

# Competition within the Australian banking sector

December 2010

ANZ Submission to the  
Senate Economics References Committee



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# EXECUTIVE SUMMARY

## EXECUTIVE SUMMARY

ANZ is pleased to provide a submission to the Senate Economics Committee Inquiry into Competition in the Australian banking sector.

In our assessment, competition in the Australian banking sector has changed in nature over the last three years. The number of lenders has reduced as securitisation markets have closed, although there has been no meaningful reduction in the range of lending products available to borrowers. Conversely, competition for deposits has intensified as banks and other lenders have sought to improve the proportion of their funding from core deposit sources.

While we have seen some concentration in the market, this has not reversed the long-term downward trend for interest rate margins. During the GFC margins have fluctuated in a small range just over 2 per cent above lenders' funding costs. The market has remained competitive and held margins at around historically low levels.

The RBA cash rate has an increasingly loose connection with banks' cost of funds and hence lending rates. The out of cycle rate rises ANZ has made since January 2008 reflect a pass through of our increased funding costs. This has been caused by increases in the major components of bank funding, including:

- Greater competition for customer deposits which is increasing the cost of deposits (and depositors are benefiting from higher returns on their savings);
- An increase in wholesale funding costs due to a repricing of risk on wholesale debt markets; and
- A change in the funding mix towards longer-term wholesale debt and deposits as more stable sources of funding.

It is important for the long term health of the Australian economy that lending generates adequate return on the capital employed in the industry. Without adequate returns, lenders would be unable to attract the capital required to support the growth in credit required to finance economic growth.

On fees and charges, bank customers have also benefited from changes in industry practice. 'Direct charging' reforms to foreign ATM fees, driven by the RBA, have made the fee for using another bank's ATM transparent and had a marked effect on consumer behaviour. The RBA estimated that consumers have saved around \$120 million in the first year of implementation of the reform. Exit fees on loans are now covered by the Unfair Contract Terms legislation. ASIC has recently issued guidance on how that legislation applies to both loan establishment and loan exit fees. In addition, ANZ has recently removed its Deferred Establishment Fee from variable rate mortgages.

Some attention has been drawn to the absolute level of bank profits. To assess whether these profits are appropriate, dollar amounts need to be measured against capital employed and risks associated with earning these profits. On this measure, Return on Equity, bank profits are not excessive and are in line with other large companies in other industries. It should also be recognised that a reasonable level of profits is required to ensure:

## EXECUTIVE SUMMARY

- That confidence in the financial system is maintained in periods of economic downturn by ensuring that banks are able to absorb higher bad debt expenses without incurring losses and
- There are sufficient amounts that can be retained to fund the regulatory capital required to fund increased lending and support economic growth.

Given our assessment, ANZ would support practical measures which will increase competition and consumer choice in the market without imposing unnecessary costs on banks and their customers, and which will ease the cost of providing credit to borrowers.

Measures we believe fit this description include:

- Further support for the securitisation market through measures which will increase liquidity and confidence in the market and allow it to become self-sustaining;
- Support for diversification of bank funding sources, for example, allowing Australian banks to issue covered bonds;
- Support for development of a substantive corporate bond market in Australia, in particular further measures which will increase retail investors' confidence in the corporate bond market as an attractive asset class; and
- Improving the financial literacy of consumers to support better decision making and use of existing switching services.

# COMPETITION IN AUSTRALIAN BANKING

## COMPETITION IN AUSTRALIAN BANKING

To understand where we are today it is useful to consider the benefits to Australian bank customers that resulted from the substantial deregulation of the Australian banking sector during the 1980s.

Prior to deregulation access to finance for consumers was limited. The interest rate which a bank could charge for a loan was controlled and quantitative lending controls placed restrictions on the amount of lending to various sectors of the economy. These controls restricted credit supply. As a result, only customers with a very good credit record and high income and/or savings were able to obtain a loan without needing to resort to supplementary forms of finance. Dr Ken Henry, Secretary of the Treasury discussed this in a recent appearance before the Senate Economics Committee:

*the effect of regulated interest rates in that period—that is, prior to May 1986—was that people who had sufficient wealth to be able to get to the front of the queue were able to get low interest mortgages and those, particularly young people, who did not have sufficient accumulated wealth had to go elsewhere. Obviously they paid much higher interest rates on their mortgages.<sup>1</sup>*

Removal of interest rate and quantitative lending controls has made credit much more accessible and helped to underpin growth in the Australian economy.

The number of suppliers of credit and other financial services also expanded significantly with the entrance of foreign banks in the 1980s and the entrance of mortgage originators in the early 1990s.

Borrowers were clear beneficiaries of financial deregulation: credit became both cheaper and more readily available. The combination of relatively wide margins (which are contained in the actual rate of borrowing) of four to five percent on mortgage loans and financial innovation in the form of securitisation enabled mortgage originators to undercut banks' pricing and enter the home loan market. This put additional downward pressure on the price of home loans. The Wallis Inquiry (1997: p.625) found that '[t]he rapid growth of mortgage securitisers ... turned the market for housing finance into one of the most competitive segments of the Australian financial system'.

As other developed countries also deregulated their financial systems at this time, the deregulation of Australia's banking system and advances in communication technologies saw rapid integration of Australia's banking system with global financial markets. Banking became a globalised industry, but at the same time an important sector of the Australian economy.

<sup>1</sup> House of Representatives Standing Committee on Economics, Review of the Reserve Bank Annual Report 2010, Committee Hansard, 26 November 2010, available at <http://www.aph.gov.au/hansard/senate/commtee/S13310.pdf>, p 87

# COMPETITION IN AUSTRALIAN BANKING

## IMPACTS OF THE GFC

When the US banking system experienced instability, this was quickly transmitted to other banking markets around the world, including Australia. The GFC had three main components: a 'drying up' of liquidity, an upward repricing of risk and a requirement for more capital.

Immediately following the onset of the financial crisis, the cost of funds on global wholesale funding markets increased dramatically as investors became reluctant to lend and supply dried up. After the collapse of Lehman Brothers in September 2008, wholesale funding markets were effectively closed to Australian financial institutions and most institutions globally for around six weeks. There were also legitimate concerns that fear of contagion would lead to a "run" on banks globally.

There was also a repricing of risk which has affected the cost of borrowing globally. As noted by RBA Governor, Glenn Stevens this was unavoidable:

*I think it is probably reasonable to conclude that, given that we know that risk generally around the world was underpriced for at least a few years prior to the events of 2007 and 2008, there was always going to be, even in a highly competitive market, some repricing of risks.<sup>2</sup>*

## ROLE OF GOVERNMENT GUARANTEES

Actions taken by governments around the world in response to the severe disruption in global financial markets included instituting guarantees on deposits in order to shore up depositor confidence. For example, European Governments, including Ireland, Germany, Denmark and Iceland, moved to insure 100 per cent of eligible deposits. Other governments, including the US and the UK, increased their deposit insurance caps. Governments also provided support for financial institutions to gain access to wholesale borrowing, including guarantees on debt issuance in order that they could continue to lend to their customers.

