Westpac

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Senator David Bushby
Chair
Senate Economics References Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Senator Bushby,

Thank you for the opportunity to make a submission for the Senate Economics Committee's Inquiry into competition within the Australian banking sector. I look forward to appearing before the Committee on 13 December to present the views of The Westpac Group.

In the meantime, if you or your fellow Committee members wish to discuss any of the points in our submission, I would be very happy to do so.

Yours sincerely

The Westpac Group's Submission to the Senate Economics Committee Inquiry into Competition within the Australian banking sector

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Executive Summary

Australia has a strong, reliable and resilient banking system, with all of its participants contributing to that strength in their own way.

While pursuing increasingly differentiated strategies, the four major banks provide national strength and stability. The regional and community sector provides a more local alternative for customers, and global banks have traditionally met a range of customer needs, particularly in business banking.

Australia has come through the global financial crisis (GFC), the worst global economic event since the Great Depression, because of the strength of its banking system and because the Government, regulators, the banks and the community worked together to ensure that it has stayed strong.

In fact our banking system truly showed its worth through the crisis. The crisis reminded the nation, and the world, how important it is to have a safe and strong banking system. As one of the largest members of the banking system, we are proud of how we have all – Government, regulators, major, regional and community banks and the community at large – worked together through the crisis to protect the Australian economy.

The Westpac Group through the Crisis

Founded in 1817, Westpac is Australia's oldest bank. For nearly 200 years we have been deeply committed to serving the Australian community and to playing a positive role in the development of our nation.

Our focus during the GFC was no different. We saw our obligation to our customers, and to the communities we serve, as our paramount responsibility.

At Westpac, we continued to lend, even when others pulled back. Ensuring that there was a steady supply of credit available through the crisis was probably the most important contribution we could make. At times in 2009 we were providing nearly half of the new home lending in the market. We also supported smaller lenders by providing funding so they in turn could continue to lend.

We increased our support for customers experiencing financial distress by further strengthening our "Westpac Assist" program and launching St.George Assist. We actively supported small business customers, many of whom were particularly affected by the crisis. We also invested heavily in our businesses, for example in our "Westpac Local" initiative, putting new and more senior bank managers and business bankers into our branches, in expanding our St.George branch and ATM network and beginning a $2 billion program in technology to enhance customer service and efficiency.

Notwithstanding the crisis, we continued to implement our customer centric multi brand strategy. A critically important step was merging with St.George Bank in 2008. The merger brought new strengths to both St.George and Westpac, and St.George's vibrant, independent brand continues to offer a real alternative to customers. In fact we are pleased to say that St.George now serves more

customers than it did before the merger, and maintains an important and distinctive regional role in the Australian banking system.

The Impact of the Crisis on the Australian Banking System

The GFC has had, and will continue to have, a profound effect on global financial markets. Indeed in recent times, the financial rescues of Greece and Ireland have reminded us that the turmoil is far from over.

This dislocation in financial markets has manifested itself in a number of ways, and borrowers in these markets, including our banks, have found funds much more expensive and at times scarcer.

From Australia's perspective the crisis demonstrated our reliance as a nation on offshore financial markets, and the desirability of diversifying the sources of funds available to our banks.

Compared to many other leading economies, a larger proportion of Australia's current account deficit can be attributed to private debt. In other words, much of our deficit stems from wholesale funding raised offshore by the banking sector to supplement local wholesale borrowings and customer deposits, enabling banks to meet their customers' needs.

As the crisis unfolded, Australian banks moved to reduce their reliance on wholesale funding (both domestic and offshore), not just because the crisis had made that funding scarcer and more expensive, but also to achieve a better balance between wholesale funding and customer deposits in the overall bank funding mix.

This rebalancing led to significantly increased competition for customer deposits. As a result, customers now enjoy some of the best offers on deposits in many years. Banks have never competed as hard as they do now for customers' deposit business. For those of us who are savers, and for older customers and retirees in particular, this is an unequivocally positive competitive outcome.

However the increased prices banks pay for their funding – driven both by more expensive wholesale markets and increased competition for deposits – has significantly increased the industry's cost of lending to Australian consumers and businesses.

All lending institutions in Australia have been affected by this. Some responded to their increased cost of funding by reducing lending (so needing to raise less funding themselves). Others withdrew entirely from lending. Some, such as Westpac, a strong player, continued to meet customer borrowing needs, a conscious choice even though it meant us raising more funding ourselves at more expensive rates.

Over the course of the crisis, mindful of the impact on customers and communities, banks including Westpac have needed to adjust prices charged to borrowing customers to reflect these heightened costs and to keep our banks financially secure, safe and stable.

No one is sure how long bank funding costs will remain elevated. At Westpac we expect those costs to eventually settle at a new equilibrium, lower than current levels, but certainly more expensive than before the crisis began. When that

happens competition will ensure that customers who borrow from banks will see the benefit, as lending rates reflect lower bank funding costs.

Facilitating Competition in the Australian Banking System

As the impacts of the GFC on our banking system have been felt in the wider community, we have seen the emergence of a broad national debate focused on two key questions:

1. Has there been a reduction in competition in banking in Australia, as a result of the GFC?
2. How do we encourage/assist more competition in the Australian banking market?

Australia's banking system provides a broad range of financial services to individuals, business and government including: savings and broad access to savings via branches, ATMs, EFTPOS and online banking; personal, housing and business lending; wealth management, insurance, payments infrastructure, and treasury and risk management.

In each of these areas significant competition exists including from the many players in the wealth management and insurance industry, to the major banks, overseas banks, regional banks, and credit unions and building societies in the savings market.

In certain markets (for example customer deposits as mentioned above) competition has never been more intense. In lending markets, change has occurred with some players retreating and others withdrawing. Having said that, the evidence shows that competition has remained vibrant with home lending a prime example. There are currently more than 100 lenders offering mortgages in Australia. The extent of competition is readily apparent in areas such as price (where we have the greatest variation in standard mortgage rates seen in many years) and the number and types of products on offer.

In business lending, although we have seen reduced demand as customers deleveraged during and following the GFC, competition is still intense. For example, it appears that in recent times some banks have lowered price and non-price lending criteria for better quality customers.

Further, at the heart of healthy competition lies choice, and it needs to be emphasised that customers make choices based on a wide variety of factors. While price is important, so too is brand position, the customer service proposition, and service delivery capability. As a multi-brand organisation, The Westpac Group experiences this first hand when researching and observing customer preferences, and what we learn in the process informs the investments we make as we compete in the market to attract and retain customers.

On the second question, that of facilitating further competition, there is scope for Australia's government, in close dialogue with the industry, to work on initiatives that diversify sources of funding for our industry and assist us as a nation to reduce our reliance on offshore wholesale funding. We see two clear benefits from improving access to funding in this way: first, it will help new lenders to enter our

market and, secondly, we will transition more quickly to the more stable funding price equilibrium mentioned above.

In Chapter 6 of this submission we encourage the Government to consider four actions:

1. Work to achieve better tax equalisation between bank deposits and other, currently more tax favoured, savings opportunities for Australians.

2. Create a framework to allow covered bonds to be issued by Australian Authorised Deposit-taking Institutions.

3. Strengthen the Residential Mortgage-Backed Security (RMBS) market through continued Australian Office of Financial Management (AOFM) investment.

4. Allow master trust format for securitisation of alternative asset classes.

In our opinion, it is measures of this sort, rather than reliance on more regulation of an already well regulated industry, that will further strengthen the resilience of our banking system, and have the greatest positive impact on the provision of financial services to Australian households and businesses in the short and medium term.

Australia has much to be proud of in its weathering of the crisis, emerging as it did with strong economic growth and low unemployment. Our well regulated, safe and secure banking system, along with decisive government action, played a key role in what was an outstanding national achievement. However, we acknowledge that the Australian community wants to know more about its banks and how they compete in what has become a markedly different world. We trust that this Inquiry, and the submissions to it from Westpac and others, will assist in that process.

Chapter 1

Introduction – the Global Financial Crisis and Australia's financial services system

The three main elements shaping competition in Australia's banking system over the last three decades have been:

- reform and deregulation of the banking system;
- introduction of securitisation; and
- changes in the access to, and the price and availability of funds caused by the GFC; and the ongoing impacts of the GFC, which will be felt in Australia and internationally for many years to come.

Deregulation and other reforms of the financial system were designed to encourage competition in the market, and increase contestability in banking and financial markets. In the mid 1980s, a number of foreign banks were permitted access to the Australian market. In the 1990s, competition between banks, internet-based banks, and building societies and credit unions, continued to grow.

Australia's mortgage market, as well as the market for other financial services, has been very competitive. In addition, new stronger, and more independent regulatory financial services supervisors were established in the mid-1990s.

Looking back, it is clear that financial sector reforms and deregulation played a big role in shaping good outcomes for the nation, including bank customers and investors.

Those reforms created a framework for competition and contestability that still serves the nation well.

As the facts have borne out during and post the GFC, Australia's financial regulatory framework proved that the nation can achieve both a competitive and secure financial system.

A direct result of a more competitive system was that finance became more readily available, and mostly at lower cost than before financial sector deregulation in the 1980s.

Deregulation also raised opportunities for financial institutions to raise new and broader sources of funding for investment and lending. This was especially important for the entry of securitised mortgage lenders into the Australian market.

For many years, these changes increased the availability of funding to financial institutions, and increased the number of participants in some parts of the market.

Prior to the GFC, there was some easing of lending standards by some lenders (though not nearly to the same extent that occurred in the US and in some European countries), which increased the ease with which more Australians were able to get mortgages, small business loans and other types of credit.

The ready availability of funds over many previous years, especially in the US, contributed to the problems experienced during the GFC. Loans had been made to people who could not repay them. Some overseas banks were seen to be unsafe.

The collapse of Lehman Brothers in 2008 was a key turning point, paralysing markets and liquidity. Globally, debt investors in general retreated to safe haven assets such as cash and AAA bonds, shunning asset-backed securities.

In Australia in 2008, some funding sources shrank substantially. Lenders that relied heavily on securitisation were forced to stop or curb their lending.

Effective monetary policy from the Reserve Bank of Australia and the Australian Government's stimulus policy and spending were vital to Australia not sliding into recession.

Likewise, the introduction of the wholesale funding guarantee by the Australian Government allowed Australian banks to continue competing for funds internationally on a level playing field.

At various times during the GFC, Westpac was providing nearly half of new home lending in the market, and we supported Government measures to keep the economy moving.

Although Australia avoided the worst of the GFC, the reverberations of the crisis are still having an impact on the nation's banking system, and will do so for some time.

While financial markets are functioning again, they remain fragile. In recent months, the financial rescues of Greece and Ireland have reminded us the impacts of the GFC have some way to run.

