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# A licence to print money: bank profits in Australia

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Policy Brief

## Introduction

Banks were portrayed as the villains of the global financial crisis; many of the big international banks and their executives were associated with greed and excessive risk-taking. Regulators were obliged to step in with unprecedented rescue packages to save the financial systems in the US, the UK and, to a lesser extent, the major European countries. Australia was also affected but fortunately, the Australian banking system survived relatively unscathed.[1]

There is now a view that Australians were protected from the crisis because of the financial strength and profitability of the banks and that profitable banks provide a range of other benefits to the Australian community.[2] However, this paper puts the view that Australian banks are too profitable and that their excess profits are being made at the expense of the Australian community. The paper estimates the underlying profits of the banks to remove the impact of the global financial crisis but, as the crisis passes, actual profits will again reflect underlying profits.

The estimates in this paper suggest that the big four banks[3] alone make underlying profits of around $35 billion before tax, of which some $20 billion per annum is likely to reflect the banks' exploitation of their monopoly over the Australian payments system. The monopoly profits of the big four banks are equal to almost half of the GST and more than the fuel excise and their effect is to act like a large tax burden on everyone who uses the Australian payments system.

Concern about the exploitation of market power by Australian banks goes back to before Federation as do the efforts by policy-makers to counter it. They tried to generate competition by establishing some of the early state-owned banks in colonial times and the Commonwealth Bank soon after Federation in an attempt to offer better alternatives to the private banks. Building societies, credit unions and later the mortgage originators (for example, RAMS and Aussie Home Loans) were each supported as potential competition against the banks. Similarly, foreign banks were championed as the means of providing effective competition.[4]

In industries such as the banking industry, competition between alternative suppliers is likely to reflect the common-sense meaning of the word that we see on the sporting ground. At the

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1 Ross Garnaut provides a good readable account of the events internationally and in Australia. The Australian banks fund a good deal of their Australian business from overseas loans and thus the principal impact of the global financial crisis on them occurred because of the drying-up of lending in overseas markets. In January 2010, 22 per cent of bank liabilities were with parties resident outside Australia, according to statistics in the bulletins of the Reserve Bank of Australia (RBA). The problem was resolved with a government guarantee that underwrote bank borrowing in foreign markets. See R Garnaut and D Llewellyn Smith, *The great crash of 2008: Ross Garnaut with David Llewellyn Smith*, Melbourne University Press, Carlton, 2009 and RBA, 'Statistical Tables', Reserve Bank of Australia, Sydney, 2010.

2 Australian Bankers' Association Inc., *Banks' profits—Australian banks strong despite the global financial crisis*, media release, 4 November 2009.

3 The big four banks are the Australia and New Zealand Banking Group Limited (ANZ), the Commonwealth Bank of Australia (Commonwealth Bank), the National Australia Bank Limited (National), and the Westpac Banking Corporation (Westpac).

4 The Fraser Government's Campbell Report believed 'foreign banks offer a more immediate prospect of providing an effective competitive stimulus [to domestic banks]'. In December 1983, the government announced a review of foreign investment policy and flagged the possible entry of foreign banks. On 10 September 1984, the Treasurer Mr 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.

end of the season, there will be one winner; that is, competition gradually eliminates the weaker teams. In sport, the team that ends up on top tends to be the one that was also consistently well above average throughout the season but that is where the analogy breaks down. The survivors of competitive battles between large corporations are just as likely to have experienced a lot of luck; the organisations were bigger for some reason or started earlier than subsequent would-be competitors. The big four banks have been the same big four for decades.

As this paper shows, the big four banks appear immune from competition and have come through the global financial crisis stronger than ever with their share of the Australian financial market as high as ever. About the only things that seem to work against their might are the actions of the Reserve Bank of Australia (RBA) that effectively impose price controls on some of the banks' fees and charges.

## 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.[5] Pre-tax figures are included in the following table together with earlier figures (some compiled by the RBA)[6] that enable comparisons to be made over the last couple of decades.

### Table 1: Historical performance—profit before tax

| | 1986 | 1989 | 1999 | 2006 | 2009 |
|---|---|---|---|---|---|
| ANZ ($m) | 357 | 773 | 2,162 | 5,214 | 4,380 |
| Commonwealth Bank ($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;[7] ANZ;[8] Commonwealth Bank of Australia;[9] National Australia Bank;[10] Westpac;[11] RBA.[12]

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

6 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.

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

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

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

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

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

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

The big four banks have always been highly profitable. However, Table 1 suggests that they have been increasingly profitable over time, at least until the global financial and economic crisis hit and weakened the most recent results. In 2009, the banks' pre-tax profit slipped back to 1.9 per cent of GDP which, however, is still higher than it was a decade ago.

