AUSTRALIAN BANKERS' ASSOCIATION INC.

Competition in Banking

Australian Bankers' Association

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Contents

EXECUTIVE SUMMARY

The Australian Banker's Association (ABA) welcomes the Committee's Inquiry into Competition in the Banking and Non-Banking Sectors. It has been more than twenty years since Australia's financial system was substantially deregulated in favour of the current regulatory approach, which puts the promotion of competition as its core.

In the period since deregulation, the Australian banking system has emerged as one of the strongest and most advanced banking systems in the world. This has real benefits for Australian consumers and the wider economy.

The history of retail banking in Australia since deregulation in the 1980s is a story of increasing competitive tension, with a range of factors reducing the advantages for incumbent banks in delivering banking services.

The local subsidiaries of large internationally-owned banks are providing very effective competition as their brands have become more familiar and trusted by the Australian community.

Competition in the deposit market is currently very intense as banks and other deposit-takers compete to win deposits as a means of diversifying their deposit base away from reliance on international capital markets.

Loan markets are similarly highly competitive, with little evidence that the relative decline – albeit temporary - of non-bank lenders in the housing mortgage market will materially increase lending margins.

There are a range of public policy issues relating to competition currently being addressed by the industry, including customer switching, ATM access, EFTPOS competition and consistency of fee terminology.

The ABA encourages the Government to remove the Four Pillars policy in favour of allowing banking mergers to be assessed on the same basis as other industries – under the Trade Practices Act 1974.

Introduction

The Australian Banker's Association (ABA) welcomes the Committee's Inquiry into Competition in the Banking and Non-Banking Sectors. It has been more than twenty years since Australia's financial system was substantially deregulated in favour of the current regulatory approach, which puts the promotion of competition as its core.

In the period since deregulation, the Australian banking system has emerged as one of the strongest and most advanced banking systems in the world. This has real benefits for Australian consumers and the wider economy.

Australian banks played a critical role in shielding the Australian economy, businesses and consumers from the Asian financial crisis in 1997 and they are playing a similar role in moderating the impact of the current international credit crisis that was triggered by high default rates on sub-prime housing loans in the United States.

Surveys of bank customers show that, overall, customer satisfaction with their bank has improved markedly since the 1990s. The 1990s marked a difficult period for the Australian retail banks as a number of factors compelled banks to adjust their operating models, which resulted in branch closures, higher fees for banking services and the use of electronic channels to deliver banking services.

While the 1990s marked a difficult adjustment period, the changes were very significant, not only for bank customers, but also to the wider economy and society. Bank efficiency improvements in the 1990s were significant contributors to Australia's strong productivity performance in that decade, which helped underpin Australia's prolonged period of economic growth.

Australian banks[1] are now employers of choice for around 150,000 Australians. On average banks pay higher wages than other industries except mining; they employ a higher proportion of women than any other private-sector industry and, typically, have flexible working conditions, including leading maternity leave arrangements.

There is full employment in the banking industry, with only the booming mining sector recording a lower official unemployment rate.

Banks also have invested deeply in initiatives to assist low income and disadvantaged customers as well as projects to improve the environment and community. For example, most banks provide low income customers with bank accounts that can be operated at little or no cost to the consumer.

In summary, the bi-partisan move to deregulate the banking system commencing in the 1970s and completed in the 1980s has been a policy success story.

Competition has played a significant role in this process. Against this background, the ABA and member banks welcome the Committee's investigation of competition in the banking system today.

[1] ABA member banks.

Defining competition in retail banking

1. Defining retail banking[2]

Banks are part of the financial services industry. They are intermediaries between savers (lenders) and borrowers. At the most basic level, banks collect the funds of those who have surplus capital and then distribute those funds to businesses and individuals who have a higher valued use of that money.

As intermediaries, banks primarily make their profit on the margin charged between the interest paid on the savings collected and the interest earned on issued loans, although since the 1990s, revenue generated through direct fees and charges for services has diversified the revenue base of banks.

Retail banking refers to the collection of money from personal customers and small-to-medium sized businesses and the subsequent loans to these same customer categories. It is contrasted with the collection of deposits (and other funding instruments) from corporates, governments and other financial intermediaries.

These collection and lending functions are managed through a system of bank accounts. Bank accounts are assigned to both personal and business customers. They record the store of value (deposit accounts) or the debt (loan accounts) attributed to the owner of the account.

Another aspect of retail banking is the provision of transaction or payment services to individuals and Small and Medium sized Enterprises (SMEs). Banks provide the means for customers to transfer value in their accounts – normally a deposit account – to the account of another person or business in exchange for goods and services. A classic payment instrument is the personal cheque. It enables a customer to authorise the debiting of their account and crediting to an identified recipient.

See Appendix 1 for a more detailed description of retail banking products. Banks also offer now a range of investment, wealth management and insurance products and services, but these are not covered in this submission, which is focussed on retail 'banking' services.

2. Defining competition and markets

Competition is a process whereby suppliers engage in rivalrous market behaviour. Prices are flexible, reflecting the forces of demand and supply, and there is independent rivalry in all dimensions of the price-product-services packages offered to customers.[3]

Competition depends upon the structure and features of the market, including the level of market concentration (i.e. the number of suppliers)[4]; the barriers to entry; the degree of product differentiation and sales promotion; and the degree to which suppliers have arrangements that restrict their ability to function independently.[5]

If a customer has choices of suppliers and products, and a bank has to offer superior products, prices and service to win and retain the customer, it would appear that the bank is

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[2] It should be noted up front that ABA's submission does not attempt to define banking markets. The submission primarily discusses (a) deposit products, (b) loan products and (c) payment systems. Even within these broad categories it can be ambiguous as to the competitive market. For example, mortgage offset accounts provided by non deposit-taking institutions can operate similarly to deposit transaction accounts. The submission often uses the term 'market', but this should not be viewed as a comprehensive definition, rather a convenient term.

[3] See Trade Practices Tribunal in *Re QCMA and Defiance Holdings* (1976) ATPR 40-012 at p. 17, 246.

[4] Although, as discussed later in this submission, the research shows this link is weak in relation to banking.

[5] Ibid.

competing in a competitive market. If the products are the subject of innovation and product differentiation, and if the bank is advertising heavily, those are also indicators that the market is competitive.

The antithesis of competition is where a supplier has the power to increase its prices independently of other suppliers and to exclude entry.[6]

For example, if Bank A materially lifts the price of its transaction account, then in a competitive market it would be expected that Bank A would lose customers and profit to competitor banks that had not changed their prices. On the other hand, if Bank A could unilaterally and significantly increase its price and maintain that increase for a sustained period without losing customers, then the market would be uncompetitive.[7]

Obviously, if the costs of all competitors increase, they will all be likely to increase their prices. As they are not permitted to collude on prices, this is likely to happen by one bank taking the lead and others responding with their own offerings. Such increases in price do not indicate an inherent lack of competition, unless the price increase is unrelated to changes in underlying costs or other similar factors.

In a competitive market, prices are likely to go up and down depending upon costs and the level of supply and demand. Alternatively, the features of the product may be altered in an attempt to gain a competitive advantage and to win customers. For example, if Bank A improved the features or value of its transaction account in some way, then it may be able to increase its price without suffering erosion in customers.

Competition occurs within a market for goods or services. Although market definition is important in the analysis of competition, determining the precise boundaries of a market is often not essential in order to determine whether a supplier faces competitive constraints and is, therefore, participating in a competitive market.

Markets have four dimensions: product, geography, functional level and time. The key test is substitutability - if a customer is faced with a price increase by one supplier or for one product, then are there other suppliers or products that the customer would regard as close substitutes? Those close substitutes (if any) will be within the market.

Customers of retail banks do have a range of close substitutes in terms of suppliers and products, indicating that whatever the precise market boundaries might be, suppliers face competitive constraints from other suppliers and products.