The GFC has led to a fundamental repricing of risk. The availability of credit, especially over the longer term, is tighter, and more expensive, than it was.

Because of the GFC and its consequences, it is more expensive for all Australian banks to borrow money on international markets to fund their loans to customers. This is the case despite The Westpac Group being among only about 10 banks globally that maintained a AA credit rating during the financial crisis (three of the others are also Australian banks).

For many years prior to 2008 and the GFC, Australians were accustomed to home mortgage rate changes moving in line with Reserve Bank decisions about the overnight cash rate. However, the GFC has changed this cycle for all lenders in Australia, including The Westpac Group.

The RBA cash rate is not the rate at which a bank borrows its funds. It is rather one factor that influences the price of money in capital markets, which (along with deposits) are where banks secure a significant proportion of their funds.

Previously, the RBA's cash rate and banks' lending rates were correlated largely because factors impacting lending rates, such as risk premiums, were relatively stable and because a significant portion of funding was short term.

However, wholesale funding, previously readily and cheaply available, has become more difficult and expensive to secure. Further, to improve the quality and security

of our funding, we are increasing the term of the funds we raise in the market and these come at a higher cost than short term funds.

Finally, the cost of customer deposits has dramatically increased due to intense competition for this source of funding.

These factors mean that the RBA's cash rate and the cost of funds for banks are no longer moving in unison.

On a number of occasions, Reserve Bank officials have added clarity to the current debate by making two points:

1. Banks' cost of funds have moved up by more than the cash rate.
2. The Reserve Bank takes into account banks' expected moves in interest rates in setting the cash rate. What is important to the effective implementation of monetary policy is not the cash rate, *per se*, but the lending rate paid by customers.

In late November this year, Reserve Bank Governor Glenn Stevens, in his opening address to the House of Representatives Standing Committee on Economics, said:

"*Most lenders raised borrowing rates by more than the cash rate, given that their costs of funds had moved up relative to the cash rate. I noted the Board was taking account of these shifts in deciding the appropriate setting of the cash rate.*" *(RBA, 2010e)*

Chapter 2

Competition across the market and within the Westpac Group

Westpac believes that in responding to this Inquiry it is important to examine the competitive nature of various services offered by the financial sector and the landscape in which we operate.

2.1 Westpac is one of many providers of financial services to Australians

The Westpac Group is one of a number of banks and non-banks providing banking and other financial services in Australia.

Despite some competitors bowing out of the market because of the turmoil of the GFC, a broad range of banking service providers continues to serve Australian consumers and businesses in 2010.

According to APRA the current competitors include: 11 domestic banks, 11 building societies, 105 credit unions, 9 foreign bank subsidiaries, 35 foreign bank branches and 4 other institutions classified as Authorised Deposit-taking Institutions (ADIs), 3 specialist credit card providers and 1 other provider of payment facilities. In total 179 entities compete in the Australian banking services market.

The economy benefits from the commercial banking system. Specifically, banks facilitate the money market and reduce transaction costs by bringing together customers that lend money through their deposits to customers who require loans. But because deposits are not sufficient to cover all the loans that Australians want, banks also borrow in professional 'wholesale' markets to fill this 'gap' in their funding of loans.

Importantly, this also allows banks to create wealth in the economy. The multiplier effect that the banks facilitate includes deposits held by banks used as loans to borrowers, who will in turn purchase goods.

Australia's banking system provides a broad range of financial services to individuals, households, businesses, not-for-profit organisations, and governments and their agencies. These services include:

- savings and broad access to savings via branches, ATMs, EFTPOS and online banking;
- personal, housing and business lending;
- wealth management and superannuation;
- insurance and risk management;
- payments infrastructure critical to the effective operation of our day-to-day lives and the functioning of our businesses; and

- corporate advisory services, treasury and risk management to corporations, larger businesses and governments.

In each of these areas significant competition exists from the many players in the wealth management and insurance industry, to the major banks, overseas banks, regional banks, credit unions and building societies, in the savings market.

Competition is alive and well in areas such as price (the greatest variation in standard mortgage rates between the 100+ lenders offering mortgages in many years), and the number and type of products on offer. Further, a key element of choice for many customers is the brand promise of the lender (what they stand for), service delivery, lending criteria and physical or online availability.

2.2 Competition in housing finance

The Australian housing finance and mortgage market has been characterised by strong competitive pressures over the last two decades. Many new lenders have entered this market and, despite the GFC, many remain. They offer a variety of mortgage products and have also been responsible for bringing new products into the market.

The latest *Home Loan Star Ratings* report by CANSTAR CANNEX, a financial data provider, provides ratings on a large range of loans available to owners and investors, offered by more than 110 distinct lenders.

Market dynamics change provider numbers

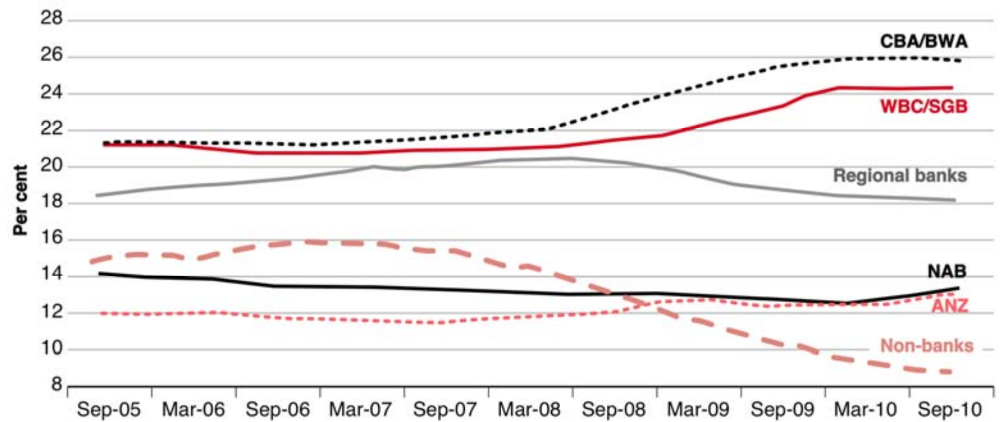
Westpac's decision to remain "open for business" and support its customers during 2009 meant we have been able to meet customer demand for mortgages.

At Westpac, we continued to lend, even when others pulled back (this is illustrated in Figure 2.1). We are proud of our role and proud of the way our staff responded. At times we were providing nearly 50 per cent of the new home lending in the market.

Continuing to lend through the crisis also had the effect of supporting the Government's stimulatory fiscal policy during the GFC.

Figure 2.1

MARKET SHARE OF HOME LENDING MARKET

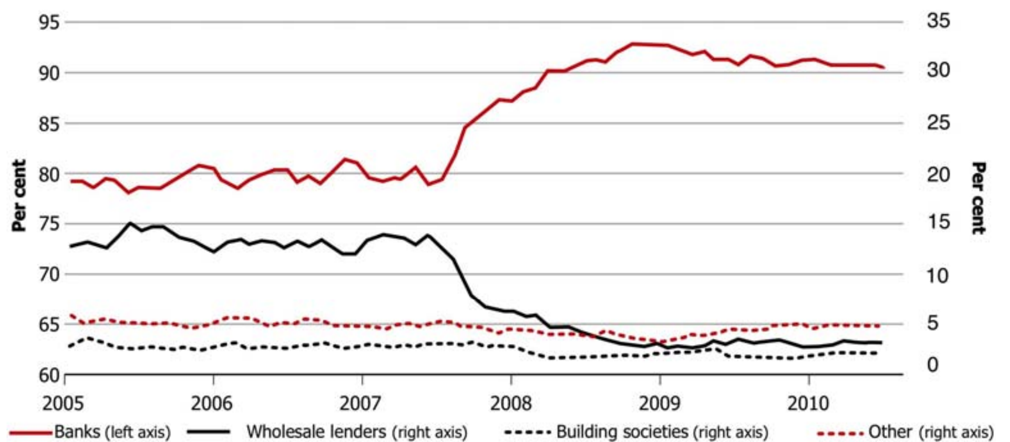


Source: The Westpac Group 2010, ABS, APRA

Mortgages issued by the major banks comprise about three quarters of all mortgages issued in Australia. Meanwhile, other mortgage providers that rely on securitisation markets (especially those that are not banks), found that their sources of funds for lending have constricted. Many of these institutions have not been able to support customer demand for lending (see Figure 2.2).

Figure 2.2

NEW HOUSING FINANCE BY TYPE OF LENDING INSTITUTION



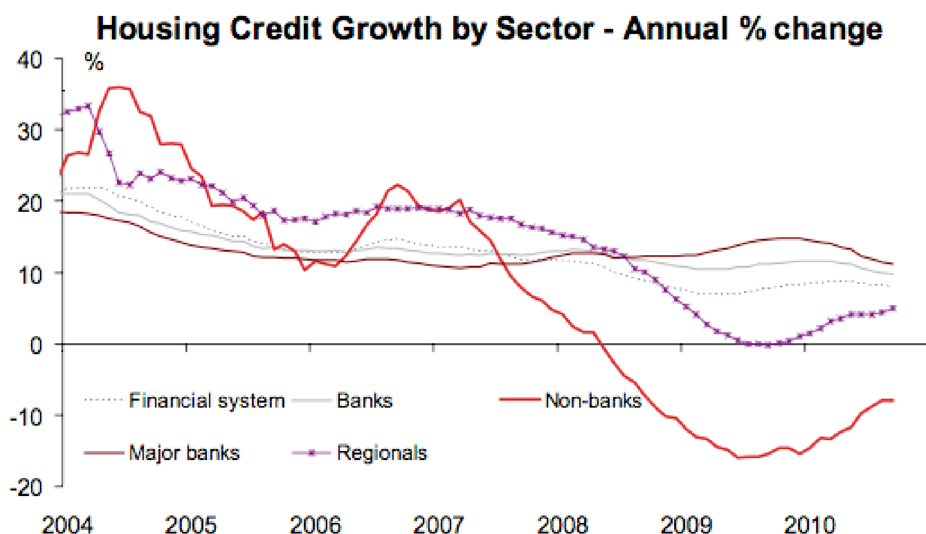
Source: ABS, The Westpac Group 2010, ABS & APRA

The reduced ability for non-bank lenders to provide finance has not led to a fall in the number of mortgages provided to Australians. Through 2010, Australia's banks have continued to expand the credit they provide to customers (see Figure 2.3 below). Mortgages accounted for almost all of this growth. The number of mortgages offered to Australians by the major banks grew at a faster pace than for

other financial institutions, including credit unions and building societies (RBA 2010c).

