Bendigo and Adelaide Bank

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20 January 2011

Mr John Hawkins
Committee Secretariat
Department of the Senate
Parliament House
Canberra ACT 2600
economics.sen@aph.gov.au

Dear Mr Hawkins,

Senate inquiry into competition within the Australian banking sector

I refer to your email dated 5 January 2011 requesting a response to some additional questions raised by the Senators of the above Senate Inquiry.

Bendigo and Adelaide Bank's (***BEN***) responses are as follows:

Question 1: How important are economies of scale in retail banking, and in participating in international lending? Does this constitute a barrier to entry and a force for concentration?

BEN does not participate in international lending and, as such, will respond on the retail banking question only.

Economies of scale in retail banking are significant and constitute a substantial barrier to entry in that market. Scale influences the underlying cost of a banking business in various ways including, but not limited to:

- Its influence on an ADI's credit rating and, therefore, cost and availability of wholesale funding;
- The ability to spread the cost of complying with regulation and regulators. Systems development, documentation changes and training costs have a significant fixed cost base which is relatively similar across institutions once they reach a meaningful size; and
- Other operational synergies that are generated from economies of scale (which are not specific to the banking sector) such as funding infrastructure investment in branch networks and payments systems, purchasing/cross-selling power, IT synergies.

Question 2: Are stamp duties an important barrier to customers switching mortgages between banks?

Stamp duties are a large part of upfront costs that borrowers must incur when purchasing a house. In some states, stamp duty is only payable on the "transfer" of the property and not on the registration of the mortgage itself. However, because stamp duty is a state-based duty, this ruling is not consistent across all jurisdictions.

For those borrowers who live in jurisdictions where stamp duty is payable on mortgages, there is a significant barrier in switching as previously paid mortgage stamp duties are not transferable (much like the issue with lenders mortgage insurance). It also means that borrowers in these jurisdictions are seriously disadvantaged compared to those borrowers wanting to switch loans in jurisdictions that are not subject to additional mortgage stamp duty.

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We would recommend that a standard approach to stamp duty is applied across all states and territories. This could then be complemented by an industry-wide move to standardised mortgage documentation for those borrowers with non-complex requirements. Such a move would allow the establishment of a mortgage clearing house and registry that would facilitate mortgage portability across institutions and eliminate the need for stamp duty to be applied again should borrowers seek to change from one institution to another.

Question 3: Reserve Bank data show that interest margins are narrower for smaller banks than the majors. Why is this?

There are a myriad of reasons for this but the key ones are detailed below.

Firstly, the introduction of the Government's wholesale guarantee (including the use of the deposit guarantee for funds over one million dollars), which used an institution's credit rating as the measure for credit worthiness, significantly widened the price differential for funding between major banks and smaller lenders. It was not just the impact in wholesale markets that contributed to this as the introduction of the guarantees also resulted in many commercial depositors moving to the major banks due to the relatively cheaper cost of accessing the guarantee.

Secondly, the GFC reduced access to wholesale funding across the board forcing all players to increase the amount of funding sourced through retail markets. This resulted in significant pricing pressure and led to the narrowing of interest margins of smaller lenders, who had been heavily reliant upon this market.

Finally, the major banks operate in markets that smaller lenders do not operate. Since the onset of the GFC these markets (i.e. institutional lending, large M&A financing) have produced higher margins as there has been a greater focus on pricing for risk.

Question 4: What do you think of the Australia Institute's characterisation of the banks using the RBA as a 'price leader' to put up their home loan lending rates even when there has not been much change in their cost of funds?

We do not agree with the argument put forward by the Australia Institute. In our view, the article is based on misunderstandings of how debt markets operate, how banks fund and any insight as to why this issue emerged.

The reality is that banks raise funds over a range of terms and do so for a number of reasons. The major of these are:

- to manage their maturity profile in order to avoid liquidity issues. It is widely accepted that banks generally fail as a result of liquidity problems as opposed to profitability or credit issues; and

- one of the key roles that banks play in an economy is to eliminate the maturity mismatch that exists between borrowers and lenders. Banks borrow across all terms but provide more long term loans than they have long term deposits. In other words, they tend to have borrowed short and lent long. Banks are able to do this as they have a stronger credit quality than most other borrowers, and they sit at the centre of most cash flows in an economy, enabling them to aggregate funds.

In debt markets credit spreads increase as borrowings move further out in term to maturity. So, as banks globally have moved (and been directed by regulators) to increase their borrowing terms, their

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cost of funds has risen. In addition there has been a general increase in the price of risk demanded by markets and a reduction in the availability of funding that has also increased funding costs. Clearly, there is irrefutable evidence that funding costs have increased for banks.

In relation to the issue of using the RBA rate as a "price leader", there is no doubt that the perception of a nexus between the RBA Cash rate and housing loan rates needs to be broken. In reality, that nexus does not physically exist.

This perception came about as a result of non-bank mortgage lenders entering the home loan market. These lenders used the securitisation market to fund their loans and the securitisation market provided those funds based on 30, 60 or 90 day bank bill rates. Yield curves in any economy merely reflect the markets expectation of the cash rate over time. As these non-bank lenders were borrowing short term, the correlation between the cash rate and their base funding rate (i.e. before credit spreads) was close enough for them to start re-pricing loans as official rates changed. Banks, erroneously in my view, elected to compete with these originators on price and were therefore led down the path of also changing pricing as official rates changed.

The irony in all this is that the non-bank lenders, who created the nexus between the official cash rate and home loan rates, no longer exist because they didn't manage their liquidity through borrowing across a range of short and long term maturities.

If you have any further questions, we would be more than happy to provide our responses.

Yours faithfully,

Mike Hirst

Managing Director

Cc: Robyn Clay, Head of Government Relations