Competition within the Australian Banking Sector : Senate Inquiry 2011

David Allen, GPO 1865, Sydney, NSW 2001 (02) 97434908
21 January, 2011

To: Department of the Senate, PO Box 6100, Parliament, Canberra, ACT 2600, Australia.

1. Executive Summary

This inquiry was perhaps initiated by people who lived in a kinder, gentler time, before IT-companies and international-organizations shaped society's norms of the Great Eastern (Southern?) Land we call, for reasons that are no longer obvious, Australia. Terms such as Competition, Productivity, Flood and Reform that are fundamental to this inquiry could have been defined before the Inquiry began, as different definitions would live even within different departments of financial organizations. Using just one example, does the Inquiry focus on competition between the banks to produce a winner or on the competition for a bank to dominate individual sectors such as Agriculture, Mining or Small Business?

Given the extent to which Australian Banks are owned by international investors, it would be expected that some competitive actions by Australian Banks may not be in Australia's interests.

It may have been wise to have included certain historical aspects in the Terms of Reference as well, as they are a cause of uncertainty. Examples include:

Ex-i) Real time payments. Banks tried them in the early days of computing. Instead of delivering efficiencies and massive profits, bank profits headed sharply southward and IT-professionals quickly reinstated the pre-IT delays. In some cases, of course, modern delays are longer than they were in pre-IT times.

Ex-ii) Insurance requirements and expectations. These changed sharply after the HIH collapse and the jailing of a few of the people who were involved. The integrity of Insurance relates to some of the products that banks in Australia provide. It may even have been useful to provide a complete overview of the products that the banks provide.

The Terms of Reference could provide an overview of the decades-old history of IT concepts such as Cloud Computing. While earlier 1980-models models were reasonably secure from a technological point of view, business concerns were important. Nowadays some technological components present a number of concerns. Given current IT-trends, it is possible that the Big Four banks will merge into an amorphous international conglomerate within two decades, reducing inter-bank competition to a number close to zero.

The Terms of Reference could provide an overview which shows what Banking is nowadays. When I was running a small IT consultancy in London in the 1970's, I used to go to The Club with a chap called Mr. Prince. Each time he was paid for his IT-services, he would overdraw his account and eventually received a letter from his bank manager stating “Might I remind you Mr. Prince that you are banking with us, not we with you”. Has international competition changed the nature of this relationship in Australia?

The terms of Reference could perhaps provide an overview that shows who owns the components of the various Australian financial institutions. Banks tend to be owned by international investors and there may be cross ownership relations between the banks and this may blur the extent to which competition exists.

The Terms of Reference appear to imply that the most important banks in Australia are the Big Four, perhaps minimizing international banks and banking facilities that institutions such as Insurance Companies provide. Which are the fastest growing bank-competitors in Australia once balance-sheets have been adjusted for off-balance-sheet items?

International banks have competed strongly for Agricultural business in Australia and the approach Agriculture has taken has been “less than optimal”. Australia is officially a net importer of food, depending on the definition of “food”. If associated products such as pesticide, fertilizers and agricultural equipment were included, then Australian Agriculture may have been a net importer for several decades. Australia is the only country that does not produce a single fruit or vegetable that is indigenous to its own locality. It would appear that competition in sectors such as Agricultural and Manufacturing may highlight a race-to-the-bottom approach.

International banks have competed very successfully for Australia’s mining bonanza and each mining multinational would have relationships with a significant number of international banks. Such alignments appear to give the impression that it would be better to exploit all of Australia’s mining resources within the next few decades, if this were possible. Such competition does not even benefit the countries-without-resources that enjoy the benefits of mining in Australia. Banking competition may need a multi-decade focus to provide ‘healthy’ competition.

The Terms of Reference do not mention the Reserve Bank and The Treasury. Responsibility for trillion dollar Asset & Debt levels may need to be allocated between various banking organizations and Treasury. There should be very little competition between Treasury and the RBA.

The terms of Reference do not mention Remuneration Competition within Australia. This competition is intense and, will quite probably be won by the banking sector in 2010/11 as quite a lot of what this year’s winner has touched has been quite a bit less than brilliant. Is a person with an astronomical salary more likely to produce poor results over a decade? The answer appears to be “yes indeed”. Does such competition benefit Australia?

