Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
Parliament House
CANBERRA ACT 2600

31 January 2011

Dear Mr Hawkins,

Thank you for your email of 5 January 2011 in which you included a number of additional written questions from the Senate Economics Committee's Inquiry into Competition within the Australian Banking Sector. The following points are our response to each of the questions.

(i) *How important are economies of scale in retail banking, and in participating in international lending? Does this constitute a barrier to entry and a force for concentration?*

- The literature on economies of scale in retail banking is inconclusive, reflecting conjecture about the point at which diseconomies occur and the diversity and uniqueness of the cases examined and the considerable variation in regulatory and operating environments across countries.
- A 1999 Reserve Bank of Australia research paper - *Trends in the Australian Banking System: Implications for Financial System Stability and Monetary Policy* (http://www.rba.gov.au/publications/rdp/1999/pdf/rdp1999-05.pdf) – notes that a consistent finding from a range of studies on the Efficient-Structure hypothesis is that cost efficiency is a "better explanator of financial institution profitability than market power".
- For example, while Australian second tier banks operate with higher 'cost to income' ratios and lower 'net interest margins' than the majors, this reflects, in large part, the relative dominance of higher yielding (and higher risk) business segment on the books of the majors. Part of the discrepancy can also be traced to higher credit ratings of the major banks which affords lower wholesale funding costs. This too has little to do with scale and more to do with quality and level of capital, management of capital and liquidity.
- In the international banking sphere there appears to be greater scope for synergies in the corporate and investment banking segments. Scale is achieved by broadening client and product coverage. Benefits derive from reducing overlap of functions (e.g. foreign exchange trade and international payments) and sharing of industry expertise and research functions. In an asset management context, scale

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is critical to reaching institutional segments and for lifting operational and reputational status.

(ii) *The return on equity in the large Australian banks is similar to that for other large companies in Australia. But should the returns be lower given the relatively low risk of banking?*

- Banks are very highly-geared organisations (compared to most other non-financial corporations) and are therefore not lower risk businesses.
- Strong regulation, predominantly to protect consumers and depositors, reduces the risks to these stakeholders in particular, but the risks to shareholders are not as insulated from market fluctuations.
- Banks are as exposed to the economy as non-financial corporations. For example, ANZ's share price fell from around $30 to around $12 during the GFC. Other Australian banks performed similarly but relatively favourably compared to other banking systems.
- While there are some stability benefits deriving from deposit-guarantee schemes, credit risk has been the predominant source of risk facing banks since deregulation.
- As outlined in our submission, return on equity (ROE) for the industry is not particularly different to other industries and is lower than the ROE before the global financial crisis. The ROE measure is a reflection of the risk the market attaches to investing in particular sectors. In this context, the market sets the level of ROE expected from sectors in the economy and if returns are below these investor expectations then investor appetite for that sector will diminish.

(iii) *Given that there appears to be widespread belief that home loan rates are tied to the cash rate but this is not the case, would you consider offering an additional home loan product where the interest rate was explicitly tied to the cash rate or a verified cost of funds?*

- ANZ is currently considering how a product of this kind might work in practice

(iv) *Have you considered lowering the amount you charge other bank customers for using your ATMs as a way of attracting more people to use them?*

- Customer behaviour post Direct Charging reform implemented in 2009 combined with our own customer research (on both ANZ and non ANZ customers) highlights that the majority of customers seek out their own financial institution ATMs where they are not charged a fee.
- Our focus is on ensuring a positive customer experience through providing a fast transaction with value added functionality, best practice availability and ensuring the ATMs are installed in highly convenient locations.

Yours sincerely

Michael Johnston
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