On 12 October 2008, the Australian Government announced that it would provide similar guarantees. The Prime Minister's announcement acknowledged that the Australian banking system is affected by global events and, if the Australian Government did not follow international developments, Australian financial institutions could find it more difficult and more expensive, to borrow in international financial markets. The Australian Government's decision to put in place wholesale funding and deposit guarantees was a rational response to the environment and dealt effectively with the systemic risks presented by disruption to global markets. ANZ supported the Government's provision of the schemes.

<sup>2</sup> House of Representatives Standing Committee on Economics, p 17

# COMPETITION IN AUSTRALIAN BANKING

## **The Wholesale Funding and Large Deposits Guarantee**

The wholesale funding guarantee facilitated access to global funding markets for Australian banks. It is important to note that banks in Australia would have survived without the scheme. However, they would have found it difficult to maintain an adequate supply of affordable credit in the economy. This could have had significant ramifications for the Australian economy and may have delayed the economic recovery. As a result it was necessary at the time for the Government to put the scheme in place urgently. However, when the emergency situation passed, the Government withdrew the scheme in an orderly fashion. This was the most effective course of action to support the economy while minimising any distortion to the market.

Reflecting the sound position of the Australian banks, and the market access rationale for the guarantee, no Australian financial institution has needed financial support from the guarantees. The Government has not “bailed out” any Australian financial institution as has occurred in many other developed countries. As at October 2010, the guarantee scheme had generated \$2.1 billion in revenue for the Government<sup>3</sup> and will generate around \$5.5 billion by the time all guaranteed debt expires in 2015. Australia is one of the few countries in the world where the government was a net recipient of funds from the banking system as a result of the GFC.

## **The Financial Claims Scheme**

The Government also implemented a Financial Claims Scheme. The Scheme guarantees deposits held in Australian Authorised Deposit Institutions (ADIs) up to \$1 million per depositor per institution and is administered by APRA. In the event of the failure of an ADI, APRA would seek to recover what money it can from the failed institution. Any shortfall would be made up by a levy on the rest of the industry.

It has been suggested that taxpayers underwrite the banks. However, despite not paying up front, it is the banks that underwrite the Scheme. In the event of a bank failure, APRA would use its powers to impose a levy on the industry to recover any shortfall in the amount paid out and the amount recovered from the failed ADI. We believe this is an appropriate approach because it ensures taxpayers do not carry the risk of a bank failure nor does it impose an upfront cost on depositors given the low likelihood that any bank will need to access the Scheme.

The Scheme as currently implemented will operate until October 2011. By then, it is expected the Government will have reviewed the Scheme and may make changes, including to the cap amount. Schemes such as the Financial Claims Scheme operate in most developed countries, although the features vary from country to country, in particular the cap applied in each country.

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<sup>3</sup> <http://www.guaranteescheme.gov.au/liabilities/summary-info.html>

# COMPETITION IN AUSTRALIAN BANKING

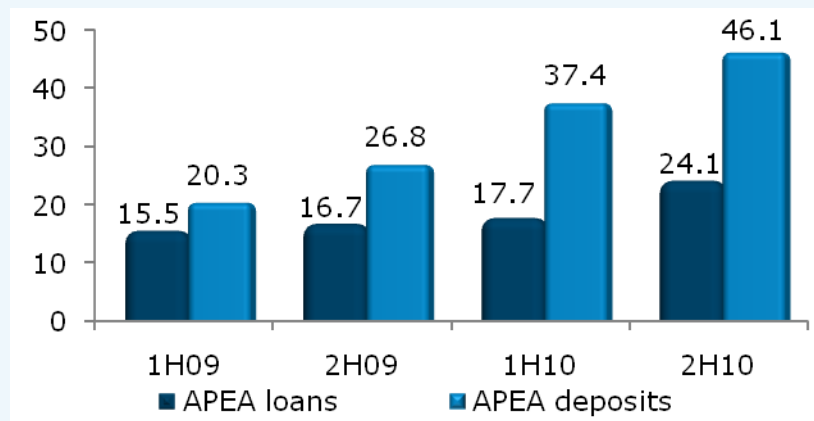
## SYSTEM STABILITY AND OFFSHORE OPERATIONS

It has been suggested that banks that expand their operations offshore pose an increased risk to the stability of the Australian banking system.

ANZ operates in New Zealand where it is the largest company by assets, has a substantial presence in 11 Pacific island economies, 14 Asian economies and offices in the major 'money centres' of New York, London, Frankfurt and Dubai. ANZ is expanding its presence in Asia as part of its strategy to become a 'super-regional' bank in the Asian region. This means ANZ is progressing towards offering the same quality of capability and service to customers as large global multinational banks such as Standard Chartered and HSBC, with a specific geographic focus on the Asia Pacific region in which Australia is located. Furthermore it means that ANZ has a meaningful presence in the economies of Australia's major trading partners and the countries on which Australia's future economic growth depends.

Rather than increasing risk, the geographic spread of ANZ's operations helps to reduce risk through diversity. In addition, ANZ's operations in Asia provide a source of deposits as people in those countries tend to save a higher proportion of their income than Australians. The chart below shows that in contrast to the situation in Australia where loans are significantly higher than deposits, deposits exceed loans in ANZ's Asia, Pacific, Europe and America (APEA) Division. This has been of value in the past few years when the cost of banks' funding has remained elevated relative to before the GFC.

**Chart 1: APEA Loans and Deposits (USDb)**



Source: ANZ

APRA's rules ensure risks in operating offshore are managed appropriately as they are in Australia. As part of APRA's accreditation of ANZ as an Authorised Deposit-taking Institution (ADI) operating in Australia, any offshore operation which is part of the Australia and New Zealand Banking Group Limited must comply with APRA prudential standards. This includes



## COMPETITION IN AUSTRALIAN BANKING

subsidiaries which are separate legal entities in their countries of operation. APRA requires that ANZ deducts the capital invested in its subsidiaries from its own capital base when calculating one of its own capital ratios for Australian regulatory purposes. In addition, Australian depositors are protected because the Banking Act requires that the assets of an ADI in Australia must exceed its liabilities (deposits) in Australia and that Australian depositors have a priority claim over the banks' assets in Australia.

Furthermore, the benefits to the Australian economy of Australia's banks facilitating trade and investment flows between Australia and the rapidly growing Asian region are clear. Australia's trade with Asian countries, particularly China, is one of the factors that helped to keep Australia out of recession and the unemployment rate relatively low at a time when other developed nations were experiencing recession and rising unemployment. If Australia is to diversify over time away from its reliance on commodity exports for its economic prosperity, growth in services exports, which includes financial services, is desirable.