Figure 2.3

TIME SERIES OF HOUSING CREDIT GROWTH BY INSTITUTIONAL TYPE



Source: The Westpac Group 2010

The wide range of mortgage product types provides choice and contestability

Financial institutions in Australia offer more product flexibility than is available in other economies.

The RBA has listed the different mortgage structures and their characteristics available in Australia (RBA, 2008a):

- *Variable interest rate loans* — a prime, fully documented loan with a 25-30 year maturity, and a maximum loan-to-valuation ratio (LVR) of about 95 per cent, comprising about 70 per cent of all housing loans. A number of features are available under this type of loan.
- *Fixed rate loans* – 10 to 20 per cent of loans are at fixed rates. Customers can typically choose from fixed rate terms of 1-5, 7 or 10 years, with similar LVR characteristics to variable interest loans.
- *Home equity loans* — these have a maximum loan-to-value of 80 to 90 per cent, and a maximum term of 30 years. These loans provide a line-of-credit secured against the property, and can be used either for home improvements or non-housing purposes. Home equity loans are offered by all major lenders and comprise around 17 per cent of all outstanding owner-occupier housing loans.

- *Low-doc loans* — these are suitable for borrowers with undocumented or irregular incomes. While low-doc loans are offered by major lenders, they have been typically popular in the non-bank lending sector and comprise around 7 per cent of all outstanding housing loans.
- *Non-conforming loans* — are suitable for borrowers who do not meet the standard lending criteria of mainstream lenders (due to poor credit or repayment histories, for example). These are offered by non-bank lenders and comprise about 1 per cent of all outstanding loans.
- *High Loan-to-Value-Ratio loans* — these have a maximum of 105 per cent loan-to-value, and are suitable for borrowers who are not able to cover the transaction costs associated with buying a home with their deposit. These loans are offered only by a small number of specialist lenders.
- *Shared appreciation loans* — are loans where, rather than paying interest, borrowers surrender a proportion of any capital gain/loss that accrues between the time that the loan was taken out, and the time that the home was sold or the loan repaid. Some lenders offer these types of loans, usually to low-to-medium income households.
- *Reverse mortgages* — are usually used by older homeowners to use equity in their property to obtain funds while living there. The loan is either repaid, or its principal and accumulated interest is repaid from the proceeds of the property sale when the borrower dies or moves home. Reverse mortgages are offered by some major lenders, but in 2007 comprised only 0.5 per cent of all outstanding owner-occupier housing loans.

Australians' attachment to variable over fixed rates

While there has been considerable home mortgage product innovation in Australia, including banks offering fixed and adjustable rate mortgages, Australians have a long-term preference for variable interest rate loans.

About 70 per cent of all housing loans in Australia are variable rate mortgages (RBA, 2008a).

One result of this preference for variable mortgages is that the economy is more responsive to RBA monetary policy changes. During the GFC, when central banks around the world lowered interest rates dramatically to stimulate economic activity, interest rate reductions in Australia (where most customers hold variable rate loans) flowed through the economy quickly. However, in the US, where most customers hold fixed rate mortgage loans, the housing loan market came to a halt because few new loans were written, and lower interest rates did not flow through to existing mortgages.

2.3 Personal credit

As well as loans to purchase homes, Australian bank customers can obtain loans for other personal purchases such as cars and holidays. Personal items can be financed by personal loans or by credit cards.

Credit Cards

Competition in the market for personal credit over recent years has been robust, particularly in the credit cards market. There is a very large number of credit card providers in Australia offering a very wide range of products.

There are over 275 credit cards from 69 institutions in Australia (CANSTAR CANNEX 2010b). Different credit cards have different characteristics. These characteristics include:

- no frills;
- interest free days / no interest free days;
- interest rate;
- no annual fee / annual fee / annual fee waived with minimum spending;
- reward/loyalty program;
- standard feature; and
- premium features.

Typically, each financial institution offers a number of credit cards to attract a varied range of consumers.

The intensity of competition in the credit card market is also reflected in market share data. In September 2010, the four largest banks accounted for about 68 per cent of outstanding credit card balances, down from 73 per cent in 2002. Foreign banks have been a major source of competition, and their market share has increased from 6 per cent to 12 per cent since 2002.

Personal Loans

Personal loans are used for a variety of purposes such as auto-related finance, debt consolidation, travel, household goods and home renovation.

In the personal loan market banks only account for 51 per cent of applications with 35 per cent of applications being written through auto-related finance and other lenders. In addition, credit unions provide 11 per cent of applications and building societies 2 per cent. These figures are based on Veda Advantage Data.

In 2002, Westpac sold its AGC finance business. AGC provided business finance, vehicle finance and in-store credit to retailers and consumers. Westpac continues to participate in the business finance market and St.George has a vehicle finance business. However, Westpac has made the conscious decision to no longer provide in-store finance to retailers and consumers.

2.4 Business credit

Credit for private non-financial firms accounts for about three quarters of business credit in Australia. Locally-owned banks account for about three-quarters of total lending to Australian business (RBA 2010a). The remainder comprises loans by foreign banks and non-bank lenders.

While household lending has grown, total business credit declined until recently, and has since remained steady.

According to the RBA, the decline in credit to Australian business was not because banks stopped lending, but because Australian businesses were reducing debt because of the GFC. The current flat period in business lending (after a decline) suggests that corporate debt reduction may be nearing an end (RBA 2010c).

This accords with The Westpac Group's experience over the past two years.

Westpac experience in commercial property

Westpac and St.George are major players in the commercial property segment. The debt reduction in this segment has been particularly pronounced. During the buoyant years competitive pressures had driven a number of changes in our pricing and policy profile including incremental changes in our lending value ratios. In line with our post merger portfolio concentration levels and the prevailing economic conditions The Westpac Group reduced some of our key lending value ratios in 2009 to be more in line with our long run risk appetite. We also adopted a more stringent approach to overrides of our credit policies. The Westpac Group has remained committed to providing credit within our prevailing risk appetite guidelines.

Westpac's experience in small business lending

Small-to-medium (SME) business customers comprise over 10 per cent of The Westpac Group's business lending portfolio. Since late in 2008, the flow of loan applications from SME business customers decreased by about 3 per cent.

During that same period, Westpac made no major changes to key small business credit policies on debt service cover, interest cover, Loan-to-Value-Ratios (excluding commercial property) or other credit policies.

However, one of Westpac's goals is to be a market leader in the SME lending segment. To this end Westpac has invested heavily in its branch network to assist new and existing customers and has placed approximately 430 local business bankers in branches as part of a program to triple the number of local business bankers across Australia. The addition of over 600 bank managers across Australia has also benefited small business customers.

Westpac's business banking centres provide advice tailored for business on issues such as managing their cash flow, traditional banking needs, equipment finance, and building wealth and trade. Westpac invested more than $50 million last year, opening new branches and specialist business banking centres, bringing the network of one-stop shops for business around the nation to 69.

SME customers have been identified as a key priority segment for both St.George and BankSA. These business banking segments will continue to receive investment that focuses on increasing the number of small business relationship managers across Australia.

After a period of decline, foreign banks appear also to be increasing their lending to Australian businesses. According to the RBA, some foreign banks have in recent quarters eased price and non-price lending criteria in this segment (excluding

commercial property), lowering margins, and applying less restrictive loan covenants.

Westpac's pricing approach for business lending customers

The decision whether to provide credit to business customers across The Westpac Group is determined by our credit risk assessment of the customer's ability to repay the loan rather than the level of collateral provided by the customer.

If the business customer meets the credit criteria of The Westpac Group the pricing then takes into consideration a range of factors including expected losses (and provisioning), the capital required to be held against the loan, the cost of originating a new loan and the cost of funding this loan. For new customers a risk grade would then be attached to the customer (existing customers would already have been given a risk grade). This risk grade determines the expected losses and capital requirements.

The capital required by APRA to be held by banks for small business loans is generally three times higher than for home loans, and can be up to seven times higher for some products.

This is because small business loans are, on average, more risky. The riskier the project being funded, the higher the interest rate. Australia's prudential standards also recognise that loans to the small business sector are statistically more risky than loans to homeowners secured by residential property.

2.5 The Westpac Group – product and brand competition for customers

Westpac is Australia's oldest bank and Australia's first company.

The Westpac Group, like many other Australian banks, has a history of acquisition. In Westpac's case this covers acquisitions in Australia, New Zealand and the Pacific Islands.

In 2007, The Westpac Group acquired the RAMS brand, franchise network and associated mortgage origination and servicing systems and contracts needed to run the distribution business. This acquisition was a part of an emerging multi-brand strategy designed to provide customers with a choice of home loan providers.

In 2008, Westpac merged with St.George Bank to create The Westpac Group: Australia's first truly multi-brand banking provider. The merger enabled The Westpac Group to continue its strong growth within Australia. Importantly, the merger was seen as an opportunity for both brands to continue to grow and prosper. Unlike most other in-market mergers, the objective was not a cost reduction/synergy strategy. Since the merger both St.George and Westpac have continued to grow their respective customer and branch numbers.

The Westpac Group now manages a number of retail brands. These include the Westpac Retail and Business Bank, St.George Bank, BankSA and RAMS. Additionally, The Westpac Group also comprises BT Financial Group, Asgard, Westpac Institutional Bank, Westpac New Zealand and our nine Westpac Pacific Islands' banks. We invest in and manage these unique brands to offer choice and

appeal to different customers. Each brand designs and implements its own customer strategies and plans.

We invest considerably in a multi-brand strategy so we can compete for customers by offering different products (including different home mortgage rates), and different brand experiences.

The differences between the brands within The Westpac Group are substantive. The price of products and services is only one factor in how customers differentiate the brands. Other competitive differences include service propositions, product features and packaging, levels of advice offered, customer support, branch availability, online and ATM experience, and differences in relationship management. The Westpac Group has preserved the unique attributes of each brand within the Group to satisfy different customer needs.

Our brands, while sharing some central services of The Westpac Group such as compliance and technology, must 'stand alone' to compete for customers.

Our brands are managed to compete against other retail brands – including other brands in The Westpac Group. Our brands have different marketing and advertising strategies. Thus, for example, Westpac and St.George have different mortgage product interest rates and other service charges.

Each brand must differentiate their offerings to attract and retain different segments of customers. This strategy offers customers a significant level of choice within The Westpac Group.

The Westpac Group in 2010 served almost 11.8 million customers in Australia and lent $478 billion to institutional, business and retail customers. It helped around 27,000 first home buyers take their first step towards home ownership and assisted over 205,000 Australians secure a new home loan, in the process, employing over 40,000 Australians.