As will be seen from this submission, the retail banks have faced market entry by new competitors with respect to virtually all of their products (indicating that barriers to entry have been significantly lowered) and competition on all of their products and prices (including vigorous competition from other domestic retail banks and, in many cases, from foreign banks and from non-bank financial institutions). They have also been forced to accept reduced margins and to roll out new technology and new products, and to otherwise respond to competitive pressures. These developments all indicate that the relevant retail banking markets are competitive.

3. Assessing competition in retail banking

Promoting competition in Australian industry has been an explicit goal of Federal governments since the introduction of the *Trade Practices Act 1974*. This Act prohibits anti-competitive behaviour, such as price fixing, provides for access rights to essential infrastructure necessary to compete in markets, and prohibits company restructures that have an anti-competitive impact e.g. mergers and acquisitions.

[6] Ibid.

[7] The important concept here is that there has been a change in the 'relative price' between Bank A's price and the rest of the market.

In retail banking, promotion of competition has also been the subject of a number of policy reviews and inquiries: the Campbell Inquiry (1981); the Martin Inquiry (1992); the Prices Surveillance Authority Inquiry (1995); and the Wallis Inquiry (1997) and the Reserve Bank/ACCC Joint Study[8] into debit and credit card schemes.

In addition, there have been a number of significant competition analyses undertaken in light of merger proposals. The most significant have been the ACCC[9] assessments of the: merger of Westpac and Challenge Bank in 1997; the Westpac purchase of the Bank of Melbourne in 1997; and the Commonwealth Bank acquisition of Colonial Bank in 2001.

This history of the competitive analysis of banking paints a story of rising competitive tension in the provision of banking products. In the 1970s, clearly the fact that prices of banking products and even the amount of credit were regulated meant that banks could not compete on price so competition manifested in the size of branch networks.

In the mid 1990s, analysis of banking competition focussed very much on market definition and whether banks and other providers competed on a product-by-product basis or whether the competition was based on the provision of a range of banking products (i.e. the 'cluster' of products approach).

Today, however, it is clear that banks face significant competition (and pricing constraints) in all of their product markets, including transaction accounts, deposit and savings accounts, credit cards, housing loans and personal loans.

The main driver of this increased competitive tension in a wider set of products relates to the increased 'contestability' of banking markets. This topic is covered in more detail in the 'Stocktake of Australian retail banking' section later in the submission, but generally, what has happened is that banks have lost the advantages they once retained over new entrants seeking to compete in banking markets.

Specifically, the benefits incumbent banks had with large branch networks, information advantages in SME lending and protection through government legislation have now been removed. Technology and other developments make it no longer necessary for a bank or other competitor to have a large branch network in order to build deposits, sell loans or provide transaction services.

It is no longer a material advantage for a bank to provide a transaction account to a SME as a means of assessing the SMEs credit standing for a loan. Most importantly, however, since the 1980s, governments no longer protect incumbent banks from price competition.

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[8] 'Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access', October 2000, Reserve Bank & ACCC. Available at RBA website www.rba.gov.au.

[9] The ACCC's former organisation was called the Trade Practices Commission.

Stocktake of Australian retail banking

The purpose of doing a stocktake of the banking industry is to assess the progress that Australian banks and governments have made in developing a world-class and competitive retail banking system in Australia and to identify areas in which to improve.

The first section traces through the key events that have shaped the competitive landscape in banking. The focus is on how these events have influenced competition in the three broad banking product markets – loans, deposits and payments systems.

Section two sets down the key factual information typically used to assess the state of competition that exists in banking. This section also sets down basic information showing the wider contribution that banks make to the community.

The third section discusses the forces likely to forge the future shape and evolution of banking.

1. Development of modern retail banking

1.1 Deposits

Up until the early 1980s, most retail deposit interest rates in Australia were subject to government regulation. Banks were prohibited from paying interest on at-call deposit accounts and interest rates on term-deposits were subject to caps.

After deregulation, however, banks were free to compete for deposits on price, but strong price competition took longer than expected to eventuate. One reason was that up until the early 1990s, deposit balances in Australian banks were essentially sufficient to fund the bank's asset growth, and so for most banks, there was little pressing need to attract greater deposits.

Compulsory superannuation - 1992

This situation changed after the introduction of compulsory superannuation in 1992 and voluntary super contributions were given preferential tax treatment. Deposit balances started to slow relative to bank asset growth and the Australian banks were forced to fill the funding gap from domestic and international capital markets. But this proved not particularly onerous because, as is now well understood, capital markets in this current decade were very liquid and the credit risk costs associated with debt was under priced.

Another factor in explaining the mild competition in bank deposits immediately after deregulation was that the internationally-owned banks, which entered the Australian market after entry restrictions were lifted in 1985, did not initially target the retail banking market. In other words, there was little new competitive threat to the well-known and trusted brands that had been protected by Government in the regulated era.

Foreign-owned banks target deposits - 2000

However, in the early part of this decade there was a significant change in the deposit market, essentially due to a change in the business strategy of the Australian subsidiary of a foreign-owned bank. This bank, with a strong credit rating, targeted the retail deposit market with aggressive pricing and product innovation.

The bank offered an online deposit transaction account that paid high interest rates and had no service fees. The initial interest rate on offer was priced above the Reserve Bank's overnight cash rate.

The primary condition on the account's usage was that customers had to manage the account over the Internet. The bank had established few physical branches. Historically, particularly in the regulated era, bank competition for deposits in Australia was based around branch networks[10] – the larger the bank's branch network, the greater its ability to collect deposits (and sell loans).

In time, all the Australian-owned banks and other internationally-owned retail banks introduced online deposit accounts that offered more competitive interest rates and lower transaction fees.

All you can eat transaction accounts - 2003

In response to community concerns over bank fees[11], a major Australian bank introduced what has come to be known as an 'all you can eat' transaction account which provides customers with an unlimited number of transactions for a fixed monthly account management fee.

Banks responded with their own competitive offerings and these types of accounts are now provided by nearly all retail banks. This development was clear evidence of innovation in the deposit market and has been well taken up by customers.

Credit crisis ushers in a further wave of deposit competition – August 2007

In the early 1990s, deposit levels in banks were broadly large enough to fund all of the bank's lending requirements. Today, retail deposits account for only about 43 per cent of bank loans.[12]

Although banks provide very good deposit and transaction services for business and consumers, Australia now has a relatively low level of deposits compared to most countries. This means we have a greater reliance on capital markets, including international capital markets. For this reason, the credit crisis triggered by the US sub-prime housing defaults could have potentially impacted Australia disproportionally more than most other countries.[13] It was the strong credit standing of them that enabled our banks to continue sourcing sufficient amounts of international capital through the crisis, albeit at higher prices.

As a consequence of the credit crisis, competition for deposits[14] in Australia has strengthened further as institutions attempt to reduce their reliance on international capital sources. Deposit rates have risen significantly on most savings and term deposit accounts.

1.2 Lending

End of government regulation

When the Fraser Government initiated the landmark review of Australia's financial system in 1978, one of the aims was to address the perceived inequity in the provision of finance in

[10] The advantage of large bank branch networks in collecting deposits has declined substantially since the 1970s. Computer and IT technology have enabled banks to develop electronic payment systems that allow salaries and other income payments to be directly credited to deposit accounts. Before electronic banking, deposits were primarily made via cheques and cash which required branch visits. The Internet and phone banking has also reduced the importance of branches in the deposit market as customers can now conduct nearly all account management procedures on line or by phone rather than over-the-counter at a branch.

[11] Most banks now also provide what are called 'basic bank accounts' for low-income customers where the customer can undertake a basic range of transactions at little or no cost. See ABA website for a list of these products at www.bankers.asn.au

[12] There is quite a lot of variation amongst the banks in their levels of deposits relative to loans. One bank has a deposit-to-loan ratio of 30 per cent whereas the highest ratio is that of 82 per cent.

[13] The potential risk to the economy of Australia's high dependency of foreign funding was a finding of the International Monetary Fund (IMF) in its assessment of the resilience of Australia's financial system in 2006.