In conclusion, a lot of work may be required to introduce healthy competition into the Australian banking sector. While the introduction of foreign banks has not provided this competition, the development of a good Australian-oriented Education system may be more successful. It is time to start writing books with an Australian orientation, as Banking-101 courses from Europe or America may have very little relevance to Australia's interests. We need to have educated people with technical experience that is relevant to the modern world to represent Australia as politicians and to guide our various departments in order to produce a playing field in which inter-banking competition can flourish in Australia.

2. Competition within the Australian banking sector, including:

(a) the current level of competition between bank and non-bank providers; Australia's Big Four banks provide a wide range of products and their balance-sheets are complex, containing items that the RBA could not imagine as well as a number of off-balance-sheet and normalized numbers. Some banking products sail a bit close to the wind, including Derivatives, Hedge funds, CDO's and CfD's – Contract for-Differences. Certainly the less competition there is to market risky products such as CfD's and CDO's the better. Appetite for risk is quite high and competition between banks to lend to risky customers is quite strong. On the other hand, banks went through a phase a few years ago when it was deemed expensive and inconvenient to accept deposits from Australian customers and branches were closed.

It is possible that financial institutions, especially insurance organizations, may be working to produce our very own sub-prime crisis by not reimbursing Customers who thought they were insured for flood damage. The ex-directors of HIH have a lot to answer for.

Basically banks and non-banks tend to be competing for different markets.

(b) the products available and fees and charges payable on those products; Australia's Big Four banks have a number of little known subsidiaries. Together they offer a wide range of financial products. Warren Buffet listed a number of companies which normally did not good investment opportunities, with banks, being on the list. Since then, an intense competition has broken out to charge customers for each aspect of each transaction. When fees and charges were investigated about a decade ago, the reply was "Banks in Australia do not charge for all the services that some overseas banks itemize". Since then, banks have become enormously wealthy and risky, as we saw in recent bank-collapses in Europe and America. In retrospect, granting banks a license to compete to print money has not been hugely successful.

The focus of this inquiry on a small number of fees is unfortunate. Australia's economy may move to a sounder footing when super-risky products such as CfD's (Contracts for Differences) are withdrawn.

Any involvement of banks in the BrisConnections products is unfortunate, as it they have cost customers a lot of money. One would hope that, if a customer buys a product, then that customer would stand a reasonable chance of making a profit from that transaction. Hopefully healthy inter-bank competition will take the interests of Australians and Australian organizations into account when new products are being introduced.

<u>(c) how competition impacts on unfair terms that may be included in contracts</u>; The competition is to include terms or products, that one bank may offer unfairly, into other banks as quickly as possible. The introduction of Foreign Banks into Australia expedited this process. Customers have little choice as terms tend to be ubiquitous across the sector.

Some customers deposited their savings in Foreign Banks and found it quite difficult to withdraw their money. The account manager might be in one country one day and another the next. This type of competition is not welcome.

The introduction of unfair terms & conditions, which may not be spelt out, represents a type of competition that could be examined by the legislature.

<u>(d) the likely drivers of future change and innovation in the banking and non-banking sectors</u>; A reasonable person would expect that the American and European Global Financial Crisis (GFC) would stimulate the banks to return to more rational roles. Overseas experience indicates that this has not been the case and that foreign bankers focus quite creatively on next year’s bonus as well as on running the bank, with Australia’s Big Four perhaps following suit.

Reports indicate that banks located in Europe and America were selling CDO’s as AAA-rated investments, even after the onset of the European and American GFC. It is possible that a disaster may trigger a slide in real estate prices in Australia, triggering a local GFC. It is possible that the floods in Queensland, NSW, Victoria, Tasmania etc may be a driver for future change and innovation for Australia’s banking sector in a negative way.
The presence of small, low-cost foreign banks in Australia may be a driver of future change and innovation in a positive way in Australia. One would hope that the presence of small, low cost, efficient **<u>local</u>** banks in Australia will be the main driver for positive change and innovation.

While flexible IT-systems are essential for any Australian bank, the Big Four trend appears to be towards locked-in inflexible communication systems.

NB: While it is unlikely that any impending change in technology such as Cloud Computing will have a positive impact on the Australian banking sector, it is possible that the availability of automated computer services from a diverse number of sources may serve to make Australian banks more efficient. There are excellent business opportunities that intelligent IT-systems could make available to Australia’s banks.

