credit cards
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Aussie

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The Secretary
Senate Economics References Committee
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CANBERRA ACT 2600

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Inquiry into competition within the Australian banking sector

Aussie appreciates the opportunity to make a submission to the Committee's Inquiry into competition within the Australian banking sector ("Inquiry"). We note the Inquiry's broad terms of reference and limit our comments to those matters which we are able to comment on relative to our business.

Executive Summary

1. The GFC exacerbated the funding difficulties and higher borrowing costs of entities with lower credit ratings (typically the regional banks and non-banks) vis-a-vis the major banks and this has severely constrained the lending activities of some participants and significantly reduced competition in the mortgage market.

2. The AOFM's support of the RMBS market has had a moderating effect and we believe the support needs to continue, with additional funding, in order to reduce the severity of the adverse credit cycle on the smaller banks and non-banks and encourage more competition in the mortgage market.

3. Other measures such as improvements in technology to facilitate transfer of customer information between providers will improve competition and promote innovation by the banks and non-banks.

Our submission

1. **The current level of competition between bank and non-bank providers**;
   - Pre-the Global Financial Crisis (GFC), Australian households benefitted significantly from strong competition in the mortgage market through the participation of non-banks over the past decade. Aside from real price competition, the non-banks introduced home loan product and distribution innovation. The GFC changed the competitive dynamics in

the financial system and the panic and flight to quality saw a shift back to Australia's banking system, aided by government support through mechanisms like the wholesale funding guarantee and deposit guarantee. Although we were completely supportive of this strategy for the national good at the time, it is important to recognise the part it played in altering the competitive landscape.

- The flight to quality and re-pricing of credit risks dramatically curbed the ability of the smaller banks and non-banks to secure funding at previously favourable prices and these players have had to substantially cut lending volumes and surrender market share to the major banks. The latest (September 2010) Fujitsu/J.P. Morgan report on the Australian Mortgage Industry state that "*As detailed in Figure 4, the shift towards the major banks is continuing at the expense of other ADI's and wholesale lenders. Even including St George Bank/BankWest Australia market share within the major bank data on a pro-forma basis prior to the acquisition by Westpac Banking Corporation/Commonwealth Bank Australia, the major banks have increased their share of the mortgage market from 67.1% to 76.3%. Furthermore, taking into account the approximate 3% shift from CBA's acquisition of BWA, major banks have been able to organically improve their combined market share by 8.4% since the onset of the GFC.*"[1]
- The collapse of securitisation markets during the GFC severely hampered the ability of many small lenders to compete. It is widely acknowledged that the non-bank lenders which primarily funded their lending through securitisation markets were responsible for the aggressive competition in the home loan market before the GFC. For example in a recent address to a Citi Australian Investment Conference in Sydney, Treasury's Executive Director, Markets Group indicated "*A particular concern is the exit and slower growth of smaller lenders that traditionally relied on securitisation markets for funding. Over the past two decades, these institutions played an important role in driving competition in lending, and reductions in interest margins.*"[2]
- If the major banks continue to enjoy the significant pricing advantage in their costs of funding over their non-bank rivals, the mortgage market is unlikely to see the same type of competition which benefited consumers in the last two decades before the onset of the GFC.

2. **The products available and fees and charges payable on those products**;
    - In a concentrated market which is dominated by the major banks, there is likely to be less product variety and innovation since there is no competitive incentive to do so.
    - The costs of establishing a new mortgage are significant and non-banks which do not collect these costs up-front lose money unless customers remain with them for a number of years. Regulation or banning of exit fees would result in cross subsidisation by the stable customers of those customers who routinely move between financiers. A user pays system which allows the recovery of fair costs is an appropriate approach and we see this as consistent with ASIC's recently released Regulatory Guide 220 on Early termination fees for residential loans: Unconscionable fees and unfair contract terms.

[1] Australian Mortgage Industry – Volume 12 08 September 2010 by Fujitsu Australia and J.P. Morgan

[2] Address to Citi Australian Investment Conference, Sydney on 26 October 2010 by Jim Murphy, Executive Director, Markets Group, Australian Government Treasury

3. **How competition impacts on unfair terms that may be included in contracts**;
   - Where there is less competition, the dominant players are in a strong position to reposition terms over time since consumers lack the relevant choice or bargaining power.

4. **The likely drivers of future change and innovation in the banking and non-banking sectors**;
   - Aside from bringing greater cost efficiencies and making things easier for consumers, technology has to be further developed to enable seamless transfer of customer information between banks and non-banks, so that consumers are able to switch providers more easily subject to addressing Privacy concerns.

5. **The ease of moving between providers of banking services**;

   Whilst not an exhaustive list, the following factors tend to act as barriers for customers to move between institutions:
   - Customer inertia;
   - Mortgage upfront and exit fees;
   - Hard-to-switch transaction accounts; and
   - Bank bundling of products and stickiness of relationship result in customers being less price sensitive. Customers who choose to have several transaction accounts or products with an institution have a greater propensity to stay with that institution.

