National Australia Bank

National Australia Bank Limited
ABN 12 004 044 937

800 Bourke Street
Docklands VIC 3008
AUSTRALIA

3 December 2010

Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Hawkins,

I am pleased to forward you National Australia Bank's submission to the Senate Standing Committee on Economics' inquiry into *Competition within the Australian Banking Sector*.

The National Australia Bank (NAB) welcomes the opportunity to provide Committee members and the broader Parliament relevant reference material and industry experience to assist the Committee in its deliberations.

NAB is a member of the Australian Bankers' Association and has the opportunity to provide input into the ABA's submission; we are broadly supportive of the document.

Accordingly, NAB's submission will not respond exhaustively to each of the inquiry's Terms of Reference; rather, the NAB submission provides additional information in three key policy areas: *Banking Competition, Product fees and charges and Funding.*

NAB looks forward to expanding upon the issues contained in the submission at its appearance before Committee members on 13 December 2010. Should you require further information on this or related matters, please do not hesitate to make contact.

Yours sincerely,

Dallas J McInerney
Group Manager, Government Affairs & Public Policy
National Australia Bank

National Australia Bank

Table of contents

Chapter one - Overview

Chapter two - Competition

Chapter three - Product fees

Chapter four - Funding

1.1 Executive Summary

"At the heart of the NAB Group is a belief in potential. This belief motivates us to make a positive impact in the lives of our customers and communities, and underpins a strong and sustainable business for our shareholders."
Cameron Clyne
GROUP CEO

National Australia Bank is a financial services organisation with over 40,000 people, operating more than 1,800 branches and service centres, and responsible to more than 460,000 shareholders. We operate major financial services franchises in Australia, as well as businesses in New Zealand, Asia, the United Kingdom and the United States.

Each of our brands is uniquely positioned but built on a common commitment to providing quality products and services, fair fees and charges, and relationships built on the principles of help, guidance and advice.

Our goal is to deliver sustainable, satisfactory returns to shareholders. Throughout the global financial crisis, NAB remained strong and secure for our shareholders, as well as our customers, our people and the community. NAB continued to support Australia's small businesses during the GFC and grew its lending to this sector as others withdrew.

Now as the economy recovers, we are looking forward to enhancing performance as we continue to reposition our Australian personal bank, invest in our operations and our reputation, and capitalise on our strong balance sheet.

NAB believes that what we do (and how we do it) is just as important as our financial results. The reputation and actions of banks continues to be under scrutiny, NAB welcomes the ongoing engagement of customers, regulators and policy makers as we consider and pursue a fairer and more sustainable banking system for Australia.

NAB does not share the view that the number of industry players directly correlates with levels of competition in Australian banking. A more meaningful consideration in the current debate concerns '*barriers to switching*', in particular, the switching costs Australian mortgagors incur when exiting a home loan product in search of a more competitive rate. The persistence of mortgage exit fees in the marketplace is an inhibitor of competitive pressure in the mortgage market.

Further, through its *Fair Value Agenda*, NAB has demonstrated that it is possible to offer a competitive product suite while removing pain points from the customer experience in the form of poorly understood or unclear fees and charges. Significantly, this view informs our approach to our standard variable rate on home loans which has consistently been the lowest of the four major commercial banks.

The challenges of funding the Australian banking system and in turn the future growth of Australia persist. The longer term implications of the recent disruptions in international capital markets and prospective changes to prudential policy will require ongoing education of all banking stakeholders, particularly retail customers. NAB believes transparency should be a guiding principle in this process that will benefit policy makers and customers alike.

1.2 Australian Banking

The National Australia Bank (NAB) supports a strong and competitive banking system.

Australia's economy continues to benefit from the banking industry's efficiency, innovation and reinvestment which have been facilitated by the progressive deregulation of the sector since the late 1970s.

Market participants are well supervised by the Australian Prudential Regulatory Authority and other regulators and have demonstrated prudent and conservative management, avoiding major dislocations and failures which were a feature of northern hemisphere markets during the GFC.

Today, Australian banks offer customers a wide range of banking products and solutions; these offerings are complimented by the mutual sector in the form of credit unions, building societies and other non bank financial institutions.

