Deloitte Access Economics

Competition in Banking

Abacus—Australian Mutuals

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Deloitte.

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12 June 2012

Dear Mark

Competition in Banking – Final Report

Please find attached our final report on *Competition in Banking*.

Thank you for the opportunity to work with you on this important project.

With kind regards.

Yours sincerely,

Professor Ian Harper
Director
Deloitte Access Economics Pty Ltd

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ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ADI	Authorised Deposit-taking Institution
AOFM	Australian Office of Financial Management
APRA	Australian Prudential Regulation Authority
BS	Building Society
CGS	Commonwealth Government Securities
GBS	Greater Building Society
GFC	Global Financial Crisis
NIM	Net Interest Margin
PC	Productivity Commission
RBA	Reserve Bank of Australia
RMBS	Residential Mortgage Backed Security
TBTF	Too Big To Fail
WL	Wholesale Lender

Executive Summary

The Global Financial Crisis (GFC) upset the balance between stability and competition in the financial sector that had served Australia well for more than a decade. The non-banking sector, regional banks and foreign banks provided innovation, choice and a high level of customer service, forcing the major banks to respond in kind and also to reduce their net interest margins (NIMs).

The efforts of government and regulators to stabilise the financial system during the GFC favoured the major banks over smaller lending institutions. Major banks have capitalised on this advantage to make competitive gains, notably at the expense of wholesale lenders, but also smaller authorised deposit-taking institutions (ADIs).

Credit unions, building societies and customer-owned banks (mutuals) emerged from the GFC in reasonably good shape, due to their prudent lending standards and conservative attitudes towards risk. Their reliance on deposits rather than wholesale markets for funding minimised the impact of the crisis.

However, mutuals now find themselves at a competitive disadvantage to the major banks, resulting from increased funding costs and other impediments to competition. Addressing the distortions in funding costs and regulatory burdens between the major banks and the smaller lenders can help to restore competition in banking markets.

While the Government is keen to support smaller lenders, the regulatory framework, in practice and how the market responds to it, operates largely in favour of the major banks. For mutuals to provide effective competition, they need to be able to increase their market share. This will depend on their absolute access to funding, mainly deposits, the cost of funding and their access to regulatory capital and the cost of regulatory capital.

The GFC and subsequent developments in the financial system have affected the ability of mutuals to access funding competitively and therefore compete effectively against the major banks. Far from alleviating the advantage enjoyed by major banks, Government efforts to restore the competitive balance have, in some cases, favoured the major banks even further. For example:

- The major banks are implicitly guaranteed against failure due to their importance to the financial system. Perversely, this may encourage the major banks to undertake riskier lending. Estimates of the value of the 'too big to fail' guarantee vary between 10bps and 50bps.
- At face value, the Guarantee Scheme for deposits reassured bank customers that their deposits would be safe at large and small ADIs alike, regardless of their credit rating. Yet the cost of insuring large deposits was linked directly to credit ratings, enabling the AA-rated major banks to offer more attractive rates to depositors than smaller ADIs. Compounding the disadvantage, mutuals rely more on deposits and have more restricted access to alternative sources of funds than do the major banks.

- Stronger account switching arrangements promise to make it easier to switch lenders. However, the larger banks will be better placed to absorb the costs of managing any new system.
- The opportunity to issue covered bonds is beyond the reach of individual mutuals and feasible only for large groups of small lenders which reduces the efficiency of fund-raising through this channel.
- The further development of the retail bond market is promising but consumer protection requirements and lack of credit ratings may affect the ability of mutuals to issue bonds.
- Implementation of Basel III by APRA will have an impact on capital requirements for mutuals and their ability to meet these changes in the face of changes in economic conditions. The mutual model is mainly limited to obtaining funds to expand through retained earnings and cannot issue share capital.

The net result of these pressures is the need for mutuals to increase scale to lower their operating costs. Numerous mergers have reduced the numbers of mutuals in recent years.

Mutuals attract custom by providing a personalised service, often to specific groups of people or regions, and recycling profits to reduce costs across a limited range of products. They often service regional areas where banks are absent or present in a limited capacity.

The regulatory framework should acknowledge the value of the mutual structure in providing financial services, with its inherent strengths and weaknesses, and promote competitive neutrality so that it can compete unimpeded with the listed bank model. As such, the regulatory burden on mutuals should not be greater than for listed banks.

A banking system that is not competitive will have significant implications for consumers. Lack of competitive pressures will lead to higher prices for services, limited choice, and ultimately lower levels of borrowing and deposits for consumers. Without competition, there will also be weaker incentives for innovation and improvements in products/services. A diminished presence for mutuals will reduce choice and access to financial services in Australia. The major banks will become even more ‘too big to fail’.

That recent measures introduced to redress the competitive imbalance in banking have had so little impact shows how difficult a problem this is. The forces bearing on the Australian financial system have changed fundamentally since the GFC.

Restoring a more even balance between competition and stability in Australia’s financial system requires a fundamental review of the structure of the system and its likely evolution over coming years. Piecemeal intervention is unlikely to succeed when the landscape has changed so markedly.

It is time for the Government to commission a fully-fledged review of the Australian financial system along the lines of the 1996-97 Wallis Inquiry.

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1 Introduction

The aim of this report is to outline the current state of competition in the banking sector, and the key regulatory barriers faced by mutuals. The mutual model provides diversity in banking services, with a different service proposition. This improves competition and increases choice for consumers. The mutual model has continued to operate throughout the GFC, but the developments have affected the ability of mutuals to access funding competitively, which in effect has reduced their competitiveness. Furthermore, Government attempts to improve stability have improved conditions for banks, and further eroded the ability of mutuals to compete.

While Australia escaped largely unscathed from the Global Financial Crisis (GFC), there are still longer run implications for the financial system. In particular, the GFC:

- sharpened regulatory focus onto systemic risk leading to
    - increased government intervention in financial markets, with regulators setting up additional safety nets
    - a global agenda to reform financial regulation, which puts Australia under pressure to align with the emerging standards;
- diminished competition in domestic financial markets as
    - smaller lenders have retired or merged on account of their reduced ability to raise funds and at competitive rates; and
- upset the balance between competition and stability which had served Australia's financial system well for more than a decade.

Prior to the GFC, smaller lenders and foreign banks provided strong competition for the major banks. In its report on competition in the banking and non-banking sectors, the House of Representatives Standing Committee on Economics noted the following:

> *The increased pressure that the non-banking sector places on banks led to the banks emulating many of the new products that were being offered. The Australian Bankers' Association agrees that foreign banks and the non-banking sector forced the banks to 'accept reduced margins and to roll out new technology and new products, and to otherwise respond to competitive pressures'.*

While the Government is attempting to restore competition in Australia's banking and financial system, questions remain about how to achieve this. In its incoming government brief, the Australian Treasury emphasised the 'clear need for a comprehensive review of the financial sector regulatory framework' (Australian Treasury 2010a).

Treasury identified several reasons for recommending such a broad-ranging review:

- the GFC highlighted the vulnerability of Australian borrowers and some retail and wholesale investors;
- systemic risk originating from outside the prudentially regulated sector played a key role;

- existing concerns about competition in financial markets have been exacerbated through consolidation and the exit of significant market participants; and
- international regulatory agencies are proposing far-reaching reforms to which Australia, as a party, is committed.

In its *Competitive and Sustainable Banking Reform* package, the Government supported the creation of a 'fifth pillar' to promote competition in banking, comprising credit unions, building societies and mutual banks (mutuals).

There is bipartisan support for reform to improve competition in the banking and financial system. The report of the Senate Inquiry on competition within the Australian banking sector released in May 2011 noted that the net effect of the GFC was a more concentrated banking market. The report made a number of recommendations, including a broader inquiry into the financial system to investigate means of increasing competition.

The Inquiry's own recommendations include:

- lowering barriers to customers switching between financial intermediaries;
- measures to ensure that smaller lenders have wider access to funds;
- measures to increase the number of competitors in the system, including foreign banks and other financial intermediaries;
- greater disclosure of information to make the banking market more competitive; and
- re-considering the ban on mortgage exit fees.

A thorough review of the financial sector would provide the scope to explore competition issues more thoroughly. Australia has not undertaken a comprehensive review of the financial system since the Wallis Inquiry in 1997.

The remainder of this report is structured as follows:

- Chapter 2 outlines trends in lending markets with a special focus on lending for housing;
- Chapter 3 analyses changes in funding costs as a result of the GFC and how these have varied between the major banks and smaller lenders;
- Chapter 4 focuses on the implications of trends identified in Chapters 2 and 3 for the profitability of various lenders;
- Chapter 5 describes some of the other obstacles to competition, along with the government measures implemented following the GFC and their impact on lenders; and
- Chapter 6 concludes the report with some observations on the need for a major review focussing on means of re-establishing a proper balance between competition and stability in Australia's financial system.

2 Conditions in lending markets

A range of quantitative and qualitative indicators can be used to assess the state of competition in banking, including:

- market share;
- product innovation;
- pricing;
- profitability; and
- market contestability (Treasury 2010a)

These are discussed in the following sections.

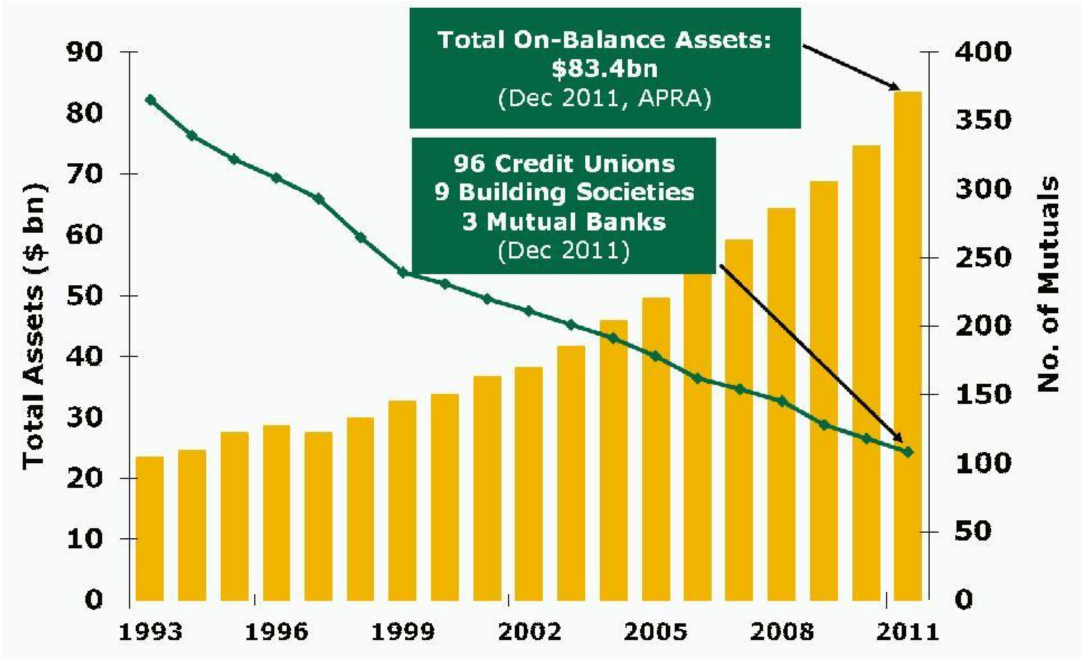
2.1 Types of lenders

Following financial deregulation in the 1980s, a wide range of lenders emerged in the Australian lending markets. In addition to the major banks and smaller banks, such as Bendigo and Adelaide Bank and the Bank of Queensland, a number of foreign banks also operate in the Australian market.

Mutuals also play a significant role in the Australian lending markets. Credit unions, building societies and mutual banks differ from listed banks in that they are not publicly listed and have a mutual structure where customers are also owners of the organisation. An inherent characteristic of the mutual model is that it is limited to obtaining funds to expand through retained earnings and cannot issue share capital.

The number of mutuals fell from 114 credit unions in 2009 to 92 in 2012, and from 14 building societies in 2005-06 to 9 today, along with 6 mutual banks. The pressure from rising funding costs has forced consolidation among mutuals (Chart 2.1), and even demutualisation. Continuing this trend, recently State West Credit Union was acquired by the Bank of Queensland.

Chart 2.1: Trends in consolidation for credit unions and building societies



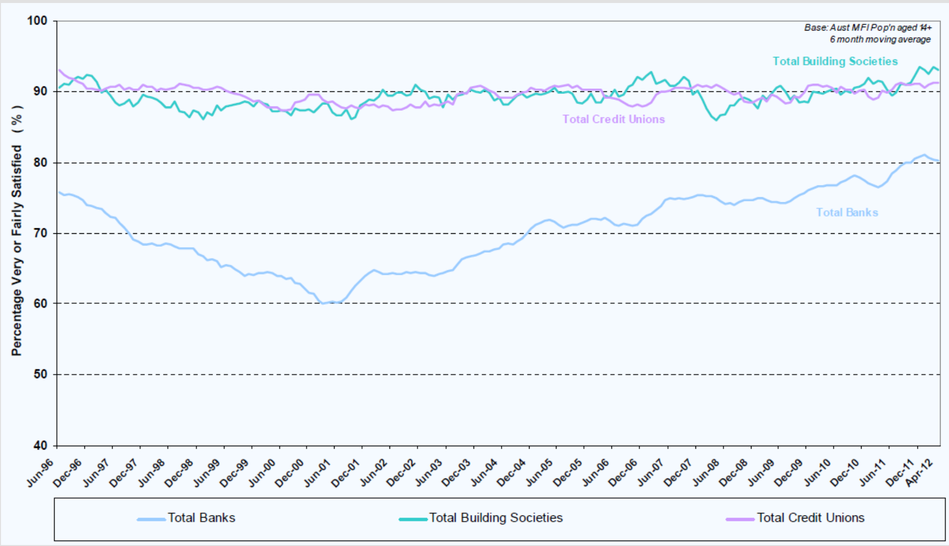
Source: ABACUS.

The mutual model

The mutual model has a long tradition of providing financial services. Mutuals provide diversity in banking services with a different service proposition that emphasises superior individual service, and increased choice for consumers.

Independent customer satisfaction surveys show that credit unions and building societies consistently and strongly outperform their major bank competitors in customer satisfaction. The most authoritative source of customer satisfaction data in the consumer banking industry is Roy Morgan Research. The graph below from Roy Morgan's April 2012 monthly report *Customer Satisfaction – Consumer Banking in Australia* shows that since 1996, 'Main Financial Institution Customer Satisfaction' for credit unions and building societies has consistently been around 90% while the same benchmark for banks has fluctuated between 60% and 80%.

Main Financial Institution Customer Satisfaction: Benchmarks, long term trends, June 1996 – April 2012



Source: Roy Morgan Research (2012).

The highest ranking institution in Roy Morgan's April 2012 report was Victoria Teachers Mutual Bank (trading as Victoria Teachers Credit Union until March 2012) with a customer satisfaction rating of 96.8%. This compares with the highest ranked major bank's rating of 77.7%. Other top ranking mutual banking institutions were Teachers Mutual Bank (93.7%), Newcastle Permanent Building Society (92.4%), Police and Nurses Credit Union (92.2%), Heritage Bank (90.8%) and Credit Union Australia (90%).

The consistently outstanding customer satisfaction performance of mutual banking institutions illustrates the strength and value of the customer-owned business model.

Retail deposits are the main source of funds for credit unions (about 90%) and building societies (about 70%). Banks, credit unions and building societies are collectively known as authorised deposit-taking institutions (ADIs).

Wholesale lenders operate by providing funds to borrowers through a retail intermediary such as a mortgage broker or in some cases a non-major bank. Wholesale lenders have typically relied on raising funds through residential mortgage backed securities (RMBS). Wholesale lenders competed actively with banks in the housing loan market prior to the GFC.

