Australian Government

The Treasury

# Senate Standing Committee on Economics

# Submission to inquiry into competition within the Australian banking sector

December 2010

# CONTENTS

## CONTENTS

## EXECUTIVE SUMMARY

1. Competition is the cornerstone of efficiency and productivity in any market. It promotes fair prices, enhances living standards and ensures that scarce resources are allocated to their highest value uses.

2. The banking sector makes a significant contribution to the wider economy. This means that healthy competition between financial institutions contributes to Australia's wellbeing.

3. The Australian banking sector has undergone significant changes over the past two decades as a result of deregulation and technological change. These changes have increased competition in the sector and delivered greater choice and savings for Australian banking customers - the range of banking products available to Australian consumers is substantially larger than a decade ago, partly reflecting innovations by new entrants.

4. Participants in Australia's banking sector are required to meet regulatory requirements necessary to promote financial stability and safeguard consumer interests. These frameworks do not constitute an unnecessary nor unreasonable barrier to market entry by new competitors, and Australia's experience during the financial crisis highlights the importance of sound regulation and supervisory oversight.

5. Market concentration in the Australian banking sector has increased as a result of the financial crisis. Since mid-2008, the major banks have increased their market share in relation to both lending and deposits. This represents a reversal of the previous trend of major banks losing market share to smaller competitors that were able to offer cheaper and more innovative products.

6. This development can be attributed to dislocation in global funding markets as smaller banks and non-bank lenders found it difficult to attract funding from investors to support their lending activities. Lack of investor appetite for the asset-backed securities that smaller lenders used to fund housing lending had a major impact on the business models of non-bank lenders that do not have access to a deposit base to fund their operations.

7. Australia's banking sector continues to be subject to competitive pressures, including competition between the major banks, with competition expected to improve as the financial system further recovers.

8. However, this does not mean there is not scope to improve the state of competition in the banking sector, and there has been considerable recent controversy about bank

profitability and the relationship between the interest rates charged by banks and bank funding costs.

- Bank profitability has recovered from the low points of the financial crisis, and current returns on equity are within the range of those that were achieved prior to the crisis.

- Since the onset of the financial crisis, there has been a slight increase in the major banks' net interest margins (NIM) (the difference between interest income on assets and interest costs on liabilities relative total interest bearing assets). This represents a reversal of the previous trend of falling NIMs.

9. During the financial crisis, the Australian Government took action to safeguard the financial system through the introduction of the Financial Claims Scheme and the wholesale funding guarantee.

10. These measures ensured that all Australian banks could continue to access the funding needed to support the provision of credit to the wider economy. The Government also assisted non-bank lenders to access funding through support for issuance of residential mortgage backed securities. These measures played a key role in promoting contestability, and therefore competition, by helping smaller lenders to continue their operations.

11. However, it remains important that policies continue to be pursued that enhance competition between banking service providers. The priorities in this regard are to improve access to funding for smaller lenders and to strengthen the capacity of consumers to make informed comparisons between products and to switch providers to take advantage of lower cost and higher quality products

12. The banking industry also has an important role to play in promoting competitive pressures, such as by supporting government policy and through industry-led initiatives.

13. On 12 December 2010, the Government announced a comprehensive package of measures to further promote banking competition. These measures build on the Government's existing efforts to help smaller lenders access the funding necessary to compete with the major banks. They also assist consumers to evaluate which products best meet their needs and reduce the costs of switching between products.

## INTRODUCTION

14. Treasury's submission to this Inquiry principally focuses on the state of competition in the banking sector, analysing recent trends in indicators of competition, including market concentration, pricing, profitability, contestability and product innovation. The submission also compares some trends in Australia with developments in other countries.

15. The submission then outlines a broad framework for considering competition in the banking sector, including the importance of :

- maximising contestability and minimising barriers to market entry;
- customer mobility and choice; and
- preventing anti-competitive conduct and ensuring that competition produces beneficial outcomes for consumers by promoting high business standards.

16. Further, the submission provides an overview of the initiatives the Government has introduced in recent years to enhance competition and the measures it announced on 12 December 2010 as part of its ***Competitive and Sustainable Banking System*** reforms.

17. This submission complements the various submissions Treasury has made to past inquiries on bank competition related issues, particularly to the House Standing Committee on Economics ***Inquiry into competition in the banking and non-banking sectors*** (2008) and the Senate Economics Committee ***Inquiry into Access of Small Business to Finance*** (2010).

18. In developing this submission, Treasury has relied on data from a variety of sources.

19. Treasury primarily relies on official data collected by the Australian Bureau of Statistics, Australian Office of Financial Management, APRA and the RBA. These three agencies publish official statistics on a wide range of banking issues, including market share, pricing, profitability and investments.

- Key market share data is sourced from RBA through its financial and monetary aggregates and APRA's ***Monthly and Quarterly Banking and Mutual Statistics*** (quarterly statistics include mutuals).
- APRA publishes ongoing pricing data on net interest margins and bank fees and charges.
- APRA quarterly banks and mutuals statistics are the key source of RoE data (although this data is also provided by financial institutions themselves in their reports to shareholders).

20. Treasury also utilises other quantitative data sources where required, including official international sources such as the World Bank, OECD and the Bank of International Settlements; and commercial information providers such as Reuters, Bloomberg and Insto.

21. Treasury also receives a variety of qualitative information from market participants through our liaison programme and consultations with industry and stakeholders.

## CONTEXT

22. The banking industry is one of the largest sectors of the finance and insurance industry, which in turn is the largest industry in Australia (accounting for more than 11 per cent of output)[1]. It is also important because the tasks of accepting deposits, advancing credit and facilitating payments are important for the wider economy.

23. Banking services are vital to almost all households and businesses in Australia. In September 2010, banks had:

- almost $2,650 billion in assets and $2,470 billion of liabilities on their balance sheets. Total bank assets were more than double Australia's GDP, with the finance and insurance industry contributing more than $130 billion towards Australia's GDP in 2009-10.

- total lending of $1,765 billion outstanding on their balance sheets consisting of $1,083 billion in personal lending (including over $975 billion in housing lending), $612 billion in commercial lending (including $460 billion in non-financial sector lending) and $70 billion in government lending.

24. Accordingly, the efficiency of the banking sector impacts on output, growth and living standards, not only in the finance and insurance industry, but across the entire economy. Healthy competition between financial institutions is a means of improving these outcomes and, ultimately, wellbeing.

25. Whilst greater competition among banks typically enhances the welfare of consumers, it may also affect financial stability, which is of vital importance for the functioning of the economy.

26. Accordingly, in the banking sector, unlike other sectors of the economy, initiatives to further competition must take account of this interaction between competition and financial stability.

- Banks are unique because of their particular mix of features which makes them vulnerable to runs with potentially systemic impacts and very important negative externalities for the economy. The fragility of banking systems was exposed during the recent global financial crisis.

- For this reason, the potential benefits of competition between financial institutions must continually be weighed against its potential risks to financial stability, for example the risks that banks lower credit quality in pursuit of more customers or higher profits.

---

[1] Based on the Gross Value Added at basic prices measure of output.

27. Australia's financial regulators are responsible for maintaining regulatory frameworks intended to promote sound risk-taking, and minimise the risk of severe disruption the financial system and the broader economy if a financial institution(s) experiences severe financial stress.

28. Also, the consumer protection framework plays an important role in maintaining competition, imposing minimum standards on banking service providers, requiring disclosure of information necessary to make informed product choices, and providing remedies in the event of poor service (including access to dispute resolution mechanisms).

29. The Australian banking sector has undergone significant changes over the past two decades. This partly reflects the deregulation of the sector in the 1980s, which removed a range of restrictions on participation in the sector and the nature of products and services that could be provided. It also reflects changes in consumer demands and banking technology (such as the move to electronic banking) and the evolution of financial markets.

30. These issues have resulted in greater competition in Australia's banking sector, driving improvements in efficiency, innovation and flexibility and delivering benefits for consumers, including lower borrowing costs, greater choice, cost savings, improvements in service delivery and a greater variety of products and pricing structures.

31. However, the competitive dynamics in any market are rarely completely static as the state of competition in any market will evolve and be driven by emerging market circumstances.

