7 December 2010

John Hawkins
Secretary
Senate Economics References Committee
Parliament House
CABBERRA ACT 2600

Dear Mr Hawkins

Inquiry into Competition in the Australian Banking Sector

The Australian Financial Markets Association (AFMA) represents the interests of participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign banks, all of the leading stockbrokers and investment banks, fund managers, energy traders and other specialised markets and industry service providers.

Australia has efficient and competitive wholesale banking and financial markets. This is important in the context of the inquiry because they are an essential building block for the provision of cost effective banking and investment services to retail consumers. More generally, financial markets are central to a productive economy by promoting national saving, the efficient use of capital and effective management of risk. Banks and other market participants perform a range of essential roles in the financial system, including credit intermediation, broking and market making. The major markets in the Australian financial system include the capital markets, money market and derivatives markets. Australia's financial markets are sophisticated in global terms.

AFMA welcomes the opportunity to make a submission to the Committee in relation to its inquiry into competition in the Australian banking sector. In keeping with our mandate as an industry association, the focus of this submission is on the competition that exists in the wholesale banking and financial markets. In summary, we believe:

- Competition in lending to large business is robust, reflecting variety in both the providers of finance and the markets in business finance;
- Competition and diversity in the exchange traded and over-the-counter (OTC) financial markets is strong;
- Government policies over many years promoting development of the financial markets and competition have largely been successful;
- The Government should accelerate implementation of its decision to boost

banking competition by removing non-resident interest withholding tax;

- Government intervention in the markets requires careful judgement to avoid unintended effects or distortions to economic outcomes.

1. **Competition in Wholesale Banking**

The market for lending to large corporates in Australia is competitive. Providers of corporate loans face competition from a number of sources including:

i. Domestic banks, foreign banks and other financial institutions in Australia;

ii. Offshore banks lending to Australian corporates;

iii. Capital markets, especially the domestic and international debt securities markets.

1.1. **Financial Institutions in Australia**

Business credit is provided by a broad range of financial institutions including banks and other Authorised Deposit-taking Institutions (ADIs) that are prudentially regulated by APRA, as well as money market corporations and finance companies. As outlined in Table 1, the market for business credit is more diversified and less concentrated than the market for household credit. In addition to the major banks, the other domestic banks and foreign banks also contribute significantly to the financing of business.

Table 1: Sectoral Lending by Financial Institutions - Market Share, September 2010

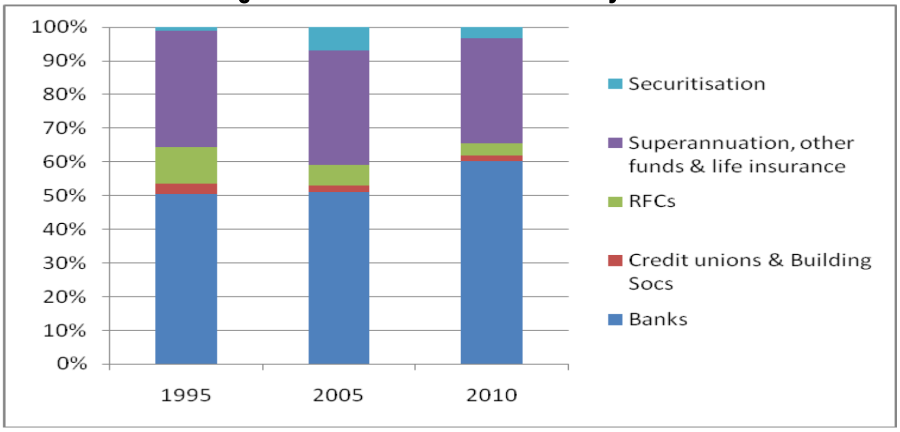
	Business lending	**Household lending**
Major 4 banks	63%	74%
Other domestic owned banks	8%	6%
Foreign bank branches	12%	0%
Foreign bank subsidiaries	4%	5%
Credit unions & Building societies	0%	5%
Registered financial corporations	12%	2%
Securitisation (mortgages)	-	9%
Total $ billion Lending	$483bn	$1,282bn

Notes: Business lending is lending to non-financial corporations of all sizes. Household credit includes home loans, housing investment loans, credit card and other loans. Registered financial corporations include money market corporations and finance companies (excluding financial leases). Derived from data published by APRA and RBA .