### CHANGES IN MARKET SHARES

Since the global financial crisis, there has been some consolidation in the Australian banking sector. The chart below shows the effect of the GFC on the market shares of total lending for different types of participants in the market.

As can be seen from the chart, non-major banks and non-banks (including finance companies, credit unions, building societies and other non-bank lenders) were maintaining a steady market share up until late 2007. However, the chart shows that, from then, the market share of non-banks and non-major banks began to decrease.

Since 2007, major Australian banks have acquired other lenders in the market, in particular Bankwest and St George (the effect of this is clear in the chart in late 2008). Securitisation as a method of funding failed as a direct result of the GFC, leading to the acquisition by banks of some non-bank lenders such as RAMs and Wizard. Some non-bank lenders have exited the market completely or are not writing new loans, including finance companies GMAC and Bluestone.

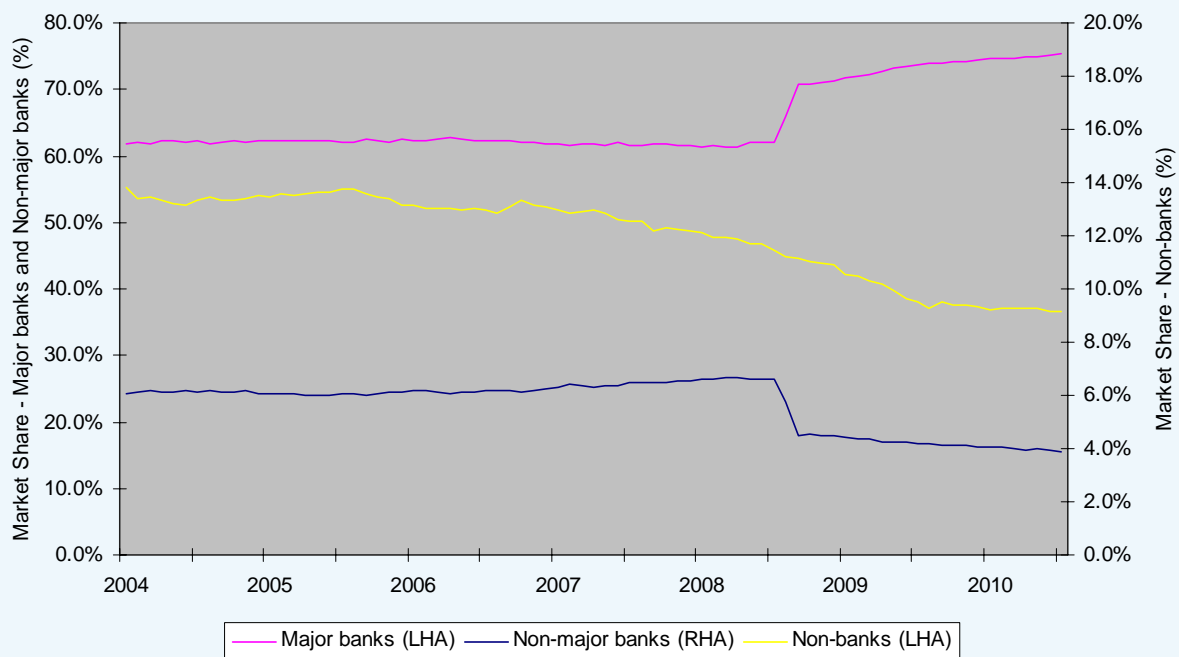
Some of this competition was from players whose business models were not sustainable and did not reflect the full cost of providing financial services throughout the economic cycle. Competition in Australia is often compared to offshore countries whose financial models were also proven to be unsustainable. Liquidity and credit risks were not being properly recognised and built into prices which ultimately resulted in the failure of those businesses.

Notwithstanding this consolidation there are still a large number of players in key consumer markets. For example, in the mortgage market, there are still over 100 providers of mortgages

# COMPETITION IN AUSTRALIAN BANKING

in the Australian market offering standard variable rates of between 6.72 per cent and 8.30 per cent.<sup>4</sup> This is a significantly greater number of providers than most other industries.

**Chart 2: Market Share of Major Banks, Non-Major Banks and Non-Banks 2004-2009**



Source: Derived from data in the APRA Monthly Banking Statistics<sup>5</sup> and RBA Lending Aggregates<sup>6</sup>

<sup>4</sup> Data sourced from RateCity.com.au on 7 December 2010

<sup>5</sup> Available at [www.apra.gov.au/Statistics/Monthly-Banking-Statistics.cfm](http://www.apra.gov.au/Statistics/Monthly-Banking-Statistics.cfm)

<sup>6</sup> Available at [www.rba.gov.au/statistics/tables/xls/d02hist.xls](http://www.rba.gov.au/statistics/tables/xls/d02hist.xls)



# INTEREST RATES

## INTEREST RATES

### OUT OF CYCLE RATE RISES

Concern has been expressed that increases in mortgage and small business lending rates beyond movements in the RBA cash rate (known as 'out of cycle rate rises') indicate a lack of competition in the industry. Banks' cost of funding is not, however, directly linked to the official cash rate set by the RBA.

Domestic saving in Australia is insufficient to fund investment opportunities and bank lending. Australia has run a current account deficit for most of the past 150 years and banks provide the conduit for tapping foreign savings to allow investment opportunities in Australia to be realised and effectively fund this deficit. All Australian banks are reliant to a greater or lesser extent on raising funds on global markets.

The cost of raising funds from wholesale markets and customers' deposits are key drivers of the price of credit products. The cost of both of these components of banks' funding has risen and this is examined in detail below.

### FUNDING COSTS

Three main factors have driven an increase in ANZ's funding costs over the last few years:

1. The increase in the cost of customer deposits due to greater competition between deposit-takers
2. The increase in term wholesale funding costs from 20 bps above the 90-day Bank Bill Swap Rate (BBSW) in 2007 to 100-160 bps above BBSW today
3. The change in the mix of funding with an increase in customer deposits and longer-dated term wholesale funding.

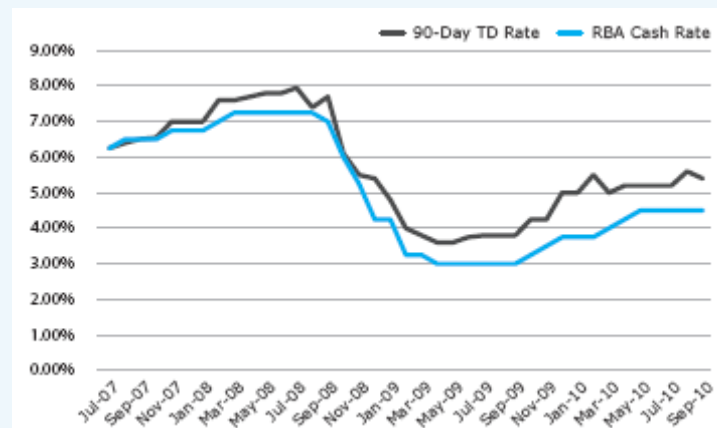
Each of these is examined below.