[14] Including, importantly, wholesale deposits.

Australia. There was a concern that small businesses and lower-income households were being unfairly restricted in accessing bank loans[15].

The Campbell Inquiry final report recommended an end to the era of bank credit rationing, along with a range of other reforms such as the end to government control over retail interest rates in favour of competitive pricing.

However, in the period 1985 to 1990, renewed bank competition was focussed in business and commercial property rather than retail banking. These commercial markets were targeted by the newly entered foreign-owned bank subsidiaries and branches.

This excessive competition in commercial lending ended up exacerbating the financial difficulties of the early 1990s. As has been well documented, the 1991 recession pushed unemployment to 12 per cent and led to the failure of a number of financial institutions.

As a result of this experience, there was a marked change in the business strategy of the banks.

Household lending more attractive – early 1990s

Australian retail banks started orientating towards lower risk business strategies and investing more heavily in risk-mitigation initiatives.[16]

Lending to households, in particular lending for domestic housing, was viewed as a lower risk market and one in which there were reasonable profit margins. The margin on a standard housing loan to cash in 1993 was around 400 basis points (compared to around 150[17] basis points today).

Credit scoring techniques introduced – early 1990s

Another response to the financial difficulties in the early 1990s, was for banks to start to investing more in technology to assist with better assessment and management of credit risk.

Credit scoring products began to emerge. These are statistical models that take a range of observable inputs about the loan borrower and wider economic environment and then make a prediction about the probability that the borrower will default on the loan. It is a tool to assist banks in their loan approval process and in setting loan limits.

From a competition perspective, the emergence of credit scoring models was very significant because they reduced the information advantage that incumbent banks had in assessing the credit risk of business customers. Banks that had a client relationship built, for example, around transaction and billing products, would have information about that client not available to businesses wanting to sell that business a loan product.

Entry of Aussie Home Loans - 1992

In 1992, Aussie Home Loans was established to compete with banks in the housing lending market. It was a financial institution that did not collect deposits. It sourced its funding initially through direct bank loans and then eventually through securitisation markets – the issuance of Residential Mortgage Backed Securities (RMBS).

This was one of the most significant events in recent banking history because it not only led to significant reductions in bank housing lending margins, but the margin squeeze materially impacted other aspects of the bank's businesses, such as the size of their branch networks, expansion in electronic banking facilities and increases in fees and charges for services.

[15] Forcing these groups to access more expensive finance outside the regulated banking sector.

[16] Another noticeable aspect was a refocussing on domestic markets.

[17] Note – this figure does not include broker commissions. If broker commissions are taken into account, the margin is more like 80 basis points. Indeed, some banks have stated publicly that they are losing money on some broker loans.

Up until about 1994, banks were largely subsidising their branch networks and payment systems through the interest margin on loans, including housing loans. This practice was iniquitous to housing borrowers but it was a well entrenched legacy of government regulation of banking.

As the market share of Aussie Home Loans began to increase markedly in the mid-1990s, the banks started responding by cutting their variable rates. There were significant cuts in 1995 and 1996.

Facing a massive reduction in loan margins, to maintain profitability, banks were effectively forced to reduce the size of their costly branch networks and migrate customer payment transactions to electronic banking channels. Banks also sought to directly recover the cost of services and there was growth in the range and level of the fees charged.

While borrowers were benefiting through lower interest rates, there was significant community hostility towards the other changes caused by these margin reductions.

9/11 and the search for yield - 2001

Another important influence on bank lending occurred early this decade. Record low US Federal Reserve-set interest rates in the period after 9/11, combined with the large pool of savings generated by Asia (mainly China), put downward pressure on interest rates throughout the world, including Australia.

The low interest rate environment created strong demand for investment securities that offered higher risk/return characteristics. This demand was met through financial engineering and, in particular, the packaging of credit risk into tradeable securities.

In short, this generated large amounts of capital for housing and other lending. High risk loans, such as sub-prime US housing loans (known as non-conforming loans in Australia) found substantial pools of ready funding. This spawned much greater participation in housing lending markets.

In the period 2001 to July 2007, housing lending margins continued to decline to the point that the Reserve Bank, APRA and individual bank chief executives were expressing concerns over what appeared to be irrational pricing.

Credit crisis disproportionally impacts non-bank lenders – late 2007

The under-pricing of credit risk and seemingly endless liquidity for housing related securities was a major boost to the non-bank mortgage lenders. Because these lenders secure all their funding through capital markets, they could originate loans, including very risky loans, with the confidence that the loan would be purchased, bundled and then securitised.

In August 2007, investor sentiment towards asset-backed securities, particularly residential mortgage backed securities, deteriorated sharply. Because nearly all non-bank mortgage lenders had not taken measures to diversify their funding base, the impact of this reversal in investor sentiment has been damaging to their business model.

In the period since August 2007, there has been a reduction in the number of non-bank securitised lenders, but it is still the case that there are a sizeable number of active non-bank competitors in housing lenders.

1.3 Payments systems

Emergence of electronic banking – 1960s and 1970s

For most of the last century, there were only two primary payment instruments available for consumers and businesses to undertake transactions involving the transfer of value. These were personal cheques and cash. This changed in the 1970s as the Australian banks moved to take advantage of computing innovations for the delivery of electronic payment facilities.

In the early 1970s, the banks formed a joint venture and developed the Bankcard credit card and began issuing these cards[18] in 1974. Later in that decade banks started installing automatic teller machines (ATMs) and issuing plastic debit cards that could be used to access cash from these ATMs.

Also in the 1970s, the banks developed a direct entry (DE) system enabling the electronic crediting into customer deposit accounts of employer salaries and other bulk income payments like pensions and unemployment benefits.

In 1984, the Electronic Funds Transfer Point of Sale (EFTPOS) system became operational. This system utilised the ATM debit card for payment of goods and services at the merchant's counter. Merchants were given an incentive to accept EFTPOS transactions via introduction of interchange fees. EFTPOS was, and remains today, a very efficient, convenient and safe payment system.

The significance of the emergence of electronic banking from a competition perspective is that it helped reduce the advantage that incumbent banks had in their large branch networks. Electronic banking did give all banks a capacity to reduce costs, but it also ended up enabling new entrants to compete more effectively against incumbent banks.

Australian banks begin to innovate - 1990s

Once the basic building blocks of Australia's electronic banking system were in place – direct entry, EFTPOS and ATM systems - by the mid-to-late 1980s, the Australian banks commenced a period of significant innovation to improve the convenience of these products for consumers.

By the early 1990s, the ATM and EFTPOS networks had become ubiquitous – meaning that a debit card issued by any institution could be used in any ATM or any EFTPOS terminal. Initially when these systems were formed, it was only possible for the customer to use their debit card in an EFTPOS terminal or an ATM owned by the card issuer's bank.

In the mid-1990s, the Australian banks invented what is known as the 'Combo Card'. These are cards that combine both credit card and EFTPOS functionality. Australia is still one of the few countries that provides this convenient option to customers.

In 1998, using the underlying infrastructure of the direct entry system, Australian banks introduced BPay and later BPay View. BPay provides world-leading phone and Internet bill payment solutions.

By the year 2000, most banks had developed Internet banking platforms that enabled customers to undertake a range of account management and payment functions. These Internet banking websites have been gradually improved with greater functionality and are now the fastest growing contact point for customers to do their banking.

The banks also made large cost reductions through the establishment of a joint cash processing facility known as Vipro.

Payments Systems Regulation Act 1998 (PSRA) - 1998

Following the Financial System Inquiry (1997), the Federal Government passed the PSRA which established the Payments Systems Board (PSB) within the umbrella of the Reserve Bank and tasked it to supervise the payments system with the objectives of improving efficiency, competition and safety of the systems.

The initial work of the PSB involved the final implementation of the Real Time Gross Settlement System (RTGS) which is Australia's system for transferring large payments between financial institutions. Previous to RTGS, there was an overnight delay in the settlement of large transactions which potentially exposed financial institutions to large counter-party risks.