The Westpac Group's multiple retail banks, along with our dedicated mortgage specialist company, allows customers to choose from a broad range of offers to meet their needs. Having in some instances Westpac and St.George branches located side by side in shopping centres demonstrates their stand-alone nature.

The core element of The Westpac Group multi-brand strategy is the preservation of difference, and our success depends upon maintaining and further strengthening the uniqueness and individuality of our brands.

Within St.George there is a greater regional banking focus and we have actively been increasing our distribution presence and reach. In 2010, we opened an additional nine branches, with more identified for 2011. BankSA adopts a local market model approach to ensure they stay close to customers and local communities. In fact, more than half of all BankSA branches are located in rural areas and BankSA is often the only bank in small rural towns.

Westpac Retail and Business Bank (RBB) has made significant investments in its branch network, adding some 14 new branches and six new business centres. Further, some 114 refurbished branches add to improved customer service. 2010 saw a further $80m invested in 200 sites around Australia. Most significantly,

Westpac RBB has brought back over 600 local Bank Managers and some 430 local Business Bankers to provide greater levels of local expertise and autonomy.

The competitive banking environment along with rapidly changing technology and subsequent consumer demands requires constant innovation and technological investment. The Westpac Group began a major technology strategic investment program in 2010, which is expected to involve an investment in the order of $2 billion over five years and will promote improved customer service and capability, as well operating efficiency. Our significant IT investment allows us to deliver innovative and secure banking services to our customers across the Group. This program includes the development of a new online banking platform and an upgrade of mortgage processing and servicing processes and platforms, as well as continued investment in our payments systems.

Chapter 3

Funding, pricing and profitability

Westpac's funding is comprised of customer deposits and wholesale funding, sourced from domestic and offshore short and long term debt markets.

3.1 Customer deposits

Customer deposits with banks are a significant source of the funds banks in Australia use to finance their lending to their customers. Deposits comprise about 55 per cent of the funds that banks use for lending.

Australian customers can choose from a very large number of institutions in which to place their deposits. There are about 175 domestic and foreign Authorised Deposit-taking Institutions (ADIs) in Australia competing for the deposits of Australians.

There has been considerable innovation in the type of deposit services banks offer over the past few years, including online deposit accounts, which can attract higher interest rates. Deposit products range from standard deposit accounts, to online accounts, to 'term' deposits offered as 'specials' by the banks, offering the highest interest rates.

According to CANSTAR CANNEX (2010c), there are 470 products offered by banks, credit unions and other financial institutions (e.g. building societies) in the deposit market. These products have different features that would appeal to the savings profiles of individuals. In general, saving accounts can be categorised as the following:

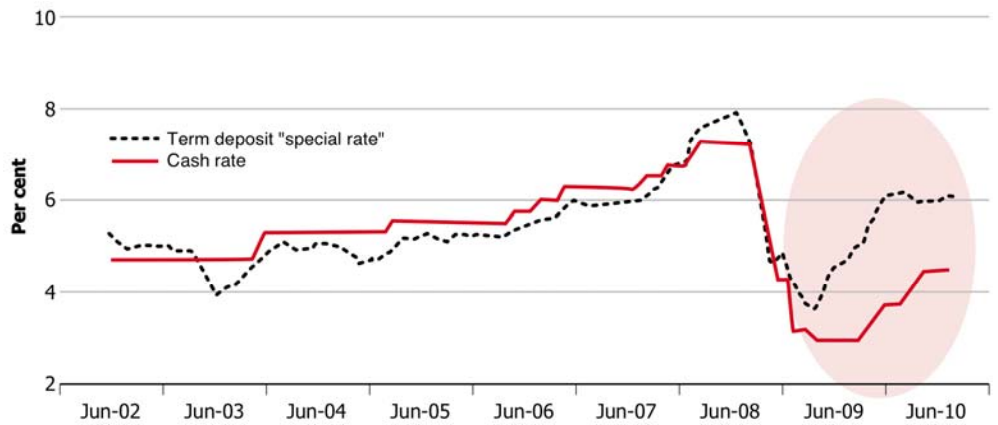
- personal transaction accounts;
- savings and investment accounts;
- online savings accounts;
- cash management accounts;
- high yield accounts; and
- children's accounts.

In recent months, interest rates on deposits compared with the RBA official cash rate have been at or around historically high levels (RBA 2010c). According to the RBA, the average interest rate on deposits has increased by around 230 basis points since early 2009, which is an increase considerably larger than the increase in the cash rate set by the Reserve Bank over the same period (RBA 2010d).

Figure 3.1 indicates that since early 2009, and as a result of very strong competition among banks for Australian deposits, a significant gap has opened up between the interest rate available on term deposits, and the official cash rate.

Figure 3.1

TERM DEPOSIT RATES HAVE DISCONNECTED FROM THE CASH RATE



Source: RBA

Term deposit rates have increased from approximately 60 basis points below the bank bill reference rate in 2007 to approximately 70 basis points above the bank bill reference rate in 2010.

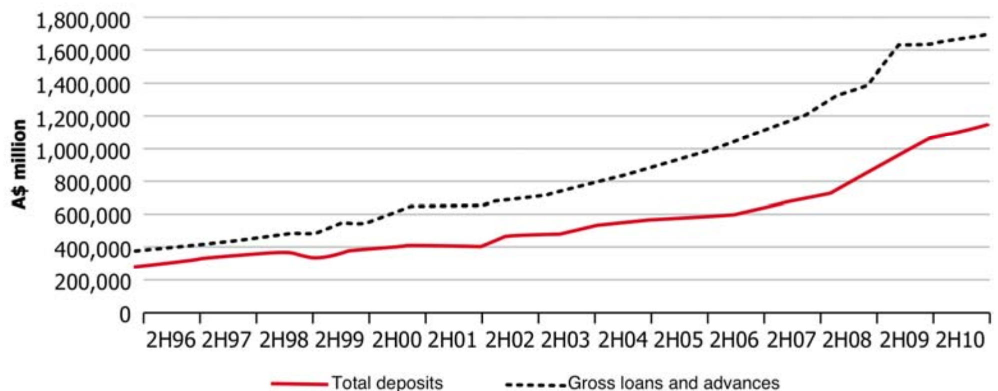
3.2 Wholesale markets

The funding gap in Australia

The need for Australian banks to source funding in wholesale markets is driven by a funding gap in Australia, which is the 'gap' between total loans and total deposits. Figure 3.2 indicates that this 'gap' has been increasing steadily over the last 15 years.

Figure 3.2

THE WHOLESALE FUNDING GAP OF THE MAJOR BANKS



Source: UBS and Company Data

In order to fund the gap between deposit growth and domestic demand for credit, Australian banks are significant borrowers in debt markets, both domestically and offshore.

As of 30 September 2010, domestic debt markets comprised about 14 per cent of The Westpac Group's total funding. In this way, domestic debt markets supplement deposits by providing an additional means for Australians' savings to make their way into the Australian banking system.

However, the relatively small size of the Australian debt market means it alone does not have the depth needed to satisfy the gap in Australia between loans and deposits.

Local banks therefore also seek funds in offshore debt markets. As at 30 September 2010, funds from offshore debt markets comprised about 25 per cent of The Westpac Group's total funding.

The Westpac Group has a long and successful track record in accessing offshore debt markets. Like other major Australian banks, The Westpac Group has a well established offshore wholesale funding franchise, having been a regular issuer into global markets, particularly the US, UK, European and Asian markets, for many years.

With a strategy focussed on diversity and flexibility, The Westpac Group has built and maintained the capability to meet global investor preferences through the successful execution of debt issuance in a range of instruments, tenors and across many geographies.

The GFC radically changed the landscape of global markets. The collapse of Lehman Brothers in September 2008 was a key turning point and associated with a sharp reduction in available liquidity and investor appetite for debt securities. Globally, debt investors in general retreated to safe haven assets such as cash and AAA bonds, shunning asset-backed securities.

Against this backdrop, Westpac maintained access to debt markets. This was possible for the following reasons:

- an Australian Government Guarantee on wholesale debt was introduced following the introduction of similar guarantees in many jurisdictions. This ensured that Westpac and other Australian banks were able to continue to compete on a level playing field with global issuers, for a fee. Over time, the guarantee fees will bring in approximately $5 billion of revenue to the Federal Government (Swan, 2010);
- Westpac and its major Australian bank counterparts retained their AA ratings, becoming four of only 10 banks globally rated AA or higher;
- the diversity of Westpac's funding base meant it had no over-reliance on any single market; and
- Westpac's liquidity risk management meant the bank's short and long term refinancing needs were manageable.

The GFC has led to a fundamental repricing of risk. The marginal cost of long term wholesale funding has increased with credit spreads widening. This can be illustrated by the increase in our long term wholesale funding cost from approximately 15 basis points above the bank bill reference rate for new borrowings in 2007, to approximately 134 basis points for new borrowings in 2010.

The average cost of wholesale funding has increased significantly as pre-GFC wholesale funding is replaced by more expensive wholesale funding.

The banks' mix of funds has changed

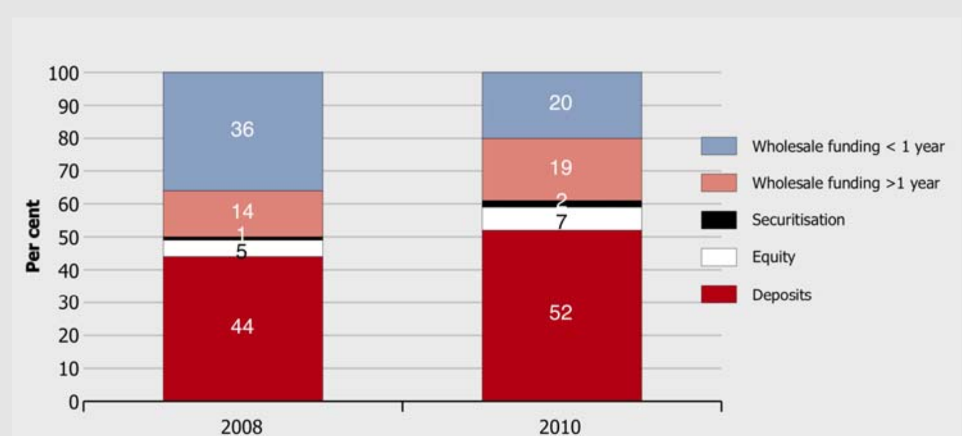
Box 3.1

WESTPAC'S EXPERIENCE WITH INCREASING ITS FUNDING SOURCES

As a result of the GFC, The Westpac Group has actively lengthened the 'tenor' of its wholesale funding over the last two years, reducing the proportion of short term funding to 20 per cent of total funding, down from 36 per cent, and increasing the proportion of long term funding to 19 per cent, up from 14 percent.

