AUSTRALIAN **B**ANKERS' **A**SSOCIATION **I**NC.

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3 December 2010

Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
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Parliament House
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Dear Mr Hawkins,

Competition within the Australian banking sector

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comments to the Senate Economics Committee's inquiry into competition within the Australian banking sector.

Please find attached our submission. The submission covers four areas:

- Provides context, outlines the impact of the GFC on Australia's banks as participants in the global banking system, and establishes the facts around some of the common myths held about Australia's banks and banking industry.
- Examines the state of competition in key financial product markets, with a particular focus on customer and consumer choice. These markets are: (a) housing finance, (b) deposits, (c) small business finance, and (d) personal lending. These typically constitute the markets that affect most people.
- Discusses various claims and suggestions of ways to improve competition.
- Outlines some proposals that the banking industry believes will foster greater competition across the banking system.

If you have any queries regarding the issues raised in our submission, please contact me

Yours sincerely

Steven Münchenberg

Submission to the inquiry into competition within the Australian banking sector

3 December 2010

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1. Introduction

The Australian Bankers' Association (ABA) represents 23 Australian and international banks and has wide representative coverage of the banking as well as the broader financial services sector. The governing body is the ABA Council comprising 14 chief executive officers of member banks. (See Appendix 1 for a list of ABA member banks.)

The ABA works with its member banks to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services. With the active participation of the member banks, the ABA works to ensure the banking system can continue to deliver the benefits of stability and competition to Australian banking customers.

1.1 ABA position on competition in the Australian banking sector

The ABA believes the evidence shows that there is competition in banking, including in key financial product markets of relevance to households and small business. Australian banking customers are able to access banking products and services at competitive prices from a number of different providers.

Currently, differences between the business models of providers mean there are differences in cost and access to funding sources, and this is impacting on the ability of smaller providers to compete. While smaller providers are currently competing with larger providers, smaller providers are facing additional funding pressures in the current different market conditions.

Therefore, the ABA believes there are measures that the Federal Government should put in place and initiatives the banking industry should take that would enhance competition further. These actions and initiatives should focus on strengthening the funding base arrangements of all participants, rather than re-regulating the Australian banking industry, which would have adverse and unintended consequences for financial institutions, consumers and the efficiency of our markets.

1.2 Background

In Australia, retail banking has been driven by competition among local banks, internationally-owned banks operating in Australia and other participants, including credit unions and building societies. Since deregulation of banking in the 1980s, the Australian banking system has emerged as one of the strongest and most advanced banking systems in the world. This has real benefits for Australian consumers and the wider Australian economy.

Australia's banks played, and continue to play, an important role in shielding the Australian economy, businesses and consumers from the global financial crisis (GFC) and its ongoing consequences. Instability in a banking system can be transmitted easily to other sectors in the economy by disrupting lending markets and payments mechanisms, thereby reducing credit availability to the real sector.

Unlike many overseas banking systems, the Australian banking system has not collapsed nor required banking institutions to be bailed out with the use of taxpayers' moneys. Unlike many overseas economies, the Australian economy has withstood the worst of the GFC and avoided the economic and social consequences evident in other countries, which have included a decline in the availability of credit to households and businesses, a rise in unemployment and corporate bankruptcies, a decrease in property and asset values, and an increase in personal bankruptcies and housing repossessions.

The ABA believes there are many interrelated reasons why Australia's economic performance is widely recognised as outperforming other advanced economies – a combination of efforts, including fiscally strong Government, appropriate stimulus, well regulated banks, well managed banks, actions taken by companies to support employment (such as through implementing non-standard working arrangements), and actions taken by banks to support mortgage holders (such as through implementing financial hardship practices).

Australia's banks continue to provide financial products and services to consumers and provide employment for a significant portion of the Australian population. Surveys of bank customers show that, overall, customer satisfaction with their bank is high, with average satisfaction levels being 76%[1]. Banks employ around 150,000 Australians and with the exception of the mining industry have the lowest unemployment rate of any industry in Australia. On average, banks pay higher wages than other industries and are leaders in implementing employment arrangements which foster flexible working conditions.

Australia's banks continue to respond to emerging community needs. Banks have developed basic banking products which offer fee free or low fee options for people receiving government assistance or on low incomes and have removed or reduced unpopular fees, such as exception fees. Banks have also invested significantly in initiatives to assist low income customers and financially disadvantaged Australians, in particular through the provision of financial literacy and financial inclusion programs.

The ABA believes that deregulation of banking has promoted competition and improved efficiencies in the delivery of banking services to Australians. Over the past decade, liberalisation of Australia's banking system has been managed carefully through a combination of:

- Closely monitored reforms to Australia's banking and financial services laws;
- Prudent supervisory arrangements and oversight of those laws by the financial regulators (Reserve Bank of Australia (RBA), Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC)); and
- Sound administration of Australia's banks by skilled bank executives and staff.

A competitive and well functioning banking system has been the cornerstone of the efficient operation of Australia's market economy and Australia's financial stability.

1.3 Key findings

The ABA's submission is divided into four main sections. Additionally, the appendices contain some descriptive material about the contribution of banks to the Australian economy and provide more detailed information regarding banks' funding costs.

1.3.1 Impact of the GFC

First, the submission provides context, outlines the impact of the GFC on Australia's banks as participants in the global banking system, and establishes the facts around some of the common myths held about Australia's banks and banking industry.

The ABA's submission provides the facts about bank performance and net interest margins. These facts are substantiated with data and are also corroborated by numerous comments made by officials, including the RBA.

Importantly, the data shows that interest rate rises beyond the official cash rate would have happened irrespective of the mortgage originators no longer participating in the market or the mergers between several Australian banks or the withdrawal of several

[1] According to Roy Morgan Research, in September 2010 customer satisfaction for the banks was 76.4%.

international banks operating in Australia – that is because these interest rate rises are related to the increased cost of funds faced by Australia's banks since the onset of the GFC in mid 2007.

During the GFC, and unlike many banking institutions in other countries, Australia's banks have continued to offer banking products and services, continued to facilitate capital mobilisation and availability of credit to the economy and absorbed some of the increases in cost of funds and reduced or removed certain fees.

Given the strength of Australia's banking system was a key reason for Australia's relatively strong performance during the GFC, the ABA is concerned that unfounded claims regarding bank profits and interest rates should not be used to justify imposing burdensome regulation on banks or potentially damaging regulation on financial product markets. Regulation invariably leads to additional business and operational costs, which are ultimately borne by all institutions and their customers.

1.3.2 State of competition

Second, the submission examines the state of competition in key financial product markets, with a particular focus on customer and consumer choice. These markets are: (a) housing finance, (b) deposits, (c) small business finance, and (d) personal lending. These typically constitute the markets that affect most people.

The ABA's submission identifies a number of key points regarding the operation of the various markets within which Australia's banks participate:

- *Housing lending*: The housing finance market continues to be a competitive sector, although the competitive dynamics have changed since the GFC with the decline in market share of the mortgage originators and smaller lenders. Based on Cannex product listings alone there are more than 100 institutions actively marketing home loans with over 500 products to choose from. Current interest rates are above long-term averages.

- *Deposits*: Heightened competition in the deposit market is a notable feature of retail banking since mid 2007, as intermediaries have sought to reduce exposure to wholesale markets. All retail banks, building societies and credit unions offer deposit products and current interest rates are well above long-term trends and margins are more favourable for depositors.

- *Small business lending*: The market for small business finance has become more competitive through 2010 as banks and other suppliers seek to grow their business credit portfolios. Concerns over inadequate supply of small business credit appear to have declined. Interest rates on small business loans are higher than long-term trends and interest rate margins are higher than for housing lending, broadly reflecting the greater credit risk associated with SME lending, including higher probability of default and loss given default, the higher capital charge imposed by regulations, and the higher cost to acquire and service. Banks have been actively advertising for small business customers and have been recruiting significantly more business bankers.

- *Personal lending*: The personal lending market is divided between two products – personal loans and credit cards. Personal lending overall has declined from 9% of total lending in the year 2000 to 7% today[2]. Credit cards account for about one-third of total personal credit. There are 64 providers of credit cards that actively market over 300 card products. Interest rates are higher than for other lending products, reflecting the nature of the product, but there is a wide choice of products. Interest rates range from 0% to 21.49%.

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[2] Derived from RBA statistics. June 2010.

While the data shows healthy competition in key financial product markets, there are medium-term challenges. The most significant is the relative funding costs of categories of lenders. The gap between the average cost of funds for the major banks and that of credit unions and regional banks has widened since 2007.

At present, the ability of participants in the second-tier financial services sector to offer long-term, sustainable, competitive consumer propositions is undermined by a constrained and expensive funding market. Due to the higher credit ratings of larger banks and other market factors which are relevant to the individual funding base of all banks and which have become more acute during the changed market conditions since the onset of the GFC, the gap between the cost of funds for the larger banks and that of other financial services institutions is a risk which if not addressed could result in further consolidation and/or a deterioration in competition across the banking and finance sector.

The ABA believes that Australia's banks provide good value services to Australia's consumers of financial products and have contributed to Australia's economic performance and fiscal management by providing safety for deposits, credit for business growth, employment for a large number of Australians, high levels of tax revenue, and significant dividend payments to direct investors and superannuants, as well as having underpinned overall financial stability.

<u>The ABA analysis shows that the key financial product markets remain sound and competitive and provide good value for customers. However, we consider that further competition would result from measures to strengthen the funding base arrangements of all participants</u>.

1.3.3 Reaction to proposals

Third, the submission discusses various claims and suggestions of ways to improve competition.

The ABA believes that there are a number of current proposals and ideas being put forward to promote competition that would, in fact, have a detrimental impact on competition in the Australian banking industry. Over-regulation can stifle innovation and actually have anti-competitive effects. We are concerned that adverse and unintended consequences need to be avoided.

1.3.4 ABA proposals to foster competition

Fourth, the submission outlines some proposals that the banking industry believes will foster greater competition across the banking system.

The ABA believes that financial product markets are operating in a manner that demonstrates competition. However, we consider there are a number of actions and initiatives that should be taken to strengthen competition further in financial product markets. Initiatives should aim to:

- Promote better regulation of banks and financial service providers and facilitate new entry by suppliers;
- Address costs and availability of funds for all participants, especially smaller banks;
- Encourage individuals to save and plan for their future; and
- Promote access to banking products and services, encourage improved levels of financial literacy among consumers and businesses, and facilitate greater customer ability to make informed decisions about their banking products, find the best priced products and services to suit their needs, and switch product providers if they so desire.

2. Context

2.1 Snapshot of the Australian banking sector

Australia commenced moving from a regulated banking system to a more open competitive sector in the early 1980s.

Over 15 million Australians are customers of banks today[3]. (See Appendix 2 for an overview of the Australian banking sector.) Unlike many overseas countries, Australia has an extremely high level of 'banked' consumers (i.e. people with access to, and use of, banking services). Deregulation, coupled with other structural adjustments and changes in the social welfare system, has meant that the mainstream banking system has become much more available than in comparable economies. Deregulation has driven competition, and in turn competition has brought about significant savings for customers, with declining margins for banks. Competition has also resulted in a wider choice of providers, products and services for customers.

According to APRA[4]:

- There are 140 banks and other authorised deposit-taking institutions (ADIs), including credit unions and building societies, which provide the main retail banking services in Australia.

Just looking at Cannex data alone[5]:

- There are over 1,000 transaction and savings accounts available in the market (this does not include term deposit products).
- There are 111 mortgage lenders in Australia.
- There are 509 variable rate and fixed rate home loan products in the market.
- There are 64 credit card issuers in Australia.
- There are 309 different credit card products available in the market.

Over the last decade, the global financial and capital markets have changed markedly, which has also impacted on the Australian banking system. The growth in direct investment in equity markets and indirect investment via the superannuation system has reduced deposits in Australia's banks. Decreases in levels of household savings and the shift in consumer funds has coincided with strong demand for credit, causing loan-to-deposit ratios among banks to increase. The result of this structural shift is that larger banks are increasingly reliant on offshore wholesale funding to supplement domestic deposits as a source of funding. Smaller banks need to rely on domestic wholesale markets, such as securitisation, to ensure they have readily available and affordable funding. The strength of these funding sources determines the ability for smaller banks to compete.

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[3] Roy Morgan Research shows, as of December 2009, banks are the *main financial institution* chosen by 15.1 million customers aged 14 and over. This is an increase of 3.0% or 444,000 customers over the past year.
[4] http://www.apra.gov.au/ADI/ADIList.cfm
[5] Data taken from Cannex provides information on a range of products being marketed through the Cannex website. http://www.canstar.com.au/

Since mid 2007, the world has changed – literally. The global financial system has been, and continues to be, under stress. What started as a sub-prime crisis in the United States has transformed into a sovereign debt crisis in Europe. Financial markets have been decimated. Capital markets have been squeezed. Advanced economies around the world have been in recession and global economic recovery is not expected for some time. Despite the fact that Australia appears to have weathered the GFC storm – and to some degree this has resulted in some apathy as to the full extent and severity of the GFC on the global financial system – the protracted nature of the GFC has resulted in a number of fundamental changes to the global banking system. It is not clear that pre-GFC conditions will return or whether, in some respects, it is appropriate for these conditions to return.

On 19 February 2010, the Reserve Bank Governor stated:

> … it seems unlikely that we will return to the easy credit conditions of three years ago. The world has changed, for a while at least. Moreover, the likely course of international standards for regulation over the next few years will probably, at the margin, act to raise the cost of intermediation by requiring banks to hold additional capital and liquidity.[6]

2.2 Impact of global financial crisis on the Australian banking sector

Banks lend to consumers (personal lending and credit cards), home buyers, small to medium size businesses (SMEs) and institutional clients. In order to support their lending portfolios, banks source their funds from customer deposits and wholesale markets, including securitisation. Larger banks source funds from global money markets to support their lending activities, with approximately 30 cents in every dollar lent in Australia needing to be raised offshore.

For most of the last decade, banks' funding sources and the cost of funding was relatively predictable. Movements in the RBA's official cash rate generally provided a close approximation for changes in total bank funding costs. However, the price that banks pay to access funds – that is, the cost of funds – depends on a number of factors, including the official 'cash rate', market access and international events, the credit rating of the bank, and the supply of wholesale funds. While the cash rate still has a significant influence on banks' funding costs, the GFC and the ongoing effects on global market conditions means that the cost of banks' main sources of funding has increased relative to the cash rate and relevant money market rates.

On 27 March 2008, the Reserve Bank Governor stated:

> The presumption that their [banks] lending rates should only move with the official rate isn't really realistic in this period, and we've indeed seen bank lending rates moving independently of the cash rate. I think that's just life in this environment.[7]

On 26 November 2010, the Reserve Bank Governor stated:

> Most recently, as you know, the Board decided to lift the cash rate by 25 basis points. Many lenders raised their loan rates by more than this. These moves have left the overall setting of monetary policy a little tighter than average, as judged by interest rate criteria. Of course, we are aware as well that, particularly for business borrowers, non-price conditions remain tighter than they were for some years prior to 2008. Overall, and also taking account of the exchange rate, which has risen substantially this year, we judge this to be the appropriate setting for the period ahead.[8]

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[6] Stevens, G (2010). Opening Statement to House of Representatives Standing Committee on Economics. Canberra. 19 February 2010. http://www.rba.gov.au/speeches/2010/sp-gov-190210.html

[7] http://www.abc.net.au/lateline/content/2007/s2201386.htm

[8] Stevens, G (2010). Opening Statement to House of Representatives Standing Committee on Economics. Canberra. 26 November 2010. http://www.rba.gov.au/speeches/2010/sp-gov-261110.html

2.2.1 Changed funding composition of Australia's banks

At the end of June 2010, bank funding was at $1.47 trillion, an increase of $100 billion or 7.3% over the previous year. Usually, banks source their funds from deposits (50%) and through short-term wholesale funding (25%)[9] and long-term wholesale funding (25%)[10] (statistics may vary from quarter to quarter). Wholesale funding is sourced from domestic and international financial markets (splits vary from bank to bank).

Prior to mid 2007, Australia's major banks were typically able to access capital markets with more certainty and less basis risk. However, banks now face elevated spreads because the global risk premium is now higher as lenders expect a higher return on their money due to the uncertain global market conditions. In addition, the cost of swapping foreign currency back into Australian dollars is also higher. Banks are paying more to access funds to ensure credit continues to flow to Australian households and businesses.

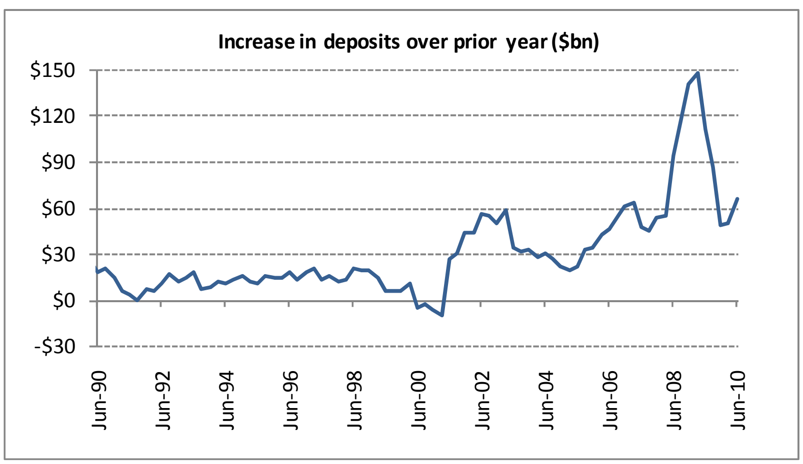
Furthermore, wholesale funding pressures and changes in the mix of liabilities on banks' balance sheets are being compounded due to pending Basel III regulations. Liquidity standards could have significant implications for banks, given that banks will be required to hold a greater proportion of longer term instruments. Banks will need to hold instruments that may be more costly due to ongoing risks with access to long-term debt. Capital standards will mean that a larger proportion of assets are likely to be allocated to lower-yielding liquid assets. It is expected that new prudential rules could compound margin pressure and funding costs.

<u>Deposits</u>

Since the onset of the GFC, and the resultant impact on capital and equity markets, net flows into retail deposits have been strong.

Over the 12 months to June 2008, the net increase in deposits was a very strong $111 billion (18.3%) and a further $94 billion (18.2%) was added over the 12 months to June 2009. While this has come back over the 12 months to June 2010, it was still a high $66 billion net increase. The peak increase in deposits over a 12 month period was $148 billion, occurring over the 12 months to the end of March 2009.

Graph 1 – Increase in deposits over prior year

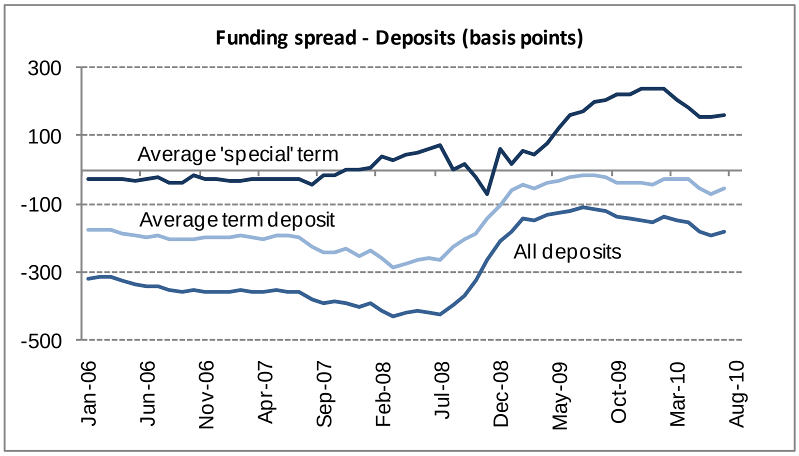


Source: ABS data

[9] Short-term funding relates to borrowings for up to 12 months.
[10] Long-term funding includes borrowings of greater than 12 months.

Australia's banks have been offering high interest rates to attract additional deposits, meaning that the costs associated with deposits have been elevated. Since late 2008, deposits have become more expensive for banks. In mid 2008, it is estimated that deposit spreads (including non-interest bearing deposits, such as everyday transaction accounts, through to higher interest accounts, such as term deposits) were about 400 basis points below the cash rate, falling dramatically to about 100 basis points below the cash rate by mid 2009. Throughout 2010, the cost of deposits has remained expensive for banks.

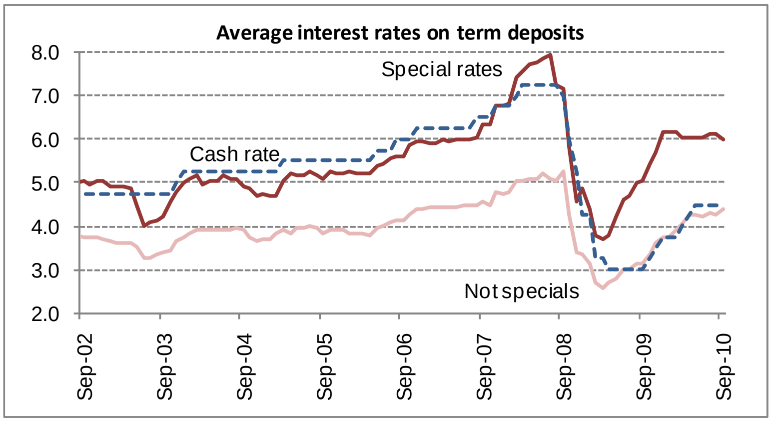
Graph 2 – Deposit spread



Source: RBA data / Cannex

Additionally, the current official cash rate is 4.75%, whereas special term deposit rates now can be as high as around 6%. In effect, over the past 2-3 years, we have seen banks increase deposit interest rates by considerably more than the official cash rate.

Graph 3 – Average interest rate on term deposits



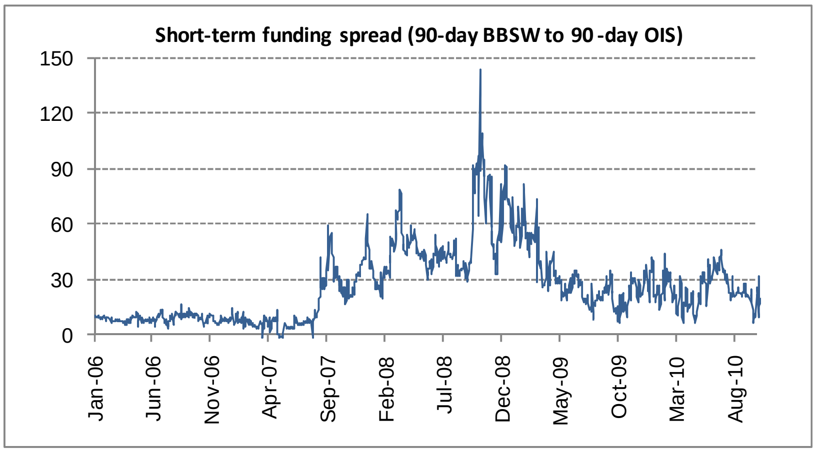
Source: RBA data

Short-term funding

In June 2010, short-term funding (excluding bills of exchange) comprised 62% domestic issuance and 38% offshore issuance[11]. (These proportions vary from bank to bank.)

From August 2007 to March 2009, short-term funding costs were extremely volatile. On several occasions during this period the 90-day Bank Bill Swap rate (BBSW) spiked sharply (August 2007, September 2007, December 2007, February 2008, March 2008, June 2008, September 2008, October 2008, January 2009, February 2009 and March 2009). While spreads have decreased on short-term funding, these are still around 2-3 times higher than the levels prior to the GFC and remain elevated.

Graph 4 – Short-term funding spread



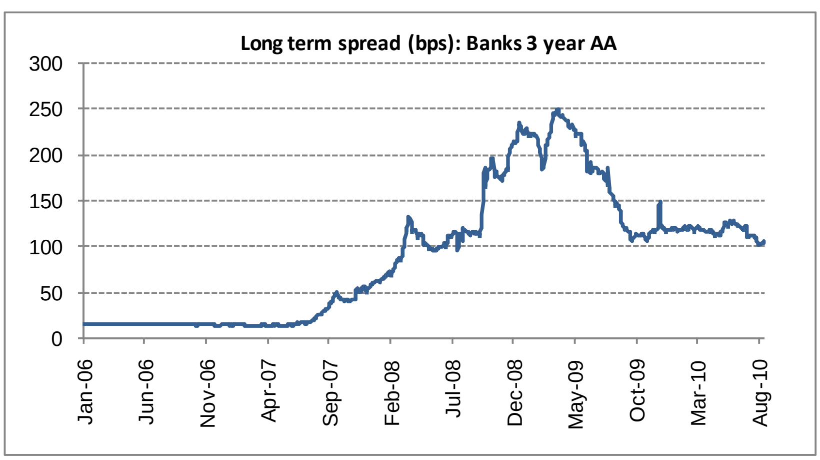
Source: NAB Economics

Long-term funding

In June 2010, long-term funding comprised 26% domestic issuance and 74% offshore issuance[12]. (These proportions vary from bank to bank.)

Since August 2007, long-term funding costs have remained elevated, with no evidence of significant easing. Spreads on long-term funding are around 8 times higher than the levels prior to the GFC.

Graph 5 – Long-term funding spread (Banks 3 year AA)



Source: CBA Economics

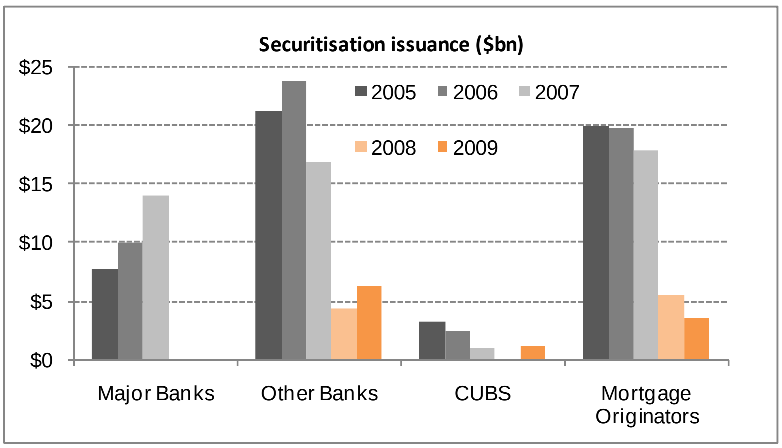
[11] ABS Financial Accounts
[12] ABS Financial Accounts

Securitisation

Since the onset of the GFC, participants have not been able to raise significant funding through securitisation markets. Securitisation markets continue to see very low issuance levels with most issuance benefiting from direct investment support by the Government. Investor interest in securitised assets (and structured products more generally) has virtually dried up as institutional investors remain uncertain about these products, despite the strong underlying collateral performance in Australian RMBS (i.e. Australian mortgages) transactions.

Those lenders with a business model more reliant on funding from the securitisation market have felt the impact of the constraints within this market. The level of issuance by smaller banks fell from $16.8 billion in 2007 to $4.4 billion in 2008. In 2009, while the level of issuance by smaller banks increased slightly to $6.3 million, issuance was significantly less than the years preceding the GFC. In fact, between, 2006 and 2009, issuance by smaller banks fell by 73%. Importantly, nearly all issuance since 2008 has benefitted from the RMBS Investment Program, which has simultaneously supported issuance volumes and reduced issuance margins for those banks able to access the program.

Graph 6 – Securitisation



Source: RBA data

Summary—Funding composition

Overall, the funding composition for Australia's banks has shifted and domestic and global factors that influence the cost of funds have changed significantly. When the term of any funding arrangement expires, either in domestic and global markets, banks have to rollover their funding.

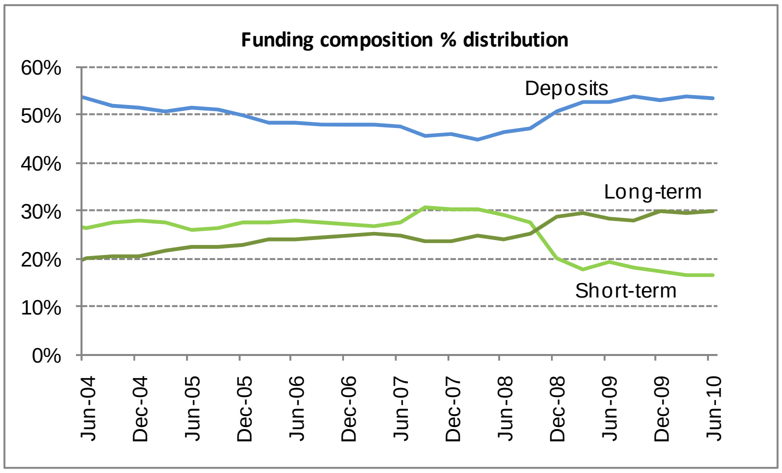
Funding costs for Australia's banks have risen significantly relative to the official cash rate, mainly reflecting the higher cost of domestic retail deposits and long-term wholesale debt, and changes in bank funding mix. The RBA has said:

> The composition of banks' funding was fairly stable over the years leading up to the onset of the financial market turbulence in mid 2007. Since then, the share of securitisation has fallen as there has been virtually no issuance in asset-backed securities (ABS) markets, and the shares of deposits and long-term debt have risen as banks have looked to attract these more stable sources of funding to underpin their strong credit ratings[13].

[13] RBA (2009). The Impact of Capital Market Turbulence on Banks' Funding Costs. Bulletin. June 2009. http://www.rba.gov.au/publications/bulletin/2009/jun/pdf/bu-0609-1.pdf

The changes in funding mix – that is, towards more stable, but expensive types of funding – means that banks' overall funding costs remain significantly higher relative to the official cash rate than they were in mid 2007. The proportions of banks' funding are now 53.5% deposits, 16.6% short-term wholesale funding and 29.9% long-term wholesale funding (Graph 7).

Graph 7 – Funding composition



Source: ABS Financial Accounts

Apart from managing cost of funds, banks are also driven to diversify their sources of funding for other reasons. Diversification of a bank's funding profile in terms of investor types, regions and markets, and products and instruments, is an important part of a bank's liquidity risk and capital management framework.

In addition to the increased share of typically more expensive long-term wholesale funding, banks have increased the average term of long-term funding since the onset of the GFC. This increase in average term has been driven by greater internal and external focus on liquidity and funding risks, the absolute quantum of funding undertaken by the banks and investor demand. For example, all major banks have issued 10 year debt since the onset of the GFC, which is more expensive than typical pre-GFC 3-5 year debt.

Importantly, the impact of increased long-term wholesale funding costs takes place over a longer period than increased costs in deposit or short-term wholesale markets. Because the average term of most banks wholesale funding is 3-4 years, banks are continuing to replace cheaper pre-GFC long-term funding with more expensive new long-term funding; even if the marginal cost of that new long-term funding is cheaper than costs at the height of the crisis, it adds to banks' average cost of funds.

2.2.2 Changed conditions of the global financial markets

Since August 2007, financial markets have experienced serious volatility and uncertainty triggered by a failure in the US sub-prime lending market, and then subsequently shocks with various banking system failures, financial institution collapses, and more recently, the sovereign debt crisis in Europe.

For banks, the GFC has made it more difficult to access funds, and the funds that are available have been more expensive.