Linguistic Creativity (LC) provides the main stimulus for change, with perhaps Accounting Creativity (AC) following not too far behind. When I was working for an associate of Cap Gemini in Europe in the 1980's, we were offered IT-services that were equivalent to what is being called Cloud Computing nowadays. We declined such offers for sound business reasons. It is interesting to see that such offers, which have been renamed and embellished with newer (or repackaged) technology a few times, are now being marketed with pretty much the same zeal that CDO's were marketed just prior to the American and European GFC. The result may see the Big Four fall into the hands of overseas organizations in the same way that other utilities have in recent years.

The term Level-Playing-Field is backed by legislature in Australia and Australian organizations are discouraged by LAW from competing in several areas.

Traditionalists refer to Australia's five Utilities such as Water. We have more than five utilities and all are at risk of departing our shores in a financial sense in much the same way that James Hardie was obliged to move to move to Europe by Europeans. NB: I became a monitor to James Hardie, trying to undo some of the damage that has been done and attempting to persuade it to return to Australia where it was created, to no avail. Indeed the people who 'persuaded' James Hardie to migrate are still being subsidized and they may succeed in encouraging other Australian businesses to relocate their domicile.

Should Australian Banks take up domicile in other countries, then most of the drivers for innovation will come from their new home-base. An organization that does business in one country and has legal requirements in several other countries may be inclined to present annual financial reports that even accountants may find difficult to comprehend.

Some drivers of innovative change may reduce competition in Australia for trustworthy financial products.

<u>(e) the ease of moving between providers of banking services</u>; It is pretty easy to move between providers of banking services in Australia although, if we give it some thought, we can make it difficult, risky and expensive.

It is important that good educational facilities be established in Australia so such matters can be discussed in a rational manner. I recently visited several university bookshops in Sydney, asking for books that were about Australia and which were 'True'. The answer appeared to be "We do not have many books in that category". Pure mathematics is essential to develop logical thinking patterns and such patterns are universal, although some countries do them much better than Australia does. All other educational topics, including mathematical statistics and banking, should have an Australian orientation.

A good, Australia-oriented educational system is essential to stimulate inter-bank competition in Australia, as its absence makes informed discussion quite difficult.

<u>(f) the impact of the large banks being considered 'too big to fail' on profitability and competition</u>; The Big Four are enormous and inflexible by world banking standards and need a disproportionate amount of Australia's limited financial resources in order to continue to be 'successful'. Other organizations that provide the nuts and bolts of

Australian society struggle to get their fair share of financial support. History shows that the Big Four will eventually be restructured or collapse, assuming they are not incorporated into an overseas institution that needs their cash beforehand.
It may be worth while analyzing which other multi-national organizations such as churches have grabbed large chunks of Australian real estate and other valuable assets. History shows that such acquisitions normally tend to revert back to a more stable situation over a period of time.

When one compares the resources that banks in other countries need in order to be quasi-profitable to the resources that an Australian bank might require, one is struck by the scale of the difference. Each Australian bank requires a new facility such as a new mine on a regular basis. Australia's mines are being exploited as quickly as possible and in the most expensive way possible, resulting in the lowest possible price for their products.

Once Australia's mineral deposits have been exploited, questions about being too big to fail become academic. One can only hope that the banking sectors that survive will be strong enough to compete for local business against very influential banks from other countries.

(g) regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis; It would be interesting to see if such regulation within the banking sector is hindering competition to i) develop new products, ii) obtain new technology iii) to compete against non-banks or iv) anything else which has not been specified.

Sectors of the international banking sector received massive handouts which may have been necessary for their survival during the American and European GFC and their gratitude to the Australian people is most welcome. Other industry sectors toughed it out as best they could, with some well managed organizations proving themselves to be 'as safe as a bank' in difficult circumstances. Regulation is almost certainly the only way to get banks back to their traditional role, despite cries of 'Bank Bashing' by highly paid executives.

Australian Banks should be required to compete on a reasonably level playing field against other industrial sectors in Australia. If Australia's banks have a proportion of the available cash that is too high when compared to other sectors of Australia's economy, then the economy will fold as banks do not produce products that can be consumed.

