30 November 2010

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

**By Email**

Dear Sir

**Submission to the Senate Economics Committee Inquiry - Competition within the Australian banking sector**

We are grateful for the opportunity to make a submission to the Senate Economics Committee inquiry to consider competition within the Australian banking sector, including the matters set out in the Terms of Reference.

We are pleased to attach comments on these matters.

Anticipating that Senate Economics Committee will receive many such submissions, we have kept our comments short in this paper, but would be happy to expand on any matters covered in it, if asked to do so.

We believe that Australian consumers should have greater choice of banking provider, and access to greater diversity of propositions, including from regional banks, foreign banks, non-bank lenders, mutuals and new entrants.

We are enthusiastic about the role we can play in bringing fresh competition, but we believe that actions such as those which we have recommended are necessary to create the environment in which this can take place effectively.

Yours sincerely

**Matt Baxby**
Managing Director
Virgin Money Australia

Attachments

VML/HEAD 0207

## Competition within the Australian Banking Sector

### Context

Virgin Money Australia is an Australian-based retail financial services business with a presence across key areas of banking, wealth and insurance, and is wholly owned by the Virgin Group. In July 2010, Virgin Money launched the first of a suite of financial services products, including an instant access online savings account. Consistent with the Virgin Group's experience across areas like air transportation and mobile telephony, one of the key objectives of the business is to bring competition to the heavily concentrated Australian financial services landscape.

Virgin Money Australia holds an Australian Financial Services Licence (but not a banking licence in Australia) and partners with various institutions to offer banking and financial services products to consumers. It should be noted that this paper reflects Virgin Money Australia's views and not those of its partners.

The purpose of this paper is to provide the Senate Economics Committee with the perspective of a recent entrant to banking in Australia. The paper covers the key areas outlined in the terms of reference with a focus on financial stability, competition and measures to bring greater competition.

### Financial stability

The stability of the large Australian banks during the financial crisis was impressive, whether because of a relatively benign local economic climate, the Australian tradition of strong and effective regulation, the support provided by the Australian government during the financial crises, or simply because, unlike their international peers, managements were not seduced by the appeal of "toxic" securities based on US sub-prime mortgages.

However, given the superior performance of Australian banks in controlling risks during the financial crisis, the higher capital ratios already required in many countries, and confirmed in the Basel III requirements, may be unnecessarily conservative for Australia, and could have negative unintended consequences:

- Higher capital ratios, and consequent limits on lending capacity, might restrict Australia's opportunity to achieve economic growth as a result of its strong position in commodities and its ability to leverage its exposure to China
- Alternatively, higher capital ratios could encourage banks to adopt higher risk profiles, to achieve returns on capital more similar to those achieved in the past. This danger is increased in Australia by the size of the big four large banks – as a result of the Global Financial Crisis, there is now an acceptance that Governments and regulators will provide support to large institutions such as the big four banks which are systemically important to continued confidence in the banking system. The same may not be said for smaller institutions, non-bank lenders, foreign banks and new entrants.

The size of the big four banks in Australia, and this systemic support, provides a source of advantage, and could distort competition in retail banking in Australia:

- In deposits, it is logical for customers to prefer the big four banks, especially given expectations that the guarantee on deposits will expire in October 2011
- In respect of loans, higher capital ratios and restricted capacity to lend has increased the power of large banks relative to their customers
- The big four banks continue to benefit from a funding rate advantage as a consequence of previous support: while the Guarantee Scheme for Large Deposits and Wholesale Funding strengthened the position of all Australian banks, it put the smaller regional banks, foreign entrants, building societies and credit unions at a relative cost disadvantage. While AA-rated major banks could raise funds at a fee of 70 basis points over the cost of funds, BBB-rated banks such second tier building societies and credit unions had to pay a fee of 150 basis points.