The main alternatives to banks in the commercial lending market are finance companies, general financiers and investment banks. Investment banks are often involved in providing business loans or investing in debt securities. Finance companies mainly borrow on financial markets through instruments such as debentures and then lend these funds to businesses and individuals. Financial leasing of fleet vehicles is often undertaken through finance companies.

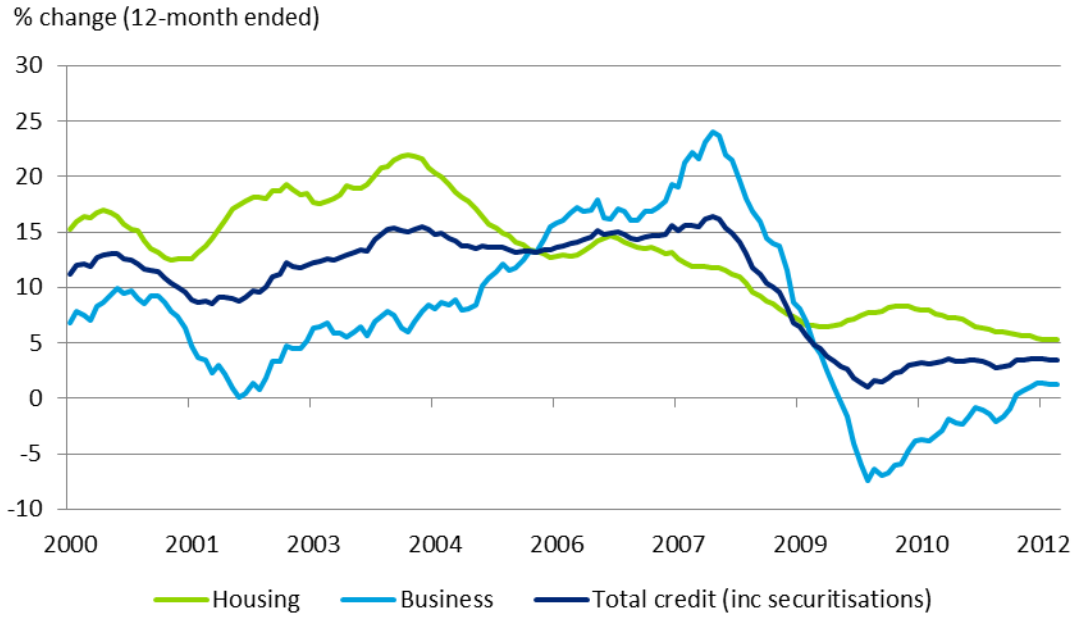
General financiers are funded by parent companies and are used to provide funding to subsidiaries or customers of the parent company. Other investment funds such as cash management trusts may also play a role in providing commercial finance.

There is competition among the major banks in the lending market, and the presence of the other lenders imposes additional competitive pressures, which in turn leads to competitive lending rates and encourages increased innovation.

2.2 Trends in the availability of credit

Between January 2000 and December 2007, total credit grew at an average annual rate of 13%, reaching 15.2% in December 2007. Since then, however, credit growth has slowed to an average annual rate of 5.3%, with the annual rate at 3.4% in March 2012, as shown in Chart 2.2.

Chart 2.2: Credit growth



Source: RBA.

Growth of business credit has been especially affected by the downturn in economic activity since 2007. While credit growth has slowed in general, business credit has actually declined since September 2009, although credit growth has picked up again since September 2011.

Prior to 2007 there was significant growth in housing credit, which grew at a faster rate than business and other personal credit. Demand for housing credit was facilitated by the increase in supply through new participants offering new products. These included:

- home equity loans, which were first offered in the mid-1990s and accounted for around 7% of owner-occupied housing loan approvals in 2010;
- low-doc loans, which made it possible for self-employed borrowers, or those with irregular incomes, who lack the documentation required for standard loans, to access housing credit—these also account for around 7% of owner-occupied housing loan approvals;
- high loan-to-valuation ratio loans, which allowed borrowers to access housing credit with either a small or no deposit—especially important in allowing first home buyers to enter the property market;
- interest only loans, which are particularly attractive to investors; and
- niche products, including non-conforming, shared appreciation and reverse mortgage loans (RBA 2010).

Tighter lending standards since the GFC together with the demise of wholesale lenders have reduced the availability of these products.

Chart 2.3 shows the percentage of all dwellings financed by first-home buyers, a group targeted by policy makers for higher participation in the housing market and who benefit especially from innovation in lending. Following a sharp increase in late 2008 and through 2009, reflecting take-up of the Government's first home owner's grant, the share of first-home buyers in the housing market has declined.

This is the combined result of less generous first-home buyer's grants but also tighter lending conditions applying to first-home buyers as well as reduced availability of loan varieties aimed at improving first-home buyers' access to housing finance.

Chart 2.3: Share of first-home buyers in dwellings financed

Source: ABS 5609.0.

2.3 Trends in market share

The GFC produced a major shift in market share in favour of the major banks. Only large lenders were perceived as likely to be rescued by government should market conditions deteriorate.

In addition, increases in funding costs and the collapse of the residential mortgage backed securities market made it difficult for smaller lenders to fund themselves economically. Mutuals faced more intense competition for deposits from banks.

Major banks, on the other hand, were able to obtain government-guaranteed funding for their deposits at a lower cost than mutuals. Wholesale lenders were unable to raise funds. This led to an increasing concentration of market share in the hands of major banks, largely at the expense of wholesale lenders but also of mutuals, as evident in the lending for housing and business discussed below.

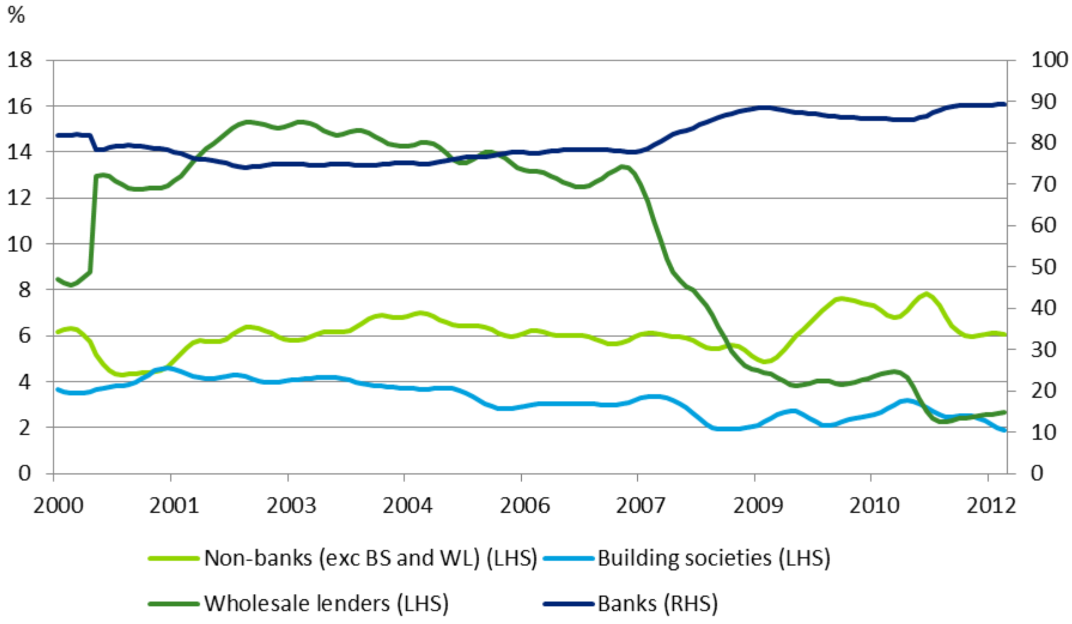
Since mid-2008 the major banks have increased their market share across all lending categories, recouping ground lost to other lenders prior to the onset of the GFC.

2.3.1 Lending for housing

Chart 2.4 illustrates how the market share of lending for housing changed after the GFC. The GFC led to a substantial shift in housing lending away from wholesale lenders (WL) towards the banks. Wholesale lenders lost market share by more than 10 percentage points between March 2007 and March 2012. The share of housing finance provided by the major banks grew substantially during the GFC, although this partly reflects the acquisition of BankWest by the Commonwealth Bank.

Mutuals have experienced relatively little change in their market share since the crisis, although other lenders also appear to have experienced some decline in market share. One of the reasons mutuals may have retained market share is that a relatively high proportion of their funding is met through customer deposits. That is, mutuals had relatively little direct exposure to the dislocation in capital markets with their financial strength more closely linked to their member's financial positions than developments in financial markets. That mutuals were unable to actually increase their market share despite their resilient financial positions indicates the presence of other obstacles to their growth.

Chart 2.4: Market share of new housing finance commitments



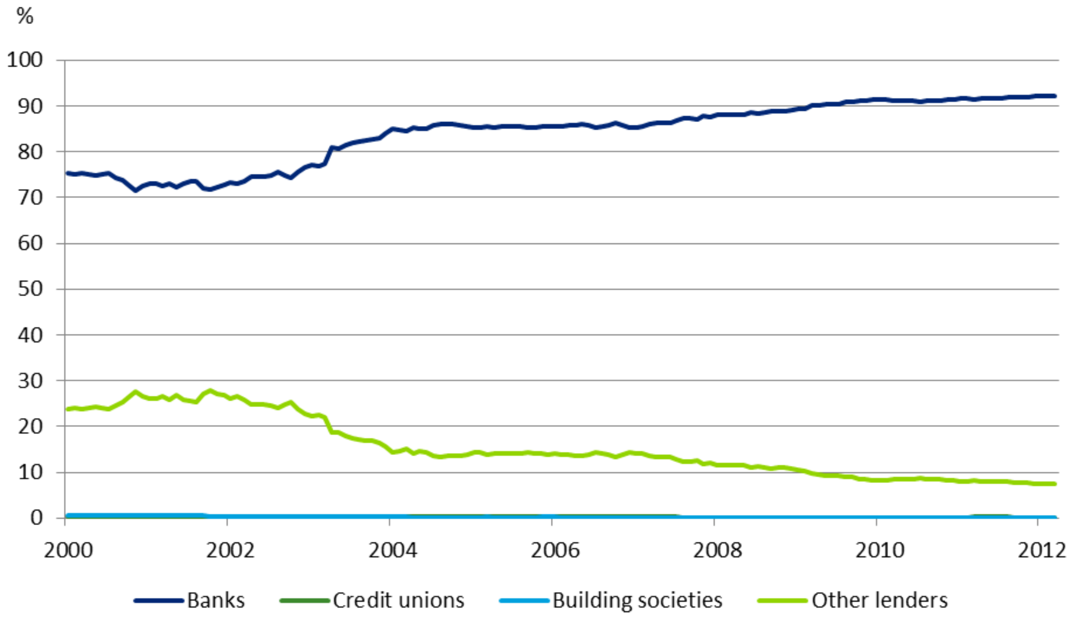
Source: ABS Cat. No. 5609.

2.3.2 Business lending

A shift of market share towards the major banks also occurred in the commercial lending market. The market share of the major banks rose significantly after the GFC from 86% in March 2007 to 92% in March 2012, at the expense of mutuals and other lenders, as shown in Chart 2.5.

The major banks' share of business lending has been increasing since the late 1980s, although it appeared to have levelled off from 2004 to 2006. Thus although the GFC appears to have played some role in increasing the major banks' share of commercial lending, part of the increase may reflect a long-term trend away from non-bank lenders for commercial financing.

Chart 2.5: Market share of business credit for banks and non-bank lenders



Source: RBA.

Note: Other lenders include finance companies and investment banks.

3 Funding costs

The changing market shares of the banks and non-bank lenders across all lending categories partly reflect changes in funding costs, in particular the major banks' ability to raise funds more economically than mutuals.

The GFC and the subsequent reassessment of risk have affected banks and non-bank lenders differently. Major banks have strong credit ratings and enjoy access to a broader range of funding sources. For the non-major banks, on the other hand, access to wholesale borrowing has been reduced and they have been unable to raise funds through securitisation.

Foreign banks have also had difficulty in accessing funds from their foreign parents as some were experiencing financial distress. Finally, non-bank lenders experienced most difficulty in raising funds as a result of the dislocation of the market for securitisation and the absence of a stable deposit base (Australian Treasury 2010a).

While funding costs have increased across all financial institutions, mutuals have experienced a relatively greater increase in costs compared to the major banks. Mutuals are largely unrated or BBB-rated making it difficult for them to access wholesale funding at a competitive cost compared to the major banks.

The ratings agencies reinforce the advantage that the majors have over smaller mutuals. Mutuals are largely unrated or, at most, have a rating of BBB/BBB+. This in turn affects the cost of raising funds through the wholesale market as well as access to and the cost of certain government initiatives. To be able to compete effectively, mutuals may find it necessary to increase their size through mergers/acquisitions.

Some mutuals do not see value in obtaining a credit rating even if they are large enough to do so. This is because access to wholesale funding is still expensive even with a credit rating. Furthermore any cost advantages through having a credit rating would be eroded by the requirements to obtain and maintain that rating.

Mutuals mostly rely on deposits, and the increased competition for deposits has raised the cost of this source of funds. However, major banks have gained the most from government support measures including the benefit of the 'too big to fail' guarantee, allowing them to offer more attractive deposit rates than mutuals while maintaining their NIMs.

3.1 Sources of funding

Australian banks rely on diverse funding bases. These include deposits, short-term and long-term wholesale debt, equity and securitisation. The composition of funding varies across the different types of banks.

Major banks rely more on deposit funding and long-term wholesale debt, while regional banks have a smaller share of deposits and offshore funding and rely more on securitisation. Foreign banks also have fewer deposits and draw more heavily on domestic and offshore capital markets.

Mutuals rely heavily on household deposits for the majority of their funding, although some also used securitisation prior to the GFC to raise funds. They do not have the scale to access offshore funding. Consultations suggest that between 30% and 50% of funding for building societies was raised from wholesale markets, primarily via securitisation.

Wholesale lenders do not have access to a deposit base and instead have typically used securitisation, usually residential mortgage backed securities (RMBS), to obtain funding.

Securitisation facilitated lending to borrowers on the strength of the assets secured rather than on the financial condition of the entity accessing the funds. As a result, many small ADIs and non-ADI lenders were able to compete on an equal footing with the major banks and offer a wider range of lending products to Australian consumers.

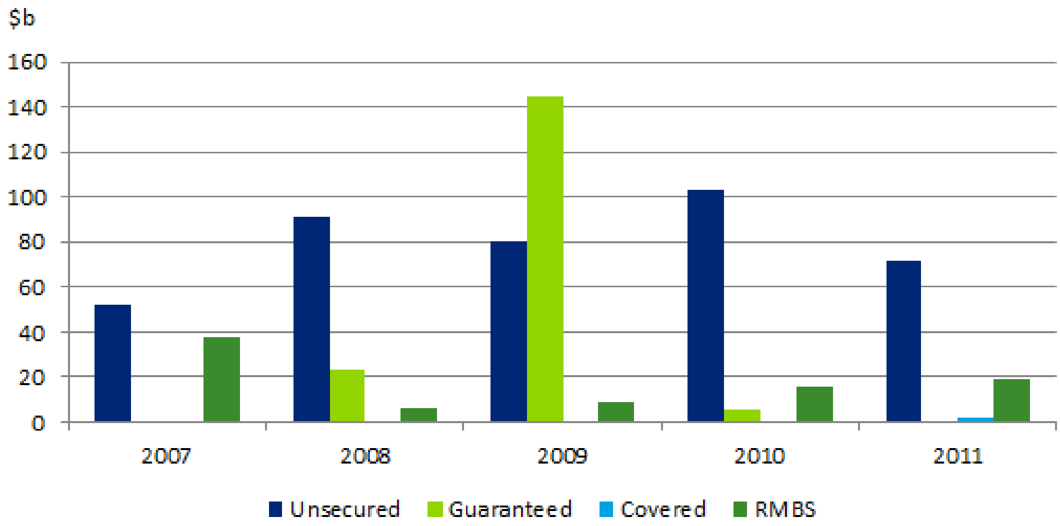
Securitisation has been a key factor reducing the funding costs for all mortgage providers, which benefited consumers through reduced borrowing costs and a wider range of competing providers to choose from.