Maintaining a strong and competitive banking system into the future is crucial to Australia's capacity to fund economic growth. A strong banking system is necessary to attract global funding, preserve the safety of deposits, moderate and manage through disruptions and economic cycles, and avoid the economic crises associated with a weakening of the banking system.

However, sound prudential settings and strong capital positions are not the only measurements of an industry's vigour and competitiveness. NAB recognises that in the broader Australian community, there exists considerable concern about some bank behaviours and practices; in many instances, this community concern is well founded and has existed for a number of years.

The disenfranchisement of the customer base from an industry's success is an unsustainable situation; the reasons for customer dissatisfaction need to be identified and addressed with meaningful responses.

This has been NAB's aim with its ***Fair Value Agenda*** which it commenced in 2009, details of this programme will be discussed below.

2.1 Competition in Banking

> ***"..In many areas it is probably the case that more competition is always better for consumers, but in banking more competition is good to a point but beyond a point more competition is not good, because the bankers can be led to do things that ultimately cause a lot of subsequent damage. I think we have to understand that. That is not to say that the current amount of competition we see in any particular market is necessarily enough, but there is a point beyond which extreme competition in lending money leads to problems.."***
> *Glenn Stevens, Governor, RBA (26 Nov 2010, House Economics Standing Committee)*

Policy settings should endeavor to accommodate both competition and stability in optimal proportionality; in the past, these two objectives have been regarded as a binary choice.

As intimated by the Governor, competition policy and considerations that are applied to the broader economy should not be *automatically* considered appropriate for the banking industry; prudent policy settings accord a high premium to stability, given the banking industry's unique role supporting the real economy.

As a general comment, the Committee should be alert to the limitations of relying upon static analysis in the place of industry trends, similarly; better policy outcomes would be achieved if future regulatory proposals were informed by structural changes in the banking industry, not cyclical phenomena.

Assessing the levels of competition in the Australian banking sector should - at a minimum - be done across a full business cycle or even across several decades, not, for example, the last 18 months.

A key consideration in the assessment of industry competition is structure; Australia's four major commercial banks now resemble a two tier structure with the two largest banks, Westpac Banking Corporation and Commonwealth Bank of Australia, each with significant scale differentiators within their operations, networks and balance sheets.

Moreover, the four commercial banks are not homogenous enterprises, for example, each can be differentiated by factors such as product emphasis, customer profile or sectoral concentration. These distinguishing characteristics are important considerations in the contemplation of future regulation or oversight of the industry.

In recent times, headline profitability has been used by some as a proxy for competition in the banking industry; it is worth noting that industry developments of the last two decades, including the emergence of non bank lenders has led to a general reduction in bank margins.

On the point of profitability, the Reserve Bank found that while Australian bank profits were at the top end of the international range, this does not mean a lesser degree of competition:

"..an important reason is that Australian banks have had an unusually low bad debt experience. Over the past decade the bad debts of Australian banks have been about half the long-run average and about half the experience of banks overseas. This has been the result of a very strong domestic economy. It is worth noting that other Australian industries have also been very profitable over this period. If we take this into account and adjust bank profitability for this unusually low bad debt experience, we find that the profitability of Australian banks is around the middle of the international range. ***Overall, when we look at all the evidence that we have, we think it is reasonable to conclude that the Australian financial sector is competitive and that it stacks up quite well across a range of international benchmarks****.."*
Ric Battellino RBA, 14 August 2008, HoR Committee Hansard

2.2 Fair Value

"..We need to have a more productive relationship with the community and we need to have the community feel proud of the banking system they've got.." [1] *NAB CEO, Cameron Clyne*

NAB took a view that the relationships Australians had with their bank needed to change – for the better! Done correctly, we knew it would set us apart in the marketplace and move NAB away from the perception that it was part of the pack and in turn, make us more competitive. We referred to this approach as our *Fair Value* agenda.

NAB has been seeking change based on real, measurable and tangible benefits for its customers. This agenda is about providing a fairer value exchange between NAB, our customers, our people, our shareholders and the broader community. We have a view that this approach will change the economic model for retail banking in Australia; the *Fair Value* agenda has four key foundations:

- Quality products and services
- Fair fees and charges
- Help, guidance and advice
- Compassion and support

In the past few years, we have undertaken a number of initiatives. These include removing a range of bank fees as well as giving the disadvantaged better access to financial services. These initiatives are not a marketing gimmick or for the short term, they are integral to NAB's long-term business model. They are unashamedly strategic, commercial, and part of a game changing agenda.

