The Australia Institute

Research that matters.

Money and power

The case for better regulation in banking

Institute Paper No. 4
August 2010
ISSN 1836-8948

Josh Fear, Richard Denniss and David Richardson

TAI

Institute Paper

Acknowledgments

The authors are grateful to Leigh Thomas and Serena Rogers from the Australia Institute for their contribution to this report. We would also like to acknowledge the financial support of the Finance Sector Union in preparing this paper.

Contents

Summary

The power of Australia's big four banks is unmistakeable. Their underlying profits equate to almost three per cent of GDP, up from less than one per cent a quarter of a century ago. Of every $100 spent in Australia, nearly $3 ends up as underlying profit for the banks.

Profits are so high because the banking market is highly concentrated. The big four banks now control more than 75 per cent of all bank assets and banks account for over 90 per cent of all lending by financial institutions in Australia. This level of concentration has distorted competition, allowing the big banks to reap underlying profits of around $35 billion per year, including $20 billion in 'super-profits' attributable to their market power. Most Australians believe that the banking market is overly concentrated: three in four survey respondents (72 per cent) said that the big four banks in Australia have too much market power.

But is the extreme profitability of Australia's banks in the public interest? Many workers hold shares in banks indirectly through superannuation, and therefore arguably receive a share of their profits. Yet the distribution of share ownership and superannuation balances means that the wealthiest Australians capture most of the dividends flowing from bank profits. And in other important respects the behaviour of the banks runs counter to the interests of the broader community.

Traditionally, banks have served a social as well as an economic function, providing a service to the community and controlling the supply of credit. But modern banking practice involves striving for maximum market share, even if this means acting against the interests of individual customers or the community as a whole. The logic of maximising shareholder value has put the marketing of debt, through credit cards and housing loans, at the centre of the banking endeavour.

This paper presents survey results that reveal the extraordinary extent to which ordinary Australians are offered new credit products, often without asking for it. Two in three respondents (66 per cent) reported receiving an unsolicited offer for a new credit card in the past 12 months, while one in two (49 per cent) had received an unsolicited offer to increase their credit-card limit. One in three (36 per cent) had received an offer for a personal loan and one in five (18 per cent) had an offer to increase the available credit on their home loan. While people on higher incomes are more likely to receive such offers, the marketing of debt among people on low incomes is clearly widespread. For example, one in three people living in a low-income household has received an offer of a personal loan in the past year without seeking one out.

When faced with calls for greater regulation, banks argue that individuals are responsible for their own financial decisions and that the predominant form of government action needed in the sector, if any, is to provide consumers with the information necessary for them to make educated individual decisions. Informed consumers, they insist, will behave rationally to ensure competitive discipline in the market, which will in turn bring about socially optimal outcomes.

This paper argues that the role for government should be much greater than the mere provision of additional information to consumers. In short, government should ensure that banks behave in ways that are consistent with the public interest rather than 'leaving it to the market'.

When people are asked to make financial decisions that they do not fully understand, they often rely on other people for help, particularly people that they regard as better qualified or informed. In the case of bank products, people often rely on the advice they receive from bank workers. What is not well understood is that bank workers in Australia are often paid commissions to sell their bank's products. The more products they sell—in other words, the more debt they convince customers to take on—the more money they make. In fact, encouraging bank tellers and call-centre workers to sell debt products is an integral part of a bank's marketing strategy. Consumers can no longer be confident that the advice they receive from bank workers is objective rather than conflicted.

Debt-pushing by bank workers is just one part of the sophisticated and multi-faceted marketing operations of Australia's big banks. They also spend enormous sums of money on advertising in the mass media, on junk-mail campaigns, and even on face-to-face marketing in public places. In fact, the big four banks spend over $1 billion every year on advertising—more than it costs to run the ABC. Together, all this marketing allows banks to take maximum advantage of the confusion and disinterest that consumers feel when faced with financial choices. And while constant marketing can maximise shareholder returns, the effect on broader society is a negative one.

The banks claim that because they compete with each other, interest rates and fees are kept at reasonable levels, a claim that rests on the assumption that consumers will readily switch banks when they see the opportunity for a better deal. By contrast, our survey results show that 43 per cent of big-bank customers have never even considered switching. In fact, only three per cent of bank customers switch banks each year, an astonishingly low figure for a sector that is allegedly subject to free and open competition. Once a bank signs up a new customer, it can be quite confident of keeping that customer for decades to come.

The global financial crisis has fostered a view in the community that the bigger a bank is, and the bigger its profits, the safer it is. Indeed, around one in five

Australians appear to hold this belief, with 19 per cent of survey respondents agreeing that it is safer to deposit money in a bank with bigger profits. If one in five Australians believe that a bank with bigger profits is safer, there is a pool of more than three million adult Australians who hold this view. This constitutes a massive marketing advantage for the incumbent players in the sector against smaller banks and credit unions.

In recent years policymakers around the world have come to recognise that many people struggle with financial decisions. In Australia, this has been officially acknowledged by the recent Cooper Review into Australia's superannuation system. The standard policy response has been to promote financial literacy through education and awareness-raising. The assumption behind these initiatives is that consumers possess the motivation and capacity to improve their financial knowledge.

But there is something missing in this approach. Consumers also need to be aware of the various ways in which financial providers may attempt to persuade them to take on more debt than they need, or to use a financial product that is not in their best interests. They also need to understand the extent to which certain providers in the retail financial sector dominate all the others and the techniques they use to reinforce their dominance.

More broadly, government needs to ensure that the environment in which consumers make financial choices is structured fairly and in a way that empowers ordinary people rather than just the big banks. To date, the principal weapon used by Australian policymakers in their battle against the might of the banks has been competition. The Commonwealth Bank was established to provide genuine competition against the private banks almost a century ago; since then there have been waves of competition from credit unions, building societies, finance companies, mortgage originators and foreign banks. Despite a century of competition, the big four banks are stronger now than they have ever been.

Policy options

The lesson of history is that competition policy is not very effective against a large, powerful industry enjoying the competitive advantages that result from incumbency and economies of scale. One solution might be to require functional or structural separation between the different functions performed by banks: deposit-taking and lending, payments facilitation, retail investment, investment banking and so forth. The aim should be to reduce bank profits to one per cent or less as a share of GDP, the level they were at two decades ago. Other policy changes that would contribute to this aim include:

- legislating to ensure that interest rates charged by banks move in line with changes to the RBA cash rate and are set and advertised as a mark-up over the cash rate
- establishing a separate licensing regime for financial institutions that provide payment services and infrastructure to retailers to encourage new entrants into this market
- capping certain kinds of bank fees at a level sufficient to cover costs, including a reasonable return on assets
- mandating that all financial institutions offer a no-frills, low-cost everyday savings/transaction account to every customer
- restricting the interest rates that can be charged on unsecured credit to levels that reflect the underlying risk to the lender.

Such initiatives would help bring profits back to a reasonable level, but it is also important that banks do not use their privileged position to exploit the vulnerabilities of individual customers. Something more is needed to ensure that banks behave in socially responsible ways that contribute to the wellbeing of the broader community.

The use of emotional techniques in advertising and marketing financial products is common and clearly effective. However, marketing that relies solely on such techniques without providing any helpful information or guidance to consumers is misleading and manipulative and contributes to widespread public mistrust of banks. Banks should promote their products in ways that contribute to, rather than undermine, broader public understanding of financial concepts and imperatives. If they choose not to do this, it is the responsibility of government to monitor and regulate their communication with customers, particularly in the marketing of credit. This can be achieved in various ways:

- establishing national laws to ensure that credit is not extended to people who do not have the capacity to repay
- preventing banks and debt collectors from pursuing debts for loans made to people who did not have the capacity to repay when the money was originally loaned
- restricting or banning sales targets and commissions for bank workers
- providing bank workers with a decent ordinary wage independent of sales-based commissions
- banning the practice of 'pre-approving' credit-card offers and/or credit extensions

- preventing banks from claiming money spent on the advertising of credit products as tax deductible business expenses.

These reforms should constitute part of a formal social contract between individual banks and government; ratifying the social contract would then become a condition of maintaining a banking licence. Without this kind of policy intervention, the profits of the big banks will only get bigger.

1 Introduction

Banking is an enormously lucrative business, and becoming more so each day. Despite the global financial crisis, the profits of Australia's big four banks have continued to rise steadily. Twenty years ago their profits were around one per cent of GDP; by 2008–09, the major banks were earning underlying profits before tax of $35 billion, or just under three per cent of GDP. This means that of every $100 spent in Australia, almost $3 ends up as underlying profit for the major banks.

When the financial sector was deregulated in the 1980s, banks accounted for 50 per cent of all lending in Australia. Today this figure is over 90 per cent. The big four banks—Westpac Banking Group (Westpac), Australia and New Zealand Banking Group Limited (ANZ), Commonwealth Bank of Australia (Commonwealth) and the National Australia Bank Limited (National)—now control 76 per cent of the banking market. It is this degree of concentration that explains a good deal of their profitability.

But is the extreme profitability of Australia's banks in the public interest? Many workers hold shares in banks indirectly through superannuation and therefore arguably receive a share of their profits. But in many important respects the behaviour of the banks runs counter to the interests of the community.

Traditionally, banks have served a social as well as an economic function, providing a service to the community and controlling the supply of credit. But modern banking practice involves striving for maximum market share, even if this means acting against the interests of individual customers or the community as a whole. The logic of maximising shareholder value has put the marketing of debt, through credit cards and housing loans, at the centre of the banking endeavour.

Taken to its extreme, this method of doing business was responsible for the sub-prime mortgage debacle in the United States and the financial crisis that ensued. And while Australia has not experienced the same degree of financial turmoil, Australian banks have nonetheless been very willing to exploit consumer debt in their quest for bigger profits. In fact, some of their most profitable customers, such as those who never pay off their credit cards in full, are also the very people who are least able to handle more debt. In this way, the impulses of individual consumers, carefully channelled by the banks, regularly come into conflict with the public interest.

