Parliament of the Commonwealth of Australia

The House of Representatives Standing Committee

on Finance and Public Administration

A POCKET FULL OF CHANGE

Banking and Deregulation

November 1991

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FOREWORD

The past decade has been one of great change for the Australian banking industry. Deregulation of the financial system has produced a new and more challenging environment for banks and their customers. Banks have faced the rigours of more intense competition, as their traditional relationship with customers has been transformed.

The changes which have taken place have resulted in significant benefits to Australia. It is evident that a more responsive and innovative banking sector is emerging in the wake of deregulation. These changes, though, have not been achieved without cost.

Community concerns about banking policies and practices led to the establishment of this inquiry. Clearly, it is one of the most significant reviews yet to be conducted by a parliamentary committee.

The inquiry provided a valuable opportunity for the Committee to assess the results to date of financial deregulation. This report can be viewed as a balance sheet for the banking industry in its first decade of deregulation.

More importantly, though, the Committee, through this report, is looking to the future of the banking industry, as Australia prepares to meet the challenges of a new century. The Committee's recommendations are aimed at ensuring a secure, competitive and fair banking sector at the heart of a stable financial system.

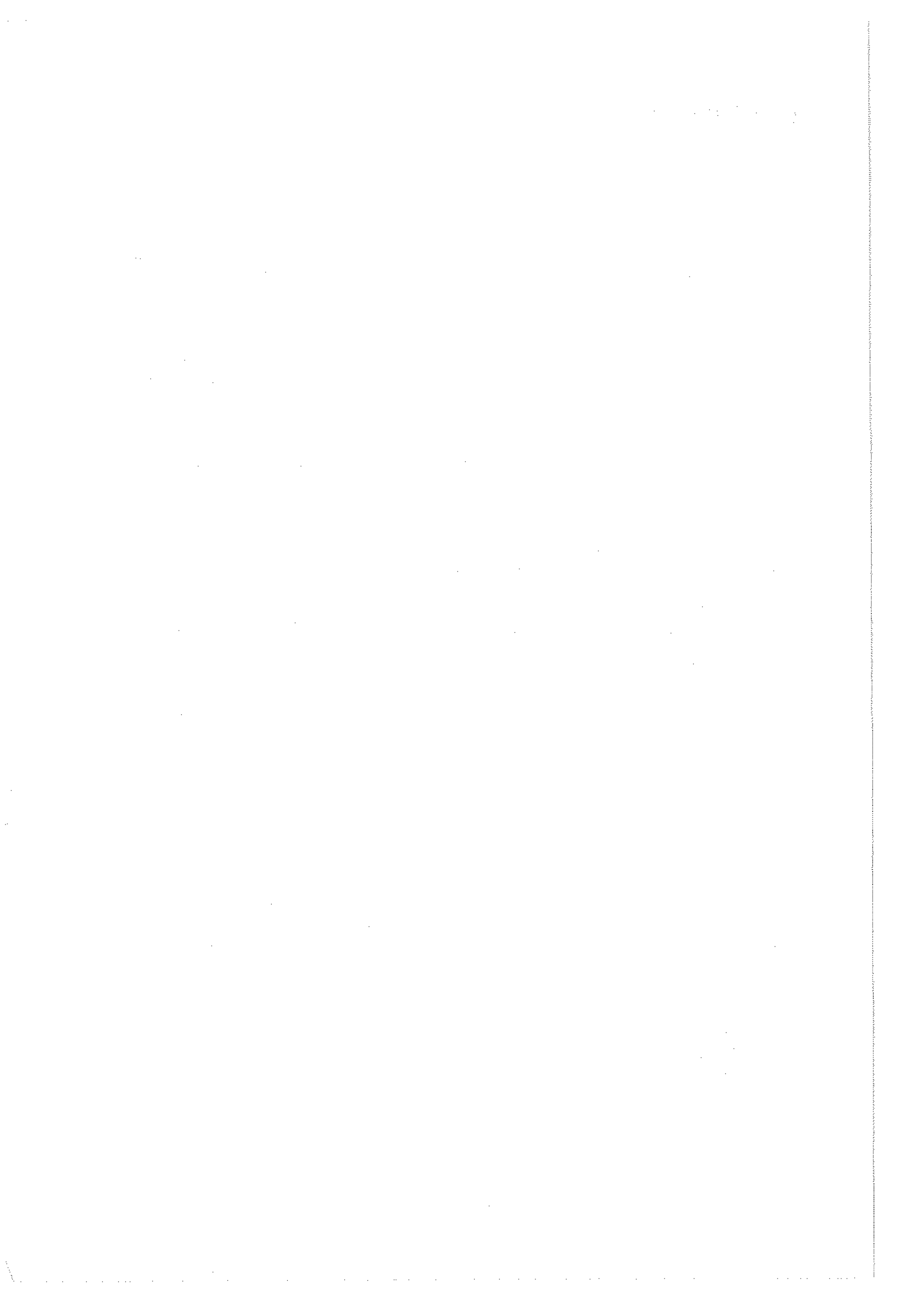
The Committee is hopeful that the banking industry, governments and the community as a whole will learn the lessons of the past decade. Adoption of the Committee's recommendations would be a significant step in the right direction.

It has been said:

> Bankers sometimes look on politicians as people who, when they see light at the end of the tunnel, order more tunnel.

Through this inquiry, the Committee has burrowed into Australia's banking tunnel and has let in the light, so that all Australians can see where the financial train is heading. The Committee's recommendations will not add to the tunnel. Rather, they will ensure that the track to the future is clear and safe, and no-one is taken for a ride.

STEPHEN MARTIN, MP
CHAIRMAN



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Members of the Committee

Chairman:	Mr S P Martin, MP
Deputy Chairman:	Hon I B C Wilson, MP
Members:	Mr J N Andrew, MP Mr R A Braithwaite, MP Dr R I Charlesworth, MP Mr B W Courtice, MP Mr A J Downer, MP Mr S C Dubois, MP Mr R F Edwards, MP Mr R P Elliott, MP Mr G Gear, MP Mr R S Hall, MP *Mr L J Scott, MP *Mr A M Somlyay, MP

* Seconded to the Committee for the term of the Australian Banking Industry Inquiry

Secretary:	Mr D R Elder
Advisers:	Mr J Hawkins Ms G Moon Mr L Spencer Ms L Spier
Inquiry Staff:	Mr A A Lomp Ms J R Starcevich Mrs A J Garlick Ms L J Gillies

Terms of Reference of the Committee

The Standing Committe on Finance and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

Terms of Reference of the Inquiry

On 25 October 1990, the Treasurer asked to the Committee to inquire into and report on

(a) the importance of the banking system to the Australian economy;

(b) the profitability of the banking sector through time and in comparison with other industries;

(c) the effectiveness of competition in the banking sector, including the impact of any barriers to competition; and

(d) the benefits of competition to different sections of the community including:

- access to financial services;
- product innovation;
- choice and quality of financial services; and
- information to users

Abbreviations

ABA	Australian Bankers' Association
ACA	Australian Consumers' Association
AFCUL	Australian Federation of Credit Unions Limited
AFIC	Australian Financial Institutions Commission
AFP	Australian Federal Police
ALRC	Australian Law Reform Commission
AMBA	Australian Merchant Bankers' Association
AMP	Australian Mutual Provident Society
ANZ	Australian and New Zealand Banking Group Limited
APR	Annual Percentage Rate
ATM	Automatic Teller Machine
ASC	Australian Securities Commission
BIE	Bureau of Industry Economics
BIS	Bank for International Settlements
CBA	Commonwealth Bank of Australia
CCI	Consumer Credit Insurance
CTRA	Cash Transaction Reports Agency
DPIE	Department of Primary, Industries and Energy
EFT	Electronic Funds Transfer
EFTPOB	Electronic Funds Transfer at Point of Banking
EFTPOS	Electronic Funds Transfer at Point of Sale
ERIC	Effective Rate of Interest and Charges
E S & A	English, Scottish and Australian Bank Ltd
FARM	Finance, Agriculture and Rural Management
FCA	Finance Corporation of Australia
FCL	Foreign Currency Loan
FDIC	Federal Deposit Insurance Corporation
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product

IAC	Industrial Acceptance Corporation
IRR	Internal Rate of Return
ISC	Insurance and Superannuation Commission
LGS	Liquid assets and Government Securities
MMB	Minimum Monthly Balance
MMC	Money Market Corporation
NAB	National Australia Bank
NBFI	Non-bank Financial Intermediary
NCA	National Crime Authority
NCAAC	National Consumer Affairs Consultative Council
NFF	National Farmers Federation
OECD	Organisation for Economic Co-operation and Development
OSFI	Office of the Superintendent of Financial Institutions
PSA	Prices Surveillance Authority
PPL	Partnership Pacific Limited
QIDC	Queensland Industry Development Corporation
RBA	Reserve Bank of Australia
ROA	Return on Assets
ROE	Return on Equity
RTS	Return to Shareholders
SBNSW	State Bank of New South Wales
SBSA	State Bank of South Australia
SBV	State Bank of Victoria
SCOCAM	Standing Committee of Consumer Affairs Ministers
SRD	Statutory Reserve Deposit
TPA	Trade Practices Act
TPC	Trade Practices Commission
UK	United Kingdom
UPT	Unlisted Property Trust
USA	United States of America
WESTPAC	Westpac Banking Corporation

CONCLUSIONS AND RECOMMENDATIONS

SECTION I: INTRODUCTION

Chapter Three: The Australian Banking Industry In 1991

Definition of a bank

It is evident that there is some confusion about the difference between financial intermediaries which are authorised as banks and financial intermediaries which simply conduct banking business. The blurring of traditional boundaries between banks and non-bank financial intermediaries following deregulation has contributed to a degree of misunderstanding within the community about the riskiness or otherwise of particular financial institutions. It also has given rise to concerns that non-bank financial intermediaries which conduct banking business but which are not supervised by the Reserve Bank are discriminated against.

While the Committee accepts that it would be virtually impossible to provide a definition of a bank which would embrace all areas of banking activity, the Committee is of the view that a more comprehensive definition of a bank than is provided in the Banking Act is required. It should be the responsibility of the Reserve Bank to provide such a definition, taking into consideration those elements which clearly distinguish banks from non-bank financial intermediaries, including prudential and supervisory requirements, particular legislative requirements, such as the statutory priority of deposits, and the risk spectrum of a bank's operations.

The Committee recommends that:

1. **the Reserve Bank develop a definition of a bank for inclusion in the *Banking Act 1959* and other relevant legislation.**
   (paragraph 3.21)

Banking, the economy and society

There can be no doubt about the importance of the Australian banking industry, not only with regard to the proper functioning of the financial system, but also in relation to the operation and development of the Australian economy as a whole. In the report, though, the Committee's main aim has not been to reaffirm the position and status of the banking industry within Australian society, but, more importantly, to assess how the industry has responded to deregulation, and to make recommendations which will assist the industry to meet the needs of the Australian economy and Australian society leading into the next century.

SECTION II: COMPETITION

Chapter Six: The Profitability Of Banks

It is important to the Australian economy that banks are strong. In order to be strong, they must be profitable.

There is a misconception that banks' profitability has increased since deregulation. In fact it has fallen slightly. Had they not reduced their operating expenses, they would have been even less profitable.

Australian banks are not very profitable at present due to the current unusually high levels of bad debts. Bank profitability should be kept under review to monitor whether it remains within an appropriate range.

Deregulation removed many of the cross-subsidies between bank customers. Whilst no conclusive evidence was found that retail customers as a class have generally been subsidising corporate customers, anecdotal evidence has suggested that this has occurred when interest rates are falling or when extraordinary bad debts have been incurred.

Deregulation has not led to a significant reduction in the average domestic interest rate margin. Any reduction has tended to benefit corporate customers rather than retail customers. The average interest margin for retail customers as a class has not changed significantly. However, certain types of retail customers, such as those who would have received cheap, rationed home loans or those who made large numbers of transactions, would be worse off as the subsidies they received are no longer available.

The profitability of banks is not only a matter of interest to banks' shareholders but also to the general community. If the community is to be better informed about bank profitability then more public information and analysis is required. The Committee notes that some banks, who file reports with the Securities and Exchange Commission in the United States, now include the additional information they provide to the SEC in their Australian annual reports.

The Committee recommends that:

2. **the information available to the Reserve Bank on, and its analysis of (a) bank margins and (b) bank profitability be made more widely available by the Reserve Bank publishing more in their annual report and/or monthly Bulletin;**

3. **all banks be required to include information in their annual reports on the profitability of various sectors of their operations and further information on non-performing loans and bad debts. The requirements of the Securities and Exchange Commission in the United States, which some Australian banks already meet, would provide a guide as to what is reasonable; and**

4. **the Reserve Bank seek to have Australia included in the OECD surveys of bank profitability. The Reserve Bank should be actively involved in the preparation of data for these surveys. It should help in the development of international standards for comparable data in this area.** (paragraph 6.72)

Chapter Seven: User Pays

The Committee recognises that user pays pricing is likely to become more prevalent in the near future as banks endeavour to charge explicitly for the services they provide. As this occurs interest margins should narrow. If user pays practices are adopted they should equally apply to the payment of interest by banks. Ultimately it will be the consumers in the market place making choices between differing bank products that will determine whether user pays is fully adopted.

