4. Require New Focus on Banking Competition

> "There seems a lack of very robust competition in banking...We are not seeing as much robust competition as we would like"*Rod Sims, Chairman of the Australian Competition and Consumer Commission*[1]
>
> "We are in a market which is, frankly, an oligopoly" *Greg Medcraft, Chairman of the Australian Securities and Investments Commission*[2]

Recommendation 3

4.1 The committee recommends that the Australian Competition and Consumer Commission, or the proposed Australian Council for Competition Policy, establish a small team to make recommendations to the Treasurer every six months to improve competition in the banking sector.

4.2 If the relevant body does not have any recommendations in a given period, it should explain why it believes that no changes to current policy settings are required.

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1 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 2.

2 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard,* 14 October 2016, p. 5.

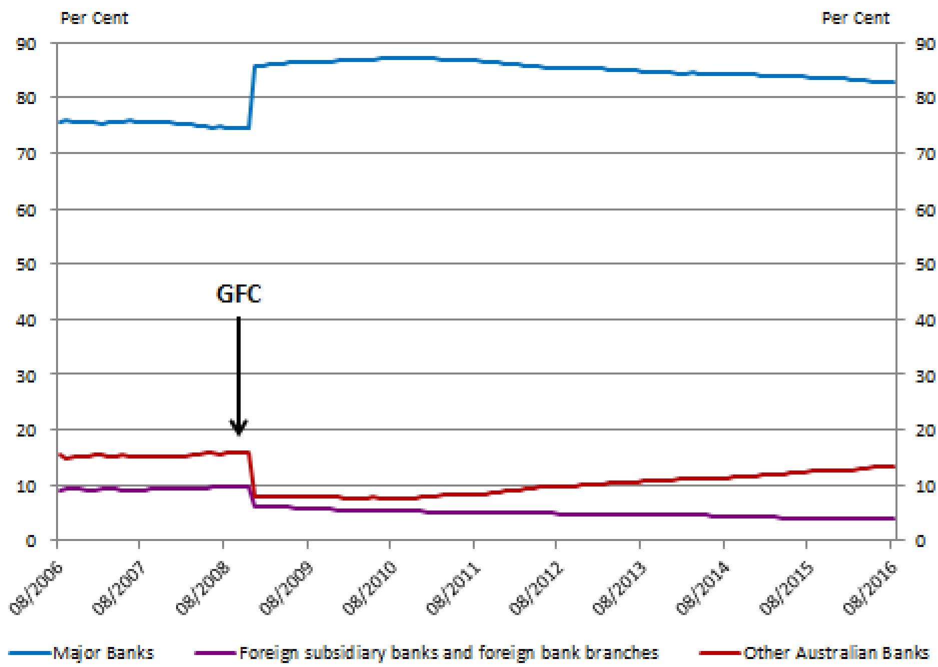
4.3 Oligopolies are problematic when they are able to use pricing power to the detriment of consumers.

4.4 Australia's banking system is such an oligopoly. Australia's four major banks have significant pricing power, higher than average returns on equity and large market shares.

4.5 This is particularly the case post-global financial crisis (GFC), due to:

- a significant degree of consolidation around 2008 as the major banks purchased a number of smaller competitors (Figure 4.1); and
- a collapse in securitisation markets, which had previously allowed the major banks' competitors to access cheap wholesale funding.

Figure 4.1 Market Shares of Bank Housing Lending



Source: APRA Monthly Banking Statistics (August 2016)

4.6 A lack of competition in Australia's banking sector has significant adverse consequences for the Australian economy and consumers.[3] It:

- creates issues around banks being perceived as too-big-to-fail (TBTF) (such as moral hazard);
- reduces incentives for the major banks to innovate and invest in new infrastructure; and
- can allow banks to use their pricing power to extract excess profits from consumers.

4.7 The committee finds it very surprising that no Australian government has completed a wholesale review of competition in the banking sector in recent times.