Table 2 examines the 2009 performance of the banks in more detail so as to consider how this has been affected by the global financial crisis. Unfortunately, these figures are accrual figures and differ from the cash figures in Table 1.

## Table 2: 2009 results—big four banks

| | Profit after tax | Provision for bad and doubtful debts | Other | Tax | Underlying profit |
|---|---|---|---|---|---|
| ANZ ($m) | 2,943 | 3,005 | 440 | 997 | 7,385 |
| Commonwealth Bank ($m) | 4,498 | 2,935 | -83 | 1,694 | 9,044 |
| National ($m) | 2,589 | 3,815 | 1,252 | 1,670 | 9,326 |
| Westpac ($m) | 3,446 | 3,238 | 1,181 | 1,469 | 9,334 |
| | | | | | |
| Total ($m) | 13,476 | 12,993 | 2,790 | 5,830 | 35,089 |
| Per cent GDP | 1.12 | 1.08 | 0.23 | 0.48 | 2.91 |

Sources: ANZ;[13] Commonwealth Bank of Australia;[14] National Australia Bank;[15] Westpac.[16]

In 2009, the big four's profit after tax was 1.12 per cent of GDP, a remarkable achievement given the backdrop of the global financial crisis and the inevitable legacy of bad debts—some of the banks' loans will not be repaid. As a consequence, the 2009 results include bad and doubtful debt provisions[17] of $13 billion or 1.1 per cent of GDP. It is useful here to add back the bad and doubtful debt provisions to calculate the underlying bank profits and remove the short-term impact of the global financial crisis. Without the bad and doubtful debt provisions, the profits of the big four would have been $26 billion or 2.2 per cent of GDP. Adding back tax as well puts the banks' underlying profit at 2.9 per cent of GDP. Table 2 also suggests that each of the banks have been similarly affected by the crisis.

As this paper was being completed, the Commonwealth Bank released its half yearly report for the six months to December 2009. The figures could have been used to derive profit results for the calendar year 2009 and would have shown that Australian banks are even more profitable than is indicated in tables 1 and 2. However, it was decided to use the actual financial-year results of all the banks.

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13 ANZ, *Annual report 2009*.

14 Commonwealth Bank of Australia, *Annual report 2009*.

15 National Australia Bank, *Annual financial report 2009*.

16 The Westpac Group, *Annual report 2009*.

17 This term could be seen as a euphemism for losses and some banks do refer just to 'losses' in their financial accounts.

The effect of bad and doubtful debts on recent bank profitability is shown in Table 3, which presents the big four's annual profit figures for the last four years, allowing the global financial crisis to be tracked in their financial performance.[18]

## Table 3: Profits in recent years—big four banks.

| 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;[19] ABS;[20] company annual reports.[21]

Bad and doubtful debt provisions are now around $10 billion more than they were prior to the crisis when they hovered around $2 billion. But, as Table 3 shows, banks have been able to claw back their income and increase their underlying profit. Although this 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, it has since bounced back to 2.91 per cent in 2009, making 2009 a record year for the big four's underlying profitability. It also demonstrates that banks are able to absorb losses by increasing profitability in other ways. For example, three of the four banks took the opportunity to raise home-loan rates by more than the increase in the official interest rate in December 2009. Moreover, it suggests that the banks' actual profitability will be much higher than ever before when they reduce bad and doubtful debt provisions back to pre-crisis levels.

Note that the banks have been able to win back their profits despite reductions in the profits of other industries in the Australian economy.[22] Indeed, the big four have been a great deal more successful at this than the smaller Australian banks. Table 4 is designed to examine that

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18 Note that figures to September 2009 are based on company reports, including 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, *Quarterly bank performance statistics*, Commonwealth of Australia, March 2009.

19 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.

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

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

22 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*.

aspect of the performance of smaller banks, which include all domestic banks apart from the big four.

## Table 4: Performance data of the smaller banks

| | Year ended | |
|---|---|---|
| | June-08 | June-09 |
| Charge for bad or doubtful debts ($m) | 449 | 1808 |
| Profit before tax ($m) | 4589 | 1846 |
| Total underlying profit before tax and losses ($m) | 5038 | 3654 |
| | | |
| 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;[23] ABS.[24]

Data limitations with regard to the smaller banks mean that the latest profitability figures in Table 4 are for June 2009 and thus lag three months behind the data for the big four presented in tables 1 to 3. Nevertheless, Table 4 clearly shows that the smaller banks have been hit by the global crisis and have not been able to compensate for their losses by clawing back profit from fees, charges or interest increases. Table 4 reveals that profit before tax almost halved, falling from $4,589 million to $1,846 million and even after adding back losses (charges for bad and doubtful debts), the total underlying profit of the smaller banks declined from $5,038 million in 2008 to $3,654 million in 2009. As a percentage of GDP, the figures are even more dramatic, with pre-tax profit plunging from 0.37 per cent to 0.15 per cent, while underlying profit fell from 0.40 per cent to 0.29 per cent of GDP. That is a major contrast to the figures in Table 3, 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.