32. In the aftermath of the financial crisis, the Group of 20 (G20) agreed a comprehensive agenda to strengthen global standards of financial regulation to address the deficiencies exposed by the financial crisis. The centrepiece of this agenda consisted of strengthening prudential regulation and supervision.

33. At the recent G20 Summit in Seoul, Leaders endorsed new prudential and liquidity standards for major banks (known as Basel III). The final version of these standards is expected to be released shortly by the Basel Committee on Banking Supervision for implementation by national authorities between 2013 and 2019.

34. Leaders also agreed on the importance of addressing the issue of systemically important financial institutions (SIFIs) that are 'too big to fail'. The Financial Stability Board (FSB) has developed recommendations for reducing the moral hazard caused by SIFIs. These include the need for strong oversight by national regulators and the importance of ensuring that SIFIs in financial stress can be resolved without the need for ultimate taxpayer support and without unnecessary disruption to the financial

system. In the case of global SIFIs, the FSB has emphasised the need for higher loss absorbency and greater cross-border cooperation.

35. In 2011 the FSB will work with other global standard setting bodies on the development of detailed standards to guide national implementation of these recommendations (although national authorities will still have some discretion in their choice of regulatory instruments).

## INDICATORS OF COMPETITION IN THE AUSTRALIAN BANKING MARKET

36. There are a range of quantitative and qualitative indicators that are useful in assessing the state of competition in the banking sector, including:

- Market Share;
- Pricing;
- Profitability;
- Market Contestability; and
- Product innovation.

37. An assessment of the state of competition in banking requires consideration of all of these indicators, and none of these indicators should be used individually as an exclusive and definitive indicator of the state of competition in the banking sector.

38. Further, in order to develop a fulsome view of the competitive dynamics in the sector, it is important to have an historical appreciation of how competition has developed in recent decades in order to place current discussions regarding bank competition in context.

### MARKET SHARE

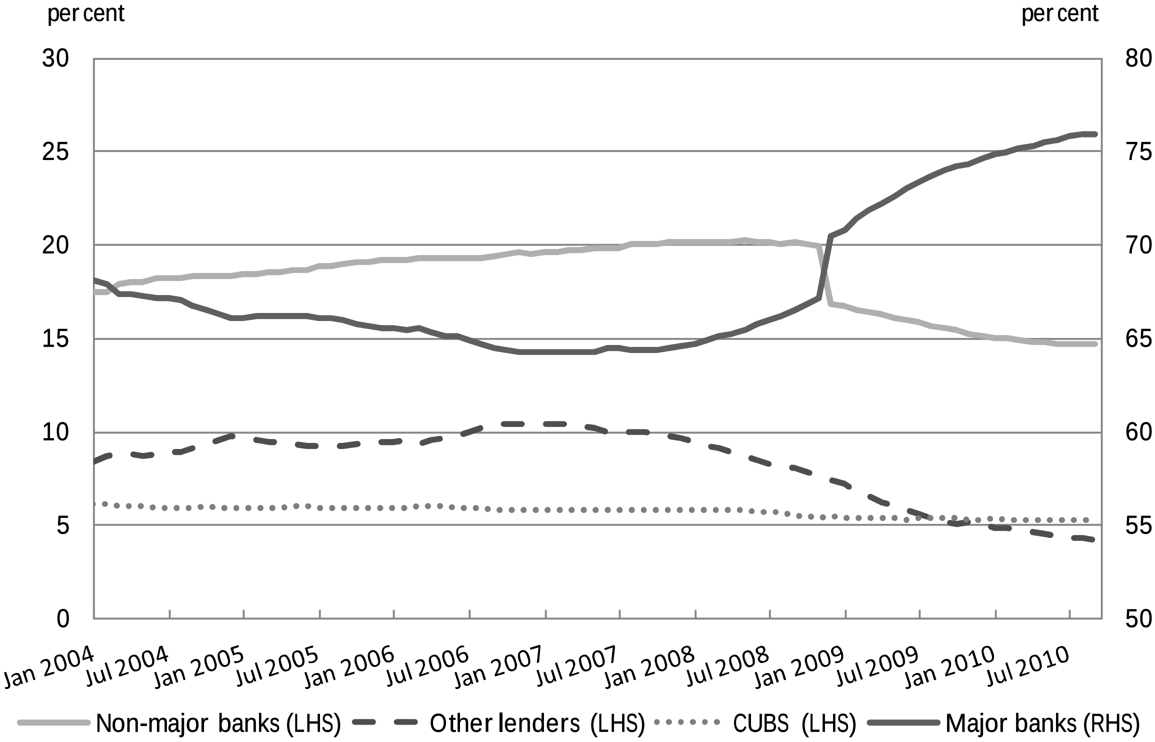
39. Market share refers to the level of concentration in a particular market. In assessing market share, it is useful to consider market shares between different categories of financial institutions (rather than changes in the shares of similar institutions).

40. Changes in market share may indicate changes in competitive pressures in a relevant market and in relation to banking, it is particularly important to focus on four markets: deposits; housing lending; business lending; and personal credit.

41. Charts 1 to 3 show the evolution of market share since 2004 in relation to housing lending; business lending and personal credit, showing the market shares of four categories of lenders, being major banks; non-major banks; credit unions and building societies (CUBS) and other lenders.

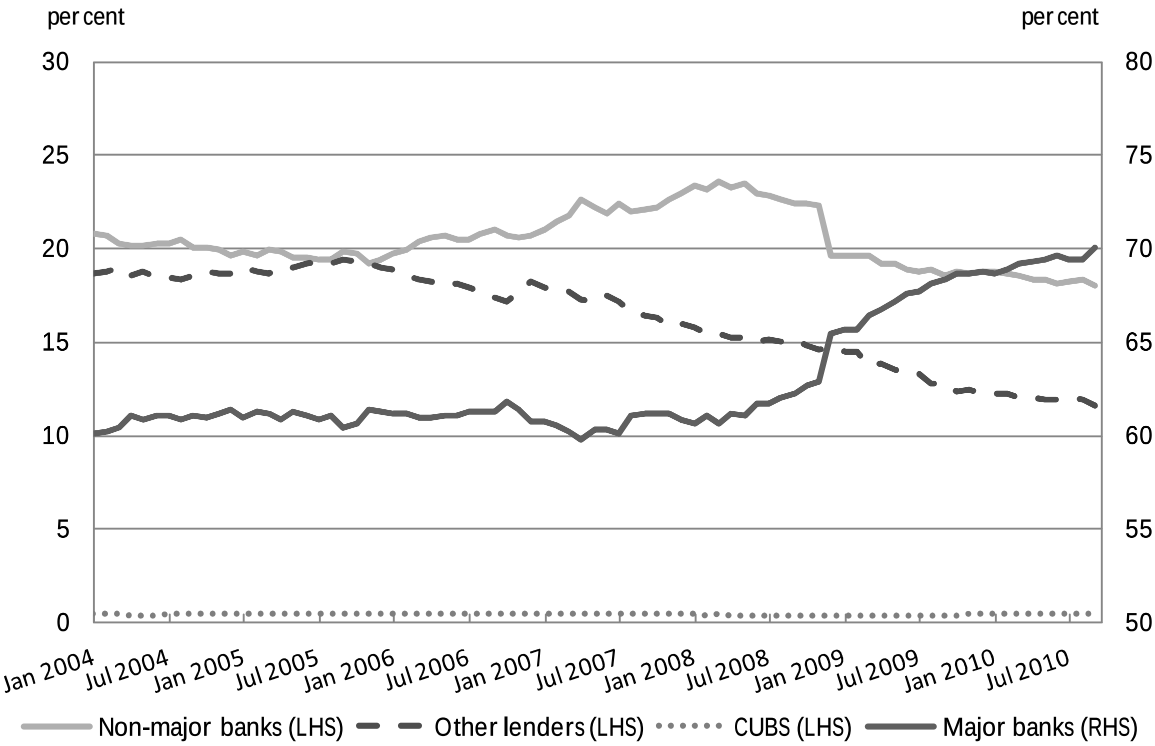
42. The major banks category consists of the four major banks plus St George (both before and after its acquisition by Westpac). The non-major bank category includes all other Australian-owned and foreign-owned banks. The other lenders category consists of non-bank lenders (such as mortgage originators).