4.8 More surprising, however, is that despite the Australian Competition and Consumer Commission's (ACCC's) clear concerns about the level of banking competition, it has acknowledged not closely monitoring the sector because 'the RBA, APRA and ASIC are...observing the banks.'[4]

4.9 None of these regulators, however, have a clear mandate to promote competition in the financial sector. The ACCC does.

4.10 The Reserve Bank of Australia (RBA) are primarily concerned with financial stability; ASIC with ensuring market integrity and protecting consumers; and APRA with ensuring the financial soundness of prudentially regulated institutions.[5]

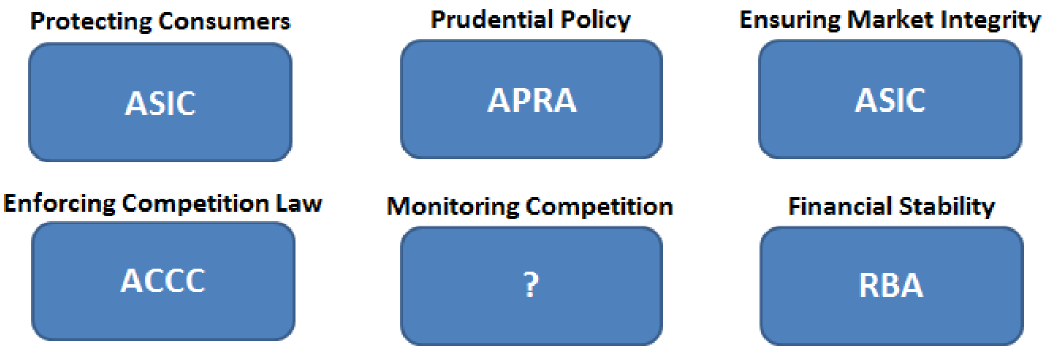
4.11 This means that no regulatory agency is regularly considering the level of competition in Australia's banking sector and whether change is required (Figure 4.2).

3 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 16.

4 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 3.

5 While APRA must balance the need for competition against its other mandated objectives, this is secondary to APRA's need to promote financial stability.

Figure 4.2 Regulatory oversight of the banking sector



4.12 The committee endorses the Government's decision to have the Productivity Commission periodically review financial sector competition. However, the committee does not believe that structural reviews undertaken 'as appropriate'[6] go far enough.

4.13 To create this accountability, the committee recommends that the ACCC (or the proposed Australian Council for Competition Policy (ACCP)) establish a small team dedicated to the continual monitoring of competition in the banking sector.

4.14 This team should make recommendations to improve competition in the banking sector to the Treasurer every six months.

4.15 Given repeated statements from the ACCC that the sector is uncompetitive, if the ACCC/ACCP does not make any recommendations for policy change in a given period, it should explain why that is appropriate.

4.16 Ongoing monitoring of the banking sector's competitiveness will fill an important gap in Australia's regulatory framework.

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6 Australian Government, *Attachment: Government response to Financial System Inquiry Recommendations*, <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt-response-to-the-FSI/html/08-Attachment>, viewed 20 October 2016.

4.17 In addition to filling a regulatory gap and improving the sector's accountability for its conduct and the pricing of interest rates and fees, the creation of this team would significantly enhance the ACCC's understanding of competition in the sector. This would better equip the ACCC to assess whether any potential future mergers or acquisitions are likely to significantly lessen competition.

4.18 This is of particular importance given that ASIC[7] and the ACCC[8] both advised the committee that prior mergers had lessened competition and that other competitors had not emerged as the ACCC had expected.

4.19 The committee does not imply that the ACCC acted inappropriately in its decision to not oppose many of these transactions. The committee is suggesting that enhancing the ACCC's understanding of competition in the sector on an ongoing basis should leave it better equipped to assess the effect of any future transactions.

7 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard*, 14 October 2016, pp. 21-22.