The losses of the smaller banks seem to have gone straight to the bottom line, perhaps because they appear to operate in a more competitive environment. In a competitive market, a firm cannot increase its prices at will to compensate for any losses it may incur as it would expect to suffer a drop in market share and profit. The big four, by contrast, have been able to exploit their market power, apparently having no concerns about putting up their prices to cover their losses.

Because of the lack of competition and their control over credit cards and the payments system, it is clear that the big banks have been able to extract monopoly profits from the Australian economy. The former Governor of the RBA, Ian Macfarlane, in one of his semi-annual appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration, was once questioned on the high profits earned by the banks. His comments are worth reporting at some length. He said;

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23 APRA, *Quarterly bank performance statistics, June 2009,* Commonwealth of Australia, December 2009.

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

> 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.
>
> …
>
> Any business, whether it is a bank or any other business, if it is aiming for extremely high rates return on equity—if it is aiming for 18 or 20 per cent in an environment of two per cent inflation—it seems to me there are an awful lot of very useful things that could be done which are profitable, but they are not quite that profitable.
>
> …
>
> If they are literally doing what they are aiming to do they are failing to invest in a lot of things which are reasonably profitable and socially very useful.[25]

Monopolies typically use their market power to limit services, creating an artificial scarcity and so increasing prices and profit. It is important to note that the return-on-equity[26] figures quoted by Ian Macfarlane above are after tax. A 20 per cent after-tax return is 28.6 per cent before tax. The figures in Table 2 record the underlying profit of the big four banks as $35.1 billion or a 26.4 per cent return on the banks' shareholders' equity of $133.1 billion,[27] which is not very different from the rates of return Macfarlane complained about. That rate-of-return figure reinforces the point that the underlying profits of the banks are continuing to hold up well despite the global financial crisis. Indeed, the big banks' excessive profits can be likened to a massive tax that banks impose on the Australian payments system; nearly every time someone uses the payments system in Australia, the banks are able to extract additional profit, including through excessive fees and charges or excessive interest charges on credit-card balances.

The rates of return earned by the banks (26.4 per cent using pre-tax underlying profit) can be compared with the rates of return earned elsewhere in the economy, which are estimated at approximately six to seven per cent.[28] The average increase in the ASX accumulation index since December 1979 gives a figure of 12.3 per cent for big companies in general.[29] However, as these figures include the banks' results, they are higher than they might otherwise be.

A second interesting comparison can be made with the alternative uses of their capital that other investors have to consider. The risk-free alternative use of capital can be taken to be represented by the 10-year government bond rate, which was 5.56 per cent in January 2010

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

[26] The 'return on equity' is a common measure of the performance of companies. It expresses the profit of the company as a percentage of the amount invested by shareholders, which can be thought of as equal to the paid-up capital of the company plus any retained earnings. However, there are also contributions from a host of other items that affect the valuations of assets or the value of liabilities. Shareholders' equity can also be thought of as the net worth of the company, the total of all assets less the value of all liabilities.

[27] The latter figure is from APRA, *Quarterly bank performance statistics*.

[28] There are arguments that suggest the average rate of return should equal the growth in GDP. The budget projections beyond the forecast period show GDP growth at 6.75 per cent for 2012–13.

[29] RBA, 'Statistical Tables'. The figure is the geometric mean of the increase between December 1979 and October 2009.

and has averaged 5.65 per cent since January 2000.[30] Adding a reasonable margin for risk implies a target rate of return at around the eight to nine per cent level.

These figures suggest that the underlying rate of return on equity in banks is at least 15 per cent higher than it might be in a truly competitive market, from which it can be inferred that the monopoly profits of the big four banks are around $20 billion, close to half the Commonwealth Government's total GST collections in 2008–09 and well over the $15.8 billion collected in fuel excise.[31]

## Concentration in banking

In Australia, one of the problems with the banking industry is the high level of concentration. The top four now represent 76.1 per cent of all banking when measured by assets; just 12 months ago, their share was 67.5 per cent of assets.[32] Since then, the Commonwealth Bank has taken over the Bank of Western Australia Ltd (BankWest) and Westpac has taken over St George Bank (St George). For former Treasurer and Prime Minister, Paul Keating, the implication was obvious:

> [I]n the end what they'll do is, working on the basis of never give suckers an even break, they'll simply put the margins up.[33]