Chart 1: Shares of outstanding housing credit (by lender type)



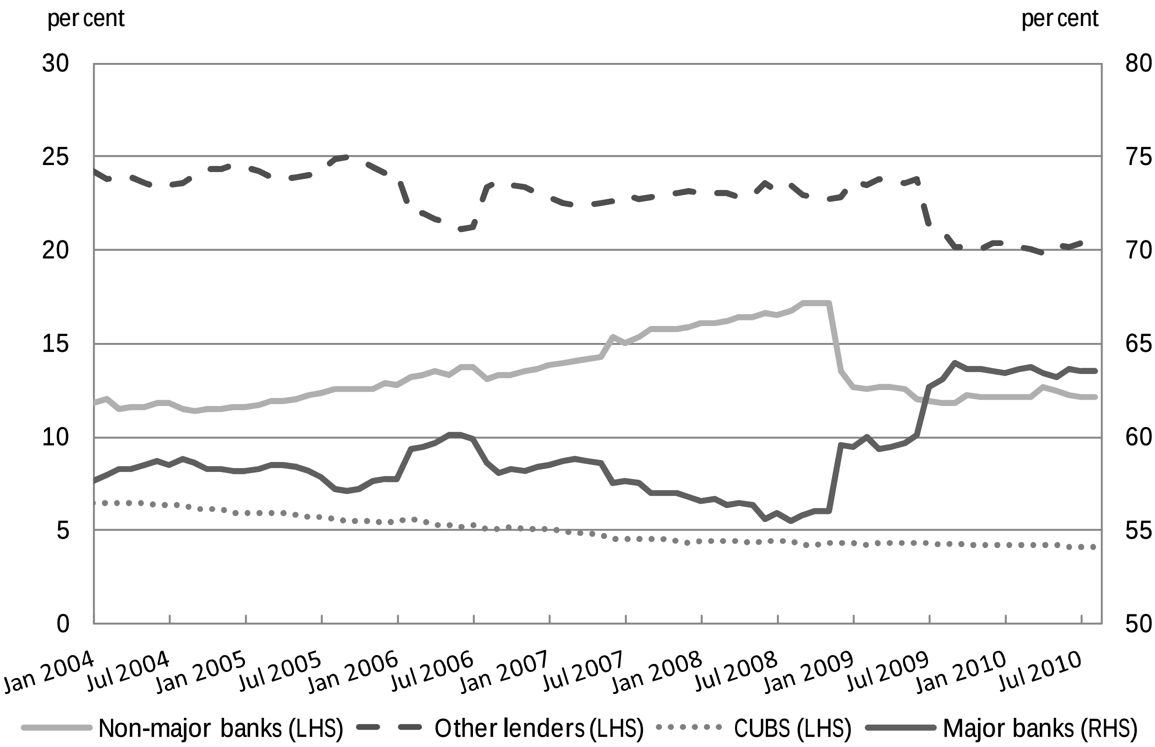

Source: RBA. Note: Major Banks includes BWA from Dec 08; ANZ, CBA, NAB, STG, WBC for entire sample. Other Lenders includes wholesale lenders. Non-Major Banks include foreign banks.

Chart 2: Shares of outstanding business credit (by lender type)




Source: RBA. Note: Major Banks includes BWA from Dec 08; ANZ, CBA, NAB, STG, WBC for entire sample. Other Lenders includes cash management trusts, specialist credit card institutions and some additional securitisation data. Non-Major Banks include foreign banks.

Chart 3: Shares of outstanding personal credit (by lender type)




Source: RBA. Note: Major Banks includes BWA from Dec 08; ANZ, CBA, NAB, STG, WBC for entire sample. Other Lenders includes cash management trusts, specialist credit card institutions and some additional securitisation data. Non-Major Banks include foreign banks.

43. Between 2004 and mid-2008 the major banks lost market share in housing lending to non-major banks and non-bank lenders. They also lost market share in personal credit to non-major banks. However, their share of business lending remained stable.

44. Following the onset of the financial crisis in mid-2008, the major banks began to increase their market share in all three lending categories at the expense of non-major banks and non-bank lenders. Their share of the total:

- housing lending market increased by 11.7 per cent (although this growth appears to have levelled out more recently, with non-major banks increasing their shares of new residential mortgages since March 2009);
- business lending market increased by 10.3 per cent;
- personal credit market increased by 13 per cent.

45. The main explanation for these developments is the differential impact of the financial crisis on the fund raising capacity of Australian financial institutions.

46. Despite the measures introduced by the Australian Government to limit the impact of the crisis (including the wholesale funding guarantee and support for the issuance of residential mortgage backed securities - RMBS) dislocation of global funding markets affected all Australian lenders.

47. The major banks were best placed to cope with these pressures because of their stronger credit ratings and access to a broader range of funding channels, including large deposit bases. This allowed them to continue lending during the crisis.

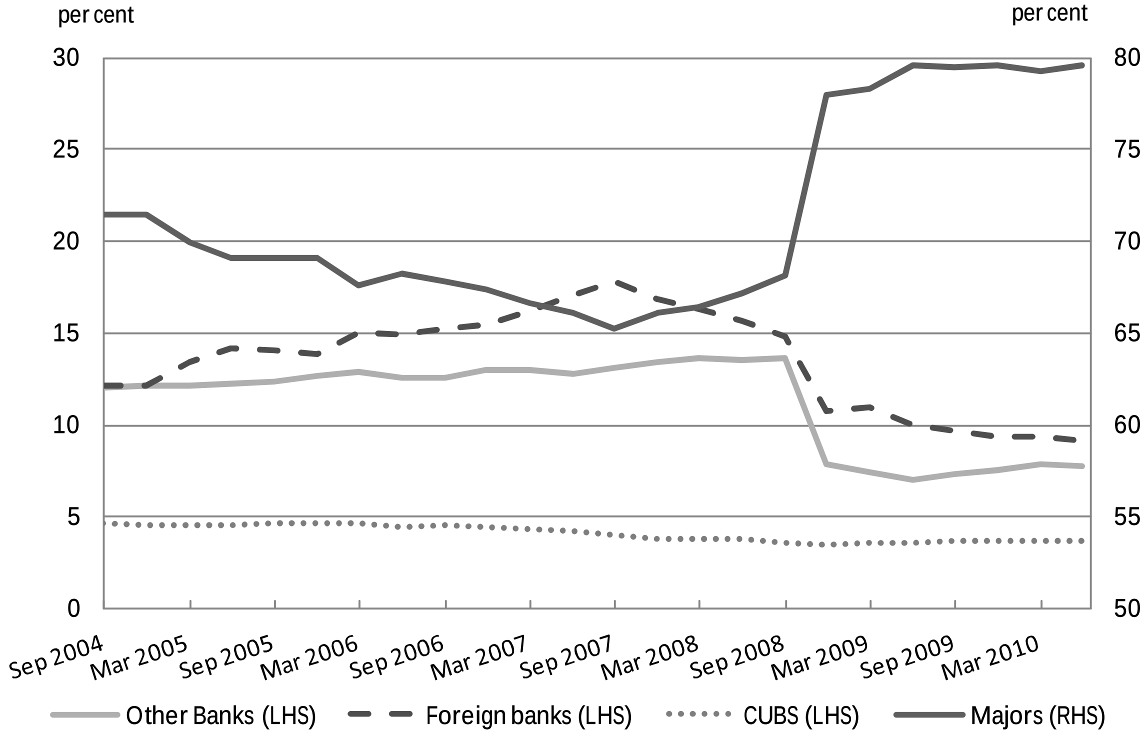
48. The non-major banks suffered from reduced access to wholesale borrowing as well as their inability to raise new funds by securitising their loan portfolios. The foreign-owned banks also found it harder to access funds from their foreign parents, some of which were experiencing severe financial distress.

49. Non-bank lenders suffered most from their inability to raise funds by securitising loan portfolios due to a lack of investor interest in these products as well as the absence of a deposit base on which to draw.

50. However, access to funding is not the sole explanation for the increase in the market shares of the major banks following the onset of the financial crisis.

51. Some of the trend is explained by the acquisition of BankWest by the Commonwealth Bank in late 2008. In September 2008 BankWest was Australia's seventh largest bank with $57.6 billion in assets. It had been using funding from its UK-based parent to aggressively pursue market share and held around 2.5 per cent of the housing loan market when it was taken over. Following its acquisition by the Commonwealth Bank, BankWest's loan portfolio moved from the 'non-major bank' to the 'major bank' classification.

