Australian Government

The Treasury

Senate Economics Committee

Submission to the inquiry into the post-GFC banking sector

19 June 2012

Contents

Key Points

The Australian banking system demonstrated considerable resilience during the global financial crisis (GFC).

In contrast to many of its international counterparts, the Australian Government was not required to bail-out any authorised deposit-taking institution (ADI). However, it acted prudently by introducing the Financial Claims Scheme (FCS), as well as a fee-based guarantee for large deposits and wholesale borrowing, support for Australian residential mortgage-backed securities issuance and some restrictions on short-selling.

The Government closed the guarantee for large deposits and wholesale funding at the end of March 2011 and restrictions on short-selling have been relaxed. However, the Government has retained the FCS (albeit at a lower cap of $250,000) and continues to support issuance of asset-backed securities by non-major lenders.

In the wake of the financial crisis, G20 members worked cooperatively on a wide-ranging work plan to strengthen the regulation and supervision of the banking sector. As noted in Section A, the new Basel III standards are at the core of these reforms. The aim of these standards is to improve the resilience of the banking system, especially in relation to capital and liquidity. In Australia, the Basel III standards are being implemented by the Australian Prudential Regulation Authority (APRA). Implementation commences in 2013. APRA's submission contains a detailed overview of its proposed arrangements for implementing Basel III.

Since late 2008, Australia's major banks have taken steps to improve their capital positions and funding profiles in response to market pressures, including the ongoing threat of instability emanating from Europe. These efforts, combined with APRA's conservative approach to applying Basel II, have reduced the effort needed to comply with Basel III.

The GFC has had a significant impact on Australia's banking industry. The major banks increased their share of most significant lending markets by around 10 percentage points as smaller lenders struggled to raise new funds to lend as depositors and investors became much more risk averse. Lenders who relied on offshore parent funding or securitisation found it more difficult to access funding.

As noted in Section B of this submission, the period since the GFC has seen substantial competition for funds, including deposits. This has benefitted depositors and investors. There has been strong competition for deposits between the major banks. However, major bank net interest margins and profitability remain around longer-term averages. The current environment of low credit growth is likely to encourage competition between lenders for market share. The Government has also acted to boost competition in lending by abolishing exit fees, strengthening disclosure of borrowing costs and making it easier to switch transaction accounts.

Investors and depositors have become much more risk averse in the wake of the GFC. This has meant that lenders have had to pay more for deposits and other funds. Transaction costs associated with offshore borrowing have also risen. As noted in Section C of the submission, investors and depositors have benefitted from higher rates relative to key benchmarks. On the other hand, the RBA has estimated that, on average, the major banks' cost of funding their aggregate loan books has increased by around 140-150 basis points since mid-2007. The Government has boosted the sustainability of Australia's ADI sector by allowing ADIs to issue covered bonds and through continued support for securitisation by smaller lenders.

Section D of the submission deals with business lending practices. This is generally governed by State and Territory law and well as the general law of contract and equity. However the *Australian Securities and Investments Commission Act 2001* provides protection for consumers and small business in relation to the provision of credit by prohibiting conduct that is unconscionable and deceptive as well as prohibiting false and misleading representations. The *Corporations Act 2001* also regulates the conduct of receivers appointed to corporations that default on a debt. Some industry bodies have also developed codes or practice governing lending activities. The submission notes that the period since the GFC has seen a global re-assessment of risk. As part of this process, there has been a reassessment of the capacity of borrowers to repay loans as well the value of collateral offered for new loans.

SECTION A – RECENT REGULATORY CHANGES

The GFC prompted international standard setters to reassess the adequacy of global standards governing the prudential regulation of deposit-taking institutions (especially those considered to be systemically important).

There was a consensus within the G20 that the existing standards were insufficient and that more needed to be done to strengthen the resilience of major financial institutions.

In response, the Basel Committee has agreed to a package of new capital and liquidity standards for banks know as Basel III. These were largely finalised in December 2010 and, in November 2012, were endorsed by G20 Leaders at the Cannes Summit.

Basel III will require banks to have more and better quality regulatory capital. Banks will be subject to a maximum unweighted leverage ratio. They will also be required to have more sustainable funding profiles, including sufficient liquid assets to survive a 30-day crisis scenario. These measures are intended to improve their capacity to absorb shocks without requiring government support.

APRA is responsible for implementing Basel III in Australia. Its submission provides a detailed summary of how it proposes to implement the reforms. This process will begin in 2013, when the first stage of the new capital requirements will come into effect. This is not expected to have significant implications for Australia's banks as they have relatively high and conservatively constructed capital ratios.

SECTION B: BANKING MARKET SHARES

A lender's market share can be measured by their total lending as a proportion of the total lending market, inclusive of bank and non-bank lenders. Using this approach, it is useful to examine market share across the key banking markets that lenders operate in. On the lending side, the key markets (by volume) are the provision of credit to the housing and business sectors. On the funding side, the largest single source of funding is deposits.

There was a material increase in the major banks' market share in both the housing and business lending markets of around 10 percentage points between mid-2008 and mid-2010.

This increase is primarily due to the impact of the financial crisis on the fund raising capacity of Australian financial institutions. Those lenders, primarily non-ADI's and foreign banks that had business models reliant on securitisation and offshore funding, were unable to retain market share once these funding markets became more expensive during the GFC.

In response, the Australian Government took steps to provide temporary support, including the introduction of a fee-based guarantee for wholesale funding[1] and directly purchasing non-major bank securitisations.[2]

There was also a material increase in the market share of the major banks in the deposit market since the financial crisis.

Despite the increased market share of the Australian major banks in these markets, there is evidence that Australia's banking sector is competitive.

- Customers can choose from a wide range of providers and products. According to Canstar Cannex, there are currently around 115 providers of over 1,961 mortgage products; 32 providers of over 263 different business loans; and 91 providers of over 392 different deposit account options.
- Competition has intensified in the deposit market, reflected in the higher deposit rates over this period.
- Competition remains strong between the major banks, with NAB and ANZ being particularly aggressive in housing credit over the last year.

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[1] The Guarantee Scheme for Large Deposits and Wholesale Funding commenced on 28 November 2008 and closed for new liabilities at the end of March 2010.
[2] The Government has supported the securitisation market through the purchase of AAA-rated Residential Mortgage-Back Securities (RMBS) through the Australian Office of Financial Management (AOFM).