#### 1. Customer deposits

Competition for deposits has stepped up significantly since the onset of the GFC as all banks have sought to rely more on this as a relatively stable source of funding. For example, in 2007, the rate offered by ANZ on a 90-day term deposit was very similar to the RBA cash rate. Today, it is around 100 basis points above the cash rate. Chart 5 shows ANZ's 90-day term deposit rate compared with the RBA cash rate.

# INTEREST RATES

Chart 3: 90-Day Term Deposit Rate vs RBA Cash Rate



Source: ANZ and RBA

## 2. Wholesale funding costs

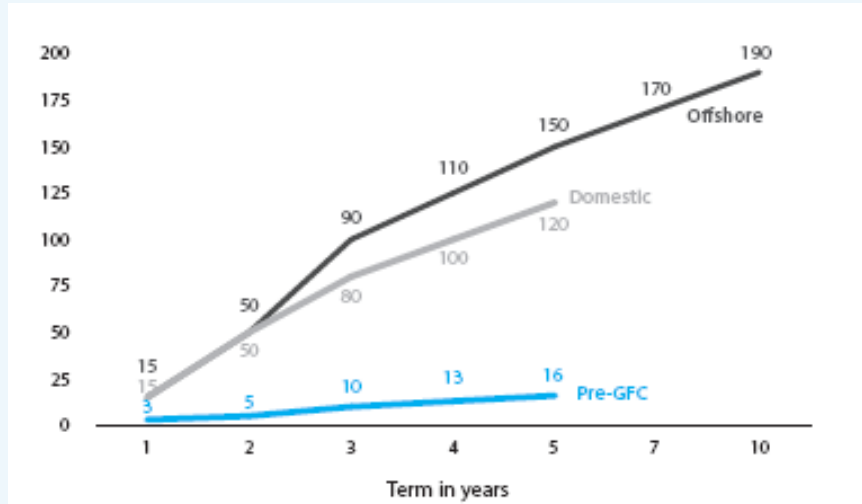
Following the collapse of Lehman Brothers, wholesale funding markets closed for around six weeks and the cost of wholesale funding increased dramatically. The marginal cost of term wholesale debt reached a peak in March 2009 at levels which, if maintained, would have greatly increased borrowing costs to consumers. Fortunately, the cost has declined significantly since then but it remains elevated and volatile in comparison to pre-GFC costs.

Before the GFC, the average cost of five-year term funding was 16 bps above BBSW. Today, the cost of five-year term funding is between 120 and 150 bps above BBSW. BBSW is the swap rate (usually the 90 day rate for bank funding instruments) and moves in a reasonably limited band around the RBA cash rate.

The costs at which ANZ can raise term funding today and before the global financial crisis are shown in Chart 3. This has contributed to an absolute increase in ANZ's funding costs since 2007 relative to the RBA cash rate. The offshore component of our wholesale funding is of course, not related to the rate set by the RBA.

# INTEREST RATES

**Chart 4: Indicative Term Funding Costs (basis points above BBSW)**



Source: ANZ; NB Pre-GFC data is the average cost of offshore and domestic funding

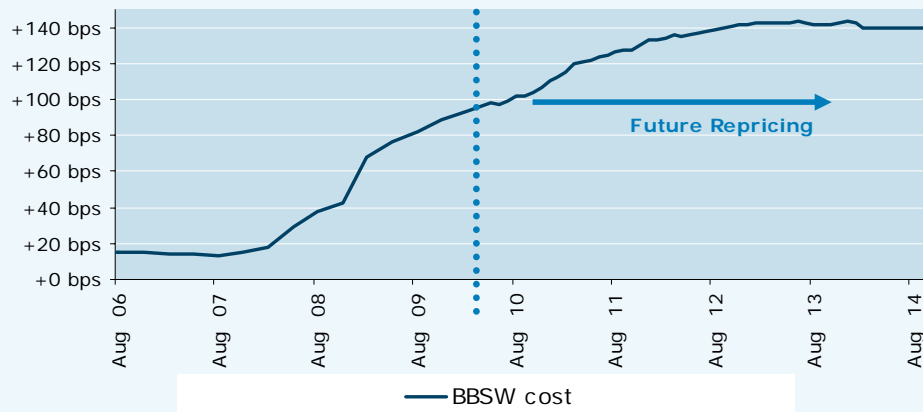
ANZ has also sought to increase the proportion of funding sourced from longer-term debt. This gives more certainty over funding as it is locked in for a longer period and not subject to short term volatility in the markets. To continue to provide a premium rating, ratings agencies are demanding a greater proportion of longer term funding to insulate banks from short-term shocks. ANZ has adjusted its term debt portfolio from terms mostly of 1, 3 and 5-year debt to 3, 5 and 7-year debt. As shown in Chart 3, longer-term debt is more expensive than shorter-term debt and the increase in this form of funding is contributing to an increase in overall funding costs. This is part of ANZ's strategy of helping maintain its AA rating. APRA has also been encouraging banks to increase term funding and reduce reliance on cheaper short-term wholesale funding.

### *The Outlook*

Even if the cost of wholesale funding did not rise further, the average cost of ANZ's wholesale funding portfolio would continue to rise gradually as cheaper pre-GFC debt expires and is refinanced with more expensive debt at today's prices. To continue lending, ANZ has around \$100 billion of term funding on issue. Of this, around \$20 billion is pre-GFC funding. We expect this effect to continue to put pressure on lending margins for at least another 18 months as the remaining pre-GFC debt expires and is replaced as is shown in Chart 4.

# INTEREST RATES

**Chart 5: Repricing of ANZ's Wholesale Funding Portfolio**



Source: ANZ

Wholesale funding costs will be affected by ongoing developments in the world economy. In particular, the current bailout of Ireland by the European Central Bank and the IMF and the possibility that Portugal and Spain will also need support in due course are likely to create both volatility and upward pressure on pricing on wholesale funding markets in the future.

### 3. Funding mix

In addition to increases in the absolute costs of funding, a change in the funding mix is contributing to higher costs. The change in funding mix is shown in Chart 6.