Chart 4: Shares of deposits (by lender type).




Source: Treasury and APRA Quarterly Statistics. Note: Majors include BWA (previously Foreign Banks) and STG (previously Other Banks) after December 2008.

52. Chart 4 shows the evolution in market share since 2004 in relation to deposits, based on APRA data. It shows the market share of four categories of deposit-taking institutions: majors; other banks; foreign banks; and CUBS. The majors classification consists of Australia's four largest banks. In contrast to RBA lending data, St George is not classified as a major until its acquisition by Westpac. Prior to this it was classified as an 'other bank'. The other banks category consists of Australian owned banks, with foreign banks classified separately.

53. Between 2004 and mid-2008, the major banks were steadily losing market share to foreign banks.

54. Following the onset of the financial crisis in mid-2008, the majors gained market share in deposits at the expense of other banks and foreign banks. Between September and December 2008, the majors' share of deposits increased by 9.8 per cent. A significant part of this shift can be attributed to the re-classification of the deposits of St George and BankWest as belonging to the 'majors' following their acquisitions by Westpac and the Commonwealth Bank respectively.

55. The majors have maintained this higher market share since December 2008.

56. Aside from the reclassification of the deposits of St George and BankWest, there are two possible explanations for the increased share obtained.

- The first is a ‘flight to quality’ in the early period of the financial crisis prior to the introduction of the Financial Claims Scheme in October 2008. This could have occurred if the majors were perceived to be safer than other banks.

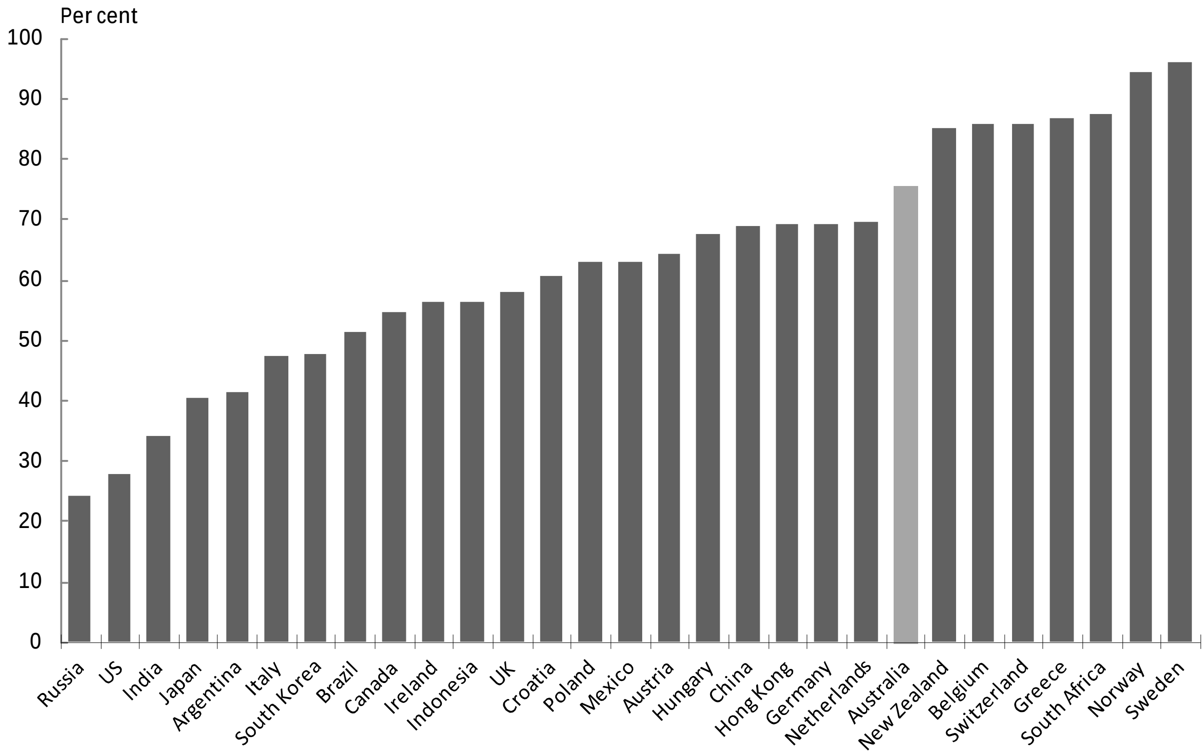
- The second is the aggressive strategies that have been used by the majors more recently to boost their access to deposits.

### *International Comparison*

57. The Organisation for Economic Cooperation and Development (OECD) collects data on the degree of market concentration in members’ banking sectors. The most recent data is for the period up to 2008. It is based on the combined market share of each country’s top three banks. Chart 5 uses this data to compare Australia with other countries and indicates that the level of market concentration in Australia is not unusual by global standards.

58. While there has been some increase in market concentration in Australia since 2008, anecdotal evidence suggests that similar trends have been in many other countries, especially those that have been most directly affected by the financial crisis.

Chart 5: International Comparisons of Bank Concentration (average 2000-2008)




Source: Treasury and World Bank (Financial Structure Dataset). Note: Concentration measured as assets of three largest banks as a share of assets of all commercial banks.

## PRICING

59. Pricing refers to the cost of financial products such as interest rates, fees and charges (or their returns, in the case of deposits), and changes in pricing can indicate changes in competitive pressures.

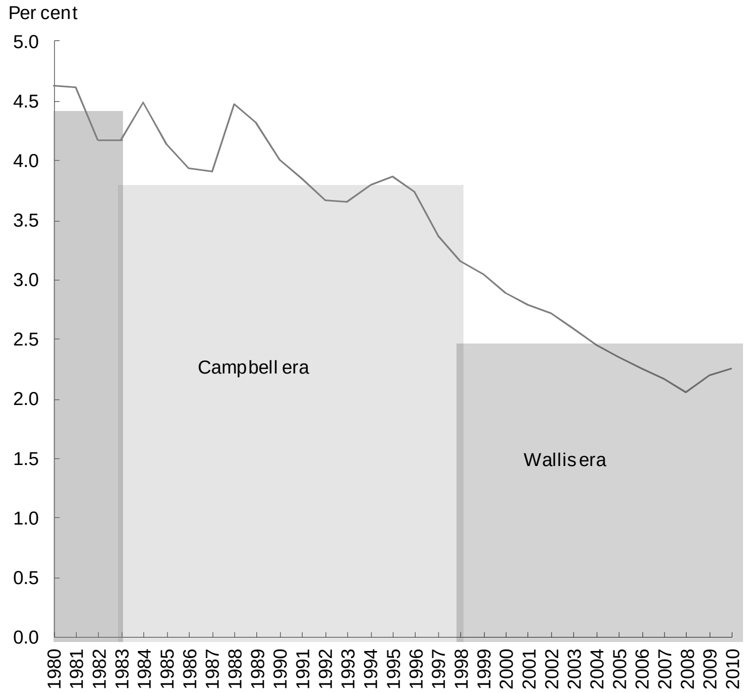
- In relation to interest rates, these are set by lenders for different loan products, with the level at which interest rates set depending on a number of factors, including the cost of providing the product (especially the cost of funds), the lender's assessment of the risk associated with the loan and the lender's commercial business strategy. This is why interest rates can vary substantially across different banking products and lenders

60. In analysing pricing developments, it is useful to focus on net interest margins (NIMs) (the difference in basis points between the interest income generated by banks on their assets and amount of interest paid on their liabilities relative to their interest earning assets) and data on fees and charges.

### Net Interest Margins

61. Whilst declining NIMs can indicate increased competition, because NIMs do not take account of banks' non-funding costs, an increase in NIMs may not be reflective of a decline in competition. This is because profitability may be falling even when NIMs are increasing.