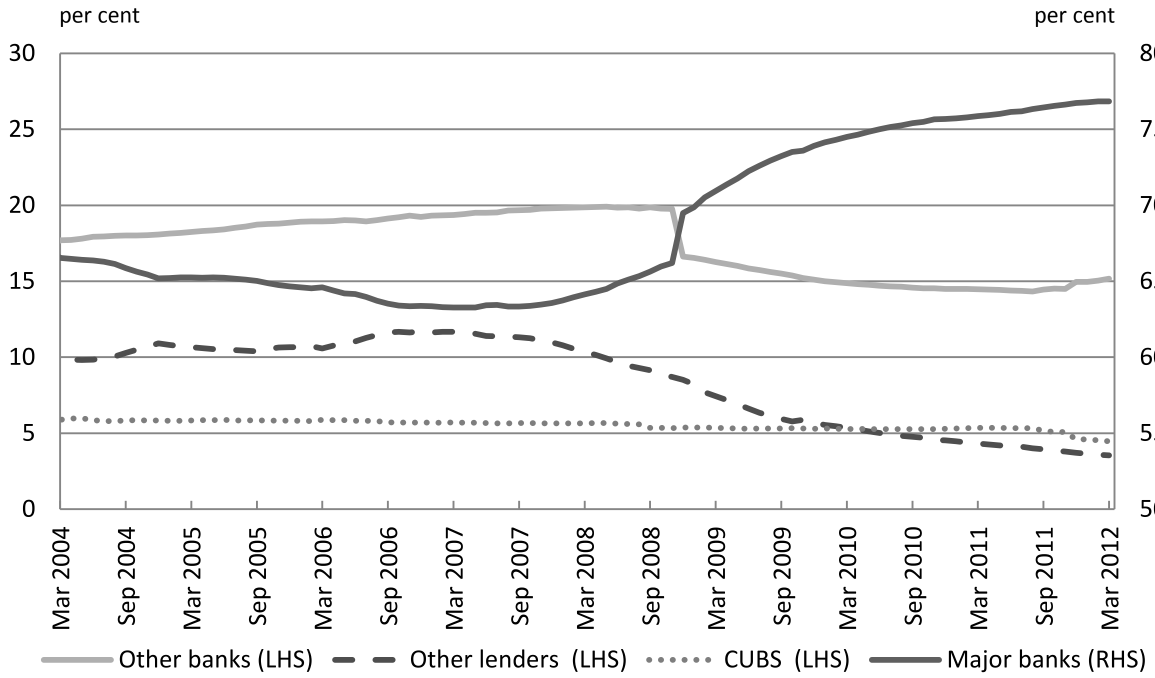
- Indicators of major bank profitability, including Net Interest Margins (NIMs) and Return on Equity (ROE), remain around longer term averages.

The low credit growth environment is likely to continue to encourage all lenders to compete for mortgage customers to maintain profit growth.

Market share - housing credit

The following chart illustrates changes in the market share of outstanding housing credit since 2004.

Shares of outstanding housing credit (by lender type)[3]



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, wholesale lenders, securitisers etc. Other banks include foreign banks and CUBS that have rebranding as banks.

Between 2004 and mid-2007 the major banks lost market share in outstanding housing credit to other banks and securitisers (other lenders). Since mid-2007, this trend reversed, and the major banks' market share increased from around 64 per cent in mid-2007 to be around 77 per cent in March 2012.

Some of the post-GFC increase in market share by major banks is explained by the acquisition of BankWest by the Commonwealth Bank in late 2008, which was approved by the Australian Competition and Consumer Commission. In September 2008, BankWest was Australia's seventh largest bank with $57.6 billion in assets. Following its acquisition by the Commonwealth Bank, BankWest's loan portfolio moved from the

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[3] The 'non-major bank' category includes all other Australian-owned and foreign-owned banks, including those mutuals that have recently rebranded as banks. The 'other' lenders category consists of non-bank lenders (such as mortgage originators and securitisers). The 'Major bank' category consists of the four major banks plus St George (both before and after its acquisition by Westpac), as prior to their acquisition they were considered to be a major bank in the RBA statistics.

'other bank' to the 'major bank' classification, leading a sharp increase in reported 'major bank' market shares in late 2008.

The longer term trend in market share since the GFC also reflects the impact of the financial crisis on the fund raising capacity of Australian financial institutions. The crisis highlighted the relative strengths and weaknesses of each lending institution's funding strategy. Those lenders more reliant on securitisation and short-term wholesale debt were most vulnerable.

Non-bank lenders with a business model dependent on securitisation found it difficult to raise reasonably priced funds due to a lack of investor interest. The market share of non-ADIs fell from over 11 per cent in mid-2007 to less than 3 per cent in March 2012. The Government's investment in smaller lenders continues to help those remaining in the banking sector to put competitive pressure on the major banks.

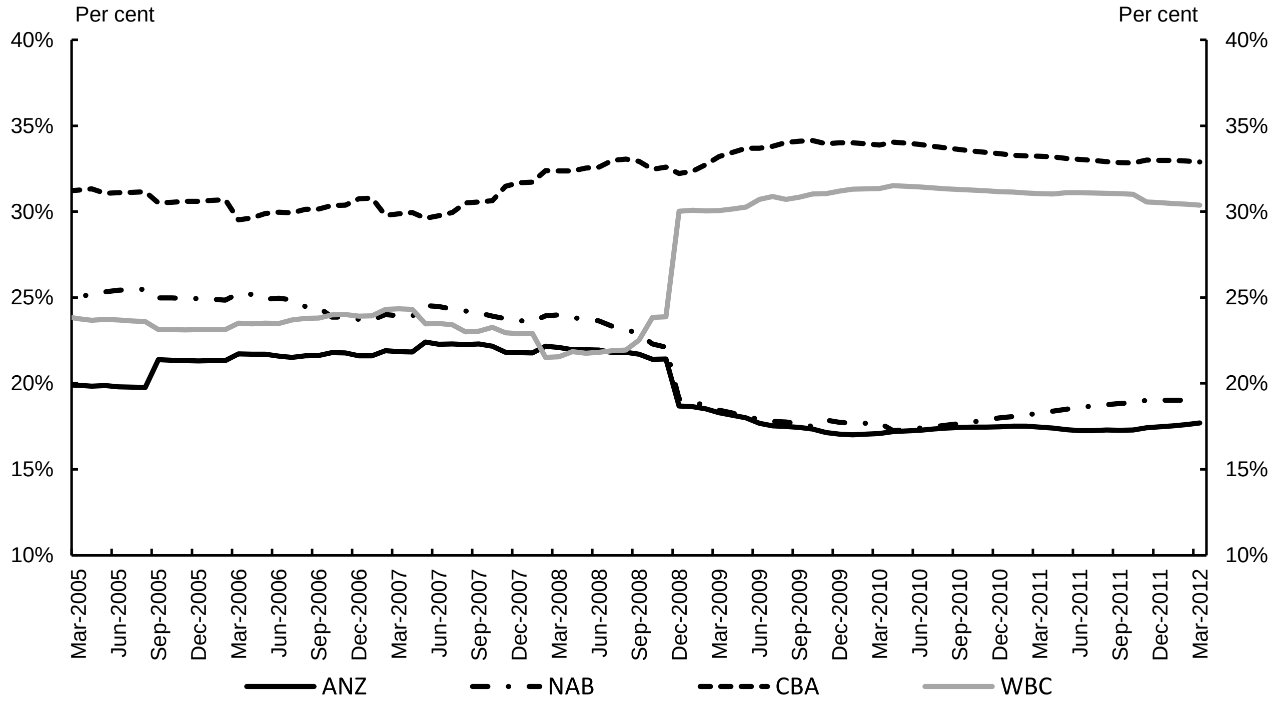
Some foreign-owned banks found it harder to access funding from their parents, particularly if the foreign parent was experiencing financial distress.