8 Mr Rod Sims, Chairman of ACCC, *Committee Hansard*, 14 October 2016, p. 14.

Pricing Power

4.20 One of the most powerful indicators of an oligopoly is pricing power.

4.21 The evidence suggests, and the ACCC Chairman agrees,[9] that the major banks' have significant pricing power. They have effectively lifted average interest rates across the economy; have passed increased costs on to consumers; and do not always compete aggressively for increased market share.

4.22 In the wake of the GFC, a comprehensive set of financial sector reforms have been progressed to improve ADIs' resilience. This includes increased capital and liquidity requirements, the introduction of a Net Stable Funding Ratio in 2018, and the development of a Loss Absorbing Capacity framework in line with international developments.

4.23 While these are necessary and critical reforms, they have come at a significant cost. In Australia this cost appears to have been borne largely by consumers.

4.24 There have been two clear recent examples of this.

4.25 Firstly, post-GFC, banks have been required to increase the share of their assets that are held in securities by around five per cent. The average return on these liquid assets is less than one per cent, which is significantly lower than the return on, for example, residential mortgages.[10]

4.26 In response to these lower rates of return, Australian ADIs have widened their lending spreads. This has forced consumers to bear the costs of holding these additional liquid securities, rather than shareholders.[11]

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9 M Roddan, 'Sims: ACCC 'covering most sectors', won't confirm banks', *The Australian*, 25 July 2016, <http://www.theaustralian.com.au/business/financial-services/sims-accc-covering-most-sectors-wont-confirm-banks/news-story/7201c237ed1362d861449e8bce29e511>, viewed 20 October 2016.

10 Dr Philip Lowe, Governor of the RBA, *Committee Hansard*, 22 September 2016, p. 7.

11 Dr Philip Lowe, Governor of the RBA, *Committee Hansard*, 22 September 2016, p. 8.

4.27 Secondly, in October 2015, the major banks announced out-of-cycle increases in mortgage standard variable rates (SVRs). This was attributed to APRA's interim work to implement the Financial System Inquiry's (FSI) recommendation that APRA:

> Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models [the major banks and Macquarie] and those using standardised risk weights [all other ADIs].[12]

4.28 APRA's changes to mortgage risk weights for banks using IRB models have increased the capital that the major banks have to hold against residential mortgages.

4.29 However, the magnitude of the interest rate increases in October 2015 (between 15 and 20 basis points for each of the major banks) indicates that the cost of higher capital requirements was borne largely by mortgage holders as opposed to shareholders.[13]

4.30 The major banks' pricing power is also observable in the fact that they closely follow one another's price changes, rather than attempting to increase their market share.

4.31 Since 2000, the spread between the interest rates charged on many retail and small business products and the cash rate has increased (Figure 4.3).

4.32 The committee understands that funding for these products comes from a range of sources, at costs that can differ widely from the cash rate.

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12 D. Murray et al, Financial System Inquiry, *Final Report*, 2014, p. 60.

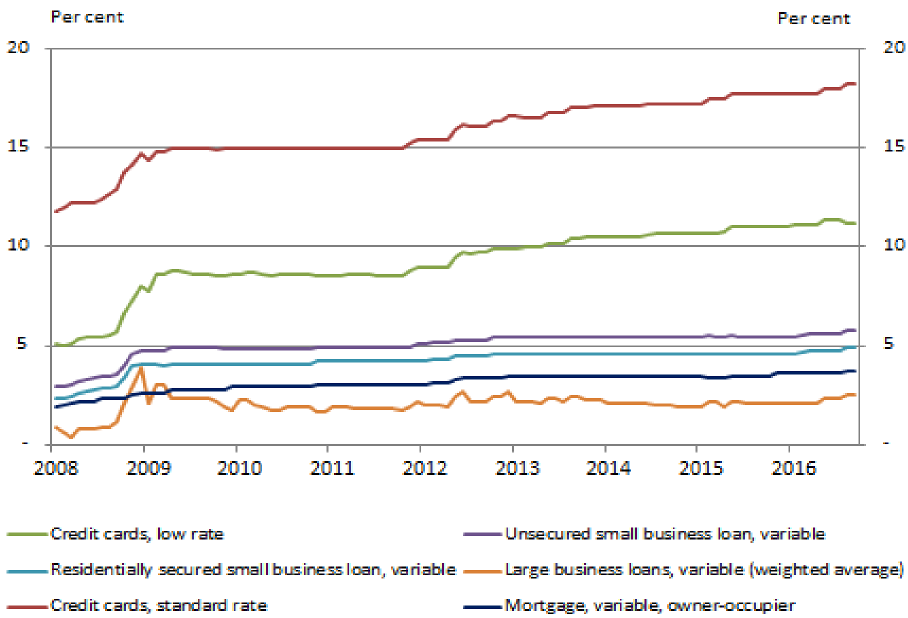
13 UBS, *Westpac Banking Corporation strengthens the balance sheet & reprices mortgages*, 2015, p. 1.