Australia's major retail banks have AA credit ratings, and are among only nine banks around the world with this high credit rating[14]. During 2009 and 2010, Australia's major banks were large issuers into offshore markets in order to meet the demand for credit in the Australian economy – the major banks accounted for 10% of global financial

[14] http://www.nomura.com/research/getpub.aspx?pid=391640

institutions long-term debt issuance, up from 4% in 2007[15]. Banks with strong credit ratings from well performing economies have found sufficient liquidity in global debt markets. However, even though spreads in long-term wholesale markets have stabilised over 2010, spreads remain elevated at more than 5 times pre-crisis levels.

The smaller banks have proven to be just as resilient as AA rated banks, but are presented with other funding challenges. Smaller banks are finding it more difficult to access longer term funding and hence during 2010 concentrated more on short-term funds, private placement and deposit growth. Given those entities lower credit ratings, senior unsecured market access remains constrained.

The ABA notes a number of initiatives have been taken by supervisory authorities around the world in the context of the broader global initiatives that are aimed at resolving the financial crisis and ensuring that credit continues to be available within each country.

In response to similar actions in other jurisdictions, the Australian Government put in place a guarantee to protect customers' deposits and a guarantee to allow Australia's banks to raise money overseas to lend in Australia during the GFC. These guarantees helped maintain stability in the Australian banking system and ensure the strength of the Australian economy – to keep credit flowing, to keep businesses going, and to support jobs. These guarantees also ensured that the Australian banking system was not placed at a disadvantage compared to other countries, which already had announced similar schemes or put in place emergency schemes during the GFC.

The Australian Government:

- Implemented the Financial Claims Scheme (FCS) so customers of all banks, credit unions and building societies have a guarantee on their retail deposits (currently up to $1 million). In the unlikely event that a bank or other ADI fails and there is not enough money for depositors, the legislation in place providing the guarantee authorises the Government to recover any money used for the guarantee from banks and other ADIs. (In other words, should a bank or other ADI fail, the scheme is actually underwritten by the banking industry, not taxpayers.)
- Implemented the Guarantee Scheme for large deposits and wholesale funding when global markets became difficult to access and a global 'credit squeeze' started to emerge. For this guarantee, Australia's banks are currently paying $100 million a month to the Government. So far, Australia's banks have paid over $2 billion, and are expected to pay a further $3.5 billion by the end of the scheme. (In other words, banks are contributing to government revenues.)

The Australian Government also instigated the RMBS Investment Program via the Australian Office of Financial Management (AOFM) to provide support for the securitisation market, in particular for smaller banks and non-bank lenders. Since the inception of the program, as at the end of November 2010, the AOFM has invested around $12 billion in 65 RMBS transactions sponsored by 18 issuers. Around a further $4 billion is available to be invested under the existing RMBS Investment Program[16].

The ABA agrees that these measures were vital for the stability of the Australian banking system during the GFC. Given this support, it is appropriate that the Government, through APRA, continues to supervise banks closely. However, we do not believe these measures require or warrant Government taking a more direct role in the commercial decisions of Australia's banks.

[15] Citigroup (2010). A Champion mortgage model – One size might fix all. 7 October 2010.
[16] http://www.aofm.gov.au/content/rmbs.asp

2.3 Facts about bank stability

In Australia, banks are financial institutions authorised under the *Banking Act 1959*. The *Reserve Bank Act 1959* gives the Reserve Bank of Australia (RBA – the central bank) a wide range of powers over the banking industry. Additionally, the Australian Prudential Regulation Authority (APRA) oversees banks and some other financial institutions, including credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

The regulatory authorities have in place measures to protect depositors by ensuring banks safeguard their capital base. As part of protecting the financial strength of Australia's economy, Australia's banks comply with international prudential regulations on banks, set by the Bank for International Settlements (BIS). Under Basel II, introduced in 2007, banks hold a minimum 8% of their calculated 'risk-weighted assets' in the form of capital. This means, for example, that every time a customer takes out a personal or commercial loan, the bank must put aside 8% of the loan value as capital. Risk-weighting recognises the different creditworthiness of alternative loans in the balance sheet. Personal and commercial loans, being higher on the credit risk spectrum, attract a 100% Basel rating, implying that the full 8% has to be set aside for these loans, which increases the risk and cost for banks.

These stringent prudential rules apply only to banks and other ADIs and not to non-banks, a fact that sets banks and other ADIs apart from other financial institutions, including non-bank credit providers. Therefore, banks must be very careful in managing their balance sheet prudently, because putting aside capital has an impact on the revenue of a bank.

As a consequence of the GFC, new international prudential requirements (known as 'Basel III') are being developed. These new prudential rules will impose different capital and liquidity standards on banks.

<u>Banks' balance sheet decisions protect our national financial stability</u>

Decisions by banks concerning their balance sheet play an indispensable role in protecting the financial system. The amount by which a bank's assets exceed its liabilities amounts to the capital or shareholders equity of a bank. Higher capital and reserves provide a cushion against unexpected loan losses or draw downs of deposits. The return banks earn on these assets is usually lower, which means these reserves are more costly for banks. However, a well capitalised bank provides a buffer for depositors and for the economy, in particular at times of economic downturn.

Australia's banks have demonstrated sound regulation and management structures, unlike many banking institutions (and subsequently banking systems) in other countries, which failed because of a systemic breakdown in the regulatory structures, supervision and management of banks.

<u>Banks' lending policies mean sustainable economic growth</u>

Decisions by banks concerning their lending books play an essential role in facilitating economic growth. If the approach to lending by banks is imprudent, the result can be an unbalanced economic cycle that ends in recession. This will occur if bad loan losses are allowed to get out of hand, or if one part of banks' lending portfolios grow faster than others, leading to unbalanced economic development and an asset-price bubble in the affected sector of the economy. In both cases a sharp curtailment in lending will be the inevitable outcome, with adverse effects on jobs, business plans, national wealth, and Australia's overall economic performance.

Australia's banks run a high quality lending book, with non-performing loans at steady low rates and arrears in comparison to other countries are very low. The explanation for Australia's banks' high asset quality has to do with the approach to lending. Australia's banks have maintained prudent loan assessment procedures based on conservative risk profiles and rigorous assessment of customers' capacity to repay, rather than being tempted to follow the practices of some overseas banks and lenders, for example, in the US sub-prime market. At the height of the GFC, the non-conforming housing loan segment in Australia (the closest equivalent to the US sub-prime market) was very small – less than 1% of outstanding mortgages – compared to about 13% in the United States[17].

Australia's banks prudent lending book decisions and responsible lending practices explain why the Australian banking sector is strong and why banks have been able to continue to lend and support economic activity during the GFC, unlike banking institutions in other countries, which required taxpayer funds to bail them out and/or restricted credit to households and businesses.

Soundness of banks

The GFC has demonstrated the close connection which exists between a nation's banking and finance sector and its economic prosperity. Bank performance – or profitability – is critical to the financial stability of the institution and the financial strength of the economy.

Australia's banks are among the most sound in the world and continue to provide core banking services to the community, unlike some banking institutions overseas. In the United States and Europe, for example, over the last three years banking activities have contracted and economies have stalled as a direct consequence of the GFC. Because of their different decision-making prior to, and during, the crisis, Australia's banks are in a better position to maintain their important role within the economy after the crisis.

Table 1 – Soundness of banks: World rankings

Country	Ranking
Australia	4
United States	40
United Kingdom	44

Source: World Economic Forum, Global Competitiveness Report 2008-09

In February 2009, Oliver Wyman's *State of Financial Industry* report found that Australian banking is one of the most resilient industries in the world: "The Australian financial services sector is holding up remarkably well when compared to its counterparts in other countries. The Australian majors had shown resilience to date, outperforming their global peers on a relative shareholder value basis"[18].

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[17] RBA (2008). Financial Stability Review. March 2008.
http://www.rba.gov.au/publications/fsr/2008/mar/html/contents.html

[18] Oliver Wyman (2009). Annual State of the Financial Services Industry 2009. 12th Edition.
http://www.oliverwyman.com/cn/5907.htm

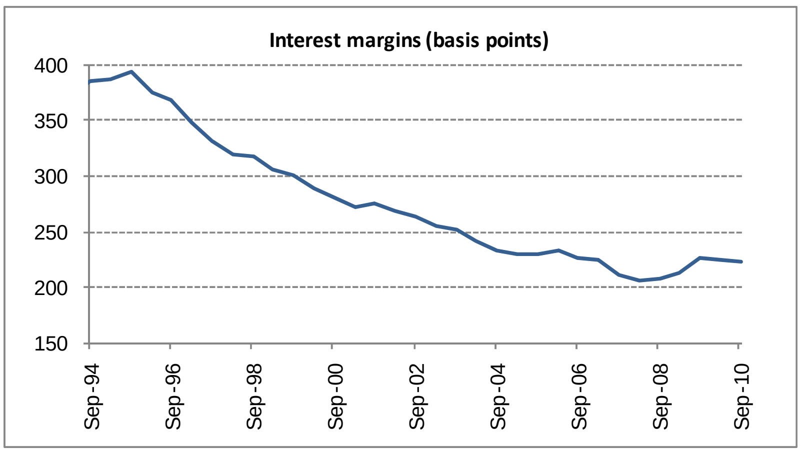
2.4 Facts about interest rates

Over the past decade, primarily due to competition, average interest margins in the banking industry have narrowed considerably.

With the onset of the GFC, uncertainty in global capital markets created extreme volatility in both short-term and long-term wholesale funding spreads, especially over a period of 18 months from August 2007 to March 2009, where spreads were not only volatile, but spreads also increased significantly in trend terms placing additional upward pressure on banks' cost of funds. This impacted on banks interest margins. Despite spreads remaining elevated on pre-GFC levels, the decrease in net interest margin (NIM) demonstrates that banks have absorbed to some extent these increased cost pressures[19].

The latest data on NIM[20] for Australia's major banks demonstrates that margins fell by a small amount (4 basis points) over the 12 months ending September 2010. <u>In short, the fall in NIM means that funding costs grew faster than interest income over the period</u>.

Graph 8 – Banks' net interest margin (NIM)



Source: UBS Research

Due to the protracted nature of the GFC and the need to rollover term funding, at higher cost, pressures on refinancing costs continue for Australia's banks.

Prior to the GFC, in late 2005 and early 2006, the average NIM of the four major banks was in the range 230-233 basis points. With the onset of the GFC, the cost of funds quickly increased and, as a result, margins tightened, reaching a low of 206 basis points in the first half of 2008 – this can be seen in the trough in the data series over the period from mid 2007 until mid 2008 (Graph 9). In essence, during this early period of the GFC it is reasonable to suggest that banks were absorbing higher funding costs across their lending books.

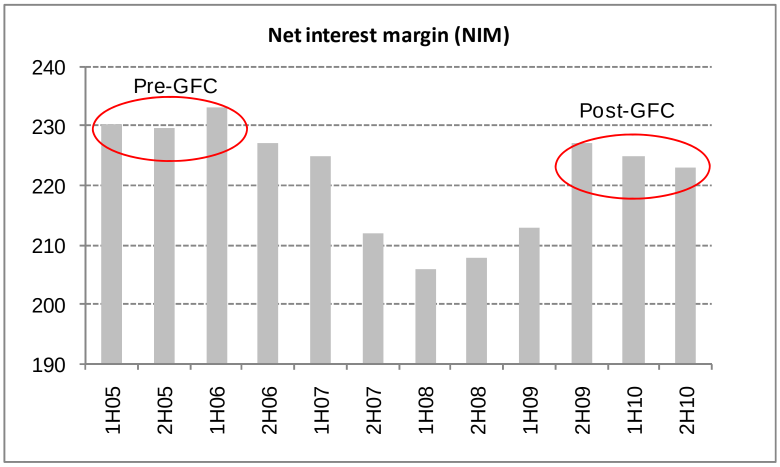
During 2008 and early 2009, banks started to re-price risk and pass on more of their funding cost increases to customers. By late 2009, margins were briefly starting to restore to levels just prior to the GFC. However, over 2010, there has been continuing pressure on the cost of funds due to continuing strong competition for deposits and the need to rollover term funding at higher cost. In fact, interest rates for some deposit products are now even above the official cash rate.

[19] The ABA notes that the difference between the average interest rate on a bank's interest-earning assets and its average cost of funds is called the bank's interest rate 'margin'.

[20] The ABA notes that NIM includes banks' lending portfolios (residential and business loans) as well as other banking activities. Over recent years, banks have been re-pricing business loans due to concerns over economic expectations, higher losses and other lending factors.

According to UBS data, which is based on results for the four major banks as at the end of reporting for 2010, the net interest margin is 223 basis points. Over the past two half year periods, margins have fallen by 2 basis points each half, or 4 basis points in total.

Graph 9 – Banks' net interest margin (NIM) – by half year



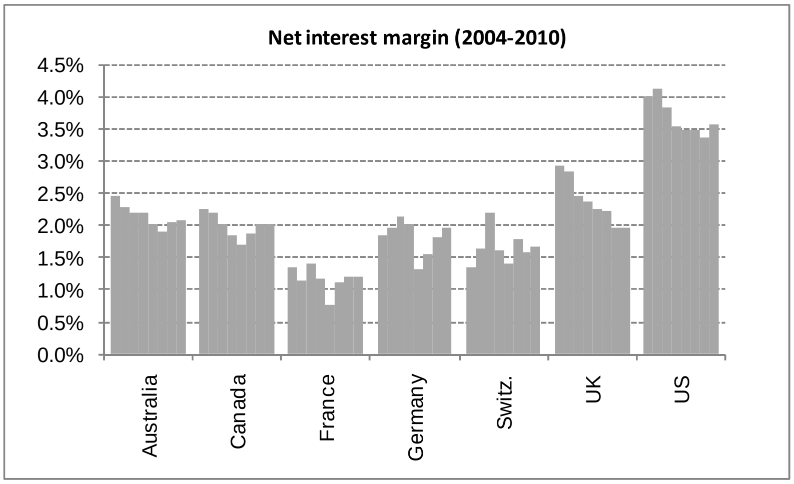
Source: UBS Research

According to UBS data[21], the net interest margin for Australia's main retail banks is generally within the range of 2.0% to 2.5%. (It is noted that the RBA also shares this view regarding the longer term data series.) In 2010, UBS forecast that the average NIM for Australia's banks would be 2.07% while the global average will be 2.06%. The average for the US banks in 2010 is forecast to be 3.57%, which is considerably higher than for Australian banks. The average for the UK banks in 2010 is forecast to be 1.95%, which is lower. However, when two of the larger UK banks currently with extremely low NIM due to their financial circumstances as well as domestic economic circumstances are removed, the average is adjusted to 2.46%, which is higher than for Australian banks.

Graph 10 shows a trough in the net interest margin in the early stages of the GFC for several countries, such as Australia, Canada, France, Germany and even Switzerland with margin rebuild occurring after that. Interestingly, margins do not return to the levels over the earlier years of the data series for these countries. However, for the United States and the United Kingdom margins continue to show trend decline, symptomatic of the problems which continue to be faced in these economies and their banking systems.

[21] The ABA notes that data for Australian banks in this graph may not be the same as data presented in the previous section, although the data series pattern is consistent. The reason for the difference in the data between the two NIM data series is a result of applying a standardised methodology to present the international data series in a comparable manner across jurisdictions.

Graph 10 – International comparison of net interest margin (NIM)



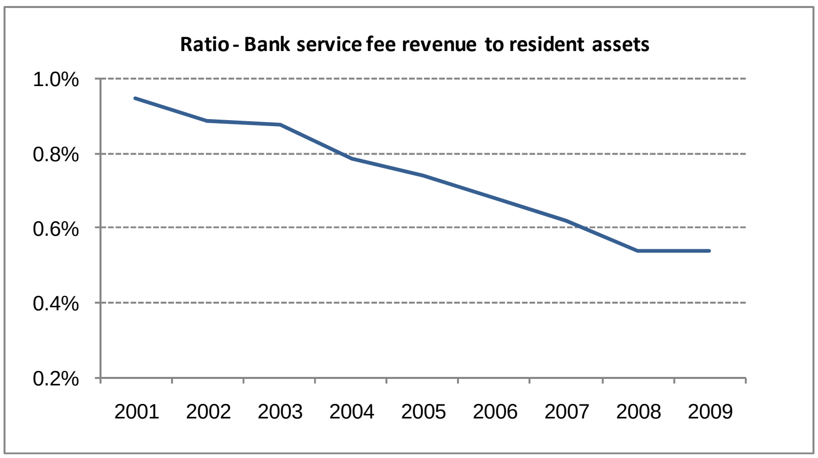
Source: UBS Research

The RBA's Monetary Policy November 2010 meeting minutes outlined:

> Most banks had reported a small reduction in net interest margins in their most recent half-yearly accounts, though some had experienced an increase. Deposit competition appeared to have levelled off in recent months. In debt markets, spreads on short-term bank bills had narrowed to be not far above pre-crisis levels. Spreads on longer-term bank debt had stabilised at levels that were significantly higher than before the crisis. This was slowly adding to the banks' cost of funds as banks rolled over debt issued earlier at lower spreads. Members noted that there was a possibility that banks would increase interest rates on loans by more than any move in the cash rate.[22]

In addition to the decrease in net interest margin, net fees paid by customers as a percentage of banks' total assets also dropped during the period, to a low of just 0.54% in 2009.

Graph 11 – Banks' non-interest margin (fee ratio)



Source: RBA data / ABA calculations

The above graphs show that banks' pricing decisions on interest rates and fees have together reduced costs for consumers.

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[22] http://www.rba.gov.au/monetary-policy/rba-board-minutes/2010/02112010.html

The ABA is concerned that the focus by some public commentators on banks' margins, and the need to decrease margins as a measure of competitive markets, could result in short sighted and adverse outcomes for the Australian banking industry. If margins are too low and risk premium is priced out, then this could lead to bad lending practices (such as those in the US sub-prime market). Alternatively, supporting an expansion of margins to long term trend levels is likely to result in additional competition being drawn into the market.

The ABA notes that determining aggregate cost of funds requires a very detailed analysis of all funding components and how these components are changing. It is different for each bank and is dynamic depending upon the specific mix of funding, products and markets used. (See Appendix 3 for an overview of banks' funding sources.)

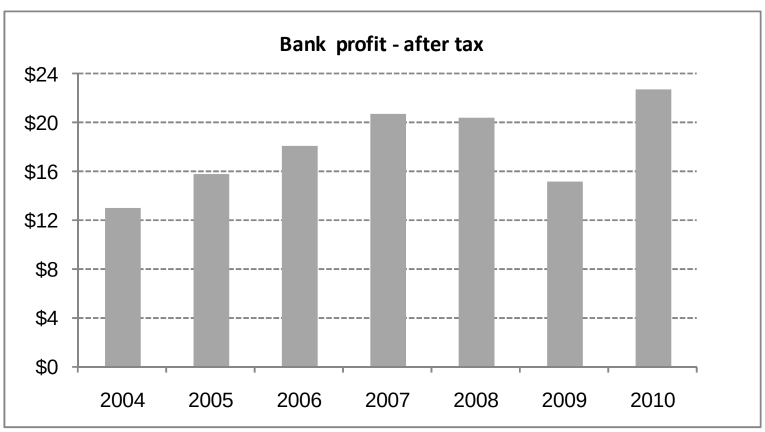
The evidence shows that banks' funding costs have increased, yet net interest margins have declined. Despite recent increases in mortgage interest rates by banks, due to continuing pressure on cost of funds, the decline in margins demonstrates that Australia's banks are absorbing some of these costs. Additionally, there is no clear evidence that consolidation in the Australian banking industry has resulted in increased margins.

2.5 Facts about bank performance and profits

Despite the difficult market conditions, the Australian banking system has withstood the worst of the GFC. There are a number of contributing factors for the resilience of the Australian banking system. However, the profitability of Australia's banks is critical to the stability of individual institutions and the system as a whole. As participants in financial markets, banks have generally performed well. Since the early 1990s, when the banking system came under strain, Australia's banks have produced consistently solid results. Throughout the GFC, banks remained sound, although the current data shows that profitability is yet to return to average levels.

In 2010, profit after tax for the main retail banks was $22.7 billion showing a recovery after two years in which bank profits fell. This fall in bank profits in 2008 and 2009 can be attributed to the market conditions created by the GFC. During this period there was a slowdown in economic growth and demand for credit and an increase in provisioning for bad debts. In the very early period of the GFC, Australia's banks generally absorbed the increase in funding costs, and hence to some degree, banks' lagged actual changing conditions in the markets.

Graph 12 – Banks' net profit after tax

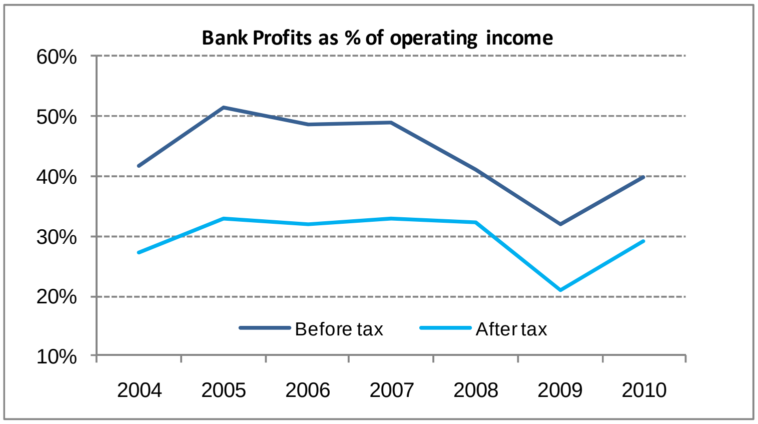


Source: Bank Annual Reports

Ratio: Profit to operating income

The latest data shows banks increased profit margins in 2010, but the current level of 29.1% is well down on the long-term average of 32.5%.

Graph 13 – Banks' profit as % of operating income

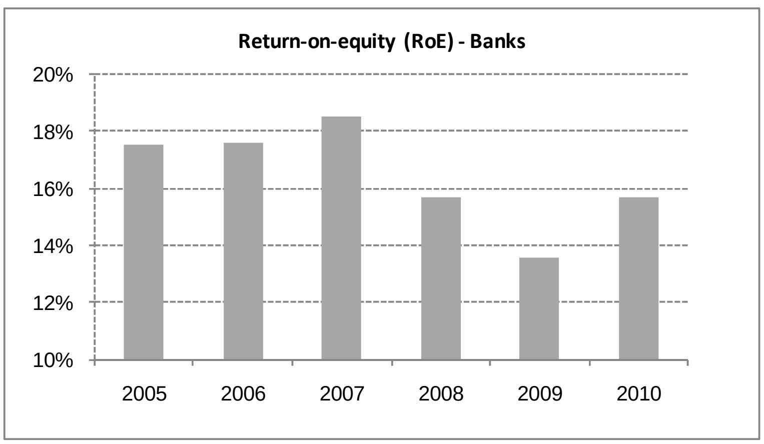


Source: Bank Annual Reports

Ratio: Profit after tax to total assets (ROE measure)

The most common measure of bank performance is that of return on equity (ROE). Overall ROE for the major banks increased from 13.6% in 2009 to 15.7% in 2010. Current bank ROEs are still significantly down from pre-GFC levels, with the long-term average over the three years prior to the GFC being 17.8%.

Graph 14 – Banks' return on equity



Source: Colonial Research

The ABA notes that Australia's banks ROE (based on all banks in the ASX Index, not just the major banks) is not as high as other industry sectors on the ASX. Furthermore, on an individual company by company basis, the major banks can be half the ROE of other large Australian companies.

Table 2 – Australian Market (ASX200) Return on Equity

	2005	2006	2007	2008	2009
Banks	16.3	18.2	19.7	17.4	14.8
Consumer Goods	21.5	22.9	23.3	24.1	17.8
Resources*	36.8	47.4	41.7	27.6	22.0
Industrials	15.2	9.0	16.6	15.0	4.1
Telecommunications	22.8	19.4	20.6	20.4	21.6
Consumer Services	18.5	20.5	19.6	13.5	12.4
All ASX200	*18.5*	*20.2*	*20.4*	*16.7*	*14.1*

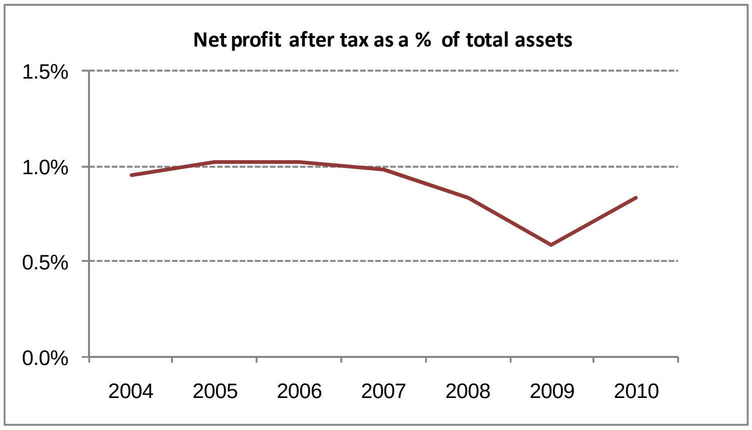
* Resources is mining and energy, excluding basic materials

Source: Reuters / DataStream

Ratio: Profit after tax to total assets (ROA measure)

Return on assets (ROA) is a common indicator of bank performance as a measure of the underlying capacity of banks to generate revenue from loans. In 2010, the ROA was at 0.9%, whereas the average from 2004 has been 1.0%. Profit after-tax as a proportion of total assets has been at low levels throughout the GFC.

Graph 15 – Banks' profit as % of total assets



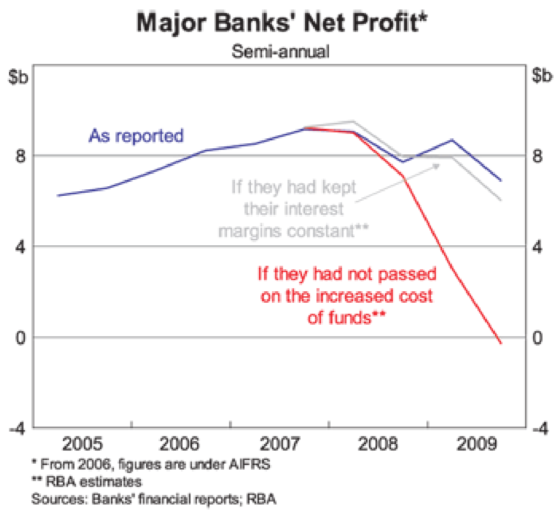
Source: Bank Annual Reports

The ABA is concerned that the focus by some public commentators on bank profits and the need to limit profitability or the need to limit interest rate rises could result in significantly damaging outcomes for the Australian banking industry and the wider Australian economy. Furthermore, we are concerned about the perception that bank profit is revenues only generated by retail banking activities. Australia's banks do not only provide retail banking services, but also provide other banking, finance and trading services, including funds management, insurance, stock broking, business and agri-business services, corporate advisory services, and institutional banking.

According to the RBA, the adjustment of lending rates during the GFC, which resulted in increases in interest rates beyond the official cash rate, was necessary, otherwise banks would have incurred losses.

On 16 December 2010, the Reserve Bank Deputy Governor stated:

> …the push by banks to increase the share of their funding that comes from deposits has added substantially to their costs. At the same time, the cost of long-term debt has risen sharply relative to the cash rate because of the global crisis.
>
> These changes in banks' cost of funds relative to the cash rate have meant that the relationship between bank lending rates and the cash rate has also become looser. It is difficult for banks to adjust their lending rates in line with changes in the cash rate when the cost of their funds is rising substantially relative to the cash rate.
>
> We estimate that if banks had not adjusted their lending interest rates to reflect their higher cost of funds over the past couple of years, they would now be incurring losses. That would have threatened their ability to keep raising funds and, in turn, their capacity to lend.[23]



If Australia's banks are unable to demonstrate solid profitability, there would be a direct impact on banks' ability to raise funds for households and businesses. Bank performance measures are critical for a bank to retain a high credit rating – without a high credit rating, the cost to access money and capital markets is higher. If banks have to pay higher rates for money, then individuals and businesses will also pay higher rates to borrow from banks.

The evidence shows that banks' performance measures declined during the GFC and have not yet fully recovered. Despite the strong performance of the Australian banking system throughout the GFC and financial stability of Australia's banks, bank profits continue to lag long-term trends and have not recovered to expected trend levels. Apart from economic conditions influencing profitability, Australia's banks have also responded to community demands and reduced or removed unpopular fees – this has had a direct impact on bank profits.

2.6 Facts about distribution of bank income

The ABA notes that some commentators allege that bank actions are aimed solely at deriving profit for shareholders. While it is true that as public companies – operating under the *Corporations Act 2001* – banks are required to undertake actions that will advance the interests of their shareholders, the extent to which other stakeholders have an interest in bank performance is often overlooked.

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[23] Battellino, R (2009). Some comments on bank funding – Remarks to the 22nd Australasian Finance & Banking Conference. 16 December 2009. http://www.rba.gov.au/speeches/2009/sp-dg-161209.html

Bank income is derived from two primary sources, that of interest repayments on loans and fees and charges. In 2010, total bank income was $187 billion. This is a substantial proportion of Australia's economy, roughly 15%. From this amount, banks then make distributions to a wide range of stakeholders, including:

- depositors that receive interest income;
- borrowers who are late on repayments (effectively they are consuming income);
- bank staff;
- businesses that provide services and equipment to banks;
- government (through taxation); and
- shareholders, including superannuation funds (through retained earnings and dividend payments).

Table 3 – Distribution of bank income by stakeholder

	2005	2010	Change
Depositors	50.3%	51.3%	0.9%
Bad and doubtful debts	2.1%	6.6%	4.5%
Bank staff	13.0%	11.5%	-1.5%
Service and equipment providers	15.3%	14.4%	-0.9%
Government	5.5%	5.7%	0.2%
Shareholders	13.7%	10.5%	-3.3%

Source: APRA data / ABA calculations (as at 30 November 2010)

In 2005, depositors (which include large depositors holding bonds and other securities) accounted for over 50% of total bank income. In 2010, this proportion increased to 51.3%. This has been an important for individuals and businesses. Personal deposits include a high proportion of older people and self-funded retirees, especially term deposits.

Bad and doubtful debts have recorded the largest percentage increase over the last five years (although the base proportions are low).

In 2010, shareholders have experienced deterioration in the proportion of bank income that they receive. In some ways this is surprising, certainly given that capital levels have increased markedly between 2005 and 2010. In other ways, this is a natural response from listed companies that generally reduce dividend payments during difficult market conditions and periods of decreased profitability. Notwithstanding, Australia's banks continue to provide good yields for shareholders. Given that banks comprise around 25% of the ASX Index, this has been an important factor for the recovery of the Australian stock market and the more recent performance and recovery of superannuation for Australian superannuants.

In 2010, the Government (through tax revenue excluding guarantee payments) received 5.7% of bank income, up marginally from 5.5% in 2005. Interestingly, the figures show that in 2010, the government received more than half of what shareholders received.

The evidence shows that bank income is not just for the benefit of shareholders.