**Competition**

The retail banking market in Australia is heavily concentrated. The big four banks together account for nearly 80% of the household deposits on the books of individual banks.[1] UK retail banking is also concentrated, and the top six banks account for 88% of retail deposits, while in France, the top 10 banks account for 88% of retail deposits; in Germany, the top seven banks account for 68%; while in the US the top eight banks account for only 35%.[2] Similarly, the big four Australian banks together account for in excess of 80% of housing loans and advances on the books of individual banks[3].

High market concentration does not necessarily indicate weak competition, or vice versa, but there are some grounds for concern:

- Acquisitions across banking products during the Global Financial Crisis (including the acquisition of Bankwest by Commonwealth Bank, St George Bank by Westpac, the RAMS brand name and infrastructure by Westpac, and a 33% stake in Aussie Home Loans by Commonwealth Bank) have increased concentration in a retail banking market that was already concentrated
- Following these acquisitions, Australian retail banking is now polarised between the (even larger) big four banks on one hand, and fewer regional banks, foreign entrants, credit unions, building societies and new entrants on the other. There are now no middle-sized retail banks which can seriously challenge the large banks across Australia, or which could credibly acquire the retail banking activities of one of the four big banks, should it get into difficulties
- The limited emergence of new entrants in retail banking is disappointing, and suggests that there may be significant barriers to entry. Although new entrants have made some progress in deposits and mortgages, and in credit cards, they have not, at least so far, been able to achieve a strong position in transaction accounts, which are core retail banking products that enable banks to establish long-term relationships with customers and to obtain information about them, and to cross-sell other products to them.

[1] APRA, Monthly Banking Statistics, September 2010
[2] UK Independent Commission on Banking Issues Paper, September 2010, page 9
[3] APRA, Monthly Banking Statistics, September 2010

- Given the apparent barriers to entry and expansion in transaction accounts, and low switching rates in them, organic growth in this core relationship banking market is likely to be slow. The alternative of growth by acquisition is not easy, given the absence of smaller banks with reasonable scale in transaction accounts and with national branch networks

**Measures to bring greater competition**

Academic papers point to a degree of tension between the objectives of achieving financial stability and strong competition, with one of these being more important at some times and the other at other times.[4] The recent priority has, clearly, been financial stability, and the attention given to this may have led to some reduction in competition in Australia, and in other countries.

As the global economy recovers, we believe that it is necessary to ensure that banking markets are competitive – and that, if they are not, steps should be taken to encourage greater competition, without undermining the ongoing need to ensure financial stability.

We list below a number of issues which relate to competition in retail banking, and recommendations on actions which might be taken to improve competition, including encouraging stronger participation by mutuals and regional banks, increased entry, and greater expansion by new entrants.

**1. Deposit guarantee**

***Issue***

The big four banks have an unfair advantage in attracting retail deposits.

***Recommendation***

We recommend an extension of the deposit guarantee beyond October 2011 to prevent a flow of deposits from smaller banks to the big four banks (as happened during the financial crisis). As well as removing a potential distortion to competition, this step would reduce the risk of liquidity shortages emerging in smaller banks.

**2. Consumer inertia in switching banking provider**

***Issue***

Low switching rates in banking providers, caused partly by the perception that switching will be problematic, make it difficult for new entrants to achieve scale within a reasonable period.

***Recommendation***

We support recent calls for a national system which would make it easier for customers to switch transaction accounts. We suggest that, in this system, the transfer of direct debits and other regular payments could be imposed on the institution rather than the customer and should be done

[4] See for example "Bank Competition and Financial Stability: Friends or Foes?" by Thorsten Beck for the G20 Seminar on Competition in the Financial Sector in Bali, February 2008

automatically through a process agreed between all banks, and that accounts should be transferred within a short period (of 7 or 14 days). Consideration might also be given to the portability of transaction accounts, given that there appears to be consumer demand for this.

### 3. Transparency of charges on banking products

*Issue*

Charges on banking products may not be sufficiently transparent, and customers may find it difficult to compare the charges across products offered by different providers. There are clear benefits for consumers in exercising choice to switch providers – recent research commissioned by Virgin Money Australia and conducted by Access Economics found that just 10% of Australians switching could lower households' interest costs and increase returns on savings by as much as $10 billion over 10 years[5].