Westpac has recently been severely criticised in the popular media[34] and elsewhere. Normally, the banks adjust their interest rates in line with changes in the official rate but when the RBA raised this by 0.25 per cent on 1 December 2009, Westpac led the charge to higher interest rates among the banks by responding with a 0.45 per cent increase. *The Daily Telegraph* reported that the banks' recent history of not passing on the full cut when official rates were falling and passing on more than the increases now that they are rising had the effect of 'stripping an extra $3000 a year from homeowners and credit-card users because of the global financial crisis'.[35] Tony Abbott, Leader of the Opposition, said 'I can understand why people are angry about this, I really can. I can understand why Westpac customers feel ripped off'.[36] In response, Westpac released a patronising cartoon video using the increasing cost of bananas and the subsequent increase in the cost of banana smoothies as an analogy to explain why it needed to raise its interest rates higher than the official increase.[37]

While this episode certainly suggests economic power on the part of Westpac, the more normal procedure, where the banks follow the lead of the RBA and put up rates by the same amount as the increase in official interest rates, implies economic power on the part of all the banks. It is almost as if they have a tacit agreement that they will just follow the RBA's interest rate changes. The problematic aspect of this behaviour is that we know that changes in the official rate do not mean an equivalent increase in the cost of funds to the banks. Overseas interest rates on their foreign borrowings do not change at the same time and interest charges on many accounts do not increase—indeed, interest rates on many deposits remain fixed at zero.

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30 RBA, 'Statistical Tables'.

31 Australian Government, *Budget strategy and outlook, 2009–2010,* Budget Paper No 1, 12 May 2009.

32 APRA, *Statistics: Monthly banking statistics, December 2009*, Commonwealth of Australia, January 2010. St George is now included in Westpac figures and BankWest in the Commonwealth Bank's figures.

33 AAP, 'Paul Keating says lack of bank competition a risk', *HeraldSun*, 27 October 2009.

34 For example, see N Gardner, 'How banks gouge $7b from us', *The Sunday Telegraph*, 5 December 2009.

35 Gardner, 'How banks gouge $7b from us'.

36 P Martin, 'Westpac risks mortgage exodus', *Sydney Morning Herald*, 3 December 2009.

37 I Woods, 'Oz bank goes bananas to explain rate hike', *Sky News*, 9 December 2009.

RBA data disclose that in December 2009, the Australian-based business of the banks was backed by liabilities worth $2,240 billion,[38] of which $520 billion was in foreign loans.[39] Total deposits by Australians amounted to $1,360 billion, but only $370 billion of that comprised term deposits on which the banks pay competitive interest rates.[40] Current accounts, on which banks pay no interest, totalled $210 billion leaving $780 billion, or 35 per cent of bank liabilities, on which banks pay derisory interest, subject as it is to minimum balance requirements and other rules that serve to limit the amount of interest banks must pay. In addition, foreign loans and current deposits together worth $730 billion, or 33 per cent of bank liabilities, are unaffected by official interest rate adjustments. Roughly speaking, when official interest rates change, a third of bank interest costs are unaffected, another third possibly respond in full albeit with a lag and another third will respond to some extent, perhaps halfway. Without better disclosure on the part of banks, it is not possible to be more precise but we can certainly be confident that costs in respect of a third of the banks' liabilities will be unchanged.

## Competition as the solution?

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 resident monopolist. For example, Paul Keating recently criticised the Rudd Government for not doing more to preserve competition in the banking sector.[41]

Pricing power, leading to astronomically 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 set 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 existing banks were considered avaricious and incompetent and the Legislative Council of New South Wales established a Select Committee on Monetary Confusion, which actually 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.[42]

At the Commonwealth level, the government established the government-owned Commonwealth Bank of Australia in 1911 when 'the argument for the national bank was based on the proposition that the existing banks were avaricious and incompetent'[43] 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. In the 1960s and 1970s, competition from the building societies and credit unions was seen as the answer to the power of the banks, and in the 1980s it was argued that foreign banks would provide the necessary competition. More recently, regional banks and mortgage originators (for example,

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38 This is the value of total bank liabilities less the amount due to overseas operations. See RBA, 'Statistical Tables'.