2.7 Facts about the government guarantee

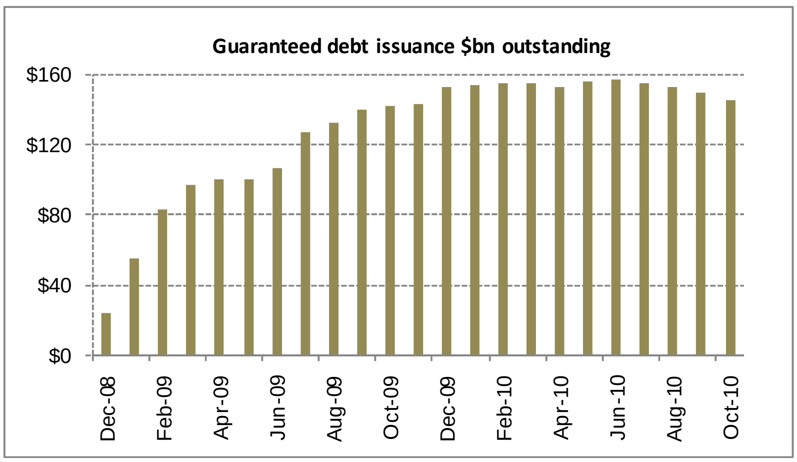
In October 2008, the Australian Government announced guarantee arrangements for wholesale borrowing. Given that these guarantees were being implemented in a number of other countries – as a result of huge disruption to financial markets at that time – it was important that Australia also had such a system in place to ensure continued and smooth access to capital markets.

As at the end of October 2010, the total guaranteed debt issuance stands at $144.9 billion[24].

Apart from government distributions via company and other explicit taxes paid by banks, some banks also provide an ongoing monthly revenue stream to the Government over the life of a guaranteed debt issuance (with some maturities to 2014).

As at the end of October 2010, banks participating in the scheme have paid $2.1 billion to the Australian Government, and are expected to pay around $5.5 billion by the end of the scheme.

Graph 16 – Guaranteed debt issuance outstanding



Source: Australian Treasury

The evidence shows that instead of taxpayers' monies being used to bail out banks, like in many other countries, Australia's banks have contributed to government revenue as a result of the wholesale guarantee.

Summary

The ABA believes that Australia's banks remain well capitalised and well managed, which has been instrumental in ensuring the stability of the Australian banking system and the strength of the Australia economy.

However, contrary to some public commentators, banks' performance indicators are lagging long-term trend levels, including on ROA and ROE measures.

Australia's banks continue to absorb the increased cost of funds that have characterised the global markets since the onset of the GFC – this is demonstrated in the declines in net interest margins, and current margins being below long-term trend levels.

Australia's banks profitability continues to lag long-term trends and has not recovered to expected average levels.

[24] The ABA notes, on 7 February 2010, the Australian Government announced the removal of the wholesale funding guarantee.

3. Competition in key financial product markets

The ABA believes that the best way to assess whether there are competition issues is to examine the individual key financial product markets of importance to consumers and small business. The following is the ABA's analysis of the current state of those markets.

Summary—key findings

The ABA's key findings are:

- The housing finance market continues to be a competitive sector, although the competitive dynamics have changed since the GFC with the decline in market share of the mortgage originators and smaller lenders. Based on Cannex product listings alone there are more than 100 institutions actively marketing home loans with over 500 products to choose from. Current interest rates are above long-term averages.

- Heightened competition in the deposit market is a notable feature of retail banking since mid 2007, as intermediaries have sought to reduce exposure to wholesale markets. All retail banks, building societies and credit unions offer deposit products and current interest rates are well above long-term trends and margins are more favourable for depositors.

- The market for small business finance has become more competitive through 2010 as banks and other suppliers seek to grow their business credit portfolios. Concerns over inadequate supply of small business credit appear to have declined. Interest rates on small business loans are higher than long-term trends and interest rate margins are higher than for housing lending, broadly reflecting the greater credit risk[25] associated with SME lending. Banks have been actively advertising for small business customers and have been recruiting significantly more business bankers.

- The personal lending market is divided between two products – personal loans and credit cards. Personal lending overall has declined from 9% of total lending in the year 2000 to 7% today[26]. Credit cards account for about one-third of total personal credit. There are 64 providers of credit cards that actively market over 300 card products. Interest rates are higher than for other lending products, reflecting the nature of the product, but there is a wide choice of products. Interest rates range from 0% to 21.49%.

While the data shows healthy competition in key financial product markets, there are medium-term challenges. The most significant is the relative funding costs of categories of lenders. The gap between the average cost of funds for the major banks and that of credit unions and regional banks has widened since 2007.

The ABA's submission argues that the key financial product markets remain sound and provide good value for customers. As the major participants in the markets, the banks have contributed strongly to the value being generated.

It is important to recognise that just because one type of institution, such as mortgage originators, is less competitive today than pre-GFC; this does not mean the housing loan market is less competitive from a consumer's perspective. All markets evolve over time, relative costs between suppliers shift continuously, and in every market this natural process produces beneficiaries and disadvantages others. Public policy should not aim to alter this natural process but confine actions to overcoming any short-term shocks to the process.

[25] The ABA notes that the higher credit risk with business lending is due to higher probability of default (PD) and loss given default (LGD), higher capital charge imposed by regulations, and the higher cost to acquire and service.
[26] Derived from RBA statistics. June 2010.

The GFC was one such shock and there is a case for government actions to ameliorate its impacts on a temporary basis. Any long-term subsidies or lop-sided regulatory solutions should only be pursued with full cost-benefit analysis and appropriate community consultation.

3.1 Participants in financial markets

It is important to recognise that banks are simply participants in financial markets; they do not per se constitute markets themselves. The key role of financial markets is to facilitate the transfer of money from savers to investors. While banks are the dominant form of intermediary, they control only 57% of total financial assets[27].

The next largest intermediary group by assets is the superannuation funds, which have roughly 20% of total financial assets. Table 4 shows that there are 13 different categories of financial intermediaries operating in Australia.

Table 4 – Financial intermediaries by % assets

Institutions	% total assets
Reserve Bank	2%
Banks	57%
Building societies	1%
Credit unions	1%
Money market corporations	1%
Finance companies	2%
Life insurance offices	4%
Superannuation funds	19%
Public unit trusts	6%
Cash management trusts	1%
Common funds	0%
General insurance	3%
Securitisation	3%
Total	**100%**

Source: RBA data / ABA calculations

In addition to sourcing funds through intermediary institutions, investors can directly source funds through various financial markets – bypassing intermediaries. The two most common forms of direct financing are the equity and debt markets.

Companies can raise money by directly issuing share stock on a public exchange such as the Australia Securities Exchange (ASX), or through private equity placements. Similarly, companies can issue bonds[28] and other securities in their own name. At a conceptual level, these direct forms of finance compete with intermediaries in the process of transferring money from savers to investors.

This is relevant to discussion over competition and regulation. By focussing only on intermediaries and not markets in general, policy solutions can create distortions. One lesson reinforced by the GFC is that capital typically migrates to where regulation is lightest.

[27] Derived from RBA data. June 2010.
[28] One major bank is pioneering a 'retail' bond issuance.

The most commonly cited example is the non-bank mortgage securitisers that pioneered sub-prime lending in the United States. The lesson is that unless regulation can adequately cover all participants operating in relevant markets (e.g. even the broad market involved in transferring savings to investors), then policy makers should ensure there are sufficient benefits in doing so.

3.2 Housing finance market

3.2.1 Context to competition in housing finance

The market for housing finance constitutes the largest market for Australia's domestic banks and has increased in importance over the last two decades, accounting for around 60% of total lending. In 1990, the proportion of bank lending to housing accounted for only 40% of their total lending.

Until the 1980s, the Government imposed controls on bank interest rates and credit growth. These controls had the effect of muting competition in the housing finance market as banks were disadvantaged compared with housing lenders that faced less regulatory control, such as credit unions and building societies.

Even after deregulation in the mid-1980s, the banks looked more to the business lending market to compete than the housing market. It wasn't until the early 1990s when banks – scarred from losses on business and property loans – began rebalancing their lending portfolios towards housing lending. This coincided with the entry into the housing finance market of non-bank mortgage originators.

Initially, the mortgage originators offered deeper interest rate discounts to housing borrowers than the banks. They were able to do so because they were not encumbered by the costs of large and expensive branch networks.

Also, because the early 1990s recession had dramatically reduced inflation in the economy, interest rates were very low compared with the 1980s. This reduced the relative funding benefit banks received from low-cost deposit balances.

Competition from mortgage originators put downward pressure on housing interest rate margins throughout the 1990s and into the new decade. By early in the new decade, however, there were other factors – apart from mortgage originators – that contributed to competitive pressure. A large and efficient mortgage broker network had established itself. By the middle of the decade, 30% of all housing loans were being originated through brokers.

The second factor contributing to competition was the enhanced use of the Internet. The Internet reduced search costs for prospective housing loan borrowers, enabling them to more easily compare loan products online, including fees and charges. This process was assisted by free product comparison websites, such as that provided by Cannex.

The third factor was greater focus by foreign-owned subsidiaries on Australia's retail banking markets. When foreign banks first entered the Australian market in the mid-1980s, their initial competitive focus was large businesses and property lending. Starting in the late 1990s, there was greater interest in the retail market.

The competitive dynamics in the housing finance market was changed materially in mid-2007 with the commencement of the GFC. Housing finance was particularly impacted early on as the GFC trigger was high default rates on securitised US housing loans and, specifically, sub-prime loans similar in nature to 'non-conforming' loans in Australia. The crisis badly damaged investor confidence in all securitised housing assets and, indeed, other asset-backed securities, even though Australian RMBS continued to perform well. It became obvious by late 2007 that mortgage originators were having trouble finding investors to fund securitised loans and that this would impede mortgage originators' and other institutions reliant on securitisation to compete.

Without adequate funding, mortgage originators and other lenders were forced to find new and stable sources of funding. Some managed to secure lines from Australian banks. Some closed their doors and sold their assets to banks and credit unions. Others merged with banks.

The funding difficulties of mortgage originators and smaller lenders led the Australian Government to commit to invest $16 billion in RMBS. The investment is based on the stated policy rationale of improving competition.

3.2.2 State of competition today

Market size and growth rates

The current amount of housing debt outstanding is $1.1 trillion. This accounts for around 60% of total intermediated credit in the economy – 70% of the debt is for owner-occupiers and 30% for investors.

Growth in housing credit is currently well under the long-term average. Since 2000, total housing credit has grown on average at 14% per annum. In the twelve months to October 2010, growth was only 7.7%.

For investor housing, the gap between long-term growth rates and current rates is even more dramatic. The average growth in this type of housing lending since January 2000 was 15.6% per annum, whereas the last twelve months resulted in growth of only 8.1%.

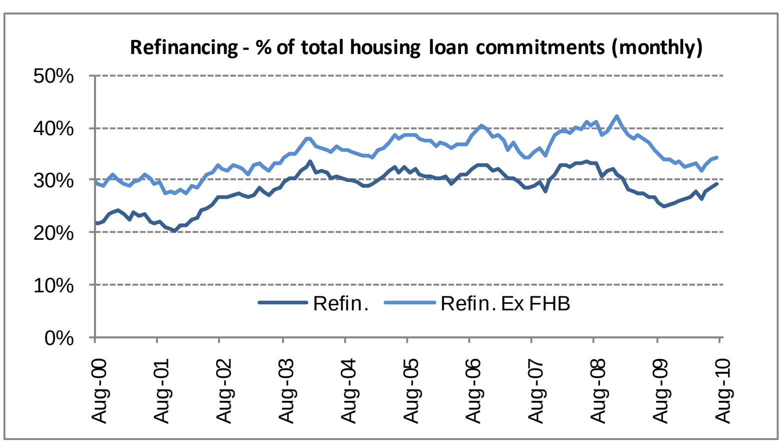
Slower housing credit is putting profitability pressure on banks. Housing is the main source of interest income for banks and slower loan growth makes the task of increasing returns to shareholders more challenging. It is, in fact, this slower growth level that will help underpin competition in the sector.

Indeed, in September and October 2010, banks announced increases in their maximum loan-to-value ratios (LVRs); partially reversing earlier policies aimed at reducing credit risk exposures. This is a sign that banks are seeking to increase volumes of housing credit and are willing to take on some more risk to do so.

Refinancing activity

ABS monthly housing finance data shows that, over 2010 to date, 28% of all housing loans commitments made to owner-occupiers are for the purpose of refinancing. If first home buyers (FHB) are removed this increases to 33%. In total, over the past 12 months to August 2010, around 170,000 home loans have been refinanced.

Graph 17 – Refinancing



Source: ABS

<u>Providers and products</u>

While the major and other banks moved to fill the gap in the housing lending market left by mortgage originators and some other lenders, resulting in the major banks increasing market share from a low of 60% in early 2007 to around 75%[29] today, the greater concentration has not adversely impacted housing loan borrowers.

Cannex data shows there are 111 institutions marketing home loans through the Cannex website. These listings show over 500 home loan products. While there might be fewer mortgage originators, there are still plenty of competitors.

Australian customers have access to many differing types of housing loans with many different features. The standard loan in Australia is that of a variable rate loan, with a 25-year maturity, and repayable on an amortisation schedule. But there are many different varieties from this standard, including:

- Fixed rate loan, with terms for one to five years;
- Split loans, where the interest payable is split between fixed and variable;
- Interest only loans, where borrowers pay only interest for up to 15 years;
- Low-doc loans;
- Reverse mortgages – this is where the borrower only pays interest and principle when the property is sold;
- Shared equity loans – this is a product where a third party takes a passive equity stake in the house in exchange for finance.

<u>Pricing</u>

Since the relative decline of mortgage originators and other institutions, it has been speculated that a major source of price competition has been removed from the market. The data does not support this contention.

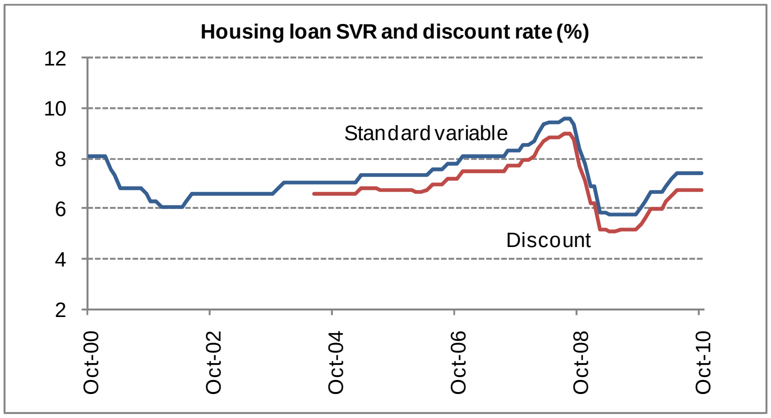
According to Cannex, the average interest rate on a variable home loan is around 6.7%, with a range between 6.31% and 8.34%. 6.7% is roughly equivalent to the average 'discounted' mortgage interest rate offered since 2004[30].

On the latest RBA data published on its website, the major banks' standard variable rate is 7.8% (November 2010). This is 54 basis points higher than the average rate since 2000.

The major banks' current 'discounted' rate is 7.15%, which is about 25 basis points above its average since 2004 (the earliest data available on the RBA's website).

[29] Represents market share of outstanding credit. Note that share of new lending was higher.
[30] The ABA notes that data was sourced prior to the RBA November Board Meeting.

Graph 18 – Selected housing loan interest rates



Source: RBA data

At present, the major banks are offering a 'discount' variable interest rate that is 65 basis points under the standard variable indicator rate (Graph 18). In mid-2007 – before the GFC and when mortgage originators were thriving – the discount offered was only 60 basis points. This is important because there is no media or other pressure on banks to adjust their 'discounts', apart from competition.

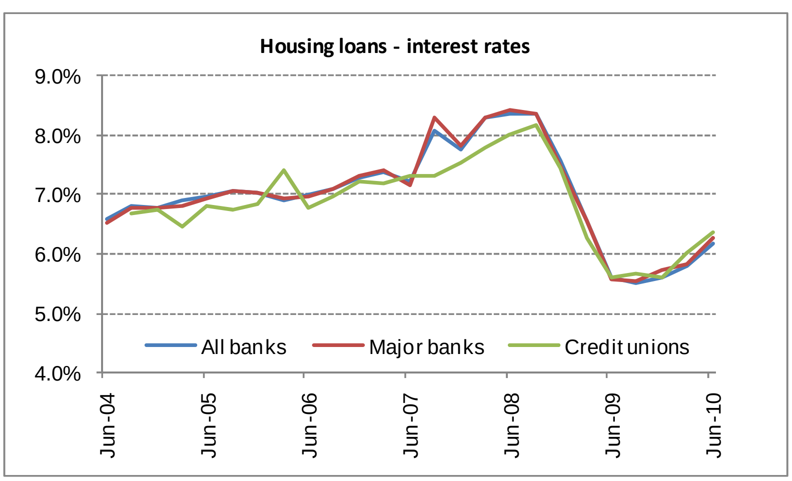
Another factor demonstrating competition in housing lending is the fact that for at least a period of the post-GFC environment, banks were essentially cross-subsidising housing lending. This point was made recently in a Macquarie Bank research report:

> In the early part of the GFC, mortgage repricing lagged business repricing, forming an effective cross subsidisation between the two lending classes.[31]

A further point of evidence of competition is the fact that the implied interest rates charged by the four majors and credit unions are very similar. Graph 19 derives implied housing loan interest rates by dividing total housing interest income by the stock of housing assets. It shows that the real interest rates being charged by these categories of lender are very similar. This indicates price competition.

While pricing is very similar in the housing mortgage market (as demonstrated by Graph 19), it should be noted that interest rate spreads on housing loans appear to be marginally wider for the major banks than for credit unions and other banks.

Graph 19 – Average housing loan interest rates by lender category



Source: Derived from APRA quarterly statistics

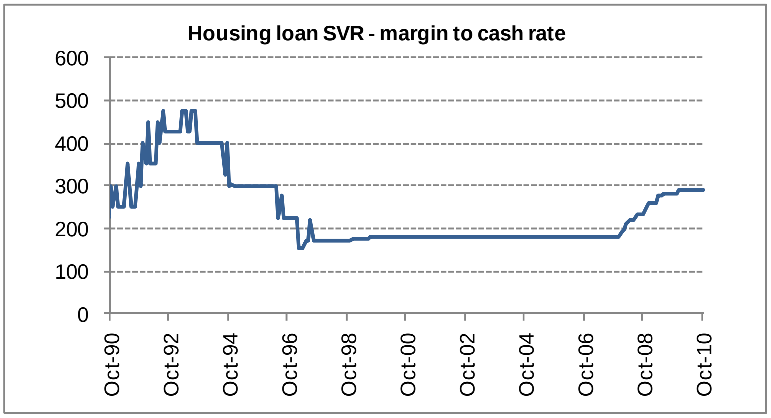
[31] Macquarie Equities Research. 'Regional Banks Competition conundrum'. 17 November 2010.

Margins

The margin between the housing variable rate and the cash rate has historically been used to assess price competition in the housing finance market. Since 2007, there has been a widening in the margin between the cash rate and the standard variable rate (SVR) of around 110 basis points[32].

This movement reflects the fact that since 2007, changes in the cash rate have not fully reflected the increased cost of funding loans.

Graph 20 – Margin on housing standard variable rate to cash rate



Source: RBA data / ABA calculations

Recent trends in market share

In August 2007, the banking sector accounted for 78.4% of new housing loan commitments. The balance of housing commitments was divided between credit unions, building societies and mortgage originators.

With the difficulties in the securitization market and consolidation in the industry, the banks share of new loan commitments rose to a peak of 90% in January 2009. Since then, however, the banks have been gradually losing market share to non-bank lenders. In September 2010, banks accounted for 86.6% of new commitments.

International

In terms of international comparisons, the Australian housing lending margins are consistent with other similar countries. Table 5 gives estimates of margins on the five year mortgage rate against the relevant swap rate. The five year rate was chosen as not all countries have a standard variable rate housing loan similar to Australia's.

The average margin across the countries surveyed is 2.42%. Australia's margin is 2.07%. It should be noted that of all the housing loan products in Australia, there is probably the least competition in the 5 year fixed housing loan market.

[32] The ABA notes that data was sourced prior to the RBA November Board Meeting.

Table 5 – Comparisons of housing lending margins

	Cash rate (%)	5-year fixed mortgage (%)	5-year Swap Rate (%)	Margin vs Swap (%)
UK	0.50	4.85	2.40	2.45
Canada	1.00	5.29	2.50	2.79
NZ	3.00	7.08	4.73	2.35
Australia	4.75	7.79	5.72	2.07

Source: National sources (as at 30 November 2010)

3.3 Deposit market

3.3.1 Context to competition in the deposit market

In the era of Government regulation, banks were restricted in their capacity to compete for deposit balances on price, so the competition centred on service. Banks grew large branch and agency networks throughout the country. When the financial system was deregulated, banks were free to compete for deposits by offering higher interest rates. But, initially, there appeared little incentive to do so as deposit balances were sufficient to fund lending growth. (At that time, the cost of operating deposit accounts and branch networks was subsidised through higher lending margins).

It wasn't until the early 1990s when the Hawke/Keating Government introduced compulsory superannuation laws and tax incentives for voluntary superannuation contributions, that a gap emerged between the level of deposits and the funding needed for loan growth. Compulsory superannuation drew deposits away from banks and into superannuation trusts.

Throughout the 1990s, the emerging gap between deposits and loans did not pose any difficulties as Australia's banks found easy access to wholesale debt markets.

Initially, banks looked mainly to the domestic capital markets to supplement their deposit funds, but eventually the growth of the Australian economy and demand for credit, particularly housing credit, was such that larger banks needed to look offshore to acquire sufficient funding.

Up until 2007, banks appeared to easily access wholesale funding, aided by a glut in world savings and low official interest rates in the USA.

Notwithstanding, competition in retail deposits started to heat up in the late 1990s. An Australian subsidiary of a foreign bank began targeting the Australian retail market. It offered a high interest rate savings account, with the only restriction being that it did not allow branch access to service the account.

This started a new line of competition in the deposit market. The Internet-based accounts paid higher interest and allowed more transactions than a standard savings account.

Between 2000 and 2007, deposit competition remained strong with more institutions introducing high-interest Internet accounts. Other signs of competition included the introduction of deposit accounts that did not charge transaction fees, but offered customers unlimited transactions for a monthly fee.

Bank fee data also shows that the ratio of revenue from fees on deposit accounts, relative to bank assets, declined significantly throughout this decade.

When the GFC hit in 2007, there was an immediate impact on competition in the deposit market.

The financial crisis highlighted the vulnerability of banks to liquidity strains and, specific to Australia, the vulnerability of a bank relying on high levels of wholesale funding to support its loan book, particularly short-term funding. As a consequence, since late 2007, Australian banks and other institutions have competed much more intensively for deposit balances.

3.3.2 State of competition today

Unlike housing lending, the Government prudentially regulates deposit-taking as a business. APRA authorises only three categories of deposit-takers: banks, building societies and credit unions. Banks dominate the retail deposit market, with total market share of around 95%, although credit unions dominate in overall numbers of institutions and advertise that they have around 4 million customers.[33]

Table 6 – Numbers of Authorised Deposit-taking Institutions

Institution type	Number
Retail banks	
. Australian owned	12
. Foreign owned subsidiaries	11
Building societies	11
Credit unions	106
Total	**140**

Source: APRA data

<u>Market size and growth rates</u>

In Australia today, there is roughly $1.4 trillion[34] in bank deposits equivalent to around 58% of total liabilities. Since the GFC, banks have enjoyed strong growth in deposit balances, particularly in 2007 and 2008, when economic uncertainty led many households and businesses to invest in the safety of bank deposits. Deposit balance growth benefitted from government guarantees as funds shifted towards deposits and away from some non-guaranteed savings products.

<u>Products and providers</u>

The retail deposit market can be usefully viewed from a product perspective. There are three broad categories of deposit products: (a) transaction accounts, (b) savings and online accounts, and (c) term deposits. Savings, online and term deposits account for around 70% of total balances, and transaction accounts constitute 30%.

From a bank's perspective, the most valuable deposit balance is that held in a transaction account. These accounts are designed to manage an individual's day-to-day purchase of goods and services and they typically pay low interest, although fees on these accounts have fallen over the last decade.

Interest rates on transaction accounts have not increased materially in recent years.

[33] Roy Morgan Research shows, as at December 2009, banks are the *main financial institution* chosen by 15.1 million customers aged 14 and over. This is an increase of 3.0% or 444,000 customers over the past year. Credit unions are the main financial institution for 1.7 million customers while for building societies it is 578,000 customers.
[34] This total includes deposits in addition to household and business retail deposits. It includes, for example, deposits by large pension funds.

Savings accounts

Savings accounts encompass 'bonus saver' accounts; 'Internet' based accounts and 'cash management' accounts. They are distinguished from transaction accounts because they pay higher interest but are designed for accumulating balances as opposed to managing day-to-day purchases of goods and services.

There are 40 providers actively marketing savings accounts through the Cannex website. These providers have listed 47 products. Interest rates on these products vary from 0% to 4.75%.

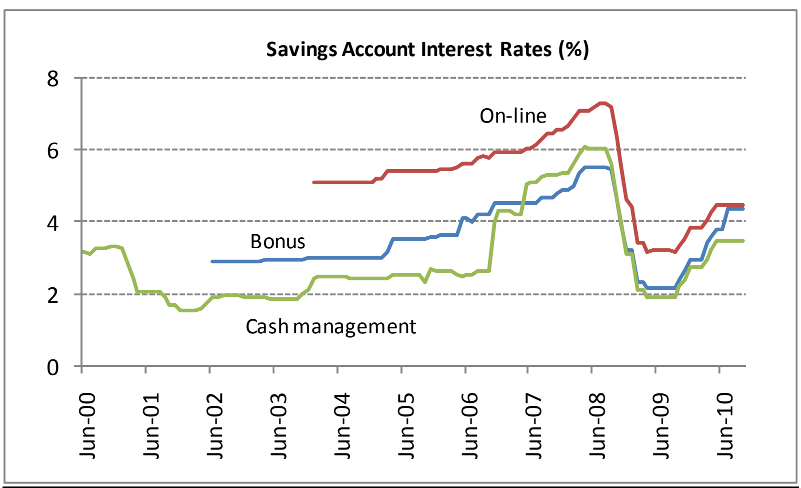
The RBA publishes deposit indicator rates, which are averages of interest rates offered by the major banks. This data shows that 'bonus saver' accounts are offering rates of about 4.65% - which is 105 basis points above the long-term average rate since the data series commenced in June 2002.

Cash management and online savings accounts

Cash management accounts are offering deposit rates of 3.70%, which are 75 basis points above their long-term average (since 2000).

Interestingly, while Internet based accounts still offer the highest rates – currently averaging 4.65% – this rate is below the long-term average rate, probably reflecting the degree of competition focussed on Internet accounts since their inception in the late 1990s. However, in the market today, some institutions are offering Internet accounts paying up to 6.5%.

Graph 21 – Savings account interest rates



Source: RBA data

Term deposits

The third category of deposit account is the term deposit. These accounts have fixed terms, ranging from three months to five years. They pay higher interest rates but the trade-off is that money cannot be accessed (without incurring early termination costs) until the term expires.

The term deposit market is a current source of strong competition amongst providers. The Cannex website[35] shows that:

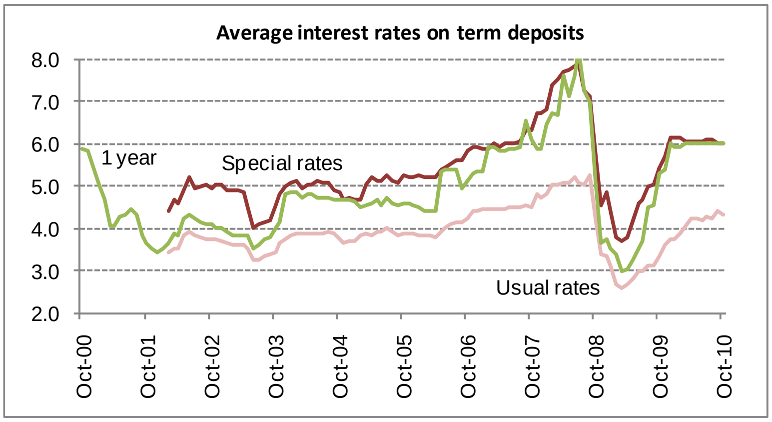
- Ninety institutions are competing to offer three-months term deposits. Rates range from 2.0% to 6.15%. The average rate is 4.68%.
- The same number of institutions is offering 180 day term deposits. The range is from 2% to 6.30%.
- Ninety two institutions are marketing one-year term deposits. The maximum rate as listed by Cannex is 6.5%.
- Fifty five institutions are offering three-year term deposits with the maximum rate available 7.13%.

RBA data tells a similar competitive story. The central bank publishes estimates of 'average' deposit rates and also 'special' term deposit rates. Currently:

- The average term deposit is 4.40% – 40 basis points above the long-term average (since the data series commenced in February 2002);
- The 'specials' term deposit rate is 6% – 57 basis points above the long-term average (since the data series commenced in February 2002);

In conclusion, the interest rates being paid on household and business deposits are very favourable to consumers. It indicates that the strongest competition in retail banking has moved to the liability side of the bank's balance sheet.

Graph 22– Average term deposit interest rates



Source: RBA data

[35] The ABA notes that data was sourced prior to the RBA November Board Meeting.

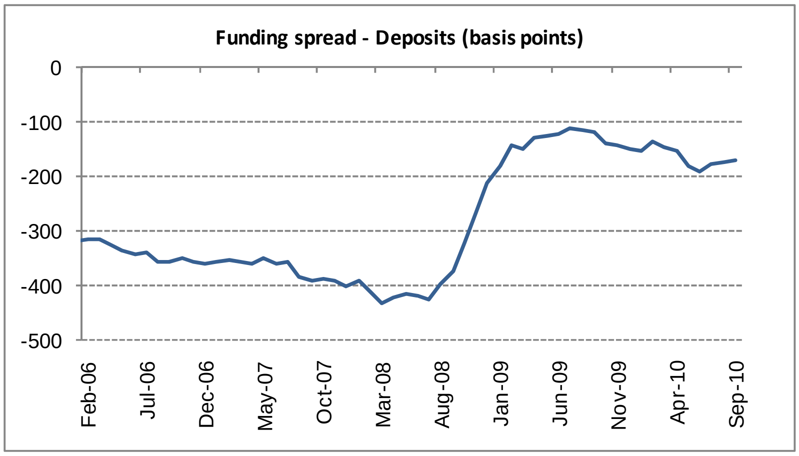
Margins

The estimated spread on overall deposits to the cash rate is currently 171 basis points, meaning that current rates are 171 basis points below the cash rate. This represents a considerably higher rate of interest relative to the cash rate since the levels applying pre-GFC.

In the two years prior to March 2008, average deposit rates were around 430 basis points below the cash rate.

The peak in deposit rate margins was in late 2009 with average rates around 100 basis points below the cash rate.

Graph 23 – Margin on deposits



Source: RBA data / ABA data / ABA calculations

The higher deposit rates relative to the cash rate reflect strong competition in the deposit market as lenders attempt to increase their level of deposit funding, which is viewed as a more stable funding source.

3.4 Small business finance market

3.4.1 Context to competition in small business finance

Businesses have four main sources of financing, each offering different risk and return characteristics. First, businesses can issue equity in their business, either on a private basis or by listing stock on a publicly traded exchange.

Second, they can borrow directly from the public by issuing debt securities in their own name. Third, businesses can invest operating profits back into their business. And fourth, they can borrow from lenders such as banks.

For small businesses and medium (SME) sized businesses, often defined as those businesses with loans under $2 million, the latter two options (re-investing earnings and lending) are most applicable, as issuing debt or equity directly to the public is uneconomic and often impractical on a small scale.