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[18] Initially Bankcard was solely a paper-based system in that all transactions used paper dockets.

In October 2000, the Reserve Bank and the ACCC released what is known as the 'Joint Study' – a major report into access and interchange agreements in the EFTPOS, ATM and credit card networks. This document set out a blueprint for reform of retail payment systems.

The Joint Study examined three aspects of these payment systems. Firstly, it examined the role of interchange fees and assessed these fees against cost benchmarks. Secondly, it looked at restrictions the schemes placed on merchants, particularly relating to rules prohibiting merchants from surcharging customers.

Thirdly, the Joint Study examined access issues and concluded that there was considerable scope to reduce restrictions on entry into the supply of these payments systems – both supply to merchants (known as 'acquiring' services) and supply to consumers (known as 'issuing' services).

Reforms to access arrangements that now exist in the payments system is discussed later in this submission.

Credit card reforms in 2002

In 2002, the Reserve Bank introduced a number of regulations to govern aspects of the credit card market. The main reform involved reducing by half what is known as the credit card interchange fee which, in turn, reduced the revenue that credit card issuers generate through credit card usage.

The intention of this regulation was to change the relative consumer pricing signals between credit cards and debit cards. The concern was that credit cards were too cheap to use relative to debit. This reform resulted in increases to annual credit card fees and introduction of other fees.

However, the market intervention did appear to result in a larger range of credit card products being offered in the market, in particular, credit cards offering lower interest rates and card products giving the consumer a choice over loyalty programs.

2. Current state of retail banking

In this section, the submission details key information relevant to consideration of the competitive operation of the banking industry. 2.1 discusses the structure of the banking industry and information on how it compares to other industries. 2.2 examines bank profit performances.

Parts 2.3 and 2.4 give statistical information on bank market share and margins for loans and deposits respectively. 2.5 describes the current state of the payments system. In part 2.6 the issue of bank concentration is discussed from a theoretical perspective. In 2.7, there is an extended discussion on contestability of banking markets. Finally, section 2.8 summarises the landscape of consumer choices in retail banking.

2.1 Structure and contribution of banking industry

There are 50 registered banks in Australia, 12 of these offer a broad range of retail banking services to the community. Total domestic assets of banks operating in Australia were $1.98 trillion as at November 2007. Around 70 per cent of these bank assets are loans and advances to households, businesses and other.

The finance and insurance industry contributed 7.9 per cent to national economic activity in 2007, up from 6.4 per cent a decade before. This represented a contribution $78.5 billion to economic activity in 2007. In comparison, mining contributed $69.3 billion, construction $69.2 billion and retail trade $58.5 billion.[19]

[19] Based on ABS data.

According to Roy Morgan research for September 2007, banks are the main financial institution chosen by 14 million customers aged 14 and over. Credit unions have 1.8 million primary customers while building societies 630,000.

As at December 2007, the market capitalisation of Australian retail banks was $312.7 billion. This represented 26% of the market capitalisation of the S&P/ASX200. Seven Australian Bankers' Association member banks are amongst the top 20 companies in Australia as listed by market capitalisation.

The Australian Bureau of Statistics (ABS) experimental estimates of multifactor productivity (which incorporate both labour productivity and use of capital) show that between 1985–86 and 2005–06 average annual productivity growth for the finance and insurance industry (on a value-added basis) was around 1.8 per cent per year. This was stronger than the average annual market sector productivity growth of 1.2 per cent per year.

ABS lists the finance and insurance industry as one of three industries which has had high productivity over the last 20 years. The other two are (a) Communication Services and (b) Agriculture, forestry and fishing. Over these years, competition and technology adoption have been key drivers of productivity growth by banks.

As of November 2007, ABS data showed that there were 207,200 people employed in the finance industry, making up 2 per cent of the employed labour force in Australia. Over the past 10 years, this contribution to total employment has remained in a tight range 1.9% to 2.3%. At 3.6% average growth per year over the last five years, employment in the finance industry has exceeded that for the overall employed labour force of 2.6 per cent per year since 2002.

The quality of bank lending which includes housing, business and personal loans is very high. An important indicator of asset quality is the rate of non-performing loans (which are made up of impaired assets and past due items). As at December 2007, the Reserve Bank reported that the ratio of non-performing loans as a percentage of total bank assets was 0.43 per cent. This has remained at record low levels over the past three years.

2.2 Profit performance

As at the end of profit reporting in 2007, the 12 Australian retail banks reported $21.6 billion in after tax profit (NPAT), an increase of 15 per cent over the previous year. The four major banks contributed 78 per cent of profit, while the smaller banks contributed 22 per cent.

Of this total profit, 77 per cent was generated in Australia and 23 per cent from overseas, including New Zealand. One bank sourced 40 per cent of its profit from overseas.

In 2007, banks contributed about $9.4 billion in taxation, 16 per cent higher than the previous year. Banks are one of the only private sector industries that pay the full rate of company taxation.

In fact, Price WaterhouseCoopers (PWC) analysis shows that in 2007 banks paid 30.8 cents in tax for every dollar of profit. This compares favourably to the average for all industries of only 26.7 cents in the dollar. Not only do make makes healthy profits, they pay the highest proportion of tax per dollar of profit.

The total dividend paid to shareholders in 2007 was $14.1 billion with a further $7.4 billion retained by banks for future investment.

Around 85 per cent of bank profit comes from banking activities, 9 per cent from funds management and 5.3 per cent from insurance. The net interest margin in banking has fallen from 3.64 per cent in 1993 to around 2.15 per cent today.

The profitability of Australian banks has been strongly influenced over the past 10 to 15 years, up to mid-2007, by a very sound Australian economy which featured low inflation and low unemployment. This favourable environment has been offset by increased competition from a broad range of bank and non-bank participants, resulting in ongoing, gradual margin compression. During the latter stages of this period, the competitive environment has reduced Australian banks' pricing power, with substantially reduced opportunities to offset revenue pressure through fee increases.

Since mid-2007, there has been increasing evidence of a slowing in credit growth, rising inflation, rising impairment charges and a continuance of high interest rates, all of which are impacting bank profitability and contributing to the overall lower outlook for growth in the short to medium term.

Over the last six months, Australian bank share prices have fallen some 30% as a result of investor nervousness about the above negative factors coupled with the impact of global funding and liquidity pressures, and a small but growing number of one-off corporate losses.

2.3 Deposits[20]

Total deposits in Australia stands at $1.13 trillion (this includes deposits from households and businesses and tradeable deposits e.g. certificates of deposit).

- Of this total, banks account for 95.4 per cent.
- The major four retail banks account for 59.6 per cent, less than two-thirds. Since 2002, the major banks' market share has fallen from 62.4 per cent.
- In terms of business deposits, the major four banks account for 70.0 per cent of the market, down from 74.5 per cent in 2002.
- In respect of household deposits, the major banks represent 58.9 per cent of the total. In 2002, the major bank share was 61.9 per cent.
- Margins (gap between the indicative deposit rate and the official cash rate) on bank deposits have increased on transaction accounts over the last five years as monetary policy has tightened. But there is evidence of very strong and increasing competitive pressure in the investment and in the one-year term deposit market - as seen from Table 1.

Table 1: Deposit products that have seen material reductions in margins since 2002[21]

	Cash management a/c ($10,000)	Cash management a/c ($50,000)	One year term deposit ($10,000)	Online savings accounts ($10,000)
May 2002	-275	-150	-25	
Aug 2007	-125	-110	-55	-50
May 2008	-120	-100	-10	-10

The fact that deposit margins have continued to decline since August 2007 on key deposit products indicates the competitive pressure for deposits that has emerged since the credit crisis hit in August 2007. Online savings accounts attract interest rates only a fraction below the official cash rate.

[20] Source data used to calculate the proportion of deposits for banks is from APRA as of March 2008. Interest margins are calculated using RBA statistics.