(h) opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers; It is possible that banks, which enjoy special privileges, offer too many services for their own security and for that of Australia. New Australian banks are necessary so we have a starting point when cumbersome banks become too big too compete efficiently. America's practice of restricting their banks to their State-of-Origin is excellent and Australia could do well to follow suit, with a traditional Commonwealth Bank being an exception.

It is possible for banks to provide new services. One service that banks offer is a detailed analysis of burning questions such as “Will the RBA increase interest rates this month?” and “Will the AUD maintain parity with the American Dollar?” Such discussions are a bit like a soap opera and tend to focus the attention of Australians away from real issues. Australian banks could perhaps address real questions such as “How is it possible for oil to go from $18 a barrel to $147 a barrel without causing inflation?” and “How is it possible for Australia to enjoy the best Terms-of-Trade in its history and suffer the worst trading deficits we have ever experienced?”

More important questions relate to efficiency and productivity. “How is it possible, given decades of increasing IT efficiency and productivity, that an IT-system now costs about one billion dollars?” “How is it possible, given decades of increasing agricultural efficiency and productivity, that the Australian continent with a population of 22 million people is now a net importer of food?”

Enormous opportunities exist for Australian Banks to offer new services. While we are watching the earth’s resources decline, it is possible to reverse this trend. International media campaigns and a ‘steady as she goes’ mindset are the main obstacles to the creation of new and exciting banking services that would benefit the Australian nation.

Opportunities to improve the Australian banking system abound and it is not always necessary to change The Law. Indeed it may be appropriate to occasionally apply The Law as it now stands. Bankers are occasionally arrested in foreign countries but appear to have a clean record in Australia.

Opp1 - IT: Banks, which generally have a strong balance sheet, should be able to afford their own computers. The risks associated with being dependent on the IT-services of foreign IT-companies which have been rescued by government support on several occasions are real and obvious to any person who does the analysis. Should the Banks be willing to accept advice that is independent of the main hardware and software vendors, then they should be able to enjoy the financial benefits of the IT-revolution.

Opp2 - New Business Areas. Several existing approaches to doing business in Australia have been colossal failures. Opportunities abound to do the analysis and to assist with promoting ventures that are sustainable, stable and profitable.

Opp3 – Diverse Employee Selection: Banks tend to lack the ethnic diversity that the rest of Australia enjoys, especially at senior levels. Changing the way bank executives are selected in Australia could see an improvement in the quality of the work that banks do and a reduction in credit card and mortgage debt levels. If necessary Australia could introduce the system of popular elections for senior positions in our major corporations just as we do for Federal and State Governments, although a two-party divide-and-rule approach might not be appropriate for the Big Four Banks, the RBA and for Treasury.

Opp4 – Rationalize the structure of banking in Australia. Once the overlap (and underlap) between the TBA and Treasury has been resolved and responsibility for Australia's fiscal and monetary policies has been given a more Australian flavor, then Australians should see a banking system that routinely providing and supporting small business opportunities that are essential to the sound performance of any economy. While small businesses tend to fail more frequently than large institutions do, the cost of such failures is much smaller. Banks need to see a way to be more supportive of the main pillars of Australia's economy.

Banks could be encouraged to become more efficient and innovative, enabling them to compete to provide services that make Australia's economy stronger.

<u>(i) assessment of claims by banks of cost of capital</u>; The world of international finance does not have a reputation for honesty and integrity. Claims that the Cost-of-Capital was quite high immediately after the GFC in America and Europe are almost certainly exaggerated. Banks in America and Europe have been stress-tested a few times since their GFC but still need extra funds despite good report-cards.
Banks compete for capital. It is possible that they acquire the cheapest capital and report the most expensive.

<u>(j) any other policies, practices and strategies that may enhance competition in banking</u>, including legislative change; The most fundamental change that the Australian banking System requires involves a change in the role of the Reserve Bank of Australia. Trillion dollar Credit Card & Mortgage debt levels, along with abysmal trading figures that Australia had when we enjoyed the best Terms-of-Trade ever show that the RBA is simply not functioning in Australia's interest. It is too open to the influence of international bodies which do not know how to run Australia, as they have no incentive to find out how the real Australian economy functions.

We can see how easily the RBA's of other countries are sidelined when they adopt policies that are contrary to certain international interests. As foreign interests and NGO's take over some RBA-functions, the local currency collapses with Zimbabwe being just one example. It would be optimistic to think that such a fate could never happen to Australia.