While the banking industry is less regulated than it once was, it is also less competitive. The high degree of market concentration allows the big banks to charge fees for an extraordinary variety of 'services', often at well above cost. These include, but are by no means limited to, ATM fees, credit-card fees, interchange fees, merchant fees, transaction fees, account-keeping fees, and so-called 'exemption' fees (otherwise known as penalty fees). As well as charging their customers directly, banks charge retailers, intermediaries and even each other in every conceivable way, thus increasing the cost of virtually all goods and services in the regulated economy. Although it is impossible to determine how much of the price of any individual product corresponds to the extra costs imposed by banks, as a whole bank fees and charges represent a major impost on the wider economy, analogous to a private-sector 'tax' on economic activity.

In response to criticism, the major banks typically argue that competitive forces are strong because there are four big organisations that compete on more or less equal terms and keep each other 'honest'. By this logic, the structure of the banking sector is inevitable, a natural result of market forces and the strength of the organisations that dominate the industry. Little or no mention is made of the massive advantages of historical incumbency or a regulatory environment that favours big players over small.

When faced with calls for greater regulation, the banks argue that individuals are responsible for their own financial decisions and that the predominant form of government action needed in the sector, if any, is to provide consumers with the information necessary for them to make educated individual decisions. Informed consumers, they insist, will behave rationally to ensure competitive discipline in the market, which will in turn bring about socially optimal outcomes. This paper argues that the role for government should be much greater than the mere provision of additional information to consumers. In short, government should ensure that banks behave in ways that are consistent with the public interest, rather than 'leaving it to the market'.

The paper is set out as follows:

- Section 2 describes the key characteristics of the banking market in Australia.
- Section 3 looks back at historical attempts to maximise competition in the sector.
- Section 4 discusses the way Australians do their banking and how they feel about the behaviour of big banks.
- Section 5 explains how real people, rather than the consumers of economic theory, make financial decisions, and how banks exploit human nature in their approaches to marketing.
- Section 6 assesses the state of the banking industry in Australia and suggests more appropriate policy options given the reality of the sector and the way consumers actually behave.

The paper concludes that the high degree of concentration in the banking market and the huge profits it generates are inevitable in a deregulated banking system such as Australia's. With consumers powerless to change corporate behaviour and new entrants unable to compete on a level playing field, the big four banks are relatively free to gouge as much money from the Australian economy as they are able. Better regulation in banking is urgently needed.

2 Bank profits: how big is too big?

In assessing how well the banking market works in Australia, it is important to gain a sense of the scale of bank profits. This section presents key facts on the nature of bank activities and their profitability. It describes the key characteristics of the retail banking market and documents the trend towards ever-higher profits for the big four banks.

The retail banking market

Financial systems are built around two core activities: lending and deposit-taking. In Australia, lending is dominated by banks. Of the total loans and advances outstanding in Australia in April 2010, 91 per cent was issued from banks; the remaining nine per cent came predominantly from building societies, credit unions and other minor institutions. In April 2010, banks accounted for all but five per cent of the total deposits raised in Australia.[1]

Banks dominate the financial system, but banking itself is dominated by just four big banks: ANZ, Commonwealth, National and Westpac, which together accounted for 82 per cent of all lending by the 54 banks in Australia and 78 per cent of all bank deposits.[2]

For most consumers, bank deposits are a way of parking money for use in ordinary transactions. A survey by the Reserve Bank of Australia (RBA) shows that consumers undertake about 38 per cent of the value of their transactions with cash, which the majority withdraw from a bank. Other transactions are made through bank accounts and include cheques, which used to be popular but now account for only 11 per cent of the value of non-cash transactions, and electronic payments, which are mainly facilitated through banks. Of all non-cash transactions, direct debits and credits account for 86 per cent, with debit cards, credit cards and BPAY accounting for the remainder.[3] Most electronic transactions attract a fee of some kind, which earns the banks a good deal of their income.

Bank fees raised $11.6 billion in 2008 (the latest figure available). Around $6.7 billion was collected from fees on business, most of which would be passed on to customers in the form of higher prices. The rest, $4.8 billion,

---

1 Reserve Bank of Australia, 'Statistical Tables'. Available at: http://www.rba.gov.au/statistics/tables/index.html

2 APRA (Australian Prudential Regulation Authority), *Statistics: Monthly Banking Statistics*, *April 2010*, 31 May 2010.

3 RBA (Reserve Bank of Australia), *Payments System Board Annual Report 2009*, Reserve Bank of Australia, 2009, pp. 6–17.

came from fees on retail customers. Fees on transaction accounts amounted to $1.8 billion, on credit cards to $1.3 billion and on housing loans to $1.0 billion. A further $1.0 billion was charged to households in the form of so-called 'exemption' fees.[4,5]

Bank profits

In 2009, the after-tax profit of the four majors was $13.4 billion, down substantially from the $16.5 billion profit of 2008.[6] Table 1 compares total pre-tax profits for the four major banks over the past quarter-century and shows that such profits now consistently represent around two per cent of GDP, more than double the figure in 1986.[7] Underlying profits (profits adjusted for bad debts) are now close to three per cent of GDP (see Table 2).

Table 1: Historical performance—profit before tax

	1986	1989	1999	2006	2009
ANZ ($m)	357	773	2,162	5,214	4,380
Commonwealth ($m)	396	813	2,498	5,704	5,975
National ($m)	484	1,110	4,141	7,275	6,962
Westpac ($m)	540	926	2,026	4,547	6,096
Total ($m)	1,777	3,622	10,827	22,740	23,413
Per cent GDP	0.7	1.0	1.8	2.3	1.9

Sources: ABS;[8] ANZ;[9] Commonwealth Bank of Australia;[10] National Australia Bank;[11] Westpac;[12] RBA.[13]

---

4 RBA, 'Statistical Tables'.

5 Exemption fees are now the subject of a class action against the banks levying these fees.

6 These figures consist of the sum of the profits reported by each of the big four banks in their 2009 annual reports.

7 The table also uses cash figures to match earlier data that the RBA put to a Parliamentary Committee in 1994. As the name suggests, cash figures use cash accounting results which basically measure cash in versus cash out. The rest of the figures used in this report are based on accrual figures which take account of transactions that give rise to receipts and liabilities in the future. These are the figures usually used to express companies' financial results. See RBA, *International Comparisons of Bank Margins*, *Appendix 3*, submission to the House of Representatives Standing Committee on Banking, Finance and Public Administration, August 1994.

8 ABS, *Australian National Accounts: National Income, Expenditure and Product, June quarter 2009*, Cat No 5206.0, 2 September 2009.

9 ANZ, *Annual report 2009*, Melbourne, November 2009.

10 Commonwealth Bank of Australia, *Annual report 2009*, Sydney, 12 August 2009.

The effect of bad and doubtful debts on recent bank profitability is shown in Table 2, which presents annual profit figures for the big four over the last four years. This allows us to assess their financial performance as the global financial crisis unfolded.[14]

Table 2: Profits in recent years—big four banks.

	Year to			
	Sep-06	Sep-07	Sep-08	Sep-09
Pre-tax profit ($m)	23,043	25,398	18,856	22,096
Bad and doubtful debt provisions ($m)	1,801	2,278	6,675	12,993
Underlying profit ($m)	24,844	27,676	25,531	35,089
	% GDP			
Pre-tax profit	2.38	2.43	1.67	1.84
Bad and doubtful debts	0.19	0.22	0.59	1.08
Underlying profit	2.57	2.65	2.26	2.91

Source: APRA, ASIC and RBA;[15] ABS;[16] company annual reports.[17]

Bad-and-doubtful-debt provisions are now around $13 billion, $11 billion more than they were prior to the crisis. Yet even as their bad debts nearly doubled, the big banks were able to claw back income and increase their underlying profit. Although profits fell from 2.65 per cent of GDP in the year to September 2007 to 2.26 per cent in the year to September 2008, in 2009 it has bounced back to 2.91 per cent making 2009 a record year for the

11 National Australia Bank, *Annual financial report 2009*, Docklands, November 2009.

12 The Westpac Group, *Annual report 2009*, Sydney, 2009.

13 RBA, *International Comparisons of Bank Margins, Appendix 3*.

14 Note that figures to September 2009 are based on figures in company reports, including that of the Commonwealth Bank, which reports on a financial year ending in June. The other three banks have a financial year ending in September. Earlier years are taken from the quarterly bank performance statistics of the Australian Prudential Regulation Authority (APRA). See APRA, *Statistics: Quarterly bank performance statistics*, Commonwealth of Australia, March 2009.

15 APRA, ASIC and RBA, *Survey of the OTC Derivatives Market in Australia—May 2009,* Australian Prudential Regulation Authority, Australian Securities and Investments Commission, Reserve Bank of Australia, May 2009.

16 ABS, *Australian National Accounts, National Income, Expenditure and Product, June quarter 2009*.

17 ANZ, *Annual report 2009*; Commonwealth Bank of Australia, *Annual report 2009;* National Australia Bank, *Annual financial report 2009;* The Westpac Group, *Annual report 2009.*

underlying profitability of the big four banks and indicating their ability to absorb losses from bad debts by increasing profitability in other areas. In December 2009 for example, three of the four major banks took the opportunity to raise home-loan rates by more than the increase in the official interest rate. This situation suggests that the banks' actual profitability will be higher than ever before when they reduce bad-and-doubtful-debt provisions back to pre-crisis levels.

That the major banks have been able to win back their profits despite reductions in the profits of other industries in the Australian economy is evidence of their market power.[18] Indeed, the big four have been a great deal more successful at this than the smaller Australian banks. Table 3 examines the performance of the smaller banks, comprising all domestic banks apart from the big four. It shows that the smaller banks were hit by the global financial crisis but have not been able to compensate for their losses by clawing back profit from fees, charges or interest increases.

Table 3 reveals that among the smaller banks profit before tax almost halved, falling from $4,589 million to $1,846 million; even after adding back losses (charges for bad and doubtful debts), total underlying profit declined from $5,038 million in 2008 to $3,654 million in 2009. As a percentage of GDP, pre-tax profits plunged from 0.37 per cent to 0.15 per cent, while underlying profit fell from 0.40 per cent to 0.29 per cent. This is a major contrast to the figures in Table 2, which show that the big four banks increased their underlying profit from 2.26 of GDP in 2008 to 2.91 per cent in 2009.