Market share among the major banks

While the above analysis compares sectors of the lending industry, it is also useful to consider the market share among the four major banks.

As shown in the chart below, CBA and Westpac made substantial acquisitions during the crisis period, yet have both lost market share to NAB and ANZ over the last two years.

Shares of outstanding <u>housing</u> credit (by major lenders)

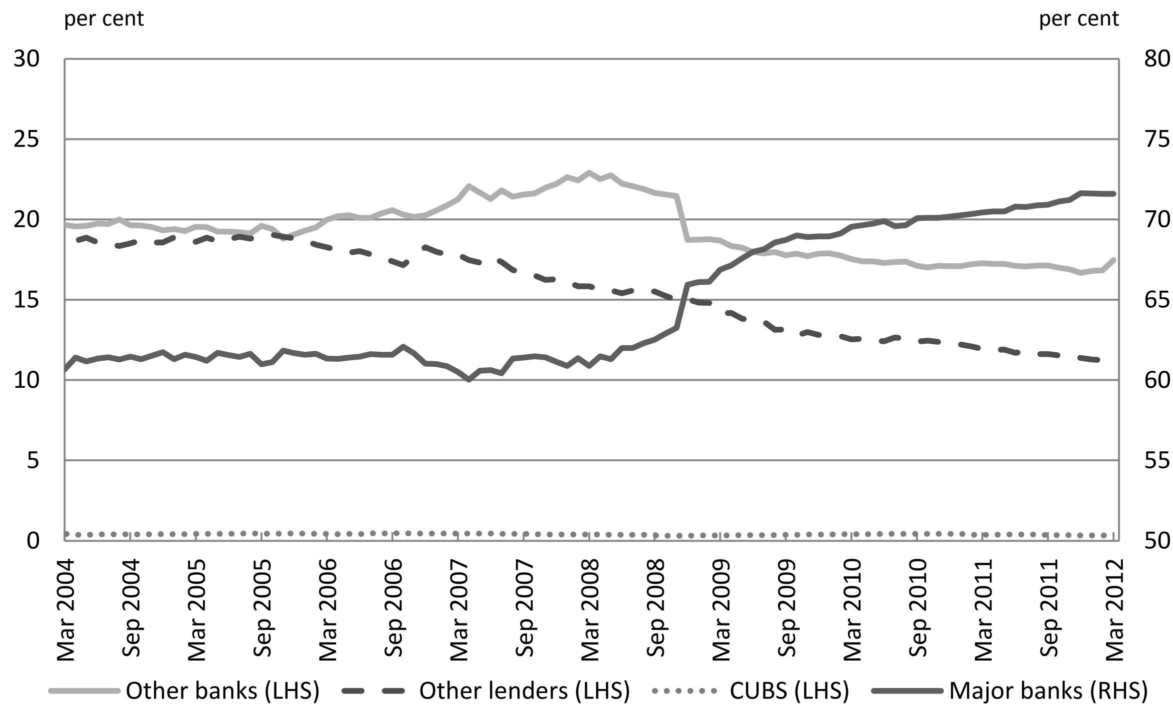


Source: APRA Monthly Banking Statistics

Market share – business credit

The following chart illustrates changes in the market share of outstanding business credit since 2004.

Shares of outstanding business credit (by lender type)



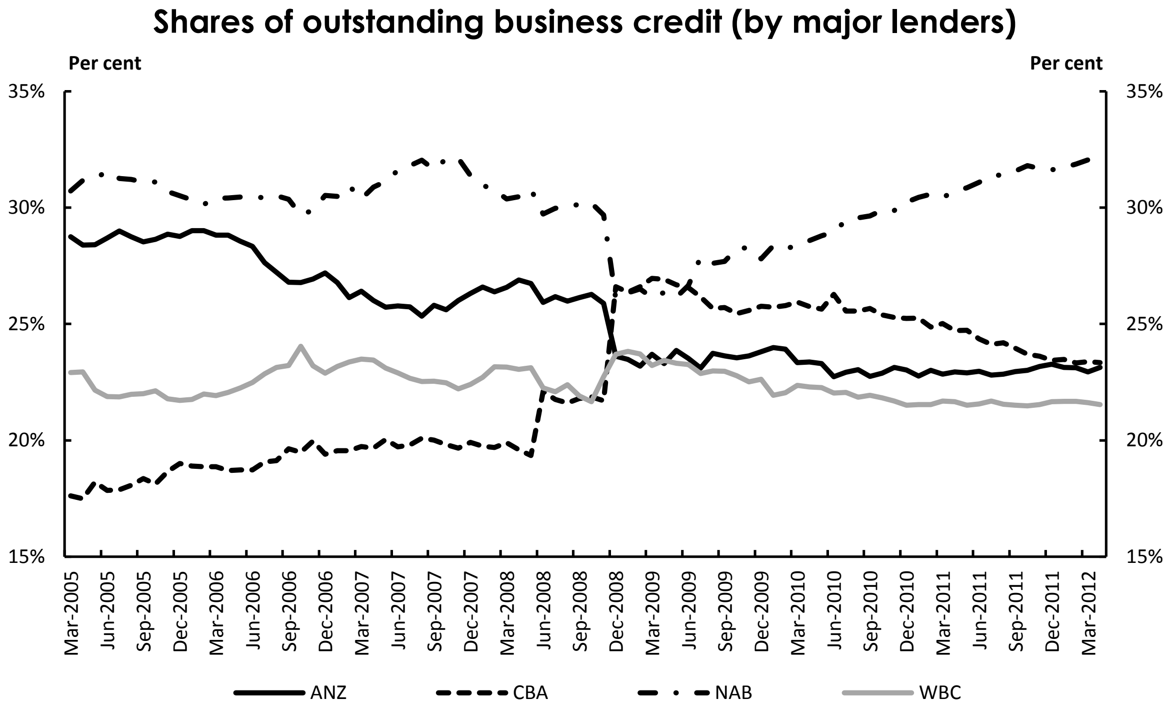
Source: RBA. Note: Major Banks includes BWA from Dec 08; ANZ, CBA, NAB, STG, WBC for entire sample. Other Lenders includes cash management trusts, specialist credit card institutions and securitisers. Other banks include foreign banks and CUBS rebranding as banks.

