



ACTU Submission

to the

**Senate Economics Committee
Inquiry**

into

**Competition within the Australian
Banking Sector**

6 December 2010

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The Australian Council of Trade Unions welcomes the opportunity to provide a brief submission to the Senate Economics Committee's inquiry into competition within the Australian banking sector.

The ACTU is the peak council for organised labour in Australia. Unions affiliated to the ACTU cover all sectors of the economy, across all states and territories, representing approximately two million members. The ACTU is an affiliate of the International Trade Union Confederation, a body established to promote and defend workers' rights and interests globally through international cooperation.

The ACTU is also a member of the newly-formed Australian Financial Integrity Network (AusFin), a group of organisations united in calling for more effective regulation of the financial services industry in the interests of Australia society. AusFin is also providing a submission to the Inquiry, and this brief submission is intended as a supplement to AusFin's submission. The Finance Sector Union (FSU) has also provided a submission to the Inquiry and the ACTU fully supports their submission.

Summary

Banking and the broader financial system are central to the modern economy and therefore to workers' lives. A bank account is a necessity for effective participation in modern Australian economic life, and should therefore be regarded as an essential service.

There are widespread concerns that the nature of the regulatory architecture for Australian banks does not adequately reflect their status as providers of essential services with a combination of implicit and explicit Government guarantees of their liabilities. As a result of this, the FSU has called for a social and economic compact for the benefit of all Australians, a new regulatory approach that recognises the centrality of banking to Australians' lives. The ACTU supports this call.

The ACTU also supports calls to ensure that there is an appropriate level of competition in the Australian banking industry. However, we note that there are many existing institutions, such as Members Equity Bank, that already attempt to compete with the big four banks. Smaller banks and non-bank financial institutions can face significant impediments to competing on equal terms with the big four banks, and regulatory attention should be directed towards ensuring that smaller institutions are properly supported.

The Commonwealth Government has already implemented some measures to assist small banks to continue to compete, most notably through intervention via the Australian Office of Financial Management in the residential mortgage-backed securities market. The ME Bank submission to this inquiry contains a number of suggestions for reforms that may further assist small banks to effectively compete, and the ACTU believes these suggestions are worthy of consideration. Supporting small banks is vital to restraining the ability of the big four banks to exploit their market power.

The big four banks are able to raise funds much more cheaply on international wholesale markets. This is, in large part, due to the perception that the banks are 'too big to fail' and therefore ultimately supported by the Commonwealth Government. This situation entrenches the market power of the dominant oligopolistic firms, and they are able to extract significant returns which are then largely distributed to shareholders and senior executives. There is little ability for the Government to disavow responsibility for the banks' liabilities; if it made such a claim it would not be believed by markets, the large banks would continue to enjoy a discount on their risk premia owing to the perception of implicit support, and the level of competition would continue to be sub-optimal.

The ACTU is concerned that Australian banks have indicated their intention to expand into riskier offshore jurisdictions in order to remain 'growth stocks'.¹ The pursuit of ever-higher rates of return on equity is not appropriate for institutions that possess Government guarantees of their liabilities and that are too big to be allowed to fail. It may therefore be appropriate to ensure that Australian banks conform to a 'narrow banking' model. Under this model, guaranteed deposit-taking institutions would enjoy the benefits of Government support, yet be restrained from undertaking excessively risky activities, while other institutions are afforded no Government protection or guarantee.

The ACTU believes that:

- A regulatory regime should be considered in which Australian banks are regulated as public utilities and forbidden from expanding into risky asset classes and/or jurisdictions while they enjoy a Government guarantee (explicit or implicit) of their liabilities;
- The tax system should ensure that Australian banks bear the cost associated with their guarantees;
- The Australian Government should make it clear that it will not act to ensure the continued viability of non-deposit taking institutions that pursue excessively risky investments;
- All appropriate measures should be explored to increase competition in the financial system, particularly as regards to deposit-taking institutions and home mortgage lending, including assistance to ensure that small banks can more effectively compete with the big four;
- The portability of account numbers and other measures to improve consumers' effective choice should be implemented;
- Tax measures such as a financial transactions tax should be advocated by the Australian Government in international forums such as the G20;
- Domestic tax arrangements for the financial sector should be considered as part of a review of the overall financial regulatory architecture, including the taxes proposed by the IMF in its report to the G20; and
- Measures that would restrain the rate of growth in executive remuneration at Government-guaranteed institutions through the tax system should be explored. The 2009 ACTU Congress endorsed the attached proposal to address excessive executive remuneration.