Figure 3.3

WESTPAC'S FUNDING COMPOSITION



It can also be seen that The Westpac Group has been increasing its deposits and equity holdings over the last two years.

Source: The Westpac Group, 2010

Westpac's experience in changed funding composition is broadly representative of the Australian major banks. The shift by banks away from shorter-term wholesale debt in favour of deposits and longer-term wholesale funds has raised the banks' cost of funds.

While the intense competition for funding has dominated the GFC period, the overall long-term perspective on the impacts of competition can be best examined through the bank's net interest margin.

3.3 Net interest margin

The Net Interest Margin (NIM) is Net Interest Income divided by Average Interest Earning Assets.

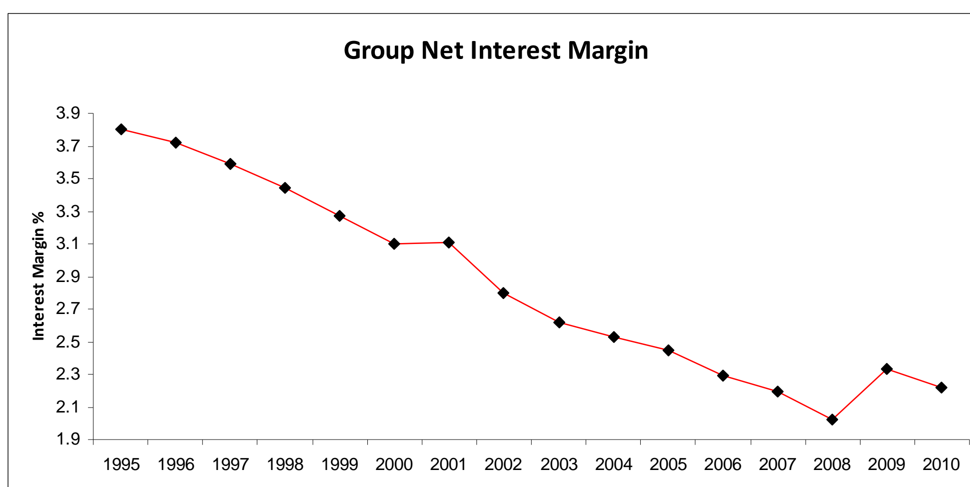
Figure 3.4 shows that NIM has been declining over a long period for The Westpac Group. This decline reflects the continual impact of increased competition as a

result of financial market deregulation in the 1980s and early 1990s, and the increased availability of relatively cheap forms of debt in the lead up to the GFC.

Global capital supply progressively grew until 2007 and supported lending by a broad range of financial intermediaries. The competition this generated in turn contributed to the reduction in net interest margin across the industry. The onset of the GFC and dislocation in capital markets reduced the availability of funds and increased their cost. Volatile markets also increased treasury earnings which positively impacted net interest margin. This is reflected in a small upward adjustment of net interest margin in 2009. Notwithstanding the changed market conditions during and following the GFC and after factoring in lending rate changes during that period, The Westpac Group's net interest margin has continued to be relatively consistent. In 2010, at 2.22%, net interest margin was 0.03% higher than 2007 and 0.07% lower than 2006. This experience is consistent with the commentary by RBA Governor Stevens in his testimony to the House of Representatives standing Committee on Economics (November 2010) where he stated 'the overall net interest margins have been fluctuating between 2¼ and 2½ for about four or five years. There is not a lot of change.'

Figure 3.4

THE WESTPAC GROUP'S NET INTEREST MARGIN



Source: The Westpac Group, 2010

3.4 Profitability and shareholdings

Profits and our shareholders

The Westpac Group is a large organisation with over 561,000 shareholders holding nearly 3 billion ordinary shares. Many different kinds of people and institutions invest in The Westpac Group, the majority of whom are Australian. Australians own around 80 percent of shares on issue, with retail investors owning approximately 47 per cent and Australian institutions owning approximately 33 per cent. Many of the Australian institutional investors manage the investments of superannuation funds, who ultimately are seeking to maximise the future retirement income of many

Australians. Generating healthy financial returns is important to allow adequate returns to be passed on to these shareholders.

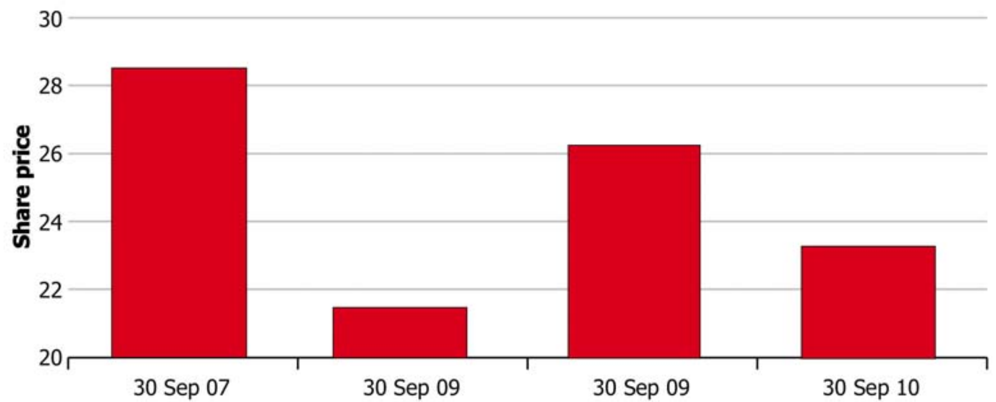
Since 2007 we have returned an average of 71 per cent of profits to shareholders as dividends, with the remaining 29 per cent retained to fund future growth, including as loans to customers. In our 2010 financial year, cash earnings per share were $1.98. As a large organisation, with nearly 3 billion shares on issue, the aggregate amount of cash earnings was $5.879 billion. With a payout ratio of 71 per cent this means over $4.1 billion will be paid to shareholders as dividends in 2010.

Like borrowers, shareholders have also been impacted by the GFC, with returns reduced. This has occurred through lower share prices and reductions in dividends.

The GFC resulted in The Westpac Group experiencing a decline in profits, which impacted returns to our shareholders. The Westpac Group's dividends were reduced because of the lower profit in 2009 and to increase our capital buffer, thus improving our safety. As shown in Figure 3.5 our share price also reduced and has still not returned to pre-GFC levels.

A measure that demonstrates the value returned to shareholders and accounts for both share price changes and dividends paid is Total Shareholder Return (TSR). This takes into account the change in value (or return) to our shareholders by looking at dividends paid to our shareholders as well as growth (or decline) in the share price over a period. Our shareholders have experienced volatility in their returns since the GFC. As can be seen in Figure 3.6, our shareholders experienced a significant fall in the value of their Westpac investment in our 2008 financial year, which has only returned to a positive TSR in 2010.

Figure 3.5



Source: The Westpac Group, 2010

Figure 3.6

TOTAL SHAREHOLDER RETURN

Period	TSR (per cent)
1 year TSR (1 October 2007- 30 September 2008)	-11.4
2 year TSR (1 October 2007 – 30 September 2009)	-2.5
3 year TSR (1 October 2007 – 30 September 2010)	3.7

Source: The Westpac Group, 2010

Return on Equity

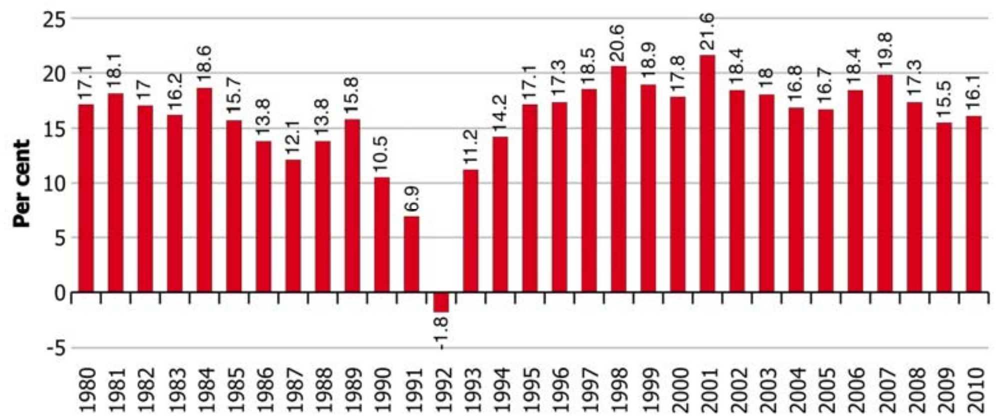
Holding equity capital to support lending is a requirement of any bank. Holding adequate buffers of capital is critical for the safety of banks, as it provides a buffer to absorb losses and/or provisions. During the period of market volatility, Westpac pro-actively raised over $3.8 billion of ordinary share equity to increase safety buffers.

To obtain equity, banks must compete with other businesses for the shareholder dollar. A key measure that captures the banks' ability to compete for equity is the banks' return on equity (ROE) being the bank cash earnings divided by average ordinary equity. A strong ROE is important for the banking industry given the cyclical nature of banking and inevitable downturns.

The major banks' return on equity during 2010 was 16.1 per cent and is in line with the thirty year average, and materially below the average of the past fifteen years (UBS 2010b). This can be seen in Figure 3.7.

Figure 3.7

MAJOR AUSTRALIAN BANKS' RETURN ON EQUITY

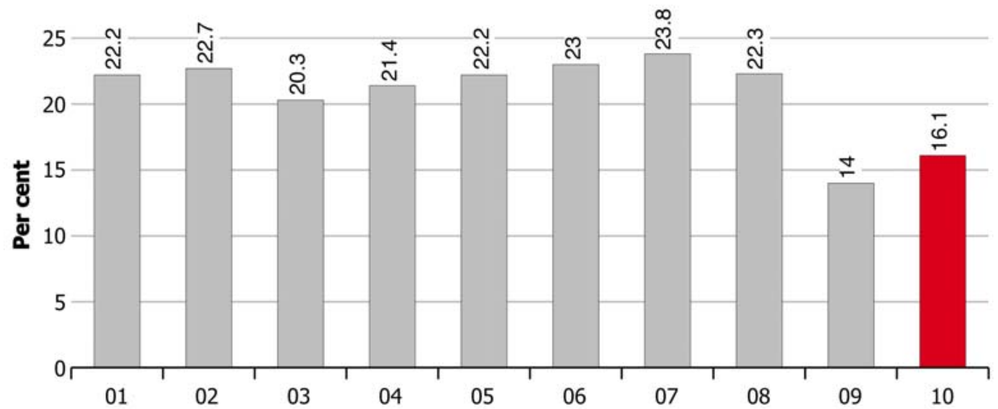


Source: Company data, UBS

The return on equity for The Westpac Group shows a similar recent decline. Figure 3.8 shows that The Westpac Group's ROE has reduced in the last two years compared to the rest of the decade. This has been driven by the lower profitability related to GFC impacts, and increased equity levels, as shares were issued to increase safety during the GFC and the effect of issuing shares as part of the merger with St.George Bank. The increase in ROE during 2010 was a result of improved cash earning mostly from the marked decline in impairment charges (bad and doubtful debts).