Following the GFC and a general reappraisal of risk, the demand for RMBS and other asset-backed securities narrowed substantially, especially in offshore markets. As a result, access to cost-effective wholesale funding has been restricted, making it difficult for smaller lenders to compete.

3.2 Composition and cost of funding

The following chart shows the composition of bank RMBS and wholesale funding over the last few years. The share of unsecured funding actually increased between 2007 and 2011, reflecting a compositional effect. Some banks, particularly non-banks, were significantly more reliant on RMBS for their funding than the larger banks and, following the dislocation of the securitisation market, the larger banks now account for a much larger share of the financial sector in 2011 than in 2007 (RBA 2011d).

Chart 3.1: Australian RMBS and bank bond issuance



Source: RBA.

Following the implementation of legislation allowing for the issuance of covered bonds in October 2011, the major banks have raised more than $22 billion through covered bonds. While this is not yet a major source of funding, it provides yet another avenue for the banks to raise funds and, moreover, at longer terms, of 5 to 10 years, than are usually available for unsecured bonds, which are usually issued with maturities of 3 to 5 years (RBA 2012).

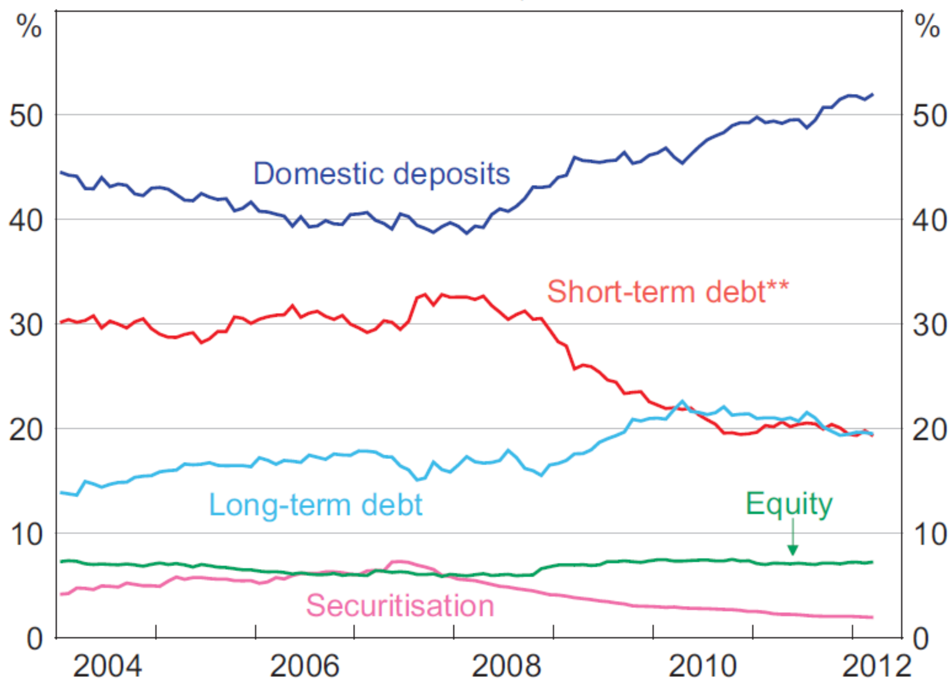
Leading up to the GFC, spreads on the various sources of funding remained stable, with movements in the cost of funding tending to follow the cash rate.

After mid-2007 the relative costs of deposits and long-term wholesale debt have been increasing. The composition of banks' funding has also changed, with banks relying more on these sources of funding than securitisation. As a result, banks' funding costs rose relative to the cash rate. The RBA estimates that by 2010 the average cost of major banks' funding had risen to around 90-100 basis points higher relative to the cash rate than it was in mid-2007 (RBA 2010). Smaller lenders including mutuals experienced an even greater increase in the overall cost of funding since their lower credit ratings have produced larger increases in the cost of deposits and wholesale debt.

Since mid-2011, deposit rates and yields on bank debt have been declining. However, this decline has been less than the decline in the cash rate over the same period. Therefore the weighted-average cost of funds relative to the cash rate has continued to rise (RBA 2012).

Chart 3.2 illustrates the change induced by the GFC in the composition of funding for Australian banks. With the reassessment of risk and regulatory and market pressures following the GFC, banks have increasingly relied on more stable sources of funding, namely deposits, particularly term deposits, and long-term wholesale debt, with a corresponding decline in their use of short-term debt and securitisation. Term deposits have accounted for most of the growth in bank deposits, and now account for around 45% of banks' deposits, compared to 30% in mid-2007 (RBA 2012).

Chart 3.2: Funding composition of banks in Australia (share of total, all banks)



* Adjusted for movements in foreign exchange rates

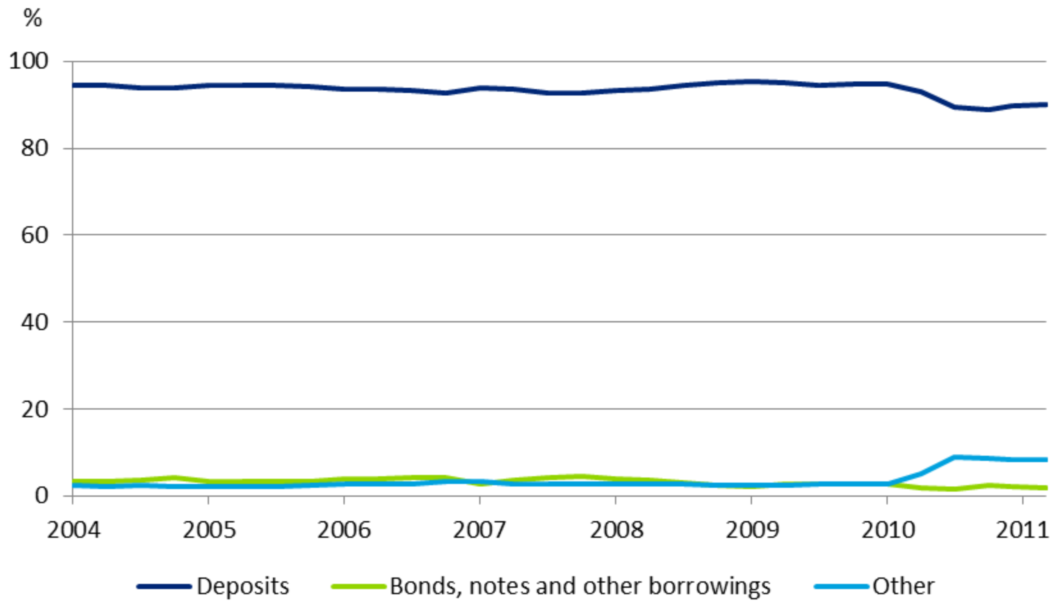
** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Source: RBA.

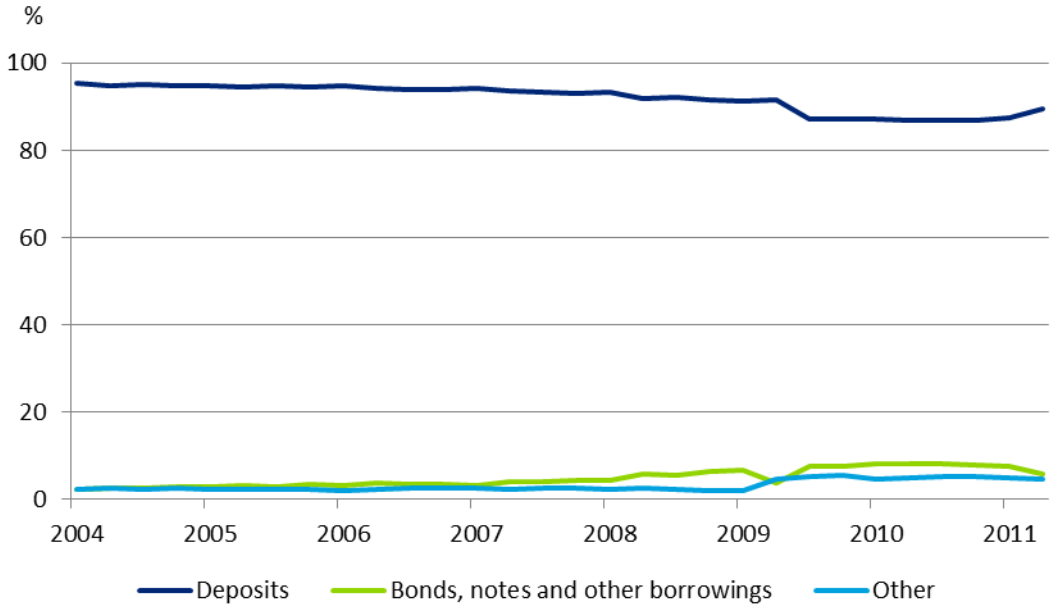
Credit unions and building societies, on the other hand, have seen a slight decrease in their reliance on deposit funding, although in both cases deposits remain the overwhelmingly major source of funds for lending. The slight but discernible reduction reflects heightened competition for deposits in the wake of the GFC. See Chart 3.3 and Chart 3.4.

Chart 3.3: Credit unions funding sources (share of total liabilities)



Source: APRA.

Chart 3.4: Building societies (share of total liabilities)



Source: APRA.

Table 3.1 shows how the funding composition for a major credit union has changed since before the GFC. While the share of total retail deposits has remained the same, there is an increasing reliance on term deposits, which increased from 34% to 49% of total funding between June 2007 and December 2011, following a trend similar to that for the major banks.

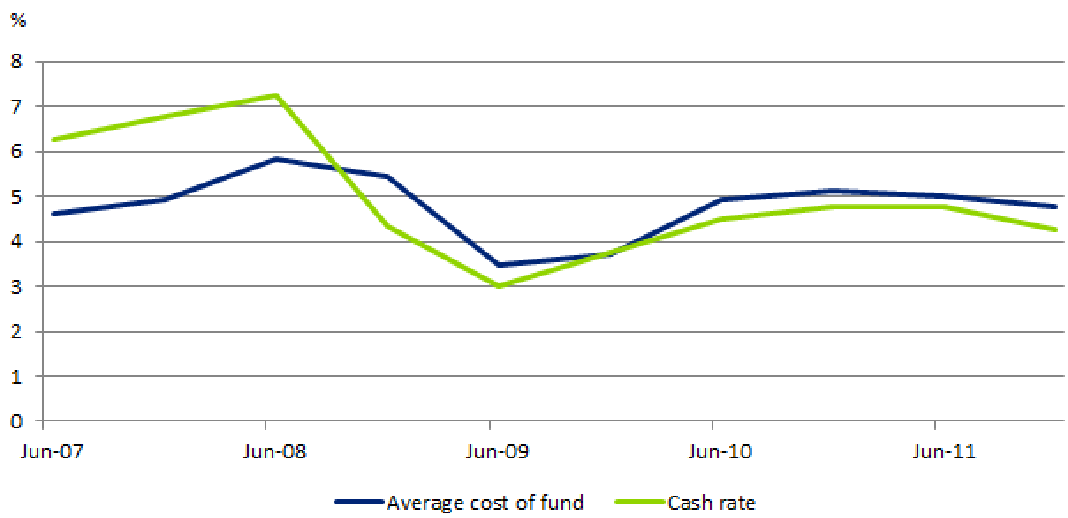
Table 3.1: Credit union's funding composition ($ million)

	June 2007		December 2011	
	$ million	**Share (%)**	**$ million**	**Share (%)**
Retail savings	764	57	1,277	40
Term deposits	453	34	1,570	49
Warehouse securitisation	107	8	127	4
Term RMBS	0	0	247	8
Borrowings	8	1	0	0
Total	**1,332**	**100**	**3,221**	**100**

Source: Community CPS. Note numbers may not add because of rounding.

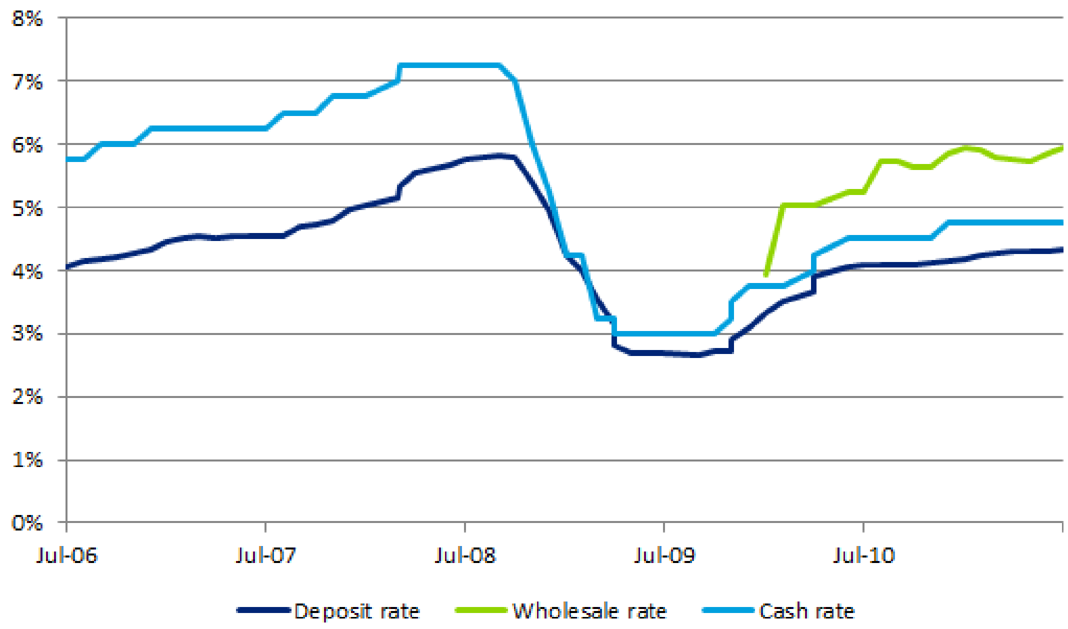
The changes in the funding composition have implications for the cost of funding as the relative costs of different sources of funding have changed. Each of these sources is discussed in more detail below, but the overall impact has been an increase in the cost of funds. This is evident in the cost of funding for a representative credit union (Chart 3.5) and a representative mutual bank (Chart 3.6). Both show that the cost of funding has increased relative to the cash rate.

Chart 3.5: Credit union's cost of funding



Source: Community CPS.

Chart 3.6: Mutual bank's cost of funding



Source: Bankmecu.

3.2.2 Deposits

Deposits have become increasingly attractive as a source of funding because of their stability and comparatively lower cost. This has heightened competition in the market for deposits. With access to offshore funding disrupted by the GFC, the majors have been placing more reliance on domestic retail deposits, and driving the price pressures for this source of funding for all players. The increase in the savings rate has helped the financial sector, particularly the mutuals, without which access to funding would have been even more difficult.