4.33 The committee also understands that these products can have differing levels of risk that may have been inaccurately priced pre-GFC (such as small business loans).

4.34 However, it is notable that post-GFC:

- spreads have increased on all consumer and small business products, including on low-rate credit cards - a product where providers ostensibly compete on price and not features;[14] and
- spreads have increased by less on lending to large businesses, that likely have access to a wider variety of non-ADI funding sources, than small businesses and retail customers.[15]

Figure 4.3 Consumer and business credit products' spread to cash rate



Source: RBA Indicator Lending Rates (September 2016)

14 Mr Antony Cahill, Chief Operating Officer NAB, *Committee Hansard*, 6 October 2016, p. 25.

15 From January 1990 to August 2016, following the deregulation of the banking sector, this effect is more pronounced. The spread on loans to large businesses has declined by 20 basis points while the spread on SVRs, for example, has increased by 400 basis points.

4.35 This means that the gap between the cash rate and the interest rate on a broad range of consumer and small business products has become larger.

4.36 The major banks' pricing power is also observable in the net effect of their changes to mortgage SVRs that have been to consumers' relative benefit or detriment since 2000.

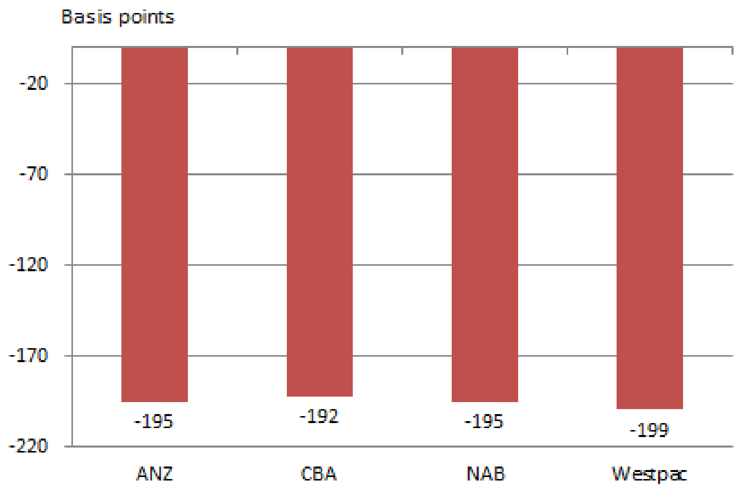
4.37 Mr Wayne Byres, APRA's Chairman, noted that in a competitive market, over the economic cycle, the net effect of these changes should be around zero.[16]This has not been the case in this century.

4.38 Since 2000, the major banks have made changes to their SVRs that have left mortgage holders with rates at least 195 basis points higher than they would be if the interest rate had simply tracked the cash rate (Figure 4.4).

4.39 In fact, since 2000, the major banks have averaged around one SVR change to consumers' relative benefit, compared to an average of around 19 SVR changes that have left consumers relatively worse off (Figure 4.5).