There are some areas where the Committee believes the bank pricing policies are neither fair nor efficient, such as the way banks pay interest on some types of deposit account and the arbitrary nature of some early repayment penalties. Recommendations concerning these areas are made elsewhere in the report.

The Committee does not believe the gamut of bank charges should be referred to the Prices Surveillance Authority. It believes the competitive market will generally be the best arbitrator of what is reasonable.

Chapter Eight: Competitive Structure

Industry dominance

It is evident that deregulation has led to a significantly more competitive environment within the banking industry and the financial system as a whole. There is a far greater number of institutions competing for market share than was the case prior to deregulation. Also, the substantial erosion of traditional lines of demarcation has allowed bank and non-bank financial intermediaries to compete across a broader range of activities for a more varied spread of business.

While foreign bank entry may not have met expectations in terms of competition in the retail banking sector, the presence of foreign banks in Australia remains an important competitive spur to domestic banks, principally in the wholesale area. (Issues relevant to foreign banks are discussed further in Chapter 10).

Despite the increased number of competitors, though, the level of concentration in the banking industry has remained high. The entry of new banks in the wake deregulation may have resulted in an initial drop in market share for the incumbent nationally operating banks. However, the more recent consolidation of market share by the major banks following a series of mergers and acquisitions has reinforced a high level of industry concentration.

It is not possible for the Committee to predict the competitive structure which will emerge as the banking industry continues to develop in a deregulated environment. The Committee concurs with the Campbell Committee that precise details about the institutional structure can be regarded as incidental provided certain performance objectives, as outlined in paragraph 8.5, are met.

In this regard, healthy competition between institutions for the retail and wholesale business of consumers must remain a principal performance objective for the industry. The level of competition in the industry must be a fundamental consideration in any future proposals for structural change within the banking sector.

The concerns which exist among various sections of the community about the trend towards increased concentration in the banking industry are shared by the Committee. There are dangers that increased concentration, by reducing the number and influence of competitors, ultimately could affect the level of industry efficiency, as the incumbent banks would be under less pressure to generate improved performances. Equally, there is greater likelihood of collusive or anti-competitive practices emerging, with consumers having less opportunity to move their business to alternative institutions. Clearly, such outcomes would be counter to the aims of financial deregulation.

The Committee considers that further concentration in the banking industry could have significant implications in terms of the competitiveness of the industry. It is of the view that any arrangement or agreement which would lead to further concentration should be subject to careful scrutiny, and should be required to demonstrate substantial public benefit before being allowed to proceed.

The Committee acknowledges the TPC's concerns about the existing mechanisms for dealing with mergers and acquisitions which may result in the substantial lessening of competition in a market. As the Committee's investigations were focused specifically on the banking industry, it is not in a position to comment on the need for broad changes to the merger provisions of the Trade Practices Act, particularly as those changes would have implications beyond the terms of reference of the

inquiry. In any case, the issue of the appropriate merger test for the TPA is the subject of a 1989 report from the House of Representatives Standing Committee on Legal and Constitutional Affairs, as well as an existing inquiry by the Senate Standing Committee on Legal and Constitutional Affairs.

In terms of the banking industry, though, there is considerable merit in the TPC's suggestion that any mergers or acquisitions in that industry be referred to the TPC for examination. The banking industry occupies a crucial position within the Australian economy, and as such deserves special attention to ensure that matters of public interest are given appropriate consideration. In light of the concerns about levels of concentration in the banking sector, it would be in the public interest if mergers or acquisitions in the industry were the subject of close scrutiny. As the TPC has primary responsibility for competition matters, and as it also has expertise in assessing both the structure of arrangements and their potential market effects, it is appropriate that the TPC be involved closely in the process of determining the acceptability of mergers and acquisitions in the banking sector.

Bearing in mind that the Banking Act provides the Treasurer with a discretion to approve or disallow bank mergers and acquisitions, the Committee considers that, in exercising this discretion, one factor which should be taken into account by the Treasurer is whether the merger or acquisition in question substantially lessens competition in a substantial market. It is in determining this issue that close consultation with the TPC should occur.

The Committee recommends that:

5. **the Treasurer, in considering proposals for mergers or acquisitions in the banking industry, prohibit any mergers or acquisitions which would result in a substantial lessening of competition in a substantial market, unless public benefit can be shown; and**

6. **the Treasurer, in considering proposals for mergers or acquisitions in the banking industry, refer to the Trade Practices Commission for determination the questions of whether the proposed merger or acquisition would substantially lessen competition in a substantial market, and whether there are any public benefits which would outweigh the detriment from the substantial lessening of competition.** (paragraph 8.42)

Bank ownership

The Committee considers that the existing restrictions on ownership of bank shares are appropriate. Not only are they a means of preventing particular shareholders from exercising undue control over a bank, but they also are a mechanism for preventing undue concentration in the industry. The Committee has received no substantive evidence to indicate any need for changes in this area. Indeed, the evidence received has been in support of retaining the existing restrictions on ownership.

The Committee recommends that:

7. **the existing restrictions on ownership of bank shares contained in the *Banks (Shareholdings) Act 1972* be retained.** (paragraph 8.51)

Efficiency

Deregulation of the financial system has resulted in substantial changes within the banking industry, both in terms of the way in which banks conduct their operations and in the way in which they have responded to the changing needs of the community. It is clear that a major catalyst for this change has been the increased competition which has been brought about by deregulation.

In considering whether this increased level of competition has led to a more efficient banking industry, the Committee took into account the evidence available on operating costs, as well as indicators that the industry has adapted to the changes of the more competitive environment. These indicators have included the use of more advanced technology and product innovation.

While the evidence on efficiency gains was not extensive (availability of information is addressed further in Chapter 21), the Committee was able to conclude that increased competitive pressures arising from deregulation have forced participants in the banking industry to reduce operating costs, through more efficient use of personnel and use of more advanced technology, and to become more innovative in satisfying customer needs.

However, deregulation has carried with it certain costs. The most visible of these has been the poor lending decisions of the 1980s, which have resulted in high levels of bad and doubtful debts. This is in contrast to reductions in operating costs. With the benefit of hindsight, it is evident that, in a number of cases, the savings of the community have not been directed to the most productive areas of economic activity. The reckless support of elements within the entrepreneurial sector has created a misallocation of resources towards unproductive takeover activity.

To an extent, the poor lending decisions of the 1980s can be attributed to the new competitive pressures faced by the banks, in that fear of new competitors and the potential loss of market share resulted in banks being less prudent than had been the case previously. At the same time, it is abundantly clear that a lack of preparedness by the incumbent banks for the new wave of competition contributed significantly to the mistakes which occurred and which are acknowledged.

Despite the difficulties which have arisen, effective competition remains essential to the efficient operation of the banking industry and the financial system as a whole. In this regard, the Committee has made recommendations earlier in this chapter which seek to ensure that there is no lessening of competition in the market for banking and financial services.

While it is obviously in the interest of banks to become more efficient, the main guarantee that efficiency gains will continue to be pursued is the ever present threat of competition. In this regard, it is not only important to reinforce the competitive structure of the industry, as the Committee is seeking to do, but also to work towards the removal of any remaining barriers to competition, both regulatory and commercial. These are considered in Chapter 9.

Chapter Nine: Barriers To Competition

Access to the payments system

It is evident that access to the payments system is crucial for any financial institution competing in the market for financial services. Restrictions on access are a significant barrier to competition.

The question of access, though, cannot be considered in isolation from the broader issues of confidence in and stability of the payments system. The existing restrictions, which limit direct participation to banks and authorised money market dealers, are based on the principle that only those institutions which satisfy the most stringent prudential requirements should be allowed direct access. Given the importance of the payments system to the overall stability of the financial system, the Committee considers that this principle must be upheld.

Nevertheless, the Committee is conscious of the competitive disadvantages which arise for non-bank financial intermediaries because of their inability to gain direct access. While reforms to the payments system since deregulation have improved the situation, by enabling increased access through agency arrangements at a more competitive price, non-bank financial intermediaries clearly believe the reform process has not gone far enough.

Many of the Committee's recommendations in this report are aimed at ensuring a strong competitive environment within the banking industry. Access to the payments system, on terms which are fair and equitable, is vital to this aim. In this context, the Committee is of the view that further consideration needs to be given to the question of access for non-bank financial intermediaries.

The Committee notes that the Reserve Bank is participating in the implementation of reforms to the payments system, as recommended by a task force commissioned by the ABA. As part of that process, the Reserve Bank should investigate the feasibility of alternative arrangements for access by non-bank financial intermediaries. In particular, the feasibility of establishing industry banks as a vehicle for direct access by non-bank financial intermediaries should be explored.

The Committee recommends that:

8. **the Reserve Bank, in implementing the recommendations from the review of the payments system commissioned by the Australian Bankers' Association, investigate the feasibility of providing non-bank financial intermediaries with direct access to the payments system, either through the establishment of industry banks, or through some other arrangement.**
(paragraph 9.29)

Government guarantees

From the evidence available, it is difficult to determine with any precision the value of the government guarantee attaching to the Commonwealth Bank and the State banks. While the guarantee offers some advantage, enabling government owned banks to acquire funds at a lower cost, it is unclear how significant the advantage really is.

It is evident that a government guarantee provides a certain level of reassurance for depositors. However, this should not be overstated. It is, after all, the prudential supervision of banks, rather than a government guarantee, which should be the crucial factor in maintaining confidence and stability in the banking industry and the financial system.

Regrettably, the recent history of State banks in South Australia and Victoria has demonstrated that this has not been the case. In both situations, a government guarantee was vital in protecting depositors and ensuring the stability of the financial system. The Committee is concerned about the lack of appropriate prudential and supervisory arrangements which were evident. The relevant issues are examined further in Section III.

The Committee notes that the operations of government owned banks have become indistinguishable from those of privately owned banks. In this regard, it is likely that government ownership of banks, particularly State banks, will diminish over time. The government guarantee in relation to such banks obviously should be phased out if the banks are sold to private interests. Until such time, a government guarantee should continue to apply to government owned banks.

Commercial advantages

The commercial advantages enjoyed by established domestic banks, particularly their branch network and their broad customer base, are a barrier to competition in the sense that they make it more difficult for new entrants to gain a share of the market. These advantages have been built up over a considerable length of time and reflect an extensive investment by the established banks.

It is important to remember these advantages are not exclusive to one bank. Four major banks at the national level, and a number of regionally operating banks, benefit from the networks and relationships which they have established. All of these banks are in vigorous competition against each other for market share.

Commercial impediments to competition can be neutralised by ensuring that any regulatory barriers which favour the position of established domestic banks are removed. The Committee has made a number of recommendations aimed at such an outcome. In particular, it has recommended that steps be taken to improve access to the payments system (paragraph 9.29) and to improve opportunities for foreign bank entry to Australia (paragraphs 10.22 and 10.46).

Government regulation

While the Committee accepts that the verification requirements of the cash transaction reporting system may contribute to a reluctance on behalf of customers to change the financial institution with which they conduct business, the it does not regard those requirements as being either unreasonable or a significant barrier to competition. As all financial institutions have a minimum obligation in terms of the account opening procedures, the requirements of the system should be neutral in their effect.

The Committee notes with interest evidence from the CTRA that some financial institutions have streamlined their procedures to assist customers in satisfying the requirements of the cash transaction reporting system. The Committee encourages all financial institutions to adopt this approach. The liaison committee, which is chaired by the CTRA and which includes representatives of major cash dealers, should have a role in this regard.

The Committee is aware that a review of the cash transaction reporting system is due within three years of its operation. As part of that review, the verification and reporting requirements of the system should be assessed not only to ensure that the objectives of the system are being met, but also to ensure that the benefits of the system justify the costs for the financial services sector.

The Committee recommends that:

9. **as part of a broader review of the cash transaction reporting system, due within three years of its operation, the verification and reporting requirements of the system, as they impact on financial institutions, be assessed to ensure that the benefits which are being achieved justify the costs which are involved.** (paragraph 9.59)

Chapter Ten: Foreign Banks

Open entry

There was widespread support for the removal of existing restrictions on further foreign bank entry into Australia. Amongst those in favour of such a move were the major domestic banks and the foreign banks which commenced operations in Australia from 1985 onwards.

Sound reasons were advanced for the removal of existing numerical restrictions on new foreign bank entry. No submissions raised objections to a policy of open entry based on the principle of reciprocal access for Australian banks in overseas markets. It is evident that a policy of reciprocal open entry may assist in providing an ongoing spur to competitiveness of existing banks, because of the competitive implications arising from the threat of new entry. At the very least, the removal of limits on the number of foreign bank licences will facilitate access to overseas markets by Australian banks, particularly in countries in which reciprocal treatment is part of official policy. Given that Australian banks are pursuing an increased international focus, and given that banks around the world are operating on a more global basis, a policy of reciprocal open entry for foreign banks is important in ensuring that Australia is able to participate fully in the worldwide financial system.