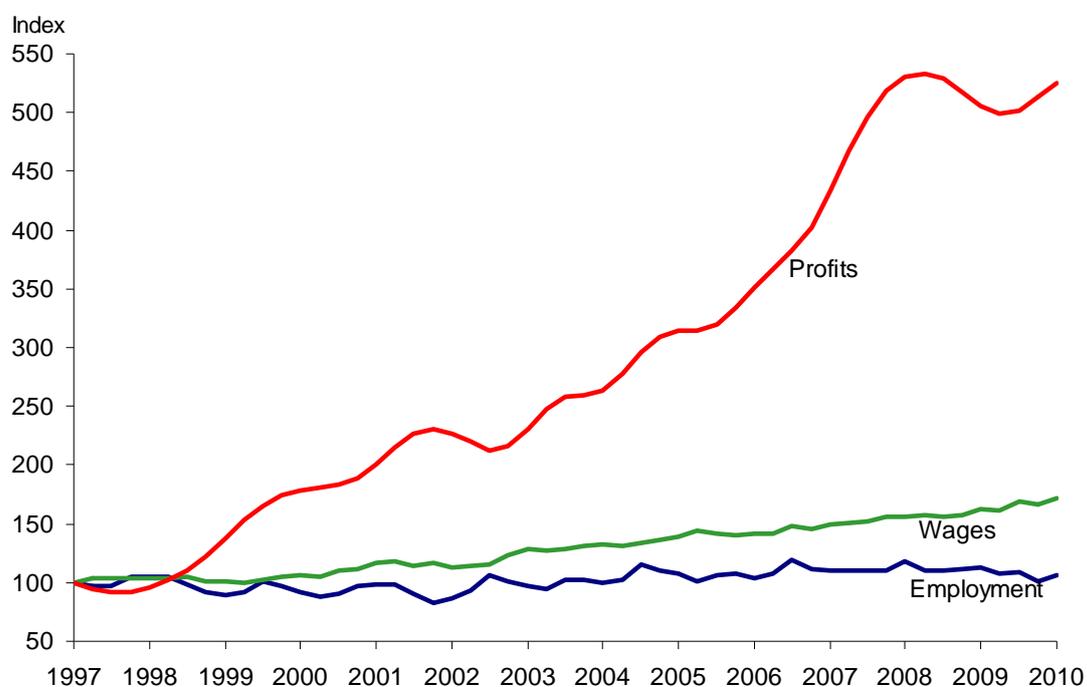
¹ 'Banks to look offshore for growth after consolidation deal blocked', *The Australian*, October 7 2010.

The Commonwealth Government has begun to implement several of the recommendations of the 2008 House of Representatives *Inquiry into competition in the banking and non-banking sectors*, and we welcome and support these reforms. Nevertheless, there is more to do to ensure that the Australian banking system delivers the maximum social and economic benefit to the people of Australia.

Trends within the industry

In recent years, profits in the finance industry have grown considerably faster than employment or wages. The chart below depicts the change in profits, wages and employment in the finance industry since 1997. 1997 was chosen as the base year for this comparison as it was when the Financial System Inquiry ('Wallis Inquiry') was completed.