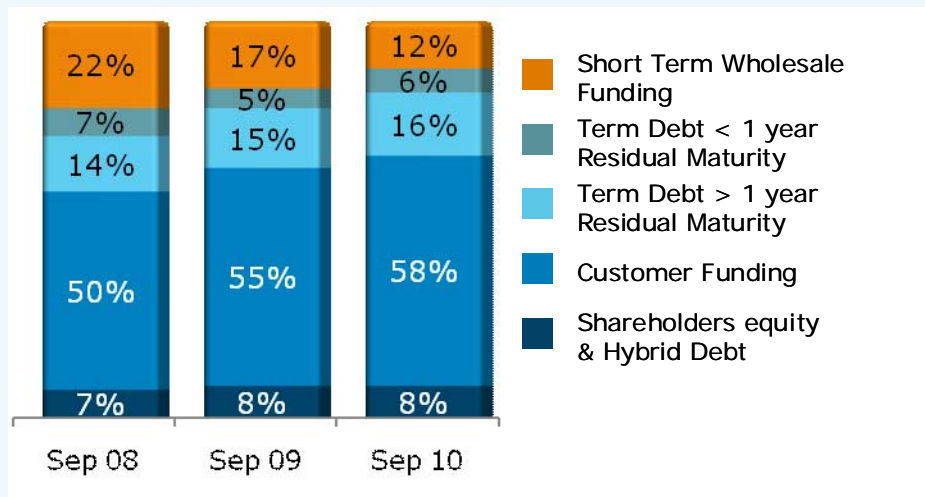
Between 2008 and 2010 there has been a marked decline in short-term wholesale funding and an increase in the proportion of ANZ's funding which is sourced from customer deposits and long-term wholesale debt. These are more stable sources of funding which give greater certainty in a volatile environment and help to underpin ANZ's AA rating. The RBA has described the greater reliance on deposits as 'prudent'<sup>7</sup>. As noted above, both these sources of funding have increased in cost, relative to the RBA cash rate, since the global financial crisis.

The mix of Customer Deposits has also changed, as depositors attracted to the higher customer rates on offer (refer above) have moved their funds out of savings deposits (a cheaper source of funding for ANZ) and into term deposits and on-line saver accounts (a more expensive source of Customer Deposit funding). ANZ funding costs from deposits has therefore been impacted by both rate and mix movements.

<sup>7</sup> House of Representatives Standing Committee on Economics, p. 7

# INTEREST RATES

Chart 6: Composition of ANZ's Group Funding Sep 2008-Sep 2010



Source: ANZ

## INTEREST RATE MARGINS

Concern has been expressed that since the GFC banks' net interest margins (NIMs) have widened due to insufficient competitive pressure.

As a result of competitive pressure, the trend in net interest margins on lending has been downward for around the past 15 years. Chart 7 shows margins above the cost of funding across all credit products over the period 1994-2010. Margins across all forms of credit have declined from nearly 4 per cent in 1995 to just over 2 per cent today.

Since 2004, margins have fluctuated within a relatively small range just above 2 per cent. The strong downward trend which occurred in the late-1990s and early-2000s has reduced but notwithstanding the difficulties of the global financial crisis, the benefits to customers of this longer-term decline in margins have been maintained.

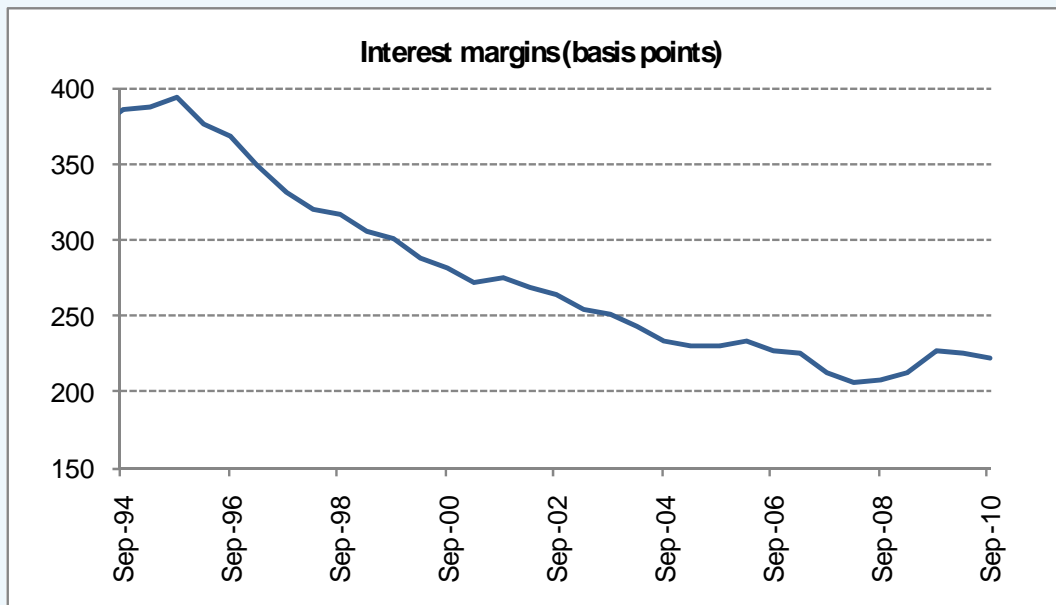
This has been confirmed by the RBA Governor:

*[O]verall banks margins that we see today are a little higher than they were a couple of years ago but, compared to 10 or 15 years ago, are much lower, particularly in the mortgage base. That is a result of competition and efficiency gains, and most of those gains are still in place today<sup>8</sup>*

<sup>8</sup> House of Representatives Standing Committee on Economics, p 8

# INTEREST RATES

Chart 7: Industry Interest Margins 1994-2010



Source: UBS Warburg

## ANZ'S MARGINS

Net interest margins (NIMs) for a large bank that operates in 32 economies and offers a large range of products and services to Institutional, small and medium business and consumer customers are complex. Chart 8 shows the NIM for the consolidated ANZ Group (including both Australian and overseas operations) from 1998 to 2010.

This shows that ANZ's NIM declined from around 3 per cent in 1998 to around 2 per cent in 2008 and has increased slightly to just below 2.5 per cent. The recent change in margins reflects a 'cocktail' of factors:

- A change in the mix of business – with the onset of the GFC many Institutional customers previously able to borrow on their own account returned to the intermediated market. As conditions settled, higher quality Institutional customers were able to refinance in the capital markets so that improvement in margin resulted as lower margin customers moved off the balance sheet.
- A repricing for risk – one of the key effects of the GFC has been a repricing for risk as markets globally have realised that prior to the GFC there was insufficient recognition of the risks inherent in banking and an upward repricing has followed.
- A 'timing' issue in some markets – in some markets the repricing for risk was delayed by the structure of products. In New Zealand, for example, 2-3 year fixed rate mortgages are common and those mortgages underwent repricing as their fixed term expired and pre-GFC

