

The current state of retail banking

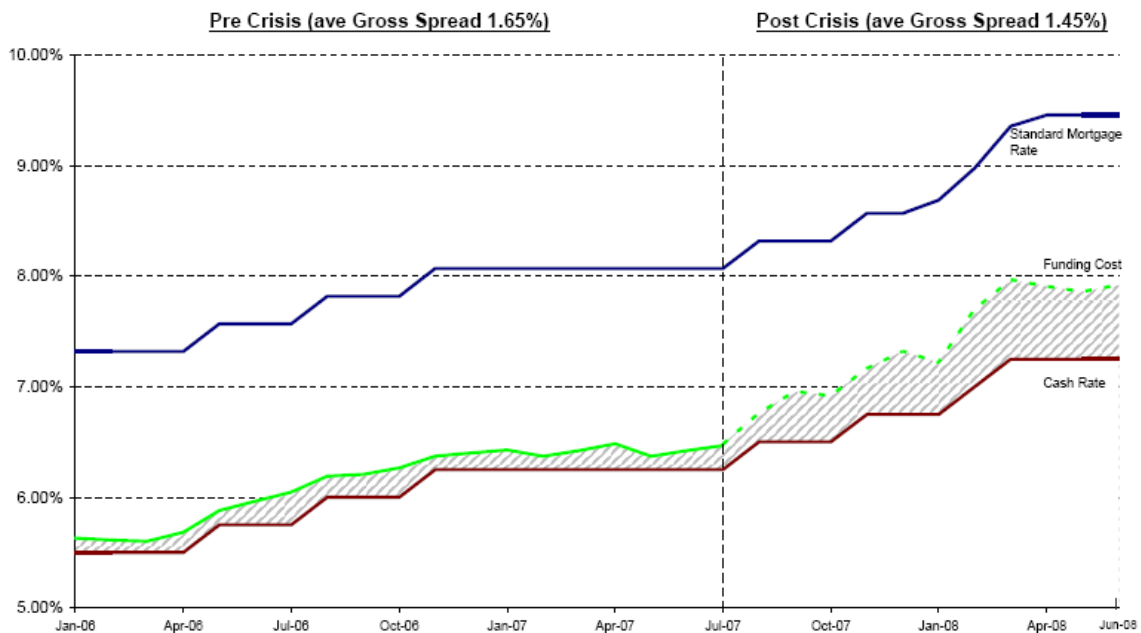
NAB holds that strong competition continues for Australian retail banking customers. In recent years, we have seen high levels of competition that have delivered for Australian customers on price, product choice, innovation and service.

At NAB, we are looking continually at ways of improving choice and value for our customers, which is necessary in a market that competes intensively for retail banking customers. In transaction accounts, for example, in November 2007 we launched our Smart Everyday Banking accounts, aimed at giving customers the choice to pay reduced fees or no fees. Since then, we have further reduced fees and are about to launch a home loan product in this product range, our Clear Banking Home Loan, which will be exit fee free. For customers wishing to exit their home loans before term, the potential savings are up to \$1200 in addition to not paying a monthly account keeping fee.

The recent developments in global credit markets have had implications for retail banking. Whilst we have arguably seen greater impacts on the non-bank lenders than on the bank lenders, all have been impacted. As highly leveraged non-bank lenders and those with fixed business models have had trouble in adapting to scarce and higher cost funding, some have fallen behind, or even exited the home loan market.

This has meant that banks with less reliance on wholesale funding have been able to maintain their home loan offerings, albeit it at higher cost. Some have cited this development as a lessening of competition, seeing home loan customers paying higher rates of interest and banks maintaining profits. However, what this criticism fails to take into account is the absorption by banks of greater input costs than those passed on to customers and the increased operating efficiencies of banks over the last 15 years or so, during which time cost income ratios have fallen from the 60s to the mid 40s. The graph below shows the decline in NAB’s gross mortgage margin (the mortgage rate less funding costs) by 20 basis points or 12% less margin, post the credit crisis.

Standard variable rate v funding costs v cash rate



Recent developments in products, providers and distribution channels

Customer choice and technology have been the key drivers of developments in retail banking over recent times. At NAB, our customers have been telling us that they want us to provide choice, value, simplicity and convenience and to be involved in their communities. Our Customer promise (copy attached) articulates this.