A key issue in the small business finance market over many decades has been the ease of access small businesses have to bank loans and, to a much lesser degree, the interest rate payable on those loans.

The issue of small business access to bank finance appears to have emerged sometime in the 1960s. The 1965 Vernon Inquiry – a major investigation into Australia's economy – noted that it had received some representations from business that accessing bank finance was difficult.

After commissioning some expert opinion, the Vernon Committee concluded that the demand for finance by small business was being reasonably well satisfied, although it did recommend further investigation.

Against a backdrop of high and sustained inflation, in 1978 the Fraser Government commissioned a major inquiry into the financial system, known as the Campbell Inquiry. Access to finance by small business was investigated by the Committee. In its conclusions, the Inquiry found that any deficiency in the supply of small business finance was likely to be related to the restrictive regulatory environment.

Deregulation of the financial system in the mid-1980s liberated banks to compete more aggressively in the business finance market. This competition was spurred by the entry of 15 foreign banks in 1985. The period of 1985 to 1990 marked a considerable expansion in business and property lending, including SME finance.

This period of credit expansion spilt into property prices and this is one of the factors that helped create the conditions for a significant recession in the early 1990s. The losses on bank business and property lending were material and this lead to a re-evaluation of business and property lending risk. (While the losses in the 1990s recession were greatest to large business, small businesses losses were also significant.)

Banks introduced higher collateral requirements and, generally, a more rigorous process to source bank financing was applied, particularly for businesses that had a higher risk profile.

As a result, in the period from the early 1990s to mid-1990s, small businesses and their advocates voiced concerns over access to finance. Yet, the concerns seemed to dissipate over time. From the late 1990s till 2007, business surveys and other evidence indicate that small businesses generally had sufficient access to bank finance. Due to this high availability of funding and competition, margins were contracting on business lending by around 10 basis points per annum[36], and the risk premiums being charged reduced. Some lenders eased their credit standards and non-bank lenders made credit available to segments of the market that were not being served by banks due to their risk profile.

With the commencement of the GFC in mid-2007, the risk environment changed markedly and, as with all periods of economic uncertainty, such as the 1990s recession, the banks and non-bank lenders took steps to re-evaluate risks associated with business lending.

Overall, while some high risk business loan products were removed (e.g. low-doc business loans), banks did not materially change lending policies towards SMEs. The main stress[37] in the market came from the exit of non-bank lenders, suppliers that typically dealt with customers whose risk profile prevented them obtaining bank finance.

In 2009, business surveys showed significant concerns over access to bank finance (see Appendix 4). This concern was magnified because, as already stated, many businesses had become more reliant on bank finance as other sources of finance had become more problematic, such as automobile leasing finance from non-bank financiers.

A Senate inquiry on Small Business Finance reported in 2010 and concluded in relation to the supply of credit that:

"The slowdown in lending to small business appears to reflect a combination of demand factors…and supply factors such as;

- *fewer small businesses being able to meet existing lending standards in the wake of the global recession;*

[36] The ABA notes this estimate is based on discussions with a major bank.
[37] Another point of stress was in the commercial property lending market. Given historically this type of lending has caused problems for banks, it is a fact that banks took steps to reduce their overall exposure to this market.

- *some tightening of lending standards by financial intermediaries. It is arguable that banks were tending towards recklessness in the preceding boom, and that some tightening of credit standards represents a prudent return to 'normal' practice, but there may also be cases where banks are over-reacting; and*
- *non-bank lenders having fewer funds available as securitisation and interbank lending markets dried up and/or interest rates in them became prohibitive."*[38]

Within the categories of business lending, the data shows that lending to the small business sector was reasonably stable through the GFC whereas there were net declines in credit volumes to larger business.

3.4.2 State of competition today

Market size and growth rates

Total business lending, including credit to small, medium and large businesses, stands at $683 billion, equivalent to 34% of total credit in the economy.

Currently, the annual growth rate in overall business lending is -3.2%. Growth has fallen every month for the last three months. The average growth rate in business credit since the year 2000 is 8.4%. This current downturn reflects primarily reduced demand, driven by continued balance sheet deleveraging, concern over the economic outlook and higher interest rates resulting from monetary policy and bank risk repricing.

From a credit supply perspective, there is evidence of a more normal environment since the difficulties experienced in 2008 and 2009. The August 2010 ACCI business survey shows that the issue of access to bank finance does not register in the top 5 constraints to investment in any of the business categories: small business, medium business or large business (see Appendix 4).

Growth in small business lending (that is defined as loans under $2 million) has held up better than the wider business lending market over the last 12 months. It is currently flat, although this category of lending has not experienced a material decline in absolute balances throughout the GFC. Commercial property lending is showing signs of picking up, having declined materially post GFC.

Through the course of 2010, many banks have undertaken extensive advertising campaigns aimed at the small business sector and a number of banks have announced significant expansions in the hiring of business bankers.

Products and providers

The Cannex website includes data[39] on small business lending, deposit and credit cards – see summary in Table 7. It shows:

- There are 26 providers of business transaction accounts, offering 33 products, with interest rates ranging from 0% to 6.15%.
- Fifteen providers of credit cards, offering 37 different products. Interest rates range from 10.98% to 20.4% with an average of 15.66%.
- Twenty four providers of business overdrafts offering 55 different products. Interest rates range from 6.5% to 15.64%.
- Twenty seven providers of residentially secured overdrafts. There are 55 products advertised with an interest rate range of 4.85% to 12.39%. The average rate is 8.43%.

[38] Senate Economics References Committee. Access of Small Business to Finance. June 2010.
[39] The ABA notes that data was sourced prior to the RBA November Board Meeting.

Table 7 – Business banking: Selected products

Market	Provider choices	Product choice	Interest rate range (% annual)			
Business banking	Number	Number	Min	Max	Average	Mode
Business transaction accounts	26	33	0.01%	6.15%	0.45%	0.01%
Business Credit cards	15	37	10.98%	20.40%	15.66%	17.15%
Business overdraft	24	55	6.50%	15.64%	9.68%	10.05%
Residential secured overdraft	27	55	4.85%	12.39%	8.43%	7.33%

Source: Cannex

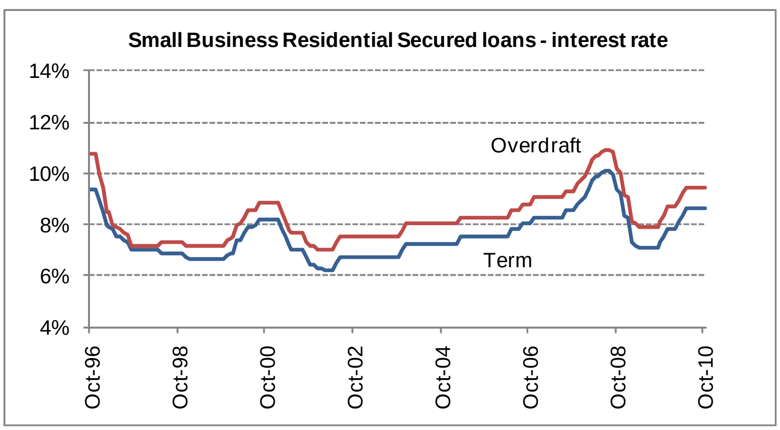
Pricing

While indicator reference[40] rates in the deposit market are well over long-term averages, interest rates paid by small business are also above long-term averages. Estimates of indicator business lending rates are published by the RBA. They show:

- Interest rates on residentially secured term loans are currently 9.0%, compared to an average since 2000 of 7.69%.
- For residentially secured overdrafts, the current rate is 9.85%. The long-term average is 8.46%.
- Unsecured small business term loans are currently 9.70%. The average since 2000 is 8.30%.
- Unsecured overdrafts are around 10.65%, whereas the long-term average is 9.14%.

Relative to housing rates, the current business rates appear to be elevated, indicating that banks have priced in more risk in business loans than housing loans. In times of uncertainty, business rates usually have higher risk premiums loaded in as these loans are riskier, even for residentially secured business loans.

Graph 24 – Small business loans – residentially secured



Source: RBA data

[40] The ABA notes that reference rates are only a guide as most banks will price each client based upon the client's risk profile. This can be done through either rating the likelihood that the borrower will default and/or an assessment of the underlying collateral.

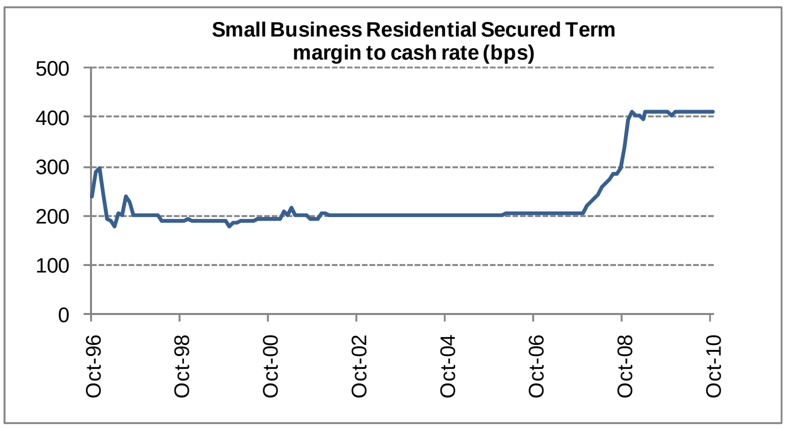
Margins

As with the margin between the housing standard variable loan rate and the cash rate, business loan margins have also increased since the global financial crisis in 2007.

For 10 years prior to the GFC, the margin between the cash rate and the small business residential term secured variable rate was very stable, averaging about 200 basis points (i.e. 198 bps). Since then, the increase in the small business margin has been more marked – increasing by around 200 basis points, whereas the housing margin increased only 110 basis points[41].

The reasons for this higher small business margin increase are three fold: (a) small business loans are riskier and so attract a higher risk-premium than residential housing loans; (b) the margins being charged before the GFC were too low and the higher margin today reflects a more appropriate rate, and (c) higher levels of capital are required for small business loans (compared to housing) as part of the prudential regulatory regime.

Graph 25 – Small business lending spread



Source: RBA data / ABA calculations

3.5 Personal lending market

3.5.1 Context of competition in personal lending

Personal lending has been in decline for much of the last two decades. The current proportion of personal debt relative to total credit in Australia is 7%. In 2000, the proportion of personal credit to total credit was 9%.

This decline is primarily due to the fact that interest differentials between personal and housing lending have encouraged consumers to access home equity for purchases of large items rather than take out personal loans.

Personal lending also competes with many unregulated lenders, such as 'pay day' lenders, merchants that provide in-store financing facilities, and home equity withdrawal products offered by non-banks.

[41] The ABA notes that data was sourced prior to the RBA November Board Meeting.

3.5.2 Current state of competition

Market size and growth rates

The amount of outstanding personal credit is $141 billion. As with housing and business lending, growth in personal credit is currently well below long-term trends. Annual growth currently stands at 2.8%. Since 2000, personal credit growth has averaged 6.7% on an annual basis[42].

There are two categories of personal lending – credit cards and personal loans. The latter are used for purchases of cars, boats and other large items. Credit card debt is mainly used for smoothing consumption and income patterns.

Total outstanding credit card debt is $50 billion or around 3% of total outstanding credit in Australia. This proportion has been stable for around 12 years.

Products and providers

In the market today, there are 64 providers of credit cards. Card types include Visa, MasterCard, American Express and Diners Club. Technically, the latter two are not credit cards, but are known as charge cards as they do not extend a line of credit beyond the payment settlement date. The ABA includes these cards as they compete directly with credit cards.

The issuers and/or agent distributors of these cards (collectively 'providers') include banks, credit unions, building societies and a number of firms specialising in card products. There are around 300 credit card products. These totals include a small number of charge cards which are differentiated from the credit card by not having a revolving line of credit associated with it.

Pricing

Cannex data shows there is a wide range in both credit card and personal loan products:

- Interest rates charged on credit and charge cards range from 0% to 21.49%, with an average of 16.21%.
- Personal loans are priced at a minimum rate of 6.16% and a high of 14.70%. The average rate is 11.08%.

There are often concerns raised over the level of credit card interest rates. The main reason for higher rates is that credit cards provide unsecured credit, which is a riskier form of lending.

3.6 Competition going forward – funding cost challenges

While the consumer data outlined above shows healthy competition in key financial product markets, there are medium-term challenges. The most significant is the relative funding costs of categories of lenders. The gap between the average cost of funds for the four major banks and that of smaller banks and other financial institutions has widened since 2007.

In the three years to June 2007, major banks, regional banks and credit unions could source funding at reasonably equivalent cost. Over the last 12 months, the regional banks have been paying around 41 basis points above that of the major banks. If this differential was to continue, it could place medium to longer term strains on competition.

[42] Derived from RBA statistics.

4. ABA comments on proposals and initiatives

The ABA is aware of a number of proposals and initiatives currently being debated. The following provides the ABA's views on each of these areas.

<u>ACCC power to investigate collusive price signalling</u>

The ABA does not support this proposal. We believe that the Australian Competition and Consumer Commission (ACCC) should administer the *Trade Practices Act 1974* to ensure competition in the market to benefit consumers, businesses and the community. However, we consider the existing provisions of the law provide adequate powers to the regulator to ensure that unfair trading, predatory practices and collusion are prohibited.

New laws that limit the ability of banks to explain the cost of funds and how banks may need to deal with those higher (or lower) costs to their customers and other stakeholders will disadvantage consumers.

An absence of information about the cost of funds would make it even more difficult for banks to explain interest rates and market movements, and in fact, could lead consumers to make bad decisions regarding their product or loan choices. The proposal significantly increases regulatory risk for all businesses, not just banks.

The ABA notes that individual banks and the ABA are constantly facing inquiries from journalists, politicians and bank customers seeking a response to comments, allegations or analysis regarding banks' funding costs and other pricing-related issues. Many of these inquiries stem from comments or analysis from parties other than the banks themselves. Recent examples include:

- Comments from the RBA's Board Meeting minutes regarding banks' funding costs and margins;
- Comments from the Federal Treasurer and the Federal Opposition Leader on whether banks are justified in moving retail rates outside changes in the RBA's official cash rate;
- Comments from a number of prominent investment bank analysts on margin pressures faced by banks;
- Media commentators have discussed banks' funding costs at length; and
- Academics and consumer advocates also regularly comment on the legitimacy of pricing–related changes.

In practice, it would be difficult for laws to discern intent, and therefore the likelihood of regulatory risk is high.

The ABA is concerned that new laws which prevent public discussion around banks' funding costs, interest rate margins and product fees would curb public debate, stifle public commentary, restrict the ability for commentators to present an informed and balanced view and result in a situation where allegations or assertions could be made with no way for individual banks to respond, correct misinformation and provide facts about banking services and markets. This would result in less informed markets and less transparency about banking.

<u>APRA to investigate whether the major banks are taking unnecessary risks</u>

The ABA does not support this proposal. We believe that APRA already has a central role in promoting financial stability and supervising risk management systems, the effectiveness of which was well demonstrated during the GFC, and that no additional investigations are necessary and risk distracting APRA from its current supervisory activities.

RBA to publish regular reports on bank net interest margins, returns on equity, and profitability

The ABA notes that the RBA and APRA already publish this information on a regular basis.

Data sought	Publication details - RBA	Publication details - APRA
Net Interest Margin (NIM)	Half yearly[43] [44]	Quarterly[45]
Return on Equity (ROE)	Monthly[46]	Quarterly[47]
Profitability	Monthly[48]	Quarterly[49]

Australia Post provide a distribution channel

The ABA notes that Australia Post has provided agency facilities for banking transactions for at least 100 years and already acts as a distribution point for more than 70 banks and other financial service providers[50]. It is open for other financial service providers to form the same commercial relationship.

Treasury and the RBA to investigate ways to improve securitisation markets

The ABA supports this proposal. We believe that additional initiatives are required to assist in rebuilding the securitisation market in Australia. (See section 5.2.3 of this submission.)

Simplification of the Financial Services Reform Act

The ABA supports this proposal, however, we note that since its implementation in 2002, the banking industry has been advocating changes and refinements to the FSR Act to ensure that regulation does not stifle the ability for banks to provide retail banking products and services by imposing unnecessary regulatory requirements and unnecessary compliance costs.

The ABA notes the existing and recent reviews of the advice and conduct and disclosure obligations.

APRA to explore whether risk-weightings on business loans secured by residential properties are punitive

The ABA notes that APRA already assesses risk-weightings applied to loans offered by banks and other supervised entities. Banks are required to set capital against risks they undertake. Capital is allocated according to risk categories determined by the Basel Committee on Banking Supervision, within the Bank for International Settlements (BIS) – the international standards setter for prudential rules. We consider that it would be highly unorthodox for APRA to unilaterally change these agreed rules.

Introduction of covered bonds

The ABA supports this proposal. Covered bonds represent another source of term funding for banks. Having said that, we consider that introduction of covered bonds should be part of a package of reforms aimed at addressing the cost and availability of funds in Australia. (See section 5.2.2 of this submission.)

43 RBA Stability Review.
44 The major banks 'interest spread' – similar to NIM - is reported monthly by the RBA as part of the RBA Chart pack.
45 APRA Quarterly Banking Statistics.
46 RBA Chart Pack is published monthly. This does not mean that the relevant data are renewed every month.
47 APRA Quarterly Banking Statistics.
48 RBA Chart Pack is published monthly. This does not mean that the relevant data are renewed every month.
49 APRA Quarterly Banking Statistics.
50 http://auspost.com.au/personal/personal-banking-at-australia-post.html

Review of the financial system

The ABA notes that there have been numerous inquiries conducted recently into aspects of the Australian banking system. We also note the substantial amount of regulatory reform currently underway which affects banks and the financial system. The banking industry has been under review since the GFC began in 2007. We also note that with the capital and liquidity standards still to be finalised at the international level, any domestic inquiry will, at best, be partial. A review now would be based on a set of unsettled international rules and policies. Therefore, while the ABA would participate in a 'Son of Wallis' type inquiry, we do not believe that such a review at this time would be capable of adequately assessing the regulatory framework or would facilitate sound judgments about whether changes to the framework are necessary in Australia. We consider a review could be considered once the new international prudential regulation and market regulation reforms are fully finalised.

Implement a social compact for banks

The ABA does not support this proposal. We believe that corporate responsibility is a necessary part of good business management practice and that it should be a driving factor of corporate strategy, as well as an important part of brand or reputation management and corporate identity. However, implementing a 'social compact' which defines and limits the duties and rights of banks would cause significant detriment to banks and hinder the competitiveness of our banks globally.

In Australia, the banking industry is recognised for its leadership in the area of corporate responsibility. Many banks have adopted corporate responsibility programs and practices that demonstrate their commitment to managing social, environmental and governance issues and the impacts of their operations as well as financial performance and their key role within the economy. Banks that have adopted corporate responsibility programs and practices have recognised it as a driving factor for being able to differentiate themselves through effective forms of stakeholder engagement. The high level of innovation, creativity and competition in areas related to corporate responsibility is reflected in many banks introducing internal programs and undertaking extensive external programs, with some banks producing an annual corporate responsibility report or community investment report, along with their annual report and financial statements.

In the year to June 2010, it is estimated that community organisations received over $180 million[51] of direct support from the main retail banks in various forms – from philanthropic partnerships and projects with local and national not-for-profit organisations to gifts and sponsorships to supporting charities' efforts with disaster relief to matching donations supporting staff fundraising activities. Funding contributions from banks provide support to many areas across our community, including education, arts, environment, welfare, health care and research, sports and so on.

In addition, the banking industry is committed to a long-term strategic priority of helping improve Australians' financial literacy. Australia's banks have a strong tradition of free education in financial skills and have in place a wide range of financial literacy, financial inclusion and capacity and enterprise building programs. In the year to June 2010, it is estimated these programs also received over $36 million[52] of direct support from the main retail banks. Program contributions include building understanding in the areas of managing money, finance and banking, developing budgets, managing debt, building basic investment, insurance and superannuation knowledge, planning for life stages, including home ownership and retirement. These programs target efforts to assist the most vulnerable parts of the community.

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[51] The ABA notes that community contribution includes charitable gifts, community investment, community initiatives, and management costs via cash, time or in-kind contributions. The figure has been adjusted to exclude contributions related to financial literacy, financial inclusion and capacity building and enterprise development programs.
[52] The ABA notes that contribution does not include loan capital to micro-finance programs and may not include staff hours, such as training for community staff, secondments by bank staff, and other direct knowledge and in-kind support provided by banks to their financial literacy and inclusion programs.

Overall, Australia's banks are doing a lot to give people the appropriate financial skills, knowledge and information to ensure they are better placed to make informed decisions about their money and avoid being misled on financial matters, as well as providing support for many local and national community activities. This voluntary commitment by Australia's banks clearly indicates the well established and growing importance of responding to the broad expectations of shareholders, customers, governments and the community.

The ABA considers that it is important for corporate responsibility principles to encourage responsible business practices, enhance legal compliance and ethical corporate cultures and promote consideration of wider stakeholders' interests across the community. However, rigid rules would merely stifle innovation, commercial differentiation and competitive forces which drive change across the banking industry.

Mandate basic transaction account

The ABA believes that the proposal to mandate that banks, as distinct from other ADIs, offer a free transaction account to all account holders in Australia, whatever their legal and financial status, is anti-competitive, and therefore would distort the provision of retail banking services in Australia. We note that while described as a 'basic account', the prescribed features are so broad that most transaction accounts would be covered.

The ABA notes that no other business in Australia is required to provide its services free of charge. Furthermore, we note that various banks:

- Already provide, voluntarily and competitively, a range of basic bank accounts that allow customers on low incomes to access basic services at no cost. This accounts for one in six customers in the Australian banking population.
- Offer accounts where a number of transactions are free before charges apply.
- Offer accounts which are free of exception fees or have reduced exception fees. Over the past three years, banks have been responding to community sentiment that exception fees are unpopular and have been abolishing or reducing these fees.

For non-bank ADIs that offer low cost as distinct from no cost accounts, competition from banks that are required to offer fee free accounts with regulated features would force them to lower their fees on these accounts or discontinue these services because of the costs of continuing to maintain them. Ultimately, if banks were required to offer free bank accounts, this would likely result in non-bank providers being forced out of the market. Consumers would be the losers as there would be less competition.

Furthermore, the ABA considers that reductions in exception fees and the emergence of accounts which do not charge these fees demonstrates the market is delivering results for bank customers. Intervention to mandate basic transaction accounts is not necessary, and in fact, would have adverse and unintended consequences for the market and for consumers.

Cap charges for use of banks' ATMs

The ABA believes that the proposal to mandate that transactions conducted at a bank's own-branded ATMs are to be free of charge and to cap fees for the use of a bank's ATMs by customers of another ADI would result in anti-competitive pricing variations and distortions across the electronic payments network in Australia.

As at June 2010, there were 28,764 ATMs in Australia, with bank branded ATMs accounting for around 46% of ATMs[53]. Under the proposal, non-bank or third party ATM deployers would still be able to levy whatever fee they deem appropriate. Banks would have limited ability to recover the costs associated with maintaining their ATM network, especially in

[53] ATM and EFTPOS Statistics. Australian Payments Clearing Association.
http://www.apca.com.au/Public/apca01_live.nsf/WebPageDisplay/Stats_Terminals

remote, rural and regional Australia where services are more costly to operate (because costs relate to hardware, software, installation, cash delivery, security, information technology and infrastructure, maintenance, card issuing and rent). Pricing differentials would be entrenched in ATM services and different fees would eventually apply in different locations.

The ABA considers that the number of bank branded ATMs would decline over time, as it would become less and less viable for banks to provide an ATM network, and customers using non-bank ATM facilities would be paying more or would likely have greater difficulty in using ATM services, especially in areas where cash services are more costly to operate. We note the UK experience where similar regulations were put in place, resulting in non-bank ATM providers moving into the market and charging higher fees.

Mandate fixed interest gap loans

The ABA believes that the proposal to mandate that an ADI which offers any mortgage product must offer a "fixed interest gap mortgage" to all of its existing and prospective customers would result in greater volatility in mortgage interest rates. In practice, APRA would be required to develop matrixes on a continuous basis to establish rates for all ADIs – this would be impractical, and would also lead to distortions in the lending market.

Furthermore, demand for such a product is unknown, yet banks and other ADIs would be subjected to additional costs in developing, launching and administering the product that would add cost to all lending. We note that there are a number of recent examples of policy driven products that have not proven to be commercial viable, or have not attracted consumer interest, or have subsequently been cancelled. If a commercially viable market existed in Australia for such a mortgage, we consider that one or more of the 111 institutions marketing home loans would have provided this product.

The ABA notes that the impact on fixed interest rate mortgage products, mortgage products priced by reference to bills of exchange or other benchmark rates and on non-ADI lenders and the securitisation market is also not known.

Cap mortgage and loan exit fees

The ABA understands that a proposal to cap mortgage and loan exit fees is only being contemplated to apply to banks and other ADIs, and not more widely to other mortgage product providers, such as finance companies and non-conforming lenders, including fringe and predatory lenders which are not regulated by APRA, and therefore is anti-competitive. It would distort the lending market, favouring non-bank lenders over banks, including non-major banks. We note that the evidence shows that entry fees in Australia are much lower than in the United Kingdom and United States. Additionally, in Australia, non-bank lenders mortgage exit fees are typically higher than for banks[54].

The ABA notes that the National Credit Code regulates early termination fees on consumer mortgage facilities, including fixed interest rate mortgages. Furthermore, on 10 November 2010, ASIC released its Regulatory Guide 220 *Early termination fees for residential loans: unconscionable fees and unfair contract terms* [RG 220] which sets out guidance for lenders on points including:

- what costs and types of loss can be included in exit fees;
- types of loss that should not be recovered through exit fees; and
- the limited circumstances in which a lender may vary exit fees during the life of a mortgage.

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[54] ASIC (2008). Review of mortgage entry and exit fees. April 2008. http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/REP_125_Review_of_mortgage_entry_and_exit_fees.pdf/$file/REP_125_Review_of_mortgage_entry_and_exit_fees.pdf

The ABA considers that additional regulation is unnecessary and the existing regulatory guidance provides the community with greater insight into the nature, extent and factors underlying early mortgage exit fees across the market.

<u>Ban increases in interest rates for 2 years</u>

The ABA believes that a current call to ban banks from increasing their interest rates above any rise in the official cash rate by the RBA for two years is based on misconceptions and ill-conceived ideas that would be damaging for Australia's financial system. Prohibiting the ability for banks to recoup the true costs involved in intermediation would have serious consequences. We note that had banks not been able to recoup their higher funding costs, Australia's banks would have made losses and the ramifications for Australia's economy would have been severe. We note that our concerns are mirrored by the RBA.

On 18 November 2010, the Reserve Bank Deputy Governor stated:

> …it probably is important to explain how all that fits together with monetary policy, because I think the crux of the debate, as far as I can tell, is that people feel there is or there should be a rule that says banks can't increase their lending rates more than the official interest rate set by the Reserve Bank, the cash rate. Well, that rule doesn't exist – it has never existed – and it would be quite risky for the stability of the financial system to have such a rule. The question is why has that perception arisen and, when you look back, I think what's happened is that we went through a period from the second half of the 1990s and the first half of this decade where financial markets were very stable, so all interest rates were moving more or less in line. And so, when banks were adjusting the interest rates to take account of their cost of funds, that, in turn, was lining up more or less with what the Reserve Bank was doing. So everything was moving in line with what the Reserve Bank was doing.
>
> But, as you know, in the last three years with the global financial crisis that's no longer the case and we've seen very sharp increases in the cost of deposits, for example, much more than the increase in the cash rate. We've seen very big increases in the cost of long-term bonds. And, unfortunately for the banks, the regulators and the rating agencies are encouraging the banks to do more of their funding through these high-cost sources, through deposits and long-term bonds, because these are seen as being more stable.
>
> So this is all pushing up the cost of funds to the banks more than the cash rate. And you look at any measure you like. Basically, most measures of the cost of funds have risen by at least 1 per cent more than the cash rate in the last few years, and the banks obviously have to pass those costs on. And, as I said, on average, that's what they've done. The margin on banks' loans really hasn't changed over five or six years. They don't do that smoothly from month to month because the cost of funds is varying every month and it builds up. The cost builds up for a while and then the banks eventually catch up and do an increase and, at that point, it looks like the margin has gone up but, eventually, over the next few months, it erodes back down again. So, basically, as I say, the margins have been fluctuating between 2.25 and 2.5 per cent.
>
> Some people feel, well, what does that mean for monetary policy? Surely that means monetary policy is not as effective as it might have been? Well, the answer is no, because the Reserve Bank takes all that into account in setting the cash rate. So, broadly speaking, the level of mortgage rates, for example, that exist at the moment is basically in line with what the Reserve Bank thinks it should be, and it's got there through a combination of rises in cash rates and rises in deposit rates and other funding costs. So, the outcomes are basically okay as far as we can tell.[55]

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[55] Transcript of Q&A session with Mr Ric Battellino.18 November 2010.

Limit bank profits to 1% of GDP

The ABA believes that a call to limit bank profit to 1% of GDP is seriously flawed and misguided and would require banks to reduce profits to one-third of their current levels[56].

Bank profits are simply the difference between revenue and costs, and therefore a profit cap would require either a decline in revenue (price and/or volume) and/or an increase in costs. Any adjustment would cause serious dislocation and adverse consequences for the community and the wider economy.

Material intervention in lending rates or volumes would interfere with monetary policy settings and the availability of credit to households and businesses, with a direct impact on, for example, wealth creation, lifestyle choices and business productivity, and an indirect impact, for example, on economic growth and micro and macro-economic indicators.

Additional regulation artificially influencing fees and charges would potentially inhibit new entrants into financial product markets, because competitors would face existing participants that have unnaturally lowered product prices. The effect would be similar to predatory pricing and would distort supply and demand dynamics in financial product markets.

Material distortions to deposit rates might provide some benefit to banks and consumers, but it would have unintended consequences for other investment markets, including share and property markets, and an overall efficiency cost to the economy.

Additional operating costs would have adverse consequences for market efficiency and institutional productivity.

The ABA considers that the implementation of a profit cap that reduces the return on capital would create incentives for investors to deploy capital elsewhere – this would have drastic consequences for capital and savings intermediation and shift capital mobilisation into the "shadow banking system". Regulatory arbitrage was a central cause of the GFC: unregulated lenders originated sub-prime loans and then the funding for the loans was sourced through unregulated investment banks, hedge funds and pension funds.

Additionally, the ABA considers that the implementation of a profit cap that reduces banks' return on equity would have immediate and long term implications for share prices and market performance. A reduction in bank profits by two-thirds would cause bank ROEs to fall to 4.62%, which is below current investment deposit rates. Banks share prices would be severely affected and the stock market battered (because banks constitute around 25% of the ASX Index). Lower share price returns would impact returns for direct investors and superannuants.

The ABA is concerned that in response to this, banks would need to dramatically cut costs, including through reducing services and staffing, which represent major operating costs for banks.

Regulate banks as 'too big to fail'

The ABA notes that the Financial Stability Board (FSB) published a paper in October 2010 detailing a range of issues with regards to systemically important financial institutions. There is no advice at present that Australian banks are in the class of "SIFIs".

The ABA is concerned that actions to regulate banks taken ahead of international standard setters could be detrimental to the competitiveness of Australia's banking system.