[18] By contrast, the 'gross operating surplus' (which is equal to profits before deducting interest expenses and depreciation) for non-financial corporations fell four per cent in nominal terms from the second half of 2008 to the first half of 2009. ABS, *Australian National Accounts, National Income, Expenditure and Product, June quarter 2009*.

Table 3: Performance data of the smaller banks

	Year ended	
	June-08	June-09
Charge for bad or doubtful debts ($m)	449	1,808
Profit before tax ($m)	4,589	1,846
Total underlying profit before tax and losses ($m)	5,038	3,654
Performance indicators—%GDP		
Charge for bad or doubtful debts share of GDP	0.04	0.14
Profit before tax share of GDP	0.37	0.15
Total underlying profit before tax and losses share of GDP	0.40	0.29

Source: APRA;[19] ABS.[20]

The figures presented above highlight the difference in the reaction of the big banks to the increase in bad debts associated with the global financial crisis compared with that of the smaller institutions. The major banks simply increased the amount they charged their 'good' customers in order to help offset the losses they were incurring by lending too much money to 'bad' customers. Although they would have liked to, smaller banks could do not do the same because they do not possess the same level of market power.

Implications

The very large profits earned by Australian banks have long puzzled those who look at the industry from the orthodox point of view. For example, the former Governor of the RBA, Ian Macfarlane, has said:

> I, like you, have often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia … They always were very profitable, let's face it. They were very profitable in the regulated phase, and some of us thought that those profit rates would go down in the deregulated phase, as competition heated up. So you can understand why people are very interested in profits and very surprised that profits or rates of return on equity have remained so high.[21]

---

19 APRA*, Statistics: Quarterly bank performance statistics*.

20 ABS, *Australian National Accounts, National Income, Expenditure and Product, June quarter 2009*.

21 Australia, House of Representatives, Standing Committee on Economics, Finance and Public Administration, *Reference: Reserve Bank of Australia annual report 1997–98*, Melbourne,

As the next chapter will show, the real reason behind the power of Australia's large banks to extract disproportionate amounts of profit compared with both smaller banks and other categories of business is the degree of centralisation in the sector. Put simply, the behaviour of the banks increasingly resembles the sort of behaviour that occurs in a monopolistic market. Monopolies typically use their market power to limit services, creating an artificial scarcity and so increasing prices and profit. Indeed, the excessive profits of the big banks can be likened to a massive tax that they impose on the Australian economy.

Hansard, Thursday 17 June 1999, pp. 77–80. (Mr Ian Macfarlane, Governor of the Reserve Bank of Australia).

3 Bank competition: a history lesson

When Australian financial markets were deregulated in the 1980s, it was predicted that greater competition would deliver efficiency gains and a better deal for banking customers. This section describes how the theoretical forecasts of the impact of deregulation bear little resemblance to the way events have unfolded. The architects of financial-market reform assumed that deregulation would lead to an increase in the level of competition because it would remove barriers to the entry of new financial institutions. Yet precisely the opposite has occurred: since 1983, the major banks have steadily consolidated their market power at the expense of credit unions, building societies, foreign banks and home-loan originators.

The power of incumbency

Concerns about the exploitation of market power by Australian banks go back to before Federation, as do the efforts by policymakers to counter them. Early governments tried to generate competition in colonial times by establishing some of the early state-owned banks and, soon after Federation, the Commonwealth Bank in an attempt to offer fairer alternatives to the private banks. Building societies, credit unions and later the mortgage originators (for example, RAMS and Aussie Home Loans) were each promoted as potential competition against the banks. Similarly, foreign banks have at times been championed as the means of providing effective competition.[22]

In industries such as banking, 'competition' between suppliers appears to reflect the common-sense meaning of the word applicable to the sporting ground. At the end of the season there will be one winner, competition having gradually eliminated the weaker teams. In sport, the team that finishes on top tends to be the one that was also consistently well above average throughout the season—the top performer in other words. Unlike competition between sporting teams however, the survivors of competitive

---

[22] The Fraser Government's Campbell Report concluded that 'foreign banks offer a more immediate prospect of providing an effective competitive stimulus [to domestic banks]'. In December 1983, the Hawke Government announced a review of foreign investment policy and flagged the possible entry of foreign banks. On 10 September 1984, Treasurer Paul Keating announced that the government had decided 'to call for applications from both domestic and foreign interests wishing to operate as banks in Australia'. The aim was to have foreign banks compete with domestic banks and so bring 'the development of a more innovative, efficient and competitive financial sector'. See Australian Financial System Inquiry, *Australian Financial System: Final Report of the Committee of Inquiry into the Australian Financial System*, (Mr J Campbell, Chairman), AGPS, Canberra, 1981; P Keating, 'Participation in banking in Australia and other issues of financial deregulation', statement by the Treasurer, 10 September 1984.

battles between large corporations are likely to have experienced a great deal of luck. For example, these organisations might have been bigger to begin with, or they may have been established before their competitors.

In Australia, the big four banks are the lucky recipients of just such an advantage—that of incumbency. They have therefore appeared to be largely immune from external competition and have emerged from the global financial crisis stronger than ever. Virtually the only procedures that seem to work against their market power are the actions of the RBA, which effectively imposes price controls on some of their fees and charges.

Failed attempts to make the banking industry competitive

A highly concentrated industry in which the top firms make very high profits implies an industry that needs a dose of competition to challenge the incumbents. That, at least, seems to be the thinking of most commentators. There has been a strong and persistent view that if monopoly (or oligopoly) is a problem, the solution is to pit more competitors against the monopolist.

Pricing power, leading to high profits and resulting in dangerous social and economic consequences, has been a common theme in Australia, and there is a long history of attempts to find competitors to pit against the banks. One of the early examples followed the crisis of 1841–43, which saw banking collapses and banks forcing borrowers into insolvency. The Legislative Council of New South Wales established a Select Committee on Monetary Confusion, which proposed a central bank that would compete against the private banks with its own notes issue. (In those days, even private banks issued their own currencies.) As it happened, the legislation that followed the Committee's report was refused assent by the King's representative in NSW.[23]

At the Commonwealth level, the government established the government-owned Commonwealth Bank of Australia in 1911. At the time, 'the argument for the national bank was based on the proposition that the existing banks were avaricious and incompetent'[24] and had contributed to the earlier speculation and subsequent slump of the 1890s. It was thought that the private banks needed competition from a socially responsible institution.

---

[23] S J Butlin, *Foundations of the Australian monetary system 1788–1851*, University of Sydney Press, Sydney, 1968.

[24] R Gollan, *The Commonwealth Bank of Australia: Origins and early history*, ANU Press, Canberra, 1968, p. 18.

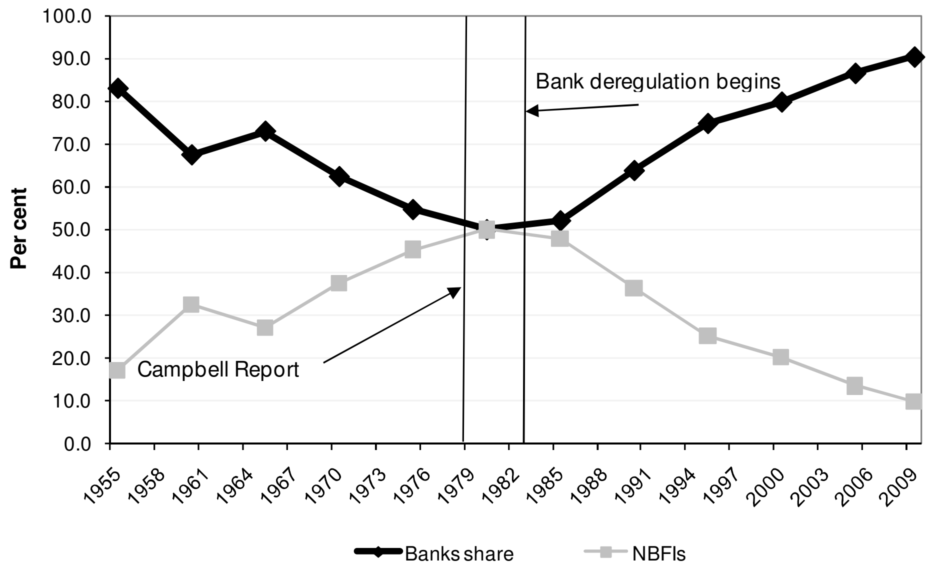
In the 1960s and 1970s, competition from building societies and credit unions was seen as the answer to the power of the banks. In the 1980s, it was argued that foreign banks would provide the necessary competition. More recently, regional banks and mortgage originators (for example RAMS) were expected to challenge big-bank market power, but these organisations have suffered as a result of the global financial crisis and have lost market share to the big four.[25]

Despite the faith of successive governments in the capacity of new entrants to prevail over the big banks, their impact never reached expectations. Figure 1 illustrates the results of such policies by tracking the market share in loans and advances across all financial institutions in Australia since the mid-1950s. The top line traces the shares for banks and the bottom for non-bank financial intermediaries (NBFIs), which include building societies and credit unions as well as finance companies, mortgage originators and a host of other financial institutions.[26] The figure shows that soon after World War II, banks occupied a dominant position in the credit market, holding 83 per cent of all loans and advances. By 1980, however, their share had shrunk to 50 per cent. Significantly, this period of decline was dominated not by faith in competition but by regulation. When the deregulation phase that began in the 1980s was complete, the share of overall lending attributable to the banks had increased again and now exceeds 90 per cent.

[25] It would take us too far afield to examine all the competitive initiatives mentioned here but a fuller discussion would reveal a similar history—a brief challenge that is soon met and neutralised by the major Australian banks.

[26] Some of the other significant financial institutions are money market corporations, life offices and superannuation funds, cash management trusts and general insurance offices.

Figure 1: Market share: banks and non-bank financial intermediaries



Source: RBA.[27,28]

The 'four pillars' policy

Attractive economies of scale in banking lead to the conclusion that further concentration among the remaining banks is likely. While such consolidation leads to increased profit, the reduction in competition is likely to be bad for consumers; without pressure from rivals there is no compelling reason for the banks to pass on the savings achieved through economies of scale.