A full summary of the Fair Value initiatives can be found in Appendix no. 1.

2.3 ATMs

NAB notes recent consumer and regulatory interest in automatic teller machines and their service proposition to Australian bank customers; this has been an area of recent focus for NAB.

At 30 Nov 2010, NAB had 1758 ATMs in its network, an increase of 124 since the RBA introduced its rule changes on direct charges in March 2009.

Since their introduction, NAB has not made any changes to its deployment strategy. We continue to install ATMs in locations that best support our cardholder base.

NAB welcomes initiatives that provide transparency in fees and charges to customers. Since the introduction of direct charge our pricing has been $1.50 per withdrawal and $0.50 per balance enquiry. This pricing is consistent across our entire network and no differentiation is applied for either location or time of day, 36 selected locations apply no direct charge on any withdrawal or balance enquiries.

We note that our Direct Charge is priced under the current market average of $2 per withdrawal and balance enquiry.

Further, in 2009, we joined forces with *rediATM* to create one of Australia's largest ATM networks (approximately 3100 locations across Australia), giving NAB customers significantly enhanced options in better managing or avoiding additional ATM fees.

Access for cardholders with a disability is considered a high priority by NAB and as such 100% of the NAB ATM fleet are audio enabled – no other provider has 100% of their fleets enabled in this manner.

There has been a growing concern over the supply of the availability of ATMs in gaming venues as this is believed to exacerbate problem-gambling. NAB does not locate any ATMs in gaming venues, nor does our affiliated *rediATM* network – we were quite explicit about this when we negotiated our agreement.

National Australia Bank

3.1 Products: Fees and Charges

NAB estimates that its Fair Value initiatives and the partial responses of our competitors have led to Australian bank customers saving approximately $900 million in fees and charges annually (see appendix one).

To further encourage confidence and gain trust from consumers, NAB decided to remove those '*gotcha moments'* and perceived punitive practices that have evolved over the years. That is why NAB removed overdrawn fees on everyday transaction accounts and put in place a $1000 buffer for small business accounts.

Further, NAB removed the over limit fee on our personal credit card range and reduced the late payment fees. Similarly, we have amended the payment processes on credit cards so that customers always pay off the debt with the highest interest rate first.

One of the positive learnings from the last 18 months is that the abolition of a number fees and changes in process around this has removed a number of complexities in our business. This simplification of our offers means that we are able to better explain our products and services to our staff and customers, and do so at a reduced cost.

3.2 Mortgages, SVRs and Exit Fees: Unfinished business

In recent months there has been a considerable focus and discussion on the standard variable rates of the major commercial banks in the context of competition in Australian banking. As part of its Fair Value agenda, NAB made a commitment to be more transparent about funding and pricing decisions, particularly as they relate to home loan products. NAB has committed to regularly publishing an information pack on its web site to better explain this area of bank policy.

National Australia Bank

For 17 months, NAB has offered its customers the lowest standard variable mortgage rate of the major banks. NAB's rate of 7.67% pa means NAB customers save between $32 and $47 a month on an average $300,000 variable rate home loan compared to the other major banks.

	Standard Variable Rate pa **(as at 15 Nov 2010)**
NAB	7.67%
ANZ	7.80%
CBA	7.81%
Westpac	7.86%

Last month, NAB announced it would abolish Early Exit Fees on new and existing NAB home loans. This follows an earlier announcement by the Treasurer about the Government's intention to move against these fees as part of its consumer credit law reforms.

At the time, the Treasurer was explicit about the policy and the need for further competition in the home mortgage market:

> ***"..Currently, some banks are using mortgage exit fees to lock customers into their home loans. Exit fees can be so high that there is no incentive to switch to another lender, even if they are offering a substantially lower interest rate. These new powers will make it easier for borrowers to switch to a competitor who offers a cheaper rate, providing a major boost for competition in the mortgage market."*** *(The Hon Wayne Swan MP, 27 June 2010)*

ANZ bank has also announced a similar response in relation to mortgage exit fees, however it has not been a uniform response across the four major commercial banks.