39 This figure includes non-resident liabilities and foreign currency loans from Australian residents.

40 RBA, 'Statistical Tables*'.*

41 AAP, 'Paul Keating says lack of bank competition a risk'.

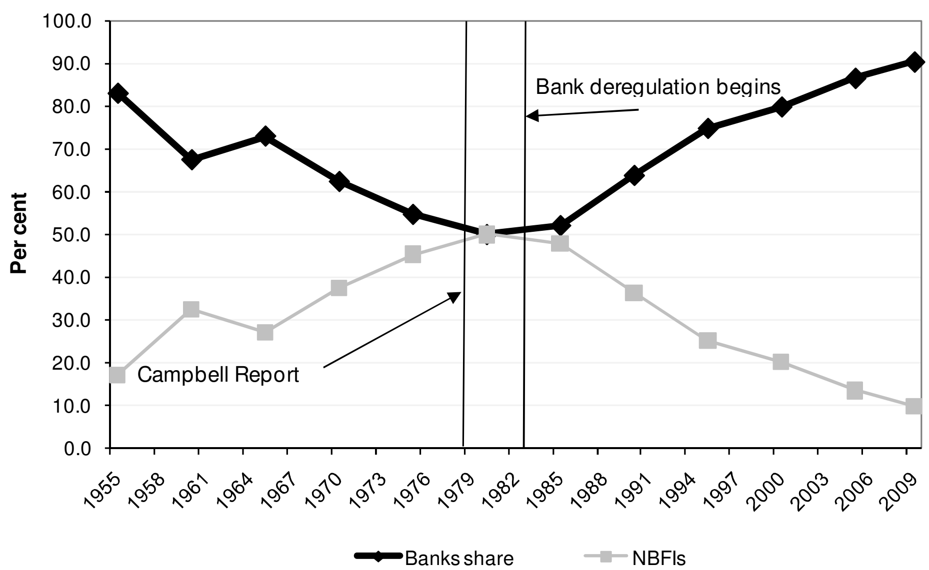
42 S J Butlin, *Foundations of the Australian monetary system 1788–1851*, University of Sydney Press, Sydney, 1968.

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

RAMS) were expected to challenge the market power of the big banks but, in fact, both suffered as a result of the global financial crisis and lost market share to the big four.[44]

Despite the faith of successive governments in the capacity of new entrants to prevail over the big banks, the impact of these rivals never equalled expectations. The results at the end of all this competition are given in Figure 1, which graphs the market share in loans and advances across all financial institutions in Australia at selected dates. 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.[45]

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




Source: RBA.[46,47]

The graph clearly 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. However, by 1980 the banks' share had shrunk to 50 per cent. Significantly, this period of decline was dominated not by faith in competition but by regulation, which severely inhibited the behaviour of the banks over that time, as Figure 1 suggests. After the deregulation phase beginning in the 1980s, the banks' share again increases so that by the end of the period they account for over 90 per cent of lending. Unregulated, the banks started the post-war period (or soon thereafter) in a dominant position and six decades later ended up in a dominant position again with much lighter regulation. The deregulation phase began with the commissioning of the Campbell

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44 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.

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

46 RBA, 'Statistical Tables'.

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

Inquiry in 1979, which reported in 1981,[48] but most of the deregulation initiatives were introduced under the Hawke Government following its election in 1983.

Table 5 examines the assets of those financial institutions that deal with retail customers—the banks, building societies and credit unions.[49]

## Table 5: Market share in assets (share of authorised deposit-taking institutions only)

| | Banks | Building Societies | Credit Unions | Total |
|---|---|---|---|---|
| 1955 | 95.0 | 5.0 | 0.0 | 100.0 |
| 1960 | 93.4 | 6.5 | 0.1 | 100.0 |
| 1970 | 92.9 | 6.4 | 0.7 | 100.0 |
| 1980 | 82.5 | 14.9 | 2.7 | 100.0 |
| 1990 | 91.2 | 6.4 | 2.4 | 100.0 |
| 2000 | 95.5 | 1.6 | 2.9 | 100.0 |
| Jun-09 | 97.5 | 0.8 | 1.7 | 100.0 |

Source: RBA.[50,51]

It is important to consider the role of the building societies because, while they started out as distinctly different institutions, they ended up perhaps indistinguishable from banks and, as it happened, many of them decided to become full banks in their own right.

The figures in Table 5 support the conclusions identified in Figure 1. Post World War II, banks were in a dominant position, were then challenged by regulation through to the early 1980s, but resumed their dominant position during the age of deregulation.

Housing loans represent 59 per cent of bank lending[52] and are traditionally the most high-profile segment as well as being the most politically significant. Table 6 shows housing commitments[53] over the last three decades.

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48 Australian Financial System Inquiry, *Australian Financial System*.

49 These are now referred to as authorised deposit-taking institutions (ADIs). This terminology was introduced at about the time the Commonwealth Government took over the states' responsibilities for regulating the building societies and credit unions. They were included with banks under the umbrella of APRA.

50 RBA, 'Statistical Tables'.

51 RBA, *Statistics: Australian Economic Statistics 1949–1950 to 1996–1997*.

52 Including both owner-occupied and investment. See APRA, *Statistics: Monthly banking statistics*.

53 A 'lending commitment' is a firm offer to provide finance, which has been or is normally expected to be accepted by the borrower. Table 6 uses December figures at five-year intervals.