In recent decades, an important theme has been the prevention of further mergers between the remaining big four banks, a policy sometimes termed as the 'four pillars' banking policy. It is generally believed that, bad as the present situation might be, it would be worse if any of the remaining banks merged. The four pillars policy evolved from the 'six pillars' policy formulated by Keating in 1990,[29] which prohibited mergers between the big four banks and the big two life-insurance companies, AMP and National Mutual Life Association (now AXA Asia Pacific). Notably, the National is

---

27 RBA, 'Statistical Tables'.

28 RBA, *Statistics: Australian Economic Statistics 1949–1950 to 1996–1997*, Occasional Paper No. 8, various dates.

29 P J Keating, *Proposal for Merger of ANZ Banking Group (ANZ) and National Mutual Life Association*, press release by the Acting Prime Minister and Treasurer, 23 May, Canberra, 1990.

currently part of a bid for AXA Asia Pacific and, if successful, this would turn the six pillars into five.

The global financial crisis has meant that the biggest of the banks are growing even bigger. The total share capital of the Australian banks was $111 billion at June 2009,[30] approximately 10 per cent of Australian GDP. These institutions are now not only 'too big to fail', but are rapidly becoming too big to save.[31] Ross Garnaut has argued that Australia's regulatory system 'should seek to avoid the emergence of banks that are too big to fail'. He adds that the 'encouragement of new deposit-taking institutions with conservative approaches to lending would help'.[32]

In the UK, the Bank of England has expressed concern that larger banks are becoming too complex. It complains that 'some large, complex banks have over 2,000 distinct legal entities across different countries' and, as a result, it has called for the breakup of large banking groups.[33]

Some commentators have suggested that the banks need to be trimmed down to their core functions. Recently Strauss-Kahn, the Managing Director of the International Monetary Fund, has said

> … [I]n the wake of the crisis, it is now widely accepted that in some countries, the financial sector has grown too large. It has gone well beyond its core function of financial intermediation, and devoted much energy to financial engineering—generating products that have been profitable for the industry, but of more doubtful value to the economy as a whole.[34]

Similar concerns could be expressed about the Australian banking system.

Implications

Competition has an important function in modern economies. Its end result should be that markets are served by suppliers that earn just enough to cover the cost of the resources they use and provide a modest return on investment. However, in an industry such as banking, the end result of competition is the dominance of the market by a small number of large

---

30 RBA, 'Statistical Tables'.

31 'Top 1000 shows risk of top-heavy giants persists', *The Banker*, 7 July 2009.

32 R Garnaut and D Llewellyn Smith, *The great crash of 2008: Ross Garnaut with David Llewellyn Smith,* Melbourne University Press, Carlton, 2009, p. 216.

33 Bank of England, *Financial Stability Report,* Issue No. 25, 26 June 2009.

34 D Strauss-Kahn, 'National, European, or global? The future of bank regulation', remarks by Dominique Strauss-Kahn, Managing Director, International Monetary Fund, Paris, 24 November 2009.

players earning excessive profits at the expense of the rest of society. If the market acts perversely, as it has in the Australian banking sector, non-market solutions are necessary to prevent a small number of large institutions from extracting monopoly profits from the broader economy.

In the wake of the global financial crisis, which has seen an increase both in the underlying profitability of the big banks and the levels of concentration in the industry, strong competition policy and firm action against anti-competitive behaviour are going to be even more critical. A common response from government to the power of the banks has been to suggest that consumers 'shop around'. As the then Treasurer Peter Costello remarked in 2000, 'I always encourage people having trouble with their banks to take their business elsewhere'.[35] More recently, the Australian Government has introduced switching policies designed to make it easier for customers to shift their accounts to other banks, an idea based on research by the Organisation for Economic Co-Operation and Development (OECD) that found increased scope to enhance competition by helping customers move more easily between providers.[36] Unfortunately, Australian customers appear particularly unwilling to change their banks and only three per cent do so each year.[37]

The explanation for ever-increasing market concentration (and the profits this brings) lies in the interaction between banks and their customers. In the next section, we describe consumers' banking experiences and the attitudes of ordinary Australians towards banks.

---

[35] P Costello, Interview with Alexandra Kirk, Transcript No 2000/61, *ABC AM*, 31 May 2000.

[36] Treasury, 'Inquiry into competition in the banking and non-banking sectors', Submission 32 to House of Representatives Standing Committee on Economics, July 2008.

[37] Australia, House of Representatives Standing' Committee on Economics, C*ompetition in the banking and non-banking sectors*, Commonwealth of Australia, Canberra, November 2008.

4 Consumer experiences of banking

The nature and structure of the banking sector depends to a large degree on the individual decisions of millions of Australians about which institutions to trust with their financial affairs. This section examines how different sections of the population tend to favour different categories of financial institution and discusses the extent to which customers consider switching between banks, a key measure of competition from the consumer perspective. The section goes on to describe how millions of Australians are regularly encouraged by overtures from financial institutions to take on more debt in one form or another and finally reports on community attitudes towards the market power of the big banks.

Banking habits

The information presented below is drawn from a survey of 1,360 adults conducted by The Australia Institute in March 2010.[38]

As Table 4 shows, survey respondents reflected the profile of the retail banking market, with most respondents (70 per cent) saying they did most of their banking with one of the big four banks. Fourteen per cent reported using another bank, while another 15 per cent banked with a credit union. Younger people (76 per cent of 18 to 24 year olds) were more likely to bank with one of the big four than older people (61 per cent of those over 55 years).

Table 4: With which kind of institution do you do most of your banking?

	18–34 years	35–54 years	55+ years	Total
One of the big four banks	76.4%	71.7%	60.8%	69.6%
Another bank	14.8%	13.8%	13.8%	14.1%
A credit union	6.8%	13.3%	24.1%	14.8%
Other	1.9%	1.2%	1.4%	1.5%
Total	**100%**	**100%**	**100%**	**100%**

Base = 1,360

Respondents who banked with one of the big four were asked whether they had ever considered switching to another bank (not one of the big four) or a credit union. Roughly half (49 per cent) had considered switching

38 Further details on the survey methodology are available at Appendix A.

to another bank, while 41 per cent had considered switching to a credit union; together, 57 per cent had considered switching to one or the other. Viewed another way, fully 43 per cent of people banking with one of the big four have never considered switching to a smaller bank or credit union.

Marketing of debt

Survey results reveal the extent to which ordinary Australians encounter offers from banks to take on debt in various forms, even without going near a bank branch. Two in three respondents (66 per cent) reported receiving an unsolicited offer for a new credit card in the past 12 months, while one in two (49 per cent) had received an unsolicited offer to increase their credit-card limit. One in three (36 per cent) had received an offer for a personal loan, and one in five (18 per cent) had an offer to increase the available credit on their home loan.

Such unsolicited offers, which can come by post, by email, in a bank branch and even in a public place such as a shopping centre, were by no means restricted to those on substantial incomes. As tables 5 and 6 show, a majority of respondents who were not in paid employment together with a majority of those living in households with a combined income of less than $40,000, had received an offer for a new credit card in the previous 12 months. While people on higher incomes were more likely to receive such offers, the marketing of debt among people on low incomes is clearly widespread. For example, one in three people in low-income households had received an offer of a personal loan in the past year without seeking one out.

Table 5: Unsolicited offers for credit in the previous 12 months, by employment status

	In paid work	Not in paid work	All
Offer for a new credit card	69.2%	60.6%	65.8%
Offer to increase credit card limit	54.9%	40.8%	49.4%
Offer for a personal loan	39.7%	30.8%	36.3%
Offer to increase the available credit/redraw on home loan	21.1%	13.5%	18.2%

Table 6: Unsolicited offers for credit in the previous 12 months, by household income

	Less than $40,000	$40,000–$80,000	More than $80,000	All
Offer for a new credit card	58.8%	67.1%	73.3%	65.8%
Offer to increase credit card limit	41.2%	52.1%	58.0%	49.4%
Offer for a personal loan	31.4%	39.6%	39.3%	36.3%
Offer to increase the available credit/redraw on home loan	16.5%	16.3%	23.2%	18.2%

Community attitudes towards big banks

Survey findings indicate that most Australians do not believe that the highly concentrated structure of the banking market is desirable. Three in four survey respondents (72 per cent) agreed that the big four banks in Australia have too much market power, while only 13 per cent disagreed. People who did their banking with a smaller bank or credit union were more likely to believe that the big four have too much market power.

Table 7: In your view, do the big four banks in Australia have too much market power?

	Banks with one of the big four	Banks with another bank	Banks with a credit union	Total
Yes	69.1%	77.6%	81.6%	72.3%
No	14.5%	9.9%	7.5%	12.7%
Not sure	16.5%	12.5%	10.9%	15.0%
Total	**100%**	**100%**	**100%**	**100%**

