Banking Amendment (Keeping Banks Accountable) Bill 2009

Submission to the
Senate Economics Committee

September 2009

The Banking Amendment (Keeping Banks Accountable) Bill 2009

The *Banking Amendment (Keeping Banks Accountable) Bill 2009* would require authorised deposit-taking institutions (ADIs) to satisfy the Treasurer that:

- an increase to their standard variable home loan interest rates of more than a change in the Reserve Bank of Australia's official cash rate; or
- a decision not to pass on in full a cut in the official cash rate;

is not contrary to the public interest.

If the Treasurer believes that the ADI's decision is contrary to the public interest, he or she may direct it to set its standard variable rate at a prescribed rate before the end of a specified period.

If the ADI fails to comply, the Treasurer may determine that the Commonwealth Government's Financial Claims Scheme (FCS) no longer applies to deposits held with that ADI. The FCS was established in October 2008 to protect consumer deposits in the event of insolvency of an ADI in Australia. If an ADI becomes insolvent, the Government guarantees consumer deposits up to $1 million. The Government will provide the funds to make payments under the FCS. It then has the ability to recover money from the failed ADI in the winding up process and make up any shortfall from a levy on the industry. Consumers do not need to pay to be covered by the scheme. Consumers with deposits over $1 million can elect to pay to access the Government's Large Deposits Guarantee Scheme.

Deregulation of financial markets

The Australian financial market was substantially deregulated in the 1980s. Before this the interest rate which a bank could charge for a home loan was controlled. Quantitative lending controls placed ceilings on interest rates that could be charged to borrowers.

In this period, access to housing finance for many consumers was limited. The regulatory restrictions on the price of credit caused a restricted credit supply. As a result, only customers with a very good credit record and high income or savings were able to obtain a home loan without needing to resort to supplementary forms of finance.

In 1981, the Campbell Inquiry recommended that the Government abolish quantitative lending controls. These were largely removed in June 1982, although a cap of 13.5% applied to pre-existing housing loans until 1986.

In 1997, when the Wallis Inquiry examined the effect of financial deregulation, it found that the benefits for consumers outweighed the costs. As a result of deregulation, choice and access to home loan products increased substantially and the financial system became more efficient. The entry of new home loan providers was encouraged by the removal of controls on interest rates, enabling them to be

determined by market forces. A return to an environment where interest rates are controlled may lead to credit rationing and reduced access to housing finance for some consumers.

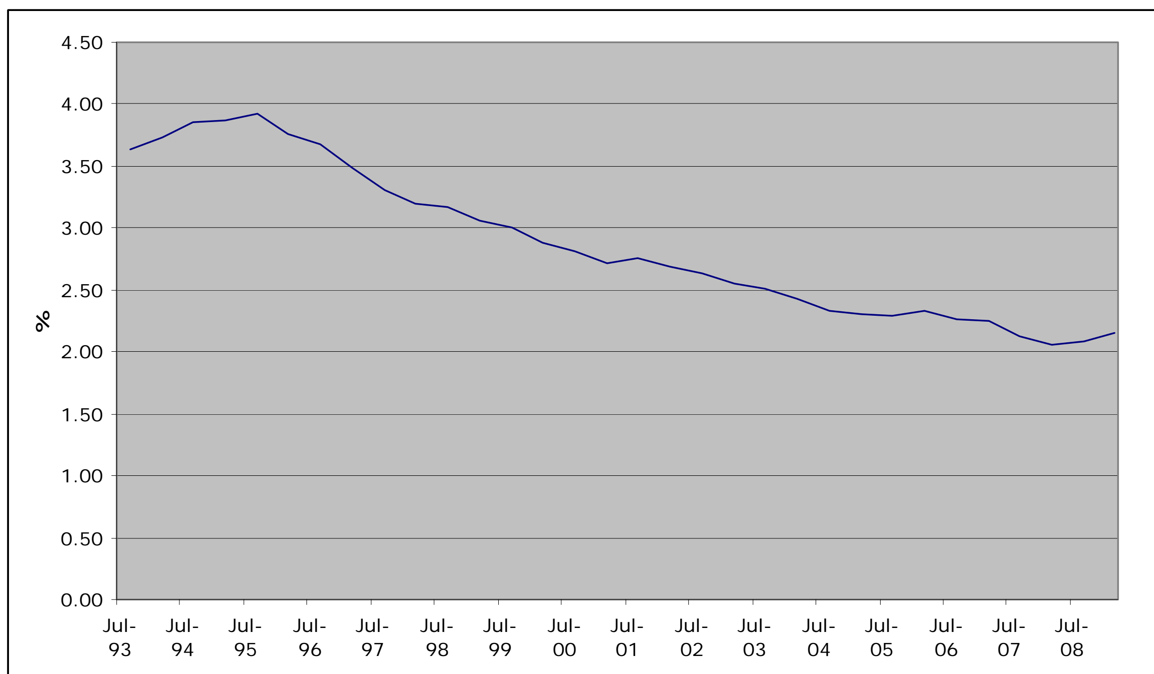
In the early 1990s the growth in the securitisation market enabled mortgage originators to enter the home loan market. This put additional downward pressure on the price of home loans. The Wallis Inquiry (p 625) found that '[t]he rapid growth of mortgage securitisers … turned the market for housing finance into one of the most competitive segments of the Australian financial system'.