Foreign banks have a much larger presence in the business banking market, reflecting the focus of foreign bank branches on wholesale clients in keeping with their regulatory obligations. They have contributed significantly to competition in the domestic banking market since policy reforms introduced in 1992 enabled the establishment of foreign bank branches. Over the following decade, the largest merchant banks (which are not prudentially regulated by APRA) and many licensed bank subsidiaries converted to foreign bank branch status in response to a range of business and regulatory factors.

Registered financial corporations include money market corporations that primarily lend to large corporations and finance companies that provide loans to households and small- to medium-sized businesses. Their relative importance has declined significantly over the last 15 years, as outlined in Figure 1, in large part reflecting the transfer of business by many merchant banks into APRA regulated bank operations.

Figure 1: Structure of Financial System



Note: Derived from data published by Reserve Bank of Australia.

Foreign bank branches are particularly important in the large business loan market that is of most concern to AFMA and they increased their Australian resident assets at an annual average rate of 31% in the 5 years to December 2007 (more than double the rate of growth for all banks). This contributed to a significant reduction in the cost of loan finance to business prior to the global financial crisis (GFC).

The Reserve Bank of Australia observed in the March 2007 Financial Stability Review:

> *"Much of the pick-up in foreign-owned banks' business lending growth has been in 'large' loans (defined as loans over $2 million), with these banks accounting for around one quarter of outstanding bank loans of this size. The activity of foreign-owned banks appears to have been one of the catalysts for stronger competition in this market, which in turn has been associated with a contraction in lending margins."*

The GFC had an adverse impact on the credit market, as banks globally sought to re-evaluate and re-price risk, which led to a raise in margins. Another consequence was a reduction of 25% in foreign bank branches' balance sheets between December 2007 and September 2010, in part because of global consolidation of lending by international banks in response to the GFC. Experience varied across banks with some significantly increasing their lending over this period contrary to the aggregate trend. Foreign bank subsidiaries and 'other domestic banks' also experienced a reduction in their balance sheets over this period, in part because some banks were acquired during the GFC.

The Reserve Bank has observed that competition has again become more intense since the end of 2009, through renewed activity of foreign banks, together with continued improvement in capital markets. This is evident through a reduction in the margins to large business lending from their recent peak and some banks also have applied less restrictive loan covenants in some areas.[1]

1.2. **Offshore Banks Lending into Australia**

The Australian Government's policy to operate a very open financial system has been successful in the wholesale sector, with foreign financial institutions participating in our banking and financial markets, either directly by basing operations in Australia or indirectly by investing in Australian securities and lending to Australian companies.

1 Reserve Bank of Australia, Financial Stability Report, September 2010.

The syndicated loan market is an important financing market for Australian companies and it benefits from participation by the major Australian banks and foreign banks based in Australia and overseas. Banks who participate in the market heighten competition for the provision of finance to large companies. Syndicated lending involves large loan amounts, often $500 million or more, and is provided through a single loan agreement under which a number of banks provide funds to the borrower and take the credit risk for their portion of the total loan.

The Reserve Bank commented in its March 2007 Review that:

> *"Domestic banks face competition from banks located overseas, with the value of cross-border loans outstanding to Australian businesses increasing strongly in the past two years, to stand at around $45 billion at end 2006, compared to an average of around $20 billion over the preceding decade"*

Foreign-owned banks continued to participate in syndicated loan deals throughout the turmoil period, and more recently the market has expanded. The major domestic banks collectively accounted for 50% of the syndicated loan market in the first nine months of 2010, when US$35 billion was raised.[2] Banks from Europe, China, Japan and the US were the other most prominent lenders in this market over this period.

2. **Capital Markets**

2.1. **Debt Capital Market**

The offshore debt securities market is a major alternative source of funds for Australian corporates and, thus, provides competition to bank intermediated finance. The market has experienced strong trend growth of almost 15% over the last decade. For instance, the US private placements market is attractive to Australian companies and an important source of finance to them because it has good liquidity, long dated debt finance is available and deals may be brought to market quickly.

Corporate bond issues have similar characteristics to intermediated debt, such as syndicated loans, as they provide large amounts of finance, involve at least several financiers and may suit large companies. However, corporate bonds and loans are not perfect substitutes for borrowers or investors because loan arrangements are more flexible and, while loans may be tradeable, bonds have superior marketability

Lending has changed in the post-global financial crisis environment, with credit tightening and lending institutions becoming relatively more risk averse. However, the market has managed to sustain its development and Australian companies (ie non-financial corporates) had $119 billion in long term debt securities on issue in overseas markets at end-September 2010.