The major banks market share of outstanding business credit is around 72 per cent, slightly less than their market share of outstanding housing credit. However, it has increased from around 60 per cent in mid-2007. Part of this increase has been due to the BankWest acquisition in late 2008, which involved redefining around 3 per cent of market share to the major banks.

Since the crisis, the market share of other lenders has trended lower, reflecting their reliance on funding sources that became more expensive and volatile during the crisis. The major banks have been the primary beneficiaries of this trend as they have been able to step into these markets and provide credit to businesses where it has been needed.

Market share among the major banks

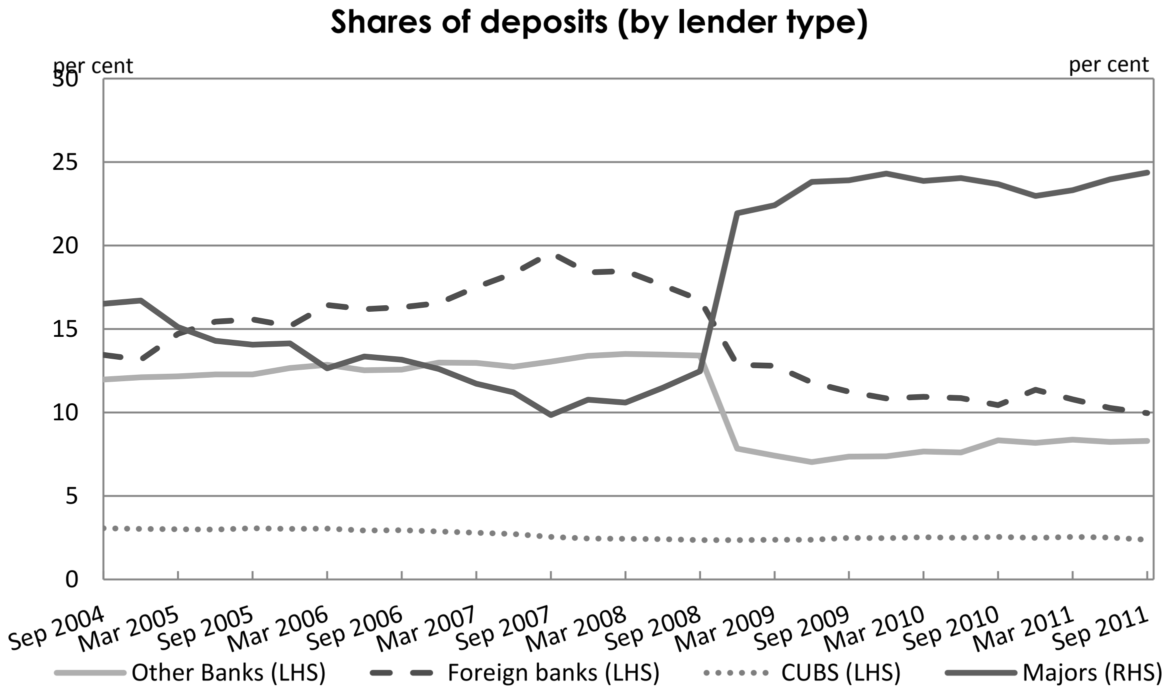
As shown in the chart below, despite the increased market concentration in business lending, the competition among major banks has intensified. Since late 2008, NAB's aggressive expansion has captured around 5 percentage points in the share of business credit outstanding from the three other major banks, CBA in particular.



Source: APRA monthly banking statistics. The share of BankWest and St George are included in the market shares of CBA and Westpac on acquisition.

Market share – deposits

Data on deposits with ADIs is captured by APRA. The chart below illustrates the change in market share since 2004 in relation to deposits.[4]



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

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[4] In contrast to the above RBA lending data, St George Bank was 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.

Between 2004 and mid-2008, the major banks steadily lost market share in the deposit market, primarily to foreign banks. This trend reversed after the start of the crisis.

The longer term trend is characterised by an increase in the major banks' market share. [5] One part of this longer term trend is that depositors have participated in a 'flight to quality' in the early period of the financial crisis prior to the introduction, in October 2008, of the Financial Claims Scheme, which now helps support deposit funding for smaller lenders.

Indicators of market competition

While market share is one important factor in assessing competition in any market, it is not the only factor. A more complete assessment of the state of competition in the banking sector involves consideration of a number of additional factors, including profitability and market contestability. A brief analysis of these factors is provided below.

Net Interest Margins

Net interest margins are a measure of how much a bank receives in interest payments relative to how much it pays in funding costs. NIMs are useful, although lagging, indicators of the impact of funding costs on profitability. Higher NIMs generally suggest higher bank profitability. [6]

While the NIMs of the major banks dipped during the GFC, they have fluctuated within a relatively narrow band over the last three years. NIMs are currently around pre-crisis levels.

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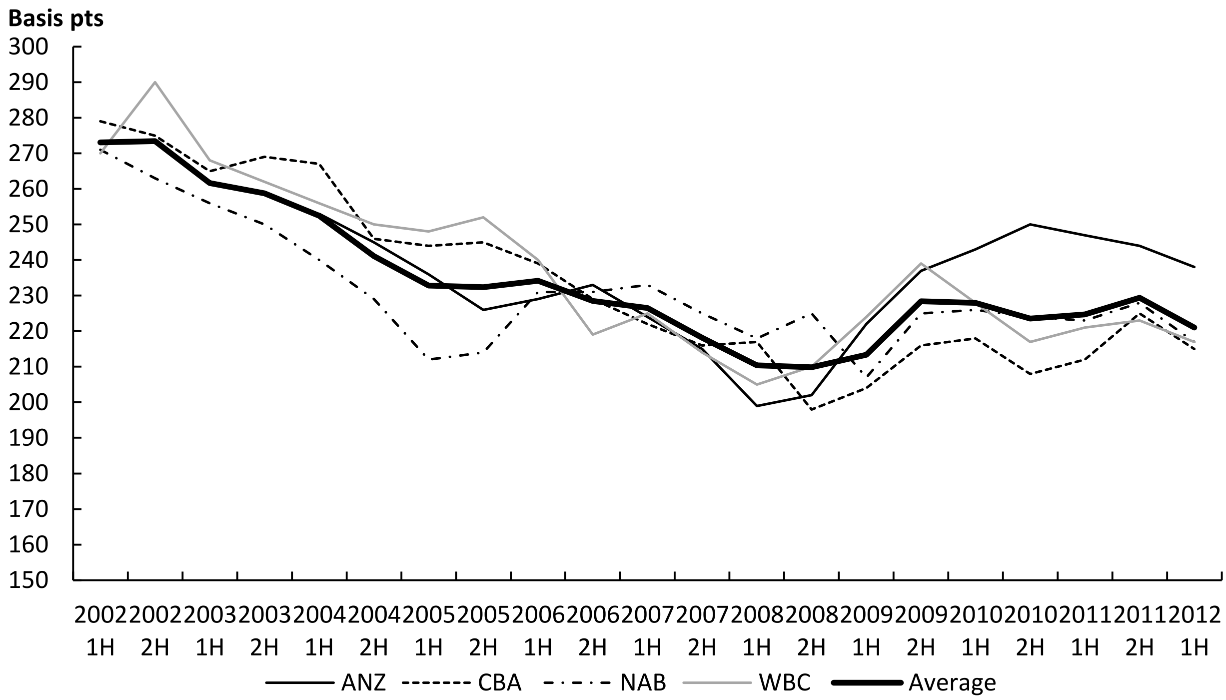
[5] The data reflects the re-classification of the deposits of both St George and BankWest as being 'major banks', following their acquisitions by Westpac and the Commonwealth Bank respectively.