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[56] Fear, J, Denniss, R and Richardson, D (2010). Money and Power: The case for better regulation in banking. The Australia Institute. August 2010. https://www.tai.org.au/file.php?file=/media_releases/IP 4 Money and Power.pdf

<u>Summary</u>

The ABA believes that a number of the proposals above would have the effect of harming competition, the community and the wider economy. This highlights the dangers of attempting to deliver better outcomes for consumers through interventions, such as direct price controls or mandating specific products. A better approach to driving better outcomes for consumers is to enhance competition through strengthening the funding base, and hence capacity, of all banks in Australia.

5. ABA proposals to enhance competition and improve regulation

Section 3 of this submission sets out the evidence showing that there is competition in banking, including in key financial product markets of relevance to households and small business. Australian banking customers are able to access banking products and services at competitive prices from a number of different providers.

Currently, differences between the business models of providers mean there are differences in cost and access to funding sources, and this is impacting on the ability of smaller providers to compete. While smaller providers are currently competing with larger providers, smaller providers are facing additional funding pressures in the current different market conditions.

Therefore, the ABA believes there are measures that the Federal Government should put in place and initiatives the banking industry should take that would enhance competition further. These actions and initiatives should focus on strengthening the funding base arrangements of all participants, rather than re-regulating the Australian banking industry, which would have adverse and unintended consequences for financial institutions, consumers and the efficiency of our markets.

The ABA believes the following policy principles should guide the identification, development and implementation of actions and initiatives to enhance competition, namely:

- Maintain financial stability;
- Ensure a level playing field;
- Avoid regulatory arbitrage;
- Address dependencies, through coordinated withdrawal;
- Promote international harmonisation of standards, with national discretion; and
- Increase accessibility of retail banking services.

With these policy principles in mind, the ABA believes there are a number of actions and initiatives that could be taken to enhance competition in the Australian banking industry and to improve regulation of the Australian banking industry.

5.1 Promote better regulation of banks and financial service providers

The ABA believes effective regulation is essential to ensure confidence in our markets and to help protect consumers. Banks hold an important position in the market, both by virtue of the size of the sector and the special function banks perform within the economy. This necessarily impacts on the regulation of the banking sector.

However, "good regulation" requires coordination and cooperation between legislators, government, regulators and industry. In this context it is important to get the balance right between the cost and benefit of regulation, clarity and certainty and flexibility of regulation, and to ensure that subsequent interpretation and enforcement correctly reflects original intent. If the balance is wrong, regulation can stifle innovation and hinder competition and can lead to costly and less customer-friendly outcomes for consumers.

The ABA is concerned that the regulatory burden faced by the banking industry has increased sharply in recent years as both Australian and international authorities have instituted substantial changes. Operational and compliance costs have risen significantly and the products being offered to consumers have been affected. This process of regulatory change is still under way with a wave of new regulation emanating from the G20 Leaders and through the Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO). While some of the new international standards are known, the detail of much of the new regulatory framework, in particular the new liquidity standards, is unknown, and therefore the costs and compliance implications are still uncertain.

The ABA believes that a robust and safe banking and finance sector supported by a sound regulatory framework is crucial to the success of market economies. The damage that failure of significant financial institutions and regulatory structures can inflict on economies and individuals has been clearly demonstrated by the GFC. However, equally, it needs to be recognised that the success of market economies is built on their ability to respond flexibly and in innovative ways to changing circumstances. "Poor regulation" can harm this flexibility. Regulation should only intervene where there is a clear need to address market failure and should only be introduced in ways that minimise costs and distortions.

The ABA makes the following recommendations to address the impact of regulation on competition within the Australian banking industry.

5.1.1 Support principles-based and outcomes-focused regulation

The Federal Government should continue taking a lead in the developing principles-based and outcomes-focused models of regulation in international forums.

The ABA believes that while harmonisation of standards is important to ensure global consistency and a level playing field, the Government should also encourage the recognition that regulatory frameworks may need to evolve as specific regulations are made operational.

In developing international standards, international authorities should take due regard of the impact of rules on local market conditions and legal systems, and therefore recognise the importance of national discretion. In adopting international standards, Australian legislators and regulators should have due regard to the impact of early adoption of standards on the international competitiveness of domestic participants.

5.1.2 Develop performance indicators to benchmark compliance costs

The Federal Government should develop a range of performance indicators for benchmarking the compliance costs of business regulation, as part of a wider regulatory reform program aimed at reducing unnecessary regulatory burden and compliance costs on business.

The ABA believes a benchmarking framework would be useful in identifying best practices that monitor and measure performance of business regulation over time, including regulation across jurisdictions. Benchmarking regulatory performance has a number of benefits:

- Improving efficiency and effectiveness of regulation;
- Ensuring consistency of regulation across jurisdictions;
- Improving transparency of regulatory decision-making and accountability of regulators; and
- Ensuring regulation delivers 'net benefits'.

5.1.3 Codify effective consultation processes

> The Federal Government should embed the 'better regulation' principles into all economic and regulatory reforms to ensure that consultation focuses on the most cost effective means to achieve the stated policy intent.

The ABA believes that consultation should be conducted when policy is designed, legislation is drafted, legislation is translated into specific regulations or new procedures are adopted by the financial regulators. Consultation should be conducted in a way that facilitates early engagement and broad participation and provides adequate time to contemplate the possible implications of any new policy or regulation. The Office of Best Practice Regulation should be given additional accountability and review mechanisms to ensure processes for policy and regulation making deliver effective and efficient regulation that promotes economy-wide domestic and international competitiveness.

5.1.4 Examine barriers to entry

> The Federal Government should examine the extent to which Government licensing and regulatory burdens act as disincentives for potential entrants into the financial services and credit markets.

The ABA believes that while regulation is important to ensure participants interact with consumers efficiently and fairly, the Government should acknowledge that over-regulation disproportionately impacts smaller participants and new entrants to the market. An examination of the regulation imposed on banks, financial institutions and other market participants would be useful in understanding how regulation can create barriers to entry and decrease competition. We consider that in implementing new regulations, Australian legislators and regulators should take due regard of the impact of rules on all participants, and therefore recognise the importance of striking an appropriate balance which does not result in regulatory arbitrage for some participants.

5.1.5 Introduce simplified depositor protection

> The Federal Government should retain the Financial Claims Scheme (FCS) and consultation should be conducted to ensure an orderly transition and to avoid anti-competitive effects.

The ABA notes that the Federal Government recently announced the withdrawal of the guarantee scheme for large deposits and wholesale funding. The Financial Claims Scheme (FCS) provides a guarantee for retail deposits of up to $1 million per depositor per ADI until 12 October 2011.

The ABA believes that consultation on any change to the cap must start as early as possible to ensure an orderly transition and to avoid anti-competitive effects. Under the FCS, the Government initially provides the funds to make payments to depositors. Moneys paid are recovered from the ADI concerned, as part of the winding up process, and any shortfall is met via a levy on other ADIs. We consider this approach should be maintained, as well as the process for initiation of the FCS.

The ABA notes that the Federal Government is currently considering additional compensation schemes for financial services providers. We consider that a legal requirement for banks (and banking groups) to participate in multiple schemes is redundant and would result in additional regulatory burden and unnecessary compliance costs without additional protections for consumers and retail investors.

5.2 Address cost and availability of funding sources for banks

The ABA believes actions to encourage competition through addressing the funding pressures of all banks is critical to positioning the Australian banking system to deal with the immediate and longer term challenges of structural adjustment as a result of the GFC and global economic conditions. We consider that a multi-faceted package of reforms and initiatives will be necessary to address concerns with the funding needs of banks and to support access and competition across participants irrespective of the nature or size of the financial institution or the structure of their banking business.

All banks in Australia require access to deep, diversified and stable sources of funding to fulfill their role in terms of financial intermediation and economic facilitation. However, the evolution of the global financial system, coupled with the GFC, highlighted a number of features specific to the Australian banking system, including reliance on international funding markets, the importance of the securitisation market and the impact of superannuation and taxation policy on deposits.

The ABA is concerned that Australia's banks face a number of funding pressures due to both global market conditions as well as domestic market considerations. Over the next 18 months to 2 years, due to the need to rollover short-term funding and longer term funding, banks will continue to face funding challenges. (See Chapter 2 of this submission for an explanation of banks' cost of funds.)

Experience with global capital markets over recent years demonstrates the need for domestic markets to contribute a greater share towards banks' funding. There are a number of market and regulatory barriers associated with access to domestic markets, which compound reliance on offshore funding sources and expose banks to external market volatilities and price shocks. We consider the adoption of new Government policy, new regulatory approaches or initiatives to build (or rebuild) markets would address structural imbalances between investment markets and assist banks' access domestic funding sources, and thereby reduce banks' reliance on international funding sources.

The ABA believes that thorough assessment of the structural changes and challenges facing banks and considered implementation of initiatives to address these changes and challenges is crucial to the ability of banks to continue to perform financial intermediation and facilitate economic growth. Constraints and weaknesses in funding sources can harm competition. Actions to address constraints and weaknesses in banks' funding sources should reduce banks reliance on short-term wholesale funding, ensure all participants have access to funding alternatives (now and in the longer term), and create a more robust economy that is less vulnerable to external shocks in offshore credit markets.

The ABA makes the following recommendations to address the impact of the cost and availability of funding sources on competition within the Australian banking industry.

5.2.1 Remove tax distortions and incentivise deposits

> The Federal Government should introduce measures to increase the supply of deposits (and the proportion of savings allocated to deposits) and to reduce the inequality of tax treatment across saving products, investments and asset classes to strengthen the funding of banks operating in Australia and put downward pressure on the cost of funds.

The ABA notes that currently deposits account for around 50% of total bank funding. While deposit markets are attracting funds from the domestic pool of savings due to unsustainably high interest rates and continuing uncertainty from investors with regards to alternative investments, such as the stock market, it is anticipated that as difficult market conditions ease, investors will naturally shift their savings back to other investments. Banks are taking steps to restructure their balance sheets. However, additional measures will be needed to support longer term adjustments.

The ABA believes that further reforms could be implemented in a number of ways, including:

(1) Accelerating the introduction of the already announced tax discount measures and removing the threshold for individuals to receive a 50% tax discount;

(2) Exempting non-resident deposits from IWT, and ultimately removing IWT altogether; and

(3) Removing the LIBOR cap on deductibility of interest paid on branch-parent funding.

Accelerate the introduction of the tax discount measures and remove the threshold for individuals to receive a 50% tax discount

The ABA notes that the Federal Government announced as part of the 2010-11 Budget changes to the tax treatment of interest bearing deposits. From 1 July 2011, Australians will be able to obtain a 50% tax discount for the first $1,000 of interest earned on deposits. However, since this announcement, the Government has announced that this reform would be delayed until 1 July 2012, and for the first year would apply only to the first $500 of interest earned on deposits.

Currently, the tax treatment penalises deposits with effective marginal tax rates as high as 80%[57]. While this reform will address some of the tax anomalies between interest bearing investments and other investments or asset classes (including shares, managed investments, property), it has been proposed in a manner that only applies in a limited way. In the absence of further reform, this is unlikely to provide tax incentives adequate enough to significantly influence consumers' savings and investment decisions, and therefore is unlikely to substantially shift the pool of domestic savings towards interest bearing deposits. The proposed tax change would only impact on a small proportion of deposits (and taxpayers) – the change as initially announced would roughly provide a tax incentive for individuals with deposits of around $20,000 (at 5% p.a.). However, according to Cannex data, 11.6% of the aggregated value of total household deposits held is under $20,000. Therefore, the change as revised would have even less of an overall impact on the domestic savings pool.

The ABA believes that by accelerating the introduction of the tax discount and removing the proposed $20,000 threshold for individuals to receive a 50% tax discount, this reform would address the imbalances within the current tax arrangements for deposits and provide an incentive for individuals to increase their savings using deposit accounts. In doing so, this reform would shift the bias in the domestic savings pool from alternative forms of savings or investments. Importantly, we consider that there should not be a threshold. Alternatively, over the longer term it may be reasonable to align a threshold with the specified limit imposed through the Financial Claims Scheme (FCS). Furthermore, we consider that further reforms would support the opportunity to ensure that retail investors have in place savings and investment strategies which recognise the importance of having a diversified portfolio as a way to address investment risk and return over the longer term.

Exempt non-resident deposits from IWT, and ultimately remove IWT altogether

The ABA notes that the Federal Government announced as part of the 2010-11 Budget a phase down in interest withholding tax (IWT). The reform will apply to the borrowings of local financial institutions from their overseas parents, from 10% to 7.5% on 1 July 2013 and to 5% from 1 July 2014 (with a possibility of 0% thereafter); the borrowings by any Australian branch of a foreign bank from its overseas head office, from the 5% to 2.5% on 1 July 2013 and to 0% on 1 July 2014; and any financial institution that borrows offshore retail deposits which they on-lend in Australia, from 10% to 7.5% on 1 July 2013 and to 5% on 1 July 2014 (with a possibility of 0% thereafter).

[57] Deposits are typically after-tax monies which are treated as income for tax purposes, and therefore taxed again at marginal tax rates. (Some tax relief is available if superannuation monies are subsequently invested in deposits.)

The ABA also notes that both the Australia's Future Tax System Final Report ("Henry Report"[58]) and the Australian Financial Centre Forum's report *Australia as a financial services centre: Building on our strengths* ("Johnson Report"[59]) recommended a complete abolition of IWT on interest paid by financial institutions on their offshore borrowings. While this reform will eventually address some tax disparities, it has been proposed in a way that will not provide immediate relief due to the delayed start date and phase down/out, address biases in funding choices by banks or provide the potential benefits for foreign-owned banks enabling access to surplus overseas funds and lower interest rates for Australian borrowers.

The ABA believes that by exempting non-resident deposits from IWT, and ultimately removing IWT on interest paid on offshore borrowings, paid to foreign-owned banks by their Australian branches, and related party offshore borrowings, these reforms would promote more efficient capital flows, cheaper cost of funds, greater diversification of funding sources for Australia's banks (not just Australian major banks, but potentially Australian regional banks) and provide potential benefits for bank liquidity and lower interest rates for Australian borrowers. Furthermore, these reforms would increase the total deposits in the Australian economy providing a balance against the superannuation guarantee and diversify banks' funding sources by creating an inflow of offshore retail funds (not just wholesale funds). It should be noted that the Government will broadly recoup lost IWT revenue from increased company tax earnings.

The ABA notes that this reform provides opportunities for banks to diversify their funding sources, contribute to more efficient global capital flows and promote Australia as a financial services centre, especially in the Asian region. The tax cut should increase the competitiveness of the Australian banking system, promote access to local capital sources for non-Australian domiciled banks operating in Australia, and cut costs for Australian borrowers. Over the longer term, this change will enable banks to supplement their offshore wholesale funding programs with potentially cheaper funding from offshore retail funds. Furthermore, we consider that changes to IWT will provide tools to assist banks transition to the new Basel III rules, which favour retail deposits.

Remove the LIBOR cap on deductibility of interest paid on branch-parent funding

The ABA believes that by removing the LIBOR cap on deductibility of interest paid on branch/head office (which includes branch-branch) funding, this reform will address tax constraints related to offshore borrowings. Under the foreign bank branch rules of the income tax law, deductibility for interest paid by the Australian branches of foreign banks on funds borrowed from their offshore branches/head office is limited to the London Interbank Offered Rate (LIBOR). Funds provided at a rate above LIBOR are denied a deduction for those amounts. During the GFC, the difference between LIBOR and commercial rates significantly widened. This reform would ensure that banks operating in Australia have access to alternative funding sources at competitive rates.

5.2.2 Introduce covered bonds

The Federal Government should introduce legislation to support the development of a covered bond market in Australia. Having said that, the introduction of covered bonds should be part of a package of reforms aimed at addressing the cost and availability of funds in Australia.

The ABA notes that the pending Basel III regulations will impact on banks globally. Banks will be expected to hold more capital and significantly more liquidity. The reform proposals will create significant challenges for banks operating in Australia and the Australian economy.

[58] http://taxreview.treasury.gov.au/
[59] http://www.treasury.gov.au/afcf/content/final_report.asp

Covered bonds are a full recourse debt instrument that is secured by a pool of mortgage assets. Assets could also be secured by public sector claims. Unlike securitisation, the assets stay on the banks' balance sheet and are ring-fenced to give investors some protection in the event of bankruptcy of the issuer.

Covered bonds are attractive to investors, as they can offer:

- *High credit quality*: The major credit rating agencies have slightly different approaches to rating covered bonds, but all focus on the structure of the cover pool and the quality of the mortgages. To a lesser degree they factor in the issuer's rating. Most covered bonds AAA-rated or AA-rated.
- *Yield*: Covered bonds can potentially offer investors yields higher than government bonds without significantly altering the risk profiles of conservative portfolios.
- *Diversification*: Covered bonds allow conservative investors to diversify into mortgage securities without diluting the credit quality of their overall portfolios. Typically, investors looking for AAA-rated investments must invest largely in sovereign and agency bonds.
- *Protection against event risk*: Covered bonds are full recourse debt instruments, meaning that holders have a preferential claim on the assets in the cover pool and the proceeds arising from them if the issuer defaults. Should an originating bank fail to make payments on a covered bond for any reason, interest payments from the underlying mortgages would go to investors.

For issuers, the strict regulatory framework needed for covered bonds and the high quality of the underlying loans create high credit ratings for covered bonds. In many cases, covered bonds carry ratings higher than those of the issuers themselves. The high credit ratings can result in lower interest payments to investors, which reduce the cost of funding for the originator. For example, overseas covered bond markets demonstrate that these markets can be more liquid with supply and demand not as impacted as other markets during the GFC.

The ABA notes that because an issuer's covered bonds usually receive higher credit ratings than its senior unsecured debt, covered bonds attract a different group of investors, which helps to broaden the issuer's funding sources. However, introduction of legislation would be needed to facilitate covered bonds issuances in Australia and to address various interests. Other aspects that could be explored further include the introduction of conditions, such as being limited to offshore issuance only[60] or support via a Government purchase program (similar to the European Central Bank (ECB) purchase program introduced last year). Other considerations that could also be explored further include the development of alternative bond structures which address legal issues (i.e. structured uncovered bonds to create similar instruments) or issuer issues (i.e. pooling to address lower rated banks or tranches).

The ABA believes that covered bonds would enable banks, especially the larger banks, to diversify their funding sources. Additionally, while the availability of covered bonds will not be a complete solution to meet banks' increased liquidity requirements, covered bonds represent another source of term funding for banks.

[60] However, the ABA notes that while this may address concerns held by some banks and other stakeholders about domestic issuance, it would not address concerns with the reliance on overseas funding sources.

5.2.3 Rebuild the securitisation market

The Federal Government should support further reforms and efforts to re-establish a properly functioning market for securitised mortgages. Immediate and longer term efforts will be required:

- *Immediate*: Government should extend investment support via the Australian Office of Financial Management (AOFM) into the Australian Residential Mortgage Backed Securities (RMBS) market.
- *Longer term*: Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to rebuild the securitisation market in Australia.

Rebuilding the securitisation market in Australia is essential not only in terms of addressing the availability and cost of funds for banks and promoting competition within the Australian banking industry, but also in terms of providing an alternative asset class to bank paper necessary for meeting the new liquidity standards.

The ABA notes that the degree to which banks utilise the securitisation market to access funds differs across the Australian banking industry. Notwithstanding, since mid 2007, the levels of liquidity on secondary markets of securitised products has completely disappeared. Loss of investor confidence in the Australian securitisation market has been driven by experience in the US securitisation market and explicitly in relation to sub-prime related assets where these instruments were considered too complex and with an opaque portfolio of underlying assets.

Accordingly, the Government has made investments via the AOFM in the Australian RMBS market in order to support securitisation issuance and competition in the mortgage lending market in Australia[61]. The RMBS market allows all banks to access funds with minimal cost differential. However, we consider that uncertainty associated with the pending Basel III regulations continues to put pressure on the RMBS market in terms of recovery in spreads and liquidity. Additionally, while some major wholesale investors are returning to the RMBS market, overseas experience with securitisation markets continues to impact investor confidence, despite Australian RMBS representing higher credit quality.

Therefore, the ABA believes that by extending direct investment into the RMBS market, this financial support will provide pricing support for certain tranches in the securitisation market, and in doing so, address some of the immediate funding challenges. We consider that the first mandate improved not just investor confidence, but also pricing signals. While subsequent mandates are having a positive influence on the operation of the market, the securitisation market in Australia continues to struggle with the protracted nature of the GFC. It should be noted that direct investment is not a long term solution for rebuilding the securitisation market, but in the short term provides an alternative funding source, especially for smaller banks and non-bank participants. It will be important to consult with banking industry experts on how any refinements could be made to the existing program.

[61] The ABA notes that under the RMBS Investment Program, the AOFM invests in RMBS at pricing levels that support competition for residential mortgage lending and to support lending to small business. Since the inception of the program, the AOFM has invested $12 billion in 65 RMBS transactions sponsored by 18 issuers. A further $4 billion is available to be invested under the existing RMBS Investment Program. http://www.aofm.gov.au/content/rmbs.asp

The ABA believes there are also a number of options for addressing some of the longer term challenges for the securitisation market. We consider further reforms could be implemented, including:

(1) Accepting third party AAA RMBS paper as an asset under the new liquidity rules.

(2) Introducing a fee-based facility for providing Government support to the Australian RMBS market based on certain regulatory requirements.

(3) Establishing a Government corporation or market-based SPV to provide mortgage lenders with mortgage default insurance as credit quality enhancement.

(4) Developing a new "bullet" RMBS security.

<u>Acceptance of third party AAA RMBS paper as an asset under the new liquidity rules</u>

The ABA believes that by accepting third party AAA RMBS paper (currently eligible securities for repurchase transactions by the RBA) as an asset under the new liquidity rules, this reform would not only assist in rebuilding the primary and secondary securitisation markets in Australia, but would also assist banks to meet their obligations under the pending Basel III regulations, especially in the absence of adequate sovereign debt issuance and the inability to utilise bank paper[62]. Qualifying RMBS would necessarily distinguish between related and non-related RMBS issuance.

The ABA notes that repo eligibility means that a borrower is able to use the instrument as collateral. Repo eligibility increases trading and improves liquidity in the secondary market. However, in practice, banks are not entering such agreements due to the broader implications that could be inferred with regards to capital needs, and consequently, regulatory and market scrutiny.

<u>Introduce a fee-based facility for providing Government support to the Australian RMBS market based on certain regulatory requirements</u>

The ABA believes by introducing a fee-based facility for offering Government support for the payment of principal and interest on the securities, this reform could provide an opportunity for improving liquidity in the secondary market, but also encourage investment in primary issuance. Furthermore, this reform could restructure the securitisation market and achieve broader regulatory objectives by identifying those securities that qualify for liquidity support. For example, certain market attributes and credit quality standards could include setting minimum loan-to-value ratios, imposing loan servicing criteria, improving transparency of data about issuances/tranches, imposing a retention (or capital) requirement, requiring credit quality enhancements or insurance, and establishing origination standards by requiring APRA licensing. Inevitably, this reform would deepen the pool of high quality RMBS paper as well as assist in setting a benchmark against which other lesser quality RMBS paper could be priced. However, further consideration would need to be given to determining conditions and/or if conditions are necessary where existing market practices satisfy similar outcomes.

<u>Establish a Government corporation or market-based SPV to provide mortgage lenders with mortgage default insurance as credit quality enhancement</u>

The ABA believes that by establishing a Government corporation or market-based SPV which provides mortgage default insurance to mortgage lenders, this reform could facilitate the securitisation of a part of the residential mortgage pool. Insurance would enhance the credit quality of RMBS. Pooling could address concerns with individual issuances.

[62] Prudential Standard APS 210 aims to ensure that all ADIs have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances.

The ABA notes the Canada Mortgage and Housing Corporation (CMHC) model. The CMHC is owned by the Canadian Government and was originally established after World War II to provide housing for returned soldiers. Now, the main function of the CMHC is to provide mortgage insurance for residential mortgage loans to Canadian home buyers. Insurance protects mortgage lenders against defaults on mortgages of less than 20% equity. A direct government guarantee facilitates more economical lending and the risk transfer provides a high degree of financing certainty for the mortgage industry. Government controls around lending standards, minimum criteria and allocation manages this risk, while at the same time provides access to funding for smaller lenders[63].

Develop a new "bullet" RMBS security

The ABA believes that by developing a "bullet" RMBS security which enables efficient recycling of mortgages and removes the prepayment risk inherent in pass-through RMBS instruments, this reform would not only assist in rebuilding the securitisation market in Australia, but assuming a degree of government support, it would also assist banks to meet their obligations under the pending Basel III regulations. A bullet RMBS security is backed by a pool of mortgages which are revolved to maintain a fixed payment to the holder of the security. The removal of prepayment risk would likely see pricing of a bullet RMBS security more in line with senior unsecured debt. However, structures would need to be considered and government support would be required (at least in the initial years) to provide adequate liquidity to the market.

5.2.4 Examine appropriate changes to the superannuation and retirement incomes system

> The Federal Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to promote investment in deposits and fixed income assets within superannuation and retirement income products.

The ABA notes that the superannuation system has delivered significant benefits to Australians. However, while superannuation is a vital part of Australia's retirement incomes system, other private savings are also important.

The ABA believes that self-provision in retirement should be the aim of strategies for enhancing financial independence and retirement income adequacy. Part of improving retirement income adequacy, incentives for superannuation and private savings should promote long term savings and address current inequities between particular financial products and investments. Furthermore, encouraging diversified pre-retirement savings and post-retirement incomes will supplement superannuation savings and reduce fiscal pressure on the age pension by enabling greater choice, financial independence and a higher standard of living in retirement. It is important that anomalies are addressed so that incentives are equitable and allow people to ensure their superannuation and other investments are diversified. It is also important that tax anomalies and disincentives are removed so that Australians have an incentive to save and put in place risk strategies that will help them better manage their finances now and into the future.

Notwithstanding, the ABA is concerned that incentivising savings should be done in a way that does not undermine the importance of the superannuation system or substantially competes with the tax incentives provided to promote superannuation savings. However, low levels of savings in deposits, coupled with high spending by consumers and the offshore flow of funds (international investment either directly or indirectly via

[63] While the CMHC model has some similarities to the government-sponsored enterprises Freddie Mac and Fannie Mae in the United States, it is a direct guarantee. It should be noted that as the sub-prime mortgage crisis in the United States demonstrates, this type of model can come under pressure to prop up the housing market and keep credit flowing to high risk borrowers, and ultimately, can have damaging effects across the economy and financial system if governance is not strictly adhered to and the policy intent underpinning the model is not respected.

superannuation), has immediate and long term implications for Australia's economy, capital flows, fiscal position and the current account deficit. Furthermore, low levels of investment in capital guaranteed return products has implications for income stability of self-funded retirees. Therefore, we consider there is a need to examine the current superannuation settings and expand the proposed tax treatment of interest bearing deposits to address these imbalances as well as to provide banks with better access to domestic sources of funding.

The ABA is not advocating for interventions that disrupt the superannuation system. Prescribing investment options or mandating asset allocations is likely to have unintended and adverse consequences for superannuation fund trustees acting in the best interests of all members in their fund. However, options such as providing incentives, addressing imbalances, or promoting annuities that target certain asset allocation towards cash, fixed income securities and cash equivalent instruments that qualify as an asset under the new liquidity rules, should be examined. Targeted changes to the superannuation and retirement incomes system should seek to improve incentives for private savings, support development of life risk insurance products which address longevity risk, address the retirement savings gap and insurance protection gap, sustain retirement incomes and assist in managing health and age-related expenditure.

5.3 Encourage individuals to save and plan for their future

> The Federal Government, in partnership with the banking industry, should conduct research into consumer behaviour and conduct a consumer education campaign to encourage Australians to save and plan for their future.

The ABA believes that Australians should be encouraged to save and plan for their future. Information and targeted incentives will lead to greater interest and commitment in saving and planning early for retirement, as well as persuade those with the capacity to meet their own retirement income provision, not only benefiting individuals' standard of living in retirement, but also more broadly Australia's national savings.

The ABA believes the Federal Government, in partnership with the banking industry, should:

- *Conduct research into consumer behaviour*: By having a better understanding of the motivations and expectations of Australians towards their workforce participation and retirement, this approach would ensure that strategies for lifting household savings and messages promoting Australians to think about their retirement lifestyle and income as well as their superannuation and private savings are better and more targeted. A research exercise as part of responding to the 'Cooper Review' should look at conducting thorough analysis of the drivers and barriers for saving, thereby identifying how best to target savings messages. Understanding the factors that influence individuals' decisions about money, savings, investment, superannuation, debt and lifestyle choices will be important for determining how best to encourage greater personal superannuation contributions and private savings.
- *Conduct a consumer education campaign*: By lifting consumers and retail investors' awareness so they are better informed about their savings, this approach would ensure that consumers and retail investors are aware of their options. Assisting people better understand the characteristics of deposits (i.e. guaranteed) will give people greater control over their savings decisions as well as promote greater interest in deposits. A consumer education campaign as part of responding to some of the underlying issues associated with the GFC, including lack of diversification, as part of a "National Strategy on Financial Literacy" should promote the importance of having deposits as part of a diversified portfolio of savings and investments as well as promote the importance of taking an interest in asset allocations and investment options within superannuation.

5.4 Promote access to banking products and services

The ABA believes financial independence and financial security should be attainable for Australians. However, we consider that it will take a multi-dimensional approach from the Government, financial services industry and the community to ensure that all Australians take responsibility for managing their money and savings. A multi-dimensional approach must involve improving access to information about retail banking products and services, promoting access to financial advice that is appropriate for individuals' circumstances and needs, developing and broadening individuals' financial capabilities, providing individuals with better opportunity to find the best priced products and services to suit their needs and building national savings and lifting financial prosperity for Australians.

5.4.1 Information

> The Federal Government should enhance levels of financial literacy of all Australians by developing and publishing a "National Strategy on Financial Literacy". In addition, the banking industry should improve access to, and availability of, information on basic retail banking products and services.

The ABA believes that financial literacy is a vital life skill. The ABA and its member banks have demonstrated a long term commitment to promoting consumer understanding and financial literacy. For example, the ABA's financial literacy program "Broadening Financial Understanding" has been going for over seven years[64]. As part of this program, the ABA has published a number of financial literacy materials to assist consumers better manage their finances. The ABA has also hosted a number of events, including most recently the ABA's Financial Literacy Conference held in June 2010.

The ABA believes that it is important for individuals to have the skills to understand their money, savings capacities, attitudes to debt, access to investments, and lifestyle choices so that they can better manage their finances. The benefits of improved financial literacy are well-informed consumers, greater personal savings and investment opportunities, improved management of household debt and a reduction in the likelihood of periods of financial stress, decreased need for welfare or other government assistance, greater national savings, more efficient markets and increased personal economic security. Strategies to improve community awareness and understanding must seek to assist Australians make better savings and income decisions. Strategies for improving financial literacy should target those sectors of the community with the lowest levels of financial literacy, as improvements in financial literacy can result in lifestyle gains for individuals of all ages across the community.

The ABA notes that much material already exists about financial products and services. However, there is a need for information to be consolidated and simplified and delivered in a manner that is accessible and meaningful to different people. Understanding where to get information and how to use information on banking products and services will help consumers make better informed decisions. Therefore, we consider that it is important for the public and private sector to work together to better promote savings messages as well as better inform consumers of the options available to them to assist them make better informed decisions and empower them to take responsibility for managing their money, savings and debts.