The Committee notes that the Industry Commission came to a similar conclusion on foreign bank entry in its draft report on the availability of capital. In that report, the Industry Commission recommended that the restrictions on the number of foreign bank licences be lifted, subject to the maintenance of suitable prudential requirements for new entrants. The Committee supports this recommendation, on the understanding that the new entrants provide a wide range of banking services, as was expected in 1985.

On the basis that a policy of reciprocal open entry is adopted, the Committee considers that foreign banks which choose to exit from the Australian market should be able to re-enter the market whenever economic or market conditions provide them with an opportunity to do so. This, however, should only be the case if such banks, in deciding to exit, follow appropriate procedures for an orderly exit.

The Committee recommends that:

> **10.** **the existing restrictions on the number of foreign bank licences be removed for new entrants from countries offering reciprocal access for Australian banks, subject to the maintenance of appropriate prudential requirements.** (paragraph 10.22)

Branches versus subsidiaries

There was widespread support for allowing foreign banks to operate in Australia as branches. The main evidence for this proposal was provided by foreign banks operating in Australia as subsidiaries. The major domestic banks also favoured this approach, while the Reserve Bank did not raise any substantive objections.

The Committee considers that there are a range of benefits which can be achieved by allowing foreign banks to operate in Australia as branches. First and foremost of these is the possibility of increased competition in the banking industry. By having a broader capital base and improved fund raising capabilities, it is evident that a branch of a foreign bank would be in a far better position than a foreign bank subsidiary to compete against the incumbent domestic banks.

In addition, it is evident that reciprocal access for Australian banks to overseas markets, as well as Australia's future trading position with the European Community, hinges to a significant degree on the conditions of entry into the Australian market for foreign banks. Allowing foreign banks to operate as branches will bring Australia into line with the practice of the major world and regional financial centres. It is an appropriate signal to the international community about Australia's desire to participate openly in the worldwide financial system. There is no doubt that it will improve opportunities for the international expansion of Australian banks, and will contribute towards Australia's efforts to achieve a more liberal trading regime globally.

The Committee, of course, is mindful of the difficulties associated with prudential supervision of foreign bank branches, and the concerns which exist in this regard. It is encouraged, though, by the confidence of the Reserve Bank that satisfactory arrangements for supervision can be worked out. The Committee is adamant that prudential standards must not be sacrificed in the pursuit of an improved competitive environment.

On balance, the Committee supports the proposal to allow foreign banks to operate in Australia as branches, as long as appropriate supervisory arrangements can be established. The benefits to Australia, particularly in terms of competition and trade relations, outweigh the risks which may be involved.

The Committee recommends that:

11. **foreign banks, from countries offering Australian banks reciprocal access, be permitted to operate in Australia as branches, subject to them satisfying the following conditions:**

    - **maintenance of appropriate prudential requirements specified by the Reserve Bank;**

    - **provision to the Reserve Bank of information relevant to the foreign bank's Australian operations;**

    - **allowing access by Australian bank examiners to the foreign bank's operations in Australia as part of the appropriate supervisory arrangements; and**

    - **ensuring, to the satisfaction of the Reserve Bank, that Australian depositors with foreign banks are protected to the same level as Australian depositors with Australian banks.** (paragraph 10.46)

Chapter Eleven: Diversification Of Banks' Activities

Conflicts of interest in funds management

There are grounds for concern about potential conflicts of interest when banks are involved in funds management activities.

The Committee recommends that:

12. **the regulators should satisfy themselves that appropriate systems are in place to ensure adequate separation of the banking and funds management activities of financial conglomerates.** (paragraph 11.27)

Perceptions of customers

The Committee is concerned about the current situation where many customers may form the impression that the sponsoring bank is guaranteeing the performance of funds managed by it or its subsidiaries. However the Committee acknowledges some advantages to consumers in being able to invest in such funds through banks and would not want to prevent the involvement of banks in this area.

The Committee recommends that:

13. **brochures or advertising by banks state clearly that the bank does not guarantee any fund it manages. This statement should be given as much prominence as the fact that the fund is managed by a bank or its subsidiary.** (paragraph 11.36)

Banks' holdings of equity in non-financial corporations

Australian banks may be unduly discouraged from providing equity capital to business by Reserve Bank guidelines. Some restrictions on banks' holding of equity are desirable on prudential grounds, however, reflecting the differing risk characteristics of equity rather than loans.

The Committee recommends that:

14. **banks be permitted to take equity positions in non-financial companies but there should be strict limits on the size of individual exposures and some limit on the aggregate exposure.** (paragraph 11.63)

Diversification and competition

The trend towards increasing concentration in the broad financial sector is of concern. There are dangers that increased concentration could reduce the spur to efficiency or allow anti-competitive practices to develop. Competition levels in all areas of the diversified financial sector need to be closely monitored. Detailed information about market shares and cross-ownership needs to be regularly analysed and published.

The Committee considers any merger or arrangement which would lead to further concentration should be subject to careful scrutiny. Only those proposals that can be shown to generate substantial public benefits should be approved.

The Committee recommends that:

15. **the Treasurer, in considering applications for mergers or substantial increases in cross-ownership between banks and other major financial institutions, should prohibit any which would result in a substantial lessening of competition, unless public benefit can be shown. In making this judgement, the Treasurer should seek the advice of the TPC.** (paragraph 11.76)

Disclosure of information and consumer remedies

Benefits to consumers as a result of diversification cannot be assured unless significant improvements are made in the areas of information and dispute resolution.

The Committee recommends that:

16. **where applicable, the recommendations concerning disclosure made in Chapter 21 also apply to other activities of bank-led conglomerates, including companies with which they have close associations;**

17. **the Lifewriters' Association and other representatives of financial advisers and agents should be invited, along with government and consumer representatives, to participate in a general review of quality control of financial advisers and agents; and**

18. **the Commonwealth Government consult with industry and consumer groups in the development of a list of required features for industry-based dispute resolution procedures and establish a process through which the Government, the industry and consumer representatives can look at options for rationalising the various schemes and proposed schemes.**

SECTION III: SUPERVISION

Chapter 13: Improving The Current Approach To Supervision

The focus of prudential requirements

The Committee supports the current emphasis on capital as the integral part of the supervisory framework. Strong steps should be taken to prevent banks' capital being eroded because experience has shown that tardiness will increase the chances that depositors' funds will be lost.

The Committee recommends that:

> 19. **the Reserve Bank should use its legislative power to supervise actively the operations of any bank whose capital ratio falls significantly below the minimum standard.** (paragraph 13.9)

Prudential aspects of the payments system

The banking system would have greater safety and soundness if inter-bank exposures were limited. Accordingly it would be desirable if the current reform of the payments system were to result in a high-value electronic payments system which operated on similar principles to the Swiss system. For similar reasons the Committee supports measures to facilitate effective 'netting' of exposures.

The Committee recommends that:

> 20. **the Reserve Bank encourage the formation of a high-value electronic payments system which strictly limits the exposures of banks to each other.** (paragraph 13.16)

Exposure to speculative assets

Banks have shown a tendency to become excessively exposed to speculative commercial property involvement and other asset-price speculation to the detriment both of their prudential standing and national development.

The Committee recommends that:

> 21. **banks enhance internal monitoring systems to limit their exposure to particular classes of business such as speculative property developments. The Reserve Bank should satisfy itself that such systems are adequate, and if necessary impose limits on banks' exposure.** (paragraph 13.25)

The approach to bank supervision

The current arrangements between the Reserve Bank and the banks' external auditors are inadequate. Information is not provided to the Reserve Bank in a sufficiently timely or secure manner. The Bank's requirements are not clearly explained. There is a need to tighten up the relationship.

The lack of consistent standards in some aspects of banks' reporting to the Reserve Bank has made the supervisory task more difficult.

There is a need for a 'hands-on' supervisory capacity within the Reserve Bank to allow it to monitor banks more closely and to assess the adequacy and consistency of banks' treatment of doubtful debts and non-performing loans.

The Committee recommends that:

22. **the Reserve Bank hold an annual meeting with banks' auditors to discuss aspects of the auditors' role in prudential supervision;**

23. **the Reserve Bank put in place appropriate mechanisms to assist auditors in understanding the views each has on prospective economic conditions;**

24. **auditors send their reports directly to the Reserve Bank at the same time as they are sent to the client bank. The auditors should be free to raise issues of concern with the Reserve Bank at any time and should be protected from action being taken against them for doing so;**

25. **the Reserve Bank develop consistent standards for the reporting of banks' non-performing loans and that the banks' auditors be required to certify these returns; and**

26. **the Reserve Bank should develop a capacity to inspect banks' systems and assess their valuation of assets, particularly the adequacy of provisions for doubtful debts and non-performing loans. It is suggested that senior ex-bankers be hired as examiners on a consultancy basis and include them among the inspection teams. These inspections should occur on both a random, but frequent, basis and when there are particular concerns. The inspection teams should monitor the assessment of the credit worthiness of large borrowers to whom loans have been made by more than one bank to achieve consistency of prudential approach.** (paragraph 13.57)

Deposit insurance

The issue of supplementary forms of depositor protection were only canvassed in the latter stages of the inquiry as there were no calls for their introduction in the major submissions. In view of its proposed continuing role in reviewing banking issues, the Committee will assess whether there is a need to examine supplementary forms of deposit protection and if so determine who should carry out such an examination.

State banks

The Committee sees no purpose in State banks remaining under government ownership when they are operating in the same manner as commercial banks. The options are to float them, either singly or as a group, or sell them to an foreign or domestic bank or other financial institution. The Committee would prefer they be floated and brought fully under the Banking Act and the Banks (Shareholdings) Act. Any sale to another bank should be referred to the Trade Practices Commission for review of whether it would substantially lessen competition and, if so, whether there were sufficient public benefits to justify approval of such a purchase.

If the banks are not sold, or until they are, the Committee believes steps need to be taken to address weaknesses in the existing 'voluntary' arrangements for the supervision of State banks.

The State governments need to recognise that Reserve Bank supervision is for the protection of depositors not shareholders, and therefore ensure that they closely monitor the operations of their banks to protect taxpayers' interests.

The Committee recommends that:

27. **State governments formally refer powers over State banking to the Commonwealth Government so that state banks can be regulated and supervised in the same manner as private banks. If the State governments choose not to do so, the Reserve Bank should exercise its power to supervise their activities outside their home State; and**

28. **where governments own banks, they ensure that they have appropriate mechanisms in place to monitor closely the operations of the bank with a view to protecting the interests of the shareholders.** (paragraph 13.96)

The Commonwealth Bank

The Committee recognises the potential for an apparent conflict of interest in the Secretary of the Treasury being on the boards of both the Reserve and Commonwealth Banks. It remains appropriate, however, that the Commonwealth Government be directly represented on the Commonwealth Bank board.

The Committee recommends that:

29. **the Secretary of the Department of Finance replace the Secretary of the Treasury on the board of the Commonwealth Bank of Australia. The Department should receive copies of all documents prepared for the Board and senior policy committees of the bank; and**

30. **in order to reinforce public confidence, the Reserve Bank publicly confirm that it adopts no less strict supervision for government-owned banks under the Banking Act than it does for banks without a government guarantee.** (paragraph 13.101)

Miscellaneous 'Quasi-Banks'

The Committee recommends that:

31. **the Reserve Bank undertake a comprehensive review of quasi-bank organisations such as the Queensland Industries Development Corporation to ascertain whether they should be subject to similar prudential supervision as banks.** (paragraph 13.103)

Money market corporations

The Committee recommends that:

32. **the exemptions from section 66 of the Banking Act given to money market corporations be revoked and money market corporations should be prohibited from describing themselves as 'banks'.** (paragraph 13.106)

Supervision of managed funds

The Committee is aware that managed funds are the subject of examination by a number of organisations. While a number of concerns were drawn to the Committee's attention, detailed conclusions about the supervision of the funds management industry are outside the scope of this report. The Committee does, however, believe that the following issues need to be included in current investigations:

- market concentration;
- scope for rationalisation of the roles of the ISC, ASC and RBA;
- need for supervision to cover State government owned operations;
- need for liquidity guidelines and restrictions on borrowing;
- need for superannuation funds to diversify portfolios;
- marketing practices;

- conflicts of interest in investment decisions by funds managers;
- adequate disclosure of fees;
- provision of comparable and meaningful information on fund performance;
- *training of staff; and*
- the need to preserve a spectrum of risk.

The Committee recommends that:

33. **the present reviews being undertaken into aspects of the financial services industry take into consideration the issues listed above with a view to ensuring that comparable institutions and products are subject to the same high regulatory standards and requirements.** (paragraph 13.113)

Chapter 14: Alternative Arrangements For Supervision

Should the central bank also be the supervisor of banks?

The Committee believes there are arguments which support both the view that the Reserve Bank should continue to be the supervisor of banks as well as having responsibility for the implementation of monetary policy and for the separation of these functions. On balance, the disadvantages in terms of duplication or the need to establish extensive co-ordination arrangements tend to outweigh the advantages from specialisation.

Accordingly the Committee concludes that the prudential supervision of banks *remain with the Reserve Bank of Australia. However, the Committee concluded that* the Reserve Bank's ability to conduct prudential supervision needs to be enhanced. Recommendations to this end are contained in the previous chapter and the following sections.