Government tax policy changes that have gradually reduced the interest withholding tax burden on non-resident investors, for example through renegotiated international tax treaties and expanded s.128F relief, have helped to sustain development of this market. More recently, the law amendment last month to reverse the effect of the Sons of Gwalia High Court decision is helpful because it restores certainty for international investors that their claims will rank ahead of shareholder claims on a company.[3]

2 Comments are based on Thomson Reuters data.
3 Corporations Amendment (Sons of Gwalia) Bill 2010.

Issuance by non-financial corporations in the Australian corporate bond market is smaller than the offshore market with $42 billion outstanding at end-September 2010. The Australian Financial Centre Forum's Report into Australia as a financial centre made recommendations to develop a retail bond market that are being acted upon by the Government, which may assist the further development of this market. This would complement reforms recommended by the Australia's Future Tax System Review's Report to increase the competitiveness of the tax system for investors' interest income, which is being implemented in part by the Government (now deferred by one year).

We note that non-financial corporations account for only 10% of the private sector bond market in Australia. Banks and other financial institutions are the main issuers of bonds accounting for 40% of the market, followed by non-residents (kangaroo bonds) at 30% and asset backed bonds at 20%. This complements the government bond market in providing a range of fixed interest investment opportunities for investors.

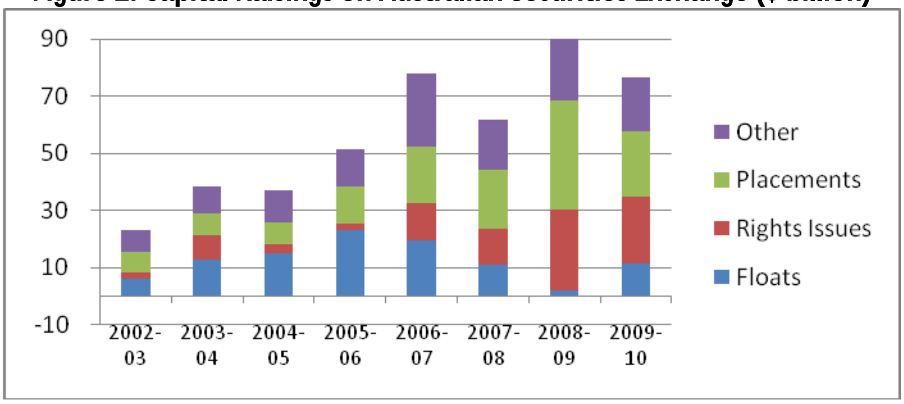
Data on the management and underwriting of debt issues show there is a broad range of domestic and international banks and securities firms that service the domestic and international bond market. The institutional arms of the major Australian banks accounted for half of the issuance in the first 9 months of 2010, with North American and European banks also particularly prominent in the market.

2.2. **Equity Capital Market**

Companies seeking to raise finance for investment may tap the equity market as an alternative to debt funding though bank loans or marketable securities. While the intrinsic properties of debt and equity differ in fundamental ways, from both an issuer and an investor perspective, they are imperfect substitutes that may have more or less relevance at different points in time.

For example, the ability of listed companies to raise equity capital quickly and efficiently during a period of turmoil in the GFC when debt markets were constrained was an important mechanism enabling many companies to reduce debt exposure and strengthen their balance sheet (see Figure 2). Consequently, leverage in the corporate sector declined during the GFC, with intermediated debt being replaced by record raisings of equity.

Figure 2: Capital Raisings on Australian Securities Exchange ($ billion)



Note: Derived from ASX data

The capital raising market in Australia is serviced by a wide spread of stockbrokers and investment banks but it is dominated by foreign-owned firms. It is a highly competitive with the top 4 firms accounting for 50% of the market in the first nine months of 2010. [4]Investment banking fees for underwriting and advice during 2008 and 2009 were justunder 2%, which compares well against fees of 3% or more in the US and otherinternational markets. Australia is regarded as having one of the most competitiveinvestment banking markets in the world.

The experience of the GFC shows that more flexible capital raising arrangements available in Australia, assisted by corporate law reforms in 2007 to improve the efficiency of secondary market raisings, enable the economy to better adapt to volatile economic circumstances and have helped promote financial stability. In summary, the reforms aimed at making capital raisings more flexible and efficient have served the economy well.

ASX has observed that the corporate bond market in Australia, in contrast to the equity market, remains relatively underdeveloped and does not provide as robust an avenue for raising long-term capital. While government and industry led initiatives are underway to further develop the corporate bond market, it is evident that the equity market will remain as a significant alternative source of finance to both bank loans and marketable debt.