## Table 6: Housing commitments

| | Banks | Non-Banks | Permanent Building Societies | Wholesale Lenders n.e.c | TOTAL |
|---|---|---|---|---|---|
| Value ($m) | | | | | |
| Dec-1975 | 239 | 211 | 150 | 0 | 450 |
| Dec-1980 | 304 | 344 | 226 | 0 | 648 |
| Dec-1985 | 587 | 323 | 219 | 0 | 910 |
| Dec-1990 | 1135 | 461 | 212 | 0 | 1,596 |
| Dec-1995 | 3,014 | 546 | 196 | 208 | 3,559 |
| Dec-2000 | 4,840 | 1,318 | 205 | 927 | 6,158 |
| Dec-2005 | 10,374 | 2,698 | 296 | 1,819 | 13,072 |
| Dec-2009 | 14,030 | 1,495 | 233 | 517 | 15,526 |
| Percentage | | | | | |
| Dec-1975 | 53.1 | 46.9 | 33.3 | 0.0 | 100.0 |
| Dec-1980 | 46.9 | 53.1 | 34.9 | 0.0 | 100.0 |
| Dec-1985 | 64.5 | 35.5 | 24.1 | 0.0 | 100.0 |
| Dec-1990 | 71.1 | 28.9 | 13.3 | 0.0 | 100.0 |
| Dec-1995 | 84.7 | 15.3 | 5.5 | 5.8 | 100.0 |
| Dec-2000 | 78.6 | 21.4 | 3.3 | 15.1 | 100.0 |
| Dec-2005 | 79.4 | 20.6 | 2.3 | 13.9 | 100.0 |
| Dec-2009 | 90.4 | 9.6 | 1.5 | 3.3 | 100.0 |

Source: ABS.[54]

Table 6 shows that the share of housing commitments accounted for by non-banks peaked at 53.1 per cent in 1980 and has declined steadily ever since. However, wholesale lenders appeared suddenly, took a significant share of the market and then almost as suddenly shrank to next to nothing. 'Wholesale lenders' is the term used by the Australian Bureau of Statistics (ABS) for the commitments arranged by mortgage originators, for example Aussie Home Loans and similar companies. Reacting to figures similar to those above, the RBA commented:

> Recent developments in the mortgage market have occurred against a backdrop of significant changes in market shares. Most of the new lending over the past year or so has been by the major banks, which have increased their share of new owner-occupier loan approvals to 81 per cent as at July 2009, from around 60 per cent in mid 2007 (Graph 53). In contrast, lenders that had previously relied on securitisation for funding have lost market share, with the share of approvals accounted for by mortgage originators falling to around 2½ per cent in July, compared to around 12 per cent in mid 2007. The smaller banks and, to a lesser extent, credit unions and building societies have also lost

54 ABS, *Housing Finance, Australia, December 2009*, Cat No 5609.0, Canberra, 10 February 2010.

market share. These movements follow a lengthy period when the major banks had been losing market share as securitisation markets expanded.[55]

## Why do banks always win against their competitors?

The data presented above demonstrate that the major banks are very adept at seeing off their competition. In the past, the Australian Competition and Consumer Commission (ACCC) has acknowledged that barriers to national entry are high and appear to be even more significant for 'branch-centric products'.[56]

One possible explanation for their resilience is that collectively banks lose very little as a result of competition from building societies. The balance sheets of building societies in August 2009 record that over two thirds of the funds not loaned to their customers was deposited with other institutions, mainly the big four banks. In the case of credit unions, almost 90 per cent of their assets other than loans are on deposit with the banks.[57] When a retail customer withdraws money from a bank and deposits it with a credit union, a large proportion is likely to return to the banking system. Either the credit union will deposit the money directly with a bank or it will be put back into circulation as a loan, but eventually it will return to the banks.[58]

These sorts of considerations apply to most of the NBFIs but mortgage originators are different because companies such as Aussie Home Loans do not carry loans on their own books. They sign up the customers and then sell the loan to a bank or operate for the banks on a commission basis. Most of the business of this sector is more akin to a contracting out of the sales function of banks rather than to genuine competition against the banks.

In modern economies many industries are characterised by economies of scale, which means that as the output increases the unit cost of production falls. The most 'efficient' arrangement may be for industries to be dominated by one or two firms; larger firms are able to produce more cheaply than smaller firms, which tend to leave the industry, often as a result of takeovers by larger firms wishing to further increase their market share.

The implication of economies of scale is that large corporations will emerge as a result of competition and they will be in a position to deliver their products at low cost to themselves and therefore potentially more cheaply to consumers. However, the paradox is that an industry with only one or a few suppliers is likely to consist of strong but lazy corporations with large concentrations of economic power. Without the threat of vigorous competition, the dominant firms in the industry will have no incentive to innovate or to tempt customers with special deals.