Profits, Wages and Employment in the Finance Industry: 1997-2010²



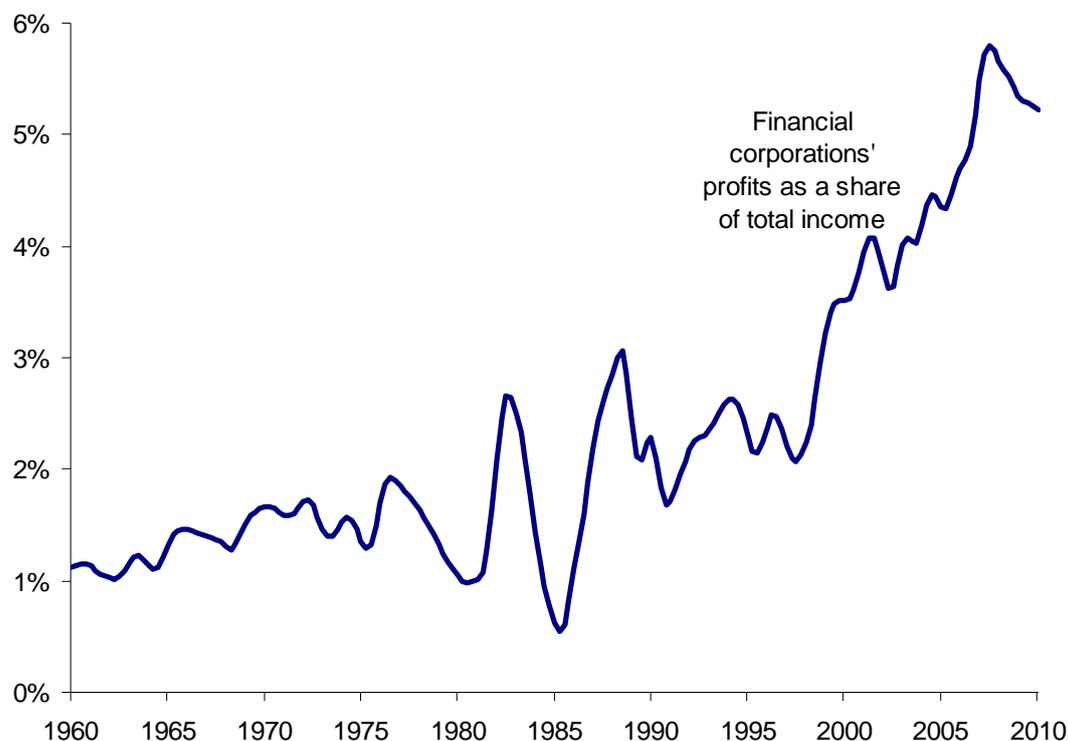
Note: the definition of the 'finance industry' that is used for each of these measures differs. See footnote number 2 for clarification.

Since 1997, financial corporations' profits have increased by over 400% in nominal terms, while nominal average wages in the industry have increased only 70%, and total employment in finance has increased by a mere 5%. It should be noted that the nominal average wages growth figures are likely to be distorted by disproportionate gains in earnings at senior levels.

² 'Profits' refers to Financial Corporations – Gross Operating Surplus, derived from ABS 5206.0, *Australian National Accounts*, Table 7. 'Wages' refers to Average Weekly Earnings, Persons, Total earnings, Financial and Insurance Services, derived from ABS 6203.0, *Average Weekly Earnings*, Table 10. 'Employment' refers to total persons employed in the finance sub-division of the financial and insurance services industry, derived from ABS 6291.0.55.003, *Labour Force, Detailed, Quarterly*, Table E05.

Financial corporations' profits have not just grown at a faster rate than wages and employment in the finance industry; they have also outstripped income growth for the economy as a whole. The chart below depicts financial corporations' gross operating surplus (a measure of profit) as a proportion of total factor income since 1960.

Chart: Financial Corporations' Profit Share³



In March 1997, financial corporations' profits accounted for 2.5% of national income. By September 2010, that proportion had more than doubled, to 5%. Financial corporations' profits now represent 18.4% of all corporations' profits, up from 10.9% in March 1997.

These figures include non-bank financial institutions, but the trend is clear: finance has become increasingly central to the Australian economy, and the expansion of the industry has been largely accrued as profits rather than as expansion in employment or average wages.