The Committee recommends that:

34. **the Reserve Bank appoint a second Deputy Governor with specific responsibility for prudential supervision. The occupant should be titled the Supervisor of Banks.** (paragraph 14.15)

Should the Reserve Bank supervise building societies and credit unions?

The Committee believes that the current process of harmonising the supervisory requirements of the States is a valuable first step in ensuring a more uniform supervisory regime for smaller NBFIs. The process should be completed as a matter of urgency. However, the Committee believes that, in the longer term, the supervision of these intermediaries would be more efficiently achieved by a national supervisor. The Committee would not favour governments guaranteeing deposits with co-operatives and any arrangements adopted should be careful not to create this impression.

Those large organisations which engage in essentially banking business and which the general community expects to be as safe as banks should be supervised by the Reserve Bank in the same manner as banks.

Co-operative status is not a sufficient reason for denying the issue of a banking authority. However, there are limits to the number of organisations which the Reserve Bank has the capacity to supervise without diminishing the quality of that supervision.

The Committee recommends that:

35. **co-operative organisations with assets in excess of $1 billion which undertake banking business be required to obtain a banking authority and hence be supervised by the Reserve Bank.** (paragraph 14.31)

Supervision of banks' subsidiaries

The fact that banks do not provide formal guarantees to their subsidiaries is not sufficient to prevent these subsidiaries having the potential to damage the standing of the banks. As a consequence banks will be under pressure to prop up subsidiaries which will weaken the position of banks.

The Committee recommends that:

36. **banks with Australian subsidiaries whose principal business is raising deposits and making loans be required to wind them back into the parent bank within three years; and**

37. **in the interim there be prominent disclosures on prospectuses that subsidiaries are in no way guaranteed by the parent bank.** (paragraph 14.39)

Greater co-ordination between supervisors

The continuing trend within the financial system for the creation of financial conglomerates creates a need for closer co-ordination between the various supervisory organisations. This could be achieved by the creation of a formal council bringing together very senior representatives of the various supervisors for regular meetings. The secretariat for such a council could either reside within the Reserve Bank (as with the Australian Payments System Council) or in a government department.

The Committee recommends that:

38. **a Council of Financial Supervisors be established to facilitate closer co-ordination between the supervisors of the Australian financial system. The Council should include the Reserve Bank, AFIC, the ISC and the ASC and be chaired by the Supervisor of Banks.** (paragraph 14.43)

Lead regulators

There is merit in achieving greater co-ordination of supervision by designating one supervisor the 'lead regulator' for each financial conglomerate.

The Committee recommends that:

39. **the Council of Financial Supervisors designates one supervisor as the 'lead regulator' with overall responsibility for each financial conglomerate but that supervision of the individual arms of the conglomerate remain with the individual supervisors.** (paragraph 14.49)

A Mega-Supervisor

The Committee is not convinced the establishment of one mega-supervisor is necessary at this time to ensure adequate protection of the savings of the public. In particular, it is mindful of the difficulties this would cause in maintaining both the reality and the perception of a clear range of risk/return options for investors.

The Committee recognises the financial system is evolving rapidly. There may be a need for re-examining the case for a mega-supervisor at a later date, especially if the trend towards the formation of conglomerates by merger or alliance continues. In the event that a mega-supervisor was found to be desirable the Council of Financial Supervisors could form the basis for it. The Committee will continue to monitor this issue closely.

SECTION IV: BANKS AND SECTORAL FINANCE

Chapter 15: Banking And Business

Corporate or large banking business

The problems of the 1980s in the corporate area can lead to a conclusion that deregulation caused many of the excesses. However, the Committee has outlined the broad range of factors that gave rise to the events of the 1980s, only one of which (albeit an important one) was financial deregulation. In particular, the anticipated and actual entry of new players was a spur to the vigorous competition that occurred in the corporate business area.

Banks should have been better prepared for the changes that deregulation brought about and have been able to respond in a more mature way. The experiences of deregulation in other countries would have provided a guide to banks of what to expect. A number of banks had branches in some of the countries which had experienced a deregulated system. Instead banks engaged in what one witness described as a 'collective madness' of lending without sufficient attention being paid to a prudent approach.

The Committee is keen to see banks develop a sound approach to the financing of business that allows the freedom available as a result of deregulation to be utilised to its best advantage. The Committee would see banks making a significant contribution to the development of business in Australia.

Business product innovation

Product innovation has been one of the major benefits to all business from deregulation. However, much of the innovation has been of particular benefit to large business. An area where small business requires assistance is in financial management and planning. Banks should develop more materials and advisory services to assist small business in this area. Such assistance will be to the benefit of both small business and banks.

The Committee recommends that:

40. banks further develop packages and advisory services that will assist small businesses to improve their financial management and planning;

41. small business representative organisations and relevant Commonwealth and State government departments, provide advice to small business about the products and services available from banks; and

42. **banks look at further product development for business, particularly small business, to provide for the payment of interest on working capital accounts when the accounts are in credit.** (paragraph 15.37)

Credit availability and credit assessment

The Committee recognises that a tightening of bank credit assessment procedures was necessary following the excesses of the 1980s. However, it is important that banks do not overreact but continue to lend to sound business that meet normal credit criteria.

The Committee views with concern the issues raised by small business about the process of 're-visitation', especially in the current economic environment where sudden and unannounced changes to small business financial arrangements could have a dramatic effect on the viability of a business.

In the process of reassessment of lending facilities to small business, banks should deal fairly with customers by contacting them to discuss the review, providing written notification prior to any changes and offering an appeal mechanism. These requirements are especially important in the current environment where banks are re-assessing all their outstanding loans.

The Committee recommends that:

43. **banks reassess their lending procedures affecting small business to ensure that sound proposals that meet usual credit criteria are funded; and**

44. **in reassessing small business loans banks should:**

- **consult with the customer;**
- **advise in writing any changes prior to them being made;**
- **provide an appeal mechanism against any decision; and**
- **give added emphasis, in the current economic climate, to assisting businesses to manage themselves out of difficulty where some prospects for improvement exist rather than taking precipitate action.** (paragraph 15.60)

Business interest margins

Deregulation has resulted in small business paying higher margins than large business. There are two main reasons for this:

- the lifting of ceilings on interest rates removed the cross subsidies that favoured those small businesses able to obtain bank finance;
- the lifting of restrictions on the amount banks could lend;
- banks began to price for risk and small business generally was considered more risky than large business; and
- banks began to lend to businesses that previously would have received finance from other intermediaries.

The Committee considers that banks should review their risk premiums to small business in the light of the stability of some areas of small business and in view of the security over property taken on most small business loans.

The Committee recommends that:

45. **banks review their risk premiums on small business loans in the light of the lesser risk of some areas of small business and in view of the security over property taken for most small business loans.** (paragraph 15.72)

Disclosure of margins, fees and charges

The Committee considers there should be better disclosure of information by banks to small business borrowers. The following areas require attention:

- that margins above the appropriate bank indicator interest rate, fees and charges be disclosed as part of agreements between banks and small business;
- any changes made to margins above the bank indicator rate, fees and charges during the course of a loan be implemented only following advice to, and in appropriate circumstances, consultation with the customer; and
- that a rate for comparison incorporating all costs associated with small business loans be disclosed by banks to customers. The Standards Australia comparative interest rate for consumer credit should be used.

The Committee recommends that:

46. **all margins above the bank indicator interest rate, fees and charges be disclosed as part of loan agreements between banks and small business;**

47. **any general changes made to margins above the bank indicator rate, fees and charges during the course of a loan be implemented only following advice to customers and any changes made on the basis of reviews of an individual customer's circumstances only be implemented following consultation and advice; and**

48. **a comparative rate incorporating all costs associated with small business loans be disclosed by banks to customers. The Standards Australia comparative interest rate for consumer credit should be used.** (paragraph 15.82)

Means of redress

The Committee is aware of the difficulties of small businesses in obtaining inexpensive and satisfactory resolution of disputes with banks. However, it can not support the extension of the Banking Ombudsman to cover small business generally. The size and complexity of many small business operations would swamp the Ombudsman's Office at the expense of small consumers. In Chapter 20 where the Ombudsman scheme is discussed, the Committee will suggest the monetary extension of the scheme and the inclusion of incorporated bodies up to this monetary limit. This will give to small business access to dispute resolution by the Ombudsman.

However, many small businesses will be required to use the court system to obtain redress. In this context, the Committee views the allegations of abuse of process by means of delaying tactics and poor discovery as serious. The courts have powers to ensure that their processes are not abused by any party. The issue of the cost of pursuing litigation is a further issue of concern. The Committee considers there should be an investigation by the Australian Law Reform Commission of the powers of the courts to deal with abuse of their processes and whether there is a need for legislation in this area. The Committee notes that the Senate Committee is undertaking an inquiry into the cost of justice and the Committee will refer the issue of the cost of justice in cases between banks and customers to that committee for inclusion in its consideration.

In terms of redress available through the courts, the Committee notes the extension of the unconscionability provisions of the Trade Practice Act to cover small business. This will assist in reducing some of the disparity in the relationship between banks and small business.

The Committee recommends that:

49. **the Australian Law Reform Commission examine the powers of the courts to deal with abuse of their processes and consider whether there is a need for legislation in this area to assist the courts to deal with abuse of process; and**

50. **the Senate Committee on Legal and Constitutional Affairs, as part of its inquiry into the cost of justice investigate the issue of the cost of justice in cases between banks and customers. The Committee will refer the information it has taken on this issue to the Senate Committee.** (paragraph 15.91)

Chapter Sixteen: Banking And The Rural Sector

Banking products provided to rural borrowers

Banks have produced a wide range of products to meet the needs of the farming community but widespread awareness of their availability may be lacking. Banks, government departments and relevant industry bodies should ensure that farmers are made aware of the availability of these products.

The Committee recommends that:

51. **the banks ensure that farmers are made aware of the full range of products they have available by ensuring bank staff are familiar with the products and have the relevant expertise to advise customers on their application; and**

52. **the Department of Primary Industries and Energy, financial counsellors, the National Farmers Federation and the State based organisations and government departments provide information to the rural sector about these products including independent assessments of their usefulness.** (paragraph 16.17)

Costs involved in borrowing for agricultural purposes

The Committee has concluded that due to the trust held in banks, some farmers did not seek additional advice from solicitors, accountants, rural counsellors or other relevant professionals about their finances. While this is now changing, farm organisations should encourage farmers to seek opinions from other financial advisers.

The Committee recommends that:

53. **farm organisations encourage farmers to seek opinions from appropriately qualified financial and other advisers.** (paragraph 16.44)

Rural indebtedness and bank foreclosures

The Committee has concluded that claims of widespread bank foreclosure in rural Australia for other than commercial reasons are overstated. However, in a number of cases it was clear that some banks were taking unreasonable action to force farmers in default of their loans to leave their properties. Some banks were also reluctant or simply refused to negotiate with rural borrowers facing financial difficulties. In these cases banks need to adopt a more sympathetic approach so that these farmers can attempt to trade out of their difficulties rather than being forced out of the industry.

Pastoral companies as providers of finance

The Committee was concerned to find that the special nature of the relationship between pastoral companies and government business enterprises such as QIDC and their rural clients had led to allegations of unreasonable behaviour by these financiers. It was concluded that the claims by borrowers were justifiable in some cases. As a result, the Committee believes that the lending policies of the pastoral companies should be revised to take account of sound business ethics.

The Draft Code of Practice relating to the bank-farmer relationship should be applied, with appropriate amendments, to the relationship between pastoral companies and rural borrowers.

Addressing the imbalance between lenders and borrowers in rural areas

The Committee considers that a code of practice governing the bank-farmer relationship is a worthwhile concept. Properly developed, it has the potential to alleviate many of the difficulties experienced in farming communities. In particular, it provides the opportunity for farmers to obtain a better understanding of what banks are offering when providing a lending facility.

However, the existing draft Code of Practice is deficient in many respects. In particular, it lacks detail about disclosure, dispute resolution and guidelines for borrowers exiting properties. In addition the pastoral companies are not included in the existing draft Code. These deficiencies need to be rectified.

The need for wider consultation in developing the draft Code is required. Such consultation should occur between representatives of the banking industry and the rural sector. As with other codes, the Trade Practices Commission should be involved in the consultative process and provide final authorisation. Once implemented the Code should be reviewed on a regular basis.

The Committee recommends that:

54. **the existing draft Code of Practice on the bank-farmer relationship be re-examined in consultation with the ABA, NFF, State farming associations, DPIE, rural counsellors and the Trade Practices Commission. The final code should be authorised by the TPC;**

55. **bi-annual reviews of the Code of Practice governing bank-farmer relationships be undertaken to ensure the Code is achieving its original purpose; and**

56. **the Draft Code of Practice relating to bank-farmer relationship be amended to include pastoral companies and government business enterprises conducting similar business.** (paragraph 16.70)

Rural finance in Nyngan

The Committee considers that the Commonwealth Bank has a legal and moral responsibility for the actions of its own staff. It regards the bank's attitude to the Nyngan problems as totally unacceptable. The bank has endeavoured to place blame for the unsound lending practices used in Nyngan solely on Mr Littlehales. Accordingly, due to the widespread nature of the problems in Nyngan a special conciliatory mechanism is required to deal with the situation.