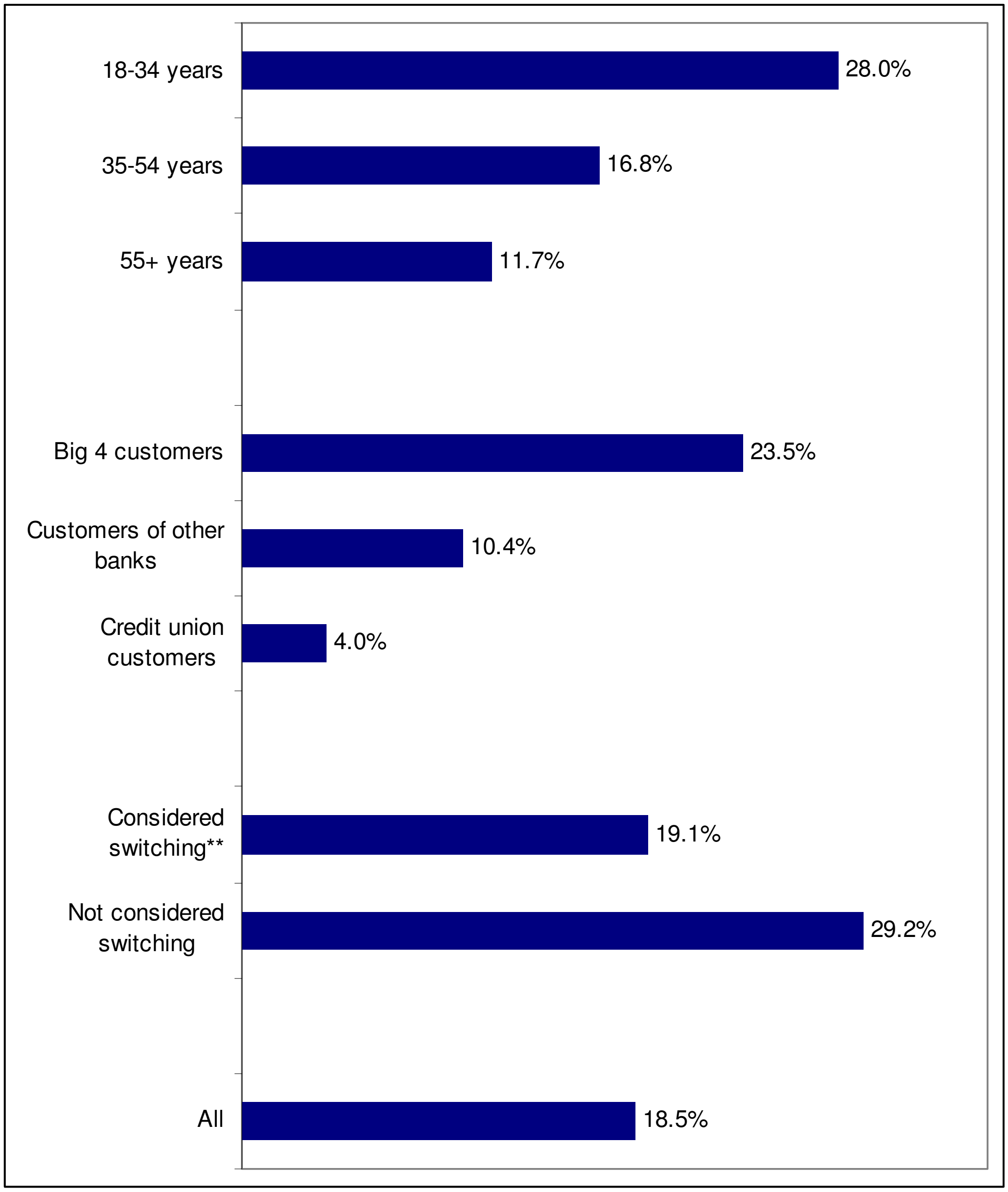
Base = 1,360

The survey also asked respondents for their views on whether its profits affect how 'safe' a bank is. Around one in five (19 per cent) said that it is safer to deposit money with *a bank with bigger profits*, while four per cent said that *a bank with smaller profits* is safer. Most respondents (67 per cent) said *neither—profits make no difference to how safe a bank is*.

Younger people were much more likely to believe that a bank with big profits is safer. People who banked with one of the big four were also more likely to hold this view, suggesting that perceived 'safety' is a factor in their choice of financial institution.

Among those who banked with one of the big four, respondents who had never considered switching to a smaller bank or credit union were more likely to believe that bigger profits equal more safety than those who had considered switching. Around a quarter of big-four customers apparently do not interpret recent bank profits as evidence of overcharging; on the contrary, they see such profits as evidence they have chosen a 'safe' bank for their funds.

Figure 2: Proportion of respondents who said that it is safer to deposit money with a bank with bigger profits*



* Base = 1,360

** Considered switching from one of the big four banks to a smaller bank or a credit union.

Implications

These survey findings present an interesting snapshot of the relationship between banks and their customers. They show that older people are more willing to use alternatives to the major banks: more than one in three people over 55 years use a smaller bank or credit union compared with one in five people under 35. However, three in four Australians still do most of their banking with one of the big four.

Of those that bank with one of the big four, 43 per cent have never even considered switching to a smaller bank or credit union. This result is surprising given the industry's claim that competitive pressures in the sector are strong. Even with constant negative media coverage about the major banks and widely reported community concerns about their conduct, many Australians are simply not prepared to shift their banking to a smaller institution. This is despite the fact that customers are regularly subjected to attempts by banks to lend them money, even where they have expressed no interest whatsoever in taking on debt.

Perceptions about 'safety' appear to be related to the tendency for Australians to stick with what they know when choosing a bank. Of course, nobody wants to lose their money and anyone would be well advised to avoid financial institutions without a strong track record and balanced books. However, the level of prudential regulation in this country, along with the government's guarantee on deposits of up to $1 million, mean that there is very little risk in choosing a credit union or smaller bank over one of the big four. Young people are more likely to equate big profits with safety and also more likely to bank with one of the big four.

It is *perceived* rather than actual risk that predominates in such decisions. In the realm of consumer psychology where perceptions are so critical, the incumbents have the advantage. Even as they make record profits, the big four are simply reinforcing a common community misconception that the bigger a bank's profits, the safer it is. The survey results show that one in five Australians believe this to be the case, although people who bank with smaller banks or credit unions are much less likely to hold this view.

Despite the suggestions of economic theory, choosing a bank is not a simple matter of comparing fees and interest rates or weighing up the relative risks of different institutions. Instead, it is a decision influenced by a host of non-rational 'human' factors. The next section explores the way people make financial decisions in an increasingly complicated and confusing environment.

5 Choice and confusion in financial decision-making

As discussed above, the big four banks command three-quarters of the retail banking market in Australia. A great many factors influence the choices people make about their financial affairs, including which institutions to bank with.

This section provides a real-world account of the way people make decisions about banking. It draws on research into consumer choice in financial services to explain how the orthodox economic theory of the rational consumer is inadequate, both in describing behaviour and guiding regulation. Instead, behavioural economics presents a much more compelling account of why people make the financial decisions they do in the real world.

The psychology of finance

Choice in economic theory

In the ordinary course of our lives we make all manner of decisions ranging from the trivial and inconsequential, such as which breakfast cereal to buy, to important judgements that will affect our future, such as which career to pursue. Modern society presents us with an increasing number of choices in almost every facet of our lives. Indeed, one of the defining characteristics of the globalised economy is the range of choices available to ordinary consumers.

Choice is usually regarded as inherently good. Common wisdom has it that people like choice and that governments and businesses contribute to social wellbeing by facilitating greater choice. At the individual level there is much evidence to support this view. Choice has been shown to enhance people's sense of self-determination and motivation to perform tasks, while the increased sense of control associated with choosing leads to improved psychological and even physical health. Choice can also help people to be more positive about the decisions they have made.[39]

Consumer choice is at the heart of mainstream economic thought. Rational choice theory, for example, assumes that individuals have well-defined and consistent preferences and will act in ways that maximise their own 'utility'.

---

[39] S Botti and S Iyengar,'The Dark Side of Choice: When Choice Impairs Social Welfare', *Journal of Public Policy and Marketing* 25 (1) 2006, pp. 24–38.

It also assumes that people can access enough information to enable them to properly assess the costs and benefits of each option, so that the right choices can be made.[40] If the right information is not immediately available, it is possible to assess the costs associated with acquiring that information, at which point an 'informed' judgement can be made about whether to seek out further information. When the costs and benefits of all these options (including finding more information) have been weighed up, the outcome will, according to rational choice theory, maximise individual wellbeing. Increasing the amount of options allows every individual to express his or her preferences more exactly and this enhances collective welfare. By this argument, more choice automatically translates into greater overall utility.[41]

Of course, it is difficult and perhaps impossible to determine what competing factors coalesce in the minds of individuals as they form their preferences. Rather than examining how people assess different options, economists rely on the theory of revealed preference, the idea that an individual's actions, usually in the form of their purchasing decisions, are the true test of their needs and wants. The axiom of revealed preference provides a sort of guarantee that the choices people make are always in their best interests, and that collective choices are in the best interests of society generally. But in so doing it relies on a circular logic, assuming that people always understand completely what choices reflect their best interests. Challenging the notion of revealed preference, there is persuasive evidence that people often make choices based on emotional factors rather than a strictly rational appraisal of costs and benefits.

Choice in personal finances

Most decisions about personal finances, including decisions about savings, investments, retirement planning, insurance and other financial products and services, involve determining which product is most suited to one's needs. It is reasonable to say that one savings product is 'better' than another because it earns more interest, or that one insurance policy is superior to another (on comparable terms) because it is cheaper. It is the 'right' decision to choose an investment product which will maximise returns, and the 'wrong' decision to opt for a product with lower returns. Although financial providers often rely on subjective or emotional triggers to advertise and promote their products, orthodox economic theory assumes

---

[40] R Frank, S Jennings and B Bernanke, *Principles of Microeconomics,* McGraw-Hill, North Ryde, 2007.

[41] B Schwartz, 'Self-Determination—The Tyranny of Freedom', *American Psychologist* 55 (1), 2000, pp.79–88;
Botti and Iyengar, 'The Dark Side of Choice'.

that people make decisions about financial products according to objective rather than subjective criteria. However, emotional factors such as trust in particular institutions or brand recognition have a disproportionate influence on financial behaviour.

In order to make the right choice, consumers of financial products need the right information. This is not necessarily a problem for very knowledgeable consumers, who are able to understand the implications of each option. For other consumers, however, the cost of acquiring and interpreting this information, the 'cost of thinking', is very high. This could be the result of insufficient education or problems with numeracy, or it could simply be through lack of experience. Faced with a decision they are not qualified to make, people often end up making no choice at all, even when that is the worst option available. According to psychologists, 'the more choosers perceive their choice-making task to necessitate expert information, the more they may be inclined not to choose, and further, they may even surrender the choice to someone else'.[42]

This account of how people make choices is very different from that advocated by orthodox economics. While 'irrational' decision-making may not be a problem for many of the insignificant choices we make in everyday life, it can have serious implications for our personal finances. The consequences of some financial decisions are only felt many years later, by which time a poor choice will be too late to rectify. Further, some people may never realise that they have made the 'wrong' decision because they are unaware of what alternatives there might have been. Despite this, the range of financial options available to consumers, and the knowledge required to assess them, continues to grow. The assumption behind these trends is that people generally like more choice, and in particular prefer more choice in the context of their finances. Yet, as recent empirical research has shown, 'posing choices in this way … is to pretend that Australians understand and like the financial sector'.[43]

Exacerbating this situation is the fact that much of the information currently available to consumers, both on individual financial products and general financial issues, can be extremely bewildering. This was acknowledged by

---

[42] S Iyengar and M Lepper, 'When Choice is Demotivating: Can One Desire Too Much of a Good Thing?', *Journal of Personality and Social Psychology* 79 (6), 2000, pp. 995–1006. This tendency is borne out by the growth in the financial advice sector, which has taken place at the same time as the range of options available to retail investors has grown.