## Four pillars policy

Economies of scale in banking lead to the conclusion that further concentration among the remaining banks is likely. Of course, as mentioned above, fewer banks are likely to be associated with even worse outcomes due to the abuse of market power. Unfortunately, while such consolidation leads to increased profit, the reduction in competition is likely to be bad for

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[55] RBA, *Financial Stability Review*, Sydney, September 2009.

[56] ACCC, *Westpac Banking Corporation—proposed acquisition of St George Bank Limited—Public competition assessment*, Australian Competition and Consumer Commission, August 2008.

[57] Building society and credit union balance sheet items are given on the RBA site. See RBA, 'Statistical Tables'.

[58] The discussion can become complex as can the circulation of money itself. The process may be long and drawn out but eventually the money returns to a bank.

consumers; without pressure from rivals there is no compelling reason for the banks to pass on the benefits of 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 might be, it would be so much worse if any of the remaining banks merged. The four pillars policy evolved from the 'six pillars' policy expressed by Keating in 1990.[59] The six pillars policy prohibited mergers between the big four banks and the big two life insurance companies, then AMP and National Mutual Life Association (now AXA Asia Pacific) and was triggered by a proposed merger between the ANZ and National Mutual Life Association, later quashed by the government. At the time of writing, the National Australia Bank in conjunction with AXA SA of France is bidding for AXA Asia Pacific. That bid, if it is successful, would turn the six pillars into five.

The arguments for permitting mergers between the big four are most commonly put by the banks themselves, their main argument being that they want to form 'mega' organisations to compete with major world banks in other countries such as China. This is sometimes referred to as the 'national champion' argument. David Morgan, former chief executive officer of Westpac, has criticised the existing policy as 'forcing bigger banks to compete globally with one hand tied behind our backs'.[60] But if there were to be a merger of two of the big four, there would then be one bank with about 40 per cent of the market and two banks with just under 20 per cent each. Pressure on these two to combine would be strong. The RBA's submission to the Wallis Inquiry expressed deep concern about the possibility of a banking system dominated by just two large banks.[61]

The perception that Australia should have a large banking industry with substantial overseas business is not necessarily attractive. Among other things, there is the risk that Australian taxpayers would be responsible for bailing out any failing international business of the banks. The global financial crisis has shown that responsibility for failures rests with the monetary authorities in the bank's home country rather than where it does its business or where it gets into trouble.[62] Hosting a multinational bank is a double-edged sword.

The national champion argument may not be persuasive in the near future. There is now a concern that the global financial crisis has meant that the biggest of the banks are growing even bigger and are not only too big to fail, but are rapidly becoming too big to save.[63] The total share capital of the Australian banks was $111 billion at June 2009,[64] or approximately 10 per cent of Australian GDP. 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'.[65]

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59 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.

60 G George, 'Keep banking's four pillars standing', *The Age*, 27 February 2006

61 RBA, *Submission to the Financial System Inquiry*, Occasional Paper No. 14, 6 September 1996, p. 76.

62 Garnaut and Llewellyn Smith, *The great crash of 2008*.

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

64 RBA, 'Statistical Tables'.

65 Garnaut and Llewellyn Smith, *The Great Crash of 2008*, p. 216.

In the UK, the Bank of England has also argued that the larger banks are becoming too complex. It complains that 'some large, complex banks have over 2,000 distinct legal entities across different countries';[66] as a result, it has called for the breakup of large banking groups.

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]in 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.[67]

Similar concerns could be expressed about Australian banks.

## Is there anything left to use against the banks?

Competition policy and action against anti-competitive behaviour are going to be even more important following the increase in the underlying profitability of the banking system and the increasing concentration in the industry since the global financial crisis. A common response from recent treasurers to the power of the banks has been to suggest that consumers shop around. This view was proclaimed by Peter Costello some years ago when he said, 'I always encourage people having trouble with their banks to take their business elsewhere'.[68] 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 OECD work, which found that there was scope to enhance competition by helping customers to move more easily between providers.[69] Unfortunately, Australian customers appear particularly loath to change their banks and only three per cent do so each year.[70]

The lesson of our history seems to be that competition policy is not a very effective instrument against a large, powerful industry enjoying the competitive advantages resulting from economies of scale. A solution might be to split each of the top four banks in two, one business to undertake functions that constitute the core of the payments system and another to undertake non-core functions. For the businesses with payments-system functions, the aim should be to reduce the share of bank profits back to the values of a couple of decades ago—one per cent or less as a share of GDP—undertaken through a variety of measures:

- influencing banks to keep lending rates to a constant markup relative to official interest rates
- reducing particular fees to amounts that just cover costs, including a reasonable return on assets.

The latter would exercise controls over fees charged by banks, including honour fees, administrative fees, and the rest. Exit fees applying to mortgages are a particular concern,

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

67 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.