While Nyngan provides a particular focus in examining the bank-farmer relationship, similar predicaments could well arise in other areas in the future. The Committee believes that it is appropriate to develop a mechanism which could be applied to address similar situations in other parts of rural Australia if required.

The Committee recommends that:

57. **the Commonwealth Bank establish an independent mediator or panel acceptable to both the bank and the borrowers to mediate the disputes arising in the Nyngan region. This mechanism should include rural counsellors and should not affect recourse under the law which either party may wish to pursue; and**

58. **the mechanism should be developed to have application to other areas where similar circumstances arise. It could be activated either by the initiative of the bank involved or by recommendation of the Banking Ombudsman.** (paragraph 16.83)

Chapter Seventeen: Foreign Currency Loans

Advantages to banks in foreign currency loans

The Committee concludes that the primary reason for banks offering foreign currency loans to a much wider market than had previously been the case was competitive pressure. This competitive pressure came initially from merchant banks and the anticipated entry into the market of other players who would offer such a product. The competitive pressure increased with the offering of the product by some of the major banks, resulting in all the major banks and some other banks becoming involved to a greater or lesser degree. The competition then fed on itself. Financial advisers and brokers also were promoting the advantages of the product and acting as intermediaries between banks and borrowers.

Much of the evidence from borrowers and their advisers on the alleged profit and other advantages to banks from the selling of foreign currency loans was either misguided or misleading. Upon examination, many of the allegations of advantages to banks could be explained in commercial terms or were incorrect.

However, the Committee has identified that, at the time, there were perceived tax advantages to some banks from the selling of foreign currency loans. It would appear that some banks deliberately structured the product to take advantage of the perceived tax benefits. The Committee notes that the question of any tax benefits resulting from foreign currency loans has been an issue between some banks and the Australian Taxation Office and that all outstanding issues have been resolved by means of settlements.

While perceived tax advantages may have stimulated the motivation for some banks to sell foreign currency loans, not all banks which sold foreign currency loans perceived that there were tax advantages in doing so. The primary reason for all banks being involved remained the competitive pressure to provide such a product to small customers to maintain or increase market share.

The Committee sees a need for greater disclosure in the area of foreign exchange so that customers, such as small foreign currency borrowers, are advised in advance of the fees and all other charges they will incur for foreign currency transactions.

The Committee recommends that:

59. **banks ensure greater disclosure in the area of foreign exchange transactions by advising foreign currency loan customers in advance of all fees and charges associated with foreign currency transactions.** (paragraph 17.94)

The 'marketing' of foreign currency loans

The banks argued that they did not 'market' nor even 'promote' nor 'sell' foreign currency loans. They endeavoured to portray themselves as the passive victims of borrowers (often advised by brokers) determined to obtain foreign currency loans. This may be true in some instances, but it is difficult to sustain in all cases.

It was noted in the previous section that competitive pressure was the primary force driving banks to offer foreign currency loans. In such a competitive environment, it is difficult to believe that the banks did not make efforts to ensure that customers were aware that they offered a foreign currency loan product.

The Committee has identified at least some of the promotional measures adopted by some banks:

- there was some advertising of the product as part of general advertising approaches;
- some seminars and other 'promotions' were conducted which involved a discussion of foreign currency loans; and
- there was at least one instance where a bank staff person had targets for the selling of foreign currency loans.

These do not amount to a massive market campaign or to evidence of aggressive selling and do not apply to all banks. However, they do indicate that some banks involvement in the product was not passive. The pattern of take up of loans indicates that some bank staff may have been involved, together with others outside the banks, in stimulating local demand for the product. Whether this may have led to a failure to adequately warn borrowers about the risks of foreign currency borrowing is examined in the next section.

The Committee notes the involvement of financial brokers and other advisers in the promotion of foreign currency loans. These people disappeared from the scene when borrowers experienced trouble leaving only the borrower and the bank to face the problem. They must accept the blame in some areas for the interest that was evident in foreign currency loans.

Disclosure to borrowers

Banks had an obligation to warn borrowers that unhedged foreign currency borrowing was risky and that the risk could be managed by hedging. In the formal policy guidelines, documentation and approaches of banks relating to foreign currency loans there was provision for basic warnings to be provided to potential borrowers and for information to be given about hedging. The Committee saw no evidence that banks had a policy to deliberately mislead borrowers about the risk of the product to entice borrowers to take loans. However, the Committee notes that the banks' advice that to hedge would have negated the expected advantages of a foreign currency loan, while accurate, reveals a certain hypocrisy on their part in providing such a unmanaged product to customers on the basis that it could be advantageous to them.

However, the delivery of the banks' advice would have been variable, depending on the expertise and understanding of the product possessed by particular bank staff. There is evidence in the banks internal documentation and in admissions to the Committee that the delivery of the product was patchy, and that training of staff involved in delivery of the product was inadequate in some cases to ensure that borrowers had expert assistance available to them. This is confirmed by evidence from some borrowers about the advice they received from their bank.

While there were obligations on the banks to provide warnings, borrowers also had a responsibility to inform themselves about foreign currency risk. It was the borrower who was making the final decision on the loan and it was the borrower who had to manage the exchange risk.

Monitoring and management

The Committee concludes banks had a moral obligation to assist foreign currency loan borrowers following the dramatic fall in the Australian dollar in early 1985. The banks belated response to the problems of borrowers was unsatisfactory.

The strengthening of guidelines and procedures on foreign currency loans by some banks indicates an awareness, in hindsight, that the product was inappropriate to some of the borrowers to whom it was sold and some banks had inadequate procedures in place to filter out inappropriate borrowers.

Settlement process and litigation

The Committee concludes that the law is adequate in this area to provide redress for borrowers with well-founded cases. The Committee emphasises that each borrower's circumstances are different and the individual cases need to be assessed on the particular facts. The courts are well placed to make such assessments.

In Chapter 15 the Committee expressed concern about allegations made by small business of abuse of court processes by banks by means of delaying tactics and poor discovery. The issue of the cost of pursuing litigation is a further issue of concern. The Committee recommended there should be an investigation by the Australian Law Reform Commission of the powers of the courts to deal with abuse of their processes and whether there is a need for legislation in this area. The foreign currency loan cases could provide useful case studies for such an investigation. The Committee also noted that the Senate Committee is undertaking an inquiry into the cost of justice and the Committee will refer the issue of the cost of justice in cases between banks and customers to that committee for inclusion in its consideration.

However, the Committee considers that the approach adopted by some banks to settle foreign currency loan cases before court proceedings demonstrates the advantages for all of conciliation wherever possible. The court process is expensive for all parties, and can be traumatic for borrowers. The Committee favours a mediatory system being available prior to, or as an alternative to, litigation in foreign currency loan cases from the 1980s. In Chapter 20 the Committee examines broader issues of dispute resolution.

While favouring a mediatory approach the Committee expresses concern about settlements made between banks and foreign currency loan customers being confidential. The Committee considers this protects the banks, but does not allow adequate scrutiny of the settlements that are reached.

In regard to the unresolved problems of foreign currency loans of the 1980s, the Committee can not agree to the proposal to refer the foreign currency loan cases to the Banking Ombudsman. The Committee considers that the foreign currency loan cases have such complexity that the Ombudsman's office would become clogged with these cases at the expense of the general case work.

An alternative would be the appointment of an independent mediator to act as an intermediary between the bank and customer and, where necessary, make a non-binding determination of a settlement. The mediator would be an independent person of stature acceptable to both the borrowers and the banks.

Given that the banks have taken varying approaches to the resolution of foreign currency loan cases, it could be expected that some banks would have more matters that could be mediated than others. Therefore, like the current Banking Ombudsman scheme, it is suggested that the banks pay proportionally for their usage of the mediator. Alternatively, each bank could appoint a mediator, acceptable to borrowers, in relation to its loans.

In view of the thorough investigation undertaken by the Committee and the conclusions reached, the Committee sees no need for a royal commission into foreign currency loans. Any royal commission would be expensive and arrive at conclusions similar to those reached by the Committee. The priority now should be to resolve the outstanding disputes and the mediatory mechanism recommended by the Committee and the court processes, if necessary, allow the opportunity for this to occur.

The Committee recommends that:

60. an independent mediator (or mediators), funded by the banks, but acceptable to both banks and foreign currency borrowers be appointed to mediate in foreign currency loan cases that remain in dispute. Mediation is not compulsory, banks will pay for their own mediators or for a general mediator based on usage. The determinations of the mediator will not be binding on either party. Banks should endeavour, to the extent possible, to advise all foreign currency loan borrowers of the mediatory mechanism. The mediator should operate under the following conditions:

- **mediation would not be possible where cases have already proceeded through all stages of appeal so that the court processes are recognised;**
- **mediation would also not be possible where out of court settlements have been reached;**
- ***mediation can be sought where cases are still in court* without final decision, or pending; and**
- **any determinations of the mediator will be non-binding on both parties so that both have the appropriate option of pursuing court action.** (paragraph 17.193)

The 'Westpac letters' and Partnership Pacific Limited

The Committee considers that Westpac has provided reasonable mechanisms for the resolution of the claims of former customers of PPL who had managed foreign currency loans. However, it notes that the tabling of the 'Westpac letters' before the Committee and the Committee's investigation of the issues stimulated Westpac into a belated response to the problems that existed in PPL. No additional mediatory mechanisms are considered necessary. Individual borrowers have the opportunity to pursue their cases through the courts.

While the Committee recognises the role of the State police, it considers the issues raised by the 'Westpac letters' involve complexities of foreign exchange dealings that require examination by a body expert in investigating such issues. The Committee considers that the National Crime Authority (NCA) would be an appropriate body with the necessary expertise to undertake such an investigation. The Committee will assist the NCA by making the relevant public records from its inquiry available. The Committee will seek approval from those who provided in camera evidence that is relevant also to make that available. The Committee asks that Westpac co-operate with the investigations.

The Committee recommends that:

61. **the Attorney-General refer the so-called 'Westpac letters' to the National Crime Authority for investigation as to whether any criminal wrongdoings arise from the management of foreign exchange contracts by Partnership Pacific Limited.** (paragraph 17.208)

Chapter Eighteen: Fraud

Cases of fraud alleged by Mr Paul McLean

The Committee concluded that Mr McLean was unable to demonstrate to it's satisfaction that fraud had been perpetrated by the banks in the cases cited. He was unable to indicate what he perceived to be the advantages to banks from their involvement in actions of this nature. When questioned about the banks' motives he replied 'I do not know the answer'. When questioned further whether banks made or lost money out of the alleged schemes he replied, 'I think that is a question that needs to be answered, and I cannot'.

Mr McLean admitted that he had no evidence of any personal gain accruing to individual bank officers from the alleged fraudulent activity. He stated:

> No, I do not know what is in it for the bank officers. I have got no evidence of bank officers getting anything from the process but I have evidence of them participating in the process.

The Committee also concluded that Mr McLean was unable to demonstrate or substantiate collusion between bank staff and others in the cases presented. As these were among his major claims the Committee could not draw the conclusion that fraud was widespread within the banking industry.

It was suggested by Mr McLean that a Royal Commission into the Australian banking industry was necessary to address, among other things, the issue of fraud. The Committee considers that a Royal Commission is inappropriate given the extensive investigation it has undertaken.

Cases of fraud alleged by Mr John Salmon

The Committee concluded that the instances described by Mr Salmon as 'fraud' and 'corruption' are, at best, commercial banking practice and, at worst, improper or uncompetitive behaviour. The most significant example of improper behaviour was the charging of excessive margins by individual officers in National Australia Bank.

The critical issues arising from Mr Salmon's allegations can be addressed by ensuring that the banking industry remains strongly competitive and adequate disclosure occurs to eliminate inappropriate charging. The Committee concluded, therefore, that Mr Salmon had failed to substantiate his allegations of fraud within the banking industry.

Methods used by banks to detect fraud

The Committee accepts that fraud does exist in the banking industry as it would in any other industry of its size. However, it believes fraud is of a relatively minor nature only. The central issue to determine was what banks and/or their staff gained in the cases of alleged fraud. The Committee does not accept that the generalisations presented by some witnesses justify the claim that fraud is widespread or systemic in the industry.

Furthermore, the Committee has also concluded that the banks have adequate processes and procedures to deal with fraud. However, these should be subject to continuous monitoring to ensure there is effective detection.

The Committee considers that 'whistleblower legislation' in relation to the banking industry is not necessary at this stage. However, the Committee believes that banks should develop processes that allow staff to express suspicions of instances of fraud. Staff should be able to report concerns to senior bank management without fear of retribution. Customers should also have the opportunity to report suspicions of fraud.

The Committee recommends that:

62. **banks establish internal processes that allow staff to report instances of suspected fraud to senior management without fear of retribution and provide opportunity for customers to report suspicions of fraud and corruption.** (paragraph 18.59)

SECTION V: RETAIL BANKING

Chapter 19: Banking, Competition And The Consumer

Consumer credit

Credit cards

Despite falls in interest rates over the past two years, the Committee notes there has been no reduction in credit card interest rates. Not only has there been no reduction but in some cases the interest free period decreased.