3. Competition in the OTC Financial Markets

Anecdotal and survey evidence supports the contention that Australia's wholesale banking and financial markets are competitive. The wholesale OTC markets are substantially institutional markets, have a broad range of participants and are not dominated by any particular group of banks. They provide a wide range of essential liquidity, investment and risk management services to the financial services industry and to their business clients.

Efficient and competitive institutional OTC markets are also an important component in the provision of cost effective financial services to retail clients. Financial intermediaries provide a range of economic functions, such as maturity transformation of deposits into longer term loans, that can only be undertaken in a low cost manner if deep and efficient markets are available for them to actively manage the associated financial risks. Fortunately, Australia is well serviced by a range of cash and derivatives markets (both exchange and OTC markets, which are interconnected) that provide a wide range of products and services and are competitive.

In a survey of foreign banks in 2005[5], respondents viewed the following markets as moderately to intensely competitive:

- Money market (88% of respondents)
- FX and derivatives markets (92% of respondents)
- Equities market (90% of respondents)
- Treasury products/services (100% of respondents)
- Investment banking (87% of respondents)
- Lending (92% of respondents)

4 ISS Governance – Equity capital raising in Australia during 2009, August 2010.
5 PricewaterhouseCoopers, *A Survey of Foreign Banks in Australia*, 2005.

Analysis of market turnover data for 2009-10 provides evidence that is consistent with the views expressed in the 2005 survey and with the anecdotal feedback by members. Table 2 illustrates this conclusion by reference to the collective market position of the four major Australian banks. It is evident that the major four banks are key players in the wholesale financial markets but they do not have an individual or collectively dominant position in the markets. There is a wide range of competing banks from Australia, North America, Europe and Asia that also compete in these markets. The largest firms compete across the product range, while others have a more specialised presence in the markets. Typically, firms are strong in a number of particular markets but not in all.

Table 2: OTC Markets in 2009-10 – Selected Market Share Data[6]

Market	Market turnover ($ billion)	Major 4 banks Market share	Top 4 providers Market share
Government bonds	928	30-40%	59%
Non-government bonds	675	60-70%	75%
Foreign exchange	40,274	30-40%	63%
Interest rate & cross currency swaps	5,923	60-70%	67%
Forward rate agreements	4,519	50-60%	62%

The electricity derivatives market is dominated by generators and retailers, with intermediaries having a smaller role; although it too is diverse (top four traders account for 54% of the market).

A joint RBA, ASIC and APRA *Survey of the OTC Derivatives Market in Australia* in 2009 found that Australia's OTC markets remained robust during the GFC, with greater attention paid to the management of operational, credit and market risks. The Survey reinforces the industry view that our OTC markets were relatively stable and were resilient during a period of great strain in global financial markets. We believe this is largely the result of the balanced character of our OTC derivatives market, Australia's comprehensive system of regulation and our market infrastructure.

4. Comments on Policy Issues

4.1. Retail Banking Services

Healthy and competitive wholesale banking and financial markets support innovation and competition across the system. Most obviously, this helps to reduce the cost of funding and financial services for Australian business and enhances both the quality and range of products and services offered to them.

It also provides significant downstream benefits to retail consumers by reducing the costs of inputs to the provision of those services. For example, a bank that raises funds on the international debt markets to support its consumer loan business would use the cross currency swap market to manage the associated currency exposure and would incur a cost in doing so. These costs are reduced, and the cost of the consumer loans reduced, if the wholesale markets operate efficiently.

Wholesale markets have the capacity to support competition within the retail market by

6 Derived from data compiled for the *2010 Australian Financial Markets Report*, AFMA.

providing a mechanism for non-bank entities that wish to participate in the retail market to fund their business. The securitisation market is the most obvious example of this, which had a particularly significant impact by reducing home loan margins in the[7] mid-1990s. While the securitisation market experienced a serious setback during the GFC, the Reserve Bank recently observed that the market is slowly returning to life and expects it will again play a useful role in the provision of credit in Australia.

Effective wholesale markets also assist product development and innovation in the provision of retail banking services. For example, banks offering investment loans for shares often offer the borrower a capital protection facility to manage their market risk and this is enabled by the ability of the bank to efficiently hedge the risk it takes through the share and derivatives markets. Similarly, a bank that offers a capped interest rate loan to consumers may hedge its associated risk in the interest rate derivatives markets.