Chart 6: Bank Net Interest Margins (1980-2010)



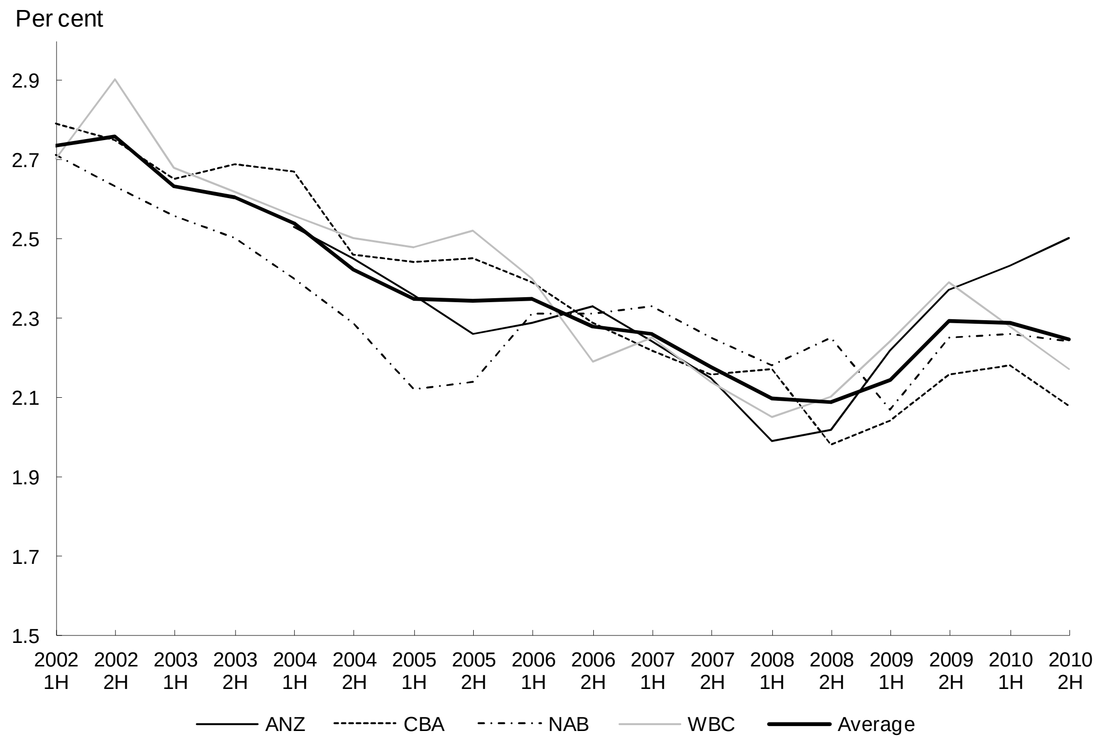

Source: Treasury with RBA data. Notes: Based on annual Data. Post 2006, data calculated on an IFRS basis.

62. Chart 6 uses RBA data on bank net interest margins since 1981. It shows that bank NIMs have declined steadily since the early 1990s and have roughly halved since the mid 1980s. They were at historic lows prior to the onset of the financial crisis.

63. This trend can be attributed to increased competition in lending as well as the removal by banks of internal cross-subsidies through the introduction of a user-pays pricing system.

64. Chart 7 shows the NIMs of the major banks since 2002, indicating that these have increased slightly since the onset of the crisis in mid-2008. However they are still well below 2002 levels. In addition, they declined on average in 2010.

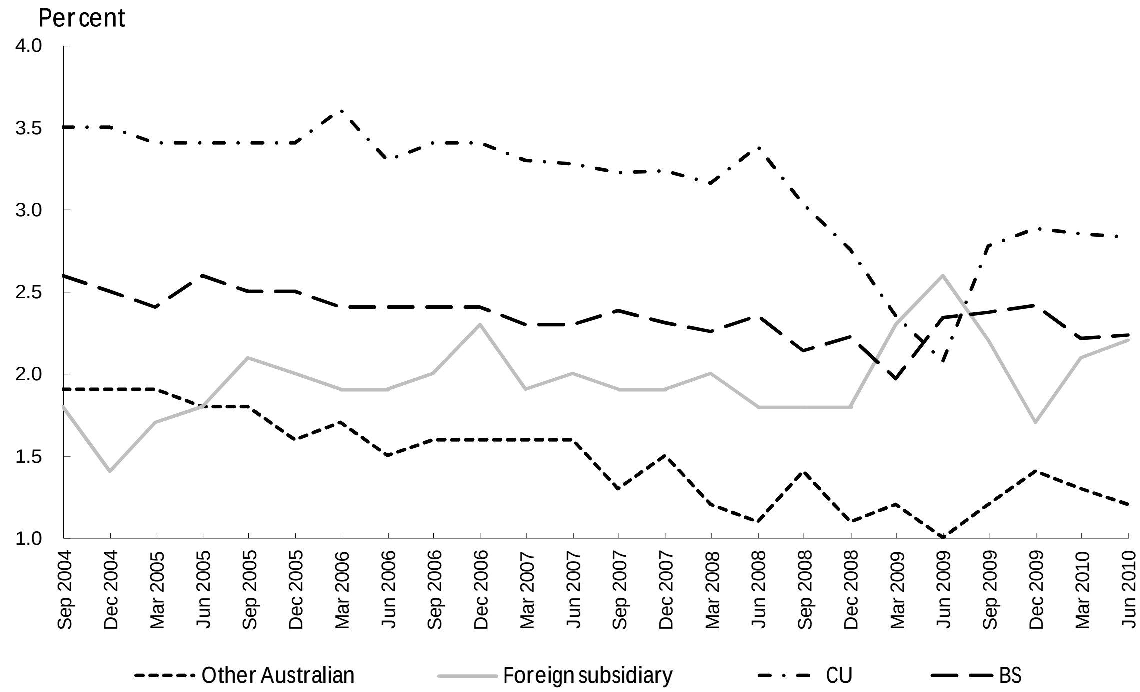
Chart 7: Net Interest Margins – Four Major Banks




Source: Major banks' financial disclosure documents. Notes: Data is half yearly. Calculated as net interest income to average total interest earning assets on a group basis. ANZ data unavailable prior to 2004.

65. Chart 8 shows the NIMs of other ADIs since 2004. Smaller lenders may have higher NIMs due to different asset and funding mixes. For example, personal credit tends to account for a larger proportion of their asset base. These loans typically feature higher interest rates than housing or business loans.

Chart 8: Net Interest Margins – Other ADIs




Source: APRA Quarterly bank and CUBS statistics. Note: Calculated as net interest income to average total assets.

## Fees and charges

66. The second dimension of pricing relates to fees. RBA data indicates that the level of revenue that banks derive from fees has increased since the early 1990s. Between mid-1997 and mid-2009, total income from fees increased from $3.9 billion to $12.7 billion. This increase in revenue was initially driven by the introduction of new fees, including for services that were previously cross-subsidised from interest income.

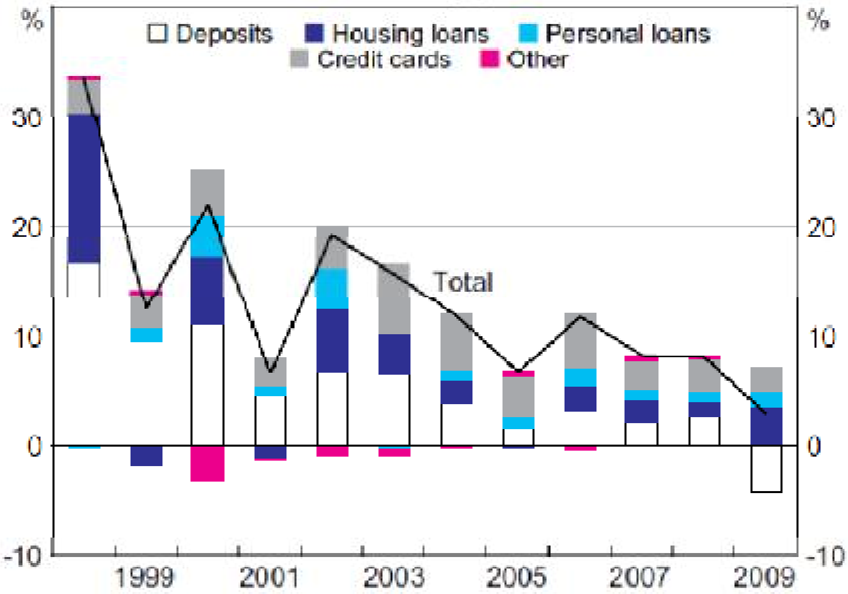
67. To some extent this development was a product of the emergence of competition from new participants that were able to target banking markets with high interest margins.