[6] It should be noted that the NIM calculation can be distorted by changes in the level of equity (as there is no interest paid on equity, despite it being a source of funding), the quality of the loans written by the bank (higher risk loans lead to higher interest payments, despite funding being unchanged) and does not take into account non-interest revenue (such as fees and charges).

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.

Profitability

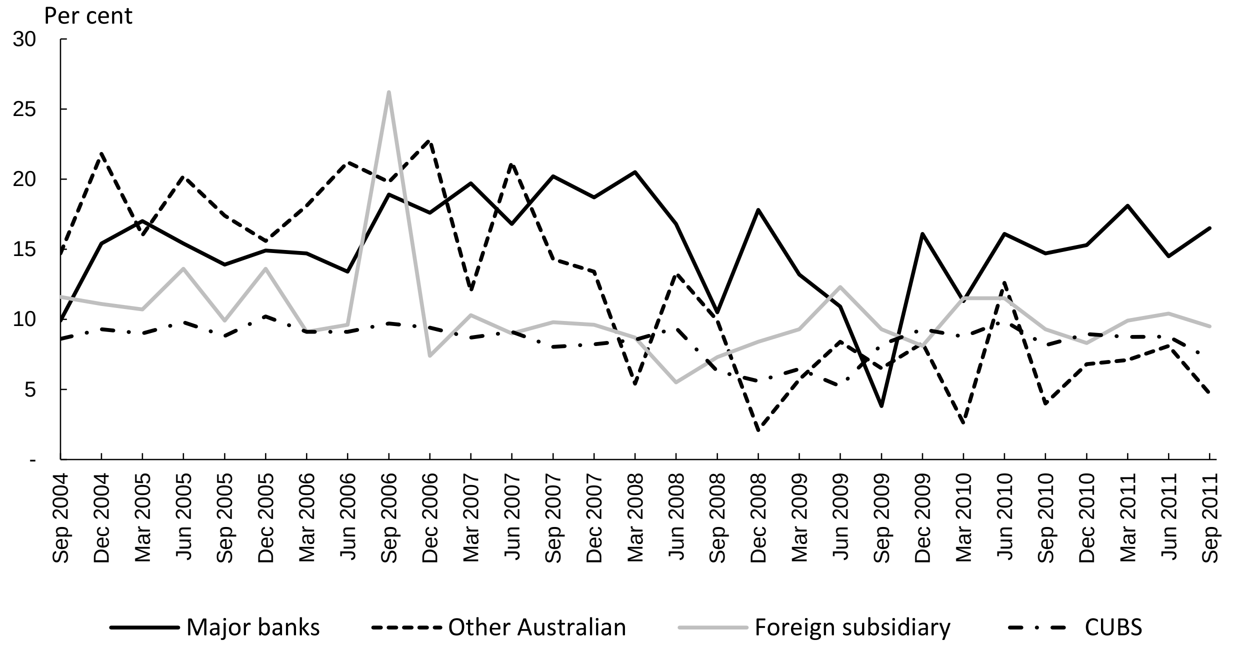
Bank profitability has recovered from the low points of the financial crisis and current returns on equity are around pre-crisis levels. Bank profits over time have been sustained by strong growth in lending and transaction volumes, low levels of problem loans and significant reductions in operating costs.

Return on Equity is the main indicator used to assess trends in the profitability of financial institutions. A company's ROE indicates how effectively the company is using shareholder equity to generate profits.

As outlined in the chart below,[7] the major banks' reported ROE has varied between 15 and 20 per cent over the last decade, with returns of around 17 per cent over 2011. Of note, other Australian banks were consistently more profitable than the majors in the period leading up to the GFC.

[7] 'Major banks' in this chart refers to only the four major banks (ie does not include St George 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).

ADIs Return on Equity



Source: APRA Quarterly bank and CUBS statistics.

In response to competitive pressures in their core banking markets, some banks have expanded into other activities such as wealth management. Wealth management now makes up a large proportion of the non-interest income of the retail banks. In 2010-11, the four major banks reported a total profit of around $2.94 billion from wealth management activities.[8]

Market Contestability

Competition can exist in markets with a small number of entities, particularly where there is a credible threat of competition from new entrants. Notwithstanding the prominence of the four major banks, there is evidence that the Australian banking sector is contestable.

Entry into the Australian banking sector is open to any institution (Australian or foreign), provided it meets relevant regulatory requirements. These requirements are designed to balance the goals of safety, competition, efficiency, market integrity and consumer protection and are consistent with international best practice. They do not represent significant barriers to entry.

It is sometimes suggested that the power of established brands and the large marketing budgets of existing players act as a barrier for challenger banks to establish themselves as a safe and credible alternative. As part of the Government's banking reforms in 2010, the Government introduced an Australian Government guaranteed deposit symbol, to inform consumers that the Government guarantees deposits of up to $250,000 with any

[8] Source: Major banks' annual financial statements.

ADI. The seal enables smaller institutions to demonstrate the safety of most of their deposit products.[9]

