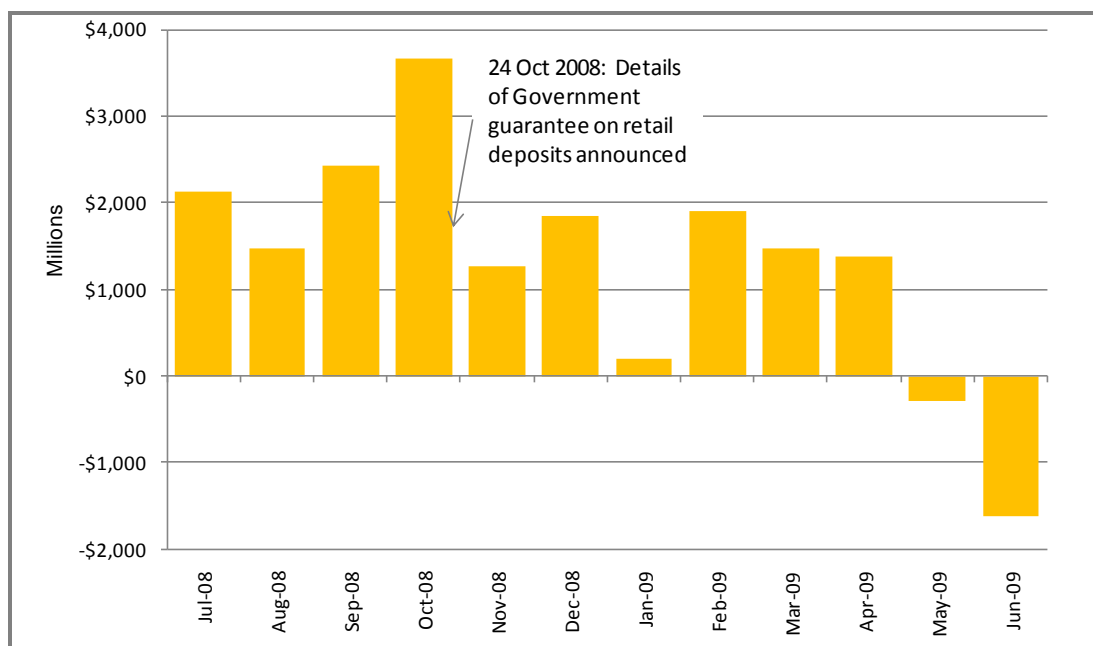
## 6.0 Government Guarantees

The Bank welcomed the introduction of the Government guarantee for customer deposits as the extent of the domestic impacts of the GFC became apparent. Our strong belief is that the Government response to stabilise consumer confidence in the smaller institutions and the wider banking system was decisive and correct.

Likewise the introduction of the bank wholesale funding guarantee to support bank borrowing in order to keep credit flowing to the Australian economy was necessary in the face of widespread sovereign support for other banking systems around the world.

However, there is a public misconception that taxpayers “bailed out” banks such as CBA and protected it from failure. This is not correct. Indeed the strength of this Bank allowed it to step in and provide a sustainable future for Bankwest as the crisis was taking hold. Moreover, as Figure 8 indicates the introduction of the deposit guarantee stemmed a flight to quality of deposits to CBA that had begun with the advent of the crisis. The rapid build up in CBA’s deposit book was curtailed once the Government agreed to protect depositor funds irrespective of the risk rating of the financial institution.

**Figure 8: Impact on CBA of Government guarantee on retail deposits (change in spot balances)**

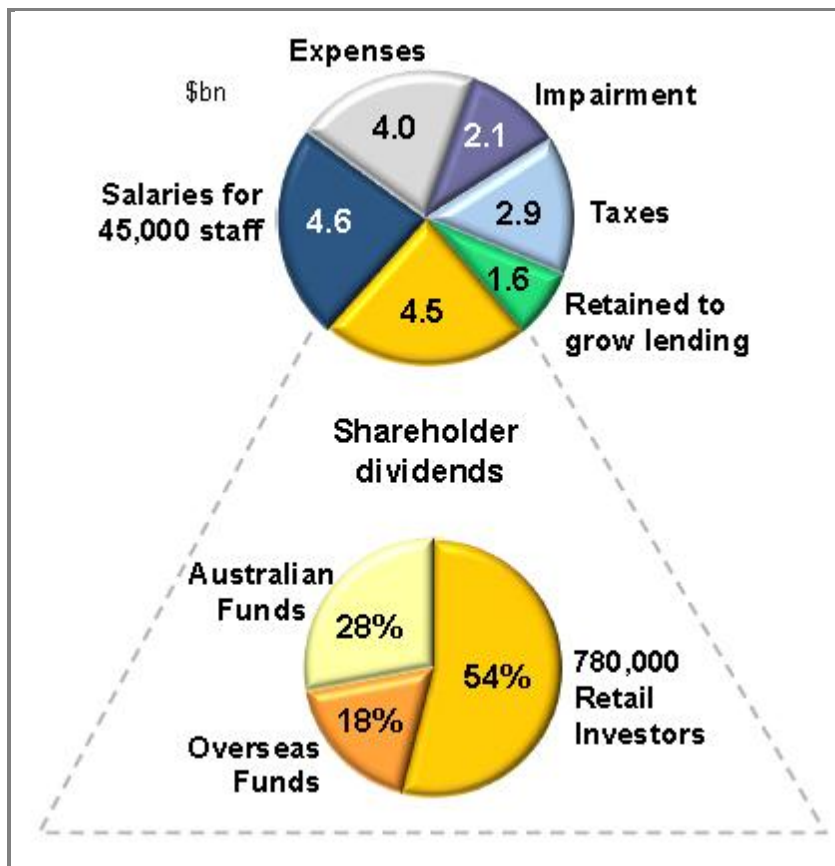


Note: The growth in Dec 2008 and then again in Feb, March and April 2009 was influenced by the Government stimulus payments which were made in these months and largely spent in the following months. Retail deposits are household deposits as defined by APRA

Source: CBA

The wholesale funding guarantee did assist the Bank (and competitors) maintain access to offshore funding to fulfill the Government's objective of keeping credit flowing to the Australian economy. Access to the Guarantee was not free. The Bank has paid \$331m to the Government to date for the guarantees (almost all of which is for the wholesale funding guarantee) and estimates it will have paid over \$910m by the time of the wholesale funding guarantee's expiry. It also provided an alternative income source for the Government, with over \$5b in fees expected to be raised over the life of the wholesale funding guarantee from banks using that guarantee.

## Attachment 1: Distribution of CBA's income in FY10



Source: CBA