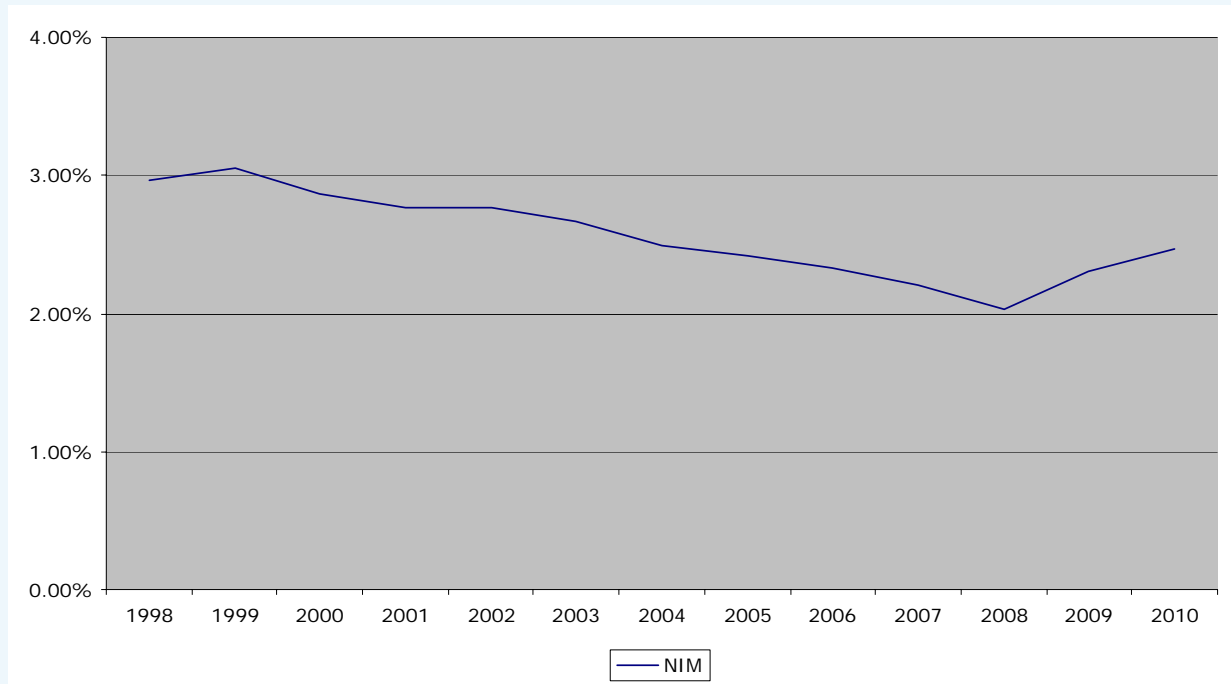


## INTEREST RATES

funding was replaced by higher cost funding, so we are seeing the tail end of some of that in margin improvement. At the same time, some of the fixed rate loans were replaced by higher margin variable rate loans.

- A margin benefit of having a strong level of capital – ANZ has the strongest reserves of capital amongst Australian banks. Earnings on this capital have a margin benefit.

**Chart 8: ANZ Group Net Interest Margin (%) 1998-2010**



Source: ANZ;

Note: There is a break in the series due to changes in accounting policy. 1998-2004 are AGAAP figures, 2005 onwards are IFRS

# INTEREST RATES

## Residential Mortgage vs Small Business Lending Rates

Concern has been expressed about the difference in interest rates for lending to residential mortgage customers compared with small business lending, including where that lending is secured by a residential property. Interest rates set by the banks must take account of the risk of lending money. In accordance with APRA's prudential standards, that risk is determined primarily by two factors:

- **Probability of default** – How likely a customer is to be unable to repay their loan. Small business customers have a higher probability of defaulting than Mortgage/Retail customers; and
- **Loss given default** – The amount the bank can recover if a customer defaults on a loan. A significant proportion of small business loans are unsecured, therefore the bank generally will be able to recover less than other forms of lending with higher security (e.g. mortgages).

The higher probability of default and loss given default for small business customers when compared to mortgage customers requires banks to hold a higher level of capital and reserve more for bad debt expenses for small business lending. A requirement to hold three times as much capital for small business customers than residential mortgage customers is typical and is required by APRA. This increases the cost of providing small business loans relative to retail lending generally.

The number of small business customers who are 90 or more days past due on their credit facility increased as a result of the financial crisis. In our Small Business Banking segment the delinquency rate has more than doubled since 2007. An increase in delinquencies increases the probability of default and the capital we must hold and therefore the cost of lending to small business. While the delinquency rate in our mortgage portfolio also rose, its absolute level is around half that of the small business portfolio. We believe the level of delinquencies in small business lending has reached a plateau and if so is unlikely to put further significant pressure on the cost of small business lending.

## ASSISTING CUSTOMERS IN FINANCIAL DIFFICULTY

The global financial crisis has been difficult for some customers. We are committed to offering arrangements for customers experiencing financial difficulty to give them time to get back on their feet.

We can offer our mortgage customers a 3, 6 or 12 month repayment deferral. This reduces the burden on customers who may be experiencing difficulty for reasons such as loss of employment. It allows them to manage through temporary difficulty without having to sell their home.

Last financial year, ANZ assisted 13,000 customers through our hardship scheme. Growth in the number of customers has slowed significantly this year as many customers are now coming out of hardship and returning to normal repayments.

## INTEREST RATES

ANZ also made a number of commitments to help our small business customers manage through the difficult economic times, including:

- providing easy access to our dedicated specialists, who are trained to help small business customers experiencing financial difficulty, through our toll free hotline (1800 252 845); and
- considering tailored solutions on a case-by-case basis including: deferred or reduced repayments for periods of up to 12 months (with interest capitalised into the loan), fee waivers and repayment extension periods - temporary adjustments to customer lending limits including business credit cards and overdrafts.

## OTHER FEES AND CHARGES

### OTHER FEES AND CHARGES

Concern has been expressed recently about some fees and charges, including mortgage early termination fees and foreign ATM fees. These fees relate to specific events or services provided by ANZ. Charging fees on a user pays basis ensures that customers who would not incur them are not unfairly required to subsidise those who do. Where exit fees apply, this is clearly disclosed in terms and conditions and loan offer documents. On both these fees, changes in industry practice over recent years have benefited consumers.

### FOREIGN ATM FEES

In March 2009, the RBA implemented reforms to the way consumers are charged for using ATMs. Prior to the reforms, each time a customer made an ATM transaction at an ATM not owned by their financial institution, their financial institution paid a fee to the ATM owner for that service. Most banks passed on the fee to customers as a 'foreign fee'. The existence and amount of the fee was not clear to the customer at the time of the transaction.

As part of the reforms, the fee that financial institutions paid to ATM owners was eliminated. Instead, the ATM owner can now charge the user of the ATM a fee directly – this is known as 'direct charging'. The fee is displayed on the screen before the customer commits to the transaction. At this point, they have the choice of cancelling the transaction without charge or proceeding. This has increased the transparency of these fees.

Direct charging has affected customer behaviour. ATM users have increased the number of transactions at their home bank ATM and reduced foreign ATM transactions. The RBA estimated that this has saved consumers around \$120 million in the first year of operation.<sup>9</sup>

Customers pay the fee for the convenience of being able to access other banks' ATM networks. This greatly increases the number of ATMs available to consumers and provides an incentive for banks and other providers to provide more ATMs.