Cost of living pressures

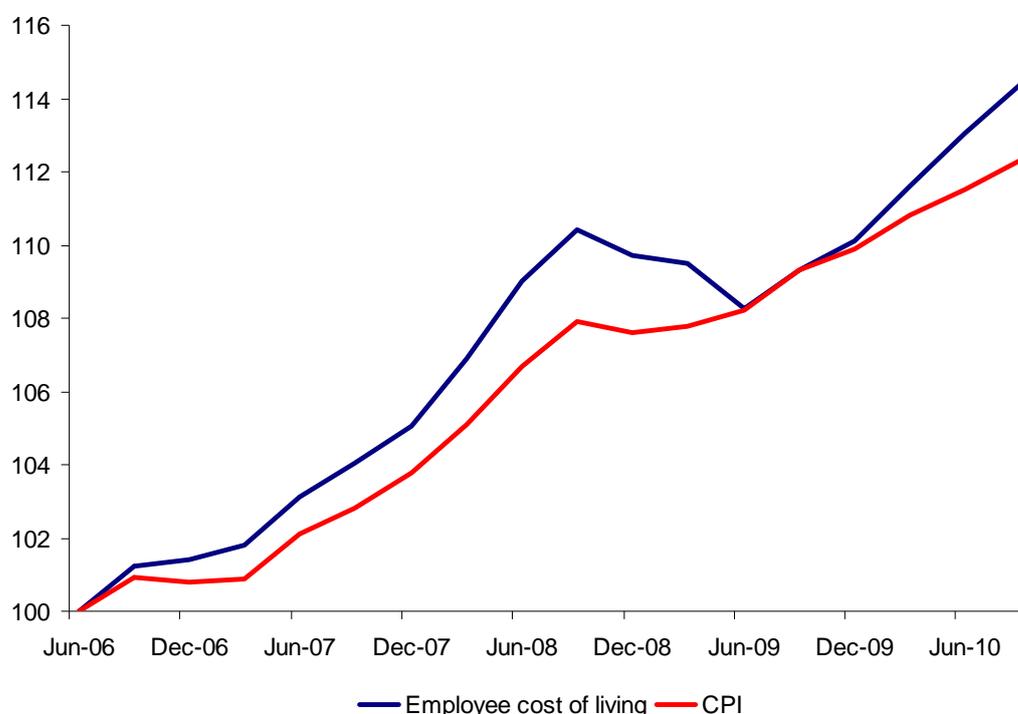
Banking is a key determinant of the cost of living for all Australians. This relationship is somewhat understated in the Consumer Price Index. The CPI measures overall movements in the price level, but the ABS says that it "is not the conceptually ideal measure for assessing the changes in the purchasing power of the disposable incomes of households".

³ Derived from ABS 5206.0, *Australian National Accounts*, Table 7.

To address this deficiency, the ABS compiles a separate set of indexes called the Analytical Living Cost Indexes (ALCI) for particular household types (employees, age pensioners, other government transfer recipients, and self funded retirees). These indexes are calculated as a by-product of the CPI survey, using the same basic data about movements in prices, but with some key differences. The ALCI include interest paid on mortgages, which the CPI does not. The indexes also treat insurance and other financial services differently.

Since around mid-2006, the cost of living for employee households has increased by more than the consumer price index. Employees' cost of living has risen by 14.4% since June 2006, whereas the overall price level has only risen by 12.3%. The graph below shows the change in these two measures, with each index set to equal 100 at June 2006.