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[64] http://www.bankers.asn.au/financialliteracy

The ABA believes the Federal Government should:

- Develop and publish a "National Strategy on Financial Literacy" that provides a framework for better coordination across stakeholder groups (government, banking and finance, education, employer and community sectors).
- Provide additional funding to ASIC so that dedicated efforts on financial literacy can be implemented separate from other ASIC priorities, including consumer protection and enforcement activities.
- Ensure ASIC, in collaboration with the financial services industry, and as part of a "National Strategy on Financial Literacy", undertakes further work to promote the importance of money management – for example, consumers should have an appreciation, awareness and understanding of banking basics and concepts.
- Conduct a national campaign to raise awareness of the importance of financial literacy and encourage Australians to access education, information and financial advice about money management, savings, debt management, retirement and estate planning.
- Measure levels of financial literacy and behavioural change to ensure that the importance of money management has been understood and translated into behaviour and action;
- Enhance Centrelink's Financial Information Service and increase support for financial counselling services, meaning all Australians can have access to information on financial issues. The Government should provide additional funding and resources so that FIS officers and financial counsellors can assist consumers and retirees with basic information about debt management, financial products and services, contracts, support services, etc.

Additionally, the ABA can:

- Coordinate efforts with educators, employers and community sector representatives to target information to the needs of different people.
- Build on existing efforts to enhance transparency of retail banking by:
    - improving communications and engagements with bank customers and members of the community; and
    - exploring better ways to provide customers with information about banking products and services, choices, fees, etc.
- Continue to work in partnership with the Government and ASIC to promote the importance of financial literacy.

5.4.2 Disclosure

The Federal Government should continue to work with the banking and financial services industry to improve disclosure documents for financial products and promote electronic distribution channels.

The ABA supports efforts by the Federal Government, through the Financial Services Disclosure Advisory Panel, to review and refine the existing disclosure requirements, in particular those relating to product disclosure statements (PDSs). Improved transparency and disclosure will drive product innovation, improve service levels, place downward pressure on fees and costs and enhance competition in the financial services industry.

Having said that, the ABA believes that any reforms must continue to recognise the primary purpose of a PDS or offer document – that is, to assist a retail investor make an informed decision. We consider that disclosure documents should:

- Be presented in a clear and concise manner utilising incorporation by reference to reduce the length of documents without compromising the quality and usefulness of information. Consumers should have easy access to information about investment options that are suitable to their individual needs and circumstances.
- Be flexible to allow information to be tailored to the product offering and provided in a useful and meaningful way for consumers.
- Be electronic to allow greater use of online communications which leverage different delivery technologies, more efficient information channels, and more interactive information repositories.

The ABA believes the Federal Government should:

- Ensure disclosure documents meet the needs of providers and consumers with regards to the different banking and financial products by targeting information and applying obligations suitable to various types of financial products and investments.
- Encourage ASIC to facilitate greater use of online channels for disclosures and communications with consumers in a manner that does not expose customers and retail clients to security risks or undermine existing consumer protection messages. ASIC relief and regulatory guidance should give banks and financial services providers' confidence in using electronic disclosure as a way to meet their disclosure obligations and provide information to their customers and retail clients.

5.4.3 Financial advice

The Federal Government should address the various barriers and improve access to, and the value of, financial advice as being important to promote greater participation by Australians in their financial decisions and banking and financial services options.

The ABA believes that financial advisers are an important part of the financial services industry. We consider that most Australians do not have adequate knowledge and skills or access to knowledge and skills to understand what actions to take to ensure they can prepare themselves financially. We also consider that many Australians do not actively engage in decisions about their investments, superannuation savings and retirement incomes.

Notwithstanding, the ABA believes that there are many advisory situations where Australians do not want investment advice and do not expect advice about a range of financial products or investment options. However, the current regulatory framework does not adequately make a distinction between types of advice or advisory situations, and therefore bank staff may also be subject to the same legal obligations and regulatory requirements as financial planners.

The ABA notes that banks provide financial advice covering the range of advisory services, including general education (online, call centre, seminars or workshops), general advice on banking products and services, limited personal advice on specific banking issues and other investments and personal advice on complex investment issues as part of a financial plan. However, some banks operate a 'no advice' model which means that their bank staff only provide factual information about banking products and services. Both banking models – 'no advice' or advice – have implications for compliance systems and costs for banks. However, the 'no advice' model means that access to helpful advice by consumers is restricted.

There are a number of barriers to the provision of 'simple advice', including:

Regulatory issues

- Lack of flexibility in the law to allow specifically for the provision of 'simple advice' which is limited to the specific needs and circumstances of the customer or in relation to specific financial products or classes of financial product.
- Complex regulatory requirements, uncertainty regarding regulatory actions, and inconsistent regulation of the advice provisions in the law, including enforceable undertakings taken that relate to 'limited' personal advice situations.
- Uncertainty regarding how personal advice may be 'scalable', including 'know your client' and the requirement to have a reasonable basis for advice.
- Uncertainty regarding the distinction between personal advice and general advice.
- Where applicable, Statement of Advice (SOA) obligations require a significant level of detail to be gathered, analysed and included, and despite recent FSR refinements, take some time to complete and include all necessary information.

Commercial issues

- Compliance costs associated with providing financial advice on basic banking products.
- Financial advisers always exercising their duty of care and taking actions to 'know your client' and make recommendations that are suitable to the needs and circumstances of their client in all situations.
- Low commercial incentive due to small economies of scale, and therefore the high cost of providing limited advisory services.
- Uncertainty regarding the development of technology systems that can support the provision of 'simple advice'. Without certainty, technology systems may be expensive or difficult to implement.

Behavioural issues

- Consumers may not understand what 'financial advice' is, and therefore not realise that the questions they are asking could result in a response that constitutes personal advice (especially in the context of retail banking).
- Consumers may not value financial advice, and therefore be reluctant to pay for advice.
- Consumers may be reluctant to take responsibility for making informed financial decisions.

The ABA believes that addressing the various barriers to 'simple advice' will focus regulators and legislators more on the customer experience, financial service providers more on the customer-provider relationship (rather than a 'tick-a-box' approach to compliance), and generally enable a better balance between regulatory obligations, commercial practices and consumer expectations. In practice, consumers' needs and objectives should limit the advice – that is, what the customer or retail client discloses and offers the adviser and what advice is delivered by the adviser. Banks should be able to tailor advice to meet the expectations of their customers.

The ABA believes the Federal Government should:

- Remove unnecessary legal obligations and regulatory requirements from 'simple advice' about basic banking and financial products.
- Adopt strategies that seek to promote the accessibility of professional financial advice. For example, clarify the law by amending the definition of personal financial advice contained in section 766B(3) of the Corporations Act and in doing so provide legal certainty and address concerns with regulatory uncertainty.
- Remove disincentives for accessing professional financial advice. For example, consider providing a tax rebate or deduction for those who seek professional financial advice in relation to investments, superannuation and retirement income products.
- Ensure the FOFA reforms do not have unintended and adverse consequences for the offering of basic banking and financial products by creating additional regulatory requirements and imposing inappropriate restrictions on the provision of banking services (including remuneration of bank staff), which result in increased costs for products and services.
- Encourage ASIC to facilitate greater use of generic online tools to enable customers to input various facts to assist them better understand their banking and financial services options. ASIC relief and regulatory guidance should give banks and financial services providers' confidence in using interactive web-based tools as a way to provide simple advice and information to their customers and retail clients.
- Conduct a national campaign to raise awareness of the importance of individuals undertaking a regular "Financial Check" – this should be seen as just as important as having a regular health check.

5.4.4 Switching

The Federal Government should recognise existing efforts by the banking industry to address community concerns with 'switching' and support the industry by removing barriers or introducing mechanisms to improve the decision-making capacity of banks and other credit providers.

The ABA believes that account portability, as frequently proposed, where a bank account number can be moved from financial institution to financial institution, would require significant investment, especially for smaller providers as well as other businesses and government departments. Furthermore, the benefits of account portability have not been demonstrated. We consider that initiatives to address barriers to switching, and thereby enhance competition in banking, need to be given careful consideration.

The ABA notes the following:

- The Government's "switching package" was introduced in November 2008. The switching service requires financial institutions to provide exiting personal customers with a list of regular payments, such as direct debits and credits, over the past 13 months. The customer's new financial institution can use this list to assist the new customer re-establish regular payments on behalf of their customer by notifying merchants, businesses and other services providers. The switching service is designed to save customers time and hassle. We recognise that usage of the switching package is low, and therefore we support further efforts to promote the availability of the switching package.

- Based on the data available, switching is already taking place – according to the Australian Payments and Clearing Association (APCA) around 10% of new deposit accounts opened represent customers switching from another financial institution. Additionally, according to the ABS, over the year to September 2010, 29% of all housing finance to owner-occupiers was for the purpose of refinancing.

- The National Electronic Conveyancing Development Ltd (NECDL) was established in January 2010 by the New South Wales, Queensland and Victorian Governments, following a Council of Australian Government's decision to develop the national electronic conveyancing system. We support this as an important initiative for national micro-economic reform and as being key to greater efficiency and convenience in conveyancing for consumers, practitioners and financiers.

- The Australian Law Reform Commission (ALRC) recommended comprehensive credit reporting in August 2008. The Government supports the introduction of more comprehensive credit reporting in line with these recommendations, provided sufficient privacy protections are put in place. (The ABA notes the remarks made by the Government: *"On balance, comprehensive credit reporting is also likely to improve competition in the credit market, which will result in benefits to both individuals and the credit industry"*[65]*.)* We support the Government's decision that would allow five data sets to be added to the existing permissible credit reporting information[66].

The ABA believes the Federal Government should:

- Recognise efforts by individual banks and industry representatives to improve the promotion of the existing "switching package".

- Recognise the value of an electronic conveyancing system to facilitate the completion, including financial settlement, of mortgage financing transactions. This will be particularly relevant in mortgage re-financing (or "switching" transactions). A national system will provide greater certainty of settlement date, delays associated with making appointments for settlement will be significantly reduced and the electronic settlement of transactions will obviate the need for bank cheques on settlement.

- Recognise the value of more comprehensive credit reporting as leading to more informed lending practices and expedite the implementation of comprehensive credit reporting. Comprehensive credit reporting will enable credit providers to make more informed assessments and streamline existing assessment processes.

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[65] Ludwig, J (2009). Privacy – The way ahead. Speech by Senator The Hon Joe Ludwig, Cabinet Secretary and Special Minister of State. Melbourne. 14 October 2009.

[66] The ABA notes the five data sets are:

1. The type of each credit account opened;
2. The date on which each credit account was opened;
3. The current limit of each open credit account;
4. The date on which each credit account was closed; and
5. An individual' repayment history over the prior two years at each point of the relevant repayment cycle (including the number of repayments cycles the individual was in arrears).

The fifth item is conditional upon the existence of an adequate framework of responsible lending obligations under Australian law. This has been put in place under the *National Consumer Credit Protection Act 2009* under which responsible lending obligations for authorised deposit taking institutions and registered finance companies will commence on 1 January 2011. Responsible lending obligations for intermediaries and other financiers commenced on 1 July 2010.

6. Conclusion

The ABA notes that financial experts are not predicting an early end to the effects of the GFC on global markets and economies, with some analysts suggesting it will take another two years to see market conditions stabilise. Furthermore, there is still uncertainty over whether or not funding costs will then return to the lower levels seen in the years preceding the GFC.

The ABA believes the evidence shows that there is competition in banking, including in key financial product markets of relevance to households and small business. Australian banking customers are able to access banking products and services at competitive prices from a number of different providers.

Currently, differences between the business models of providers mean there are differences in cost and access to funding sources, and this is impacting on the ability of smaller providers to compete. While smaller providers are currently competing with larger providers, smaller providers are facing additional funding pressures in the current different market conditions.

Therefore, the ABA believes there are measures that the Federal Government should put in place and initiatives the banking industry should take that would enhance competition further. These actions and initiatives should focus on strengthening the funding base arrangements of all participants, rather than re-regulating the Australian banking industry, which would have adverse and unintended consequences for financial institutions, consumers and the efficiency of our markets.

The ABA would be happy to provide any additional information that may assist the Committee's inquiry.

3 December 2010
Australian Bankers' Association

Appendix 1: List of ABA member banks

The following is a list of the 23 banks that are members of the Australian Bankers' Association:

1. AMP Bank Limited
2. ANZ Banking Group Limited
3. Arab Bank Australia Limited
4. Bank of Cyprus Australia Limited
5. Bank of Queensland Limited
6. Bendigo and Adelaide Bank Limited
7. BNP Paribas
8. Citigroup Pty Ltd
9. Commonwealth Bank of Australia
   - Bank of Western Australia Limited
10. Credit Suisse AG
11. HSBC Bank Australia Limited
12. ING Bank (Australia) Limited
13. Investec Bank (Australia) Limited
14. Laiki Bank Australia Limited
15. Macquarie Bank Limited
16. Members Equity Bank
17. National Australia Bank Limited
18. Rural Bank Limited
19. Rabobank Australia Limited
20. Suncorp-Metway Limited
21. UBS AG
22. United Overseas Bank Limited
23. Westpac Banking Corporation
    - St George Bank Limited

Appendix 2: Overview of the banking industry in Australia

Role of banks in the economy

Banks are financial institutions that accept deposits and issue loans. Banks act as 'intermediaries' when they mobilise savings (savers) and facilitate the transfer of these savings to finance production activities – whether that be a business or a household (borrowers). This function distinguishes banks from other 'intermediaries' in the market which can facilitate trades, e.g. between buyers and sellers of shares.

Through intermediation, consumers benefit from greater choice and lower costs. This is the intermediary's contribution to the national economy. Banks provide a valuable conduit between suppliers of finance and consumers of finance, offering the convenience of a financial 'one-stop-shop'.

Using a bank saves customers time and money instead of having to search for financial counterparties, or having to invest precious time learning banking techniques themselves. Customers benefit from being able to store their money in a safe place and also from being able to borrow money to assist them meet their financial goals, such as buy a home.

The banking network also forms part of the infrastructure of our economy. When consumers purchase goods and services or when businesses pay wages to employees, they need a mechanism for making payment. Modern banking has developed a number of ways for payments to be settled conveniently and quickly.

The national economy

Bank accounts play a vital role in our wider economy by acting as 'money'. Whenever a customer opens a new transaction account or makes a deposit in their bank, the monetary system is at work.

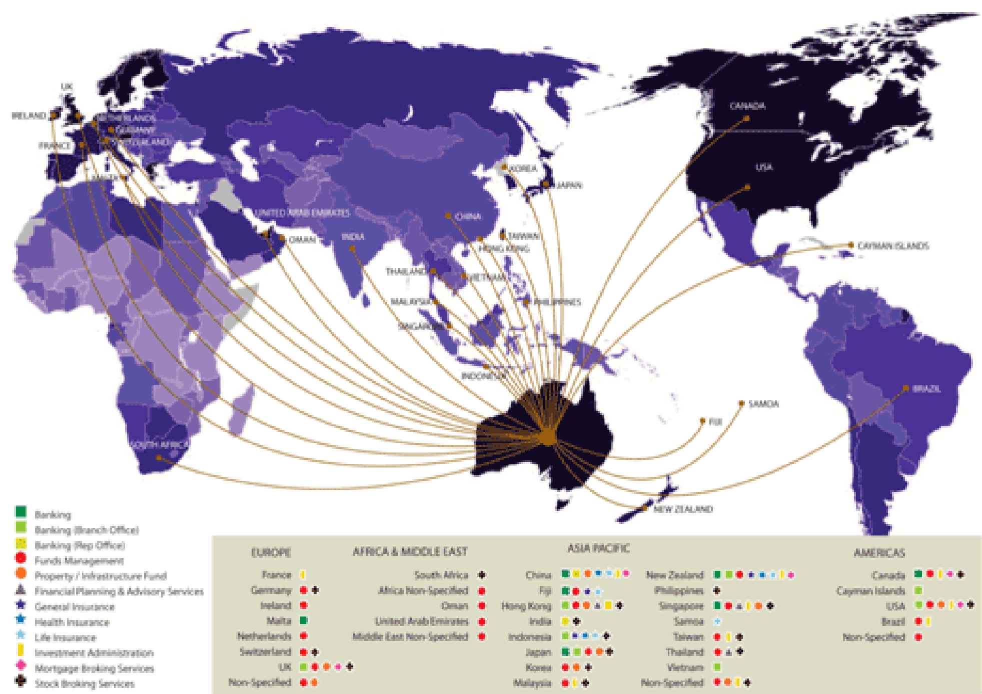
This is due to the fact that, in addition to plain currency (notes and coin), 'money' is defined to include 'liquid' bank products such as current deposits, savings accounts and term deposits.

The volume of money is one of the indicators used by Treasury and the RBA to monitor the economy and make economic policy decisions.

The international economy

Australia has a truly global financial services industry. Banks offer many international services, such as transactions for customers in foreign currencies and foreign currency risk management. Highly developed banking institutions make Australia one of the major centre's of capital markets activity in Asia. The depth, liquidity and sophistication of Australia's banks underpins the country's attractiveness as a global financial services centre.

Australia's Financial Services Industry: Global Footprint 2008



Source: Based on survey responses from a sample of Investment and Financial Services Association members

The payments system

The 'payments system' refers to arrangements which allow consumers, businesses and other organisations to transfer funds to and from accounts. It includes the payment instruments – cash, cheques and electronic funds transfers which customers use to make payments.

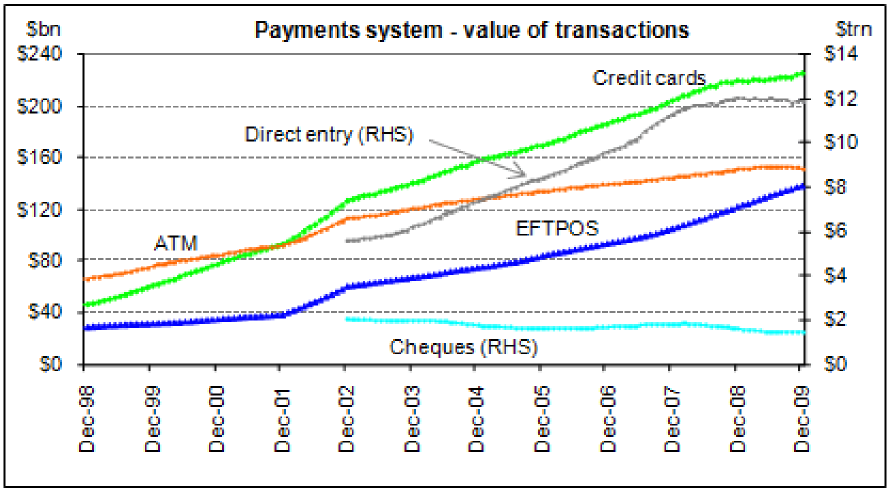
Banks provide and maintain extensive payments networks and instruments by which funds are easily and securely transferable via automatic teller machines (ATMs), credit cards, debit cards, smart cards, electronic-funds-transfer-at-point-of-sale (EFTPOS), mobile and telephone banking, and the internet.

Whenever a customer uses their ATM to transfer funds, or pays for purchases using a plastic card, they are making use of this payments infrastructure.

Use of the electronic payments system continues to expand in Australia. Electronic transfers cost a mere fraction of traditional payments methods. E-payment facilities developed in recent decades represent huge efficiency gains for our economy.

In 2009, a total of 6.7 billion transactions were conducted using ATMs, EFTPOS, cheque, direct entry and credit cards with a value of $13.9 trillion. On average there were over 18 million transactions every day:

- 2.3 million ATM withdrawals at a value of $415 million
- 4.8 million EFTPOS transactions at a value of $336 million
- 0.9 million cheques issued at a value of $4.1 billion
- 6.2 million direct entry transactions at a value of $32.6 billion
- 4.1 million credit card transactions at a value of $619 million



Source: RBA data

Over the past two decades, Australia's banks have invested heavily in the payments system and have introduced new enhancements. The system is well patronised by customers and is among the best in the world. Payment cards have become increasingly important in Australia over the past 15 years, as use of cheques has fallen rapidly. Continual innovation by banks is a hallmark of the Australian payments system.

In March 2009, reforms involving direct charging at ATM machines were introduced. This change altered the way consumers pay for using 'foreign' ATMs – that is, an ATM of another provider. The RBA said:

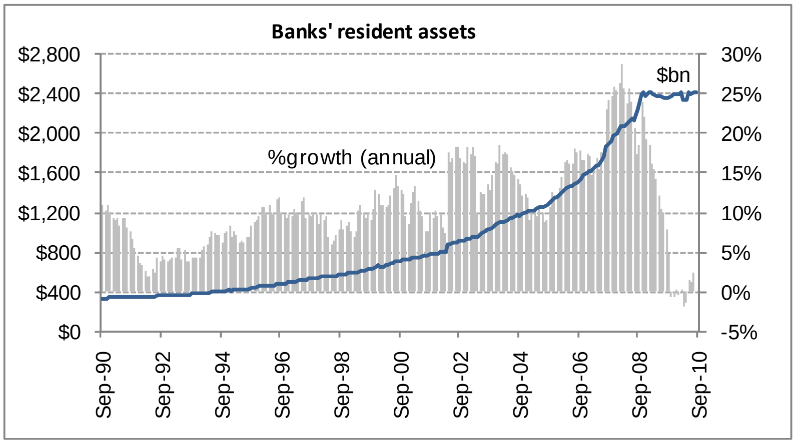
> This shift to cardholders predominantly paying the ATM owner, rather than their own financial institution, has improved the transparency of fees and will improve competition within the system … Overall these changes could be expected to offer cardholders a more competitive ATM system, with access to more ATMs.[67]

Banks assets

Australia's banking industry is large and mature, with assets equivalent to over double Gross Domestic Product (GDP) or around $2.4 trillion. There are 54 banks operating in Australia today, including 11 Australian owned banks, 9 foreign subsidiary banks and 34 branches of foreign banks. In addition, there are 119 building societies and credit unions.

At September 2010, resident assets of banks were $2.4 trillion, an increase of 3.1% over the previous year.

[67] http://www.rba.gov.au/payments-system/reforms/atm-fee-reforms.html



Source: RBA data

Tax paid by banks

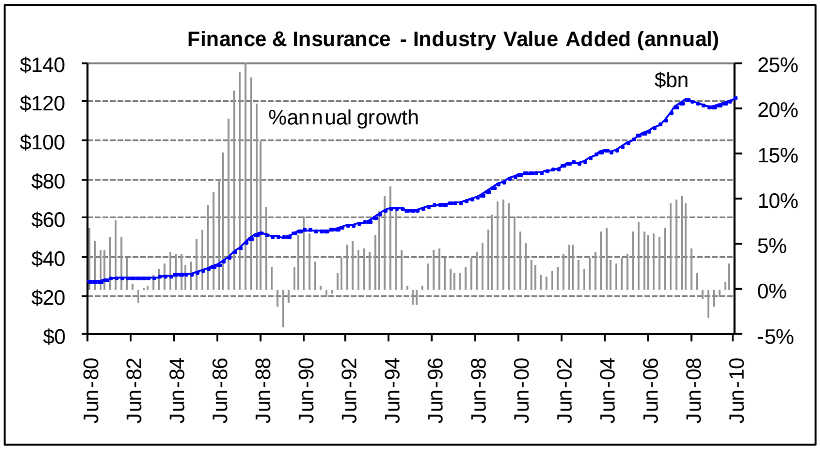
Banks have paid $38.5 billion in tax over the past five years. In addition, banks have paid $2.1 billion to date in the form of the wholesale funding guarantee.

Source: Bank Annual Reports

Economic contribution of banking and finance industry

Over the 12 months to the end of June 2010, the finance and insurance industry contributed $121.8 billion to Australia's $1.2 trillion economy, growing by 3.4% over the past year compared with 1.9% for all industries.

According to the ABS, the finance and insurance industry's contribution peaked in around March 2008 at $121.2 billion, but the GFC saw this fall to $117.3 billion by March 2009. The finance and insurance industry's contribution is now at the highest level on record.



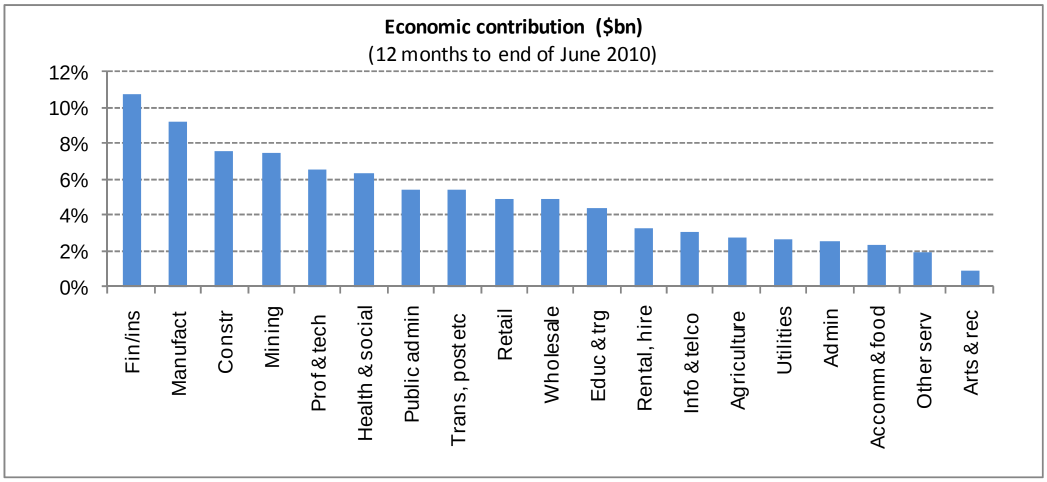
Source: ABS National Accounts

Industry summary

According to the ABS, the finance and insurance industry has been the largest industry contributor to the Australian economy since 2006.

The finance and insurance industry contributed $121.8 billion to economic activity over the 12 months to the end of June 2010. In comparison, manufacturing contributed $103.9 billion, construction $85.4 billion and mining $83.8 billion.

Gross value added $bn	Jun-2005	Jun-2007	Jun-2009	Jun-2010
Financial and insurance services (K)	$98.8	$114.8	$117.7	$121.8
Manufacturing (C)	$104.0	$105.7	$103.4	$103.9
Construction (E)	$68.4	$78.0	$84.6	$85.4
Mining (B)	$70.2	$77.6	$81.8	$83.8
Professional, scientific, technical services (M)	$62.1	$64.9	$71.0	$73.7
Health care and social assistance (Q)	$56.9	$62.2	$68.4	$71.2
Transport, postal and warehousing (I)	$52.3	$57.0	$59.5	$60.8
Public administration and safety (O)	$53.3	$57.1	$61.0	$60.8
Wholesale trade (F)	$48.8	$51.4	$53.7	$55.5
Retail trade (G)	$47.4	$50.6	$54.2	$55.1
Education and training (P)	$45.3	$46.8	$48.7	$49.7
Rental, hiring and real estate services (L)	$34.1	$34.5	$36.6	$37.3
Information media and telecommunications (J)	$29.7	$32.8	$34.1	$34.5
Agriculture, forestry and fishing (A)	$28.7	$25.0	$30.7	$31.0
Electricity, gas, water and waste services (D)	$25.7	$26.4	$28.6	$29.4
Administrative and support services (N)	$25.3	$28.2	$28.6	$28.7
Accommodation and food services (H)	$25.8	$27.0	$26.8	$25.9
Other services (S)	$20.8	$21.1	$22.2	$21.5
Arts and recreation services (R)	$8.6	$9.3	$10.2	$10.2
Gross value added at basic prices	**$980.9**	**$1,050.9**	**$1,107.2**	**$1,128.2**



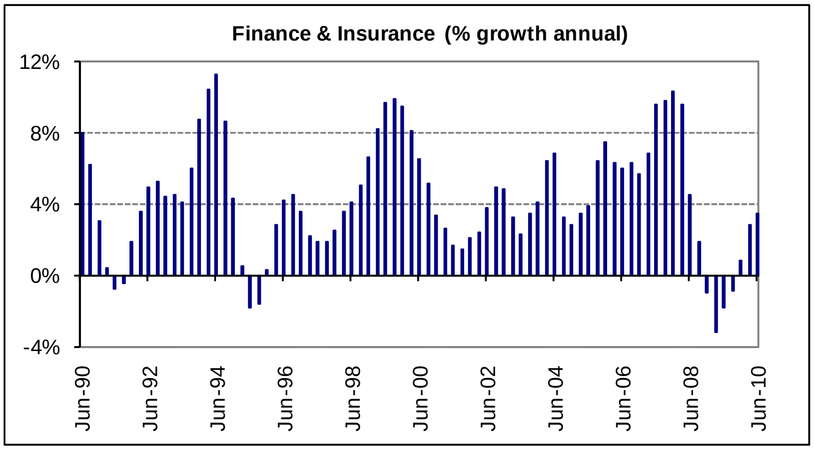
Source: ABS National Accounts

Growth rates

Over the past five years, to the end of June 2010, the average annual growth rate for the finance and insurance industry has been 4.7% per year, ranking third of the 17 industry divisions.

After reaching a peak annual growth rate of 10.4% over the 12 months to the end of December 2007 – the strongest since 1994 – growth rates for the finance and insurance industry fell rapidly, so much so, that economic activity of the finance and insurance industry had contracted by 3.2% over the 12 months to the end of March 2009.

Average annual growth	**Last 5 years**	**Last 3 years**	**Last year**
Health care and social assistance (Q)	5.0%	4.8%	4.0%
Professional, scientific and technical services (M)	3.7%	4.5%	3.8%
Financial and insurance services (K)	4.7%	2.0%	3.4%
Wholesale trade (F)	2.8%	2.7%	3.4%
Electricity, gas, water and waste services (D)	2.9%	3.8%	2.9%
Mining (B)	3.9%	2.7%	2.5%
Transport, postal and warehousing (I)	3.3%	2.2%	2.2%
Education and training (P)	2.0%	2.1%	2.0%
Rental, hiring and real estate services (L)	1.9%	2.7%	1.8%
Retail trade (G)	3.3%	3.0%	1.6%
Information media and telecommunications (J)	3.3%	1.7%	1.2%
Agriculture, forestry and fishing (A)	1.6%	8.1%	1.1%
Construction (E)	5.0%	3.1%	0.9%
Manufacturing (C)	0.0%	-0.5%	0.5%
Administrative and support services (N)	2.7%	0.6%	0.4%
Public administration and safety (O)	2.8%	2.1%	-0.3%
Arts and recreation services (R)	3.8%	3.1%	-0.7%
Other services (S)	0.8%	0.7%	-2.8%
Accommodation and food services (H)	0.1%	-1.3%	-3.3%
Gross value added at basic prices	3.0%	2.5%	1.9%

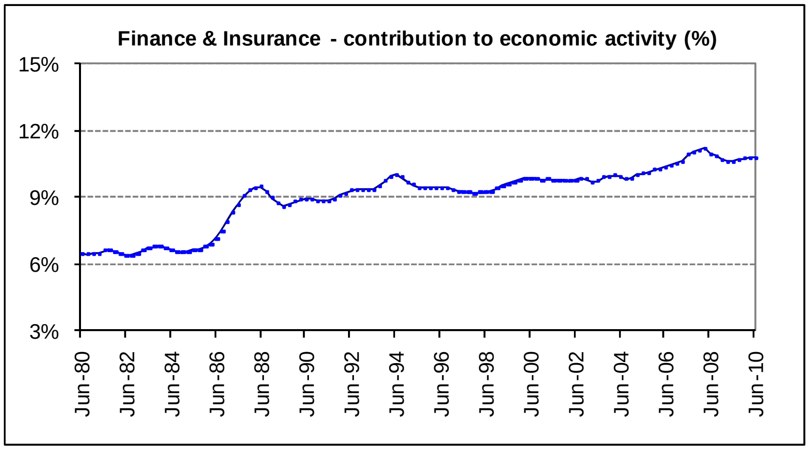


Source: ABS National Accounts

Over the 12 months to the end of June 2010, the finance and insurance industry contributed 10.8% to national economic activity. Over the 12 months to the end of March 2008, the contribution of the finance and insurance industry reached a high of 11.2%.