The Committee considers that more information is needed in order to assess the profitability of credit cards particularly in the light of overseas experience. Any further investigation would have to be undertaken by an independent authority such as the Prices Surveillance Authority (PSA).

The Committee is attracted to the argument which favours more flexibility in the system to provide consumers with greater choice. Some consumers could have greater choice if the product involved an up-front fee, transaction charges and a reduced interest rate. The Committee requires that this matter which has been on the agenda of SCOCAM for some time be resolved urgently.

On the assumption that credit cards are profitable, credit card fees could be permitted on condition that banks be obliged to reduce and maintain lower interest rates. The introduction of fees would be opposed if this resulted in consumers paying more for the product.

The Committee considers that those who use transaction facilities should pay for the use of the facility through transaction fees.

The Committee recommends that:

63. **a formal reference be given to the PSA to inquire into the profitability of credit cards. If the PSA finds that profits are not excessive, the Committee recommends that SCOCAM consider deregulation of fees on credit cards. If credit cards are deregulated, the PSA should continue to monitor credit card profitability.** (paragraph 19.53)

Dual pricing of credit cards

The Committee concludes that banks' practice of preventing merchants who operate a credit card facility from offering a discount for cash is unfair. If merchants choose not to pass on the cost of credit component built into their prices, they should exercise that discretion without suffering withdrawal of their credit card facility.

The Committee recommends that:

64. **merchants who operate a credit card facility should be free to make their own decisions as to the prices they charge. Dual pricing by merchants should not be prevented by banks.** (paragraph 19.57)

Deposit accounts

It is not clear what low or no interest deposit accounts cost banks. The Committee considers that banks should pay market rates or close to market rates for all deposits.

A large number of banks are already calculating interest daily on deposit accounts. This should become standard practice for all accounts.

The Committee recommends that:

65. **banks pay a reasonable rate of interest on all deposit accounts. This should take into account the costs of maintaining accounts;**

66. **the Australian Taxation Office investigate the possibility of changing tax laws so that taxpayers are taxed on net interest received by them. Net interest being gross income received net of interest, bank fees and charges paid; and**

67. **banks be strongly encouraged to convert all remaining deposit accounts which pay interest on the minimum monthly balance to daily interest.** (paragraph 19.81)

Consumer choice

Alternative institutions

The Committee concludes there are adequate numbers of competing institutions within the retail banking sector to enable reasonable choice for consumers in most places. For a population of 17.5 million, availability of financial services is not restricted.

Switching accounts/portability

The Committee recommends that:

68. **all banks adopt the practice of recovering actual costs for early repayment of loans rather than imposing a penalty; and**

69. **State governments reform taxes and charges they impose on mortgages so as to remove the barriers they now create to entry and exit. They should consider collecting the revenue by spreading government charges over the term of the loan.** (paragraph 19.92)

Product innovation: technology

The Committee concludes that banks should accelerate technological advances with the introduction of an interface between credit and debit card facilities.

Quality of service

Banking is a service industry which must maintain good customer relations by offering good customer service. Good customer service can be provided by reducing waiting time in queues and training counter staff to advise customers on new products and assist in resolving complaints.

Banks are endeavouring to improve their customer relations by staff training. They are focussing training on areas where they have identified the greatest need, utilising complaint statistics.

The Committee acknowledges banks are attempting to resolve shortcomings in their customer service. However, it believes more can be done to improve customer relationships.

The Committee recommends that banks should:

70. **continue to offer training opportunities to their staff especially with regard to improvements in customer relations;**

71. **speed up their implementation of effective complaint handling schemes and make known the existence of their complaint departments to their customers through brochures available in all bank branches;**

72. **make greater use of information gathered through their complaint statistics to improve their performance; and**

73. **publish customer complaints statistics in their annual reports.** (paragraph 19.121)

Availability of finance/overcommitment

The Committee concludes that based on NCAAC's report, credit scoring systems do not place sufficient emphasis on ability to repay; they focus on the credit providers ability to recover debt.

The Committee further concludes that banks should make full and proper assessment of a borrower's ability to repay loans. This will benefit the bank as well as the borrower as bad debts should be reduced.

The Committee recommends that:

74. ***banks should ensure that their assessment of risk and other*** **related areas such as ability to repay are thoroughly investigated. Credit scoring systems should be amended to incorporate criteria such as income, or where it already exists, to strengthen this requirement. Bank loans officers should be adequately trained in risk assessment techniques.** (paragraph 19.138)

Low income consumers

The Committee concluded that the non bank financial intermediaries are vital to low-income consumers continued access to financial services.

Chapter Twenty: Banker-Customer Legal Relationship And Fair Banking

Banking law

The Committee accepts the view advanced in the preponderance of submissions that codification of banking law and practice is desirable.

In forming its view on these issues, the Committee has examined the need for codes in the light of the perceived deficiencies in the present position. In recommending codification the Committee's goal is to have banking services provided on terms which are fair to both parties, which are accessible and known to them, and which provide a clear basis for resolving disputes which arise.

In addition, both the contents of the EFT Code and the experience in its development have provided some indications of the essential elements for the development of an adequate system. Market forces are not of themselves sufficient to ensure that bank services are delivered on fair and equitable terms. It is not appropriate for banks to have exclusive responsibility for setting standards of banking practice. The thinking of the Committee echoes that of the Jack Committee review:

> Historically the developing of standards of best banking practice has been the sole prerogative of banks. It has been argued in this Report that approach is no longer entirely appropriate: competition, while increasing, cannot be relied upon to secure, by itself, the improved standards for which we see a need. While banks must continue to have a major say in the development of standards of best practice, there is also a legitimate public interest in those standards, which should be reflected in some objective assessment of their adequacy.

The Committee has determined that the consumer groups' recommendation that all of banking law be codified in statute is not appropriate. Whilst clarification of the law is desirable, the size of that task would greatly delay the necessary reforms and may result in the law becoming overly rigid at a time when the pace of technological and market change necessitates adaptability.

The Committee has determined that a better overall approach would be to proceed by way of a voluntary code incorporating the lessons set out in paragraph 21.36 of this Report. The Committee considers that codification of banking practice will provide certainty in many areas of current ambiguity. It can foster transparency in two ways: the existence of a code will provide a single source of information for a customer or his or her adviser to refer to; more significantly any code will include provisions designed to ensure that customers are adequately informed of the full details of the products they are about to use. The process of negotiating a code between the banking industry, government and consumer organisations will provide an opportunity to ensure that all its provisions are fair.

In a number of areas the Committee believes desirable industry standards should be set, rather than existing standards re-stated. Whilst standards developed in the marketplace should be given great weight in this process, one of the virtues of a code is that it can address matters not sufficiently subject to competition.

However, the Committee acknowledges that, in respect of a number of distinct issues, a voluntary code may not be sufficient to overcome impediments to change in the existing common law or statute law. Such issues include:

- the right of appropriation between accounts;

- the restrictions placed by the Privacy Act 1988 on the ability of banks to provide information to intending guarantors (a matter which is specifically discussed later in this Report); and

- the banker's duty of confidentiality and any exceptions thereto.

Accordingly, the Committee proposes that, in a joint project, the Trade Practices Commission supervise the development of a code of banking practice and the Australian Law Reform Commission examine banking law. The ALRC should develop appropriate legislative proposals to deal with those areas of banking law which cannot be dealt with by a code but which require clarification or change and make recommendations as to other changes to the law necessary to facilitate the development of the voluntary code.

The Committee considers the Australian Law Reform Commission is a suitable body to undertake the task. The ALRC should examine and report on those matters which involve clarifications of, or modifications to, existing law. These include the right of appropriation between accounts and disclosure to guarantors. The ALRC should exclude from its consideration those aspects of the banker-customer relationship that would more appropriately be included in a code of banking practice. The ALRC should consult widely with industry bodies, regulatory authorities and consumer groups in developing legislation.

The Committee is of the view that a joint project would be the most appropriate way to proceed. Both the ALRC, with its experience in analysing the law, developing proposals for reform and modernisation and drafting legislation, and the TPC, with its history of developing and administering codes, have expertise which would be of immediate relevance to the task at hand.

The code should be developed through a process of negotiation between industry, consumer groups and regulatory authorities, the implementation of which is then monitored by an appropriate Commonwealth regulatory authority. That agency should preferably be the TPC. It would be renegotiated periodically to take into account technological or other changes which render it inappropriate in some way.

The Committee recommends that:

75. the Australian Law Reform Commission be requested to conduct a review of the law of banker and customer, involving consultation with industry, regulatory authorities and consumer groups. In cases where statutory change is required the ALRC should draft recommendations for appropriate legislation; and

76. **a code of banking practice, contractually enforceable by bank customers and subject to ongoing monitoring by the Trade Practices Commission, be developed as a result of a process of consultation between the banking industry, consumer organisations, Commonwealth regulatory agencies and relevant State government authorities. The consultative process should take place under the auspices of the Trade Practices Commission. Monitoring should have regard to the degree of compliance with the code and to the ongoing appropriateness of the provisions of the code in the light of changing circumstances.** (paragraph 20.51)

Regulatory authorities

The Committee recognises the value in having one agency at the Commonwealth level with the primary responsibility in relation to consumer banking issues.

The Committee considers the Trade Practices Commission is best placed to take responsibility for consumer banking issues including the ongoing monitoring of a code of banking practice. Whilst the TPC does not have existing channels of communication with the banks to the same degree as the Reserve Bank, it has dealt with them, is experienced in code development and monitoring, has contact with the consumer movement and has relevant powers and responsibilities under the Trade Practices Act.

The Committee recommends that:

77. **The Trade Practices Commission be given formal responsibility for overseeing consumer banking issues at the Commonwealth level including the monitoring of the recommended code of banking practice.** (paragraph 20.62)

Dispute resolution

Mechanisms to avoid disputes

The Committee recommends that:

78. **all banks adopt a system of regular audits of all branches. Such audits should be designed to, amongst other things, check the availability of information to customers, the ability of staff to answer questions about products and bank practices and the courtesy of staff.** (paragraph 20.74)

Banking Ombudsman Scheme

The Committee is impressed with the effectiveness of the Scheme after such a short time of operation. However, it has some concerns about its long term viability. Banks may not wish to continue to support the Scheme in its present form.

The Scheme's terms of reference are central to its long term survival. Those terms and the question of costs are linked. If the terms of reference are extended to include commercial matters and the monetary threshold is raised the scheme will become much more expensive to operate. If it becomes more expensive to operate, banks may not be prepared to continue funding.

The Committee considers that the inclusion of commercial matters and an increase in the monetary threshold of the Banking Ombudsman Scheme should be considered by banks. This could be done by raising the threshold to $200,000 and including small proprietary companies.

The Ombudsman's figures show that the upper threshold has not restricted the use of the Scheme significantly. It would remain to be seen whether the inclusion of small commercial matters up to a maximum of $200,000 would add substantially to costs of the Scheme.

The Committee does not support the Commonwealth Government becoming involved in what has been a successful self-regulating process. The Scheme is still in its infancy and should be given more time 'to bed down' (to use NAB's words). However, the Committee would be deeply concerned if the Scheme was threatened in any way because it was seen by some banks or bank management as being too successful by focussing on banks' shortcomings.

The Committee would like the Scheme to operate for another year before a further review is made. However, if it is then clear the Scheme is not providing a real alternative to the court system and not delivering fairer banking services then other options should be considered. This could involve establishing a Scheme similar to the small claims tribunals with higher limits and devoted specifically to banking or financial services matters. This is an issue the Committee will keep under active scrutiny.

The Committee favours the establishment of an ombudsman eventually to cover the whole financial services industry and considers processes should be established now to investigate this proposal.

The Committee recommends that:

79. The participating banks in the Australian Banking Ombudsman Scheme should increase the monetary threshold to $200,000 and remove the exclusions relating to small proprietary companies. The threshold should be kept under review; and

80. **a proposal eventually to establish an ombudsman to cover the whole financial services industry should be investigated by this Committee. In terms of development, such a scheme should give priority to ensuring access by consumers of retail or consumer products and services of all financial institutions, rather than, in the first instance, to incorporated entities.** (paragraph 20.114)

Internal dispute resolution

Banks have a vested interest in improving both their communications with customers and their internal dispute resolution procedures. Such initiatives make for better customer relations and, because the Banking Ombudsman Scheme is to be paid for by the banks on a user pays basis, provide a financial incentive to have disputes resolved internally.

To date, it has been a matter for each bank to develop its own internal dispute resolution mechanism and undoubtedly there are commercial advantages to be gained by the bank which best satisfies this important area of customer service.

However, the Committee believes that there are certain minimum standards which all bank internal dispute resolution schemes should satisfy. The matters that need attention are:

- the need for all complaints (other than those dealt with instantly over the counter at the time they arose and to the customer's satisfaction) to be recorded;
- a clear point of entry for a complainant seeking to have a dispute considered;
- clear steps which are readily accessible;
- clearly defined lines of responsibility, with each level of staff knowing the bounds of their discretion in resolving disputes;
- speedy timeliness for resolving disputes;
- the need for the customer to be given reasons for the Bank's decision;
- the need for customers to have access to all relevant documentation; and

- the need for information about the Bank's internal dispute resolution procedures, the steps involved and how to access them to be readily available in brochure form and appropriately displayed at all branches of the Bank. In areas with high migrant populations, such brochures should be available in the dominant community languages. The brochure might also include information on external avenues of review, including the Australian Banking Industry Ombudsman Scheme.