Figure 3.8

CASH EARNINGS TO AVERAGE ORDINARY EQUITY



Source: The Westpac Group 2010

A healthy ROE is important for the Australian banking industry because:

- it supports a strong credit rating, which for Australian banks is important, as a significant portion of funding is provided by wholesale debt markets;
- it allows banks to compete with other industries for shareholder funds to continue to support lending activities; and

- it allows banks to invest in additional services to customers.

ROE is one of the factors that shareholders look at when deciding whether to hold shares in the banking sector or another sector. Figure 3.9 shows the average ROE for the banking sector against other sectors listed on the Australian Securities Exchange. The average ROE for the banking sector is less than the ROE of a number of other sectors. As the banking sector must compete with these other sectors for equity funds to support lending and preserve safety, it is critical that banks maintain a healthy ROE.

Figure 3.9

ASX 200 index GICS sectors	2006A	2007A	2008A	2009A	2010E
Information Technology	23.7	30.0	33.7	31.8	27.3
Telecommunication Services	19.5	21.3	21.4	23.0	20.5
Materials	33.9	27.2	23.8	12.2	20.4
Metals & Mining*	38.3	36.3	29.9	16.1	20.1
Retailing*	17.6	20.2	14.7	16.1	15.4
Health Care	14.8	15.2	14.0	15.1	15.0
Banks*	**16.9**	**18.7**	**16.2**	**13.3**	**15.0**
Consumer Staples	18.2	15.5	14.6	13.1	13.7
Financials	14.8	14.1	11.2	11.8	12.5
Consumer Discretionary	10.9	10.8	9.4	11.0	12.2
Energy	18.7	13.3	17.3	9.0	8.0
Utilities	10.1	7.9	6.8	8.4	6.1
Industrials	10.7	8.7	10.4	6.1	5.5

* denotes a sub-sector within Global Industry Classification Standard

Source: Macquarie Securities estimates

Chapter 4

Competition and safety

Banks have to be very safe businesses.

It is vital that when placing deposits in banks the community has the trust and confidence that they will be able to withdraw their money when or if they need it. A further key safety concern is that the failure of a single bank can be contagious and bring down the financial system at large. A safe financial system is central to the smooth working of the economy. Many other countries at present are struggling with the turmoil and cost of failing to have a safe banking system.

To be competitive and survive over the long term, over the ups and downs of the market, The Westpac Group has to be a safe and responsible business and needs to show to regulators, investors, customers and other stakeholders that it is safe.

4.1 Prudential regulation and safety balances competition

Accountability and responsibility for the first line of defence in preserving financial safety rests with the management and employees of the bank, overseen by the Board of Directors. The fact that Westpac is Australia's first and oldest bank, serving continuously since 1817, suggests that our defences have been strong.

Having access to capital and liquidity is a further measure of the strength and safety of a bank. The capacity to raise equity invested in a bank increases safety, providing a buffer when dealing with economic adversity.

A further defence protecting financial safety is the operation of prudential regulation. A key objective of the prudential regulation of deposit taking institutions is to make sure that the risk of loss of depositors' funds is remote.

In Australia, a bank needs to be licensed to accept deposits from the public, and to use the word 'bank' in its name and operations. The licence is an authorisation. Other entities that are not banks, but that can take deposits, include building societies and credit unions. Collectively we are called Authorised Deposit-taking Institutions or ADIs.

To be authorised, The Westpac Group and other ADIs are subject to prudential regulation. If they do not comply with regulation, they are faced with withdrawal of the authority or licence.

Following the Wallis Financial System Inquiry reforms in the late 1990s, the Australian Prudential Regulatory Authority (APRA) was established as the regulator for ADIs. APRA has the responsibility for setting prudential standards for all ADIs.

All ADIs are subject to strict, legally enforceable prudential standards on capital, liquidity, risk management and governance. APRA's prudential standards are complemented by ADI monitoring, and by a comprehensive compliance regime that encourages continuing adherence to the standards.

This ensures that institutional and regulatory arrangements are working and assists early detection of problems. Remedial action is taken in circumstances where an entity or individual fails to meet the minimum requirements.

APRA has extensive powers to require information from regulated entities regarding their operations. This information forms the basis of APRA's assessments of an entity's prudential status and assists the early detection of any emerging risks.

Preserving financial safety necessarily places sensible limits on competition in the community's interest. Potential bank and non-bank competitors are free to enter the market, but must be prudent, solvent and manage key risks. APRA requires as a condition of an authority or licence to become a bank or take deposits as an ADI that the entity meets stringent requirements.

4.2 Raising safety raises costs

Safety and financial stability comes at a cost.

Holding more liquidity in reserve, which is part of making banks safe, reduces the amount of funds that can be lent to customers. Meeting the rigorous prudential requirements also adds costs. In addition, APRA charges banks and other ADIs the cost of supervising them.

Recent measures taken in Australia during the GFC to stabilise the banking system also involved costs.

In 2008 the Australian Government provided wholesale funding guarantees to assist the Australian financial sector to continue to borrow offshore, given that similar guarantees had been put in place by many other governments as part of efforts to manage the GFC. Banks wanting to use the guarantee were required to pay a fee to the government that reflected the risk of providing the guarantee. Bank regulations are in the process of being implemented to better protect the world's financial and banking systems. Key changes (known as the Basel III reforms) have recently been proposed by the Basel Committee on Banking Supervision. They are expected to be finalised in December 2010.

The new standards will be phased in over time. Westpac's strong organic capital generation means we are well placed for transition to the new capital standards, although the liquidity standards may prove to require a longer transition period.

There will be some cost implications in meeting the new standards. The Basel III standards will require higher proportions of common equity from banks, and some forms of hybrid capital will be disallowed. Holding higher amounts of common equity dilutes returns to shareholders and puts downward pressure on Return on Equity (ROE).

Banks will also need to establish capacity to survive a "run" on deposits for a month, rather than a week which applied under the old standards. This will require them to hold more liquid assets, which may limit funds available for lending to customers and add to overall costs.

In general, the effect of stricter regulations is to raise funding requirements and limit the use that can be made of funds.

A key issue in Australia is the shortage of a ready supply of appropriate liquid assets to fulfil the new standards. Reflecting a relatively low level of government debt over some decades in Australia, there are not sufficient government bonds to meet the requirements. This is an issue which is yet to be resolved.

These new provisions are expected to add more costs to banking in Australia.

We understand the need to improve the resilience of the banking system, but it is important to note that making the international banking system safer, including in Australia, does carry costs.

In general, bank investors and customers, which are broadly representative of the community at large, already pay the costs of bank safety. While there are many well intentioned proposals for further regulation currently being debated, these generally apply to charges, levies or taxes and unfortunately would likely have the effect of raising costs further. Therefore we need to be very thorough and cautious in embracing such proposals.

Suggestions of bank-specific taxes have arisen in the wake of the GFC especially overseas. The Westpac Group holds particular concerns about such taxes.

Levies have been applied to banks in the UK and were discussed, but not enacted, in the US as part of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

Applying a tax upon banks in Australia is likely to be counterproductive in regard to reducing costs for bank customers or raising competition and preserving safety.

A tax on banks has to flow through to either or both of two places. The first is to equity investors. Reducing equity returns in banking would encourage people to invest less in banks and may also raise the cost of wholesale funds. The second is to pass the tax through the products and services offered to customers. That is, the banks may have to raise the cost of lending in order to pay for the tax. Neither of these impacts seems attractive or helpful.

Applying an additional charge on banks because they are safe is likely to encourage and expand opportunities for financial institutions that are not subject to the tax because they are not subject to the same prudential requirements and regulatory oversight. That is, the measures would apply a competitive advantage to those financial institutions that are less safe. This could lead to many unintended consequences, but foremost could be higher costs for the community and government from the failure of less safe institutions.

4.3 Safety benefits

Maintaining safety brings very significant benefits for our customers. Because The Westpac Group had applied caution to lending standards and was well financed with a diversified source of funds, it was in a position to continue lending to customers even during a period of turmoil such as the GFC.

As mentioned previously, The Westpac Group continued to grow in the provision of mortgages and other services while other lenders were constrained. The securitised mortgage lenders are subject to particular constraints and many have left the

market. RAMS came under the wing of The Westpac Group and is able to lend again.

The ability to lend and provide mortgages over the period of the GFC, and after, has helped the Australian economy recover. This assisted the effectiveness of the fiscal stimulus and other measures provided by the Government, while it is likely that limiting lending, especially for housing, would have reduced the effectiveness of policy and dampened the economic rebound that Australia has experienced.

4.4 Balancing competition

Competition has increased in the Australian banking market since the 1990s.

Customers in Australia's banking market experienced a reduction in banking costs and fees over this time. However, it is also difficult to ignore that some of the new competitors (including non-bank mortgage providers) that entered the market over this time have ceased operating, and that some still operating today are struggling to attract funds.

Australia avoided the worst of the GFC, benefiting from a well-regulated and profitable banking sector. It is vital to weigh a desire to increase the number of entities in the market against the safety of the market for customers, for existing financial institutions, and for the nation.

A recent study from the UK casts additional light on the balance between competition and safety.

Bain and Company reviewed the banking sectors of 30 countries examining the balance between competition and stability. A key result of that analysis, which is summarised in an article *'Getting bank competition right post-crisis'* (Bain 2010), was that the cost of periodic instability in the UK outweighed the costs of reduced competition by a factor of four times.

Interestingly, Bain and Company used Australia's experience as an example where it was possible to get the best of both worlds; stable markets and good consumer outcomes.

Chapter 5

Facilitating competition and contestability

5.1 A wide range of ideas to facilitate competition

In recent weeks there has been significant debate about ideas intended to increase competition within Australia's banking sector and a range of ideas has been put forward by different sectors of the community. Some of these ideas involve:

- further regulation of the banking sector including: re-regulation of interest rates, banning and/or limiting product fees, prescribed products (including mandated 'fair price' loans and low-fee basic accounts), and, the introduction of price signalling legislation;
- measures to provide 'competitive assistance' or preferential treatment to non-bank and regional lenders;
- measures to facilitate the creation of a 'fifth pillar' in Australia's banking system, based on credit unions and building societies;
- measures to facilitate customer switching (including account number portability); and
- options to lower the cost of capital and improve liquidity (including changes in the tax regime and the capital adequacy requirements, options to enable new sources of funding and the provision of government guarantees).