When banks in the UK were unable to charge fees for ATM transactions, the number of bank ATMs declined. Non-bank ATM providers were still able to charge for transactions and their ATM networks grew. UK consumers were arguably disadvantaged by this as the non-bank ATM providers charged a higher fee than banks. The decline was particularly marked in lower socio-economic areas and drew a policy response from the UK Government. A working group of industry, Government and consumer groups was established to increase the number of free-to-use ATMs in disadvantaged areas and the LINK ATM Scheme changed its interchange rules to provide a financial incentive for operators to establish free-to-use cash machines in target financial inclusion areas.

<sup>9</sup> <http://www.rba.gov.au/publications/bulletin/2010/jun/6.html>

## OTHER FEES AND CHARGES

### MORTGAGE EARLY TERMINATION FEES

Early termination fees have been criticised as a potential barrier to switching mortgages. These fees are now regulated under the unfair contract terms regime and ASIC has issued guidance on how that law applies to mortgage early termination fees.

The ASIC guidance restricts the fees to a reasonable estimate of the cost. In preparing the guidance, ASIC undertook a review of mortgage early termination fees across the industry. Of particular concern were early termination fees on variable rate mortgages which were calculated as a percentage of the original loan amount or based on the required monthly repayment. ASIC has indicated it may take action in relation to these types of fees.

ANZ recently announced a new package of measures to create more choice for customers and make it easier for them to switch between mortgages. This included abolishing Deferred Establishment Fees on variable rate mortgages. Our ANZ mortgage exit fee was already among the lowest in the market and consistent with the ASIC guidance. However, by abolishing it we are telling our customers we are prepared to win and retain their business through competitive pricing, convenient products and great customer service.

ANZ also has an Early Repayment Charge (ERC) for fixed rate mortgages. This fee is fair and is consistent with the ASIC guidance. A customer who takes out a fixed rate loan signs a contract to lock in an interest rate for an agreed period of time. ANZ makes funding and hedging arrangements on the understanding that the loan will have a fixed rate and fixed repayments over the agreed period. If the customer then decides to switch to a variable rate or another fixed rate or repay the fixed loan partially or in full prior to the end of the fixed term, ANZ has to rearrange the funding and hedging commitments it has made. The ERC is ANZ's estimate of the loss it incurs by rearranging those funding arrangements.

Depending on a range of factors, such as the direction and size of movements in interest rates and how much of the fixed term remains, ANZ may not calculate a loss. In these instances, ANZ does not pass on a fee to its customers. ANZ does not charge any other fees for early termination of a Fixed Rate loan.

There is an industry/accounting consensus on a fair amount for break costs on fixed rate loans and several accepted ways to calculate that amount. Over time the Financial Ombudsman Scheme has examined the amounts we charge as ERCs (in response to customer complaints) and found us to be consistently charging according to this industry standard. Full details of the calculation methodology are detailed in ANZ's Consumer Lending Terms & Conditions.

# BANK PROFITS

## BANK PROFITS

Australia's four major banks are large businesses: all four are in the top-five listed companies in Australia by market capitalisation. The dollar amount of profits made by the four major banks is a reflection of the size of the companies and the amount of capital employed. They are not unusually profitable when compared with other industries.

The accepted way to compare profitability across industries and companies is the Return on Equity (ROE). ROE measures the profit a company generates using the capital that shareholders have invested in the company.

In the 2009/10 financial year, ANZ made a profit of \$4.5 billion representing an ROE of 13.9 per cent (on a statutory basis). That is not particularly different to other industries and it is considerably lower than the ROE before the global financial crisis. ANZ's ROE is similar to the healthcare sector (14.4 per cent) and consumer staples including supermarkets (13 per cent) and is much lower than telecommunications (26 per cent) and the resources sector (28 per cent).

These ROEs also reflect (reasonably on our view) the risk the market attaches to investing in these industry sectors. The market sets the level of ROE expected from sectors in the economy and if returns are below these investor expectations (domestic or international) then investor appetite for that sector will diminish.

Notwithstanding these comparisons, it is important that Australia's banking sector is strong and profitable. The AA rating held by Australia's four major banks enables them to continue to raise funds offshore at reasonable rates. Any deterioration in the strength of ANZ may put at risk its AA rating. A lower credit rating would raise the cost at which we could fund our lending as wholesale markets demand higher rates to compensate for higher risk – a cost that would necessarily be passed through to customers.

It should also be recognised that a reasonable level of profit is required to ensure:

- That confidence in the financial system is maintained in periods of economic downturn when losses on bad debts will inevitably increase by ensuring banks do not make losses; and
- There are sufficient amounts that can be retained to fund the regulatory capital required to fund increased lending and support economic growth.

APRA requires banks to hold substantial amounts of capital to back their lending, with the amount required dependent on the risk of the loan. The capital is sourced principally from retained earnings, that is, profit retained after dividends have been paid to shareholders. Banks need to be profitable to fund the capital required to allow them to continue to lend.

We have seen during the global financial crisis that strong banks are fundamental to the health of the economy. In Australia, the Government has not needed one dollar of taxpayers' money to

## BANK PROFITS

bailout any banks as has occurred in many other countries. In countries where this has occurred it has resulted in greatly increased public debt with the attendant problems that has created.

Banks in many developed countries have had to reduce their lending to survive the difficult economic times. The difficulties many developed countries are having in reinvigorating economic growth can in part be attributed to their weak banking systems and a shortage of credit supply. In contrast, Australia's banks have remained profitable and been able to continue lending to both consumers and businesses through the global financial crisis and continue to do so. This has underpinned a stable economy and employment in Australia during the financial crisis.

# PROMOTING INCREASED COMPETITION

## PROMOTING INCREASED COMPETITION

### HAS COMPETITION BEEN IMPAIRED?

Returning to the factors often cited as indicators of reduced competition and customer disadvantage, the analysis above suggests the following conclusions.

#### Market Share

Market share of the major banks has increased during the GFC for both deposits (from 59 per cent in June 2007 to 75 per cent in June 2010) and loans (from 62 per cent in June 2007 to 75 per cent in June 2010) as a result of a 'flight to quality' and some consolidation: CBA acquired BankWest and Westpac acquired St George.

Securitisation as a method of funding failed as a direct result of the GFC, leading to the acquisition by banks of some non-bank lenders such as RAMs and Wizard. Some non-bank lenders have exited the market completely or have not been writing new loans, including finance companies GMAC and Bluestone.

#### Out of Cycle Rate Rises

Bank lending rates are not directly linked to the RBA's cash rate. The out of cycle rate rises ANZ has made since January 2008 reflect a pass through of increased funding costs. Had we not passed through these cost increases, the rate of return on the capital employed in that area of ANZ's business would have fallen to levels unacceptable to the investors who provide us with capital and a rational outcome would be reduced lending or credit rationing. Indeed had we not passed on any of these increases the mortgage portfolio would have been operating at a loss.