Chart: Change in CPI and ALCI (employees): 2006-2010⁴



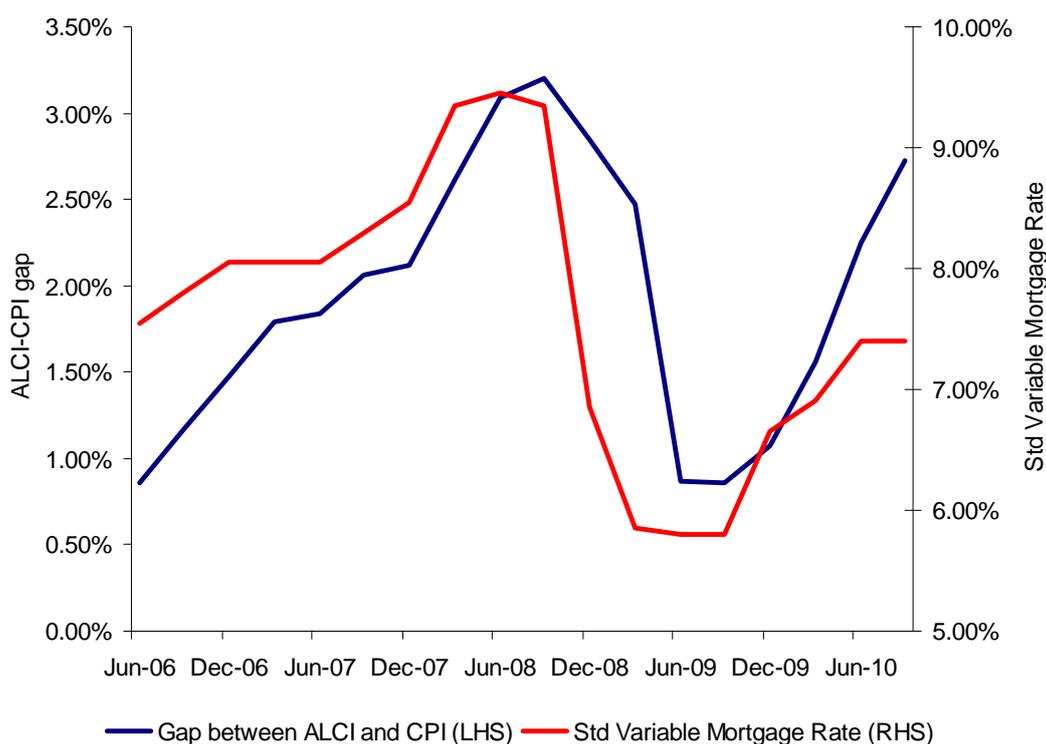
After falling slightly during the global financial crisis as the overnight cash rate was slashed, employees' cost of living has again begun to rise more rapidly than CPI.

Some of the difference between the employee households ALCI and the CPI is accounted for by the inclusion of mortgage interest payments in the ALCI calculation. This is demonstrated by the graph below, which shows the gap between the ALCI and CPI⁵ (left-hand Y-axis) compared with movements in the standard variable mortgage rate (right-hand Y-axis).

⁴ Derived from ABS 6463.0, *Analytical Living Cost Indexes for Selected Australian Household Types*, Table 7.

⁵ Calculated using the headline ALCI and CPI index numbers, as $(ALCI - CPI) / CPI$. Each measure is set to equal 100 in June 1998.

Chart: ALCI-CPI gap and standard variable mortgage rates: 2006-2010⁶



As the standard variable mortgage rate rose between mid-2006 and late-2008, so did the employee households' ALCI relative to CPI. As interest rates fell through early 2009, so did the gap between ALCI and CPI. Since 2009, interest rates have begun to rise again, and so has the gap between ALCI and CPI. This shows that Australian households' cost of living, particularly for employee households, is more closely related to changes in lending rates (and other financial services) than is indicated by the headline CPI.

Of course, much of the change in standard variable mortgage rates has been underpinned by monetary policy decisions of the Board of the Reserve Bank of Australia. Nevertheless, other changes in mortgage lending rates or the cost of other financial services directly impacts on the cost of living for Australian working families. This includes moves by the big four banks to increase the margin between their cost of funds and the rate at which they lend to the Australian public. We note that the RBA said in its submission to the Inquiry:

Most of the increase in the major banks' funding costs occurred during 2008 and early 2009, at the peak of the dislocation in markets. Since mid-2009, the major banks' overall funding costs are estimated to have moved broadly in line with the cash rate, reflecting offsetting factors.⁷

It would therefore appear that increases in major banks' margins since mid-2009 have not been justified by an increase in their cost of acquiring funds. This

⁶ Derived from ABS 6463.0, *Analytical Living Cost Indexes for Selected Australian Household Types*, Table 7, and Reserve Bank of Australia, *Statistical tables*, Table F5 – Indicator lending rates.

⁷ Reserve Bank of Australia 2010, *Submission to the Senate Economics References Committee Inquiry Into Competition Within the Australian Banking Sector*, p.14.

suggests that major banks have been able to exploit their oligopolistic power and the diminished level of competition to increase prices to the detriment of their customers.