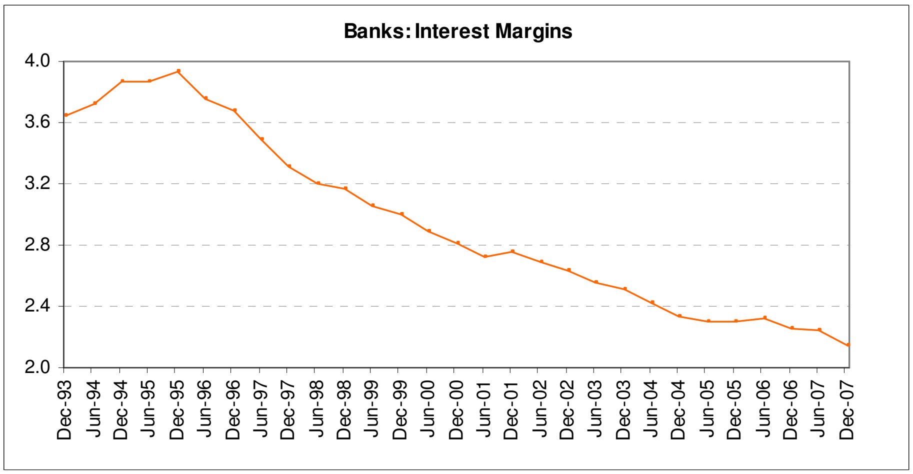
[21] Margin expressed in terms of basis points.

2.4 Loans

Total credit issued in the Australian economy is $1.2 trillion (includes loans to households, corporates, SMEs and government).[22]

- Of this total, banks account for about 76.4 per cent.
- The major four retail banks account for 50.7 per cent which is virtually unchanged as a proportion since 2002.
- In terms of margin on the total lending book, ABA estimates that in 1993, the margin of total lending to the cash rate was about 3.64 per cent. Today, the margin is about 2.15 per cent.
- If the same lending margin applied today as it did in 1993, bank loan borrowers would be paying an additional $18 billion in interest payments per year.

Graph 1: Reduction in bank interest margin since early 1990s



Source: UBS Warburg

Housing lending: currently the total outstanding housing debt in Australia is $929 billion (includes value of securitised housing loans).

- Of this total, banks account for 82.6 per cent. The major four retail banks account for only 58 per cent. These four institutions have collectively lost market share over the last five years.
- In terms of margins, the standard variable housing rate compared to the cash rate[23] is currently 2.2 per cent, up from 1.8 per cent since the credit crisis that was triggered in August 2007 (See Table 3). A problem with this measure is that it does not reflect housing loan rate discounting.[24]

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[22] Source data used to calculate the lending proportions for banks is from APRA as of March 2008. Interest rate margins are calculated using RBA statistics.

[23] Readers should note that while the margin to the cash rate is a convenient broadly indicative measure, it is not a precise measure of the margin. In the current financial environment, especially, the 'cash-rate based margin' must be interpreted or explained in terms of the significant impacts on banks' costs of funds.

[24] In its March 2008 Financial Stability Review the RBA reported that: "Over recent years, strong competition has been a feature of the Australian mortgage market and has led to a marked contraction of margins and, as noted above, a number of changes in lending practices. As discussed in previous *Reviews*, this competition has resulted in the majority of new borrowers paying an interest rate less than the major banks' standard variable indicator rate. In recent years, 'discounts' of at least 70 basis points have been common. The contraction in margins on low-doc loans had been even more pronounced prior to the recent turmoil, with many lenders ceasing to charge a premium on these loans, whereas earlier in the decade an interest rate premium was common. Reflecting this, the average

Table 2: Margin on housing loans

	Variable housing indicative interest rate: to cash (per cent)
1992 - May	4.5
2002 - May	1.8
2007 – August	1.8
2008 - May	2.2

Credit card lending: Currently the total outstanding credit card debt in Australia is $42 billion.

- Of this total debt, banks account for 76.1 per cent.
- The major four banks account for 60.6 per cent – this represents a substantial decline in market share since 2002. In June 2002, the major banks had 72.9 per cent of the total credit card lending.
- The margin on credit card lending (for standard credit cards) is 12.25 per cent. This is 1 percentage point higher than in 2002, although five years ago there were few low-rate credit cards offered in the market. The margin on low-rate credit cards is 5.35 per cent.

Personal loans: Currently, the total outstanding personal debt in Australia (excluding housing and credit cards) is $111 billion.

- Of this total outstanding, banks account for 71.2 per cent.
- The major banks only account for 46.2 per cent, although there has been an increase in their share since 2002 which was, back then, around 42.6 per cent.
- The margin on a variable rate personal loan is currently around 12.25 per cent – which represents a significant decline since the early 1990s of 15.90 per cent. Since August 2007, the margin has increased 1.4 percentage points reflecting the subprime crisis.

Business loans: Currently there is $480 billion in business loans on issue in Australia (includes small business and large business).

- Of this total outstanding, banks account for 71.7 per cent.
- The four major banks account for only 45 per cent, although this share has increased from 38.4 per cent in 2002.
- The margin on small business overdraft loans is currently 4.75 per cent – up from 4.10 since the credit crisis. Yet, the margin today is still significantly below that of the early 1990s. In May 1992, the margin was 5.10 per cent.

2.5 Payment system – physical infrastructure & usage

Branches

Banks have increased their branch presence every year for the past six years, according to the Australian Prudential Regulation Authority (APRA) survey data. As of June 2007, banks

rate paid on new low-doc loans was only around 30 basis points higher than that paid on new full-doc loans as at the end of 2006, compared with 110 basis points earlier in the decade."

had a total of 5,264 branches.

In terms of branch numbers, areas defined as moderately accessible, remote and very remote have experienced the highest average annual percentage increase over the past four years.

Banks also provide a range of other face-to-face services such as agencies and mobile banking units. There were a total of 3,124 of these services as at 30 June 2007. Growth rates for these face-to-face facilities over the past four years were strongest in those areas defined as less accessible.

ATMs

There were 26,067 ATMs operating in Australia as at December 2007.[25] The number of ATMs has almost doubled over the past seven years. A decade ago there were only 8,796 ATMs in Australia.

Over calendar year 2007, 842.9 million withdrawals were made at ATMs across Australia with a value of $145.3 billion. That is a 26% increase in the number of ATM transactions over the past five years (since 2002) and a 28% increase in the value of ATM withdrawals.[26]

EFTPOS

There were 649,820 EFTPOS terminals installed in Australia as at December 2007. Ten years ago there were 201,932 EFTPOS terminals – less than one third than exists today.

Reserve Bank of Australia statistics show that over the 2007 calendar year, there were 1.48 billion EFTPOS transactions made by customers across Australia with a value of $101.3 billion. That is a 63% increase in the number of EFTPOS transactions over the past five years (since 2002) and a 70% increase in the value of these transactions.

Other payments usage data:

A total of 411 million cheques were written in 2007 with a total value of $1.8 trillion. Over the past five years, the number of cheques written has been falling by 6.3% on average per year.

A total of 2.0 billion direct entry transactions were made in 2007 with a total value of $11.2 trillion. Over the past five years, direct entry transactions have been growing by 12.5% on average per year.

As at the end of 2007 there were 13.9 million credit card accounts in Australia as reported by the Reserve Bank. A total of 1.4 billion credit card transactions were made in 2007 with a total value of $204.8 billion. Over the past five years, the number of credit card transactions has been growing by 8.2% on average per year.

There were more than 8.5 million registered online banking customers as at September 2006 according to the Market Intelligence Strategy Centre. This is more than double the number compared to four years ago.

2.6 Bank concentration[27]

It is often erroneously stated (with negative connotation) that Australia's banking system is concentrated, but the available research shows the level of banking concentration in Australia is around the average of comparable countries. Over the last five years, the evidence suggests that the largest four banks have declined in the share of total deposits and lending, even taking into consideration the merger between the Commonwealth Bank and Colonial Bank.