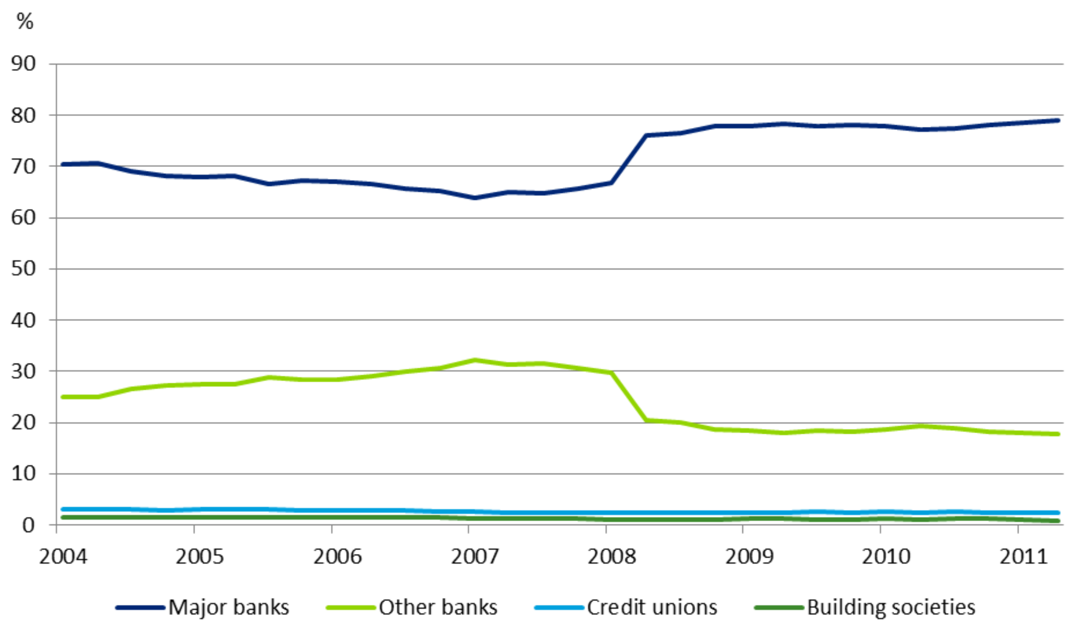
Chart 3.7 illustrates the relative market shares of various deposit-taking institutions, including the major banks, other banks, foreign banks, and credit unions and building societies.

While the major banks lost market share between 2004 and mid-2008, they have re-gained market share in the wake of the GFC. Some of this increase reflects the mergers of Westpac and St George, and the Commonwealth Bank and BankWest, which were themselves driven by the impact of the GFC on the funding costs faced by the smaller institutions.

The increased market share of the major banks also reflects a 'flight to quality' during and after the GFC since the major banks were perceived to be safer than other banks and non-bank lenders. This is in spite of the Government's Financial Claims Scheme having been introduced in October 2008 to counter such impressions.

For their part mutuals saw their share of deposits decline from 4.1% in June 2007 to 3.4% at the end of 2008, before recovering slightly to 3.7% at the beginning of 2011. It declined again, however, to 3.2% at the end of 2011, reflecting intensification in the competition for deposits in late 2011.

Chart 3.7: Shares of total deposits by lender type



Source: APRA.

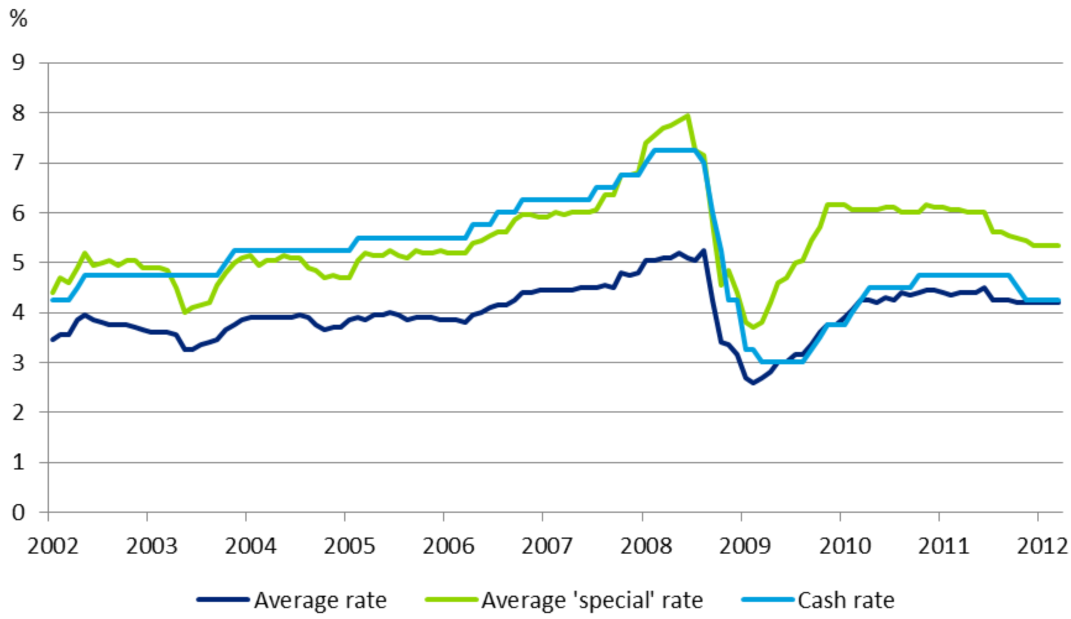
These trends in market share for total deposits are also evident for household deposits. Household deposits account for the majority of deposits for mutuals, and so they have a larger market share for household deposits at around 11.4%.

The increasing reliance on deposits as a source of funding has intensified competition for deposits, resulting in a rise in deposit rates. This has led to an increase in the average cost of new deposits relative to the cash rate.

Competition has been particularly intense for term deposits. This is reflected in the rates offered. In June 2007 the average rate paid on deposits was around 175 basis points below the cash rate, whereas now they are estimated to be only 5 basis points below the cash rate (Chart 3.8). This reflects increased competition for funds forcing ADIs to pay more for deposits.

A more relevant benchmark is the term deposit 'special' rates offered by ADIs. In June 2007 the average rate on banks' term deposit specials was 25 basis points below the cash rate but in April 2012 it was 110 basis points above the cash rate.

Chart 3.8: Average term deposit rates

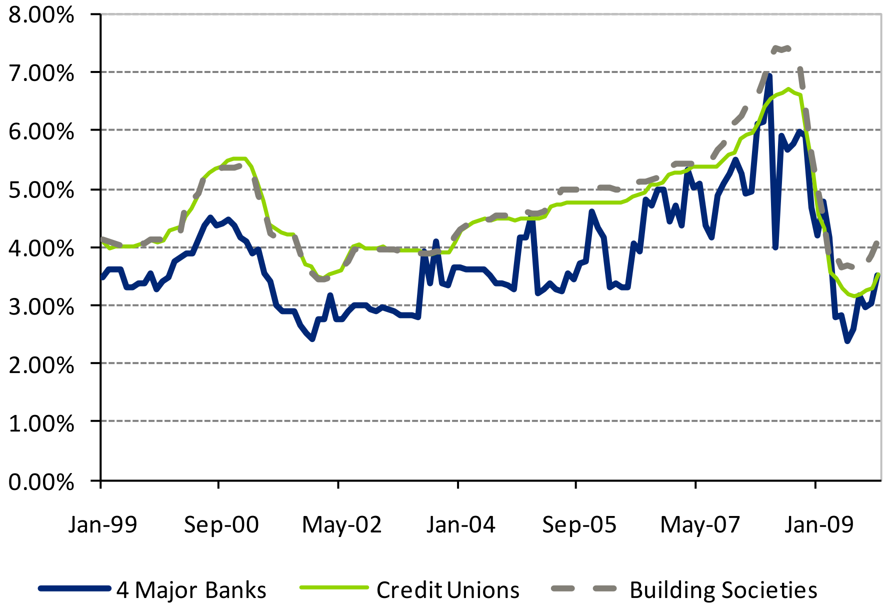


Source: RBA.

Note: The average rate refers to the average rate across 1, 3, 6, 12, 36 month terms for deposits over $10,000.

Chart 3.9 illustrates the average interest rate for 30-day term deposits over $10,000 by lender type. The interest rates offered by mutuals were typically higher than those offered by the major banks. However, the major banks are now offering rates comparable to those offered by mutuals as they seek to increase their share of term deposits. Banks face limited competition in accessing other sources of funding. But the presence of mutuals in the market for term deposits compels banks to be competitive and offer rates comparable to mutuals to access this source of funding.

Chart 3.9: Average term deposit rates by lender

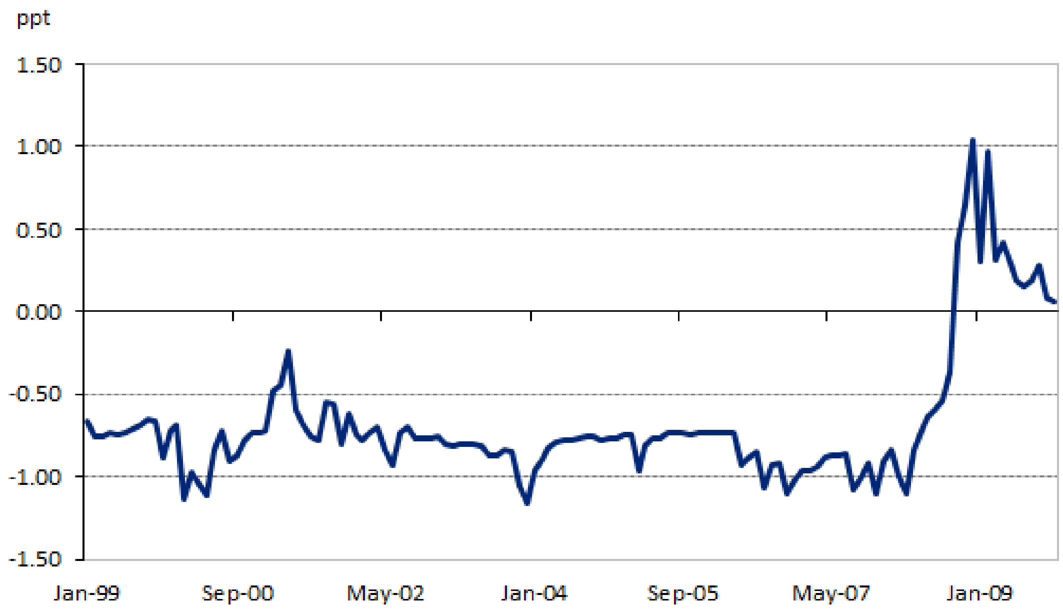


Source: CANSTAR CANNEX.

The higher cost of deposits affects regional banks and mutuals most especially since they rely more on deposits as a source of funding than do the major banks.

Chart 3.10 shows the spread between the average term deposit rates for credit unions and the cash rate, and illustrates the sharp increase in funding costs experienced during the GFC. The average term deposit rate is now higher than the cash rate, while prior to the GFC it was below the cash rate.

Chart 3.10: Average term deposit rate for credit unions (spread to cash rate)



Source: CANSTAR CANNEX.

Note: Average term deposit rate for 30 day term deposits of $10,000.

Mutuals have experienced the most growth in online deposits and term deposits. The majority of term deposits have terms of 3 to 12 months, however, and do not constitute longer term funding.

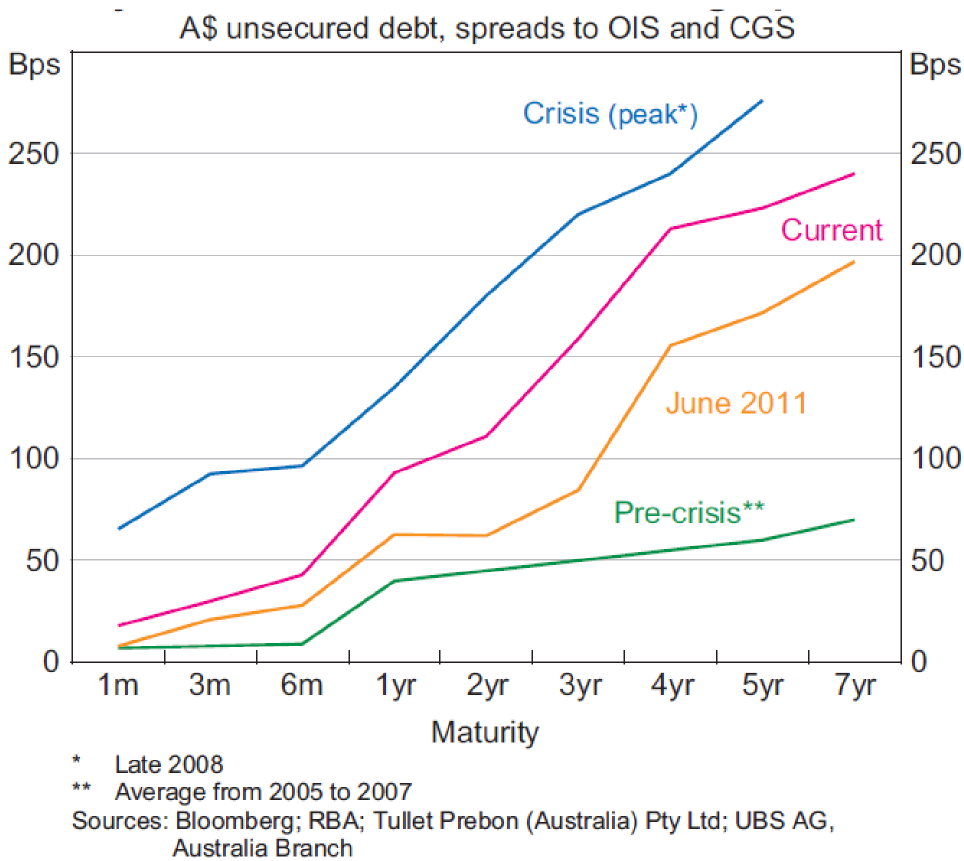
Mutuals are price takers in the term deposit market. For example, in December 2009, Westpac led the market, offering rates on term deposits as high as 220 basis points above the bank bill rate, which was matched by its competitors. According to consultations with industry professionals, the current cost of funding through term deposits for mutuals is around 100 basis points above the bank bill rate.

The key message is that the major banks have been offering higher deposit rates than in the past. The close proximity of these rates to official cash—the narrowed margin compared to the past—indicates they are paying a premium to expand their share of this source of funds. Given that their overall NIMs are holding up (see Section 4.2 below) the major banks are clearly able to offset the higher cost of deposits in other areas where mutuals pose less of a competitive threat.

3.2.3 Wholesale debt

The cost of wholesale debt has risen for banks since mid-2007. There has been a marked increase in the spreads on banks' wholesale funding, reflecting increased demand by global investors for more compensation for taking on bank credit risk, as shown in Chart 3.11 below. The increase is particularly pronounced for wholesale debt at longer maturities.

Chart 3.11: Major banks' wholesale funding spreads



Source: RBA (2012).

Prior to mid-2007 the overall spreads on 3-year bonds were around 50 basis points over comparable government bond yields. However, more recently the overall spread on 3-year bonds has been around 150 basis points above government bond yields, after the overall cost of issuing new bonds reached a peak of around 220 basis points above government bond yields.

For major banks the average cost of outstanding long-term debt is estimated to have increased by around 110 basis points relative to the cash rate as of March 2011, following the GFC (RBA 2011e). Over the past year, the cost of the major banks' outstanding long-term wholesale debt is expected to have risen by around 25 basis points relative to the cash rate (RBA 2012).

The cost of short-term wholesale debt for major banks is around 10 basis points higher relative to the expected cash rate than it was in mid-2007, although bank bill rates rose considerably above the cash rate during the GFC (RBA 2011e).

Overall, the average cost of funding for the major banks' is estimated to be around 120-130 basis points higher relative to the cash rate now, compared with mid-2007 (RBA 2012).