4.2. **Regulatory Issues**

Australia's long term policy of maintaining an open financial sector that facilitates participation by domestic and foreign bank intermediaries has been successful in promoting competition in the wholesale banking and financial markets. While there have been important milestones, like opening the market to foreign banks in 1985 and introducing the foreign bank branch regime in 1992, significant progress has been achieved through incremental changes that gradually provided a more neutral regulatory and tax environment for both domestic and foreign financial entities.

The regulation of the Australian financial sector has been significantly extended recently, though the introduction of consumer credit reforms, new unfair contracts regulation, securities lending and short selling disclosures, amongst other things. There is a steady stream of ongoing changes to regulation covering the prudential regulation of banks as the Basel III reforms are implemented, financial markets regulation and reforms to the regulation of financial advice. Care needs to be taken in the design and development of regulation to avoid the creation of unnecessarily high regulatory barriers to entry, which could have adverse competition effects (apart from the additional regulatory cost that must be borne by providers and their clients).

Fundamentally, Australia's financial system and its regulation operate effectively and have served the economy well, as was demonstrated during the GFC. We believe the industry understands the rationale for the changes that have been foreshadowed, as outlined above. Any further changes that might be considered should be measured and well-targeted to achieve specific objectives. In particular, care should be taken to fully test the implications of all policy changes and to minimise the risks from unintended consequences in the implementation of policy, including the intrusion of retail regulation into wholesale markets.

4.3. **Non-resident Interest Withholding Tax**

One of the lessons from the past is that measures to improve accessibility to international capital markets can assist the effectiveness and competitiveness of our banking and financial markets. An example of this is the tax amendment in 1996 to

7 The State of Play in the Securitisation Market, Guy Debelle, Reserve Bank of Australia, 30 November 2010.

extend the interest withholding tax exemption to funds used to make home loans, the objective of which was to inject further competition into the home loan market. This provided securitisation vehicles with more cost effective access to the international markets, with peak offshore asset backed issues of $100 billion in 2007. Another example is the extension of the s.128F interest withholding tax exemption for foreign bank branches in 2001, which helped them to build their presence in the business loan market in a cost effective manner.

In response to recommendations in the *Australia's Future Tax System* (Henry) review and the Australian Financial Centre Forum (Johnson) report on *Australia as a Financial Centre,* and as a means to boost bank competition, the Government announced reforms to reduce interest withholding tax including:

- For local subsidiaries of overseas banks, the interest withholding tax rate will be reduced on such borrowings from 10 to 7.5% in 2013-14 and to 5% in 2014-15.
- The interest withholding tax rate applying to borrowings by any bank branch from its overseas head office will be reduced from 5 to 2.5% in 2013-14 and to zero in 2014-15.
- Treasury is reviewing the Johnson report's recommendation to abolish the LIBOR cap on inter-branch funding by foreign bank branches.

AFMA believes there is a strong case to accelerate the introduction of these measures to enhance banking competition, as they will not have the desired impact until they are legislated. This greater flexibility of funding accorded to foreign bank branches would also assist them to prepare for the introduction of the Basel III liquidity reforms.

More generally, further interest withholding tax reform is desirable because this tax places an additional cost on, and is an impediment to, overseas funding by financial intermediaries. In this regard, we believe the Government should accept the Johnson and Henry Report recommendations to remove the withholding tax impost on financial institutions' foreign funding, as this would improve their access to cost effective funding from overseas sources. Not all existing funding sources are eligible for the current interest withholding tax exemptions (eg offshore retail deposits are not exempt), so this measure would promote further diversity in funding and reduce potential pressures on the cost of financial intermediation that may arise from time to time.

The reform is also significant because banks play a vital role in financing the current account deficit by raising funds overseas to on-lend to Australian business and by arranging and underwriting the issuance of securities by Australian companies in overseas markets. Thus, it is desirable from a macroeconomic perspective that the tax system does not present an unnecessary barrier to attracting investment into Australia.

5. **Concluding Comments**

This submission demonstrates that the wholesale banking and financial markets in Australia work well and are strongly contested by Australian and foreign financial institutions. Moreover, the efficiency of the wholesale markets helps to lower the cost of funding to financial institutions, to the benefit of Australians generally. The interest withholding tax reforms recommended by the Henry and Johnson reviews would promote competition and more cost effective funding for financial institutions and should be implemented as soon as is practically feasible.

AFMA appreciates the opportunity to make this submission to the Inquiry. You may contact me if you wish to discuss any matters arising from our comments.

Yours sincerely

Duncan Fairweather
Executive Director