Australian mortgagors continue to be denied the benefits of better competition in the mortgage market while dominant market players persist with fees and charges that prevent them from exercising choice and accessing more competitive home loan products.

The persistence of mortgage exit fees in the Australian market place is a classic example of a traditional ’switching cost’ mitigating against competition and better outcomes for consumers.

Switching costs are fixed costs that buyers face when switching suppliers, the larger the switching costs, the harder it will be for newer entrants to gain customers or cheaper existing participants to grow market share.

NAB recommends that the Committee further explore barriers to switching in Australian banking as a means of identifying ongoing anti-competitive dynamics.

National Australia Bank

4.1 Funding

> ***"..changes in banks' cost of funds relative to the cash rate have meant that the relationship between bank lending rates and the cash rate has also become looser. It is difficult for banks to adjust their lending rates in line with changes in the cash rate when the cost of their funds is rising substantially relative to the cash rate. We estimate that if banks had not adjusted their lending interest rates to reflect their higher cost of funds over the past couple of years, they would now be incurring losses. That would have threatened their ability to keep raising funds and, in turn, their capacity to lend***..."[1] *- Ric Battellino, Deputy Governor, RBA, 16 Dec. 2009*

Committee members have expressed an interest in gaining a better understanding of funding practices for the banking industry and the implications for pricing decisions, the following information is provided for this purpose.

Overall funding cost picture

NAB's overall funding costs have continued to increase in 2009/2010, mainly driven by the rising average cost of term wholesale funding and higher term deposit costs. Funding costs are expected to continue to increase as cheaper term funding is replaced with more expensive funding of a longer duration. Further headwinds include the impact of regulatory change, which is likely to increase the amount of retail deposit and term funding required and the amount of liquid assets required to be held under revised liquidity standards.

4.2 Funding and implications for competition

Implied reduction in competition during and following the GFC is predominantly a function of non bank institutions (Aussie, Wizard, GE Money, Liberty Financial) having unsustainable funding models almost exclusively reliant upon off shore wholesale funding. Subsequent difficulties in these markets resulted in significant changes to the lending industry.

In addition, mergers and acquisitions concentrated ownership in the financial sector (Westpac and St George; Commonwealth and Bankwest), some consolidation activity was a function of the acquired entity operating a unsustainable funding model.

Smaller lenders in the market relied more heavily on securitisation as a source of funding than the major banks (who have better access to overseas wholesale funding markets and larger deposit bases). When confidence in the securitisation market fell and funding was no longer available, the financial institutions that relied on this source were ultimately acquired by entities with stronger and more diversified funding sources.

Subsequently, regulators have imposed higher capital requirements on banks and the potential exists for higher capital requirements once Basel III is implemented; these developments should not be seen as impacting competition as Australian banks have displayed a consistent track record at attracting capital during the GFC.

Government intervention in the form of the wholesale funding guarantee could be seen as having an impact on competition through the pricing scale that was implemented. Lower rated banks (e.g. Suncorp, Bank of Queensland, Macquarie Bank) were required to pay more to the Federal Government for use of the guarantee than those banks with a higher credit ratings to reflect their higher risk.

With respect to liquidity, failure to hold adequate levels of quality liquid assets contributed to the downfall of some financial institutions as they simply ran out of money while still being well capitalised (Bear Stearns and Lehman Brothers).

Basel III (not yet implemented) advocates holding greater levels of liquid assets – enough to survive an acute stress scenario (likely to be a 30 day period).

Whilst regulation is not yet in place to increase the level of liquid asset holdings, the regulator advocates higher levels of liquid assets through ongoing industry consultation, also, there is market expectations for banks to hold higher levels of liquidity.

The implementation of the Net Stable Funding Ratio as part of the Basel III reforms will require banks to strengthen their balance sheets by matching the funding of their core assets with funding of a similar duration.

The funding of additional liquid assets and increasing the duration of the sources of funding comes at a cost and this can have a competitive impact where the second tier banks (SunCorp, Bank of Queensland) have to pay more to fund these relative to the cost that the major commercial banks incur. In short, banks with a lesser credit rating will have to pay more than those with a higher credit rating.