Regional banks have had larger increases in their funding costs after the onset of the GFC as a result of their lower credit ratings compared to the major banks. The cost of issuing 3-

year bonds was around 150-200 basis points above bank bill or swap rates in 2010, whereas prior to the GFC, the overall spread was around 40-50 basis points (RBA 2010).

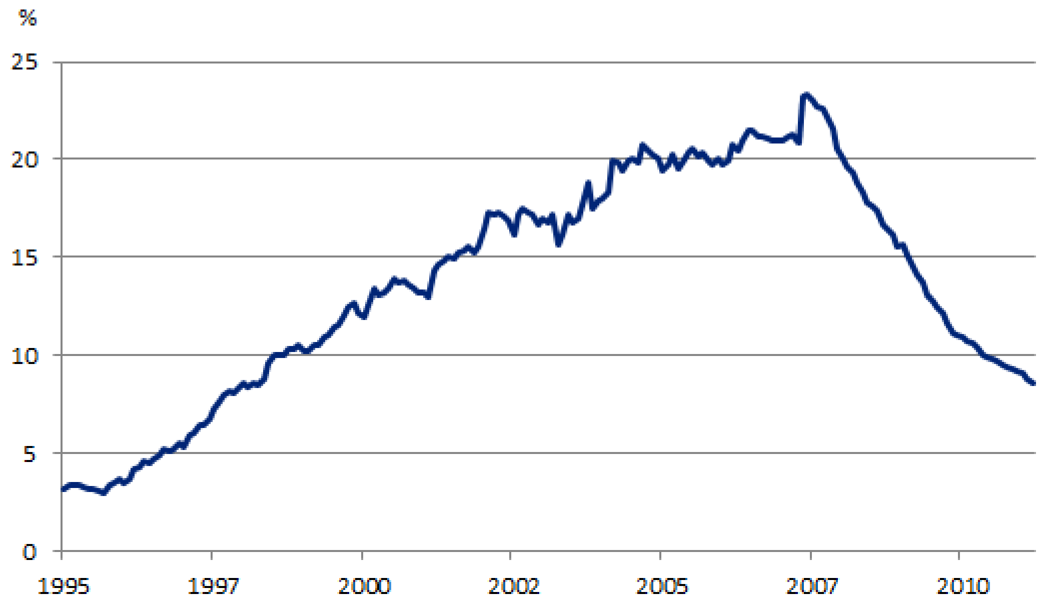
Prior to the GFC, building societies accessed wholesale debt on average at 10 to 20 basis points above the bank bill rate. Short term debt was around 5 to 10 basis points above the bill rate, while longer term debt was more expensive.

Currently however, some mutuals have continued with short term issuance but the cost of long term debt is prohibitively high at around 250 to 300 basis points above the bank bill rate, according to industry professionals.

3.2.4 Securitisation

The dislocation of the securitisation markets has increased funding costs, especially for smaller lenders that relied more heavily on securitisation, particularly RMBS. The importance of securitisation as a source of funding is evident in the increase in the share of housing lending finance through securitisation. As shown in Chart 3.12 below, this rose from less than 5% in the mid-1990s to more than 20% in 2008 before falling away dramatically after the GFC.

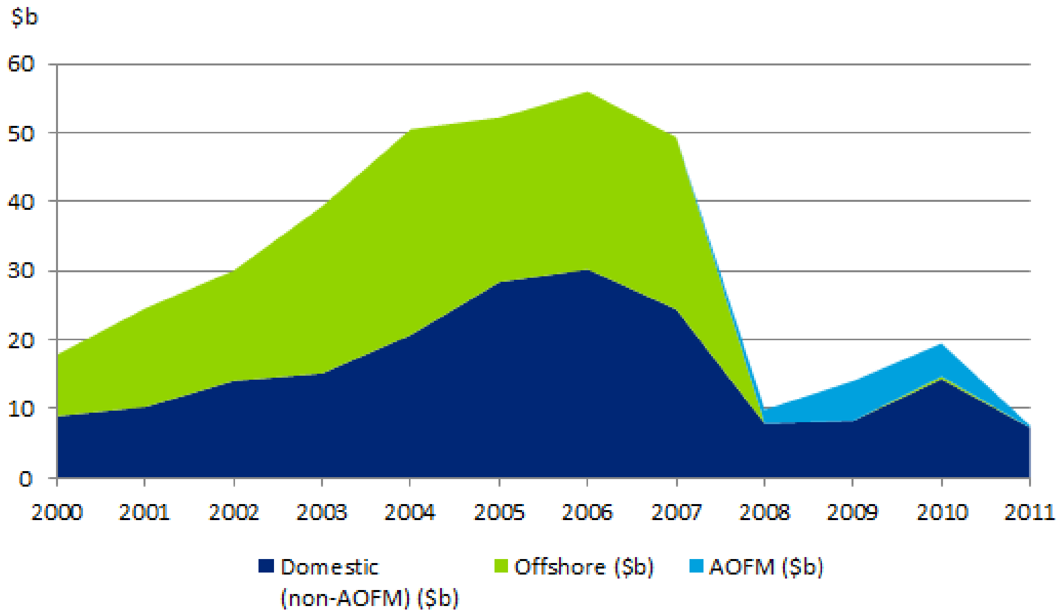
Chart 3.12: Share of housing credit funded by securitisation (%)



Source: RBA.

International markets were an important source of demand for Australian RMBS, with offshore issuance constituting more than half of Australian RMBS issuance leading up to the GFC (Chart 3.13).

Chart 3.13: Australian RMBS issuance



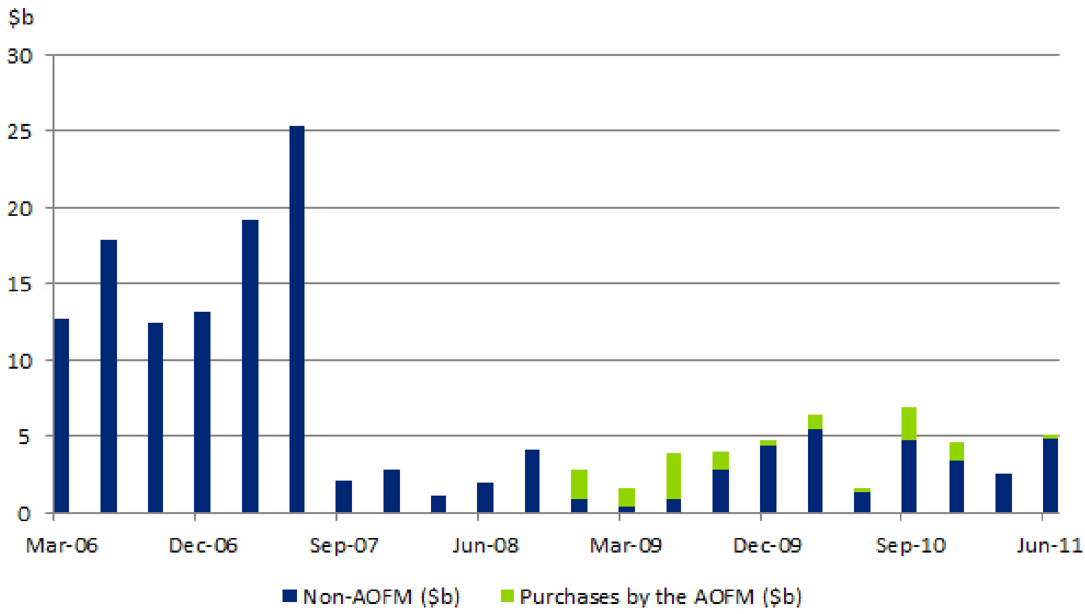
Source: RBA.

During the GFC, offshore structured investment vehicles (SIVs), which accounted for a significant share of the international investor base, were especially affected and liquidated their Australian RMBS holdings. Furthermore investor demand for RMBS declined with the result that their price in the secondary market decreased significantly.

The RBA estimates that yields on RMBS in the secondary market in Australia increased from around 20 basis points above the bank bill rate prior to the GFC to up to 450 basis points (RBA 2010a). In March 2011, the cost of new securitisation funding was around 100 basis points higher than before the onset of the GFC (RBA 2011e).

Chart 3.14 illustrates the changes in RMBS issuance pre- and post-GFC. RMBS issuance has fallen from a peak of over $50 billion annually in 2006 to around $15 billion in H12011. Housing credit growth has also declined since the GFC. Nevertheless, annual RMBS issuance is still well below that needed for securitisation to maintain its share of total housing lending, as can be seen from Chart 3.14.

Chart 3.14: Australian RMBS issuance



Source: RBA.

Prior to the GFC, building societies were issuing RMBS at rates from 40 to 50 basis points above the bank bill rate, going down as low as 18 basis points above the bank bill rate.

Greater Building Society (GBS) issued RMBS to the value of around $1.2 billion over three issues before the GFC. However, since the GFC, there have been limited issues to date because of the prohibitive cost. The cost of RMBS issuance is currently estimated to be around 185 to 200 basis points over the bank bill rate.

GBS did an AOFM-supported issue of $260 million in 2009. However, the price relief provided by the AOFM was limited. The AOFM provided cornerstone investor support although at around market prices, with the value of the support in terms of price relief estimated by GBS to be around 5 to 10 basis points.

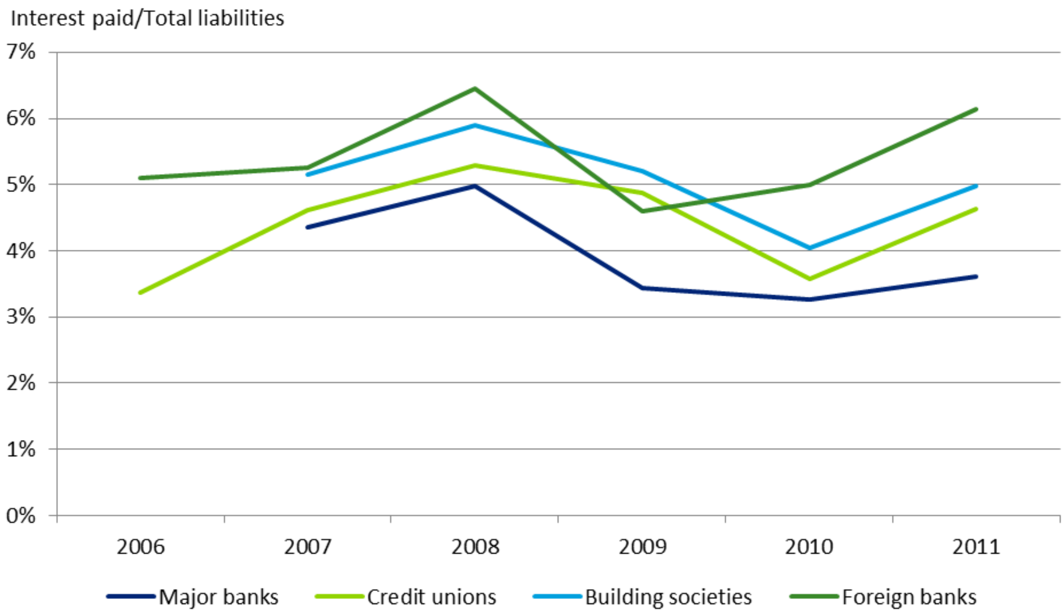
Some building societies and credit unions have access to a warehouse facility for funding through securitisation. The cost is around 210 to 220 basis points above the bank bill rate, and the facility is for relatively short term debt. There is some uncertainty about the extent of support by the funding provider.

3.2.5 Cost of capital

The primary source of capital for mutuals is retained earnings. During the GFC, securitisation was effectively closed for capital management purposes for mutuals. As shown in Chart 3.15, the cost of capital for mutuals is historically higher than that for the major banks. This is the result of the limited access to funding sources for mutuals. Major banks have access to a wider range of funding sources, while mutuals have fewer sources, limited access to capital markets, and lower capital ratings, if any.

This difference widened significantly following the GFC. While the cost of capital for credit unions and building societies fell in 2010, it has been increasing in recent times and at a rate higher than that for the major banks, widening the cost differential. Access to and cost of capital are major challenges for mutuals as they seek to gain market share.

Chart 3.15: Cost funding (Interest paid/Total liabilities)



Source: IBISWorld.

4 Effects on pricing

The interest rates set by lenders are determined by a number of factors, including the cost of funding, the risk profile of the loan and borrower, and commercial business strategy.

Since mid-2007 interest rates on all loan products have increased relative to the cash rate. The relative increase across products has varied significantly. Net interest margins for the major banks have increased slightly since mid-2008, although on average they declined in 2010.

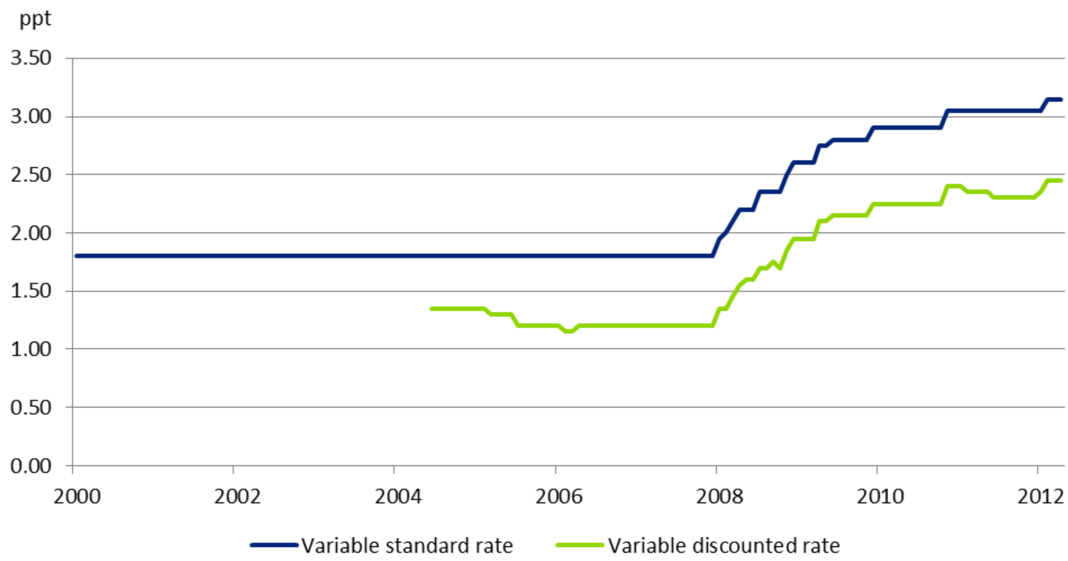
4.1 Trends in lending rates

Between 1998 and 2007 the spreads on indicator lending rates for both housing and business loans remained broadly steady as the banks' overall costs followed the cash rate. In the housing market, while the spread on the indicator lending rate remained steady, lenders offered discounted rates, narrowing the effective spread, which is a reflection of the increased competition during this period.

Since the GFC there has been an increase in costs relative to the cash rate and, as a result, lending rates have also risen relative to the cash rate.

4.1.1 Housing lending

Chart 4.1: Housing loans indicator rates (spread to cash rate)



Source: RBA.

Chart 4.1 illustrates the changes in the spread relative to the cash rate of the major banks' housing loan indicator rates.

The spread between the major banks' housing loan indicator rates and the cash rate fell from 430 basis points in 1993 to less than 180 basis points in 1998. The spread averaged around 225 basis points from 1998 to 2008. This decline in the interest spreads on housing loans was a result of increased competitive pressures on the major banks over that period from smaller lenders.