***Recommendation***

Consider the establishment of a website, sponsored by all banks and the Government, to facilitate price comparison and to give clear and full information about switching accounts.

### 4. Funding rates

*Issue*

The Australian banking system has a funding deficiency. The big four banks would have significantly less pressure to raise money and competition would be significantly enhanced given a deeper pool of cost effective funding for the mortgage market.

***Recommendation***

Consider a Government-supported funding solution possibly along the lines of the Canadian Mortgage and Housing Corporation model.[6] A government-guaranteed program to create securities from prime mortgages (similar to that in Canada) would help address both financial stability and competition issues.

### 5. Overall retail deposits

*Issue*

Efforts by large banks to improve their liquidity positions and their deposit to loan ratios could lead to them "paying up" for retail deposits in a way that smaller banks, with less diversified businesses, could not match.

***Recommendation***

Consider tax or other incentives to encourage greater retail deposits. This may help address both financial stability and competition issues. The UK, for instance, offers tax concessions for interest on the first £5,100 deposited.

[5] Access Economics, Exercising Choice with Financial Products, 21 July 2010

[6] See note by Citi Investment Research & Analysis, dated 7 October 2010

## 6. Market concentration

*Issue*

The Australian retail banking market is highly concentrated, and there is a large gap between the big four banks and smaller competitors which include credit unions, building societies and new entrants. This has been reinforced during the Global Financial Crisis with the acquisitions of potential challenger banks such as Bankwest, St George and Aussie Home Loans which may not have been approved in more stable market conditions. As a consequence, it is more difficult for smaller banks and new entrants to achieve significant scale in core banking products within a reasonable period, either organically or by acquisition.

***Recommendation***

Consider requiring reduction of retail banking assets by the big four banks (as in other jurisdictions), to create more retail-only banks able to compete with the big four banks (including in respect of core banking products and nationally).

## 7. ATM access and charging

*Issue*

Low switching rates in transaction accounts and other banking products may partly be caused by charges on using "foreign" ATMs, which give the large banks significant incumbency advantages over new entrants.

***Recommendation***

Given the implicit Government support for the Australian banking system as a whole during and since the financial crisis, and the need to encourage new entrants as an important source of greater competition, it seems reasonable to consider a review of ATM charges and access for "foreign" card users. However, the unintended consequences of this need to be fully considered to ensure that the dominance of the major banks is not further entrenched as a consequence of their ability to better accommodate fee reductions through their diversified business models and scale.

## 8. Price controls on bank lending

*Issue*

Although there is some frustration that lending rates have increased while risk-free rates have declined, the divergence can be explained, at least in part, by the increasing price for risk. The reintroduction of price controls on lending rates would probably reduce competition as a consequence of the big four banks' greater ability to accommodate fee reductions through their diversified business models and scale. Price controls and inappropriate pricing for risk might also encourage customers with poor credit worthiness to become over-indebted.

***Recommendation***

Resist pressure to reintroduce price controls on bank lending.

## 9. Exit fees on mortgages

***Issue***

Exit fees on mortgages are unpopular, and pressure to remove them has been increased as a result of political scrutiny and initiatives taken by some banks. However, it is rational to charge for the option of changing the term of a mortgage, or for the benefit of more attractive lending rates, and abolition of these charges could have negative unintended consequences on smaller banks with significant concentrations in mortgage activities.

***Recommendation***

Consider the valid reasons for exit fees on mortgages, and the possible unintended consequences of their abolition.

## Conclusion

We believe that Australian consumers should have greater choice of banking provider, and access to greater diversity of propositions, including from regional banks, foreign banks, non-bank lenders, mutuals and new entrants, which generally compete with the big four banks by offering better customer service. We believe that consumers would benefit from a step change in retail banking, with fresh competition making it a dynamic business that delivers good value and service. We are enthusiastic about the role we can play in bringing fresh competition, but we believe that actions such as those which we have recommended are necessary to create the environment in which this can take place effectively.