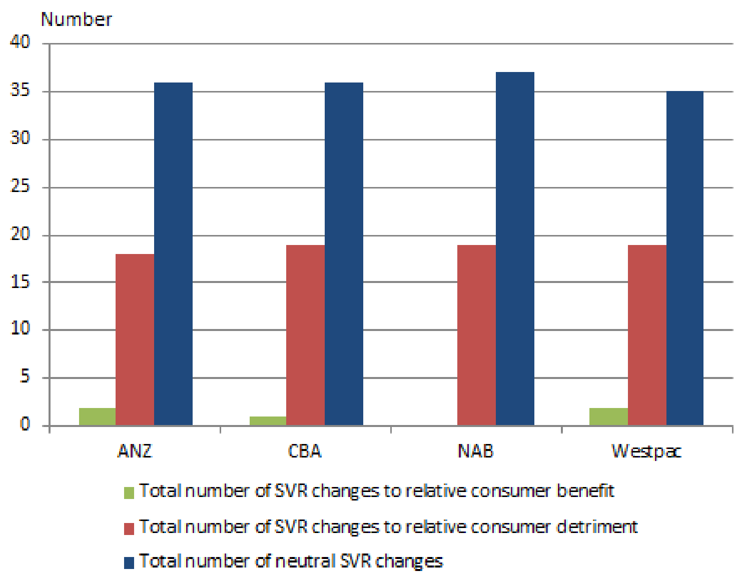
16 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 24.

Figure 4.4 Net consumer impact of major bank interest rate changes relative to RBA cash rate changes (2000 - 2016)



Source: RBA (October 2016), committee calculations.

Figure 4.5 Number of bank interest rate changes, by type, relative to RBA cash rate (2000 - 2016)

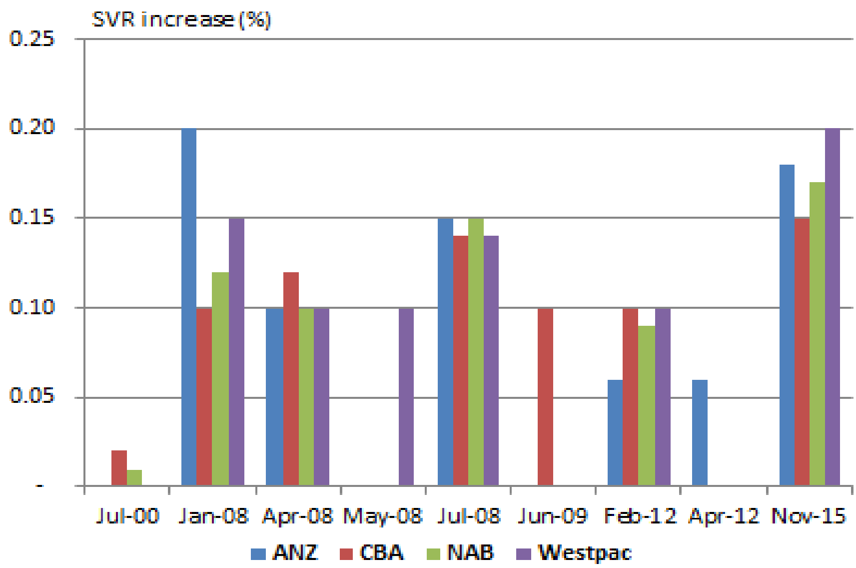


Source: RBA (October 2016), committee calculations

4.40 In addition to regularly using their pricing power, the major banks also tend to follow each other's price increases rather than compete to gain market share.

4.41 Since 2000, at least one of the major banks has increased their SVR out-of-cycle nine times. On five of these occasions, each of the other major banks has followed in the same month (Figure 4.6).

Figure 4.6 Major banks' out-of-cycle standard variable rate changes (2000 to current)



Source: RBA (October 2016)

Drivers of a lack of competition

4.42 The lack of competition in Australia's banking sector has a number of causes. These are primarily: the major banks' lower cost structures; the sector's high barriers to entry; and consumer inertia.

Cost Advantages

4.43 The funding and operating costs of the major banks are lower than their domestic competitors. Three important reasons for this are discussed below.

4.44 Firstly, the major banks are highly vertically and horizontally integrated, which provides them with significant economies of scale and scope.