[43] J Pixley, 'How Do Australians Feel about Financial Investment?' in D Denemark, G Meagher, S Wilson, M Western and T Phillips. *Australian Social Attitudes 2: Citizenship, Work and Aspirations*, UNSW Press, Sydney, 2007, p. 302.

the Australian Government's Consumer and Financial Literacy Taskforce in its 2004 report, *Australian consumers and money*.[44] The Taskforce noted that consumers 'have a number of common problems with information and advice', including:

- not knowing what information is available or appropriate for their needs
- being overwhelmed and confused by different information
- not trusting the information
- not understanding the jargon and terminology in the information and advice received
- not feeling the information is relevant to their needs and lifestyle (particularly the case with young consumers)
- understanding the information but not being able to act on it in any meaningful way.[45]

According to the Taskforce, when information becomes too confusing, 'consumers tend to resort to easier and more trusted sources of information such as the media, friends and relatives'.[46] This means that common misconceptions are perpetuated.

Together, these factors create a major discrepancy between the information and knowledge available on the one hand to financial providers and institutional investors and on the other to 'ordinary' or retail consumers of financial products and services. Consumers can find it much more difficult to assess various types of risk, including market, institutional and inflation risk, due to the inherent complexities of financial decision-making. Under orthodox economic theory, such 'information asymmetry' is actually a form of market failure. In other words, markets in which some participants possess important information while others do not tend to generate inefficient outcomes.[47]

A behavioural account of financial decision-making

Behavioural economics is a relatively recent field of study that seeks to integrate the lessons of psychology with an economic account of human behaviour. In orthodox economic theory, human beings are assumed to be strictly rational creatures who make choices by carefully assessing the

---

44 The Consumer and Financial Literary Taskforce, *Australian consumers and money*, a discussion paper, Commonwealth of Australia , 2004.

45 Consumer and Financial Literacy Taskforce, *Australian Consumers and Money*, p. 46.

46 Consumer and Financial Literacy Taskforce, *Australian Consumers and Money*, p. xiv.

47 Frank et al., *Principles of Microeconomics*.

costs and benefits of each option. As a result, 'virtually all the behaviour studied by cognitive and social psychologists is either ignored or ruled out'.[48] Behavioural economics provides an account of decision-making that conveys the many ways in which choices deviate from the rational model.

One of the key lessons of behavioural economics is that people look for shortcuts when they are forced to make decisions for which they have no clear preference or where the cost of acquiring information is high. They apply what psychologists call an heuristic, a rule or short-cut that allows them to solve complex problems even with incomplete information. Table 8 presents a list of common patterns of behaviour, identified through behavioural research, which are particularly relevant in the realm of financial decision-making.[49] Together, these well-documented tendencies support the contention that consumers often do not possess the wherewithal to make decisions about their personal finances in ways that correspond to their own self-interest.

---

[48] S Mullainathan and R Thaler, *Behavioural Economics*, Working Paper 7948, National Bureau of Economic Research, Cambridge MA, 2000, p. 2.

[49] The list of behaviours is drawn from a range of sources, but discussion of various behavioural tendencies can be found in the following sources:
R Cialdini, *Influence: The Psychology of Persuasion*, Morrow, New York, 1993;
C Sunstein and R Thaler, 'Libertarian Paternalism is not an Oxymoron', *The University of Chicago Law Review* 70 (4), pp. 1159–1202;
E Dawnay and H Shah, *Behavioural Economics: Seven Principles for Policy-Makers*, New Economics Foundation, London, 2005;
O Mitchell and S Utkus, 'Lessons from Behavioural Finance for Retirement Plan Design', in O Mitchell and S Utkus, *Pension Design and Structure: New Lessons from Behavioural Finance*, Pension Research Council, Oxford University Press, 2004, pp. 3–41;
R Thaler, 'Mental Accounting and Consumer Choice', *Marketing Science* 4 (3), 1985, pp. 199–214;
W Samuelson and R Zeckhauser, 'Status Quo Bias in Decision Making', *Journal of Risk and Uncertainty* 1, 1988, pp. 7–59;
D Laibson, 'Golden Eggs and Hyperbolic Discounting', *The Quarterly Journal of Economics* 112 (2), 1997, pp. 443–77.

Table 8: Common behavioural biases in financial decision-making

Name	Definition
Social proof	The tendency to make or justify decisions according the behaviour of other people.
The representativeness heuristic	The tendency to believe that a given instance is representative of a larger class of phenomena.
The availability heuristic	The tendency to prefer easily available information over information that is more difficult to acquire.
Choice overload	The tendency to limit decisions to a manageable range of options, in response to a large number of choices or overwhelming complexity.
Status quo bias	The tendency to stick with current arrangements, regardless of whether other options are preferable in an objective sense. Closely related to procrastination and frailty of will.
Anchoring	The tendency to base decisions of a quantitative nature on a specific, available number.
Framing bias	The tendency to make different decisions according to the way a situation is described or explained, rather than its objective reality.
Overconfidence	The tendency to over-estimate one's knowledge or competence.
Confirmation bias	The tendency to rely on facts and evidence that accord with one's pre-existing beliefs.
Loss aversion	The tendency to rue losses more than one values gains.
Mental accounting	The compartmentalisation of financial decisions based on different financial commitments, despite the complete fungibility of money.
The money illusion	The tendency to assess interest rates in nominal rather than real terms.

Marketing opportunities

Bank customers are real human beings, not the super-rational consumers of orthodox economic theory. This means that they are susceptible to predictable behavioural biases, which will sometimes cause them to make decisions that are not in their own financial best interests. As the amount of choice in the financial marketplace increases and decisions become more complex, levels of confusion and misunderstanding about financial products grow accordingly. From society's perspective, this is a negative development, but for financial institutions it presents an enormous marketing opportunity.

The fundamental aim of much of the marketing undertaken in the retail banking sector is to turn what should be objective decisions ('which product is best according to the following criteria?') into subjective or emotional decisions ('which brand do I feel best about?'). This is not easy, because financial decisions are not usually exciting or emotionally captivating. Banks therefore go to great lengths to imbue their brands with the kinds of emotional connotations that will attract customers. One of the best ways to do this is through fear: fear of not having enough money in retirement, fear of the disapproval of others, fear of losing one's life savings and so forth. The bank or its product then becomes the solution to, or a way of placating, such fears.

If, as a result of such overtures, customers decide to use financial products that match their needs, this marketing is unobjectionable. If, however, they use financial products which are inappropriate for them, it is actively working against their interests. This may be the case where people are encouraged to take on more debt than they can comfortably service, even if they can technically 'afford' the repayments. As noted in the previous chapter, 66 per cent of Australian adults, and 61 per cent of people who are not in paid work, have been offered a new credit card in the last 12 months. Similarly, 55 per cent of adults, and 41 per cent of people not working, have received an offer to increase their credit-card limit. In other words, large sections of the Australian population, including many people in difficult financial circumstances, are continually encouraged to take on more debt.

As we have seen, when people are asked to make financial decisions that they do not fully understand they often rely on other people for help, particularly people whom they regard as better qualified or informed. In the case of bank products, people often rely on the advice they receive from bank workers. What is not well understood is that bank workers in Australia are often themselves incentivised to sell their bank's products. The more products they sell—in other words, the more debt they convince customers to take on—the more money they make. In fact, encouraging tellers and call-centre representatives to sell debt products is an integral part of a bank's marketing strategy. According to a recent survey commissioned by the Finance Sector Union (FSU), 59 per cent of bank workers believe that 'selling debt to customers' has 'become a much higher priority [in recent years] and sales targets always go up'. Seventy three per cent of workers agreed that 'every year, my sales targets go up', and 43 per cent agreed that 'I am under pressure to sell debt products, even if customers don't ask for them and may not be able to afford them'. This survey found strong support among bank workers for removing the link between their remuneration and the sale of debt products, particularly for a return to an environment in which customers can be confident that the advice given by bank workers is objective rather than conflicted.[50]

Debt-pushing by bank workers is just one part of the sophisticated and multi-faceted marketing operations of Australia's big banks. They also spend enormous sums of money on advertising in the mass media, on junk-mail campaigns and even on face-to-face marketing in public places. In fact, as Table 9 shows, the big four banks spent over $1 billion on advertising alone in 2008–09, more than the Australian Government spends on the ABC each year.[51]

Table 9: Amount spent on advertising in 2008–09[52]

Bank	$ million
ANZ	195
Commonwealth	475
National	219
Westpac	155
Total	**1,044**

Together, all this marketing allows banks to take maximum advantage of the frailties of willpower and knowledge that real consumers demonstrate when faced with financial choices. And while constant marketing can maximise shareholder returns, the effect on broader society is a negative one. Given the enormous profitability of banking, it may be time to rein in the marketing of debt through greater regulation.

50 Essential Research, *Better Banking: Australian Bank Workers*, commissioned by the Finance Sector Union, April, 2010.

51 The 2010–11 Federal Budget allocated a total of $997 million for the ABC, including $586 for ABC Television, $316 for ABC Radio and $95 for the ABC's analog transmission. See Australian Government, *Budget Strategy and Outlook, 2010-11 Budget Paper No 1*, 11 May 2010.

52 ANZ, *Annual report 2009*; Commonwealth Bank of Australia, *Annual report 2009;* National Australia Bank, *Annual financial report 2009;* The Westpac Group, *Annual report 2009.* Figures for the Commonwealth include 'marketing' and 'loyalty', while figures for ANZ include 'public relations'.