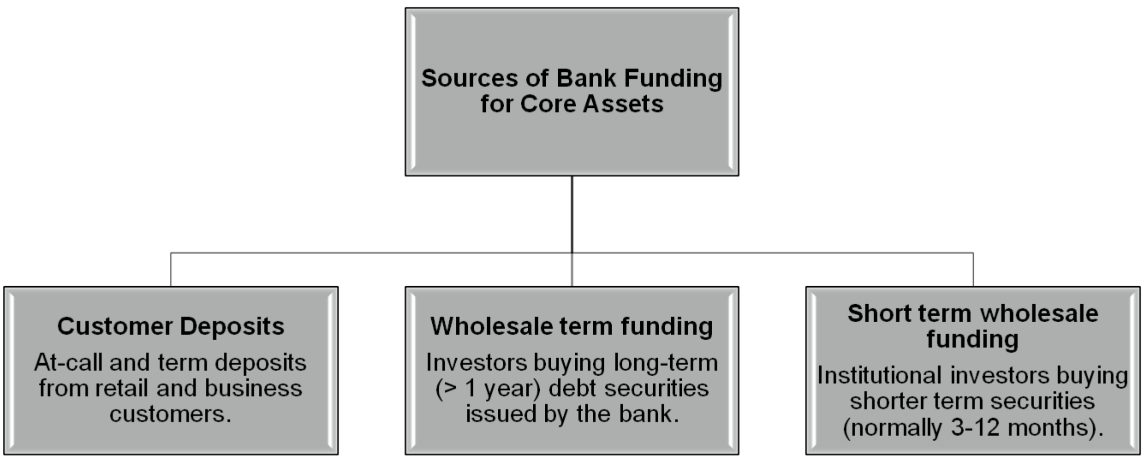
4.3 NAB Funding profile and commentary

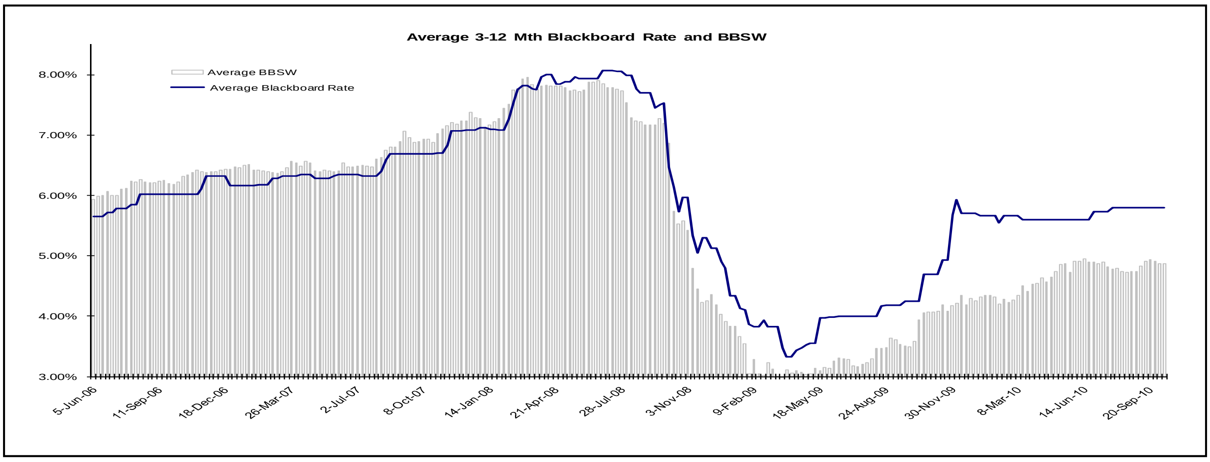
The following section outlines each of the sources of bank funding and analyses the impact on funding costs pre and post the financial crisis and over the past 12 months. An overview of each of these sources and the proportion of core lending that is funded by each is outlined below, based on the current NAB Group balance sheet.

4.4 Customer deposits

Customer deposits make up the bulk of the bank's funding base. They consist of term deposits and at-call accounts, which are split approximately 50/50. The global financial crisis (GFC) increased the cost of offshore wholesale borrowing and made overseas funding markets more difficult to access. Banks were forced to rely more heavily upon retail deposits leading to increased competition amongst banks for this source of balance sheet funding. This has increased deposit costs substantially.