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

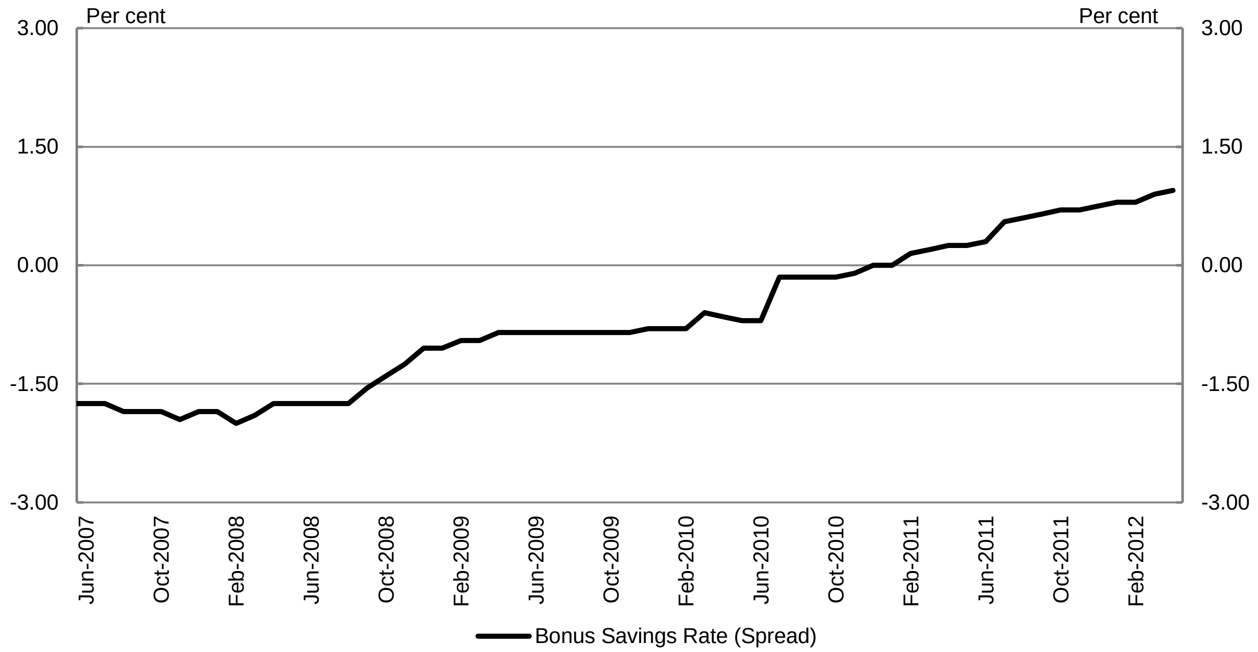
Competition in the deposit market

Despite the material increase in the level of market concentration in deposits since the GFC, the degree of competition in the deposit market has increased.

As alternative funding sources, particularly wholesale funding markets, have become increasingly expensive and difficult to access, domestic deposits have become a more attractive funding source for ADIs. This has led ADI's to more aggressively attract deposits as a funding source, resulting in stronger competition in this market.

This trend is evident in the large increase the interest rate paid by banks on their 'bonus' savings accounts compared to the official cash rate since the crisis (see chart below). Prior to the crisis the average rate paid on 'bonus' savings account was around 1.5 per cent less than the cash rate; by early 2012 the rate was almost 1 per cent more than the cash rate[10].

Difference between bonus saving account rates and cash rate



Source: RBA

Government measures to help diversify the funding options available to financial institutions and help reduce funding costs over time is covered in Section C.

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[9] To date, 66 financial institutions have licencing agreements to display the seal.

[10] As outlined by the RBA in their submission, this trend is consistent with other types of bank deposits, particularly term deposits.

Government measures to improve competition

Since the GFC, the Australian Government also announced a package of reforms to strengthen sustainability and competition in the Australian banking sector. The package included a number of steps to empower consumers and support the banking system:

- To empower consumers to get a better deal, the Government banned exit fees on home loans entered into after 1 July 2011 to reduce the costs of switching to cheaper mortgage products;
- The Government has also passed legislation to help get a better deal for Australians with credit cards by giving consumers more control over the amount they borrow while stamping out lender practices that see them pay more interest than they should;
- In addition to these measures, the Government is:
  - giving consumers the power to easily switch to another bank, building society or credit union with a new 'tick and flick' service, to be introduced by 1 July 2012, that will remove the burden of having to change the details of automatic debit and credit transactions;
  - empowering the Australian Competition and Consumer Commission to prosecute anti-competitive price signalling; and
  - introducing a mandatory one-page fact sheet to help consumers understand the costs and benefits of lenders' mortgage insurance.
- To support smaller lenders in putting competitive pressure on the major banks, and to secure critical deposit funding for smaller lenders, the Government has:
  - confirmed the Financial Claims Scheme as a permanent feature;
  - increased its investment to support the securitisation market, which many of our smaller lenders rely on to make cheaper loans; and
  - launched a national community awareness and education campaign to build understanding about the range of competitive deals available and empower consumers to shop around.

SECTION C: TRENDS IN FUNDING COSTS

Since the onset of the financial crisis, there has been a considerable change in the structure and cost of funding for Australian lenders.

Since the crisis ADIs have sought to increase their utilisation of deposit funding and increase the tenor of their wholesale funding, while reducing short term wholesale and securitisation funding. Deposits now account for around 52 per cent of bank funding, up from around 40 per cent in late 2007,[11] while short term debt has fallen over 10 per cent over the same period.

In addition, since mid-2007 each of these funding sources has generally become more expensive relative to market benchmarks, such as the cash rate.

- As outlined above, competition in deposit funding from the banks since the crisis has led to a significant increase in the cost of deposits (both term and at-call deposits) for ADIs relative to the cash rate.
- The premium that wholesale investors demand for lending to Australian banks has also raised relative to market benchmarks since mid-2007, in both securitisation and general wholesale debt markets.

The precise impact of these higher costs relative to the cash rate depends on the funding mix of each bank and their funding strategy. The RBA has estimated that, on average, the major banks' cost of funding their aggregate loan book has increased by around 140-150 basis points relative to the cash rate since mid-2007.[12] A more detailed description of trends in funding costs is provided in the RBA's submission to this inquiry.

Notwithstanding global volatility, the major banks' net interest margins are around pre-crisis levels and their return on equity is higher than many of their global peers.

Government reforms to improve bank funding markets

As outlined above, the Government has introduced a number of reforms to ensure that consumers can more easily switch between banks if they are unhappy with their service, such as banning exit fees and introducing a new 'tick and flick' account switching service.

In addition, the Government has also taken steps to strengthen and diversify the Australian financial system's access to cheaper, more stable and longer duration funding in domestic and offshore wholesale capital markets.

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[11] RBA Statement on Monetary Policy, May 2012

[12] RBA submission to Senate Economics Committee inquiry into the Post GFC banking sector, 31 May 2012.

- Following consultations with Australia's financial regulators, the Government decided to allow ADIs to issue a small amount of covered bonds. Covered bonds have proven to be an important funding source for the Australian banking sector. Covered bonds have been particularly useful at overcoming the current turbulence in international financial markets and, on occasion, have been among the few offshore funding channels that have remained available.
  - Since the passing of legislation in October 2011, banks have raised around $30 billion through covered bonds. The first non-major bank, Suncorp, has recently issued their inaugural covered bonds, which reportedly met with strong investor demand.
  - Covered bonds are a more resilient issuance class, partly because of their more diverse investor base, and also because investors are prepared to commit to long-dated covered bonds, helping Australian banks to lengthen their maturity profiles and comply with new Basel III liquidity requirements.
  - Covered bonds also provide access to lower cost funding over time relative to the cost of other forms of funding.
- The Government has also directed the Australian Office of Financial Management (AOFM) to invest up to $20 billion directly in AAA-rated Australian residential mortgage-backed securities (RMBS) issued by the smaller lenders to support competition in retail lending markets.
  - The AOFM program has so far directly supported 60 securitisation deals with a total of $15.3 billion, enabling 20 smaller mortgage lenders to raise $40.4 billion to fund new retail mortgage and business loans. The program has assisted smaller lenders fund over 215,000 home loans and $2.5 billion in funding for small businesses.[13]

[13] Estimate based on the self-reporting of lenders since late 2009.