Implications

The global financial crisis was caused in part by 'irrational exuberance,' where banks lent too much and individuals borrowed too much. A behavioural understanding of financial decision-making suggests that, when faced with numerous, complex and important choices, many people will procrastinate, go with the easiest or simplest option, or rely on others to make decisions for them. This means that policy responses need to be more interventionist than simply providing consumers with more information. Indeed, it could be argued that a substantial proportion of bank profits and, in particular, the enormous profit margins made on credit cards, are associated with the lack of attention that customers pay to their financial affairs.

The consequences of this unwillingness or inability to 'shop around' are far greater than the direct costs to consumers in excessive fees and interest-rate differentials The entire regulatory structure of the Australian banking system is based on the assumption that 'rational' banking customers will, by analysing all the relevant costs and benefits of particular courses of action and acting accordingly, keep continuous downward pressure on bank fees and interest rates.

The evidence shows that this picture of consumer banking behaviour falls woefully short of reality. In the absence of super-rational consumers who exert competitive pressures on banks, bank profits can be expected to keep rising indefinitely unless additional regulation is imposed. Policy responses should be based on the reality of the banking market in Australia, not on economic theories that do not correspond with the facts.

6 Conclusions

Recently, the big four banks have tried to claim much of the credit for the admirable performance of the Australian economy through the global financial crisis. They have used their prudential strength, which is not unrelated to their huge profits, to argue against tighter controls on their activities. Even senior government ministers praise the banks, presumably to remind voters that they presided over a system in which no Australian banks failed even as other banks around the world ran into trouble.

The power of Australia's big four banks is unmistakable; they exert an enormous degree of influence over the economy and over their customers. Their underlying profits equate to almost three per cent of GDP, up from less than one per cent a quarter of a century ago. Of every $100 spent in Australia, nearly $3 ends up as underlying profit for the banks.

Profits are high because the banking market is highly concentrated. The top four banks now control more than 75 per cent of all bank assets and banks account for over 90 per cent of all lending by financial institutions in Australia. This circumstance has distorted competition, allowing the big banks to become extremely profitable with underlying profits of around $35 billion; some $20 billion of this amount represents the rewards reaped as a result of their monopoly position.[53] Most Australians believe that the banking market is overly concentrated: three in four survey respondents (72 per cent) agreed that the big four banks in Australia have too much market power, while only 13 per cent disagreed.

The banks claim that because they compete with each other, interest rates and fees are kept at reasonable levels, a claim that rests on the assumption that consumers will readily switch banks when they see the opportunity for a better deal. By contrast, our survey results show that 43 per cent of big-bank customers have never even considered switching. In fact, only three per cent of bank customers switch banks each year,[54] an astonishingly low figure for a sector that is allegedly subject to free and open competition. Once a bank signs up a new customer, it can be quite confident of keeping that customer for decades to come.

---

[53] D Richardson, *A Licence to Print Money: Bank profits in Australia*, Policy Brief No. 10, The Australia Institute, March 2010.

[54] Australia, House of Representatives Standing' Committee on Economics, C*ompetition in the banking and non-banking sectors*.

The backdrop of the global financial crisis and financial collapses abroad have fostered a view in the community that the bigger a bank is, and the bigger its profits, *the safer it is.* Indeed, around one in five Australians appear to hold this belief, with 19 per cent of survey respondents agreeing that it is safer to deposit money in a bank with bigger profits. Customers of one of the big four were also more likely to equate profits with safety, suggesting that this is a factor in consumer decisions about which institution to bank with. If one in five Australians believe that a bank with bigger profits is safer, this means that there is a pool of more than three million adult Australians who hold this view, constituting a massive marketing advantage for the incumbent players in the sector against smaller banks and credit unions.

In the wake of the global financial crisis, the corporate sector, drawing on the doctrine of 'personal responsibility' to absolve itself of any culpability in the debt crisis, has tended to blame individuals for taking on more debt than they can handle. From the banks' perspective, the solution to excessive borrowing is to encourage greater financial literacy. At the same time, they bombard consumers, including those on low incomes and those not in paid employment, with offers of credit. Banks also encourage their workers to sell debt, a situation that often means customers can no longer be certain of receiving objective advice from their local bank branch. Instead, the remuneration for bank staff is commonly linked to the amount of debt that they are able to sell. Given the extent to which credit is marketed by banks, it is almost inevitable that some customers will take on more debt than they can manage regardless of how much 'information' is available.

In recent years, policymakers around the world have come to recognise that many people struggle with financial decisions. Their standard response has been to promote financial literacy through education and awareness-raising, the assumption behind these initiatives being that consumers possess the motivation and capacity to improve their financial knowledge. But there is something missing in this approach. Consumers also need to be aware of the various ways in which financial providers may attempt to persuade them to take on more debt than they need, or to use a financial product that is not in their best interests. They also need to understand the extent to which certain providers in the retail financial sector dominate all the others and the techniques they use to reinforce their dominance.

More broadly, government needs to ensure that the environment in which consumers make financial choices is structured fairly and in a way that empowers ordinary people rather than just the big banks. To date, the principal weapon used by Australian policymakers in their battle against the might of the banks has been competition. Almost a century ago, the

Commonwealth Bank was established to provide genuine competition against the private banks and since then there have been waves of competition from credit unions, building societies, finance companies, mortgage originators and foreign banks. But despite a century of competitive conflict, the big four banks are stronger now than they have ever been.

Policy options

The lesson of history is that competition policy is not very effective against a large, powerful industry enjoying the competitive advantages that result from incumbency and economies of scale. One solution might be to require functional or structural separation between the different functions performed by banks: deposit-taking and lending, payments facilitation, retail investment, investment banking and so forth. The aim should be to reduce bank profits to one per cent or less as a share of GDP, the level they were at two decades ago. Other policy changes that would contribute to this aim include:

- legislating to ensure that interest rates charged by banks move in line with changes to the RBA cash rate and are set and advertised as a mark-up over the cash rate
- establishing a separate licensing regime for financial institutions that provide payment services and infrastructure to retailers, thus encouraging new entrants into this market
- capping certain kinds of bank fees at a level sufficient to cover costs, including a reasonable return on assets
- mandating that all financial institutions offer a no-frills, low-cost everyday savings/transaction account to every customer
- restricting the interest rates that can be charged on unsecured credit to levels that reflect the underlying risk to the lender.

Such initiatives would help bring profits back to a reasonable level, but it is also important that banks do not use their privileged position to exploit the vulnerabilities of individual customers. Something more is needed to ensure that banks behave in socially responsible ways that contribute to the wellbeing of the broader community.

The use of emotional techniques in advertising and marketing financial products is common and clearly effective. However, marketing that relies solely on such techniques without providing any helpful information or guidance to consumers is misleading and manipulative, prompting widespread public mistrust of banks. Banks should promote their products in ways that contribute to, rather than undermine, broader public understanding of financial concepts and imperatives. If they choose not to do this, it is the responsibility of government to monitor and regulate their communication with customers, particularly in the marketing of credit. This can be achieved in various ways:

- establishing national laws to ensure that credit is not extended to people who do not have the capacity to repay
- preventing banks and debt collectors from pursuing debts for loans made to people who did not have the capacity to repay when the money was originally loaned
- restricting or banning sales targets and commissions for bank workers
- providing bank workers with a decent ordinary wage independent of sales-based commissions
- banning the practice of 'pre-approving' credit-card offers and/or credit extensions
- preventing banks from claiming money spent on the advertising of credit products as tax deductible business expenses.

These reforms could constitute part of a formal social contract between individual banks and government; ratifying the social contract would then become a condition of maintaining a banking licence. Without this kind of policy intervention, the profits of the big banks will only get bigger.

Appendix A—Survey methodology

The Australia Institute conducted an online survey of 1,360 people in March 2010. Respondents were sourced from an independent, online-panel provider, Research Now. Each respondent who completed a survey was given a small incentive of $1.50 through the panel provider.

Quotas were applied to ensure that respondents were representative of the Australian population with respect to age, gender and state/territory. Data were also post-weighted by age and gender to ensure results indicative of the wider adult Australia population.

The survey asked the following questions, as well as collecting standard demographic information.

Q1. With which kind of institution do you do most of your banking?

One of the big 4 banks (National Australia Bank/NAB, Westpac/St George, Commonwealth, ANZ)

- Another bank – skip to B4
- A credit union – skip to B4
- Other – skip to B4

[If respondent banks with one of the big 4]

Q2. Have you ever considered switching to a bank that is not one of the big 4 (National Australia Bank/NAB, Westpac/St George, Commonwealth, ANZ)?

- Yes
- No

[If respondent banks with one of the big 4]

Q3. Have you ever considered switching to a credit union?

- Yes
- No

Q4. In your view, is it safer to deposit your money with…?

- A bank with bigger profits
- A bank with smaller profits
- Neither - profits make no difference to how safe a bank is
- Not sure

Q5. In the last 12 months, have you received any of the following kinds of unsolicited offers from a bank or financial institution? This might have been by mail, over the phone, by email, or in a bank branch. [Yes/no]

- Offer for a new credit card
- Offer to increase your credit card limit
- Offer for a personal loan
- Offer to increase the available credit/redraw on your home loan

Q6. In your view, do the big 4 banks in Australia have too much market power?

- Yes
- No
- Not sure

Q7. In your view, should the Australian Government be providing financial assistance to banks to help them through the global financial crisis?

- Yes
- No
- Not sure

References

ABS (2008). *Adult Literacy and Life Skills Survey: Summary Results 2006* (Reissue), Cat. No. 4228.0, Canberra, 9 January. Available at: http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/0/B22A471C221C7BADCA2573CA00207F10/$File/42280_2006%20(reissue).pdf

ABS (Australian Bureau of Statistics), (2009). *Australian National Accounts: National Income, Expenditure and Product, June quarter 2009*, Cat No 5206.0, Canberra, 2 September. Available at: http://www.abs.gov.au/AUSSTATS/abs@.nsf/allprimarymainfeatures/1296E6064552577FCA25768D007A0D96?opendocument

ABS (2006). *Adult Literacy and Life Skills Survey: Summary Results*, Australian Bureau of Statistics, Cat. No. 4228.0.