6. **The impact of the large banks being considered 'too big to fail' on profitability and competition**;
   - The banks play an important role in underpinning Australia's financial stability and it is in Australia's interest to have a strong and profitable banking industry. On the other hand if the banking industry is too concentrated and is dominated by a few major banks, there is sovereign risk to Australia should one of the major banks fail. In view of the significant consequences of a major bank failure to the financial system, it is more likely for a major bank to be rescued as occurred in the case of Citibank which was assisted by the US government during the GFC, whereas many of the smaller US banks which previously provided an alternative for their customers have either been acquired or merged with other banks or have significantly reduced their banking activities.
   - Due to the sheer size of the major banks and their entrenched presence in the local market, new entrants or existing participants with much smaller local operations which can effectively compete (for example some of the foreign banks) are unlikely to emerge or scale up respectively, given the significant investment required and particularly where the current return on assets is less attractive than other forms of investments.

7. **Regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis**;
   - To insulate Australia from the financial turmoil during the GFC and in recognition of similar action taken by other jurisdictions, the government implemented wholesale funding and deposit guarantees. It ended the wholesale funding guarantee earlier this year and should consider scaling back the support for deposits in a measured fashion.

- We generally advocate deregulation as opposed to more regulation because deregulation resulted in the single biggest benefit to consumers on the home loan front by allowing the entry of mortgage originators like Aussie, RAMS and Wizard which were funded by securitisation markets. Deregulation has the effect of restraining bank profits and promotes innovation, which in turn rewards consumers whereas more regulation increases the barriers to entry for potential competitors and reduces competition, and it also increases costs for the whole industry. We saw a recent example of this when RAMS founder, John Kinghorn, cited the significant increase in cost of regulation as the key reason for not re-entering the mortgage market.
- The Banking Act mandates protection of depositors to the exclusion of borrowers. Changes under Basel III and APRA's APS 210 are likely to further raise the cost of wholesale borrowing as will additional measures being contemplated globally. We propose that the Banking Act be examined with a view to possibly including some protective measures for borrowers and an examination of the impact of allowing covered bonds to be utilised by Australian ADIs in the course of raising funds.
- The threat of further regulation and asset bubbles is currently a topic of hot discussion in the international investment community. Consequently, Australia is no longer viewed as a safe haven for investment funds, resulting in higher cost of raising capital.

8. **Opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers**;
   - A state-owned bank or lending entity which is funded by taxpayers (modelled similar to Kiwibank, or a Freddie Mac or Fannie Mae) is not a solution to injecting more competition as there is no rational reason for goverments to run a banking business and the risks of banking failure places a potential charge on taxpayers.

9. **Assessment of claims by banks of cost of capital**;
   - The Basel III rules governing the amount and type of capital which the banks need to hold, in response to the GFC, are yet to be settled and consequently we cannot comment on the banks' capital position.
   - Aussie has observed in its capacity as mortgage originator of residential mortgage-backed securitisation programmes that the weighted average market rate for settling, maintaining and selling AAA-rated mortgage securities has risen dramatically from about 0.70% pre-GFC to about 1.80% currently for non-bank lenders. Additionally and to achieve AAA ratings, the amount of credit support required has more than doubled thereby ruling out some lenders entirely from participating.

10. **Any other policies, practices and strategies that may enhance competition in banking, including legislative change**;
    - The $16 billion Australian Office of Financial Management (AOFM) residential mortgage-backed securities package to the smaller banks and non-bank lenders has had a moderating effect and support via additional funding from the AOFM needs to continue to counter the adverse credit cycle on these participants. Availability of funding and its price is now the most important factor in relation to impacting competition in the home loan market.

- There needs to be better collaboration and coordination of objectives between different sections of government, working together to create the right incentives for the ADIs and others to invest in RMBS. We would support any moves by the government which would introduce liquidity, including defining RMBS as a liquid asset under APS 210, allowing RMBS to be included in ADIs' liquidity portfolios on the grounds that such assets are generally extremely high credit quality and as such have tended to be accepted as repo collateral by central banks for cash liquidity in return.
- We do not advocate regulation of interest rates as amongst other issues, the likely result will be a rationing and increased cost of credit.
- Consider more generous tax breaks for interest income to boost savings and the overall pool of local funds for lending.
- Coordinated and measured dismantling of the deposit guarantee which favours the major banks.

11. **Comparisons with relevant international jurisdictions**;
    We are not in a position to comment.

12. **The role and impact of past inquiries into the banking sector in promoting reform; and**
    Inquiries are important in canvassing the views of stakeholders who have an interest in the subject matter of the inquiry; however and to achieve real purpose and results they must be acted upon and should not be hijacked by political agendas.

13. **Any other related matter**.
    We have no other comments.

We would be pleased to provide any further information on the above discussed matters.

John Symond
Executive Chairman