We would summarise the key developments in NAB products, as follows:

- Product differentiation, given the highly competitive retail banking market.
- Increased transparency, for example on fees and charges.
- Value - flat fee, reduced fee or no fees products, as in the case of our Smart Everyday Banking range and Clear Banking Home Loan (exit fee free) as well as bundling of products to take advantage of discounts (e.g. interest rate discounts and fee waivers) as well as offsets between home loans and savings accounts.
- Innovative products: Internet only accounts (iSaver) and flexible products such as the NAB Visa Gift Card that is a pre-loaded gift card that can be used globally in person, on-line or over the phone.
- Community-focussed products. At NAB, over recent years we have taken our commitment to the communities we operate in seriously and created products that help those who may have problems in accessing business or personal finance. These include, for individuals, the Concession Card Account, Retirement and Student Accounts, the No Interest Loan Scheme, Step Up Loans. For businesses, we offer Microenterprise Loans, as well as the NAB Community Fee Saver Account for charities.

The key developments in providers we have seen:

- Entry of overseas non-bank lenders in Australia: from 2002.
- Direct-only providers, with no physical (branch) presence.
- New entrants, e.g. Retailers involved in the Payments System and Retail Banking.
- Retail banks offering a broader range of financial services, eg. wealth, investment and insurance services.

The key developments in distribution channels we have seen:

- New and integrated channels that deliver seamless interactions for customers by integrating branch, telephone, internet and other technologies. This delivers greater convenience and flexibility to customers seeking a wide range of banking channels that can be used 24/7.
- New technology. NAB now has around 800,000 customers who bank on-line, and we recently enabled our internet customers to access their account statements on-line, with up to 7 years of statement history available. In May 2008, we launched an SMS Banking service to our customers, and have greater integration of our customer contact centre service on-line and interactive banking.
- Specialist advice and service. NAB has recently completed a major program to put more skills into our branches, with mobile bankers, home lending specialists, business lending specialists and financial planning specialists.

- The broker channel is growing: customers want to compare products and prices, as well as source additional products such as wealth and insurance products.
- Accessibility. Bank branches are changing to reflect the fact that customers are looking for a ‘one stop’ banking experience, NAB is developing open plan branches as standard, which offers a more flexible range of services (including teller cash recyclers and a fast service wall for business customers). NAB also offers banking services at certain Australia Post outlets through Bank@Post.
- Extended banking hours, where we can identify local demand.
- Thinking locally: NAB has a local business model that allows for a wide variety of decisions, including opening hours, staff skill sets and services, to be made to suit the communities we operate in.
- Upgrades to existing technology. NAB is replacing its entire 1,600 ATM fleet with new machines utilising wireless and IP technology allowing individualisation of services, such as language and marketing.

Drivers of future change and innovation

Customer choice and technology will continue to drive the shape of retail banking in Australia, but these can only be delivered in a dynamic and responsive market. NAB is at the forefront of spotting future trends. Direct channels, such as Internet and SMS Banking, will continue to evolve to meet consumers who are increasingly time-poor and who wish to take full advantage of the developments in personal technologies. These consumers will also take more of an holistic approach to their financial needs, requiring wealth, investment and retail banking services in integrated products and channels.

Barriers to competition

NAB is working to promote Australia as a regional hub for financial services. We believe that Australia has the potential to supply a sophisticated range of financial services into the Asian region and beyond, given the growing demand from developing regional economies, such as China and India. Australia already has the world’s fourth largest funds management industry, managing in excess of a trillion dollars, with the expertise and natural advantages, such as proximity of time zones, to increase exports even further.