Appearing before the House of Representatives Standing Committee on Economics on 26 November 2010, RBA Governor Glenn Stevens said in response to questioning:

*[I]n the end, the question is really whether all those people with a mortgage are paying seriously higher rates than they should be from an economic management point of view. What I am saying is I do not think they are, because we have pretty much offset the change in the margins by doing different things in the cash rate from what we would have done had the margins not shifted.<sup>10</sup>*

<sup>10</sup> House of Representatives Standing Committee on Economics, 26 November 2010, p 8



# PROMOTING INCREASED COMPETITION

## **'Unfair' Fees and Charges**

Bank customers have benefitted from the 'direct charging' reforms driven by the RBA. The reforms have made the fee for using another bank's ATM transparent and had a marked effect on consumer behaviour. The RBA estimated that consumers have saved around \$120 million in the first year of implementation of the reform.

Exit fees on loans are covered by the Unfair Contract Terms legislation. ASIC has recently issued guidance on how that legislation applies to both loan establishment and loan exit fees.

## **PROMOTING COMPETITION**

As discussed in this submission, we believe the Australian banking sector remains competitive despite concentration having increased slightly as a result of the GFC. The Committee is seeking practical measures to support and enhance competition.

ANZ supports practical measures which will increase consumer choice and competition in the banking market without imposing unnecessary costs on banks and their customers.

Measures we believe fit this description include:

- Further support for the securitisation market
- Support for diversification of bank funding sources
- Support for development of a substantive corporate bond market in Australia; and
- Improving the financial literacy of consumers to support better decision making and encourage higher use of existing switching services.

## **Securitisation**

The securitisation market is an important source of funding for non-bank lenders and some banks. The global financial crisis caused this market to collapse. The Government has intervened to provide \$16 billion through the Australian Office of Financial Management (AOFM) to support the Residential Mortgage Backed Securities (RMBS) market and has since also directed the AOFM to use some of that funding to support securitisation for small business lending. This has maintained liquidity in the market and allowed non-bank lenders to stay in the market, supporting greater competition.

We believe that Residential Mortgage Backed Securities remain an attractive asset class for investors. The financial crisis caused a lack of confidence and liquidity in the market based on the poor performance of securitised assets overseas. Further policy measures should focus on

## PROMOTING INCREASED COMPETITION

market-led approaches to increasing liquidity, including deepening the investor base and the volume of funds that are invested in RMBS. As the market stabilises, this in turn will restore confidence.

In relation to possible policy interventions, RBA Deputy Governor Guy Debelle made this observation:

*I believe the AOFM program has a number of advantages relative to alternative means of support: it can be easily tailored to help specific types of institutions; it can be phased out easily; the likelihood that the Government loses money on its investment is very small; and there is no ongoing contingent liability to the Government from providing the support. If instead a government guarantee of RMBS were provided, it would be difficult to phase out, creating a commitment that could generate a large contingent liability for the Government.<sup>11</sup>*

### **Diversification of bank funding**

As discussed above, Australian banks are heavily reliant on wholesale debt to supplement the gap between lending growth and deposit growth. This exposes them and the Australian economy to the effects of any disruption on global wholesale debt markets. We have recently seen this during the global financial crisis. Diversifying the range of tools banks can use to raise funding would help to mitigate the effects of future disruptions.

One example of an alternative tool is covered bonds. Australian banks are not able to issue covered bonds, whereas overseas banks are, and have recently issued covered bonds into the Australian market. Allowing Australian banks to issue covered bonds would help diversify funding sources and also assist Australian banks to meet the new Basel III liquidity standard. The appetite for covered bonds issued by Australian banks is limited and this alone will not solve the long-term challenges but could help ease the pressures by diversifying the investor funding pool and helping reduce the average funding cost increase coming through the rollover of pre-GFC term wholesale funding (as shown in Chart 5).

### **Australia's corporate bond market**

The corporate bond market provides companies with an alternative source of financing and banks with an alternative source of funding. This market, particularly for non-bank corporates, has historically been underdeveloped in Australia.

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<sup>11</sup> Guy Debelle, The State of Play in the Securitisation Market, Address to the Australian Securitisation Conference, 30 November 2010, p 4

## PROMOTING INCREASED COMPETITION

Until recently, all offers of corporate bonds to retail investors generally required a full prospectus. In May 2010, ASIC released a Class Order to allow simplified disclosure documents where the offer met a number of conditions. The new Class Order will reduce the time and expense involved in issuing corporate bonds to retail investors. Further measures could focus on growing the corporate bond market and increase retail investor confidence in corporate bonds as an asset class.

### Switching

The ease with which customers can move between providers is a facilitator of competition. Financial costs associated with switching providers such as exit fees can be a disincentive for customers to switch. However, there is also effort involved in opening new accounts and ensuring any direct debits or credits are re-established before the old accounts are closed.

While we acknowledge that switching cannot be done without some effort, we believe the barriers to switching are not great and assistance to customers who wish to switch is available.

In 2008, the Government announced an Account Switching Package to help reduce unnecessary barriers to customers changing providers and increase consumer awareness of financial services products and their costs, and how to go about switching if that is what suits them best. The package included a listing and switching service that requires banks to provide their customers with accurate information on all direct debits and credits to their account over the last 13 months. The customer could then take the list to a new bank for easier transferral, if they switch. Banks are also required to assist new customers to re-establish their direct debits and credits. ANZ's listing service has been available since 10 March 2008 and is provided without charge. Information on this service is available on our website and over the phone.

The switching service has not been widely used. To assist customers who want to switch, we would support further measures which can be implemented at reasonable cost given the likely benefit. One proposal to increase the ease of switching is a portable account number. In principle, we have no objection to portable account numbers, but, as with any form of regulation, the costs and benefits of implementing it need to be considered.

The account numbering convention in Australia is bank-specific consisting of a Bank, State and Branch (BSB) identifier and an account number specific to each banks' account numbering system. Changing this protocol would be costly and would apply only to transaction accounts. Transaction account numbers are relevant for cash payments and direct entry payments. However, almost two thirds of non-cash retail payments rely on Card Scheme numbers and other references developed by BPAY and PayPal, rather than on account numbers. As the payments system evolves, it is likely that reliance on transaction account numbers as identifiers will reduce.

## PROMOTING INCREASED COMPETITION

As discussed above, we do not believe the barriers to switching are as significant as many commentators have suggested. Recent research by Choice found that 78.5 per cent of customers have not considered switching, 7.6 per cent had switched, 11.8 per cent had considered switching but not done so – of which 50.4 per cent (or 5.9 per cent of the total) cited the level of effort as the major reason they have not switched. This suggests that the number of people who want to switch banks and are discouraged by the effort is quite low.