68. Recent years have seen a slow-down in the rate of growth in bank revenue from fee income. The annual survey of bank fees released by the RBA in June 2010 found that while bank fee income increased by 9 per cent in 2008-09, this rate of growth was lower than the rate of growth in banks' balance sheets.

69. Chart 9 shows the rate of growth in the level of fees paid to banks by households between mid-1998 and mid-2009, showing that the rate of growth has decreased over this period, and fees paid by households grew by only 3 per cent between 2007-08 and 2008-09.

70. This was the slowest rate of growth since the RBA survey commenced in 1997.

Chart 9: Growth in bank fee income from households (by product)




Source: RBA Annual survey of bank fees (June 2010).

71. The RBA also found that fee income from household deposits declined by 11 per cent between 2007-08 and 2008-09, despite a large increase in the value of household deposits during the same period.

72. The decline in fees was driven by a fall in transaction fee income, partly reflecting the ATM fee reforms that came into effect in early 2009 (see below).

73. The RBA further noted that account-servicing and other fees – which are mainly exception fees – also declined in value as banks began to compete more aggressively for deposit funding. In particular, a number of banks began to offer deposit products that waive account fees if the account holder makes regular deposits of funds – such as regular salary payments – above a given threshold.

74. While there was an increase in fee revenue from housing loans in 2008-09, the RBA has observed that this was driven by establishment and early exit fees, with the available information suggesting that break fees on fixed-rate loans accounted for a significant proportion of the overall growth in fees.

75. Break fees increased as a number of customers chose to refinance their fixed-rate housing loans with variable-rate loans given the significant fall in the cash rate during banks' 2009 financial year. Excluding break fees on fixed-rate loans, the RBA estimate that housing fee income rose by around 7 per cent.

76. Since the early 1990s consumers have gained access to a range of banking products that potentially reduce the number and size of fees incurred. These include: basic bank accounts for low-income earners; 'all-you-can-eat' transaction accounts; 'no-frills' products such as credit cards; and fee discounts offered as part of product bundles (see 'Product Innovation' section).

## ATM reforms

77. In March 2009, the RBA introduced a package of reforms designed to improve competition in the Australian ATM system, including requiring ATM owners to disclose any fee to be charged to the cardholder prior to the transaction being finalised.

78. In June 2010, the RBA published an initial assessment of the reforms made to the ATM system, concluding that reforms to the ATM system are largely meeting their objectives of increasing competition and efficiency in the ATM system.

79. Further the RBA estimated that cardholders have responded to clearer price signals, and avoided paying an estimated $120 million in ATM withdrawal fees[2].

- Cardholders have undertaken a higher proportion of 'fee-free' ATM transactions such as at their own banks' ATMs (up 9 per cent) and through EFTPOS (up 9 per cent) and a lower proportion of 'foreign ATM transactions (down 18 per cent).

80. Following the reforms, the number of ATMs has increased by about 1,500 (6 per cent) as direct charging allows ATM fees to better reflect costs, the RBA reported that the reforms have facilitated larger amounts of ATMs in rural, regional and remote areas.

81. Further, while 88 per cent of ATMs still charge $2.00 for a foreign ATM withdrawal, similar to the typical foreign ATM fees of the past, the vast majority of cardholders have access to a wide network of ATMs free of direct charges, and around two-thirds of all ATM withdrawals do not attract fees[3].

## PROFITABILITY

82. The profitability of lending products can give a good indication of relative levels of competitiveness over time, particularly through examination of return on equity (RoE).

83. Bank profitability has recovered from the low points of the financial crisis, and current returns on equity are within the range of those that were achieved prior to the crisis.

84. Bank profits over time have been sustained by strong growth in lending and transaction volumes, low levels of problem loans and significant reductions in operating costs.

---

[2] Reserve Bank of Australia, Bulletin - June Quarter 2010, 'Reform of the ATM System – One Year On'
[3] Reserve Bank of Australia, Bulletin - June Quarter 2010, 'Reform of the ATM System – One Year On'

85. Some diversified financial institutions, including the major banks, have also benefited from higher income from non-banking activities, such as wealth management income associated with the growth in superannuation assets.

- In considering the profitability of banking groups, it is important to recognise that their revenue is not derived solely from banking services. In response to competitive pressures in their core banking businesses, banks have expanded into other activities such as wealth management. They have done this in anticipation of high future growth rates in this sector as well as to diversify their sources of funding and earnings.
- Wealth management now makes up a large proportion of the non-interest income of the retail banks. In the 2009-10 financial year, the four major banks reported a total profit of around $2.65 billion from wealth management activities[4].

## Return on Equity

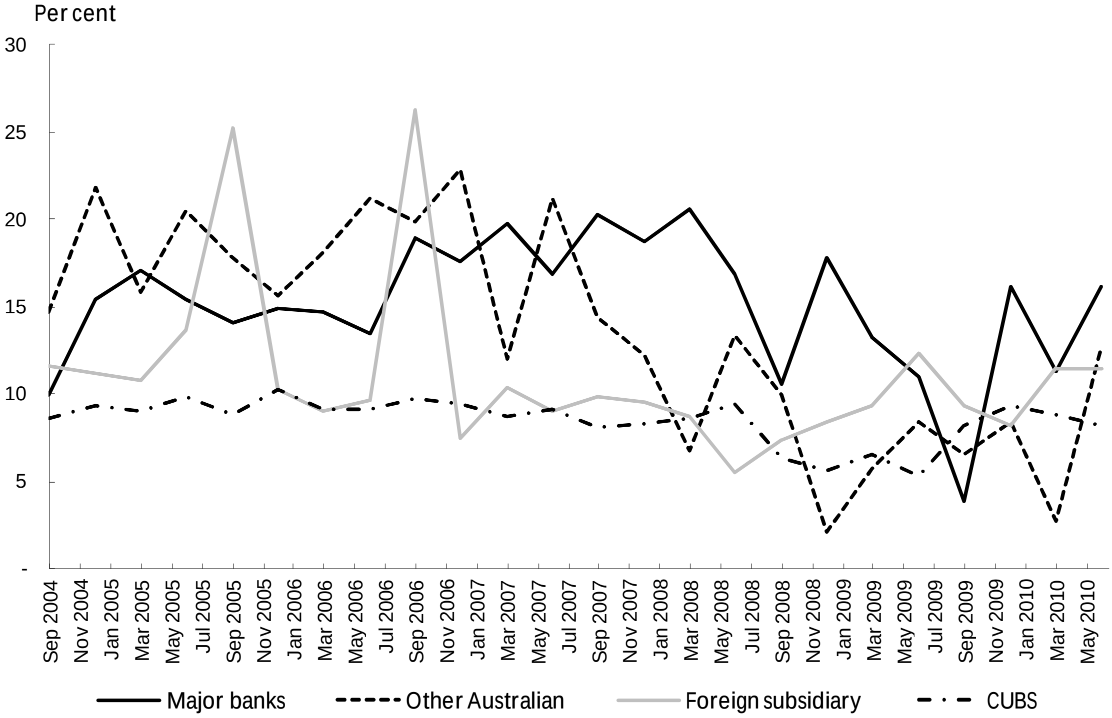
86. Return on Equity (RoE) is the main indicator used to assess trends in the profitability of financial institutions as headline profit figures such as net profit after tax ignore the amount of assets and equity required to generate the profit.

87. Return on assets can be a useful supplementary indicator of profitability because it shows how effectively an institution is using its assets. Its main disadvantage is that it does not take account of debt, which limits its use in comparing banking sector profitability with other sectors of the economy.

88. Chart 10 shows trends in quarterly RoE data for four categories of ADI since 2004: major banks; other Australian banks; foreign subsidaries; and CUBS. As this is APRA data, the term ‘major banks’ refers to the 4 majors (i.e. St George is treated as an ‘other Australian bank’ prior to its acquisition by Westpac). The foreign bank category only covers those that have a separate Australian subsidiary (not foreign banks that operate as branches).

[4] Source: Major banks’ annual financial statements.

Chart 10: ADIs Return on Equity




Source: APRA Quarterly bank and CUBS statistics.

89. Prior to the financial crisis, major banks achieved an average quarterly RoE of between 10 and 20 per cent. Other Australian banks were often more profitable than the majors.