4.45 Secondly, the market believes that the major banks are TBTF.

4.46 The credit rating agencies provide the major banks with a two-notch credit rating uplift due to a perceived implicit government guarantee, which effectively lowers their funding costs relative to other ADIs.

4.47 The RBA estimated that this implicit guarantee was worth as much as $3.7 billion to the major banks in 2013.[17]

4.48 Finally, the major banks (and Macquarie) use IRB models, as opposed to standardised models, to calculate their regulatory capital requirements.

4.49 IRB models allow banks to use sophisticated statistical techniques to determine what 'risk weights' to apply to their assets. These risk weights are used to calculate the value of the bank's 'risk weighted assets'.

4.50 In many cases, these models produce lower risk weighted asset values than the standardised model. This allows banks using IRB models to hold less capital against similar assets than banks using the standardised approach.

4.51 While APRA recently required ADIs using IRB models to increase residential mortgage risk weights to an average of at least 25 per cent, this is still substantially lower than the average risk weights that apply to ADIs using the standardised model (which can be up to 45 per cent).

4.52 APRA has calculated that the use of IRB models allows the major banks to cumulatively hold around $19 billion dollars less capital than if they were using the standardised model.[18]

4.53 The size of the major banks' funding cost advantage is shown in Figure 4.7.[19]

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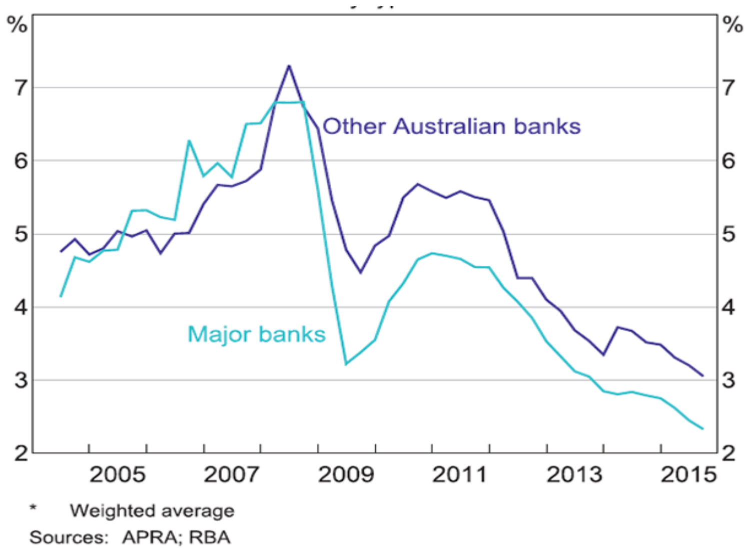
17 RBA, *Parliamentary Briefing, 24 February 2012 – Implicit Guarantees for Banks*, 2012, p. 44.

18 From 14 October 2016: APRA, *Response to a Question Taken on notice: Question Seven*, 1 November 2016.

19 Prior to the GFC, this funding cost gap was less pronounced due to mortgage lenders access to cheap funding through securitisation. As of 2015, issuance of Australian Residential Mortgage

Figure 4.7 Weighted average funding costs (per cent) for the major and other Australian banks



Source: RBA, Developments in Banks' Funding Costs and Lending Rates (2016)

4.54 The committee expects that, over time, the size of the major banks' cost advantages will decline due to:

- the Government's commitment to clarify and strengthen APRA's crisis management powers;
- APRA's commitment to introduce a domestic loss-absorbing capacity framework in line with international developments (both of which will reduce the perception that the major banks are TBTF);[20] and
- work by the Basel Committee on Banking Supervision (that APRA expects to adopt) to address excessive variability between the capital requirements for banks using IRB and standardised models.[21]

4.55 The committee strongly endorses these measures to improve competition.

Backed Securities was only around one-third of the level that it was at its peak. RBA, *Structural Features of Australian Residential Mortgage-backed Securities*, 2015.

20 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 18.

