

The return on equity in the large Australian banks is similar to that for other large companies in Australia. But should the returns be *lower* given the relatively low risk of banking? (On a more technical note, is it *total risk* or *non-diversifiable risk* that is relevant?)

It may not be appropriate to compare the ROE of banks with other large companies. ROE is a function of ROA and Leverage. Banks have very high leverage given the nature of the business. The high leverage brings higher risk and not lower. In the context of UK banks Haldane (2009) states 'Banks unable to deliver sufficiently high returns on assets to meet their ROE targets resorted instead to leveraging their balance sheets'.

Banks are risk management companies. Negative externalities get imposed on the society due to bank failure as the GFC has clearly shown. Their interconnectedness through the payment system and their central role as purveyors of credit and financial flows in the economy makes banks distinct from other firms such as the manufacturing companies. The appropriate comparisons in my view would be banks in other countries. Going by that as I said during my hearing before the Senate Committee, the five year average shareholder return of Australian banks was about 9.5% which is perhaps the highest in OECD countries. Such abnormal returns are due mainly to an uncompetitive market. It is really rent seeking exploiting the lack of competition.

As for the total risk and non-diversifiable risk the distinction becomes important depending up on the lens that you look through. From investment perspective there is little an investor can do for system wide risk. But from a regulatory perspective, in my opinion, it is total risk with particular focus on non-diversifiable risk should matter. It came to light during the crisis that regulatory focus on individual bank risk rather than system wide risk was one of the major drivers of the crisis.

As banks expand into multiple business lines, that is, they diversify their business, it may reduce the volatility of their portfolio. However, community is not concerned with bank specific risk, it is concerned with market wide risk which is non-diversifiable. Financial crisis is really a manifestation of this risk.

**How important are economies of scale in retail banking, and in participating in international lending? Does this constitute a barrier to entry and a force for concentration?**

'Important' in terms of what? From a cost perspective for individual institutions as the scale of operation expands cost per unit would fall. It is the efficiency argument. Society would like to have efficient institutions as the cost per unit would in theory decline leading to increased societal good. The issue in Australian context is whether this is happening. Is the rise in scale (larger sized banks) leading to reduced fee / reduced loan interest rates/ increased deposit rates for customers, that is, the cost and return to customers? My contention is (see my submission to the banking competition Committee and my op-eds in media outlets) it is not. A recent study shows that increased bank size may actually harm societal good. This is the reason I am asking for a review of scale of operations of our banks.

The nationwide network for the four major banks, in my opinion, imposes a strong barrier to entry in retail banking in Australia and is counterproductive from competition perspective. For this reason I suggested in my earlier submission that small financial institutions need to be given a 'favoured' treatment so as to pose an effective competition to the majors.

**Would bank account number portability increase competition? Would it cause any practical problems?**

The portability of account number involves several problems. It is often thought to be as simple as mobile telephone portability. However, there are some major issues that would arise. First is the issue of funding. Assume one desires to switch home loan account from Bank A to Bank B. In this case Bank B would need to make payment to Bank A of the home loan and grant it to the customer. Issues of additional transaction cost and financing cost would arise. For Bank A, it would be a case of re-investment of funds and finding avenues for that. Banks would ultimately pass the resulting costs on to customers leading to increased financial burden on customers. Banks would also have to cover for the risk of re-investment / refinancing depending whether you are a customer receiving bank or customer losing bank. These would get factored in to fees or interest rates leading to increased financial burden on the customer. The customer may have to sign in fresh loan documents and stamp duty cost may be involved. .

One alternative could be there would be no physical transfer of account and customer remains with Bank A but gets all terms and conditions of Bank B for the difference Bank A would need to be compensated by Bank B. The loan to the customer would now be treated as loan from Bank B to Bank A. However, again there would be several complications involved.

Because of the hassles involved for both the customer and the bank. It is unlikely that the portability of account concept would be practicable. Consequently, I do not think it may lead to any increase in competition.

**Are stamp duties an important barrier to customers switching mortgages between banks?**

As already indicated above stamp duty and other transaction costs would be a significant barrier for customer switching. Stamp duty in many states is quite high already. One way to avoid the problem could be that Bank A holds the mortgage documents in trust for Bank B and on that basis Bank B advances the loan. However, how this mechanism could work in practice would need legal experts to give a thought.

**Would allowing positive credit reporting stimulate competition?**

If it refers to customers, then the segment of customers with positive credit report would already be sought after and there would be a competition for this segment ('prime' customers as distinguished from 'sub-prime' customers).

**What do you think of the Australia Institute's characterisation of the banks using the RBA as a 'price leader' to put up their lending rates even when there has not been much change in their cost of funds?**

I would agree with the characterisation. On one hand banks keep saying that their funding costs are disjointed from RBA cash rate as most of their funding is done through purchased funds in international and domestic market. Interesting, in the vain banks however, invariably change their home lending rates as RBA cash rate changes. If as banks say their funding is decoupled from RBA cash rate then where does the need for changing mortgage rates when RBA changes cash rate arise? The spread between RBA cash rate and standard variable mortgage rate was for many long years 180 basis points (1.80%), in recent time it has gone up as high as 290 basis points when the borrowing rates in international markets and domestic markets too have considerably declined from the peak experienced at the onset of the crisis.

Where is the efficiency dividend then coming to the community from our banks who always plead for increasing size to tap scale efficiencies.