As the effects of the global financial crisis became more pronounced, the contribution fell to 10.6% at the end of March 2009. Over the 12 months to the end of June 2010, the finance industry was the only industry to contribute 10% or more to economic activity. The next highest were manufacturing 9.2%, construction 7.6% and mining 7.4%.

%contribution to economy	Jun-2005	Jun-2007	Jun-2009	Jun-2010
Financial and insurance services (K)	10.1%	10.9%	10.6%	10.8%
Manufacturing (C)	10.6%	10.1%	9.3%	9.2%
Construction (E)	7.0%	7.4%	7.6%	7.6%
Mining (B)	7.2%	7.4%	7.4%	7.4%
Professional, scientific , technical services (M)	6.3%	6.2%	6.4%	6.5%
Health care and social assistance (Q)	5.8%	5.9%	6.2%	6.3%
Transport, postal and warehousing (I)	5.3%	5.4%	5.4%	5.4%
Public administration and safety (O)	5.4%	5.4%	5.5%	5.4%
Wholesale trade (F)	5.0%	4.9%	4.8%	4.9%
Retail trade (G)	4.8%	4.8%	4.9%	4.9%
Education and training (P)	4.6%	4.5%	4.4%	4.4%
Rental, hiring and real estate services (L)	3.5%	3.3%	3.3%	3.3%
Information media and telecommunications (J)	3.0%	3.1%	3.1%	3.1%
Agriculture, forestry and fishing (A)	2.9%	2.4%	2.8%	2.7%
Electricity, gas, water and waste services (D)	2.6%	2.5%	2.6%	2.6%
Administrative and support services (N)	2.6%	2.7%	2.6%	2.5%
Accommodation and food services (H)	2.6%	2.6%	2.4%	2.3%
Other services (S)	2.1%	2.0%	2.0%	1.9%
Arts and recreation services (R)	0.9%	0.9%	0.9%	0.9%
Gross value added at basic prices	100.0%	100.0%	100.0%	100.0%



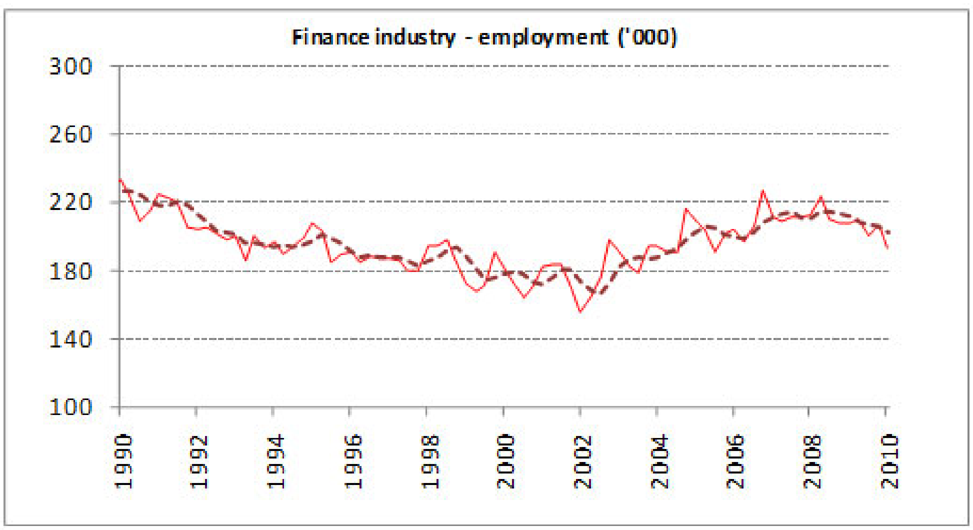
Source: ABS National Accounts

Employment in the banking and finance industry

As at May 2010, there were 193,300 people employed in the banking and finance industry, making up 1.75% of the employed labour force in Australia.

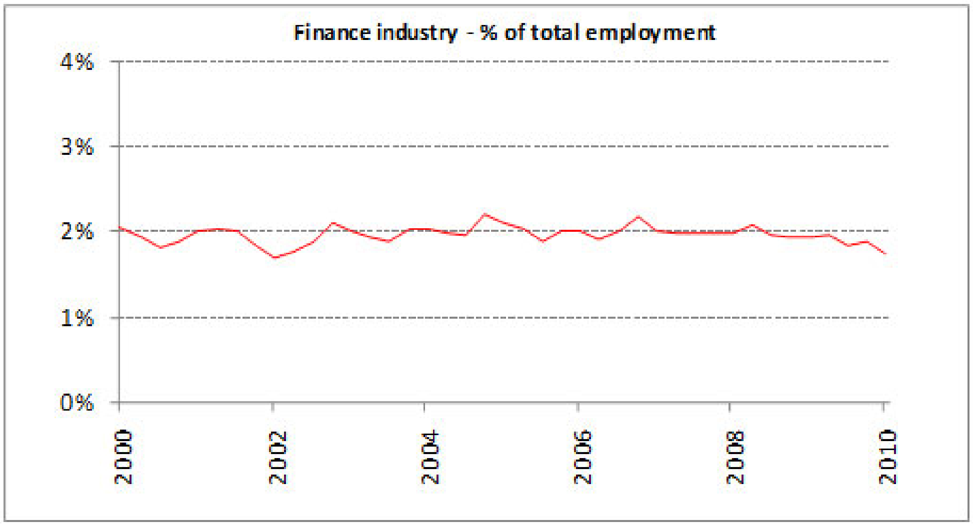
Finance industry employment peaked in August 2008 at 223,400, just prior to the height of the GFC.

The graph below shows a trend rise in finance industry employment over a six year period from November 2002 to November 2008. Over this time almost 50,000 jobs were added to the banking and finance industry, an increase of 29%.



Source: ABS

Over the past 10 years, the contribution to total employment in Australia from the banking and finance industry has remained in a tight range 1.7% to 2.2%.



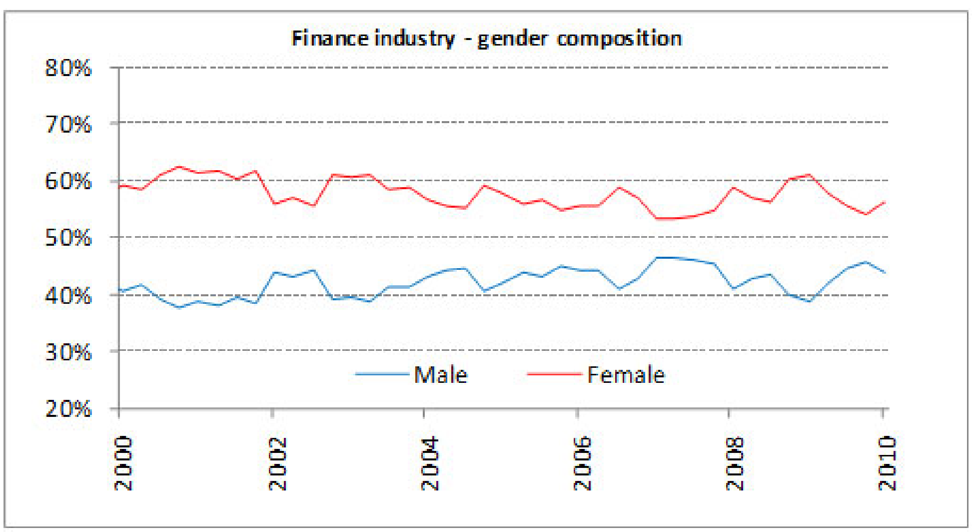
Source: ABS

Gender distribution

The banking and finance industry is a pioneering industry in providing employment opportunities for women, including working mothers.

According to the ABS, on average, over the past three years, 56.6% of finance industry employees are women, compared to the national average of around 45.4%.

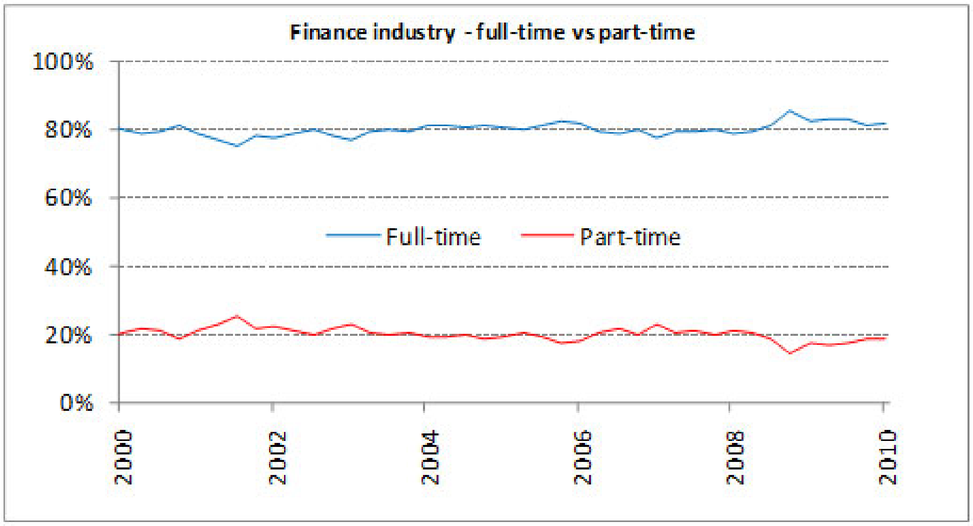
In May 2010, 56% of employees in the banking and finance industry are female, and 44% are male.



Source: ABS

Full-time and part-time distribution

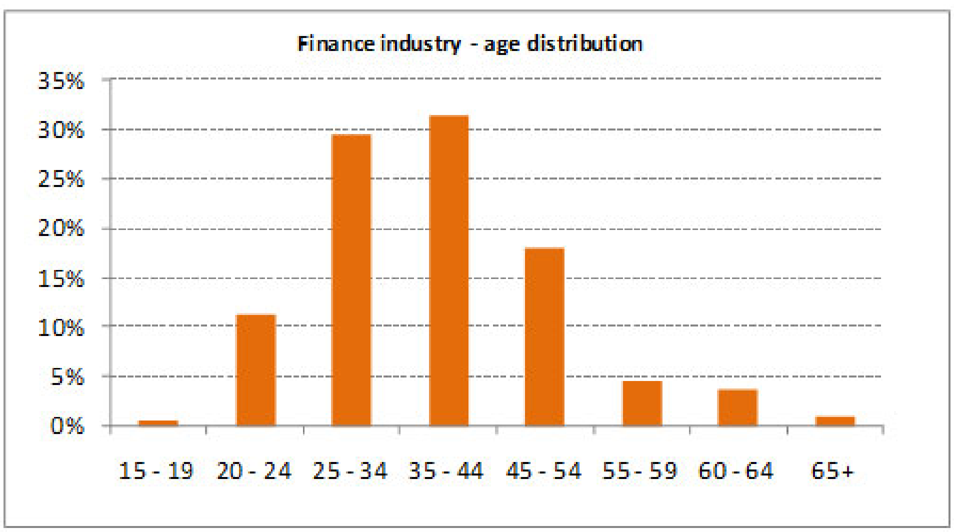
According to the ABS, the proportion of employees who work full-time in the finance industry is higher than for the overall labour force. Finance industry employment is generally distributed as 80% full-time and 20% part-time, compared to 70% full-time and 30% part-time for overall employment in Australia.



Source: ABS

Age distribution

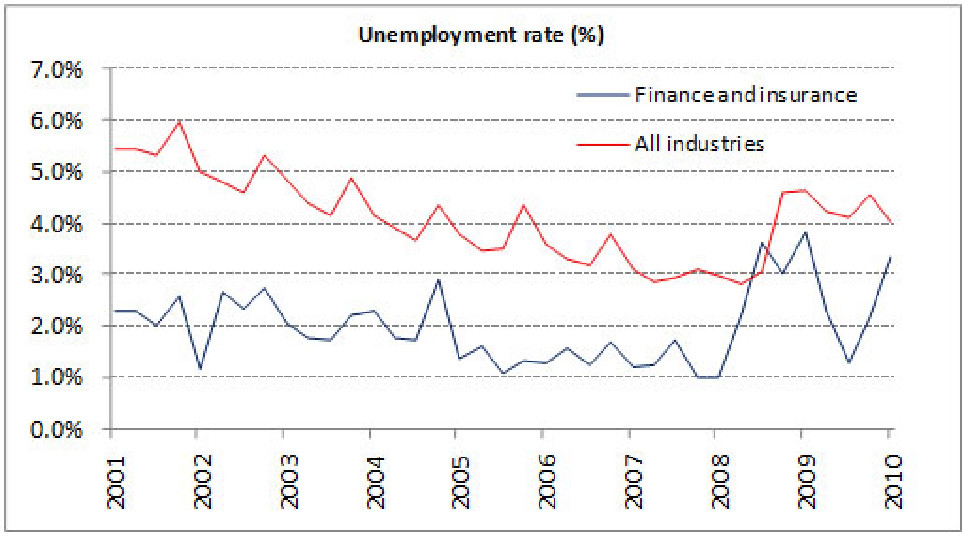
As at May 2010, almost one-third (31.4%) of the 193,300 persons employed in the finance industry were aged between 35 years and 44 years. A total of 9.3% were aged 55 or over and 11.9% were aged under 25.



Source: ABS

Unemployment in the finance and insurance industry

As at May 2010, the unemployment rate for the finance and insurance industry was 3.3%. The graph below shows that the unemployment rate for the finance and insurance industry generally remains significantly below the overall unemployment rate (i.e. for all industries).



Source: ABS

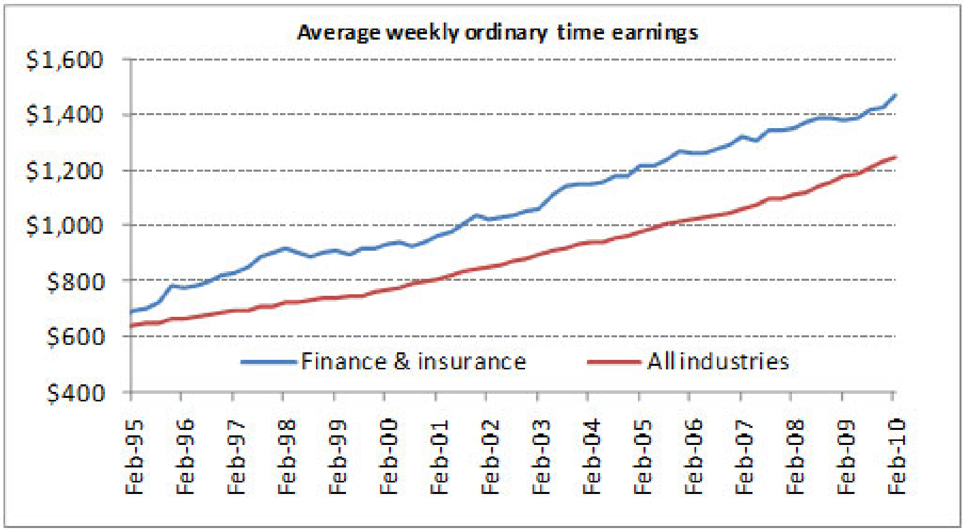
Wages and average weekly earnings

Australia's retail banks paid out $18.5 billion in wages in 2009 – this was more than half (54%) of their total operating expenses. The proportion paid out in wages increased over the three years (2005 to 2008) from 53% in 2005 to 57% in 2008.

As at May 2010, at $1,471 per week, average wages in the finance and insurance industry are 18% higher than the national average ($1,243 per week).

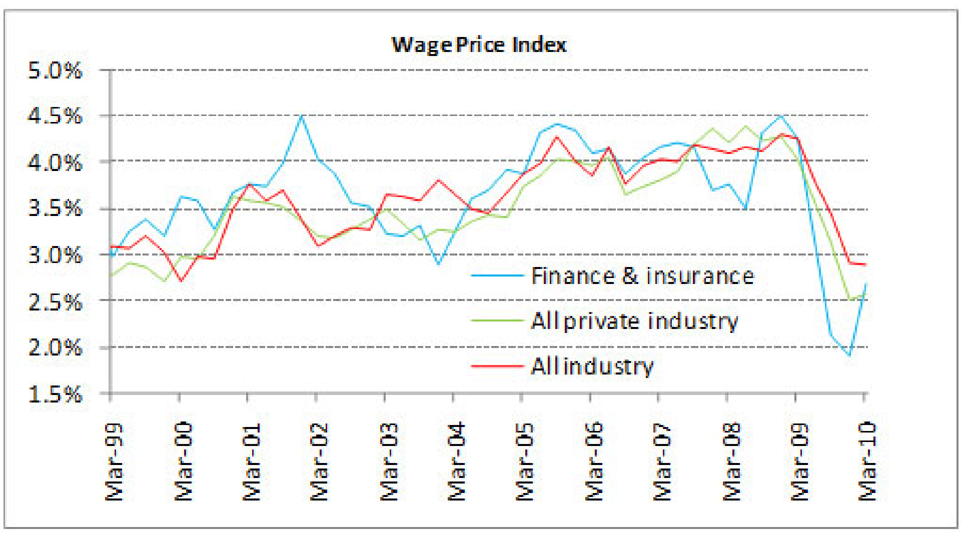
On average, over the past five years (2005-2010), average weekly ordinary time earnings for the finance and insurance industry have been 21% more than the national average.

At the beginning of 2007, average weekly ordinary time earnings for the finance and insurance industry were 25% higher when compared with all industries. By the end of 2009, this was reduced to 16%.



Source: ABS

Wage growth for the finance and insurance industry hit a peak of 4.5% over calendar year 2008, but then fell resulting in a 1.9% increase over calendar year 2009. The ABS wage price index shows that ordinary time hourly rates of pay excluding bonuses for the finance and insurance industry increased by 2.7% (over the 12 months to the end of March 2010). This compares with 2.6% for private industry overall and 2.9% for all industries (private and public).

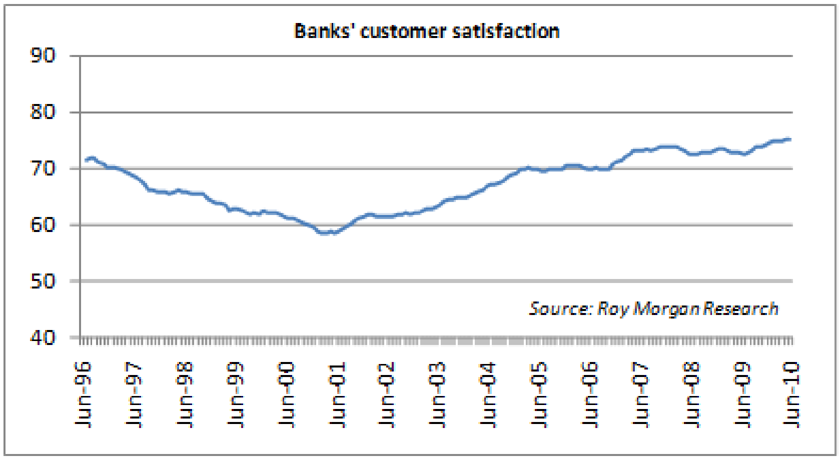


Source: ABS

Banks customers

Customer satisfaction

According to Roy Morgan research, customer satisfaction for banks is at record levels (the data series start from 1996). In October 2010, customer satisfaction for banks continued its upward trend and has now reached 76.7%. The major banks average customer satisfaction level is 75%, with the regional banks tending to have higher levels. This highest bank satisfaction level is 87.9%.



Source: Roy Morgan Research

Appendix 3: Overview of banks' funding sources

In order to support their lending, banks source their funds from:

- customer deposits;
- wholesale markets (domestic and international).

For most of the last decade, banks' funding sources and the cost of funding has been relatively predictable. Movements in the RBA's official cash rate have generally closely approximated changes in total bank funding costs. Since the GFC began in late 2007, the RBA's cash rate has not been an accurate indicator of changes in bank funding costs.

The price that banks pay for their funds is influenced by many factors. These include changes in the official cash rate, competition, international events, the credit rating of the bank, and the supply of wholesale funds.

Sources of funds

At the end of June 2010, bank funding was at $1.47 trillion, an increase of $100 billion or 7.3% over the previous year.

ABS Financial Accounts show that retail deposits constitute 53.5% ($787 billion) of bank funding while wholesale funding (or borrowing by banks) accounts for 46.5% or $685 billion.

Wholesale funding can be further disaggregated into short-term funding (of less than 12 months duration) and long-term funding (of greater than 12 months duration), making up 16.6% and 29.9% of banks' funds respectively.

Of the total $685 billion in banks' wholesale funding, $407 billion (59%) is sourced from offshore financial markets of which 80% is long-term funding.

Banks' funding – June 2010	**$bn**	**%**
Business deposits	$252.9	17.2%
Household deposits	$534.3	36.3%
Deposits – Retail	**$787.2**	**53.5%**
Wholesale funding		
Bills of Exchange	$23.9	1.6%
One name paper – domestic	$137.7	9.4%
One name paper – offshore	$83.3	5.7%
Short-term funds – total	**$244.9**	**16.6%**
Bonds – domestic	$116.6	7.9%
Bonds – offshore	$323.9	22.0%
Long-term funds – total	**$440.5**	**29.9%**
Wholesale funding - total	**$685.4**	**46.5%**
Total	**$1,472.6**	**100.0%**

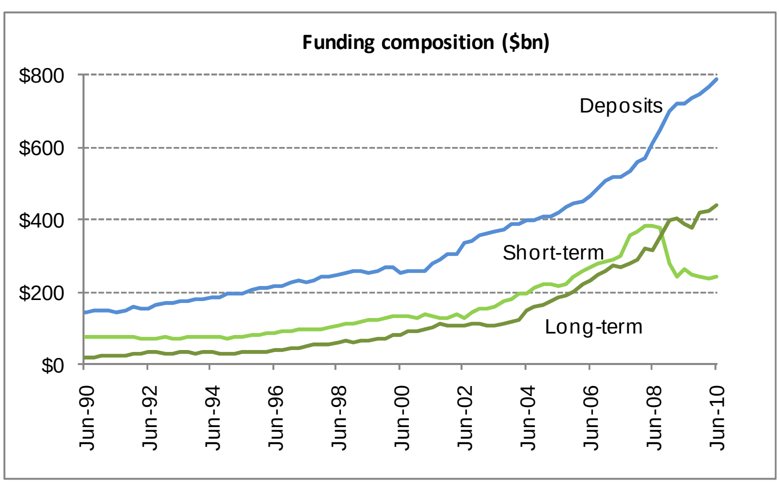
Source: ABS Financial Accounts

The table below provides a more detailed summary for the past six years.

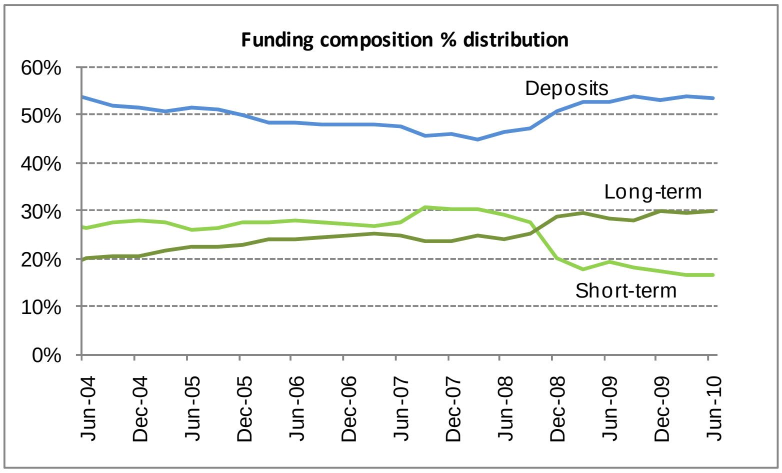
Banks ($bn)	Deposits	Bills of Exchange	One name paper - domestic	One name paper - offshore	Bonds - domestic	Bonds – offshore	Total debt
Jun-05	$420.9	$49.6	$110.3	$54.6	$38.0	$146.7	$820.1
Jun-06	$467.4	$50.5	$127.6	$91.6	$53.0	$179.3	$969.3
Jun-07	$515.7	$55.3	$136.0	$107.3	$65.0	$205.5	$1,084.8
Jun-08	$609.9	$45.9	$225.4	$113.3	$80.9	$236.8	$1,312.3
Jun-09	$720.9	$36.8	$159.0	$68.4	$104.3	$282.4	$1,371.9
Jun-10	$787.2	$23.9	$137.1	$83.3	$116.6	$323.9	$1,472.0
$-change							
Jun-06	$46.5	$0.8	$17.3	$37.0	$15.0	$32.6	$149.2
Jun-07	$48.3	$4.9	$8.4	$15.7	$12.1	$26.2	$115.5
Jun-08	$94.2	-$9.4	$89.4	$6.1	$15.9	$31.3	$227.5
Jun-09	$111.0	-$9.1	-$66.4	-$44.9	$23.4	$45.6	$59.6
Jun-10	$66.3	-$12.9	-$22.0	$14.9	$12.2	$41.5	$100.1
%-change							
Jun-06	11.1%	1.7%	15.7%	67.7%	39.4%	22.2%	18.2%
Jun-07	10.3%	9.6%	6.6%	17.1%	22.8%	14.6%	11.9%
Jun-08	18.3%	-17.0%	65.7%	5.7%	24.5%	15.3%	21.0%
Jun-09	18.2%	-19.8%	-29.4%	-39.7%	28.9%	19.3%	4.5%
Jun-10	9.2%	-35.1%	-13.8%	21.8%	11.7%	14.7%	7.3%
%-distbn							
Jun-06	48.2%	5.2%	13.2%	9.4%	5.5%	18.5%	100.0%
Jun-07	47.5%	5.1%	12.5%	9.9%	6.0%	18.9%	100.0%
Jun-08	46.5%	3.5%	17.2%	8.6%	6.2%	18.0%	100.0%
Jun-09	52.5%	2.7%	11.6%	5.0%	7.6%	20.6%	100.0%
Jun-10	53.5%	1.6%	9.3%	5.7%	7.9%	22.0%	100.0%

Source: ABS Financial Accounts

The fall in short-term funding levels is noticeable over December quarter 2008 and March quarter 2009. The disruption to short-term capital markets as a result of the GFC resulted in the level of short-term wholesale funds falling below the level of long-term capital funds in December quarter 2008. This is evident in the graph below.



Source: ABS Financial Accounts

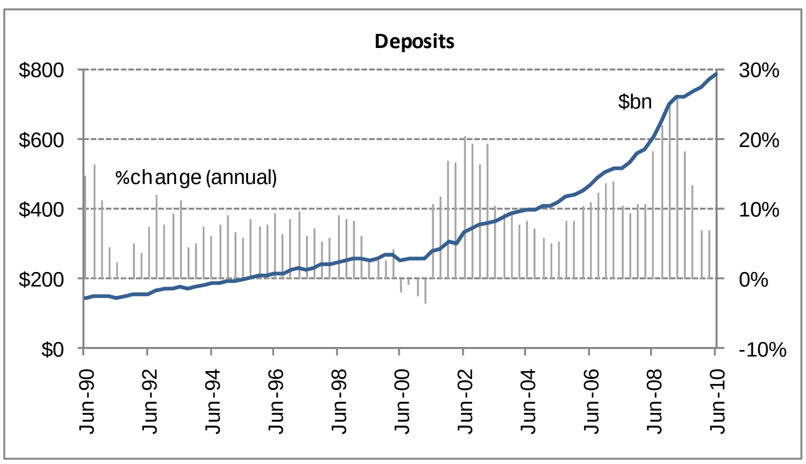


Source: ABS Financial Accounts

Retail deposits

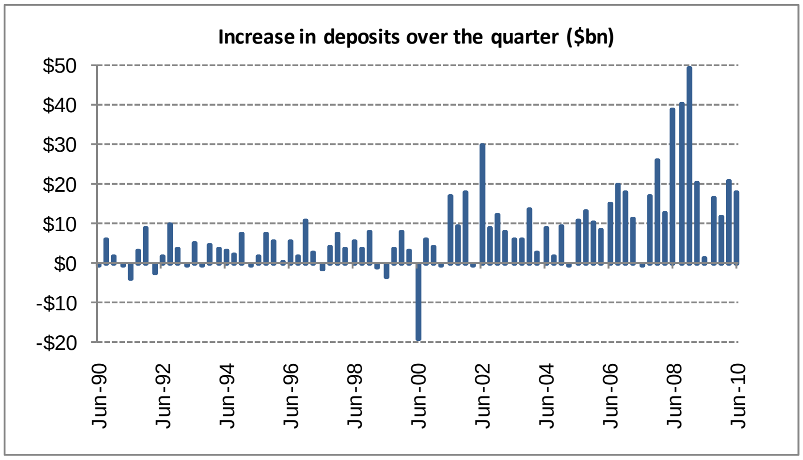
Deposits constitute the largest source of bank funding now at 53.5% of total funding. Retail deposits (i.e. deposits of households and private businesses) were $787 billion at the end June 2010. This is a 9.2% or $66 billion increase over the past year.

In late 2008/early 2009, bank deposits had been growing at the fastest annual pace in the life of the data series (i.e. 20 years), at almost 25%.



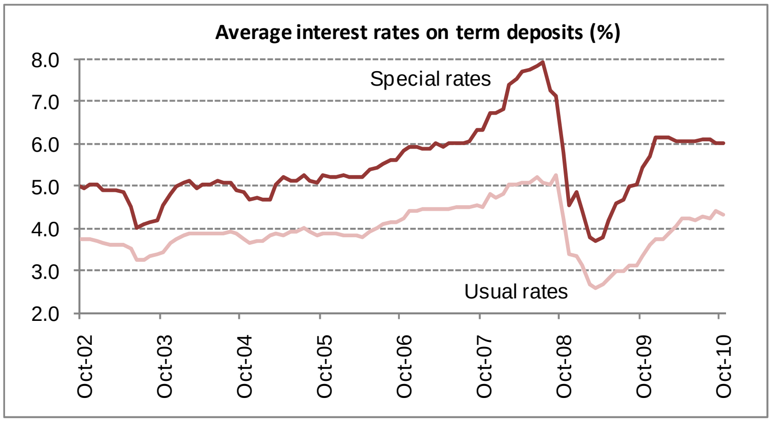
Source: ABS Financial Accounts

The graph below shows the increase in the stock of deposits held by banks over the quarter. Most noticeable are the record increases in deposits, on a quarterly basis, at the height of the GFC. In June quarter 2008, deposits grew by $39 billion, in September quarter 2008 by $40 billion, and by $49 billion in December quarter 2008.