SECTION D: BUSINESS LENDING PRACTICES AND PROTECTIONS

The decision to lend to a particular borrower is a commercial decision made by the lender after assessing the risk of the loan. Ultimately this decision is a judgement, informed by a range of factors, including the borrower's capacity to repay, credit history, management experience, collateral levels (including expected loss given default), loan covenants and expected economic conditions.

The GFC resulted in global reassessment of risk, both by investors and lenders. Australia was not immune to this development and, generally, lenders tightened their standards relative to pre-GFC levels as they reconsidered the risk to which they were exposed. This resulted in a re-pricing of loans to reflect higher default expectations, and a reassessment of the adequacy of the collateral offered for new loans.

However, as outlined in Treasury's submission to the Inquiry into Access for Small and Medium Business to Finance,[14] despite a tightening of credit standards since the GFC, credit remains available to credit worthy businesses.

- While the level of total outstanding credit to businesses is impacted by both demand and supply factors, it has remained broadly stable since 2008 for small businesses, suggesting lenders have not substantially withdrawn credit to small businesses.
- As noted in the RBA's May 2012 paper on *Small Business Funding in Australia*, around 80 per cent of small business loan applications are accepted by the major banks.

Given that weak lending practices has been identified as one of the causes of the financial crisis (particularly in the US), the Financial Stability Board (FSB) has drafted global principles for sound mortgage lending practices that seek to limit the risks that mortgage markets pose to financial stability and to better safeguard borrowers and investors.[15]

These principles include: [16]

- effective verification of income and other financial information;
- reasonable debt service coverage;
- appropriate loan-to-value ratios;
- effective collateral management; and

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[14] February 2011 - Submission to Joint Committee on Corporations and Financial Services.
[15] See RBA's Address to the Australian Mortgage Conference 2012 Sydney (23 February 2012) for a summary of these principles.
[16] FSB Principles for Sound Residential Mortgage - Underwriting Practices, 26 October 2011.

- prudent use of mortgage insurance.

General protections for business borrowers

Generally, the law allows lenders and borrowers to enter freely into agreements that they consider appropriate for their circumstances. There are a number of legal protections for small business borrowers to ensure that they are not subject to treatment that is generally considered unfair, and that the process for lenders to exercise their contractual rights over secured assets is appropriate.

Most of the legal protections for borrowers are within the ambit of the legislative authority of the States and Territories. For example, the States' real property legislation establishes the rights and obligations of lenders wishing to enforce mortgages against a borrower. The general law of contract and equity also influences the rights and obligations of parties to a loan or security agreement.

Commonwealth Legislation

While Australia's federal system limits the Commonwealth's powers in this area, the Commonwealth has enacted a number of important protections in relation to the conduct of business, including under the *Corporations Act 2001* (Corporations Act) and the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

The Corporations Act regulates the conduct of receivers appointed to defaulting corporations. Section 420 of the Corporations Act establishes general powers of a receiver to deal with the corporations assets that apply subject to the security agreement or, as the case may be, court order. Section 420A, however, also imposes a duty on receivers exercising a power of sale to take all reasonable care to obtain the market price or the best price reasonably obtainable. Receivers are also subject to the general directors' duties in sections 180-184.

The ASIC Act has a broad jurisdiction over the provision of credit to small businesses and consumers, and advice and broking conduct in relation to such credit. The ASIC Act provides protections for business borrowers as follows:[17]

- All businesses (except listed companies) can seek remedies, including compensation, in relation to unconscionable conduct by suppliers of financial services. Matters a court may consider in determining whether conduct was unconscionable include: [18]
  - the relative strengths of the bargaining positions of each party;

[17] There are counterpart provisions in force under State laws.
[18] Refer to Section 12CC of the ASIC Act for details.

- whether the borrower was required to comply with conditions not reasonably necessary to protect the lender's legitimate interests;
- whether the borrower was able to understand the relevant documents; and
- whether undue influence, pressure or tactics were used.

- Small businesses[19] are also able to rely on a broader range of prohibitions in the ASIC Act, including:
  - a broader prohibition in respect of unconscionable conduct (Section 12CB);
  - a prohibition against misleading or deceptive conduct[20] (Section 12DA); and
  - a prohibition against the making of false and misleading representations (Section 12DB).

Industry codes of practice

Some lending industry bodies have developed codes of practice that their members can agree to comply with, usually as a condition of membership, so that they must become signatories to the Code in order to receive other benefits (such as access to professional indemnity insurance arranged by the industry body).

The following are the main Codes in operation:

- the Code of Banking Practice;
- the Mutual Banking Code of Practice (Abacus Australian Mutuals is the industry body for Australia's credit unions and mutual building societies);
- the Mortgage and Finance Association of Australia (MFAA) Code of Practice (the MFAA is a professional industry association for mortgage and finance brokers, mortgage managers, lenders, aggregators and a range of other types of financial service professionals and providers); and
- the Finance Brokers Association of Australia (FBAA) Code of Practice (the FBAA is an industry body for finance brokers and mortgage brokers that offer domestic finance, commercial finance, lease and motor vehicle finance and business and debtor finance).

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[19] A small business is defined under subsection 12BC(2) of the ASIC Act as a business employing, if the business is or includes the manufacture of goods, less than 100 people, or otherwise, less than 20 people.

[20] The terms 'misleading' and 'deceptive' are not defined in the statute and should be understood in the way they are ordinarily used and defined.

The Code of Banking Practice, to which the majority of Australian banks have become signatories, covers the relationship between the bank and small businesses.[21] In particular, the Code provides to small business borrowers:

- a minimum standard of disclosure;
- obligations in relation to assessing the suitability of credit for the consumer;
- a positive commitment to assisting borrowers in financial hardship; and
- mandatory membership by members of an ASIC-approved external dispute resolution scheme.

Consumer credit regulation

COAG agreed in 2008 for the Commonwealth to assume responsibility for the regulation of consumer credit. Phase One of the National Credit Reforms was implemented through: the introduction of a national licensing scheme for lenders and brokers; the introduction of responsible lending obligations that require lenders to take reasonable steps to assess the borrower's capacity to meet repayments; and the conversion of the various State and Territory Uniform Consumer Credit Codes into a single national law.