While well intentioned, some of the proposed measures to increase competition could bring unintended consequences. We are particularly cautious of any moves that increase funding availability to financial services providers who may not have the same underwriting standards, capitalisation, profitability benchmarks or regulatory overview as the banks and other ADIs.

It must be remembered that government support arrangements in the US contributed to sub-prime lending and reductions in safety. These factors, amongst others, caused a financial crisis in the US, and led to the GFC. In Australia, a number of the new entrants and mortgage providers did not fare so well. This is reflected in their reduced capacity to act to offer mortgage finance (UBS 2010b, p.5).

As highlighted in previous parts of this submission, the well managed, well regulated and profitable nature of the Australian banks was one of the primary reasons that the Australian economy weathered the GFC.

5.2 Supporting customer flexibility and choice

Easy Switch

The Easy Switch service is an existing service available to all customers.

As a result of the industry wide Account Switching initiatives agreed with Treasury, Australian Payments Clearing Association (APCA) and the Australian Bankers'

Association (ABA), effective 1st November 2008, a listing and switching service was introduced that would provide customers with information on all their direct debits and credits and periodical payments for their transaction accounts.

The listing service provides a statement of regular transactions for the customer to take to their new bank.

The switching service facilitates the redirection of payment transactions to the new account. The Easy Switch service is available to customers of Westpac, St.George and BankSA opening an account and is a free service to assist with change of banking and payment instructions. This service provides the customers with guidance and practical advice, with examples, to ensure all arrangements have been considered. This includes online information, a checklist of typical steps and standard template documents that can be completed as relevant to the needs of individual customers.

Further improvements could be made to this service by way of:

- extending the service to support other product types, particularly mortgages;
- making the service a "one-stop-shop", with the new financial institution (FI) liaising with the old FI to get the listing of transactions; and
- more effective promotion and communication of the service.

There are other proposals, which require further investigation and detailed cost-benefit analysis:

- reducing the effort required from the customer by the new FI taking the responsibility of informing all payment partners. A new mechanism of initiating changes in the billing and paying institutions' records is needed. This may prove to be cost prohibitive on further investigation; and
- automated transaction forwarding and notification for a fixed period. This will allow more time for the customers to notify other parties of their new arrangement. This approach has been tried in other geographies e.g. the Netherlands. Further investigation is required to determine the cost of this to The Westpac Group and to the industry generally.

Me and My Bank Online

Westpac is also actively participating in the implementation of MAMBO (Me And My Bank Online) as an industry wide initiative to facilitate portability by introducing an online payment address that customers can take with them as they change banks. This will be a modular and flexible service that expands customer choice by creating a single online payment identity that can be transferred if a customer switches financial institution.

5.3 Account number portability

The idea of account switching is being talked about as a way to provide increased flexibility to consumers and improve competition across the banking sector. The Westpac Group encourages measures to promote ease of switching between institutions.

Portability of an account number relates to a customer's ability to retain a particular number, which identifies his/her account when moving from one financial institution to another.

The process of taking your account number with you when changing banks has been compared to the process that exists when a mobile phone customer changes telecommunication providers, and opts to keep their telephone number.

While the comparison with mobile number portability seems logical, there are reasons why its implementation in banking is impractical. Like banks, telecommunication companies also have account numbers to represent arrangements with their customers. These account numbers are not portable. However, they have an external representation (the phone number).

A similar external representation does not exist in banking, the account number serves as both the internal and external representation of a customer's account and arrangements with the bank.

Bank account numbers comprise:

- a Bank-State-Branch Identifier (BSB), which is issued by APCA, and which is used as the primary routing mechanism between financial institutions; and
- a proprietary account number component that is an internal identifier, which has no industry standard format.

As well as the banking industry, all industries that participate in payments rely heavily on BSB and account numbers as the identification for a customer's unique product. All payment, routing, settlement and existing systems infrastructure is built on this fundamental unit of identification.

Industry-wide systems and mechanisms, including payment schemes, clearing houses, government bodies and APCA, are affected. Further, according to APCA, "government agencies and employers rely on the current system to make sure that they can pay into bank accounts for individuals, whether it is government benefits, wages, salaries, etc." (APCA, 2008, p.29-30).

The Westpac Group does not believe that the introduction of account number portability in the Australian context will make a material difference to account switching. In fact, "churn" rates of 8 per cent relating to the opening and closure of transaction accounts demonstrate that customers have not been finding it difficult to switch their accounts. Furthermore, there is also considerable "churn" in housing lending, with 30 per cent of home loan applications each year representing switching borrowers. These figures suggest that Australia does not have a bank switching problem and that there is an adequate level of competition already across the industry.

There are other approaches to improving portability that are practical and cost effective.

5.4 Mortgage fees

Mortgage entry and exit fees are sometimes seen as barriers to competition, because they are thought to act as a disincentive to consumers wanting to change banks.

In comparison to many other countries, Australia has relatively low entry and exit fees (see Figure 5.1). The entry and exit fees that the big four banks in Australia charge are together under those of the UK, and are comparable to those of the US. The difference in exit or termination fees between Australia and the UK is often attributable to the regulatory regimes operating in each country (ASIC, 2008, p.11).

The structure of Australia's mortgage fees is broadly on par with that of other countries and this is recognised by the Australian authorities. For instance Deputy Governor Battellino of the Reserve Bank of Australia stated, during his testimony into the 2008 Inquiry into Competition in the Banking and Non-Banking Sectors, that:

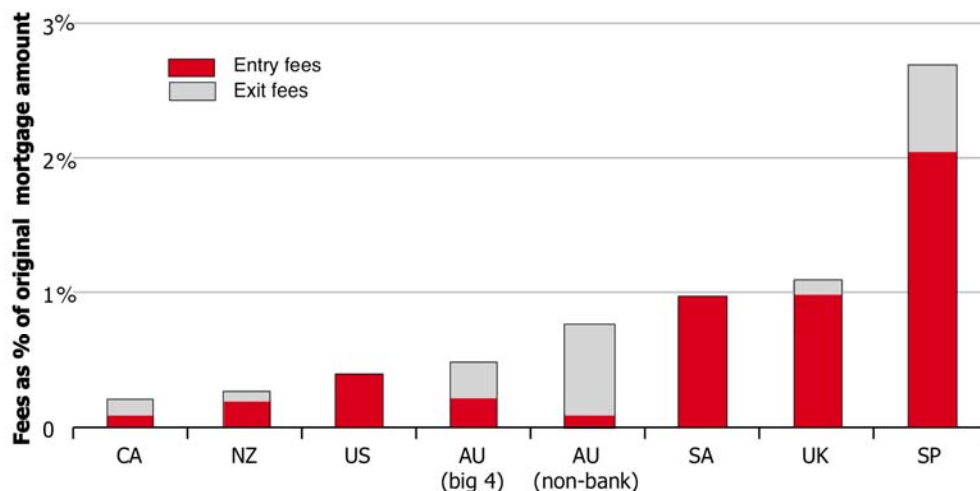
> "… by international standards we have relatively high exit fees on mortgages but we have very low entry fees. That is just the way in which banks price things here. There are advantages and disadvantages in both systems." (RBA, 2008b, p.14).

and that:

> "If you take the sum of the loan establishment fees and the exit fees, you find that, broadly speaking, they are in line with what we see overseas." (RBA, 2008b, p.14).

Figure 5.1

INTERNATIONAL MORTGAGE SWITCHING FEES COMPARISON



Source: Oliver Wyman, 2010.

What is most striking from comparison of entry and exit fees in Australia is the difference between fees applied by the major four banks and the non-bank lenders. Overall, the non-bank lenders apply higher combined entry and exit fees than the four major banks. It is notable that, on average, they apply a much lower entry fee than the major four, which is more than offset by higher exit fees. This is an effect of the vigorous competition in the mortgage market.

In Australia, mortgage fees are regulated under two laws, commonly referred to as the National Credit Code (NCC) and the Unfair Contract Terms (UCT) provisions of the ASIC Act (2001). Under the National Credit Code and the unfair contract terms provisions, borrowers and/or ASIC can challenge the validity of mortgage early termination fees that they think are unconscionable or unfair.

To assist lenders in understanding the impact of these laws, on 10 November 2010, ASIC published a Regulatory Guide indicating how it will enforce consumer protection laws on mortgage exit fees. ASIC's Regulatory Guide provided information about:

- the type of costs and losses that may be included in an exit fee;
- the type of costs and losses that may not be included in an exit fee;
- the circumstances in which a lender may vary exit fees;
- how lenders can explain their early fees transparently; and
- the break fees on fixed rate mortgages.

Notably, in releasing this regulatory guidance, ASIC also acknowledged the "diversity in the mortgage industry around pricing and structuring early termination fees". (ASIC 2010)

Neither the law nor ASIC's guidance on it prevents lenders from using flexible pricing in their residential loan offerings — including by offering discounted loan establishment fees or honeymoon-rate loans that can attract early termination fees. Rather, ASIC's guidance now clearly limits these fees, where they are applied, to the recovery of a lender's loss caused by the early termination.

New legislation affecting early termination fees may have the potential to hurt small lenders and non-banks and reduce competition:

- *They will significantly affect small lenders and non-banks' earnings* — while the biggest impact, naturally, would fall on the biggest mortgage lenders, the abolition of exit fees will have a more profound effect on small lenders and non-banks given that on average, their exit fees are about 2.7 times those of the major banks (Bartholomeusz, 2010).
- *They could hurt access to sources of competitive funding* — the abolition of exit fees and increased rates of switching and early repayment could make it difficult for the small lenders and non-banks to access securitisation markets (Bartholomeusz, 2010).
- *High exit fees and smaller lenders* — the highest exit fees are generally imposed by the smaller banks and non-banks, partly because they have been traditionally more reliant on securitisation for funding and need to deter early repayment or else compensate the investors in those securitised mortgage portfolios if they do not receive all the cash flows they have paid for. Thus, the abolition of exit fees may help to structurally entrench the banks' share of mortgage lending.

As stated in the 2008 Report for the Inquiry into Competition in the Banking and Non-Banking Sectors, when noting a point made by the Treasury:

> "… regulating entry and exit fees cannot improve competition, but rather competition can be improved through an informed consumer."
>
> House of Representatives Standing Committee on Economics 2008, p.79.