21 Mr Wayne Byres, Chairman of APRA, *Committee Hansard*, 14 October 2016, p. 6.

High Barriers to Entry

4.56 Australia’s banking sector has high barriers to entry. These arise for regulatory and commercial reasons.

- To operate as an ADI, institutions must obtain a banking license from APRA.

  Once licensed, ADIs must comply with APRA’s prudential requirements on an ongoing basis.

- Under the *Financial Sector (Shareholdings) Act 1998* (FSSA), a shareholder or group of associated shareholders cannot hold more than 15 per cent of the prospective ADI’s voting shares without an exemption.[22]
- Existing ADIs (particularly the major banks) hold significant amounts of consumer and business data that allows them to accurately model and price risk.[23]
- Existing ADIs (particularly the major banks) have strong brands and sophisticated distribution networks that are expensive to replicate.

4.57 The committee’s findings and recommendations in relation to barriers to entry can be found in Section 6.

Consumer Inertia

4.58 Customer inertia also limits effective competition.

4.59 Despite efforts to reduce consumer switching costs over recent years, switching rates remain low. For example, only 46 customers approached

22 There are reports that the FSSA is limiting bank start-ups where a small number of individuals necessarily hold the majority of the institutions shares.

23 The Productivity Commission recently noted that the data that banks hold ‘provides some degree of competitive advantage for incumbents (Productivity Commission, *Data Availability and Use Draft Report*, November 2016, p. 545.)

ANZ using the government's formal switching process to change their bank accounts in September 2016.[24]

4.60 A critical factor behind these low switching rates is that switching costs are perceived to be high. This can leave customers unwilling to seek out better priced products from alternative providers.

4.61 Customer inertia is also encouraged by non-transparent pricing and product bundling.

- Non-transparent pricing (for example, fee-free accounts with costs recouped through overdrafts) make it difficult for consumers to identify whether an alternative provider's product is a better deal – both at a point-in-time and over the life of the product.
- Product bundling reduces customer switching by both decreasing price transparency and increasing switching costs (because to switch ADIs consumers would need to move multiple products).

4.62 The introduction of a 'tracker rate' mortgage (that is, mortgages that have an interest rate equal to the official cash rate plus a fixed margin) by AusWide Bank in October 2016 represents a notable response to some of these problems.

4.63 The committee welcomes the launch of this product. ASIC's Chairman, Mr Greg Medcraft, noted that, '[tracker rate mortgages] allow...true comparability and...true competition.'[25]

4.64 The committee believes that more needs to be done to empower consumers. The findings and recommendations in relation to these matters can be found in Section 5.

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24 ANZ Bank, *Response to Questions on Notice: Question Nine,*23 October 2016, p. 2.

25 Mr Greg Medcraft, Chairman of ASIC, *Committee Hansard,* 14 October 2016, p. 4.

The Australian Council for Competition Policy

4.65 The Competition Policy Review (the Harper Review) recommended that the Government dissolve the National Competition Council and establish the ACCP.[26]

4.66 The Harper Review recommended that the ACCP have a broad role encompassing:

- advocacy, education and promotion of collaboration in competition policy;
- independently monitoring progress in implementing agreed reforms and publicly reporting on progress annually;
- identifying potential areas of competition reform across all levels of government;
- making recommendations to governments on specific market design issues, regulatory reforms, procurement policies and proposed privatisations;
- undertaking research into competition policy developments in Australia and overseas; and
- ex-post evaluation of some merger decisions.[27]

4.67 The Government has endorsed the creation of the ACCP, however this requires the agreement of the states and territories.[28]

4.68 If the states and territories agree to the establishment of the ACCP and its proposed mandate, the Government should consider whether the ACCP or the ACCC would be the more appropriate body to regularly make recommendations to the Treasurer to improve competition in the banking sector.

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26 I. Harper et al., *The Competition Policy Review*, March 2015, p. 76.

27 I. Harper et al., *The Competition Policy Review*, March 2015, p. 77.

28 Australian Government, *Response to the Competition Policy Review,* 2015, p. 34.