Prior to the GFC, term deposits were priced at or below BBSW. More recently, retail term deposits have been priced up to 0.85 – 1.20% over BBSW. The most dramatic increase in this cost has been experienced over the past year, as shown below:



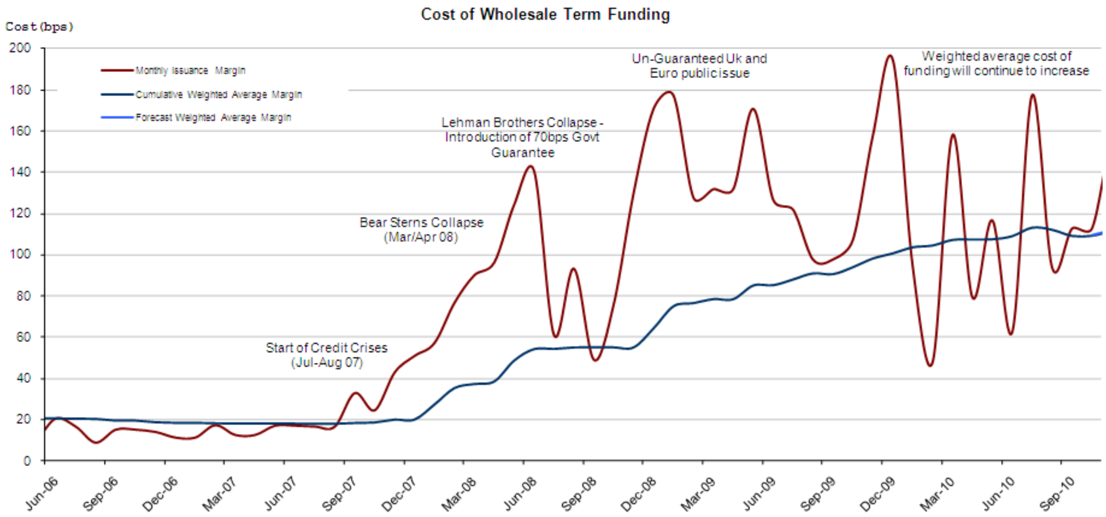


Average interest rates on at-call deposits have also increased by more than the RBA cash rate over the past year. These costs have increased less given these products tend to be less rate sensitive than term deposits.

In addition there has been a cost associated with increasing the proportion of retail deposit funding used to fund the core balance sheet. Retail deposits are a relatively expensive source of funding, relative to short term wholesale funding. The NAB's stable funding index has increased by 5.1% over the past year, due to it sourcing a higher proportion of retail deposits and term funding and a lower proportion of short term wholesale funding. This is consistent with stakeholder expectations in the current environment.