<u>(k) comparisons with relevant international jurisdictions</u>; Banks in Europe, Asia and America tend to have tighter regulations than banks in Australia do. The difference is that Australia, with a population of just 22 million people, is exploiting natural resources terribly quickly and cheaply, with some of the resulting profit being returned to Australian banks as profit. A recent media report said that if commodity prices returned to the levels they were at in 2002, then Australia's economy would be similar to Greece's – that is until we rationalized economic activity in Australia.

<u>(l) the role and impact of past inquiries into the banking sector</u> *in promoting <u>reform</u>*; Past inquiries have had a positive impact on Australian banks. Such inquiries were necessary, as different Australian banks have 'misplaced' their customers' money at various times in

our history. In recent years, several Australian banks have been involved in disastrous overseas transactions that resulted in multi-million dollar losses and which could have had a very negative effect on Australia's banking industry. Some disasters appear to have been location-based, with the UK and Hong Kong appearing to be unwise places to invest in.

Other disasters appear to have been technology-based, with the loss of large amounts of money being blamed on the use of poorly-developed technological facilities in foreign countries. Fraud is a topic that banks do not like to publicize, although Australian banks would be subject to such activity just as American and European banks are.
Money laundering is a topic that is not discussed in relation to Australian banks, despite the fact that, after New York's 2001 disasters the FBI found that Australia and Israel were the two main money laundering countries. A LateLine report on DEST-corruption about a decade ago reported that it was easier for international institutions to take money from the Australian Government than it was to take candy from a baby and it appears that this is still the case. On the other hand, Australian organizations may not even have their invoices acknowledged and due diligence takes forever.

Generally Australia's previous inquiries into its banking sector have tended to be fairly tame affairs and I expect this one to be similar, despite the gravity of the challenges that Australia's banks are facing.

Reform is a poorly defined term which appears to mean whatever America's Federal Reserve and Europe's OECD deem appropriate. It may be advisable to reverse all the reforms that Mr. Greenspan introduced, especially the God Save The GST-Tax, which provided no benefits to the Australian economy. Currently the word 'Reform' tends to mean any activity that will benefit the economies of Europe and / or America.

(m) any other related matter. Opportunities to improve competition within Australia's banking system abound and are relevant to this inquiry, as other countries have recreated themselves after being massively in debt. A defeatist attitude might be to say that, as Australia's credit card and mortgage debt head from billion and trillion dollar levels towards the quadrillion dollar mark, this is a process that is impossible to stop and that soon it will be theoretically possible to line up all our debt dollars one meter apart and see them stretch across the entire universe.

Other countries see possibilities of alleviating their astronomical debt levels by picking up some loose change from Australia and disasters such as the Queensland floods appear to provide welcome opportunities. Estimates of Queensland's flood damage rose quickly to 10 billion dollars and then to 20 billion dollars before touching (hopefully) a high of 30 billion dollars just as a senior politician touched down in Australia. Australia's opportunities from this extraordinary set of events are to i) Analyze which financial institutions were involved in making such unbelievably high estimates and ii) Try to bring such estimates back to reality as quickly as possible. This is a general problem, as reports of a few million dollars worth of damage in a few places tend to be totaled into rescue packages that cost several billion dollars.

3. Recommendations

R1: Improve Australia's educational system to facilitate informed discussion about topics such as inter-bank competition.

R2: Apply The Law as it currently exists more rigorously.

R3: Enhance The Law to close loopholes that are disadvantageous to Australia.

R4: Encourage Australian Banks to compete to provide new services that are sustainable and beneficial for Australia.

R5: Encourage the diversification senior management personnel.

R6: Encourage technically qualified people who are independent of international IT-vendors to assume senior roles in Australian banks and government.

R7: Encourage banks to use their own computers rather than remote computers that are owned by international IT-vendors.

R8: Encourage Australian banks to remain Australian by focusing on activities in Australia.

The success of the film "The Bank" and of books such as "The Bank that broke the Bank" and "HIH: The inside Story of Australia's biggest Corporate Collapse" show that Australians are quite concerned about the current low level of inter-banking competition in Australia.

The potential benefits of good, decade-long inter-banking competition are enormous.

Yours Sincerely

David Allen.