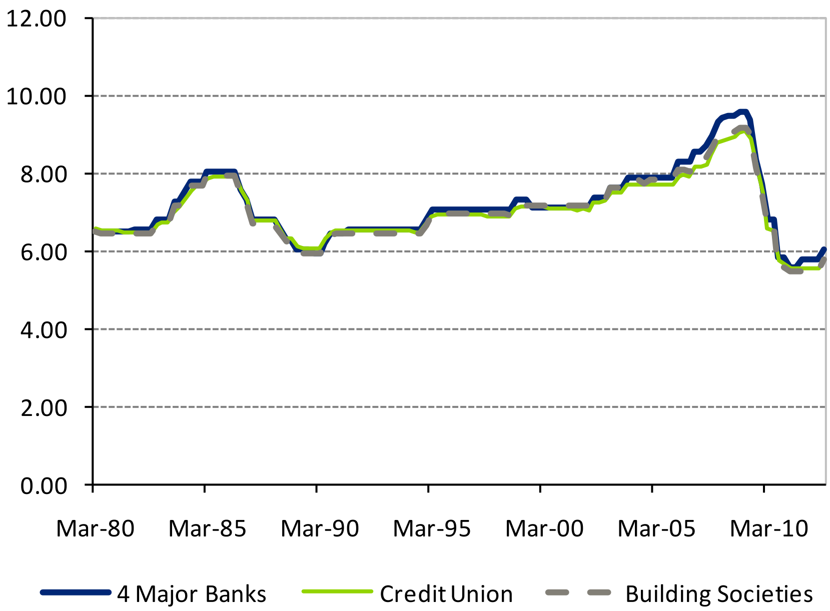
The competitive pressures meant that banks tended to offer new borrowers a discounted rate which increased to 60-70 basis points below the indicator rate. This meant that the spread between the average variable interest rate and the cash rate fell to around 125 basis points between 2000 and 2007.

The increase in funding costs following the GFC has increased the spread between lending rates and the cash rate. The average variable indicator rate offered by the major banks has increased by around 135 basis points relative to the cash rate since June 2007.

Between May 2008 and July 2010 the average standard variable home loan rate offered by credit unions increased by 97 basis points relative to the cash rate, while that offered by building societies increased by 81 basis points.

The standard variable rates offered by the major banks and mutuals are similar, although mutuals consistently offer a slightly lower rate (Chart 4.2).

Chart 4.2: Average standard variable rates

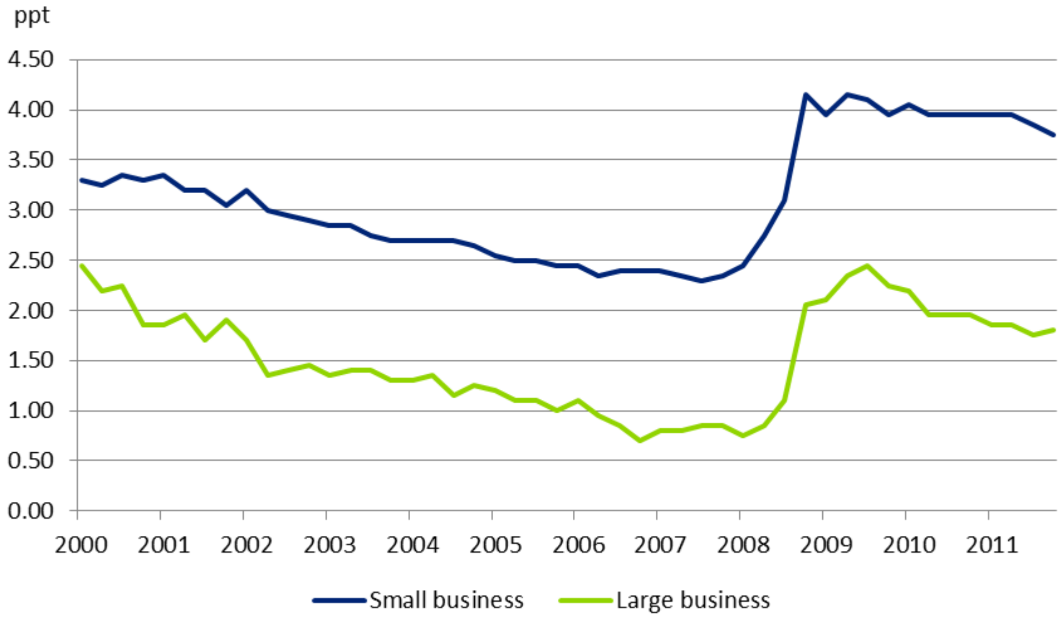


Source: CANSTAR CANNEX.

4.1.2 Business lending

Chart 4.3 illustrates the spread between the small and large business variable indicator rates charged by the major banks and the cash rate.

Chart 4.3: Weighted average rate on credit outstanding (spread to cash rate)



Source: RBA.

As with housing lending, the indicator rates have remained steady since 1998 after a period of decreasing spreads. Since mid-2007, the major banks' small business variable lending rates have increased relative to the cash rate by around 220 basis points. The overall interest rates on outstanding fixed- and variable-rate small business loans have increased by around 140 basis points relative to the cash rate.

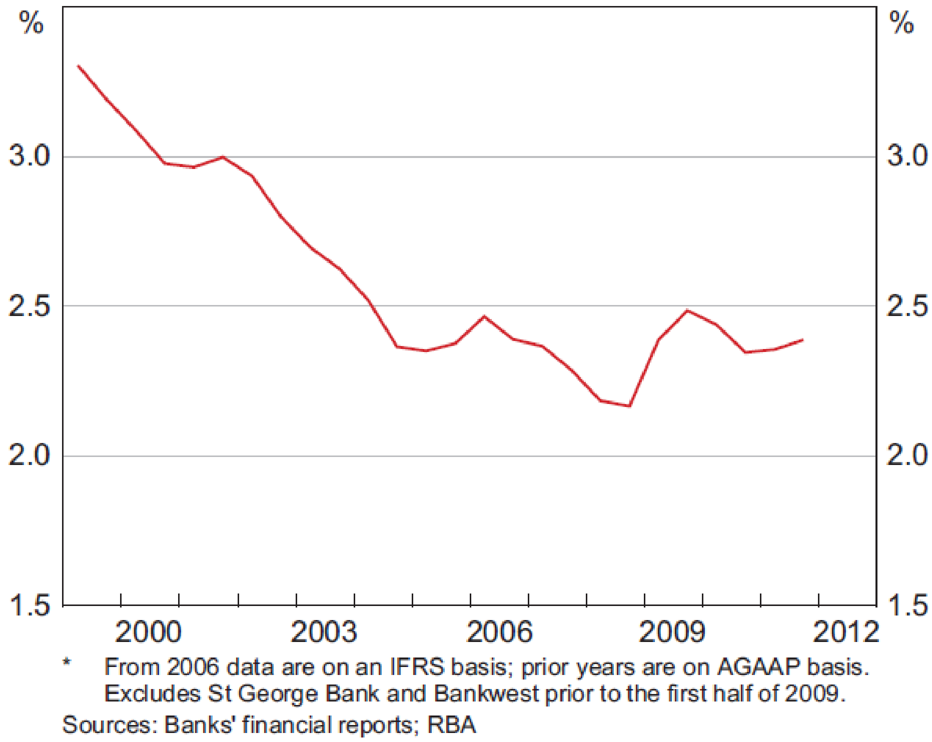
Similarly, for large businesses, the average spread on new loans has increased by around 200 basis points since mid-2007. The overall average interest rate on outstanding fixed- and variable-rate large business loans has increased by around 100 basis points relative to the cash rate.

4.2 Trends in net interest margins

Banks' net interest margins have been declining steadily since the 1990s, reaching a low of 2.25% in 2008. Increased competition over this period has played a part in lowering net interest margins.

During the GFC net interest margins reached a low point as the banks' funding costs rose ahead of their lending rates. Since then, however, the net interest margins of the major banks have risen slightly as shown in Chart 4.4 below. Although declining on average in 2010, net interest margins have been increasing in 2011.

Chart 4.4: Major banks' net interest margins

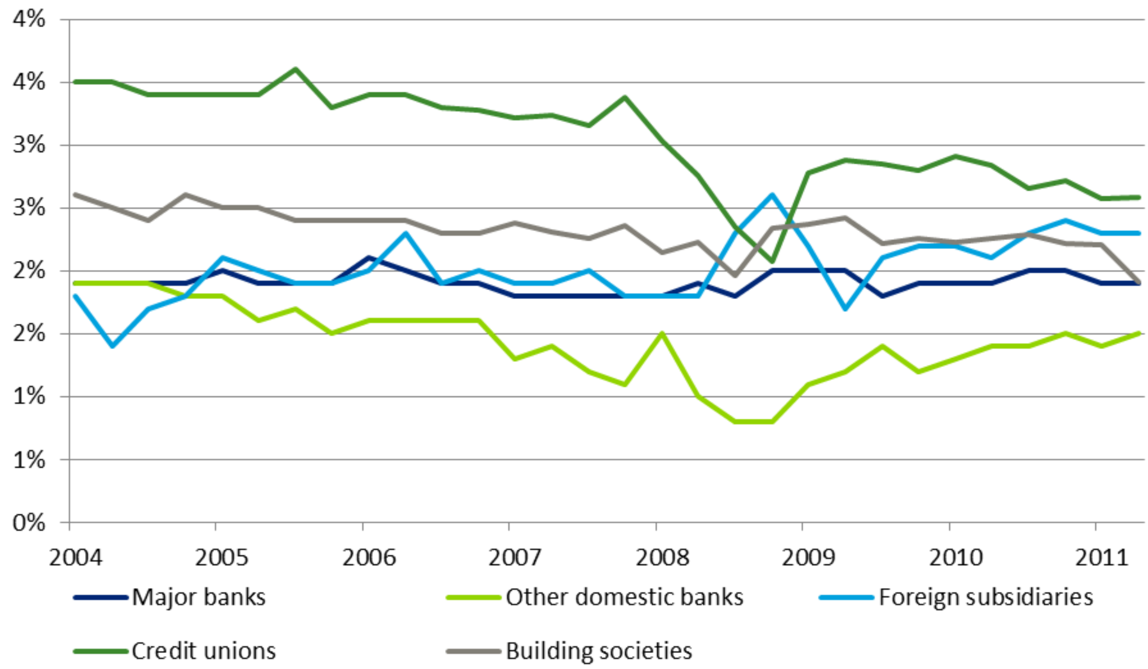


Source: RBA.

The net interest margins of regional banks have decreased by between 20-45 basis points since mid-2007. This has been the result of higher funding costs experienced by the regional banks, although again NIMs have been rising since 2010.

Smaller lenders tend to have higher NIMs as a result of their different asset and funding compositions. There has been a gradual downward trend in NIMs observed for mutuals and this intensified markedly during the GFC (Chart 4.5).

Chart 4.5: Net interest margins of ADIs

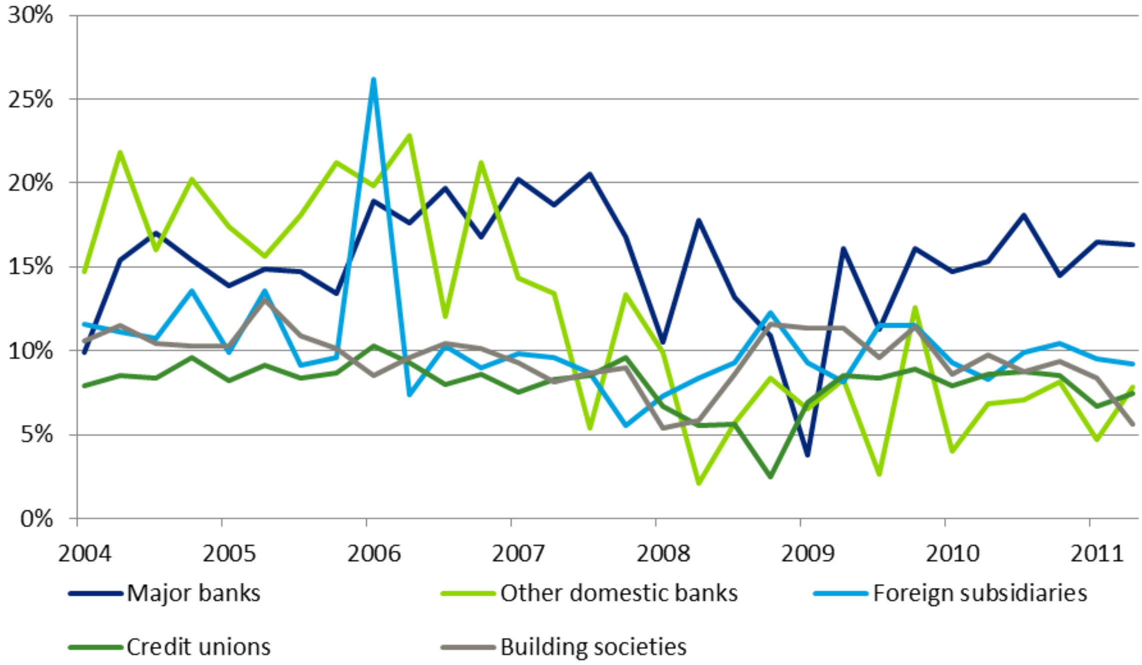


Source: APRA.

4.3 Profitability

The profitability of the major banks has recovered to the range achieved prior to the GFC, namely, an average annual return on equity of 10-20%. It remains well above that for other banks and credit unions and building societies. Chart 4.6 shows the return on equity for ADIs: major banks, other banks, foreign banks and credit unions and building societies.

Chart 4.6: Return on equity of ADIs



Source: APRA.

The report of the Senate Inquiry into competition within the Australian banking sector noted that the profits of the major banks held up well during the GFC, with the high profits suggesting that competition may not be as keen as it should be.

5 Stability and competition

The GFC has weakened the ability of smaller lenders to compete against the major banks, since they have experienced a relatively higher increase in funding costs. The dislocation of securitisation markets has removed a valuable source of funding for many smaller lenders. They are instead increasingly reliant on deposits as, albeit to a lesser extent, are the major banks.

Smaller lenders have come under pressure to withdraw from the lending markets or merge with other institutions. During the GFC, the Commonwealth Bank took over BankWest and acquired ownership stakes in Aussie Home Loans and Wizard, while Westpac acquired St George and RAMS Home Loans.

The pressure to remain competitive and meet regulatory requirements has forced consolidation among mutuals as discussed earlier. Major banks have increased their market share in all lending markets in both absolute and relative terms.

5.1 Obstacles to a level playing field

The report of the Senate Inquiry into competition within the Australian banking sector identified a number of possible barriers to entry to banking markets, including:

- branch networks enjoyed by the major banks, although some lenders are using online financial services effectively;
- low interest deposits in exchange for free services;
- financial planners;
- bundling of products, particularly account services with loan products;
- advertising by major banks;
- perceived safety and size of the major banks, including the ‘too big to fail’ implicit guarantee;
- attitudes of ratings agencies favour larger entities which in turn affects the cost of funds for financial intermediaries;
- regulatory change which places a relatively higher burden of compliance and increased costs on smaller lenders;
- cross-subsidies which the major banks find easier given their size and diversity; and
- absence of positive credit reporting, which restricts the information available to lenders, making it difficult for new lenders to differentiate between low- and high-risk borrowers when major banks gain insight from their large existing customer bases.

5.2 Government steps to promote stability and competition

The Government announced various measures to support financial system stability during the GFC. Subsequent to the crisis, three broad streams of financial reform have been developed ostensibly to promote a competitive and sustainable banking system. The measures are listed in Table 5.1 below and analysed in the following sections.