**Do you have any comments on proposals to crack down on 'price signalling' by banks? What do you understand by the term? Some proposals are to prohibit price signalling where it 'substantially lessens competition' or where it is 'for the purpose of inducing a competitor to vary a price'; would these be hard to prove? Do you agree with critics of the proposals, when they argue that a prohibition would lead to a less informed and less competitive market? Could a prohibition on public announcements be sidestepped by notifying customers privately and letting the media report it?**

*Crackdown on price signalling:* The proposal to crack down on price signalling would be a 'populist measure' at the most. Easier to announce and create an impression that 'something is being done' rather than any thing actually happening in practice. We have all seen how hard it was for ACCC to check such behaviour in case of petrol prices. The sheer cost of investigating of such behaviour and importantly establishing that price signalling has actually taken place would be prohibitive. Ultimately, the tax payer would bear the cost one way or the other. Then what would be gained if such behaviour does not get 'proved'? Also what guarantee is there that covertly such behaviour may still be resorted to whatever the law. In sum it is practically hard to police such behaviour. .

*What do I understand by the term?* In my view, price signalling would mean keeping the rival firm informed in advance about the likely direction of the price with the expectation that the rival will follow suit. It may not be difficult to prove that price signalling has taken place. For example, in recent times, one of the major banks announced that it may raise interest rates in excess of the rise in the cash rate. It was a clear signal to the rivals not only that the bank would raise interest rate but by how much it is likely to raise it. The announcement was made by way of a reply to a question from the media. It was too explicit an event. If price signalling prohibitions are made it is likely that the signalling behaviour would occur covertly. It is this type of behaviour which would be difficult to prove/ may entail significant costs to the taxpayer as indicated above.

*Whether prohibition would lead to a less informed and less competitive market?* I do not agree with this perspective. Sooner or later the decision to raise or reduce the price would be a reality and would then be a publicly known event any way. In that situation, the rival may have to decide on the course of action to take if there is genuine competition at the market place. Assume that one bank raises standard variable mortgage rates but the other does not it would be a case of genuine competition as consumer demand would shift (in theory at least) to the latter bank. However, this would set in strategic actions by the other bank which may lower its interest rates. It is this sort of behaviour that actually needs to happen in a genuine competitive environment. Of course rival firms know that if it was to actually occur it would involve significant cost to them. One way to avoid it is to maintain a sort of equilibrium in price and avoid confrontation. It is sort of a tacit / implied understanding between competitor firms the way to behave at the market place. When there are several firms in the market vying to grab each others market share such genuine confrontation at the market place should be expected. Currently in Australia the four major banks constitute a market in themselves for various reasons. I would call it a 'major banks market'. In this market no bank would like to be involved in confrontation at the market place as they know it would harm them. Instead a tacit understanding could benefit all four. It is this that we are seeing at the market place.

*Could a prohibition on public announcements be sidestepped by notifying customers privately and letting the media report it?* We know that regulation leads to 'innovation'! For example to riggle out of the capital requirements, banks formed non-bank companies to undertake lending. So regulation of price signalling is likely to lead to 'innovations' in signalling not stoppage thereof.

**Conceptually, in a competitive banking market, would you expect bank lending variable interest rates to follow movements in the banks' *average* or *marginal* cost of funds?**

Typically banks would set average lending rate after a certain mark up over average cost of funds. In an article authored by Brown et al (2010) in the RBA bulletin on bank funding costs, it is the average cost of funding against which the lending rates are being compared. In a competitive environment one would expect that banks follow the average cost of funds. For example, if one of the majors was able to secure long term funding at a very competitive rate than other banks, in a competitive environment it would use that strategic advantage to attract existing customer of the rival firm. In my opinion piece published in the Age Melbourne on 06 April 2010, I calculated that the average cost of funds of banks has actually fallen and yet the banks were screaming about rising cost of funding. It is because they based their argument on the marginal cost of funding. It was a win win for all the majors and they continued to harp on rise in cost of funds (new funds). If there was genuine competition at the market place then the bank that had competitive advantage over the other bank of having raised fund earlier at a cheaper rate would have used that competitive advantage against the other banks. It is precisely this which is not happening in the banking market in Australia.

**From the viewpoint of the financial system as a whole rather than an individual issuer, what is the advantage of financial intermediaries securitising mortgages rather than issuing bonds to fund mortgage lending which remains on their balance sheet? Are there advantages in the organisation doing the credit assessment on housing loans continuing to bear the risk on them?**

Securitisation began with the issue of collateralised mortgage obligation by Freddie Mac in June 1983. Significant rise in issuance of mortgage back securities has been witnessed in the US and other developed countries including Australia. The benefits from securitisation include enhanced efficiency and a reduced cost of financing. It also leads to incremental credit creation as well as meeting the needs of issuers and investors. It leads to expansion of the mortgage market. It frees up capital on the balance sheet of banks and allows them to make new loans. Even the IMF (2009, p.77) noted that 'restarting private-label securitisation markets, especially in the United States, is critical to limiting the fallout from the credit crisis...' and 'Securitization has been a key funding source for consumer and mortgage lending in many mature market economies' (IMF, 2009, p, 78). However, the unchecked growth of securitisation is often blamed as the culprit that led to financial crisis. Acharya et al (2010) argue 'that the manufacturing of tail risk by large, complex financial institutions (LCFIs), much in the way of AAA-rated securitised products was the major cause of the crisis'.

Keeping the mortgage loan on the balance sheet would make the balance sheet of the bank look 'traditional'. From a risk perspective there is an advantage as regulatory capital is held and the monitoring responsibility and risk is with the loan issuing bank.

**Does the issue of residential mortgage-backed securities allow more people to own their own homes, or just allow more people to bid up house prices?**

The issue of RMBS would allow more people to own their own homes but at the same time could also allow investors to use increased credit to buy investment properties. So it is really not this or that. It can have both the outcomes simultaneously.

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