The Committee recommends that:

81. **the development of comprehensive procedures for resolving complaints and disputes be considered in the development of the code of banking practice. Banks should ensure that all staff are familiar with the bank's policies and procedures relating to all aspects of dispute resolution. In doing this, banks should ensure that these policies and procedures are clearly set out in staff manuals and are incorporated into both initial training programs and refresher programs. The issues identified in paragraph 20.123 above should be included in the development of internal dispute resolution procedures.** (paragraph 20.124)

Initiatives needed to be taken by governments

The Committee concludes that there are a number of measures that could be taken by banks and government to facilitate the avoidance and resolution of disputes between banks and their customers. As the Attorney-General's Department noted in its submission to the Committee, improved dispute resolution/avoidance mechanisms lead to:

- increased consumer confidence and therefore likely increased market participation;
- enhanced image of suppliers;
- more informed consumers;
- lower dispute resolution costs for consumers and suppliers;
- reduced pressure for government intervention; and
- improved communication between suppliers and consumers.

The implementation of the suggestions made in this section will benefit all players in the banking system.

The Committee recommends that:

82. **State and Territory governments establish credit tribunals in each jurisdiction; and**

83. **all governments increase funding for independent financial counselling services, as a means of enhancing early resolution of disputes.** (paragraph 20.131)

Banks' Duty of Confidentiality

There is a demonstrated need for modernisation and clarification of the law relating to the banker's duty of confidentiality. Although banks now possess major data bases, they are not fully subject to the regulation relating to them.

The Committee recommends that:

84. **the obligation of banks to maintain customer confidences should be expressly recognised by law and should be subject to express exceptions. The exceptions to the duty of confidentiality should include the following circumstances:**

    - **disclosure of information where subpoenaed for the purposes of litigation;**
    - **disclosure under due process of law;**
    - **disclosure pursuant to express consent in writing obtained by the customer and for a particular purpose; and**
    - **disclosure to other credit providers and agencies subject to the restrictions imposed by the Privacy Act 1988 (as amended) and the Credit Reporting Code of Conduct;**

85. **the duty of confidentiality should extend to all information obtained by the bank in relation to its customer, other than information readily available to the public;**

86. **customers should have access to all personal information concerning them contained in the records of the bank;**

87. **customers should be advised upon opening an account or commencing a relationship with a bank and at intervals thereafter of their right of access to personal information about them held by the bank; and**

88. **the obligation imposed upon credit reporting agencies by the Privacy Act 1988, to take reasonable steps to ensure that accurate files are maintained, should apply to personal information held by banks in relation to customers.** (paragraph 20.159)

Guarantors

The Committee questions the appropriateness of guarantees as commonly used financial instruments.

The Committee believes that measures such as those obtained by the TPC in relation to the case involving the National Australia Bank should be adopted by all banks. The Committee also suggests that guarantors receive a clear statement of their maximum liability.

The principles laid down in the undertakings from the NAB to the TPC should be included in a code of banking practice as it relates to guarantees. This would ensure that guarantors are aware of the nature of the transaction and their potential liability.

The Committee recommends that:

89. **the use of unlimited guarantees no longer be permitted;**

90. **the details of the relationship between a bank and a guarantor be clearly laid down in a code of banking practice and include the specific undertakings that were part of the TPC's agreement with the National Australia Bank. In addition, banks should be obliged to inform guarantors as to the reasons for requiring a guarantee.** (paragraph 20.179)

Disclosure of information about the borrower

The Committee regards an intrusion on the borrower's privacy as justified in circumstances where the borrower wants the guarantor to undertake a significant financial responsibility. The information as to the borrower's financial position is not merely relevant but crucial to the prospective guarantors decision. A requirement that banks disclose to intending guarantors relevant information about the borrower would alleviate present uncertainty about what must be disclosed and what may not be disclosed. It may be that as a result fewer intending guarantors agree to go through with the transaction and that some loans are not made. The Committee regards that result as far preferable to guarantors entering improvident transactions unaware of the risk involved.

In order to implement the proposal that guarantors be provided with relevant information about the borrower, two steps will be required. First, amendments will be required to the Privacy Act to allow banks to disclose the required information where the borrowers consent has been given. Second banks should be required to insist on that consent being given as a condition of negotiating the loan and then to disclose the relevant information to the borrower. The appropriate place for such a requirement is the Code of Banking Practice.

The Committee recommends that:

91. **the code of banking practice require a bank to disclose to prospective guarantors all material facts known to it relating to the borrower and the proposed transaction. Failure to so disclose should render the guarantee voidable unless the bank can show that the failure was inadvertent and the guarantor knew of or was in a position to know of the relevant fact or would have entered the transaction if the fact had been disclosed;**

92. **the code of banking practice also require the bank to advise the guarantor of the state of the borrower's account on inquiry or as soon as the account becomes overdue; and**

93. **the Privacy Act be amended to permit banks, with the consent of borrowers, to disclose information about the borrower or prospective borrower to a prospective guarantor.** (paragraph 20.190)

Chapter Twenty One: Disclosure Of Information

Achieving better disclosure

The Committee concludes that there should be adequate disclosure by banks. The principle of disclosure should be written into an industry code of banking practice.

The Committee recommends that:

94. **the principle of disclosure be incorporated into a code of banking practice.** (paragraph 21.34)

Plain English documentation

The Committee concludes that there is a need for banks' documents to be produced in plain English. Such documents could be produced either by the banks themselves or an appropriate external legal organisation. The Committee supports the latter approach because uniformity of language and clarity of meaning would be introduced throughout the industry.

The Committee recommends that:

95. **a requirement for plain English documents be incorporated in the code of banking practice. Plain English documents should be produced urgently by the Australian Law Reform Commission working wherever possible in conjunction with State law reform commissions and in consultation with the banking industry, consumers and users. Priority should be given to producing important consumer documents such as the mortgage and guarantee documents.** (paragraph 21.51)

Market place information

The Committee concludes that disclosure of all relevant information is of vital importance. It is important not only when a customer enters a contract, but also in relation to any changes that might be made. Customers should be kept informed of all costs in such a way that they can refer to them with the minimum of difficulty. There are several ways in which banks can make this information available and update it regularly. It can be done by direct mailing to customers or be printed on statements in such a way that the information is clear, for example by being printed in bold lettering at the bottom of the statement. It can also be done the same way that banks inform customers of movements in the exchange rates on overseas currencies, by the use of boards in bank branches displaying interest rates on a variety of consumer products.

The Committee recommends that:

96. **banks should disclose all fees and charges and interest rates relating to all products. Disclosure should be done in such a way that all fees, charges and interest rates are clearly drawn to the attention of consumers.** (paragraph 21.67)

Comparative and public information

The Committee concludes that the collection and publication of detailed information about the banking industry, its operations, trends and consumption patterns would provide a significant stimulus to competition and efficiency, as would the regular publication of comparative product information.

The Committee recommends that:

97. **the Reserve Bank should immediately begin discussions with banking industry and consumer representatives with a view to implement:**

    - **ways in which more information about indicators of the banking industry's performance can be collected and published; and**

    - **ways in which more information about banking products can be collected and published.** (paragraph 21.85)

A standardised measure or 'comparative rate'

The Committee concludes that there was general acceptance of the need for adoption of a comparative rate which included all components of credit for loans and deposits. The Committee sees value in such a rate being available to consumers to enable them better to compare bank products. The Committee considers the Commonwealth Government should legislate in this area in relation to banks that fall under the Banking Act. SCOCAM should legislate similarly in relation to State institutions.

The Committee recommends that:

98. **the use of a comparison rate (as described in Appendix 12) to facilitate the comparison of the total cost of credit for loan and deposit products be implemented immediately by the Commonwealth Government in relation to banks under the Banking Act; and**

99. **SCOCAM implement urgently similar legislation in relation to the financial institutions under its purview.** (paragraph 21.106)

Access to documents

The Committee concludes that customers are entitled to have documents relating to their personal affairs. The definition of personal or own affairs contained in the Freedom of Information Act should be considered by the banks as the basis on which such information is provided.

The Committee recommends that:

100. **personal information be provided as a 'right' to individuals. This 'right' should be written into a code of banking practice.** (paragraph 21.116)

Chapter Twenty Two: Banks And Society

Access to banking and the user pays approach

Although it is clear that some adult Australians do not have a relationship with any financial institution, there is no reliable information to explain why. There are indications, however, that a connection may exist between low levels of income and low levels of participation in consumer financial services. In the light of the current trend towards 'user pays', Australia may in future begin to experience similar access problems to those apparently being experienced in parts of Europe and North America.

The Committee notes that it may be useful in the future for more information about those who do not have a relationship with a financial institution to be obtained.

The Committee recommends that:

101. **retail banks and the Department of Social Security jointly investigate the feasibility of developing a basic banking product. The product should be offered by all retail banks, should allow for a set number of free withdrawals each week and should be targeted to the needs of low-income Australians; and**

102. **a structure for an on-going dialogue between the Reserve Bank, the Trade Practices Commission and consumer representatives be established, with a view to ensuring that the Bank and the Commission are and continue to be more fully aware of the experience of consumers of retail banking services and products.** (paragraph 22.53)

SECTION VI: OVERVIEW

Chapter Twenty Three: Overview

The Committee recommends that:

103. **the House of Representatives amend the resolution of appointment of the House Standing Committee on Finance and Public Administration to include a responsibility for reviewing the banking industry. The name of the Committee should be amended to House Standing Committee on Banking, Finance and Public Administration.** (paragraph 23.28)

SECTION I

INTRODUCTION

In this section the Committee provides background information to the detailed examination of the banking system.

The first chapter describes the conduct of the inquiry and indicates the scope of the issues addressed.

Chapter 2 provides an historical overview of the financial system. It draws out a number of themes which are taken up later in the report.

In Chapter 3 there is a 'snapshot' view of the Australian banking system in 1991. *The chapter provides information on the structure of the industry and its* relationship to Australian society and the economy.

The section concludes with a brief discussion of some of the issues on the international agenda in relation to the banking and financial industries that are of relevance to issues being debated in this country. A number of these issues are taken up in detail later in the report.

CHAPTER ONE

CONDUCT OF THE INQUIRY

Background to the inquiry

1.1 For some time prior to its referral, the Committee contemplated an examination of the Australian banking industry. The Committee's interest was prompted by public perceptions about 'excessive' profits made by banks, the apparent imposition of wider margins on ordinary consumers to recover losses on loans to failed entrepreneurs and concern about the general practices of banks.

1.2 In a major speech to the Committee for the Economic Development of Australia on 4 October 1990, the then Treasurer, the Hon Paul Keating, MP, announced he intended to refer an inquiry into the Australian banking industry to the Committee. Mr Keating said he expected the Committee would inquire into:

> how competition has improved Australian banking and to determine whether the benefits of competition are being passed on to all customers.[1]

1.3 The motivation for the inquiry appeared to be similar to that of the Committee and community. Mr Keating referred extensively in his speech to the problem of banks' margins and also to a wide customer disquiet, extending from business and farmers to consumers, about some banking practices.

1.4 There was substantial public reaction even before the formal terms of reference were announced. This reaction varied from a positive view that the inquiry would provide a timely assessment of the achievements of financial deregulation to negative views that it would be superficial or would be a 'bank bashing' exercise. The Committee responded that it would be judged on its work and final report.

The referral of the inquiry

1.5 The formal terms of reference for the inquiry were referred on 25 October 1990. The Committee was asked to inquire into and report to the Parliament by 30 June 1991 on:

(a) the importance of the banking system to the Australian

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1 Address by the Treasurer, the Hon Paul Keating, MP to the Committee for the Economic Development of Australia, Sydney, Thursday, 4 October 1990, p. 10.

economy;

(b) the profitability of the banking sector through time and in comparison with other industries;

(c) the effectiveness of competition in the banking sector, including the impact of any barriers to competition; and

(d) the benefits of competition to different sections of the community including:

(i) access to financial services;
(ii) product innovation;
(iii) choice and quality of financial services; and
(iv) information to users.

1.6 The press release from the Treasurer accompanying the terms of reference expressed the Treasurer's view that the Committee would probably not need to look at the issue of bank margins.

1.7 However, at a press conference on the day the inquiry was announced, the Chairman said that the Committee would investigate any issue considered to be relevant to the terms of reference. The Chairman indicated the examination of bank margins would be important in looking at bank profitability and competitiveness.

Specialist assistance to the Committee

1.8 The Committee recognised that for such an important investigation specialist assistance to supplement its permanent staffing resources would be required. Accordingly, for the duration of the inquiry, the Reserve Bank agreed to second one of its officers, John Hawkins, to provide advice on banking and prudential supervisory issues. Similarly, Attorney-General's Department agreed to second Lucinda Spier to provide advice on competition and consumer issues.