Table 5.1: Australian Government initiatives

Date	Measure
GFC - stability	
September 2008	AOFM Purchase of RMBS Program ($8 billion available for investment)
October 2008	Financial Claims Scheme
October and November 2008	Expanded RBA repurchase operations
October 2008 (announced)	Guarantee Scheme for Large Deposits and Wholesale Funding
November 2008 (commenced)	
Post-GFC – stability & competition	
October 2009	Extension of AOFM Purchase of RMBS Program (further $8 billion)
December 2010	Competitive and Sustainable Banking System package, including further AOFM purchase of RMBS and broad issuance of covered bonds

5.3 GFC period

The primary policy focus was appropriately on systemic stability during the GFC. The Australian Government implemented a number of measures to stabilise financial markets and restore confidence in the domestic economy, including investment in Australian RMBS, restrictions on short-selling of equities, the guarantee of all retail and wholesale deposits, and a voluntary guarantee for designated state borrowings (relevant measures discussed in more detail below).

A review by the Productivity Commission (2010) on regulatory burdens noted that, in introducing these measures, the Government bypassed or truncated many of the usual processes in the development of regulation. For example, no regulatory impact statements were prepared for wholesale bank deposit schemes, exemptions were granted from the RIS process for bans on short-selling, and regulatory impact statements were prepared but not made public in relation to the introduction of the Financial Claims Scheme.

For significant changes to prudential or other regulations, the PC sees value in a wider public review of financial sector regulation in preference to piecemeal consideration of such changes.

5.3.1 AOFM Purchase of RMBS Program

In September 2008 the Government announced that the Australian Office of Financial Management (AOFM) would purchase RMBS to support competition in the mortgage markets. The investments are aimed at supporting competition in residential mortgage lending and lending to small business.

Initially $8 billion was made available for investment, with the program extended in October 2009 to include a further $8 billion, depending on market conditions. In April 2011 the program was extended yet again to allow the AOFM to invest up to an additional $4 billion in Australian RMBS.

The AOFM's support of the RMBS market secures a cheaper and more competitive source of funding for smaller lenders. As of April 2011 the AOFM had invested $12.7 billion in 45 RMBS issues, which have assisted 19 lenders to raise over $29 billion in funding.

The AOFM program expressly excludes the major banks but has to date supported rather than restored the securitisation market. Smaller banks and wholesale lenders still struggle to raise funds since the AOFM takes only the least risky tranches of RMBS.

An extension of the program to less liquid tranches of RMBS would further support liquidity in the securitisation market. Issuance of RMBS has been an important source of funding for smaller lenders and so support of the securitisation market could help reduce funding costs for smaller lenders.

The system does not help all ADIs—some are too small to issue on their own or operate under conservative, deposit-based funding models.

5.3.2 Financial Claims Scheme

The Financial Claims Scheme (FCS) was established in October 2008 to protect depositors in ADIs. The purpose of the FCS is to support depositor confidence and protect them in the case of failure of an ADI. Initially, the Australian Government guaranteed all deposits up to $1 million per depositor in any one ADI under the FCS and could be accessed when an ADI is insolvent or severely under-capitalised.

As of February 2012, the FCS guarantees deposits up to $250,000 per depositor per ADI.

The government guarantee on deposits has served to partially alleviate the concerns of depositors with mutuals as the guarantee applies to deposits at all ADIs. Nevertheless, there has still been a 'flight to quality', with the major banks enjoying the implicit 'too big to fail' guarantee securing all deposits, not just those within the FCS cap.

5.3.3 Government Guarantee Scheme

The Guarantee Scheme for Large Deposits and Wholesale Funding (Guarantee Scheme) was announced by the government on 12 October 2008 and commenced on 28 November 2008. The purpose of the Guarantee Scheme was to promote financial system stability by supporting confidence and assisting eligible ADIs to continue to access funding during the GFC.

The eligible instruments for Australian ADIs are:

- deposit liabilities in excess of $1 million at call or with maturities of up to 60 months
- wholesale funding liabilities:
  - short term liabilities – senior unsecured non-complex debt instruments with maturities up to 15 months (bank bills, certificates of deposit, commercial paper and certain debentures); and
  - long term funding liabilities – senior unsecured non-complex debt instruments with term to maturity of 15 to 60 months (bonds, notes and certain debentures)

The fees for the guarantee depended on the rating of the ADI. The fee schedule is shown in Table 5.2:

Table 5.2: Fee schedule for the Guarantee Scheme

Long term credit rating of ADI	Fee (in basis points per annum)
AAA to AA-	70
A+ to A-	100
BBB+ and below and Unrated	150

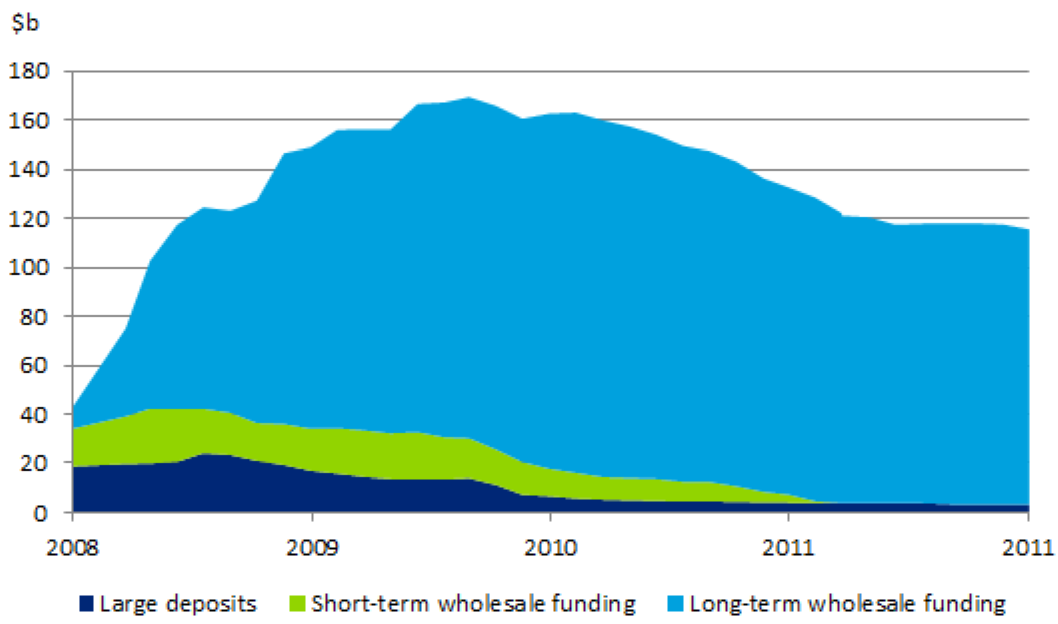
Access to the Guarantee Scheme was voluntary and subject to an approval process. The Guarantee Scheme closed for new liabilities at the end of March 2010, given the improvement in funding conditions and the recent or imminent closure of guarantee schemes in other countries.

During its operation the Guarantee Scheme provided a comparative advantage to the major banks. The fee to access the Guarantee Scheme was 70 basis points for the major banks, compared with 150 basis points for mutuals. This allowed the banks to offer more attractive deposit rates relative to those offered by smaller ADIs.

Furthermore, the guarantee is meant to indicate that the level of risk associated with the guaranteed debt is equal across all products, regardless of the issuer. Nevertheless, consultations suggest that market pricing took into account the rating of the issuer. For example, the cost of issuing guaranteed debt was higher for Macquarie Bank than for the major banks.

The Government Guarantee Scheme was mostly taken up for long-term wholesale funding, as shown in Chart 5.1.

Chart 5.1: Government Guarantee Scheme guaranteed liabilities



At its peak in March/April 2010, up to 15.4% of total ADI wholesale liabilities were guaranteed under the Scheme.

The major banks relied heavily on the Scheme, as shown in the number of guaranteed issuances by the majors and a range of smaller lenders.

Table 5.3: Number of government guaranteed issuances

Issuer	Number of government guaranteed issuances
ANZ	31
CBA	76
NAB	20
Westpac	60
Bank of Queensland	5
Bendigo	0
Macquarie	24
Suncorp	9

Source: Reuters.

5.3.4 RBA repurchase operations

In the second half of 2007 the RBA widened the range of securities eligible for its repurchase operations (repos). In October 2008 to counter deteriorating conditions in global markets and the flow-on effects to domestic markets, the RBA sought to provide ADIs with greater flexibility in managing their liquidity. Specific initiatives included:

- relaxing the restriction preventing an institution from using RMBS and asset-backed commercial paper of a related party as collateral in its repurchase operations;
- offering 6-month and 1-year repos each day in its market operations; and
- removing restrictions on substituting collateral within an existing repo, with the exception of general collateral.

In November 2011 the RBA announced that, effective from February 2012, there would be further relaxing of restrictions on eligibility to improve liquidity in domestic markets, namely:

- all senior debt securities with a residual maturity of 12 months or less that than have been issued by ADIs with a public credit rating will be eligible for market operations;
- the minimum credit rating for eligible long-term debt securities issued by ADIs will be reduced from A- to BBB+; and
- there will no longer be a requirement for the issuing ADI to be an exchange settlement account holder with the RBA.

The securities eligible for the repurchase arrangements and applicable margins are shown in Table 5.4:

Table 5.4: Margins for securities eligible for repos

Security	Minimum rating	Margin (% of market value of security)			
		0-1 years	1-5 years	5-10 years	>10 years
General collateral					
Commonwealth Government Securities	n/a	1	2	2	2
Semi-Government securities	n/a	1	2	2	2
Securities issued by Supranationals and Foreign Governments	A-1 or AAA	2	3	4	4
Securities with an Australian Government Guarantee	n/a	2	3	4	4
Securities with a Foreign Government Guarantee	A-1 or AAA	2	3	4	4
Private securities					
ADI-issued securities	AAA	6	7	8	10
	AA-	10	12	14	16
	A-	12	14	16	18
	BBB+	15	17	20	23
	Other rated	20	n/a	n/a	n/a
Asset-backed securities					
Standard	A-1 or AAA	10	10	10	10

Other	A-1 or AAA	10-20	10-20	10-20	10-20
Other private securities	A-1 or AAA	6	7	8	10

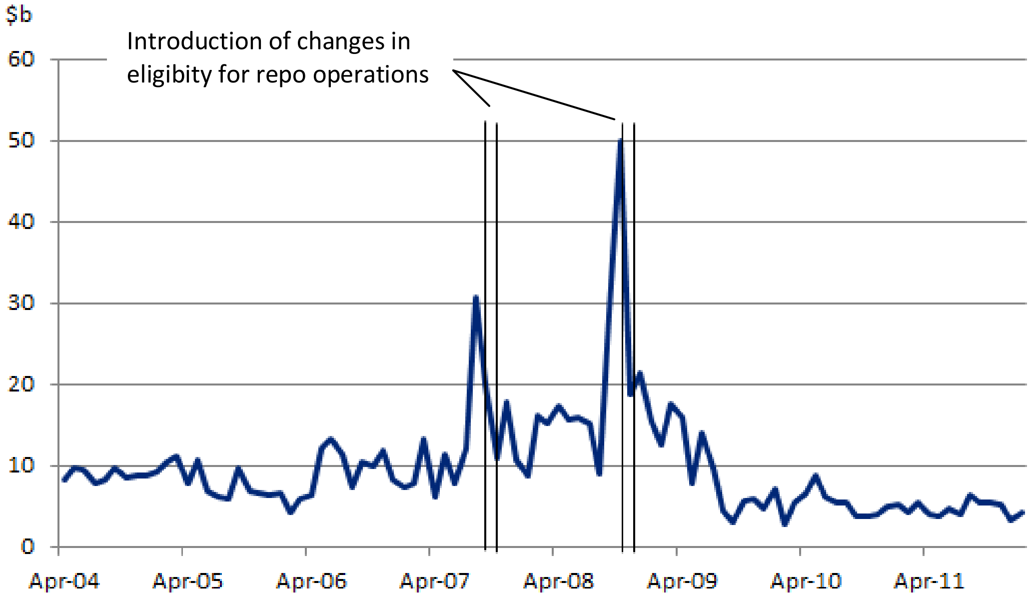
Source: RBA

Mutuals are theoretically able to access the RBA repo program but it is usually commercially unviable given the relatively high charges facing borrowers with lower credit ratings.

Although the minimum credit rating for repo eligible securities was lowered to BBB+ effective from February 2012, this is still higher than the grade considered by the industry to be 'investment grade' which is BBB-. The cost for such securities also remains well above the costs for higher rated securities.

The scale of repo activity increased following the GFC, peaking in October 2008, following the extensions in the eligibility for repo operations. The uptake of repo operations suggest that it was a significant advantage to eligible ADIs during the GFC, one that was not available to most mutuals because of the high costs associated with it.

Chart 5.2: Repurchase agreements (Private securities)



Source: RBA.

5.3.5 'Too big to fail' guarantee

Australia has a highly concentrated banking industry, with four major banks that are considered 'too big to fail'. In practice this translates into an implicit government guarantee that effectively reduces the cost of funds for the major banks. This gives them an advantage over smaller institutions that do not benefit from such a guarantee, distorting their competitive positions.

The implicit guarantee also raises issues of moral hazard in that major banks may be tempted to deploy riskier business models, which would in turn elevate systemic risk.

The G20 and IMF take the ‘too big to fail’ problem seriously and are actively exploring ways to offset the distortion that it causes. Table 5.5 presents estimates of the size of the TBTF guarantee indicating why it is such a source of concern to financial authorities.

Table 5.5: The value of the ‘too big to fail’ guarantee

Ueda and di Mauro (2010) in the IMF’s report to the G20 estimates the value of the ‘too big to fail’ guarantee to financial institutions internationally. They use two different approaches to estimate the value of the subsidy:

Event study: the value of the guarantee is inferred from how market values respond differentially to major events involving changes in ‘too big to fail’ practices. The authors compare funding costs before and after major events during the GFC that materially affected the expectation of bailouts in the US and in Europe, using financial data for large financial and non-financial corporations. Using this approach, they found that the funding cost advantage of institutions supported by the ‘too big to fail’ guarantee was equivalent to 20-40 basis points. However, this range may underestimate the total value of the guarantee since it does not account for the fact that a positive value of the implicit guarantee was already priced in before the crisis.

State support: the competitive advantage in funding is estimated using rating agencies’ expectations of government support to financial institutions benefiting from the ‘too big to fail’ guarantee. The overall rating, and therefore funding cost, of financial institutions depends on their financial strength as well as the expected amount of government support. The overall rating is regressed on these two components to estimate the relative importance of government support. The authors use large bank ratings by FITCH for the 10 largest banks in G20 countries and Spain and Switzerland over the period 2007-09. Using this approach, the authors estimate that the average value of the subsidy is around 65 basis points. This may overestimate the funding cost advantage as it captures both the government subsidy and the competitive advantage of banks that are ‘too big to fail’.

Based on these two approaches the authors find that the ‘too big to fail’ guarantee subsidises the funding costs of major financial institutions by 20 basis points on average, and within the range of 10-50 basis points depending on individual firm and country characteristics.

An earlier study by Baker and McArthur (2009) uses the difference in funding costs of small and large US banks before and after the change in the 'too big to fail' policy established by the Troubled Asset Relief Program in the US. Using this approach they find that the value of the 'too big to fail' guarantee ranges from 9-49 basis points. The study does not take into account other factors that may affect the funding differences, such as the banks' relative financial strength, and does not control for other policies and factors affecting investment decisions during the relevant period. Although there were insufficient data to determine whether the lower cost of funds for 'too big to fail' institutions is wholly or partially attributable to the implicit government guarantee, their findings are consistent with those of Ueda and di Mauro (2010).

While the studies cited in Table 5.5 focus on US and European financial institutions, they nevertheless highlight the relative funding cost advantage enjoyed by major banks that implicitly benefit from the 'too big to fail' guarantee.

The Basel Committee has noted that the 'too big to fail' problem and associated moral hazard costs affect competition. The Committee has recommended putting in place specific policy measures for banks that are considered too big to fail—the global systemically important banks—including higher capital requirements, restrictions on certain business activities, and improvements in recovery and resolution regimes coming into effect in 2016.