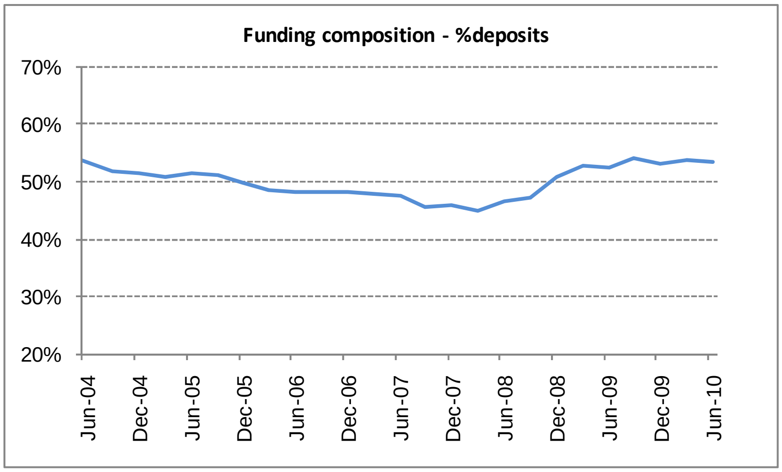
Source: ABS Financial Accounts

The strong increases in deposits during 2008 was assisted by high interest rates on term deposits, in particular, banks offered attractive 'special' rates on term deposits with the average as high as 7.95% in July 2008. There were instances where these rates were above 8.00%.



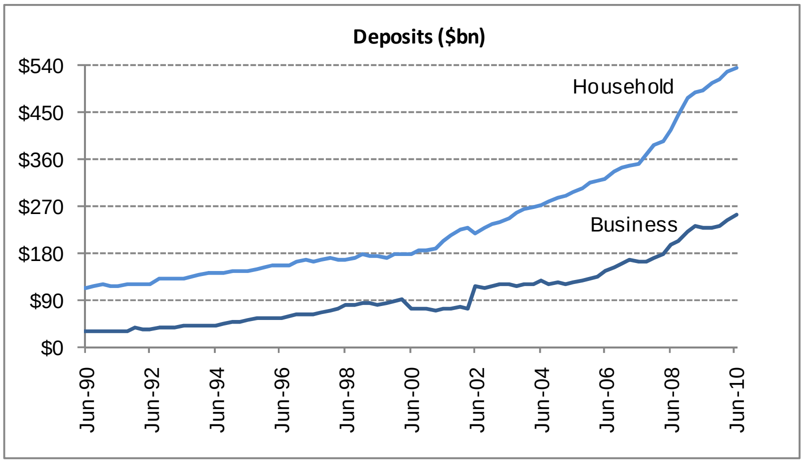
Source: RBA data

Retail deposits have increased from 44.8% of banks' funding in March 2008 to 53.5% in June 2010.

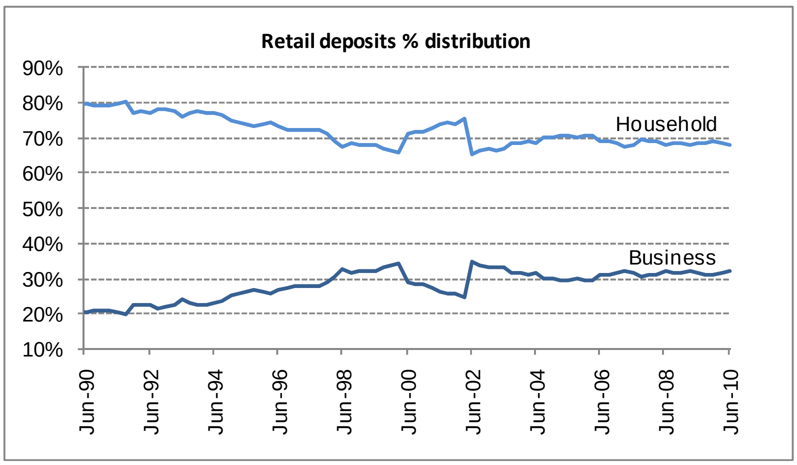


Source: ABS Financial Accounts

At June 2010, household deposits were at $534 billion, making up 68% of retail deposits. Business deposits were at $253 billion or 32% of retail deposits.



Source: ABS Financial Accounts

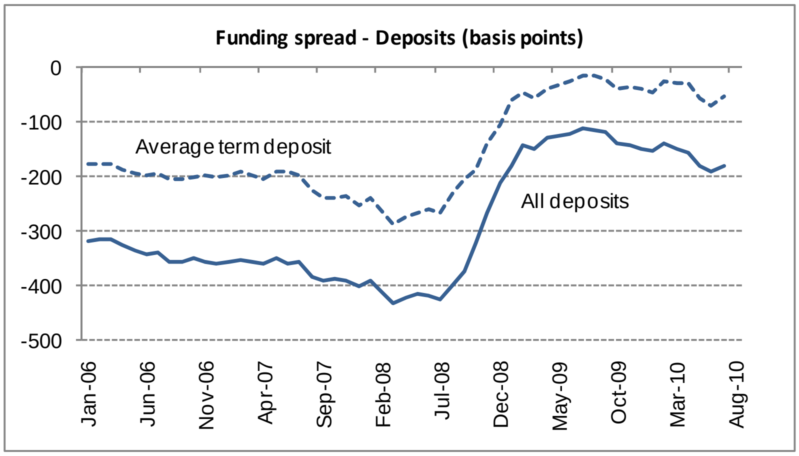


Source: ABS Financial Accounts

The graph below shows the spread for the average of interest rates on selected deposit products and term deposits to the 90 day BBSW. This is an indicative measure of the margin or spread on interest-bearing deposits, not an actual measure.

The BBSW is a benchmark for the cost of banks funds. As such, it would be expected that interest rates on deposit products would normally be priced below the BBSW. The graph below supports this. It shows that until mid 2008, the average interest rate across selected deposit products was as much as 400 basis points below the BBSW. Strong competition for deposits, however, has seen this rapidly change, so much so that the average interest rate on selected deposit products fell to 110 basis points below the BBSW by July 2009. It is now (late 2010) around 180 basis points below the BBSW.

In essence, the cost of deposits as a source of bank funding has increased significantly since mid-2008.



Source: RBA data / Cannex

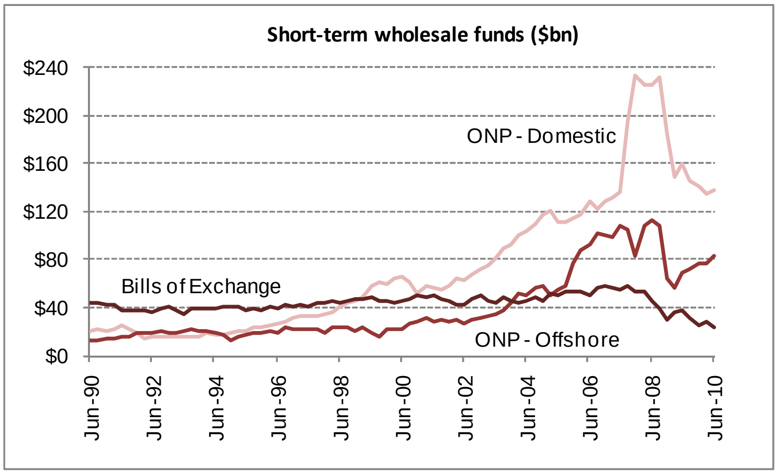
Short-term funding

At the end of June 2010, banks' short-term funding was $244 billion, a fall of $20 billion or 7.6% over the previous year.

The composition of banks' short-term funds was: bills of exchange (BoE) $23.9 billion, one name paper issued domestically (ONP – domestic) $137.1 billion and one name paper issued offshore (ONP – offshore) $83.3 billion.

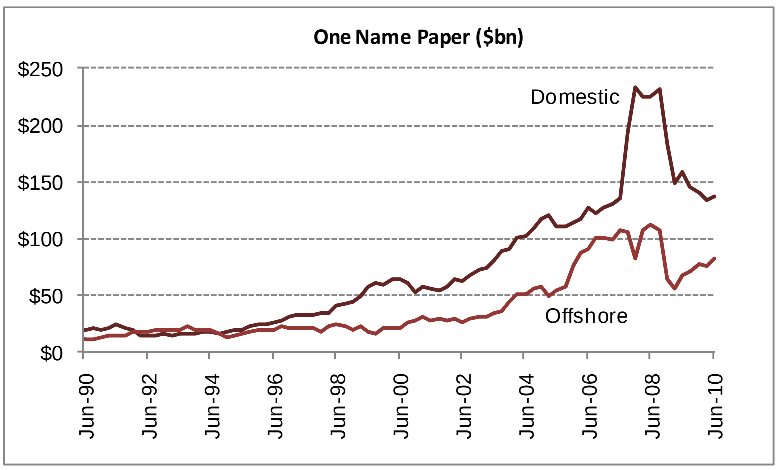
Banks ($bn)	Bills of Exchange	One name paper - domestic	One name paper - offshore	Total Short-term
Jun-05	$49.6	$110.3	$54.6	$214.5
Jun-06	$50.5	$127.6	$91.6	$269.6
Jun-07	$55.3	$136.0	$107.3	$298.6
Jun-08	$45.9	$225.4	$113.3	$384.7
Jun-09	$36.8	$159.0	$68.4	$264.3
Jun-10	$23.9	$137.1	$83.3	$244.3
$-change				
Jun-06	$0.8	$17.3	$37.0	$55.1
Jun-07	$4.9	$8.4	$15.7	$29.0
Jun-08	-$9.4	$89.4	$6.1	$86.1
Jun-09	-$9.1	-$66.4	-$44.9	-$120.4
Jun-10	-$12.9	-$22.0	$14.9	-$20.0
%-change				
Jun-06	1.7%	15.7%	67.7%	25.7%
Jun-07	9.6%	6.6%	17.1%	10.7%
Jun-08	-17.0%	65.7%	5.7%	28.8%
Jun-09	-19.8%	-29.4%	-39.7%	-31.3%
Jun-10	-35.1%	-13.8%	21.8%	-7.6%
%-distbn				
Jun-06	18.7%	47.3%	34.0%	100.0%
Jun-07	18.5%	45.6%	35.9%	100.0%
Jun-08	11.9%	58.6%	29.5%	100.0%
Jun-09	13.9%	60.2%	25.9%	100.0%
Jun-10	9.8%	56.1%	34.1%	100.0%

Source: ABS Financial Accounts



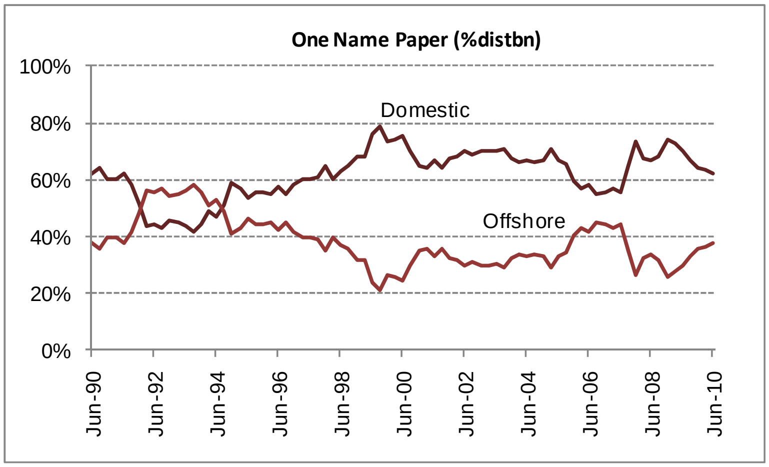
Source: ABS Financial Accounts

There has been a significant reduction in the issuance of one name paper over the past two years (since the height of the GFC). This includes a net reduction of $88.4 billion (39%) in domestic issuance and a net reduction of $30 billion (26%) in offshore issuance of one name paper over the past two years. This reflects the disruption in short-term funding markets as well as a move by banks to seek a greater proportion of their funds via deposits and longer term issuance.



Source: ABS Financial Accounts

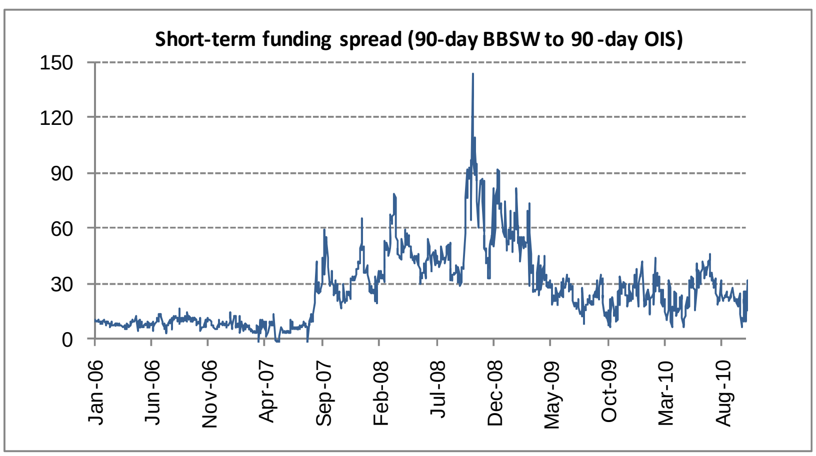
Issuance of one name paper is two-thirds domestic and one-third offshore.



Source: ABS Financial Accounts

The 90-day bank bill swap rate (90-day BBSW) is commonly used as the market benchmark for banks' funding costs. The divergence (i.e. spread) of the 90-day BBSW from a <u>market</u> indicator of the cash rate can indicate changes to the banks' short-term funding costs. This 'market' indicator of the official cash rate is called the 90-day Overnight Index Swap rate (90-day OIS).

The graph clearly shows that the cost of short-term funds (based on the BBSW to OIS spread) has been volatile since August 2007. Prior to August 2007, the cost above the 90-day OIS was only about 8-10 basis points. The spread during August 2010 has averaged 24 basis points or about three times higher than pre-GFC levels.



Source: NAB Economics

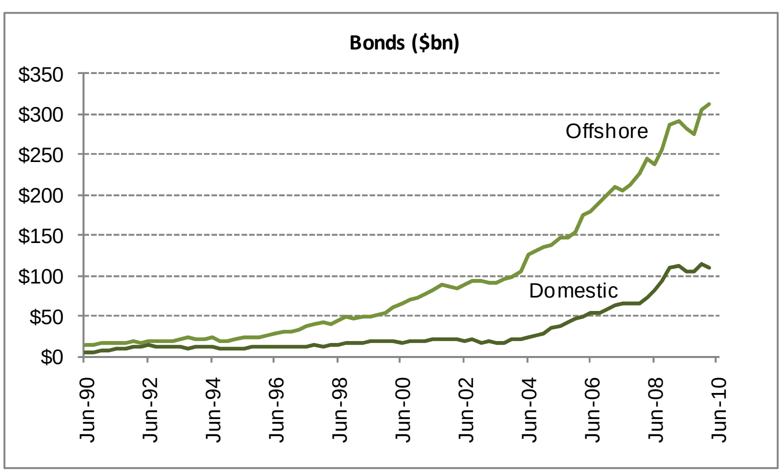
Long-term funding

At the end of June 2010, banks' long-term funding was $440.5 billion, an increase of 13.9% or $53.7 billion over the previous year.

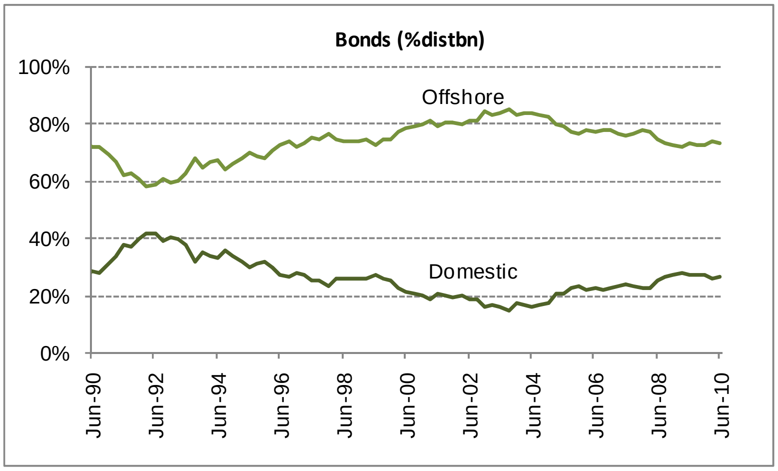
Banks ($bn)	Bonds - domestic	Bonds – offshore	Total debt
Jun-05	$38.0	$146.7	$184.7
Jun-06	$53.0	$179.3	$232.2
Jun-07	$65.0	$205.5	$270.5
Jun-08	$80.9	$236.8	$317.7
Jun-09	$104.3	$282.4	$386.8
Jun-10	$116.6	$323.9	$440.5
$-change			
Jun-06	$15.0	$32.6	$47.6
Jun-07	$12.1	$26.2	$38.2
Jun-08	$15.9	$31.3	$47.2
Jun-09	$23.4	$45.6	$69.0
Jun-10	$12.2	$41.5	$53.7
%-change			
Jun-06	39.4%	22.2%	25.8%
Jun-07	22.8%	14.6%	16.5%
Jun-08	24.5%	15.3%	17.5%
Jun-09	28.9%	19.3%	21.7%
Jun-10	11.7%	14.7%	13.9%
%-distbn			
Jun-06	22.8%	77.2%	100.0%
Jun-07	24.0%	76.0%	100.0%
Jun-08	25.5%	74.5%	100.0%
Jun-09	27.0%	73.0%	100.0%
Jun-10	26.5%	73.5%	100.0%

Source: ABS Financial Accounts

The composition of banks' long-term funds at the end of June 2010 was: bonds issued domestically $116.6 billion (26.5%) and bonds issued offshore $323.9 billion (73.5%).

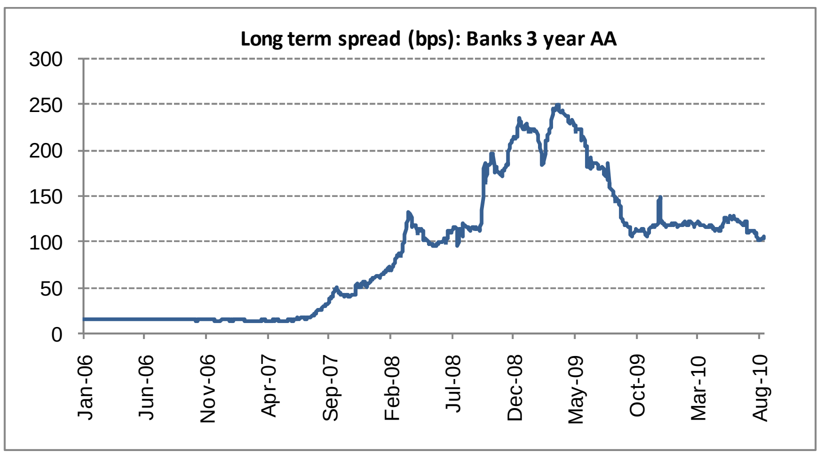


Source: ABS Financial Accounts



Source: ABS Financial Accounts

Pricing for banks long-term issuance remains about 100 basis points above swap (August 2010) for three year terms. These spreads are about 8 times higher than pre-GFC levels. The graph below shows that prior to the GFC, banks could raise three-year term funding at around 12-15 basis points above the benchmark rate. Spreads averaged as high as 242 basis points in March 2009.



Source: CBA Economics

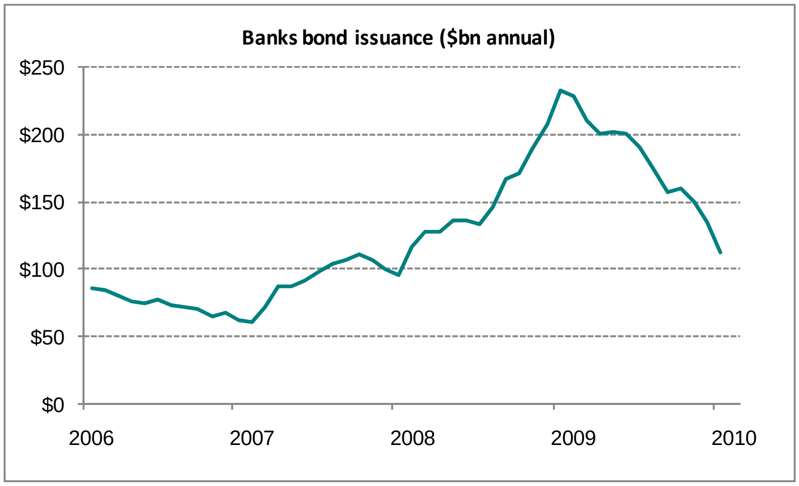
The data above shows the level of long term debt outstanding, however, it is useful to look at the issuance of bonds on an annual and monthly basis as presented in the graphs below.

In 2006, bond issuance was $85 billion, falling to $61 billion in 2007. The initial impact of the GFC affected issuance in late 2007. This lower level of issuance in 2007, resulting mainly from very low issuance in the last two months of 2007, was redressed in early 2008 where $38.7 billion was issued in the first two months of 2008 (as compared with $18.7 billion in Jan/Feb 2006 and $13.1 billion in Jan/Feb 2007).

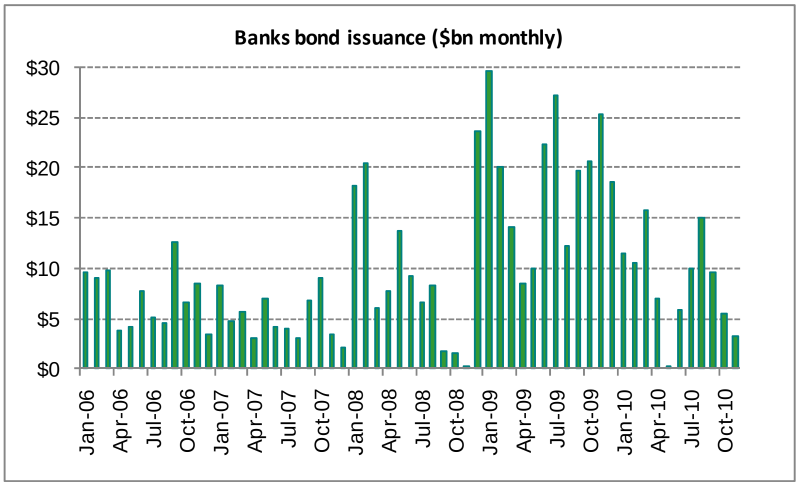
At the peak of the GFC, from September 2008 to November 2008, bond issuance fell over this three month period to $3.5 billion, the lowest level for any three month period for the five year period shown. The following three months, from December 2008 to February 2009, saw a record $73 billion of bond issuance with two-thirds (67%) of this being offshore issuance. The announcement of the government guarantee in October 2008 provided support to bond issuance programs during this time with the first guaranteed issuances in December 2008.

Monthly bond issuance remained high throughout 2009 as banks brought forward their funding needs to ensure that their balance sheets were stable and strong within a difficult funding environment.

Other factors also impacted on the very high level ($228 billion) of bond issuance in 2009. That is, disruption in the short-term capital markets saw financial institutions move to longer term issuance. The closure of securitisation markets meant that bond issuance replaced securitisation programs. This, of course, has affected the data since the onset of the global financial crisis. Bank mergers and takeovers added to the overall level of bond issuance as the securitised assets of the acquired banks were replaced with bond issuance.



Source: RBA data



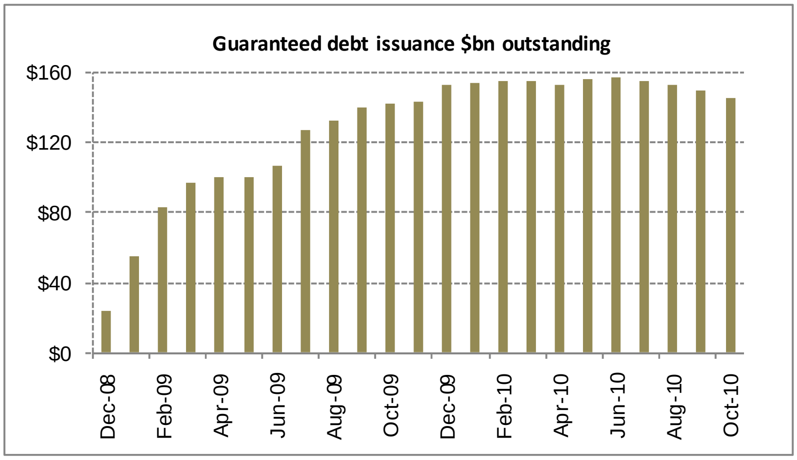
Source: RBA data

Government guarantee of wholesale funding

In October 2008, the Australian Government announced guarantee arrangements for wholesale borrowing. Given that these guarantees were being implemented in a number of other countries – as a result of huge disruption to financial markets at that time – it was important that Australia also had such a system in place to ensure continued and smooth access to capital markets.

The guarantee fees provide an ongoing monthly revenue stream for government over the life of the debt issuance, with some maturities out to 2014. To October 2010, banks participating in the scheme have paid $2.1 billion to the Australian Government.

As at the end of October 2010, the total guaranteed debt issuance stands at $144.9 billion[68].



Source: Australian Treasury

Summary of banks' wholesale funding

ABS Financial Accounts at the end of June 2010 show that wholesale funding makes up around 47% or $684.8 billion of bank funding. This is made up of $224.9 billion in short-term funding and $440.5 billion in long-term funding. Short-term funding, excluding bills of exchange (which are not classified by domestic or offshore) is 62% domestic and 38% offshore while for long-term funding this is 26% domestic and 74% offshore.

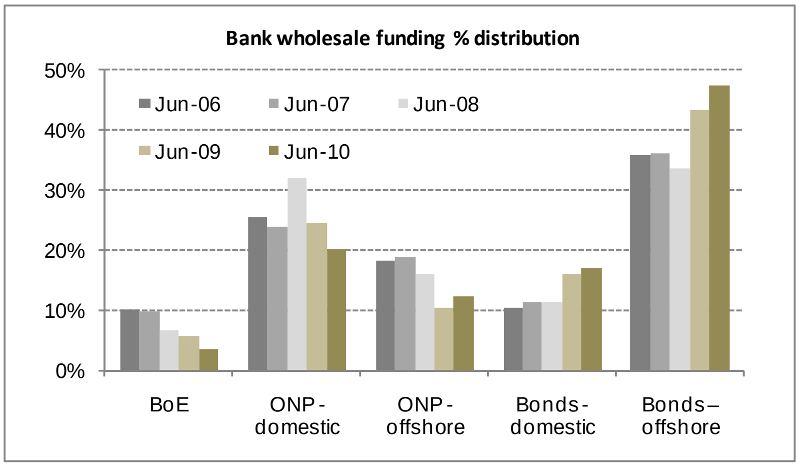
Banks ($bn)	Bills of Exchange	One name paper - domestic	One name paper - offshore	Bonds - domestic	Bonds – offshore	Total wholesale
Jun-05	$49.6	$110.3	$54.6	$38.0	$146.7	$399.2
Jun-06	$50.5	$127.6	$91.6	$53.0	$179.3	$501.9
Jun-07	$55.3	$136.0	$107.3	$65.0	$205.5	$569.1
Jun-08	$45.9	$225.4	$113.3	$80.9	$236.8	$702.4
Jun-09	$36.8	$159.0	$68.4	$104.3	$282.4	$651.0
Jun-10	$23.9	$137.1	$83.3	$116.6	$323.9	$684.8
$-change						
Jun-06	$0.8	$17.3	$37.0	$15.0	$32.6	$102.7
Jun-07	$4.9	$8.4	$15.7	$12.1	$26.2	$67.2
Jun-08	-$9.4	$89.4	$6.1	$15.9	$31.3	$133.3
Jun-09	-$9.1	-$66.4	-$44.9	$23.4	$45.6	-$51.4
Jun-10	-$12.9	-$22.0	$14.9	$12.2	$41.5	$33.8
%-change						
Jun-06	1.7%	15.7%	67.7%	39.4%	22.2%	25.7%
Jun-07	9.6%	6.6%	17.1%	22.8%	14.6%	13.4%
Jun-08	-17.0%	65.7%	5.7%	24.5%	15.3%	23.4%
Jun-09	-19.8%	-29.4%	-39.7%	28.9%	19.3%	-7.3%
Jun-10	-35.1%	-13.8%	21.8%	11.7%	14.7%	5.2%

[68] The ABA notes that on 7 February 2010, the Australian Government announced the removal of the wholesale funding guarantee.

%-distbn						
Jun-06	10.1%	25.4%	18.2%	10.6%	35.7%	100.0%
Jun-07	9.7%	23.9%	18.8%	11.4%	36.1%	100.0%
Jun-08	6.5%	32.1%	16.1%	11.5%	33.7%	100.0%
Jun-09	5.7%	24.4%	10.5%	16.0%	43.4%	100.0%
Jun-10	3.5%	20.0%	12.2%	17.0%	47.3%	100.0%

Source: ABS Financial Accounts

Almost half (46.3%) of all wholesale funding for banks is from long-term debt (bonds) issues offshore.



Source: ABS Financial Accounts

Appendix 4: Small Business Survey

ACCI small business survey on investments constraints - 2005 to 2010, August Editions

Small Business		2005	2006	2007	2008	2009	2010
	1	Business Taxes and Government Charges	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Business Taxes and Government Charges	Insufficient Demand
	2	State Government Regulations	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Insufficient Demand	Business Taxes and Government Charges
	3	Availability of Suitably Qualified Employees	Local Competition	State Government Regulations	Level of Interest Rates	Charges by Lending Institutions	State Government Regulations
	4	Federal Government Regulations	Insufficient Retained Earnings	Wage Costs	Non-Wage Labour Costs	State Government Regulations	Federal Government Regulations
	5	Non-wage labour Costs	State Government Regulations	Charges by Lending Institutions	Wage Costs	Wage Costs	Insufficient Retained Earnings
Medium business							
	1	Business Taxes and Government Charges	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Business Taxes and Government Charges
	2	Availability of Suitably Qualified Employees	Availability of Suitably Qualified employees	Business Taxes and Government Charges	Wage Costs	State Government Regulations	Local competition
	3	State Government Regulations	Wage Costs	Local Competition	Business Taxes and Government Charges	Raising Loans from Financial Institutions	Wage costs
	4	Non-wage labour Costs	Local Competition	Wage Costs	Non-Wage Labour Costs	Insufficient Demand	Non-Wage Labour Costs
	5	Wage Costs	State Government Regulations	State Government Regulations	State Government Regulations	Wage Costs	Insufficient Demand
Large business							
	1	Business Taxes and Government Charges	Business Taxes and Government Charges	Availability of Suitably Qualified employees	Availability of Suitably Qualified employees	Raising Loans from Financial Institutions	Availability of Suitably Qualified employees
	2	Availability of Suitably Qualified Employees	Availability of Suitably Qualified employees	Insufficient Demand	Federal Government Regulations	Charges by Lending Institutions	Business Taxes and Government Charges
	3	State Government Regulations	Non-Wage Labour Costs	Wage Costs	Business Taxes and Government Charges	Raising Equity Capital	State Government Regulations
	4	Local Competition	State Government Regulations	Federal Government Regulations	State Government Regulations	Insufficient Demand	Federal Government Regulations
	5	Non-wage Labour Costs	Insufficient Demand	Local Competition	Local Competition	Business Taxes and Government Charges	Non-Wage Labour Costs