90. Quarterly RoE fell for both the majors and other Australian banks following the onset of the financial crisis, with both dipping below 5 per cent. However, 'other Australian banks' were hit harder and earlier than the 'major banks'.

91. Since the crisis, both 'major banks' and 'other Australian banks' have achieved higher quarterly RoE.

## MARKET CONTESTABILITY

92. In addition to quantitative indicators covering market shares, pricing and profits, it is also important to consider the contestability of markets for banking products. This includes the:

- size of barriers to market entry / exit (especially regulatory barriers); and
- competitiveness of alternative savings vehicles and alternative forms of borrowing (including non-bank lenders and, in the case of major corporations, corporate bond issuance). The availability of alternative saving and investment vehicles and the threat of entry of prospective new entrants can serve as an important source of market discipline on existing participants.

93. Competition can exist in markets with a small number of major suppliers, particularly where there is competition from smaller players or where barriers to entry and exit are sufficiently low for there to be a credible threat of competition from new entrants.

94. Notwithstanding the prominence of the four major banks in the Australian banking sector, there is evidence that the sector is contestable.

95. Australian banking customers are currently served by a wide range of providers. These include 12 Australian-owned banks; 9 foreign-owned bank subsidiaries; 35 foreign bank branches; 11 building societies and more than 100 credit unions.

96. Further, there are currently around 111 providers of over 2,200 mortgage products; 66 providers of over 420 different credit cards; and 114 providers of over 992 different types of deposit accounts[5].

97. Experience since the 1990s suggests that smaller players can successfully compete with the major banks should opportunities arise for them to raise funds at competitive prices and provide more innovative products and services than those already provided by the major banks.

98. A particular concern following the onset of the global financial crisis has been the exit and slower growth of the smaller players, however, competitive pressure from these participants is expected to rise as the financial system and economy continues to recover from the impact of the global financial crisis.

99. The recovery of the securitisation market – which enabled non-ADIs and smaller ADIs to gain market share and put downwards pressure on interest rates in the mortgage lending market from the 1990s - should assist smaller lenders to increase competitive pressures on the major banks going forward.

- The Government's $16 billion RMBS investment program is helping to support the recovery of this market and, over the past 18 months, there have been a number of positive signs that conditions are improving in this market.

100. Despite these positive signs, there remain risks that could impact on the extent and speed of the recovery of the Australian RMBS market.

101. Competitive pressures for the banking sector can also come from sources outside the sector in some cases. For example, larger non-financial corporates have access to non-intermediated debt and equity markets as alternative sources of funding to bank loans.

[5] Source: Canstar Cannex

102. Further, the four pillars policy enhances contestability in the banking sector by prohibiting mergers between Australia's four largest banks. The policy ensures that that any merger between these banks would be considered contrary to the national interest, and would not be approved under the national interest tests in the relevant merger legislation, administered by the Treasurer.

103. On 2 June 2008, the Treasurer, the Hon Wayne Swan MP, announced that the 'four pillars' policy would be maintained by the current Government "***in the interests of stability and competition***".

## Entry and Exit

104. Entry into the Australian banking sector is open to any institution (Australian or foreign), provided that it meets the relevant regulatory requirements. For example:

- financial institutions that raise funding through deposit-taking activities are subject to prudential regulation by the Australian Prudential Regulation Authority (APRA), which is designed to promote the safety of deposits and protect the stability of the financial system;
- the provision of financial products other than credit is subject to the financial services licensing regime of the Australian Securities and Investments Commission (ASIC);
- the provision of credit is subject to consumer protection regulation by the Commonwealth; and
- other regulatory requirements specific to the banking sector include payments system regulation and anti-money laundering and counter-terrorism financing requirements.

105. These requirements are designed to balance the goals of safety, competition, efficiency, market integrity and consumer protection and are consistent with international best practice.

106. They do not represent a significant or unnecessary barrier to entry.

107. In addition to meeting regulatory requirements, participation in some parts of the banking sector may require the establishment of certain infrastructure, such as branch networks and other distribution channels.

108. However, over the past decade, the development and adoption of electronic banking methods (such as Internet banking, ATMs and EFTPOS) and alternative distribution methods (such as mortgage brokers) has reduced the impact of such non-regulatory requirements.

109. Such developments have improved the ability of potential new entrants and smaller existing players to service Australian banking customers, helping them to compete more effectively with the larger banks with established branch networks.

- Similarly, the more widespread distribution of banking services via the Internet has been a key driver of foreign banks' renewed interest in the retail banking market in recent years.

110. Some new entrants have bypassed the need for a physical branch network altogether, basing their business models predominantly on Internet, telephone and postal banking, such as by offering 'online' savings accounts or home loans that are applied for and administered over the Internet.

## PRODUCT INNOVATION

111. The level of innovation within a banking system provides a further indication of competitive pressures. As banks attempt to foster brand recognition and attract market share, they are encouraged to create unique financial products. This innovation provides consumers with the opportunity to obtain financing products that more closely match their needs.

112. The Australian banking system has experienced considerable innovation in recent decades and much of this has been driven by new entrants and smaller players who have been keen to attract market share.

113. The range of products available in the Australian banking market today is significantly different to those available a decade ago.

114. In many cases the new products reflect innovations by new entrants which effectively force incumbent bank and non-bank providers to match the improved pricing or product features in order to defend their market shares.

115. Examples of banking products and services that have been introduced or become increasingly available over the past 10-15 years include:

- high-interest online savings accounts, which offer higher interest rates than traditional transaction accounts, but may impose limits on the number and/or types of transactions that can be made using the account;

- 'all-you-can-eat' transaction accounts, which involve a simplified fee structure of unlimited transactions (of certain types) for a fixed monthly account-keeping fee;

- 'basic bank accounts', which are transaction accounts targeted towards low-income customers and are fee-free, providing that certain transaction limits and, in some cases, minimum balances are met;

- 'no-frills' credit cards involving lower interest rates and / or fees than traditional cards;
- mobile phone banking, which allows customers to check their account balance, transfer funds, pay bills and make purchases using their mobile phone;
- low-doc and no-doc loans, which provide greater access to credit for customers without the requisite documentation, such as self-employed small businesspeople;
- zero- or low-deposit home loans, which enable borrowers to enter the housing market earlier, or buy a more expensive property, than if a larger deposit were required;
- reverse mortgages, which enable asset-rich but income-poor home owners to unlock some of the equity tied up in their housing asset;
- shared equity mortgages, which can assist borrowers who cannot afford to purchase a home using a traditional mortgage to enter the housing market, by sharing ownership of the home with the lender or another entity; and
- flexible mortgage structures and features, including: redraw facilities; 'offset accounts'; 'lines of credit'; and a wider range of fixed-interest options.

116. Further in recent months, and in response to consumer demands for home loan products that assist in managing exposure to movements in the variable interest rate, a number of lenders now offer 'capped rate' variable mortgages.

- Under these capped rate mortgages, borrowers are charged a premium over the lenders standard variable rate (for example 10 basis points) for the protection that the interest rate the consumer will pay will be no higher than a pre-determined, capped rate (for example 50 basis points above the current variable rate).

117. This product suits borrowers who want some protection from rising rates but do not want to give up the flexibility of a variable rate product.

118. There are no regulatory barriers to other providers offering products of this kind and more providers would be expected to offer these products if there was sufficient demand from consumers.

119. Overall, banking customers have benefited from an improved range of product features and wider choice. Most financial institutions now provide a range of options within each product type, providing for different transaction patterns, income levels, price sensitivities and service requirements.

## FRAMEWORK FOR COMPETITION IN BANKING

120. In a 2009 paper[6], the OECD identifies a number of factors that it considers important for promoting competition in the banking sector. While some of these factors relate to the unwinding of government interventions during the financial crisis, three have much broader relevance.

121. The first is the importance of maximising contestability and minimising barriers to market entry. At present in Australia, a key barrier to increased competition is the difficulties experienced by small ADIs and non-bank lenders in gaining access to competitively priced funding from investors. This suggests that addressing funding pressures should be a focus of Government policy.

122. The second is the importance of customer mobility and choice. The OECD argues that this is essential to stimulate competition in retail banking. Customer mobility may be hampered by the existence of significant switching costs that prevent customers from moving their business between financial institutions to take advantage of lower prices or better service. For this reason, the OECD argues that switching costs constitute 'an important source of market power in retail banking'.