Phase Two of the National Credit Reforms require consideration of whether or not there should be regulation of lending and broking in relation to small business borrowers. Treasury's consultations to date have identified as a key concern the need to balance benefits to small businesses against any possible increase in the cost of credit or decrease in its availability.

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[21] Defined as a small business that is an actual or prospective customer involved in retail banking transactions. Small business that have less than 20 (full time or equivalent) people are covered, as well as a goods manufacturing businesses that have less than 100 (full time or equivalent) people.

ATTACHMENT A – COMMONWEALTH BANK'S ACQUISITION OF BANKWEST

Background to acquisition

The Bank of Western Australia (BankWest) is currently a 100 per cent owned subsidiary of CBA. BankWest's operations are concentrated in Western Australia, employing approximately 5,000 employees throughout 141 branches.[22] With assets of around $77.3 billion, BankWest has a relatively small share of the banking market (3.6 per cent of bank deposits and 4.0 per cent of bank lending to households and businesses). [23]

The Western Australian Government privatised BankWest in 1995, allowing the Bank of Scotland to acquire a 49 per cent stake in the company and list the remaining shares on the ASX. The Bank of Scotland subsequently merged with Halifax to form HBOS Plc. HBOS purchased the remaining BankWest shares and delisted BankWest from the ASX in 2003.

As the GFC worsened in late 2008, UK regulators arranged a merger between HBOS and another UK-based bank, Lloyds TSB. As part of the acquisition, the UK Government purchased a 40 per cent stake in the new entity.[24] Although the initial agreement between the parties was announced in September 2008, the acquisition was legally finalised during January 2009 after shareholder approval.

While the acquisition was occurring, the new HBOS /Lloyd TSB entity indicated that it was interested in selling non-core banking businesses, effectively putting the Australian BankWest business up for sale.[25] The number of potential bidders for the BankWest business was limited. HBOS was looking for a buyer to make an immediate repayment of around $16 billion worth of outstanding BankWest loans to its parent.[26]

BankWest acquisition

On 8 October 2008, CBA publically announced its intention to purchase BankWest and St. Andrews (HBOS Australia's insurance business), for $2.1 billion. In addition, the agreement obligated CBA to capitalise BankWest so that it could repay its $16 billion in loans to HBOS.[27]

CBA's acquisition of BankWest was subject to a number of Government processes in order to ensure that the merger complied with the relevant legislation.

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[22] APRA, *ADI Points of Presence: June 2011* (issued 24 August 2011).
[23] Ibid.
[24] ACCC, *Public Competition Assessment* (10 December 2008), [28].
[25] Kathrine Jiminez, 'Lloyds TSB likely to sell off BankWest', *The Australian* 20 September 2008.
[26] ACCC, *Public Competition Assessment* (10 December 2008), [61-62].
[27] Ibid.

- Firstly, the ACCC conducted a Public Competition Assessment to ensure the merger would not substantially lessen competition in breach of section 50 of the then *Trade Practices Act 1974*.[28]
- Secondly, the merger required the Treasurer's approval that the merger was in the national interest under section 14 of the *Financial Sector (Shareholdings) Act 1998* (FSSA).

The ACCC's competition assessment

Following the announcement of the deal, the ACCC commenced a Public Competition Assessment in accordance with its Merger Review Process guidelines on 20 October 2008. The purpose of the assessment was to determine whether the proposed merger would result in a substantial lessening of competition in a market in contravention of section 50 of the *Trade Practices Act 1974*.

The ACCC assesses the likely future level of competition in the markets if the merger were to go ahead. The ACCC then compares this to the likely future level if the merger does not proceed. The *status quo* is not necessarily a comparator.

The ACCC reached the conclusion that "despite the role BankWest had previously played … BankWest [would] not be in a position to continue to compete aggressively or act as a price leader under the counterfactual".[29] That is, if the merger did not succeed, the likely result was that HBOS/Lloyds would have halted BankWest's growth strategies in the Australian market. The ACCC also noted there was no other suitable purchaser.[30]

As such, the ACCC review did not oppose the merger on competition grounds because BankWest's market share was small and likely to contract, and consumers could access competing banks.

Application to the Treasurer

Section 11 of the FSAA prohibits a person from acquiring more than a 15 per cent stake in a financial sector corporation such as BankWest. Under section 14 of the FSSA, the Treasurer may approve, with or without conditions, an application for a person to hold a higher percentage stake if it is in the national interest. The Treasurer granted approval for CBA to acquire a 100 per cent stake in BankWest subject to conditions on 18 December 2008. Those conditions were as follows:[31]

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[28] The Act has since been replaced by the *Competition and Consumer Act 2010*.
[29] ACCC, *Public Competition Assessment* (10 December 2008), [56].
[30] Ibid, [61-63].
[31] The conditions are subject to *force majeure* exceptions.

1. For a period of at least three years after the date of acquisition:

   1. **CBA will maintain and grow the BankWest brand;**
   2. **foreign ATM fees for CBA customers using BankWest ATMs and vice versa will be removed from 3 March 2009;**

2. In addition, for the period of integration under the acquisition process:

   3. **CBA will maintain BankWest's head office, Managing Director and core functions in Western Australia and in accordance with the *Bank of Western Australia Act 1995*;**
   4. **CBA and BankWest branches and business centres in Western Australia will not close as a consequence of the acquisition;**
   5. **CBA will maximise internal redeployment opportunities available for affected staff, support external job placement where employee redundancies occur, and ensure that staff affected by the acquisition have timely access to their full entitlements under CBA or BankWest (as applicable) retrenchment arrangements;**
   6. **CBA will work through the implications for employees as quickly and sensitively as possible, in consultation with employees, the Finance Sector Union and other affected stakeholders; and**
   7. **CBA will provide specialist resources to assist staff affected by the acquisition.**

Since the approval of the BankWest acquisition, the Government has monitored CBA's compliance with the conditions. The Government is satisfied that CBA has complied with its obligations to date. Conditions 1 and 2 have now expired.

Timeline

The following table highlights the key stages in the approval process for the merger of CBA and BankWest:

Date	Event
18 September 2008	HBOS and Lloyds confirm they have reached a merger agreement.
8 October 2008	CBA announces that it has entered into an agreement with HBOS to purchase BankWest and St. Andrews for $2.1 billion.
20 October 2008	ACCC commences its review under the Merger Review Process Guidelines - Market inquiries commenced and call for submissions issued.
10 November 2008	Closing date for submissions to ACCC.
19 November 2008	Lloyds' shareholders vote to approve the merger with HBOS.
10 December 2008	ACCC releases its Public Competition Assessment not opposing the acquisition on competition grounds.
12 December 2008	HBOS shareholders vote to approve the takeover by Lloyds.
18 December 2008	The Treasurer approves the application subject to conditions.
19 December 2008	The acquisition is completed.
19 January 2009	Lloyds receives shareholder approval for its acquisition of HBOS. The Lloyds/HBOS merger is completed.