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

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

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

seeming to have been designed to protect bank profits rather than to reflect the actual costs of discharging the mortgage.

There is sometimes a presumption that governments should not directly interfere in markets and the decisions of the market players, representing the view that markets will eliminate market power, especially through the role of competition. However, leaving it to the market in this case constitutes a failure to address the abuse of market power. In the case of other monopolies (for example Telstra), governments have imposed universal service obligations and legislatively required special assistance for low-income earners. There is a case for working out exactly what consumers should be receiving from the Australian payments system and obliging the big four banks to deliver.

In the context of the global financial crisis, another strategy that has been suggested is the use of taxation.[71] Most common are calls for transaction taxes but taxation akin to the resource rent tax may be more appropriate when the concern is the excessive profitability flowing from the banks' control of the payments system. The justification is that the payments system should be a community resource and the government should have the right to tax any extraordinarily high profits that, essentially, accrue to the banks purely because of their access to the community resource. The tax should be designed to leave the banks just enough incentive to operate the payments system, but no more than that. If regulation is ineffective, a resource rent tax may be an attractive alternative. However, it would seem preferable to make the payments system as cheap as possible as the RBA's recent efforts have done in relation to the fees banks charge merchants and each other in credit-card transactions.

Banks and other financial institutions have been in the spotlight lately because of the global financial crisis and this has produced many proposals throughout the world to improve the regulation of banking. Measures introduced as a result of that agenda will have implications for the banks' monopoly profits and how these might be addressed, an undertaking that should be part of the thinking behind any other reforms introduced into the banking industry.

There have been various proposals for a people's bank and these should be mentioned in this section. New Zealand's Kiwibank, which performs a role similar to the original aims of the Commonwealth Bank, is often cited as a useful example of a low-cost, no-frills alternative to the main banks. A novel variation on that theme is Dr Nicholas Gruen's proposal for using the Australian Tax Office (ATO) as a kind of bank;[72] there are of course precedents in the student loan arrangements and Centrelink's bill-paying service.

However, the history of competition and the big banks in Australia suggests that any attempt to inject new competition into the banking industry is going to have only limited impact. While such proposals might be supported, they should not distract from the main challenge in Australia—directly addressing the monopoly power of the big banks. Equally, competition from smaller banks and other institutions should be encouraged. The takeover of St George and BankWest reduced the competition and variety in Australia and similar takeovers should not be permitted.

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[71] See International Monetary Fund, 'IMF studies how to pay for financial sector rescues', *IMF Survey Online*, 11 January 2010.

[72] N Gruen, 'Banking on the ATO', *On Line Opinion*, 10 November 2008.

## Conclusion

This paper quoted a former Governor of the RBA, Ian Macfarlane, who in 1999 said he had 'often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia'.[73] Australians have been pondering the same question for well over a century.

Competition has an important function in modern economies; its end result should be that markets are served by suppliers who earn just enough to cover the cost of the resources they use and provide a modest return on their 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 players earning excessive profits at the expense of the rest of society. The market acts perversely in this industry and non-market solutions are needed to rectify the tendency for bank monopolies to extract monopoly profits from society.

An examination of the figures shows that the big four banks have been extremely profitable and that they are growing even more profitable over time. Their underlying profits are around $35 billion or just under three per cent of GDP. Of that amount, something like $20 billion represents the rewards reaped as a result of the monopoly position of the banks. Moreover, it appears that they will emerge from the global financial crisis stronger than ever.

An important factor in the banks' monopoly position is the increasing concentration in the banking industry and, indeed, the financial sector generally. For example, the top four banks now control over 75 per cent of all bank assets and banks account for over 90 per cent of all lending by financial institutions in Australia. The four pillars policy has prevented even further concentration in the industry by ensuring that there will be at least four large banks in Australia with a ban on any mergers between those banks.

At various times, Australian policy-makers have tried to counter the monopoly position of Australian banks by establishing 'people's banks', such as the Commonwealth Bank and state banks, and promoting other financial institutions such as building societies, credit unions, mortgage originators, regional banks and foreign banks. The risk is that history will repeat itself if this generation is also to respond by trying to construct more competition against the banks without seriously tackling the monopoly power of the banks themselves. Support for a new people's bank should not be seen as an alternative to addressing the power of the big banks.

The only activity that seems to have seriously affected the banks' operations has involved the efforts by the RBA to control how they use the payments system. There is a case for extending these efforts with more comprehensive regulation over access to the payments system as well as price controls, especially controls over the various fees the banks charge.

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[73] Australia, House of Representatives, Standing Committee on Economics, Finance and Public Administration, *Reference: Reserve Bank of Australia annual report 1997–98,* pp. 77–80.

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