123. The OECD has suggested three ways in which Governments can facilitate increased switching.

- Firstly, it emphasises the importance of consumer education and financial literacy. It is important to boost consumer awareness of the full range of products and service providers (not just the major banks). Disclosure is particularly important for promoting transparency and enhancing the capacity of consumers to assess the merits of competing products in the market place.

- Secondly, it notes the importance of reducing or eliminating obstacles to switching that may be imposed by financial institutions to retain customers.

- Thirdly, it suggests that governments should explore the use of account number portability, while recognising that this may be a longer-term option due to complexities associated with its implementation.

124. The third is the importance of robust competition and financial services laws that can be used to protect the interests of consumers by preventing anti-competitive conduct as well as ensuring that competition produces beneficial outcomes for consumers by promoting high business standards.

---

[6] OECD, *Competition and Financial Markets*, Key Findings, 2009.

## GOVERNMENT MEASURES TO ENHANCE COMPETITION

125. The Government has introduced a range of measures in recent years to maximise contestability, enhance customer mobility and protect the interests of consumers. In response to the global financial crisis, the Australian Government introduced measures to enhance the capacity of smaller lenders to access funding:

- implementing a wholesale funding and deposit guarantee, which supported deposit funding and enabled non-major banks to borrow wholesale funding during a period when global funding markets were severely dislocated.
- instructing the Australian Office of Financial Management to invest up to $16 billion in RMBS, supporting funding for smaller lenders.
- announcing that it would phase down interest withholding tax for foreign lenders to enhance their capacity to access cheaper funding from overseas parents.
- announcing that it would phase in a 50 per cent tax discount up to the first $1000 of a taxpayers interest income, which is expected to support funding particularly for smaller lenders.

126. The Government also announced measures to enhance the capacity of consumers to move between financial institutions, including:

- a direct debit and credit listing service to make it easier for customers to switch from one institution to another.
- laws regarding unfair contract terms (this law applies to mortgage early termination fees).
- a package of credit card reforms.

## COMPETITIVE AND SUSTAINABLE BANKING SYSTEM REFORMS

127. Further, on 12 December 2010, the Government announced its ***Competitive and Sustainable Banking System*** reforms containing various initiatives designed to make the banking system more responsive and competitive. The reforms are divided into three streams, targeted to address specific aspects of the banking sector to:

- “Empower consumers to get a better deal”;
- “Support smaller lenders to compete with the big banks”; and
- “Secure the long-term safety and sustainability of our financial system”.

128. The package includes measures to strengthen the capacity of consumers to support competition through informed choices, including their capacity to switch between products and providers.

- The Government will make it compulsory for all mortgage lenders to provide potential borrowers with a simple, one-page key facts sheet which uses standard definitions to show consumers how much they will pay every month and over the life of their loan, and where they can shop around. This initiative is designed to enhance consumer empowerment by improving transparency to assist consumers to better understand and compare information, and make more informed choices and appropriate product selections.

- The Government will ban exit fees (deferred establishment fees) outright for new home loans from 1 July 2011 through changes to the National Credit Code. This is intended to prevent banks from using mortgage exit fees to lock customers into home loans.

- The Government is taking steps to progress the transition to full bank deposit portability. Portability would allow Australian consumers to quickly and seamlessly switch their account. The Government will appoint former RBA Governor Mr Bernie Fraser to conduct a comprehensive feasibility study to examine the technological options, the potential timeline and processes for implementing account number portability.

  The Government is also examining measures to enhance the capacity of Australian home borrowers to transfer mortgages by accelerating development of potential frameworks to:

  – transfer Lenders Mortgage Insurance from lender to lender; and

  – allow consumers to avoid lender fees, as well as mortgage discharge and re-establishment costs, through the introduction of a central repository to hold all mortgages.

- The Government will introduce legislation to increase fairness and consistency in the way fees and interest are charged on credit cards, to give consumers more say over how they use their credit cards and to help them better understand the terms and conditions. The legislation will require credit card lenders to:

  – allocate repayments to higher interest debts first;

  – prevent lenders from charging over-limit fees unless consumers specifically agree that their account can go over the limit;

  - ban unsolicited credit limit extension offers unless pre-agreed to by the consumer;
  - ensure all interest charges are applied consistently under an industry-agreed standard, including when interest starts to accrue and on what balances;
  - make sure lenders give consumers more say over nominating their own credit limit;
  - make it mandatory for credit card application forms to include a clear summary of key account features; and
  - require lenders to inform consumers about the implications of only paying minimum repayment amounts on their statements.

- The Government will launch a national community awareness and education campaign in early 2011 – ***Bank on a Better Deal*** **-** aimed at building understanding about the range of competitive deals on offer and empowering consumers to shop around. The campaign will also focus on the safety and competitive power of credit unions and building societies, and include the introduction of a new, official, 'Government Protected Deposits' symbol.

  The Government will also launch a new, interactive consumer website with ASIC to help people enhance their understanding of money matters through access to high-quality and independent online, personalised financial guidance that is free and readily accessible.

  These reforms complement the Government's existing commitment to ensuring Australian students have the skills and knowledge they need to be informed consumers and make responsible financial decisions. From 2011, the national school curriculum for Maths will contain a strong focus on the practical financial skills that students need, with additional training provided for teachers.

129. The package also includes measures to support smaller lenders so they can put more competitive pressure on the major banks. The measures are focused on funding costs, and include that:

- The Government will invest a further $4 billion in, AAA-rated RMBS to continue to support this funding market which smaller lenders rely on to exert competitive pressure on larger financial institutions. This will include the continued additional objective of supporting lending to small business, and is not to be available to support the major banks. With additional support the

RMBS market is expected to improve further from current levels and become an even more competitive funding source for smaller lenders.

- The Government will task Treasury to accelerate its work on designing the most appropriate structure for smaller lender issuance of bullet RMBS, as an alternative to traditional RMBS. Treasury will continue working with the AOFM and financial regulators to develop the market for smaller lender bullet RMBS, including support where required from the Government's new $4 billion tranche of investment in the RMBS market.

- The Government will amend the ***Banking Act 1959*** to allow Australian banks and CUBS to issue covered bonds. This initiative is designed to strengthen and diversify the financial system's access to cheaper, more stable and longer duration funding in domestic and offshore wholesale capital markets.

- The Government will confirm the Financial Claims Scheme as a permanent feature of the financial system. Deposits covered under the Financial Claims Scheme are an important source of funding for regional banks and CUBS, making this an important measure to support the capacity of these smaller lenders to access funds for cheaper loans to compete with the big banks.

- Treasury will continue to actively facilitate the efforts of CUBS to develop aggregated structures for mutuals to pool together and raise cheaper funding.

130. The package also includes the following four measures.

- The Government will amend the ***Trade Practices Act 1974*** (which from 1 January 2011 will be renamed the ***Competition and Consumer Act 2010***) to prevent banks from engaging in anti-competitive price signalling that is designed to keep interest rates or other fees higher than they would otherwise be. These reforms will apply initially to banks, with the capacity for other sectors to be specified in the future after further review and detailed consideration.

- The Government has instructed Treasury to establish a joint taskforce with the RBA to monitor the ATM industry. The Taskforce will report to the Government in June 2011 on the need for further action, with an early report in February 2011 on appropriate action for dealing with issues specifically affecting Australian indigenous and other remote communities.

- The Government will take action to help build a new pillar in the banking system from the combined competitive power of our CUBS. To help educate consumers about the safety and competitiveness of mutual lenders, the Government will emphasise the similarities between banks and CUBS.

  APRA will also conduct a review of the current guidelines for approval to use the term 'bank', and will provide the results of this review to the Government in March 2011.

- The Government will facilitate the trading of Commonwealth Government Securities (CGS) on a securities exchange in Australia as part of its broad agenda to foster a deep and liquid corporate bond market. The Treasury will report to the Government on the cost and suitability of alternative market exchanges on which CGS could trade by 1 January 2011.

  The Treasury will also finalise its work on the recommendations of the Australian Financial Centre Forum and report to Government by 1 January 2011 on the most appropriate design of reforms to better align disclosure for retail corporate bond issues with the process already allowed for share entitlement offers, which provides a high level of protection for investors, as well as reduced transaction costs for issuers.