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[25] Australian Payments Clearing Association (APCA) data.

[26] Reserve Bank of Australia data.

[27] Davis (2007) is the main source document for this section.

World Bank data shows a large number of comparable industrialised countries have more concentrated banking systems. These are: Norway, Portugal, Singapore, Belgium, Denmark, New Zealand, Slovakia, Austria, Germany, Greece, Spain, and Hong Kong.

Australia's banking system is roughly equivalent in concentration with the Netherlands and Canada. Of the major industrialised countries, the US has the least concentrated banking system – reflecting historical restrictions on interstate banking.

Concentration is often viewed as an indicator of the degree of bank competition that exists in the country, but the latest academic research shows this link to be non-existent. Strong competition can and does exist, despite high levels of concentration.

Using an analytical technique known as the "H-Statistic" developed by Panzar-Ross (1987), a number of academic researchers have found no evidence of a link between concentration and competition.

The H-Statistic is an estimate of the responsiveness of firm revenue to changes in factor inputs. For example, if wages increase, how does this impact bank revenue? The degree of response to these changes gives an insight to the competitive workings in the banking system.

Casu and Girardone (2006) examined banking markets for 15 European countries over the period 1997 to 2003 and found no evidence of a link between concentration and competition (as revealed by H-Statistics).

Claessens and Laeven (2004) undertook a study of 50 countries over the period from 1994 to 2001. Similarly, no link between concentration and competition was found.

Yildren and Philippatos (2007) study 11 Latin American countries for the period 1993 to 2000 and found no significant link between concentration and competition, although they did find a link between competition and the country's openness to foreign bank entry.

2.7 Contestability[28]

One of the pronounced themes in retail banking since deregulation in the 1980s has been the increasing contestability of banking markets, including deposits, loans and payment systems.

The advantages banks once had in the provision of banking services has broken down and the only real remaining entry restrictions are those imposed by governments in the form of licensing requirements.

Under the period of intensive government regulation, where prices were controlled, the main form of competition between institutions manifested in the rollout of extensive branch networks. When deregulation eventually came, these branch networks gave the Australian retail banks an advantage over new entrants because they were important to both the deposit and lending business.

With the emergence of Internet, electronic banking and the establishment of a large broker industry in Australia, the advantage of large geographically-dispersed branch networks has been significantly reduced.

The vast bulk of deposits made into Australian retail bank deposit accounts come in the form of direct entry payments of salaries and other income payments from the employers and the Government. In earlier generations, salary and social security payments were deposited via cheques and cash in branches.

Even cheque deposits can now be undertaken through the post rather than over-the-counter at a bank branch. Some ATMs even accept deposited cheques. With respect to cash deposits of currency notes, these are increasingly rare as the cost of making cash withdrawals along

[28] Northcott (2004) is the main source for this section.

with the time costs of visiting a branch encourages customers to hold onto cash and use it for upcoming day-to-day expenditures.

The Internet and telephone banking enables customers to undertake account management functions, such as checking balances and transferring funds, without the need of visiting a branch. Branches are increasingly viewed by banks as a means of offering a wider range of products, particularly wealth management and insurance products.

A number of foreign banks in Australia have dramatically increased their share of total deposits without significant numbers of bank branches. Indeed, the bank that increased its share of deposits over the last five years has no material branch presence.

The extensive broker network that emerged in Australia in the 1990s (in response to bank branch closures) has also dramatically reduced the advantage for banks in owning large proprietary branch networks. This point is illustrated by the fact that over 30 per cent of originated loans in 2007 came from mortgage brokers. In 2007, there were two banks that sourced more than 90 per cent of their housing loans through brokers.

Another comparative advantage that banks once had was in the ability to assess the credit worthiness of individual and business customers. Because banks normally would have an existing relationship with a potential borrower (e.g. through a transaction or savings account), this would give the bank additional information from which to make credit assessments.

This advantage began to breakdown in the early 1990s when banks in Australia and throughout the world started to rely more heavily on statistical models and computer software to assess the credit worthiness of customers. These statistical tools, known generally as credit scoring models, are now freely available to lenders. They are primarily used in: credit card lending; mortgage lending; and SME lending.

Another source of advantage often cited as supporting incumbent banks is the payments system. This concern related primarily to the fact that (a) generally, financial institutions supplying payments products were required to be authorised deposit-taking institutions and, (b) the bilateral nature of Australia's payment systems meant that new entry could be more difficult to negotiate.

In recent years, the banking industry and Reserve Bank have systematically reduced any unnecessary restrictions. Access regimes now exist for Australia's retail payments system to address these concerns. These are:

- Removal of the requirement that only authorised deposit-taking institutions can issue credit cards in the Visa and MasterCard schemes;
- Removal of the requirement that only authorised deposit-taking institutions can provide merchant acquiring services in the credit card networks of Visa and MasterCard;
- The introduction of an EFTPOS access code that guarantees new entrants (access seekers) direct access to the incumbent bilaterally-based network;
- Introduction of an access code for the Direct Entry (DE) network that guarantees new entrants (access seekers) direct access to the incumbent bilaterally-based network; and
- Pending introduction of an access code for the ATM network that guarantees new entrants (access seekers) direct access to the incumbent bilaterally-based network.

These and other changes to access have brought greater participation in the retail payments system. Some examples are:

- GE money – which is not a deposit-taking institution - now issues credit cards in its own name in addition to providing in-store charge card and credit products.

- MoneySwitch – which does not have a deposit-taking licence, has joined the EFTPOS network as a direct connector and is offering merchant acquiring services.
- Coles Myer – which does not have a deposit-taking licence - is a direct connector in the EFTPOS system and now acquires its own credit and debit card transactions.
- Woolworths – which does not have a deposit-taking licence - now acquires its own credit card transactions.
- US giant First Data operates as a direct connector in the ATM network.
- About half of the ATMs in Australia are owned by non-banks.
- Banks are also facing competition in the online payment market with strong presences of PayPal.

Also pending is the introduction of a new system of consumer charging of foreign ATM transactions – these are the transactions where the consumer uses an ATM owned by another entity other than their own bank. From March 2009, the ATM owner will charge customers directly for the transaction after disclosing the fee on the ATM screen and before the customer is committed to finalising the transactions.

While the banking industry has expressed over many years reservations about this new system, mainly because of concerns that consumers will not like it, there is the possibility it will lead to a greater number of ATMs and therefore greater choice for customers.

Another important upcoming initiative is the introduction of a scheme for EFTPOS. This will potentially enhance the competitiveness of the debit market by giving EFTPOS a more commercial operating structure. (This is discussed further below)

The Reserve Bank of Australia (RBA) has recently[29] expressed its view that competition in the payments system has strengthened considerably as a result of its reform agenda and is now seeking views whether a light touch regime can replace the regulator's direct intervention on price.

2.8 Consumer choices

Taking the consumer's perspective, it is clear there is significant choice in the supplier of banking products and in the availability of discounted products. The degree of this choice and opportunities is summarised in Table 3 below. The table is constructed from freely available data provided by Cannex and Infochoice on their websites.

On the far left column of the table is the list of some key consumer products demanded in the retail banking market today.

The next column estimates the number of suppliers of these products, although the estimate is likely to be an under-estimate as some financial institutions may not formally provide Cannex and Infochoice with product information.

The third column shows the Reserve Bank's published indicator lending and depositor rates – these rates can be viewed as industry average benchmarks. The fourth column estimates the best available interest rate in the market today. Finally, the table shows the type of institution providing the best priced product.