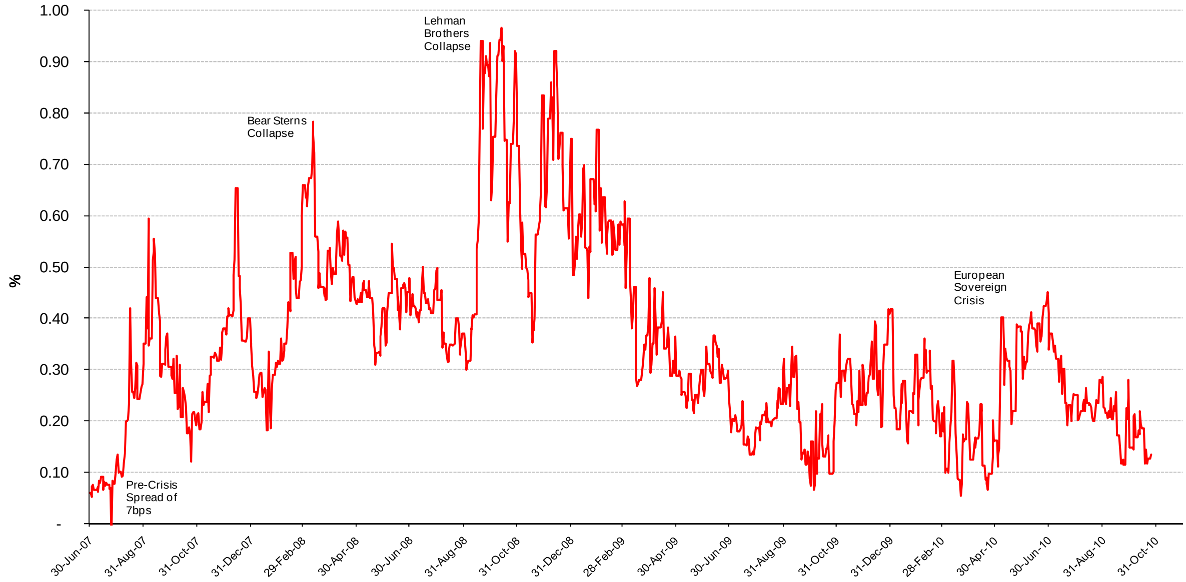
4.5 Wholesale Term Funding

Pre-crisis wholesale term funding costs averaged 0.15%-0.20% over BBSW. As financial markets have repriced bank risk, term funding costs increased sharply. The weighted average cost of term wholesale funding is expected to increase further as cheaper historical funding continues to mature and be replaced with more expensive funding. In addition, NAB is continuing to lengthen the term of its wholesale funding to reduce its wholesale re-financing risks and strengthen its balance sheet. This is factored into the term funding increases outlined below.



4.6 Short Term Wholesale Funding

The global financial crisis caused short term funding spreads to rise sharply as banks were forced to raise more short term funding onshore (pre-crisis, short term funding costs averaged 0.07%-0.10%). Over the last 12 months short term funding have begun to moderate and are averaging around 0.25%-0.30%. Short term funding spreads tend to reflect global market conditions, for example we saw volatile spreads associated with the European Sovereign debt crisis.



National Australia Bank

Appendix 1 - Fair Value Proof Points

NAB's commitment to these foundations is demonstrated in the changes announced over the past 15 months

More Give

- ✓ Invested in more points of presence with kiosks, mobile bankers; relocated and refurbished branches
- ✓ Continued to lend to business customers when the other major banks contracted their lending.
- ✓ Invested in an additional 200 business bankers
- ✓ Maintained the most competitive home loan standard variable rate across the major banks for at least 17 months offering customers a real alternative
- ✓ Doubled over ATM network through RediATM over 3100 ATM's Australia wide — **July 09**
- ✓ Launched NAB Care offering assistance to customers before they reach financial hardship — **Nov 09**
- ✓ Introduced free SMS payment reminders on NAB Credit Card accounts — **Dec 09**
- ✓ Matched the RBA move while all 3 other major increased rates beyond the cash rate increase — **Dec 09**
- ✓ Extended opening hours of the Customer Contact Centre to include weekends — **Jan 10**
- ✓ Introduced free SMS and email Alerts to help customers manage their money — **March 10**
- ✓ Extended NAB Care services to flood impacted Victorians through NAB Emergency Response Plan to support customers in times of need — **Sept 10**

Less Take

- ✓ Lead the industry in abolishing overdrawn fees putting more than $100m a year back in customers pockets — **Sept 09**
- ✓ Lead the industry in abolishing overlimit fees on credit cards and cutting the late payment fee to $5 — **Dec 09**
- ✓ Lead the industry in abolishing monthly account fees & transaction fees for everyday banking accounts — **Jan 10**
- ✓ Abolished Dishonour fees on Business transaction accounts and introduced a $1000 buffer on overdrawn fees — **May 10**
- ✓ Announced removal of Switch Fees on mortgages making it easier for customers to changes their loan and stay with us — **May 10**
- ✓ Announced simplifying of credit card payments structure to make it fairer and reduce the cost to customers (effective Jan 11) — **Sept 10**
- ✓ Simplified fee structure for NAB Broker customers by removing packaging, security, company borrowing and product swap fees and replacing the fee waiver authority with a standard application fee to make banking simpler for customers. — **Oct 10**
- ✓ Announced the abolition of exit fees on NAB mortgages (effective Dec 10) — **Nov 10**
- ✓ Announced a significant simplification of mortgage fees (effective March 11) — **Nov 10**