The measures are designed to reduce the probability of failure of such banks, reduce the extent or impact of the failure of these banks, and level the playing field by reducing the competitive advantages in funding markets that these institutions have.

The implicit 'too big to fail' guarantee also helped major banks in their credit ratings. This is apparent in the reduction in ratings on large banks in the US following uncertainty about the continuing willingness of the government to bail them out. For example, the Dodd-Frank financial reform legislation has made it less likely that the government will bail out banks such as the Bank of America, Wells Fargo and Citigroup. In response, Moody's reduced their ratings in July 2011. Moody's also downgraded the senior debt and deposit ratings of 12 UK financial institutions in response to perceived lowered degree of systemic support from the UK government.

The issue of 'too big to fail' is a live issue both overseas and in Australia. In Australia, the size and significance of the four major banks mean that these banks are domestically systemically important. As such, the Government provides an implicit guarantee against failure, which effectively strengthens their credit ratings and access to funding.

Proposals to reduce the systemic importance of the major banks include forcing them to divest/separate their operations. However, regulators in Australia do not have the power to impose such maximum size requirements. Other options include additional taxation to discourage the banks from remaining/getting too big. Finally, the Government could consider offering banking services itself in competition with the private sector, for example, by converting Australia Post to a bank.

5.4 Post-GFC period

The Competitive and Sustainable Banking System package announced by the Australian Government includes three broad streams of reform aimed at:

- empowering customers through:
  - banning exit fees on new home loans;
  - boosting consumer flexibility to transfer deposits and mortgages;
  - empowering the ACCC to prosecute anti-competitive price signalling;
  - fast-tracking legislation to get a better deal for credit cards;
  - a national community awareness campaign to make consumers better informed; and
  - setting up a taskforce within the RBA to enhance ATM competition reforms.
- supporting smaller lenders through:
  - building a new pillar in the banking system based on the combined competitive power of mutual credit unions and building societies;
  - confirming the Financial Claims System as a permanent feature to secure deposit funding for smaller lenders;
  - introducing a further $4 billion investment to support the RMBS market, bringing the total investment to $20 billion;
  - developing a 'bullet bond' structure for RMBS issuance to strengthen and diversify funding for smaller lenders.
- securing the long-term safety and sustainability of the financial system through:
  - allowing all banks, credit unions and building societies to issue covered bonds to broaden access to cheaper, more stable and long-term funding; and
  - developing a deep and liquid corporate bond market by launching the trading of Commonwealth Government Securities on a securities exchange, to reduce reliance on offshore wholesale funding markets.

Initiatives that are of most relevance for competition and mutuals are canvassed in the following sections.

5.4.1 Banning exit fees

This initiative is intended to make it easier for borrowers to switch from one lender to another, increasing competition among lenders by forcing them to work harder to retain and attract customers. While all lenders will be subject to increased competition, larger banks' capacity to offer bundles of services may help them to retain customers. Meanwhile, the costs of the change are likely to be relatively greater for smaller institutions that incur higher average (switching) processing costs and for institutions that are more reliant on (exit) fee income.

5.4.2 Portability

Increased flexibility to switch between lenders favours major banks that are better able to absorb the cost of maintaining the required technical support systems. This is not likely to improve smaller lenders' competitive positions.

5.4.3 Fifth pillar

For a fifth pillar to compete with the major banks the mutuals must be able to extend their market share. Currently, it appears that their best option for achieving this outcome is to consolidate so as to achieve economies of scale. However, scale will not necessarily overcome the major banks' advantages in access to funding.

5.4.4 Extend AOFM support, bullet bonds and retain FCS

See Sections 5.3.1 and 5.3.2 above.

5.4.5 Covered bonds

In its package of banking reforms aimed at increasing competition, the Government announced that Australian banks, credit unions and building societies would be able to issue covered bonds. The introduction of covered bonds is intended to strengthen and diversify the financial system's access to cheaper, more stable and longer duration funding in domestic and offshore wholesale capital markets.

The ability to issue covered bonds would provide an additional source of lower cost funding for the major banks. However, smaller lenders, including mutuals, will not necessarily be able to access this source of funding on account of their limited balance sheets.

To be large enough to market, covered bonds would tie up significant shares of high-quality assets. At the moment, it is also unlikely that rated mutuals can issue AAA-rated covered bonds demanded by investors—at most, they could only structure up to AA-rated covered bonds.

While the covered bond legislation contemplates aggregation of smaller lenders to issue covered bonds, there is some uncertainty over its operation and the allocation of liability. This is even greater concern with the new capital requirements to be introduced under Basel III.

Once the market is better established, there may be an opportunity for an aggregated issue by mutuals. In the foreseeable future, however, individual mutuals will be too small to issue covered bonds.

5.4.6 Development of the retail corporate bond market

The Australian Treasury and banks are in favour of expanding the size of the retail corporate bond market. Australian corporations rely on borrowing from overseas and the GFC has made it more difficult to obtain overseas funding.

The Australian Government has issued a discussion paper for consultation on reforms to develop a deep and liquid retail corporate bond market which looks at potential ways to reduce regulatory burdens and barriers, particularly in the area of streamlining disclosure and liability requirements. The discussion paper notes that companies of all sizes would benefit from being able to issue retail corporate bonds in a cost-effective way and that currently the process for issuing corporate bonds to retail investors is costly and onerous compared to other avenues for raising funds. However, it does not address concerns specific to mutuals.

The issuance of retail corporate bonds is potentially a method for mutuals to raise more capital and at competitive rates and help establish mutuals as the fifth pillar. However, mutuals are mostly not listed and the lack of credit ratings and possible consumer protection requirements may affect the ability of mutuals to issue retail corporate bonds.

5.4.7 Phasing down the interest withholding tax

Interest withholding tax (IWT) is levied on interest payments on overseas borrowings. Where it applies, it may bias the funding choices of financial institutions and also be passed on to Australian borrowers through higher interest rates.

On May 2010 the Australian Government announced that it will phase down Australian interest withholding tax arising in respect of interest paid by financial institutions on certain offshore borrowings. This is intended to support banking competition by allowing non-major banks to access cheaper funding and put downward pressure on interest rate margins.

In November 2011 the Government announced that the phase down of IWT will be deferred by one year.

The reduction in interest withholding tax will directly benefit the major banks that access overseas funding. While it will improve overall competitiveness by removing the competitive disadvantage for foreign banks accessing funding from their overseas parents, it does not assist smaller lenders, including mutuals, that do not access funding from overseas.

5.5 Basel III

The Basel Committee released a package of reforms in December 2010 to raise the level and quality of regulatory capital in the global banking system and to strengthen global liquidity rules with the goal of promoting a more resilient banking sector.

APRA has proposed adopting the minimum Basel III capital and liquidity requirements in full except where there are strong in-principle reasons to continue current APRA policies.

The key proposals by APRA in relation to capital requirements are:

- adopting the Basel III definition of regulatory capital, under which common equity is the predominant form of Tier 1 capital, and adopting the minimum requirements for Common Equity Tier 1, Tier 1 and Total Capital, and the stricter eligibility criteria for Tier 1 and Tier 2 capital instruments;

- adopting the Basel III regulatory adjustments to capital that are specified as minimum requirements with minor exceptions. The only exception is that APRA will continue to require capitalised expenses and capitalised transaction costs to be deducted from capital and will also take a more conservative approach in removing the double counting of capital in the financial system and on investments in commercial institutions;
- adding the capital conservation buffer to the prudential capital requirement that it requires for each ADI to ensure that ADIs build up capital buffers outside periods of stress that can be drawn down as losses are incurred. APRA will have regard to the cumulative impact of its capital requirements when determining the size of the capital conversation buffer to apply to each ADI;
- introducing the countercyclical buffer to ensure that banking system capital requirements take account of the macro-financial environment in which ADIs operate and imposed when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk; and
- introducing a non-risk based leverage ratio to help contain the build-up of leverage in the banking system and to safeguard against model risk and measurement error.

APRA proposes adopting the new requirements in an accelerated timetable compared to the Basel III framework, starting from January 2013.

In relation to liquidity reforms, APRA will:

- require all ADIs to implement qualitative requirements to achieve sound management of liquidity risk; and
- apply quantitative requirements to the larger ADIs—these include a 30-day liquidity coverage ratio to address an acute stress scenario and a new stable funding ratio to encourage longer-term resilience.

Implementation of Basel III by APRA will have an impact on capital requirements for mutuals. Basel III tightens the requirements for capital to qualify as Common Equity Tier 1, Additional Tier 1 and Tier 2 but allows the requirements to be tailored to accommodate mutual banking institutions. APRA is currently engaging with the mutual sector on measures to accommodate mutual capital instruments in the new prudential standards on capital adequacy for ADIs.

The mutual sector is concerned that APRA may implement new capital standards that recognise only the listed ADI model and that mutual ADIs would in future be effectively limited to retained earnings for their regulatory capital.

Denying mutuals access to Common Equity Tier 1 instruments could have the following impacts:

- mutuals will not have the ability to manage and grow their balance sheets flexibly and in a manner that best serves their members' interests;
- growth will be constrained to the uneven rate at which organic capital can be generated from retained earnings;
- organic capital will not be able to be generated quickly to respond to sudden increases in capital requirements;

- mutuals will be less able to lend in a downturn and will be less able to provide effective competition to listed banks;
- the competitive disadvantage in relation to banks resulting from lack of access to Common Equity Tier 1 risks reducing supply, and increasing the cost, of credit to customers by the mutual sectors; and
- ratings agency may take a negative view of the mutuals sector, given its restricted access to Common Equity Tier 1 capital and its increasing dependence on the economic cycle—this would have a knock-on effect on the ability of mutuals to access senior funding.

There are also some concerns about the ability to meet the new capital and liquidity requirements where the entity in which a mutual has invested funds is downgraded. There are no transition periods and so if those assets are no longer suitable, the mutual could potentially be in breach of the capital and liquidity requirements.

Regulatory compliance has significant fixed costs that can disproportionately affect smaller banking institutions. The prudential regulatory regime and APRA's handling of its prudential regulatory responsibilities are important factors affecting competitiveness in the banking sector. The differences between the mutual model and the listed bank model necessarily mean that there will be differential impacts from Basel III. While these are not unanticipated, regulators will need to be mindful of the unintended consequences detrimental to competition.

In a 31 May 2012 submission to APRA, Abacus outlined the case for recognising and accommodating the mutual model in the prudential standards, quoted in Appendix A.

6 Conclusion

Prior to the GFC, smaller lenders provided much of the increased competition in the banking system. However, they are now unable to compete as effectively on account of increased funding costs and other impediments to competition. Addressing the distortions in funding costs between the major banks and the smaller lenders can help to restore competition in banking markets.

Measures to provide much-needed stability during the GFC favoured the major banks and they have leveraged this advantage post-GFC. Endeavours to redress the balance have met with limited success or even produced perverse outcomes.

Table 6.1: Summary of stability and competition

Policy initiatives	Impact on competition
AoFM purchases of RMBS	Supports smaller lenders but has not restored securitisation as a competitive source of funds
RBA repos, covered bonds	Broadens pool of funding but not practical for many small borrowers
Portability, exit fees	Easier to switch banks but more costly for small lenders
'Too big to fail'	A 'free kick' for major banks
FCS	Stems flight to safety but relatively more expensive for smaller lenders above deposit threshold
Implications for	
Cost of funds	Major banks' natural advantage in access and cost of funds enhanced further
Market share	5th pillar struggles to build market share
Competition	Reduced competition, reduced economic welfare
Innovation	Reduced innovation, reduced choice

A banking system that is not competitive will have significant implications for consumers. Lack of competitive pressures will lead to higher prices for services, limited choice, and ultimately lower levels of borrowing and deposits for consumers. Without competition, there will also be weaker incentives for innovation and improvements in products/services.

The legislation (*Australian Prudential Regulation Authority Act 1998* (Cth)) specifically states under the purpose for establishing APRA that:

> *In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.*

The mutual model provides diversity in banking services, with a different service proposition. This improves competition and increases choice for consumers.

Given its mandate, the regulatory framework should acknowledge the value of the mutual structure as a legitimate way of providing financial services, with its inherent strengths and weaknesses, and promote competitive neutrality so that it can compete unimpeded with the listed bank model. As such, the regulatory burden on mutuals should not be greater than for listed banks.

The mutual model continued to operate throughout the GFC, but subsequent events have affected the ability of mutuals to access funding competitively, which in effect has reduced their competitiveness. Furthermore, Government attempts to undergird stability have improved conditions for banks, and further reduced the ability of mutuals to compete. Efforts to stabilise the banking system by regulators and the Government should not be at the expense of competition.

The long-term options to improve funding options for mutuals and improve the competitive landscape include policies to expand the pool of deposits available. Some options that could be considered include increasing the limit of deposits insured under the Financial Claims Scheme and potentially having a differential tax rate on different forms of savings (as proposed in the Henry Review, p58.).

The cost of funding can also be improved by long-term policy options to promote the RMBS market. These include providing a government guarantee against specific risks attaching to highly rated asset-backed securities, including RMBS, for a fee; secondary market provision of liquidity via the AOFM; and buying mortgage securities outright.

A thorough review of the financial sector would provide the scope to explore competition issues more thoroughly. Australia has not undertaken a comprehensive review of the financial system since the Wallis Inquiry in 1997.

At that time, there was a trend towards disintermediation, capital markets were booming and smaller lenders were able to access funds at competitive prices. However, subsequent developments, including the GFC and consequent dislocation of capital markets, have fundamentally changed the financial landscape.

Restoring a more even balance between competition and stability in Australia's financial system requires a fundamental review of the structure of the system and its likely evolution over coming years. There is bipartisan support for reform of the banking and financial system, and both Treasury and a Senate Inquiry have recommended a broader inquiry into the financial system.

Piecemeal intervention is unlikely to succeed when the landscape has changed so markedly. It is time for the Government to commission a fully-fledged review of the Australian financial system along the lines of the 1996-97 Wallis Inquiry.

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Appendix A

Excerpts from the 31 May 2012 submission to APRA by Abacus – Australian Mutuals, outlining the case for recognising and accommodating the mutual model in the prudential standards:

> *The mutual model is the proven alternative to the listed model in the Australian retail banking market. Mutual ADIs have 4.5 million customers, a strong share of the household deposits and new home loan markets and are consistent market leaders in customer satisfaction and responsible lending.*
>
> *The mutual model can be recognised and accommodated in the prudential regulatory framework without weakening capital standards or creating a two-tiered system. Recognition of the mutual model is critical to delivering the objectives of competitiveness, contestability and competitive neutrality, along with safety and stability, in the prudential framework.*
>
> *The mutual ADI sector is strongly capitalised and the vast majority of this capital is in the form that is of the absolute highest quality – retained earnings. However, mutual ADIs must have access to capital in addition to retained earnings to increase market share and to take opportunities in future. We want to increase, rather than reduce, access by ADIs to different forms of high quality capital.*
>
> *It is unacceptable to the mutual ADI sector to be required to demutualise to gain access to external capital.*
>
> *Capacity to access external capital is a prudential benefit per se, but also enables mutual ADIs to more flexibly manage and grow their balance sheets to serve their members' interests.*
>
> *The prudential regulatory framework already takes account of the differences between ADIs in terms of size, complexity and risk profile. Although the Basel III capital reforms are global minimum requirements for internationally active banks, Abacus does not seek exemption from the framework for Australian mutual ADIs. We seek application of the framework taking into account the mutual model, as is expressly permitted by the Basel Committee.*
>
> *The outcome we seek is equivalent treatment for mutual ADIs and listed ADIs because identical treatment of the two models in a framework that blatantly prefers the listed model will harm competition, choice and diversity for no prudential benefit.*

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