The global financial crisis has lead to a collapse in the securitisation market. This has forced many non-bank lenders from the market. However, as the economy recovers, we would expect to see the securitisation market recover and non-bank lenders re-enter the market. This process would not be assisted by additional controls on interest rates for home loan products.

Interest rate margins

As competition increased in the 1990s, margins on home loan products declined. Chart 1 shows margins across all credit products over the period 1993-2009. This shows that margins across all forms of credit have declined from nearly 4% in 1995 to around 2% today.

Chart 1: Industry Credit Margins 1993-2009



Source: UBS Warburg

Chart 1 shows a small increase in credit margins since the commencement of the global financial crisis across all credit. However, this increase has not occurred for

mortgages. A June 2009 RBA report[1] confirmed that the recent financial market turbulence has increased banks' funding costs relative to the cash rate. That report also found that credit margins on mortgages have decreased.

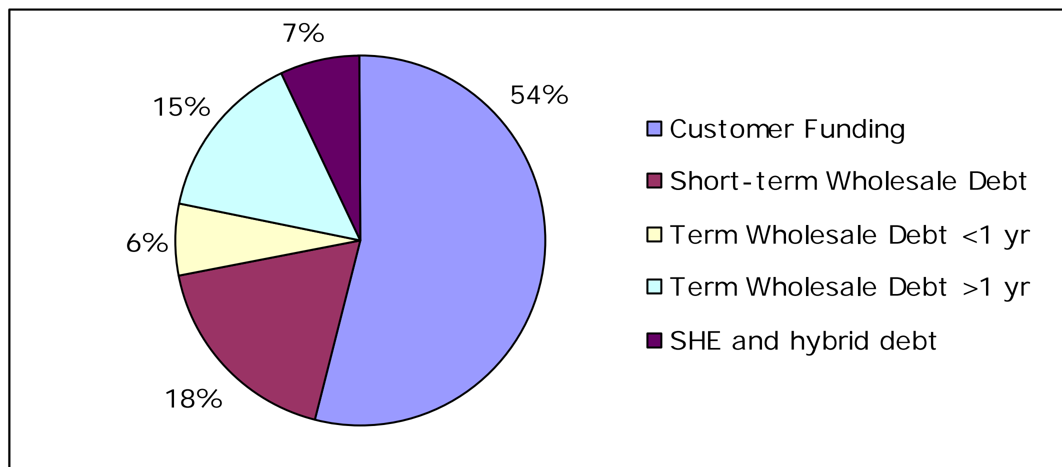
The RBA has reduced the official cash rate by 425 basis points (bps) since it commenced its loosening cycle in September 2008. However, the RBA report found that banks' average funding costs fell only 330 bps over the same period. Banks' cost of funding varies from the official cash rate because banks obtain funding from a range of sources. Very little of a bank's funding is tied solely to the official cash rate. This is discussed further below.

The RBA found that Australian lenders have passed on an average of 385 bps reduction in variable mortgage rates to consumers since the RBA commenced it current loosening cycle. As a result, margins on mortgages have decreased because lenders have reduced lending rates by 55 bps more than the reduction in funding costs.

Bank funding costs

The global financial crisis caused major upheaval on global financial markets. While the outlook has improved somewhat, for the last year global financial markets have been extremely uncertain and volatile. Between the collapse of Lehman Brothers and the start of the Government wholesale funding guarantee, wholesale funding markets were effectively closed to Australian financial institutions and most institutions globally. As discussed above, the global financial crisis also caused the collapse of the securitisation market.

Chart 2: Composition of ANZ's Funding (March 2009)



Source: ANZ internal data

[1] Reserve Bank of Australia (2009), 'The Impact of the Capital Market Turbulence on Banks' Funding Costs', *Bulletin*, June, pp 1–13, accessed at rba.gov.au/PublicationsAndResearch/Bulletin/bu_jun09/impact-cap-mkt-turb.html

In its report, the RBA found that, while the official cash rate remains a key influence on banks' funding costs, the costs of the various forms of banks' funding have not fallen as much as the official cash rate since the onset of the global financial crisis. For example, Chart 2 shows that 54% of ANZ's funding costs come from customer deposits. The RBA's report found that the cost of deposits has fallen more slowly than the cash rate over the past year. This reflects the current strong competition between financial institutions for deposits. Since early September 2008, rates on savings deposits have fallen by an average of 380 basis points, less than the 425 basis point decrease in the official cash rate.

Conclusion

ANZ recommends that Committee not support this legislation. The current system where mortgage rates are set by the market has clearly benefited consumers through lower margins, greater product choice and increased availability of credit. In the heavily regulated market which existed before deregulation, credit was rationed and access to housing finance for many consumers was restricted.

ANZ would be pleased to provide any further information about this submission as required, and can be contacted as follows:

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