ANZ (2009). *Annual report 2009*, Melbourne, November.

APRA (Australian Prudential Regulation Authority), (2010). *Statistics: Monthly Banking Statistics*, *April 2010*, Commonwealth of Australia, 31 May. Available at: http://www.apra.gov.au/Statistics/upload/MBS-April-2010.pdf

APRA (Australian Prudential Regulation Authority), (2009). *Statistics: Quarterly bank performance statistics*, Commonwealth of Australia, March. Available at:

APRA, ASIC and RBA (2009). *Survey of the OTC Derivatives Market in Australia—May 2009*, APRA, ASIC, RBA. Available at: http://www.rba.gov.au/payments-system/clearing-settlement/survey-otc-deriv-mkts/sotcdma-052009.pdf

Australia, House of Representatives, Standing Committee on Economics, Finance and Public Administration, (1999). *Reference: Reserve Bank of Australia annual report 1997–98*, Melbourne, Hansard, Thursday 17 June, pp. 77–80. (Mr Ian Macfarlane, Governor of the Reserve Bank of Australia).

Australia, House of Representatives Standing' Committee on Economics, (2008). C*ompetition in the banking and non-banking sectors*, Commonwealth of Australia, Canberra, November.

Australian Financial System Inquiry, (1981). *Australian Financial System: Final Report of the Committee of Inquiry into the Australian Financial System*, (Mr J Campbell, Chairman), AGPS, Canberra.

Australian Government, (2010). *Budget Strategy and Outlook, 2010–11 Budget Paper No 1*, 11 May.

Bank of England, (2009). *Financial Stability Report,* Issue No. 25, 26 June.

Botti, S and Iyengar, S (2006). 'The Dark Side of Choice: When Choice Impairs Social Welfare', *Journal of Public Policy and Marketing* 25 (1), pp. 24–38.

Butlin, S J (1968). *Foundations of the Australian monetary system 1788–1851*, University of Sydney Press, Sydney.

Cialdini, R (1993). *Influence: The Psychology of Persuasion*, Morrow, New York.

Commonwealth Bank of Australia, (2009). *Annual report 2009*, Sydney, 12 August.

Costello, P (2000). 'Interview with Alexandra Kirk', Transcript No 2000/61, *ABC AM*, 31 May.

Dawnay, E and Shah, H (2005). *Behavioural Economics: Seven Principles for Policy-Makers*, New Economics Foundation, London.

Essential Research (2010). *Better Banking: Australian Bank Workers*, commissioned by the Finance Sector Union, April.

Fear, J (2008). *Choice Overload: Australians Coping with Financial Decisions*, Discussion Paper No. 99, The Australia Institute, May. Available at:
https://www.tai.org.au/index.php?q=node%2F19&pubid=497&act=display

Frank, R, Jennings, S and Bernanke, B (2007). *Principles of Microeconomics,* McGraw-Hill, North Ryde.

Garnaut, R and Llewellyn Smith, D (2009). *The great crash of 2008: Ross Garnaut with David Llewellyn Smith,* Melbourne University Press, Carlton.

Gollan, R (1968). *The Commonwealth Bank of Australia: Origins and early history*, ANU Press, Canberra, p 18.

Iyengar, S and Lepper, M (2000). 'When Choice is Demotivating: Can One Desire Too Much of a Good Thing?', *Journal of Personality and Social Psychology* 79 (6), pp. 995–1006. Available at:
http://www.columbia.edu/~ss957/articles/Choice_is_Demotivating.pdf

Keating, P (1984). '*Participation in banking in Australia and other issues of financial deregulation'*, statement by the Treasurer, 10 September.

Keating, P (1990). *Proposal for Merger of ANZ Banking Group (ANZ) and National Mutual Life Association*, press release by the Acting Prime Minister and Treasurer, 23 May, Canberra.

Laibson, D (1997). 'Golden Eggs and Hyperbolic Discounting', *The Quarterly Journal of Economics* 112 (2), pp. 443–77.

Mitchell, O and Utkus, S (2004). 'Lessons from Behavioural Finance for Retirement Plan Design', in Mitchell, O and Utkus, S, *Pension Design and Structure: New Lessons from Behavioural Finance*, Pension Research Council, Oxford University Press, pp. 3–41

Mullainathan, S and Thaler, R (2000). *Behavioural Economics*, Working Paper 7948, National Bureau of Economic Research, Cambridge MA.

National Australia Bank, (2009). *Annual financial report 2009*, Docklands, November.

Pixley, J (2007). 'How Do Australians Feel about Financial Investment?', in Denemark, D, Meagher, G, Wilson, S, Western, M and Phillips, T, *Australian Social Attitudes 2: Citizenship, Work and Aspirations*, UNSW Press, Sydney.

RBA (1994). *International Comparisons of Bank Margins*, *Appendix 3*, submission to the House of Representatives Standing Committee on Banking, Finance and Public Administration, August. Available at: http://www.rba.gov.au/publications/submissions/intl-comp-bank-margins-app3.pdf.

RBA, (2009). *Payments System Board Annual Report 2009*, Reserve Bank of Australia, pp. 6–17. Available at: http://www.rba.gov.au/publications/annual-reports/psb/2009/pdf/2009-psb-ann-report.pdf

RBA, (2010). 'Statistical Tables'. Available at: http://www.rba.gov.au/statistics/tables/index.html

RBA, (various dates). *Statistics: Australian Economic Statistics 1949–1950 to 1996–1997*, Occasional Paper No. 8, various dates.

Richardson, D (2010). *A Licence to Print Money: Bank profits in Australia*, Policy Brief No. 10, The Australia Institute, March. Available at: https://www.tai.org.au/index.php?q=node%2F19&pubid=733&act=display

Samuelson, W and Zeckhauser, R (1988). 'Status Quo Bias in Decision Making', *Journal of Risk and Uncertainty* 1, pp. 7–59.

Schwartz, B (2000). 'Self-Determination—The Tyranny of Freedom', *American Psychologist* 55 (1), pp.79–88.

Strauss-Kahn, D (2009). 'National, European, or global? The future of bank regulation', Remarks by Dominique Strauss-Kahn, Managing Director, International Monetary Fund, Paris, 24 November. Available at: http://www.imf.org/external/np/speeches/2009/112409.htm.

Sunstein, C and Thaler, R (2003). 'Libertarian Paternalism is not an Oxymoron', *The University of Chicago Law Review* 70 (4), pp. 1159–1202.

Thaler, R (1985). 'Mental Accounting and Consumer Choice', *Marketing Science* 4 (3), pp. 199–214.

The Consumer and Financial Literary Taskforce, (2004). *Australian consumers and money*, a discussion paper, Commonwealth of Australia. Available at: http://cfltaskforce.treasury.gov.au/content/_download/DiscussionPaper/Full_Version_no_cover.pdf

The Westpac Group, (2009). *Annual report 2009*, Sydney.

'Top 1000 shows risk of top-heavy giants persists', *The Banker*, 7 July 2009.

Treasury, (2008). 'Inquiry into competition in the banking and non-banking sectors', Submission 32 to House of Representatives Standing Committee on Economics, July 2008.

The Australia Institute
Research that matters.

About TAI

The Australia Institute is the country's most influential progressive think tank. Based in Canberra, it conducts research on a broad range of economic, social and environmental issues in order to inform public debate and bring greater accountability to the democratic process.

The Institute is funded by memberships, donations from philanthropic trusts and individuals, and commissioned research. With no formal political or commercial ties, the Institute is in a position to maintain its independence while advancing a vision for a fair and progressive Australia.

Our philosophy

With new dilemmas confronting our society and our planet, a better balance is urgently needed. Unprecedented levels of consumption co-exist with extreme poverty. Technology has connected humanity as never before, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. If genuine progress is to be achieved, conscience, equity and concern for the future must be the guiding principles of our democracy. Socially just, environmentally responsible and economically viable solutions are possible but only if insightful questions are combined with excellent research.

Who is The Australia Institute?

The Australia Institute's board represents a range of views and priorities, and its staff includes policy experts from fields as diverse as economics, public health and law. What unites us is a belief that, through a combination of research and creativity, we can develop the new ideas and practical policy solutions that a progressive Australia needs.

Support the work of The Australia Institute

With your support we will be able to expand our influential program of research that matters.

You can offer your support via the website www.tai.org.au or by contacting our office on 02 6162 4140.

Papers available from The Australia Institute

Richardson, D, *The impact of the recession on women*, August 2009.

Fear, J and Denniss, R, *Zero-sum game? The human dimensions of emissions trading*, August 2009.

Collett, L, *A fair-weather friend: Australia's relationship with a climate-changed Pacific*, July 2009.

Fear, J, Go *Away Please: The social and economic impact of intrusive marketing*, December 2008.

Fear, J and Pace, G, *Choosing Not to Choose: Making superannuation work by default*, November 2008.

Saddler, H and King, H, *Agriculture and Emissions Trading: The Impossible Dream?* October 2008.

Harris Rimmer, S, *The Dangers of Character Tests*, October 2008.

Edgar, G, *Agreeing to disagree: Maintaining dissent in the NGO sector*, August 2008.

Fear, J, *Choice Overload: Australians coping with the new financial order*, May 2008.

Hamilton, C, Downie, C and Lu, Y, *The State of the Australian Middle Class*, October 2007.

Macintosh, A, *Climate Change and Australian Coastal Shipping*, October 2007.

Fear, J, *Under the Radar: Dog-Whistle Politics in Australia*, September 2007.

Hamilton, C and Downie, C, *University Capture: Australian universities and the fossil fuel industries,* June 2007.

Macintosh, A and Downie, C, *A Flight Risk? Aviation and climate change in Australia,* May 2007.

Rush, E and La Nauze, A, *Letting Children Be Children: Stopping the sexualisation of children in Australia*, December 2006.

Wilkie, A, *All Quiet in the Ranks: An exploration of dissent in Australia's security agencies*, November 2006.

Macintosh, A and Downie, C, *Wind Farms: The facts and the fallacies*, October 2006.