Conclusion

The ACTU believes that reforms are needed to ensure that the Australian banking industry delivers the maximum benefit for the Australian community. The facts outlined above illustrate some aspects of the need for reform of the industry. The submissions of the FSU, AusFin and ME Bank also provide vital information regarding the need for regulatory change in this area.

Resolution

SUBJECT: EXECUTIVE PAY

Introduction

1. Congress deplures, as a significant cause of the Global Financial Crisis, the irresponsible behaviour of executives that has been fuelled by remuneration packages that reward short term returns or excessive risk taking.
2. Congress draws attention to the ethically unacceptable and economically dangerous increase in executive remuneration in Australia in recent years:
 - a) Between 1990 and 2005, the average cash remuneration of the CEO in the Top 50 listed Australian companies rose by 564 percent to \$3.4 million (10.7% per annum adjusted by inflation), while average full-time earnings only rose in real terms by 1.4% per annum.
 - b) Over the same period, top CEO pay ballooned from a multiple of 18 times average full-time earnings to a multiple of 63.
 - c) In 1993, the bottom 10% of wage earners earned 32% of the median wage, while the top 10% of wage earners earned 180% of the median wage. However, by 2006, the lowest waged workers only earned 26% of the median wage, while the top earners earned 201% of the median wage.
3. Congress notes the understandable community outrage at executive pay which exceeds all reasonable community standards, especially at a time when many working Australians are having their pay frozen or their jobs cut.

4. Congress notes that the Federal Government has asked the Productivity Commission to inquire into executive remuneration in Australian companies.
5. Congress also notes the new legal context, in that the High Court has confirmed the power of the Commonwealth to directly regulate the pay and conditions of company employees, including executives, through the use of the corporations power of the Australian Constitution.

Legal Regulation

6. Congress seeks to curb excessive remuneration and inappropriate risk taking by executives through laws that regulate executive remuneration.
7. The base salaries of directors and company executives should be subject to an overall reasonableness requirement. Reasonableness should be determined according to the skills and experience of the executive, the nature of their role, and the size and complexity of the enterprise. An appropriate public oversight mechanism should be established to allow a corporation to determine in advance if a package meets the reasonableness test.
8. The Corporations Law should be amended to establish an absolute cap on the base earnings of an executive of a multiple of ten times the average weekly full time earnings paid to employees of the enterprise.
9. Any additional payments made to directors or executives, or for their benefit, should be prohibited, except for:
 - a) mandatory payments under legislation (including the Fair Work Act and superannuation legislation) or salary sacrifice arrangements;
 - b) reimbursement of legitimate expenses;
 - c) termination payments of up to one year's base salary, paid in accordance with a pre-existing agreement, and not payable in the event of dismissal due to misconduct or poor performance;
 - d) performance payments. Such payments can only be paid in cases where:
 - i. the company has performed better than its peers, over a period of at least five years;

- ii. the executive personally contributed significantly to the superior performance (rather than chance or the work of others); and
 - iii. the executive's contribution provides the foundation for sustainable business growth over the long term.
- 10. Payments in excess of the cap on base salary, or unlawful additional payments should be recoverable by the corporation on application of a shareholder or ASIC.
- 11. To discourage unreasonable payments, the tax laws should provide that any component of remuneration above \$1 million per annum should not be able to be deductible against company income.
- 12. Additional transparency measures should be imposed as follows:
 - a) The Annual Report and the Annual General meeting of the Company must receive a comprehensive report concerning payments to directors or executives, justifying the payments and certifying that they are consistent with the legislative requirements in respect of both base salaries and additional remuneration; and
 - b) shareholders should be required to approve the remuneration arrangements for directors and senior executives.
- 13. There should be strong anti-avoidance provisions in the law. Arrangements made to circumvent these restrictions should be prohibited. Benefits provided to executives (such as non-recourse loans) should be treated as if they were part of salary.
- 14. As recommended by the Corporations and Markets Advisory Committee, existing directors' duties of care, good faith and proper purposes should be extended to executives. Executives should face civil and criminal sanctions for breach of their obligations.