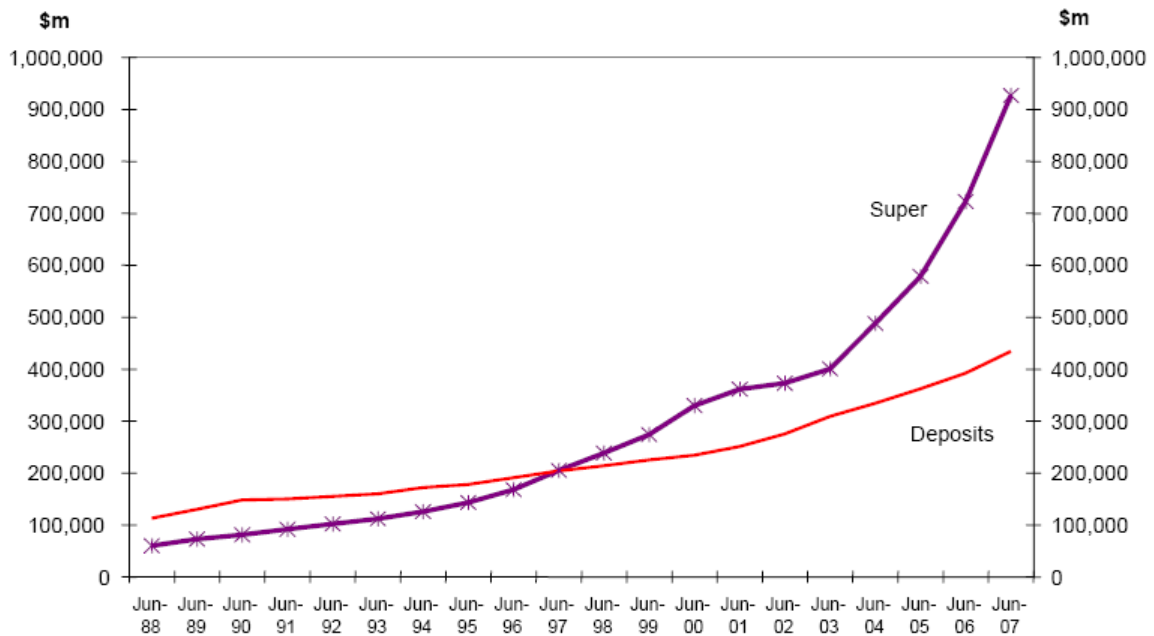
The flow-on benefits that a more export focussed financial services industry would deliver to Australian retail banking consumers would be manifold: increased economy of scale and volume would enable greater investment in innovation; scale would inevitably exert downward pressure on costs and therefore consumer prices, and learnings from operating in other markets would deliver enhanced product innovation and new technology.

However, we see two key areas that act as barriers to delivering an even more competitive banking sector: tax and regulation.

On tax, we acknowledge the major contribution that a reduction in withholding tax will have for the Australian funds management sector, enabling it to compete on a more even playing field with its commercial rivals. This was an important first step, but we see much more potential for addressing those aspects of federal and state taxes that inhibit the competitive advantage of Australian financial services. An area we would isolate for immediate consideration is improved tax treatment for Australian deposits.

A significant proportion of household and business lending by Australian banks is not funded by domestic deposits, rather it is funded by foreign borrowings. This leaves Australia vulnerable to the international price of credit. Furthermore, deposits are treated less favourably than investing in the share market. Possibly, as a result, deposit growth has lagged growth in superannuation. As the graph below shows, super growth has been double the growth of deposits. Assuming the relative growth had been equal, Australian lending could have been 100% domestically funded. We therefore consider that the taxation treatment of deposits be considered for preferential tax treatment akin to superannuation savings.

Superannuation vs Deposit Growth



In terms of regulation, we acknowledge that many aspects of the Australian regulatory system are positive for consumers in the retail banking sector, as has been witnessed in the sector's resilience to the shocks from the global financial system. We also acknowledge the recent and planned measures taken to streamline regulation via the COAG process, which will help the banking sector operate with greater regulatory certainty, for example by transfer of credit regulation to the Commonwealth.

Policies to enhance further competition and choice

NAB's view is that Government and public policy should be used in a proportional response to issues and supportive of market-based outcomes. As outlined in detail in the ABA submission, there are a number of current policy initiatives underway that are targeted at retail banking: ASIC's switching initiative, ASIC's review of mortgage entry and exit fees, the payment system's industry scheme for EFTPOS and ATM access, the RBA Review of payment systems, COAG's decision to transfer credit regulation to the Commonwealth and regulate finance brokers. This is a considerable amount of activity, with which NAB is actively involved.

Given the high level of current activity, we would therefore warn against policies that lead to inappropriate regulatory responses. Rather, the results of these current initiatives should be allowed to flow through to the retail banking sector, rather than to rush ahead with additional policy proposals.

Please do not hesitate to contact me to discuss further any of the issues raised in this submission.

Yours sincerely



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