[29] RBA (April 2008)

Table 3: Showing number of suppliers and best market interest rates on offer

Products	Number of providers	Reserve bank indicator rate[30]	Best interest rate available in market	Type of institution offering best interest rate
Housing loan – owner occupier – variable rate	139	9.45%	9.00%[31]	Non-ADI lender
Credit card – standard	101	19.5%	19.10%	Regional bank
Credit card – low rate	64	12.6%	9.55%	Building society
At-call savings a/c -on-line	55	6.80%	8.50%	Foreign-owned retail bank
At call savings a/c - standard	107	6.05%	7.4%	Major bank
1 year term deposit[32]	107	7.15%	8.7%	Foreign-owned retail bank
3 year term deposit[32]	52	5.05%	8.5%	Regional bank
Small business overdraft	34	11.55%	10.15%[33]	Major bank

Source: Cannex and Infochoice, as at 16 July 2008

The table enables a number of observations pertinent to competition analysis. The first is that there are very many suppliers of banking products. These include major banks, regional banks, foreign-owned retail banks, building societies, credit unions and non-ADI financial institutions.

The number of suppliers in each product category is particularly important because there are no material geographical constraints to a consumer purchasing a product from anyone of these suppliers i.e. all the products are in national markets. A credit union based in North Queensland can efficiently issue a credit card, home loan or term-deposit to a household based in Sydney by using the Internet, phone and mail as a means of communication.

Another observation is that if a consumer is willing to shop around, perhaps by visiting the Cannex or Infochoice websites like ABA has, then they can potentially find products with significant discounts.

Lastly, the table shows that a range of different institutions are offering the best-priced products, indeed, most of the institution categories are represented as offering a best-priced product offering.

3. Drivers of future change and innovation

To assess the drivers of change in retail banking over the next twenty years, it is pertinent to assess the factors that have driven change and innovation over the last twenty years.

As has been explained throughout this submission, the increasing competitive tension in retail banking has come about through greater contestability of banking markets. This

[30] This is a simple average of rates detailed on Cannex's database. There is no weighting formula used.

[31] ABA estimate that removes product offerings that have special conditions attached.

[32] Based on a $10,000 investment.

[33] Based on a $20,000 loan.

started with technology breakthroughs in computing and information management in the 1950s and 1960s that ultimately led to the emergence of electronic banking. Electronic banking combined with the Internet has eroded the advantage of incumbent banks in having large branch networks. Technology will continue to play a critical role in developments in banking.

A very significant factor in increasing competitive tension in retail banking was the program of financial deregulation that commenced in the 1970s and was completed in the 1980s. This allowed banks to compete on the basis of price and allow foreign banks to enter the market to compete directly with locally owned banks. While the regulatory framework currently in place appears to broadly work well in terms of enhancing safety, efficiency and competition in banking, there are opportunities to rationalise and reduce the compliance costs of regulation.

But the greatest driver of the future shape of the retail banking system will be that of customer choices and demands. Customers look for value in the products they purchase and for the products to meet their financial needs. Convenience, price and safety will continue to play a critical role into the future. Perhaps the most immediate challenge is to ensure customers remain confident in electronic banking by ensuring fraud risks continue to be properly identified and managed.

ABA comments on policy proposals and initiatives

4. Bank account switching initiatives

In February this year, the Federal Government endorsed a bank account switching initiative designed by the ABA to assist bank customers switching banks. The initiative's aim is to ensure that customers unsatisfied with their current bank can more easily switch transaction account provider.

In previous research, ABA identified that the main cost to a customer wanting to switch banks was the time and hassle involved in re-establishing direct credit and debit authorities on their primary bank transaction account. The research showed that there were no significant monetary costs in switching banks.

The switching initiative will assist customers by (a) giving the customer a list of direct debits and credits operating on their old bank account and (b) requiring the customer's new bank to assist in re-establishing these arrangements with the new bank account.

The full initiative will be implemented as of November 2008, but the banks have implemented already interim arrangements that assist customers in switching. The Federal Government has been briefed on these interim arrangements.

For additional details on the initiative, including industry updates on implementation, see the Account Switching webpage under 'Payment System' on RBA's website www.rba.gov.au.

5. Housing loan mortgage exit fees

In February this year, the Treasurer commissioned the Australia Securities and Investment Commission (ASIC) to examine any fee impediments to customers switching housing loan provider.

Following ASIC's report into mortgage entry and exit fees, the Treasurer wrote to the ABA and banks recommending that the industry consider the findings of the report which included concerns over the level of exit fees, the structure of lender's mortgage insurance (LMI) and fee terminology and disclosure.

The ABA has responded to the Treasurer. In the response, the industry acknowledged scope for improving fee terminology to promote consistency. The ABA recommended that once the Federal Government takes over regulation of credit that ASIC convene a working group to undertake this task.

As to the level of exit fees, ASIC's own report shows that when summing up the average entry and exit fees on mortgages, Australian banks are lower than their US and UK counterparts. It is necessary to look at both entry and exit fees in the context of switching as switching provider will necessarily involve the potential payment of both exit and entry fees.

The report also highlights to the competitiveness of the banks relative to non-bank lenders – banks have considerably lower exit fees than non-bank lenders and also considerably lower fees when both entry and exit fees are taken into consideration.

On the issue of Lenders Mortgage Insurance (LMI) being a constraint to switching, ABA individual banks are considering the ASIC's report, although the ABA's assessment is that this does not appear to be a material issue.

6. Government purchases of housing loans

With the decline in issuance of Residential Mortgage Backed Securities (RMBS) in the wake of the US sub-prime crisis, Australian non-bank mortgage lenders have found it difficult to raise funding to support the issuance of housing loans.

This has led to a number of proposals for the Government to establish a government housing loan funding agency or scheme and use its AAA credit rating to issue RMBS securities. This agency would purchase loans from both deposit-taking institutions and non-ADIs lenders.

The ABA member banks are likely to have differing views on the merits of a Government scheme. There are liquidity advantages for banks and other lenders in having the Government purchase housing loans, but there are also problems. This is evident with recent reports that the US Government is set to inject taxpayer's money to recapitalise Fannie Mae and Freddie Mac.

Establishing an appropriate governance regime is problematic. Giving a scheme independence from Government can result in the scheme excessively increasing its market share over time and/or investing in risky loans. Yet, giving the Government effective control over the scheme's business decisions also has the potential to result in riskier lending as Government is often influenced by political considerations.

7. Monetary policy and variable interest rates

Another consideration pertinent to whether the government should enter the housing finance market relates to the monetary policy cycle.

It is claimed that restoring the viability of a number of non-bank mortgage originators to that existing before the credit crisis emerged would reduce current bank housing interest rates by squeezing margins further. There are two relevant factors rebutting this argument:

Firstly, bank interest margins have continued to decline since August 2007 as a result of higher wholesale funding costs.

Secondly, housing variable interest rates are currently being primarily influenced by the Reserve Bank through tighter monetary policy. Reserve Bank Board Minutes indicate strongly that without the retail banks having passed on higher funding costs to borrowers, then monetary policy would have to have been tightened further.

8. Scheme for EFTPOS

In recent years, the banking industry has been working on a proposal to establish what is called a 'scheme' for the EFTPOS system. Unlike with credit card schemes of Visa and MasterCard, there is no one central management organisation dedicated to the promotion of the EFTPOS/debit product.

The EFTPOS system is being viewed not only by banks but also the Reserve Bank[34] as potential source of stronger competition in the card payments market which includes Visa, MasterCard, AMEX and Diners Club.

However, to make EFTPOS a more effective card product competitor, it is widely agreed that it needs a centralised management and coordination body. The organisation is yet to be established, but it is understood the functions of the scheme management will involve at a minimum the setting of interchange fees and promotional activities.

[34] See Reserve Bank's payments system reform preliminary conclusions report available at the Reserve Bank website www.rba.gov.au.

9. Deposit insurance

Recently the Federal Government announced its intention to legislate for what is called a Financial Claims Compensation Scheme (FCCS) which will provide Australian depositors a deposit guarantee up to the limit of $20,000. This will cover the deposits of 80 per cent of depositors.

The ABA has for many years opposed the introduction of this scheme on the basis that it is unnecessary in that there have been no material deposit losses in Australia since the 1890s depression and that deposit guarantees carry the risk of moral hazard behaviour.