Reducing or eliminating mortgage exit fees is unlikely to result in lower switching costs. In fact, this would likely lead to the reintroduction of (or increases in) entry fees, which customers would then have to pay if they switch to a new lender. Ultimately, banks have to cover the cost of early termination and of establishing the loan, and consumers make a trade-off between interest rates and fees, with a lower headline rate having the potential to attract higher fees. As stated by the RBA, 'you will either pay [the costs of originating the loan]… at the beginning or you will pay it at the end. If you switch you cannot pay it at the end; you will pay it at the beginning for the new lender' (RBA, 2008b, p.14).

5.5 A broad-based banking inquiry

In addition to the Inquiry this submission helps to inform, a large number of financial services industry related reviews have been conducted in recent years including:

- Joint Committee on Corporations and Financial Services – Access to Small & Medium Business Finance (2011 – ongoing);
- Senate Economics Committee Inquiry into the Competition and Consumer Legislation Amendment Bill (2010);
- Senate Economics References Committee – Inquiry into Access of Small Business to Finance (2010);
- Senate Economics Committee Inquiry into the Banking Amendment (Delivering Essential Financial Services for the Community) Bill (2009);
- Senate Economics Committee – Inquiry into Bank Funding Guarantees (2009);
- Senate Economics Committee – Inquiry into Aspects of Bank Mergers (2009); and
- House of Representatives Economics Committee – Inquiry into competition in the banking and non-banking sectors (2008).

There are now calls for a detailed review of Australia's financial system, given that it has been some time since the last major review. The Campbell Inquiry, which reported in 1981, was the first major external investigation into the banking system since the 1935-37 Royal Commission into the Monetary and Banking Systems of Australia. The Wallis Inquiry came more than 16 years later. Some believe that since it is some 13 years after Wallis and given the upheaval wrought by the recent GFC, it may be timely to undertake a substantial investigation into the architecture of Australia's system.

Regular reviews of the banking system have served Australia well. However, at present, it is reasonable to ask whether the new global prudential framework is sufficiently clear and whether its impacts on the global and Australian financial system are sufficiently well understood to allow an inquiry to reach useful conclusions and recommendations for change. There needs also to be consideration of the focus that will need to be given by industry, government and

regulators over the next 12-24 months to ensure that the new regulatory frameworks are properly and rigorously implemented.

Examples of global specific reforms and reviews having the capacity to impact Australia's financial services system include:

- Basel III reforms on capital and liquidity;
- Dodd-Frank Wall Street Reform and Consumer Protection Act in the US;
- OTC Derivatives Market Reforms; and
- Financial Stability Board review on systemically important financial institutions.

Therefore, although we support in principle the concept that regular reviews of the financial system are warranted, we believe that in all the circumstances currently before us, it would be appropriate to conduct such a wide-ranging inquiry when major international and domestic regulatory change has settled down over the next three to four years.

Chapter 6

Funding measures to assist competition

Healthy competition is a key driver for the economy. Australia has a strong and safe banking system, which provides a sound platform for competition.

6.1 Measures to increase funding

There are a number of options individually and collectively that could be used to diversify the existing funding base, alleviate the funding challenges facing Australian banks and drive increased competition in the banking sector. These are discussed below.

Tax treatment of savings

The deficit or shortfall between the demand for funds from mortgage borrowers, small businesses and other customers and the amount of funds raised from domestic deposits drives the need to rely on wholesale markets. This deficit in Australia is likely to continue to widen unless there is a structural change that not only encourages Australia to be a nation of 'savers', but also provides a more balanced proposition.

Australia does not have a savings problem per se. With around $1.2 trillion in superannuation our natural savings rate over the last 10 years is similar to banking in self-funded nations such as Germany and France. Australia's high bank loan to deposit ratios are therefore not from a low saving rate.

However we do have a regime that attracts savings outside the banking system and increases complexity.

To address this we should work towards tax equalisation between bank deposits and other competing savings options. This would be expected to directly encourage Australians to save more within the banking system.

An example of this type of initiative is the 50 per cent tax discount on interest income of up to $1,000 (including interest earned on bank deposits, bonds, debentures and annuity products) included in the Federal Budget 2010. While this initiative is in line with the Henry Review recommendations, the review panel's recommendation was for a 40 per cent discount on all investment income and losses, uncapped. The Westpac Group supports the recommendation of the panel.

Covered bonds

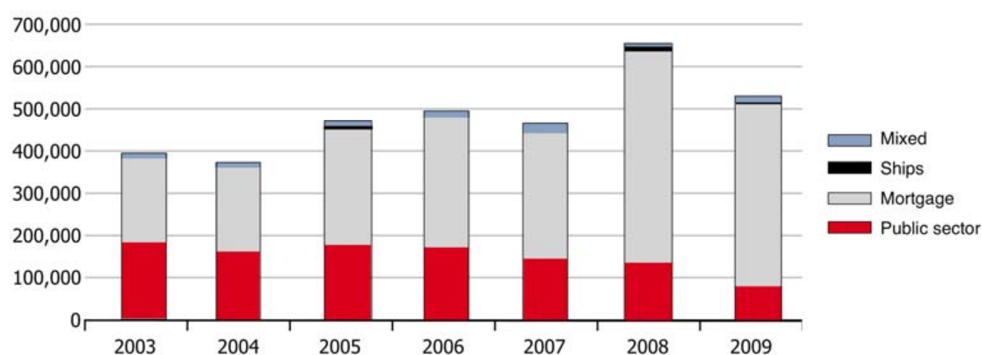
A covered bond is a full-recourse secured debt instrument issued by a bank or other financial institution. The security for the bond is not over the bank's or financial institution's assets generally, but is given over a designated pool of assets, typically high-quality mortgage loans. The pool of assets secure (that is, they 'cover') the bond obligations, creating a class of debt instruments that feature higher liquidity, a longer term before repayment and a lower cost of funds (Blake Dawson, 2009).

These types of bonds are a widely used funding mechanism in the UK, European markets and most recently New Zealand. Covered bonds are a funding mechanism not available to the Australian banking industry. Currently, regulatory standards do not support the issuance of covered bonds by ADIs because of the depositor protection provisions of the Banking Act. A possible solution would be to amend the Banking Act to allow ADIs to issue covered bonds up to a balance sheet cap. This additional funding diversity would strengthen the banks' funding positions as covered bonds provide access to a broader class of investors.

Covered bonds through the GFC provided a stable source of funding in other countries, retaining their broad investor acceptance. They have stood the test of time including a significant number of economic cycles and financial crises, and as economic and financial infrastructure has evolved.

Figure 6.1

COVERED BONDS ISSUANCE BY YEAR AND BY CATEGORY (€M)



Source: European Mortgage Federation, European Covered Bond Council, 2010

A concern regarding covered bonds is that they could inadvertently worsen competition as, if introduced, the major banks are expected to be able to issue them under better terms and in larger volumes than the smaller banks. Further, regional banks may not be able to issue them, as covered bonds generally work for issuers who are rated above a certain level (such as A). There are a number of approaches that can be used to overcome this issue:

- Spain and France have a solution to this problem with the creation of a multi-user conduit that allows smaller banks with lower credit ratings to issue AAA rated covered bonds;
- to address the volumes issue, small lenders could be allowed to pool loans to sell covered bonds through a central issuer (rather than each lender issuing small, illiquid lines); and
- combine the introduction of covered bonds with the strengthening of the RMBS market.

6.2 Strengthening the RMBS market

Strengthening the RMBS market can provide temporary relief to funding constraints and improve liquidity in the Residential Mortgage-Backed Security (RMBS) market

and consideration should be given to additional investment by the Australian Office of Financial Management (AOFM).

Since the late 1980s, the securitisation of mortgages into RMBS has provided an important source of funding for new and small mortgage lenders to compete with the major banks in lending for housing (AOFM, 2009). In light of the developments in global financial markets in 2007-08, the Australian Government decided to invest in Australian RMBS to support competition in Australia's mortgage market during the market dislocation.

In October 2008, the Treasurer directed the AOFM to invest up to a total of $8 billion in eligible RMBS, including $4 billion to be invested in securities by issuers that were not Authorised Deposit-taking Institutions (non-ADIs). The allocation to the non-ADI sector was made in conjunction with the Government's decision to guarantee the deposits and wholesale funding of ADIs. Given the continued dislocation of the RMBS market, in November 2009, the Treasurer directed the AOFM to invest up to an additional $8 billion in RMBS.

To date, the AOFM RMBS investment program has deployed about $12 billion to fund smaller lenders (AOFM, 2010).

Global markets for RMBS are still dislocated. As RAMS' founder and RHG Chairman John Kinghorn said on 12 November 2010, "…[T]hese markets have been closed since the GFC with no likelihood of reopening in the foreseeable future. When they do ultimately reopen, it is believed they will re-open with a significantly higher premium for risk." (Kinghorn, 2010, p.1)

Therefore, the continuation of the AOFM investment in RMBS beyond the announced limit would have the following benefits:

- preserve the competitive landscape while markets stabilise; and
- continue to provide liquidity to the mortgage market, in particular to non-bank lenders.

6.3 Securitisation of alternative asset classes

In addition to securitisation tools directly related to residential mortgages, there are other classes of loans that can be securitised. Developing such markets will improve the competitive landscape through enhanced funding opportunities.

Credit cards and car loans are important consumer products and are one of the most liquid securitisation classes in the world. The securitisation of these other assets by Australian institutions is under-developed as we are not currently able to utilise the Master Trust format, which is the current, global standard for Asset Backed issuers.

If the prudential standards were modified to specifically allow Master Trust issuance it would help open this market to Australian issuers, improving the funding opportunities for Australian financial institutions.

Box 6.1

SUMMARY OF PROPOSED MEASURES

Options that could be used to diversify the existing funding base, to help alleviate the funding challenges facing Australian banks and drive increased competition in the banking sector include:

- work to achieve better tax equalisation between bank deposits and other, currently more tax favoured, savings opportunities for Australians;
- create a framework to allow covered bonds to be issued by Australian ADIs;
- strengthen the RMBS market through continued AOFM investment; and
- allow master trust format for securitisation of alternative asset classes.

Conclusion

Australian banking has been transformed over the last three decades. The system enabled by financial deregulation, securitisation and prudential regulation serves Australia and Australian consumers well, and helped us withstand the worst impacts of the Global Financial Crisis.

The ongoing ramifications of the GFC show that we need innovative solutions to ensure our system continues to function as well as possible. The GFC caused a structural adjustment in how Australian financial institutions and lenders fund themselves. This new equilibrium means that the global sources of funds on which banks rely to meet the demands of their customers will remain more expensive.

We recognise that increasing interest rates causes pain for small businesses and families who borrow. That's why we're committed to working with the Government and regulators, our customers and the community to implement workable long term solutions to address funding pressures to help keep lending interest rates low and competition healthy.

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