This latter risk is exacerbated because, the ABA understands, there will be no risk-pricing in the insurance premiums. This is why the ABA previously recommended separate insurance pools for banks and mutuals.

One consequence of this policy is likely to be that smaller institutions like credit unions and building societies and higher risk institutions will be more willing to issue higher risk loans (or under-price loans).

It is rarely acknowledged, but the US sub-prime housing lending crisis is the second major housing lending crisis in the US since the 1980s. The first was that of the US savings and loan crisis which ended up costing US tax payers over $140 billion. It is widely accepted that deposit insurance was a major cause of the excessive risk-taking. In the wake of this crisis, Congress moved to legislate for risk-based insurance premiums.

10. National regulation of credit & mortgage brokers

The ABA has publicly welcomed the decision by the newly elected Federal Labor Government – in agreement with the State Governments through COAG[35] - to move the regulation of credit from the states to the federal sphere. If properly managed, this will achieve substantial reductions in compliance costs of regulated entities and improve productivity in the industry.

The decision to federally regulate the broking industry also stands to reduce compliance costs associated with state-based regulation. This will deliver efficiency benefits in addition to providing consumer safeguards against poor practices and ensuring customers are treated equally regardless of where they reside or where they undertake transactions.

11. E-conveyancing

The banking industry welcomes the Federal Government's leadership role in driving the introduction of electronic conveyancing in Australia. For some time, differences of opinions on the direction of reform plagued progress.

Achieving a more efficient and timely conveyancing system by utilising electronic channels represents a significant microeconomic reform.

12. Four Pillars

The effect of the Four Pillars policy on the degree of competition in the banking sector is ambiguous. On the one hand, because it prevents a merger of the major four banks it may constrain further concentration, but as described earlier in the submission, there is no empirical evidence that concentration in banking constrains competition.

The ABA's view is that banking mergers should be treated in the same way as mergers in other industries – they should be subject to the *Trade Practices Act 1974.*

[35] Council of Australian Governments

It needs to be recognised that prohibiting structural change in the banking industry may have adverse long-term consequences and prevent opportunities.[36]

[36] The ABA will soon be releasing a report into the barriers faced in establishing Australia as a financial hub in the region.

Conclusion

In conclusion, the ABA believes the banking system is competitive and the history of financial stability is particularly impressive.

Competition in the deposit market is currently very intense as banks and other deposit-takers compete to win deposits as a means of diversifying their deposit base away from international capital markets.

Loan markets are similarly highly competitive, with little evidence that the decline of non-bank lenders in the housing mortgage market will materially increase lending margins. In any case, it is likely just a question of timing as to when non-bank lenders regain access to RMBS financing.

There are a range of public policy issues relating to competition currently being addressed by the industry, including customer switching, ATM access, fee terminology consistency that will make incremental improvements in the various financial services markets.

The ABA encourages the Government to remove the Four Pillars policy in favour of allowing banking mergers to be assessed on the same basis as other industries – under the Trade Practices Act 1974.

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Appendix 1: Description of retail banking

Banks are part of the financial services industry. They are intermediaries between savers (lenders) and borrowers. At the most basic level, banks collect the funds of those who have surplus capital and then distribute those funds to businesses and individuals who have a higher valued use of that money.

As intermediaries, banks primarily make their profit on the margin charged between the interest paid on the savings collected and the issued loans, although since the 1990s, bank revenue generated through direct fees and charges for services has diversified the revenue base of banks.

Retail banking refers to the collection of money from personal customers and small-to-medium sized businesses and the subsequent loans to these same customer categories. It is contrasted with the collection of deposits (and other funding instruments) from corporates, governments and other financial intermediaries.

Retail banking, therefore, typically excludes the collection of money from wholesale funding sources[37] such as capital markets.

The collection and lending functions are managed through a system of bank accounts. Bank accounts are assigned to both personal and business customers. They record the store of value (deposit accounts) or the debt (loan accounts) attributed to the owner of the account.

By summing up all the deposit account balances, the bank determines its stock of deposit liabilities and the amount of potential money it has to lend. The aggregate deposits from individuals are generally referred to as deposits from the 'household' sector, whereas the deposits from business are referred to as 'non-financial institutions'.

By summing up all the loan account balances, the bank determines its total assets i.e. the amount of money from which it receives interest repayments. Once again, total lending is summarised as lending to 'households' and 'non-financial institutions'.

Also in retail banking it is useful to categorise a third function – that of the provision of payment systems. While payment systems normally involve the movement of money between holders of deposit accounts, there is a significant infrastructure established to assist these value transfers which warrants a separate categorisation.

Modern day banks also offer a range of other services to individuals and businesses, including wealth and investment products like superannuation, margin-lending and insurance. Although increasingly these products are provided by banks, they are not traditional banking services and are not examined in this submission.

<u>Deposit accounts</u>

Deposit products are further divided into transaction accounts, savings accounts and term deposits.

Transaction accounts provide customers with a convenient account from which they can purchase goods and services and have an amount of cash on stand-by to smooth consumption in between income payment periods.

These accounts typically pay low rates of interest. This reflects, in part, the historical approach by Federal Government regulation prohibiting banks from paying interest on current accounts.

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[37] It should be noted that wholesale funding is used for loans to retail customers, but the raising of wholesale funds is viewed as a non-retail function.

Savings accounts are accounts whereby customers can store money and typically earn a higher rate of interest, although the money remains at-call.

Term deposits contrast with savings accounts in that the customer agrees to locking-up the funds for an agreed period of time, typically in exchange for a higher interest rate.

Banks, credit unions and building societies dominate the provision of deposit products. To be a deposit-taking institution, authorisation from the Australian Prudential Regulation Authority (APRA) is required which, in turn, requires compliance with capital and other prudential standards.[38]

While it is often reported that banks do not generally pay interest on deposit accounts, the reality is that over 70 per cent of deposit funds are held in savings and term deposits, with the remainder 30 per cent in transaction accounts.

Loan accounts

In personal retail banking, there are three primary loan products. These are (a) housing loans, (b) credit cards, and (c) personal loans. In contrast to the deposit market, there is considerable participation in these markets from non-deposit taking institutions.

Housing loans are self-explanatory; they are secured loans to purchase both owner-occupied and investor houses. Credit cards provide two functions – a card to initiate payments for goods and services and a line of unsecured revolving credit.

Personal loans have declined in popularity with the increased usage of credit cards and are now primarily used now for purchases of large consumption items like cars and boats and also for debt consolidation.

Lending to households now accounts for 65 per cent of total bank lending with the remainder that of lending to businesses (30 per cent), other banks (4 per cent) and a very small amount to government.

Housing lending accounts for the bulk of bank lending to households, around 86 per cent, with 57 per cent to owner-occupied borrowers. Personal loans account for 10% or bank lending to households and credit cards 4%.

Loan products can be issued by non-banks such as finance companies, mortgage originating specialists and even specialist credit card businesses.

Payment systems

Payment systems describe the customer instruments and supporting infrastructure to transfer value between bank accounts in a convenient, safe and accountable manner.

Australian consumers have a wide range of payment channels and product providers from which to manage the payment of goods and services and transfer of value between accounts.

Payment channels include: branches, ATMs, EFTPOS, Internet and phone banking.

Payment instruments include: debit cards, credit cards, pre-paid cards, BPay, cheques, and direct entry.

Payment systems are predominantly supplied by banks due to the close connection between deposit accounts and payment transfers, but there is a significant role now played by non-banks.

[38] See APRA website: **www.apra.gov.au**

Summary of retail banking structure

	Personal accounts	SME accounts
Deposit accounts	Transaction Savings Term deposit	Transaction Saving Term deposit
Loan accounts	Housing Credit card Personal	Business overdraft Credit cards Leasing products
Payment systems	EFTPOS ATMs Phone Internet Cheque	EFTPOS ATMs Phone Internet Cheque