1.9 As well the Committee considered that the advice of a person with direct banking experience would be of great value. A proposal was put to the Australian Bankers' Association (ABA) that it fund an appropriately qualified person to provide such specialist advice. The ABA agreed and proposed Len Spencer, a former senior officer in the Commonwealth Bank. The Committee approved of Mr Spencer's appointment. His experience and expertise have been of great value to the Committee.

1.10 Later in the inquiry, a proposal was put to the Committee that it should obtain funding for a consumer consultant to provide additional expert advice on consumer issues. Subsequently an approach to the Minister for Consumer Affairs resulted in Ms Gillian Moon, a lawyer with a background in consumer issues, commencing work as a consultant to the Committee. She was assisted by Greg Kirk and Gordon Renouf.

Calling for submissions

1.11 The inquiry was advertised nationally on 31 October 1990 seeking submissions from interested persons and organisations. Recognising that there were a wide range of organisations and groups with a significant interest in the inquiry, submissions were sought directly from them. Among these interest groups were:

- the banks including the industry body (the Australian Bankers' Association), major banks, State banks, smaller Australian banks (including new entrants) and the foreign banks. Banks, while generally presenting a single view, differed on particular issues;
- Commonwealth and State governments and departments with an interest in banks;
- consumer organisations representing the concerns of consumers;
- business organisations, including small business;
- rural and farmer organisations;
- building societies and credit unions as the competitors of banks;
- banking unions;
- academics and banking experts; and
- the prudential supervisors and banks' external auditors.

The Committee received submissions from all these groups.

1.12 There were 121 formal submissions to the inquiry and these are listed at Appendix 1. The Committee also received 72 exhibits and these are listed at Appendix 2.

1.13 Additionally individual submissions and complaints against banks flooded in. More than 800 individual representations came from people with a diversity of backgrounds (consumers, small business people, farmers etc) all making a diversity of complaints. These raised concerns about bank interest rates, fees and charges; problems with access to too little or too much credit; and allegations of malpractice, fraud and corruption in the banking industry.

1.14 The Committee did not believe it should perform the role of a banking ombudsman or mediator in relation to the individual submissions.

1.15 Individual cases were interesting in the general picture of the banking industry. As noted later, some individuals were called to give evidence to illustrate general issues. The cases of those who gave public evidence together with a small number of other cases, were referred to individual banks for a response. Individuals were referred to the Banking Ombudsman where appropriate.

Public hearings

1.16 The Committee took the view that it should hear from representatives of all major interest groups. To facilitate this, an extensive program of hearings in Canberra and all the major capital cities was developed.

1.17 As noted earlier, the Committee wanted to hear from a sample of individual bank customers who had made submissions. A number were programmed into hearings throughout the country, in some cases to take evidence on particular issues which illustrated specific problems. Among these hearings were those held in Coffs Harbour in March 1991 on foreign currency loans, in Nyngan and Dubbo in July 1991 on the relationship between banks and rural borrowers and in Charleville in October 1991 on financing provided to rural borrowers by pastoral houses.

1.18 The program of public hearings and other activities on the inquiry is at Appendix 3. The list of witnesses who gave evidence is at Appendix 4.

1.19 The transcripts of the public hearings comprise nearly 4000 pages of evidence while the 17 volumes of submission comprise a further 4800 pages of evidence. Copies of transcripts and volumes of submissions are available for reference in the Committee secretariat, Parliamentary Library and National Library of Australia. References to evidence in the text of this report relate to page numbers in these transcripts and volumes of submissions.

1.20 The Committee decided to hold its initial hearings with the banking industry body, the Australian Bankers' Association, and the four major banks to allay concerns that the inquiry might be an exercise in 'bank bashing'. Some criticism followed these hearings, with suggestions that the Committee lacked understanding of the issues before it and was 'going soft on the banks'. The view was taken that the Committee would be judged on the entire process of the inquiry and the final outcome rather than on preliminary hearings.

1.21 With these hearings complete, the Committee in the next round pursued detailed and vigorous, but fair, questioning of all witnesses. This extended to the banks when they re-appeared at later hearings. Clearly the Committee was engaged in an important and comprehensive review of banking that would make significant recommendations affecting the future of the industry.

The 'Westpac letters' saga

1.22 The Committee's inquiry was diverted by a number of significant incidents surrounding Westpac Banking Corporation. The consequence of these incidents went to the issues of parliamentary privilege and the right of witnesses to appear before parliamentary committees.

1.23 In late January 1991, extracts from confidential letters from Westpac's solicitors, Allen, Allen and Hemsley to Westpac, written in 1987, were quoted extensively in the media. The letters provided advice to Westpac about foreign currency loan management operations of its former merchant banking subsidiary, Partnership Pacific Ltd. Through the courts Westpac successfully sought to restrain further publication of the letters.

1.24 Westpac also instituted proceedings in the Supreme Court of New South Wales against a former employee John McLennan, who had made a submission to the Committee, and who was to be called as an important witness in relation to the issue of foreign currency loans. Westpac was seeking, among other things, court orders to restrain Mr McLennan from disclosing confidential Westpac documents, including the 'Westpac letters'. Mr McLennan wrote to the Committee seeking its intervention in these proceedings as he considered them 'a blatant attempt to intimidate me over my well publicised submission to the Parliamentary inquiry'.[2]

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2 Letter from Mr J McLennan to the Committee secretary, David Elder, dated 18 February 1991.

1.25 Following consideration of Mr McLennan's letter by the Committee, the Chairman raised two concerns in the House:

1) that it be made clear that any orders sought in relation to Mr McLennan did not in any way constrain his ability to give evidence to the Committee's inquiry; and

2) the question of possible intimidation of the witness.

1.26 The Speaker responded that the orders sought could not expose the person to prosecution on account of what he may say in giving evidence to the Committee. Nevertheless, the Speaker concluded that:

> the issues are sufficiently important to have counsel seek leave to appear on my behalf before the court when this matter is called on later today to make submissions on the matter of parliamentary privilege.[3]

1.27 As a result of the intervention of counsel representing the Speaker, the orders sought in relation to Mr McLennan were altered specifically to exclude any restriction on his involvement with the banking inquiry. Mr McLennan subsequently appeared and gave evidence on 20 March 1991.

1.28 On the issue of possible intimidation, the Speaker, following the forwarding of documents relating to the circumstances of the presentation of subpoenas on Mr McLennan, considered that there was no prima facie case that intimidation had occurred.

1.29 The Committee considered the issues surrounding its action in relation to Mr McLennan were of significance in ensuring that witnesses were able to present evidence without constraint.

1.30 However, this action did not resolve the question of the Westpac letters themselves. Debate continued, including in parliaments throughout Australia, about their publication.

1.31 The Chairman considered the controversy was diverting attention from the central issues in the inquiry. He wrote to the Managing Director of Westpac, Mr Stuart Fowler, on 6 March 1991 requesting him to consider a proposal that the letters be tabled before the Committee.

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3 House of Representatives Hansard, 20 February 1991, p. 951.

1.32 In the most dramatic of the Committee's activities during the inquiry, Mr Fowler appeared before a special hearing in Canberra on 7 March 1991 and agreed to table the letters. He outlined their background in some detail. They were subsequently published by the Committee and court orders restraining media publication were withdrawn by Westpac.

1.33 The Committee indicated that it would thoroughly examine the issues raised by the letters, as well as the more general matter of foreign currency loans. This occurred in subsequent hearings and by means of detailed questionnaires sent to the banks, and by documentation requested from them. Chapter 17 reports in detail on the Committee's investigation of the foreign currency loans issue.

Detailed gathering of evidence

1.34 Following this diversion, the Committee resumed its examination of the central issues of the inquiry.

1.35 By June 1991 the Committee had heard from most organisations with an interest in the inquiry. An assessment was made of the evidence taken to that time and detailed questions prepared for referral to the banks on issues such as pricing, consumer concerns, prudential supervision and the role of auditors.

1.36 It became apparent to the Committee that the 30 June deadline for reporting could not be met. Consequently, an extension to the reporting deadline was sought from the Treasurer. This was acceded to and a 30 November reporting date set.

1.37 The Committee also published a newsletter in June 1991 which canvassed some of the issues. The newsletter was circulated widely to all those with an interest in the inquiry. A number of responses were received.

1.38 In July, the Committee commenced its final round of hearings at which issues which had emerged initially were explored in depth. This included detailed questioning of the ABA, the four major banks and the other major stakeholders in the inquiry. These hearings concluded early in October.

Overseas comparisons

1.39 Many organisations appearing before the Committee emphasised the importance of understanding the overseas experience so that a comparison with the Australian banking industry could be made. The countries most often mentioned were the United Kingdom, the United States of America and Canada. The Committee recognised the value of gaining such an understanding.

1.40 The Chairman travelled to the United Kingdom and Western Europe in June 1991 and held discussions on banking issues with a wide range of organisations. A list of the organisations with which the Chairman met is at Appendix 5. Issues canvassed included the experience of banking deregulation, prudential supervision, competition in banking and consumer issues.

1.41 As a result of the value of the Chairman's discussions in the UK and Europe, a proposal was developed for the Chairman, Deputy Chairman and staff to travel to the USA and Canada for discussions. The visit took place in late August-early September 1991 with funding support from the Prime Minister for the travel expenses of the Chairman and Deputy Chairman. The Committee funded the travel of the Committee Secretary, while the Reserve Bank met the expenses of the Committee's adviser, John Hawkins.

1.42 The visit clarified some issues before the Committee and raised new ones. Extensive discussions took place in both countries with the central banks, banking supervisors, parliamentary committee staff, banks, banking industry bodies, governmental organisations and consumer bodies. A list of the organisations with which the group met is at Appendix 6.

1.43 The major issues to emerge from the overseas discussions are referred to in Chapter 4.

The inquiry as catalyst for change

1.44 In this report the Committee has made major recommendations which, if implemented, will significantly reform the Australian banking and financial industries. However, the Committee found that, as the inquiry progressed and particular areas came under scrutiny, changes were proposed or implemented that pre-empted possible Committee findings. The Committee did not expect that the financial sector would stand still while its inquiry proceeded. The fact that changes occurred in areas that were focussed on by the Committee demonstrates the impact the inquiry was having and is a commentary on the inquiry process as a catalyst for change even before recommendations are made.

1.45 In some cases the changes have been in directions that were supported by the Committee. These changes are noted in the report and endorsed where appropriate or expanded on where necessary.

1.46 In other cases, the changes were not supported by the Committee. The Committee has taken the view that it should present its findings on the basis of the evidence that has come to it and not on the basis of what changes particular authorities thought it appropriate to take in response to issues that were emerging before the Committee.

The scope of the inquiry

1.47 It was noted earlier that the initial public view of what the Committee's inquiry was about was the profitability of the banking industry, the size of bank margins and the responsiveness of banks to consumers. The terms of reference involved an examination of these issues and an assessment of the effectiveness of competition and the extent to which competition had delivered benefits to consumers.

1.48 However, the Committee considered its task was a broader one, concerned with reviewing the financial deregulation that resulted from the Campbell Inquiry, assessing whether the changes had achieved their original expectations and whether there was a need for any adjustments to the process of deregulation.

1.49 This wider view of the Committee's inquiry was shared by the major interest groups. The Australian Bankers' Association described the inquiry as a 'progress report' on deregulation.[4] National Australia Bank considered that the inquiry would provide 'a useful opportunity to take stock of the [deregulation] changes which have taken place.[5] This view of the purpose of the inquiry was shared by the other banks.

1.50 Similarly, consumer organisations stated they regarded the Committee's inquiry as a review of the deregulatory changes to the financial system. The first of the consumer submissions was entitled 'Banks a decade after Campbell: promise and performance'. However, they maintained that the terms of reference were limited to an examination of banks. A representative of the consumer organisations noted:

> Many of the issues that we will outline today are issues about the operation of financial institutions, not just banks, and there is an increasing blurring of the boundaries between bank-like institutions, insurance companies and superannuation funds.[6]

1.51 As the inquiry progressed, the Committee recognised the importance of looking at banks within the context of the financial system as a whole.

1.52 To assess the effect of the deregulatory changes Westpac suggested that the Committee would have to judge whether there is 'an acceptable balance within the banking system between efficiency, soundness and safety, and consumer protections'.[7] To these objectives of the financial system the Committee would also add that of competition.

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4 Evidence, p. 4.
5 Evidence, p. S390.
6 Evidence, pp. 946-47.
7 Evidence, p. S223.

1.53 A similar point was made by the Governor of the Reserve Bank. He stated:

> there are a lot of trade-offs in the financial sector ... It is never simply a matter of there being regulation or market forces, and those elements need to be mixed up in a way that is calculated to generate the greatest possible benefit for the majority of Australians.[8]

1.54 Treasury also noted that the basic objectives of government banking policy were 'efficiency, safety and stability'.[9] The balance between these objectives changed over time. The deregulatory changes from the mid 1970s onwards resulted in a shift of emphasis to greater efficiency and competition.

1.55 Given the emphasis on competition and consumer benefits in the inquiry's terms of reference, the Committee concentrated initially on the themes of competitiveness, efficiency and consumer orientation in the banking industry.

1.56 However, the Committee's focus broadened to a greater attention on the prudential supervision of the financial system. The change was prompted by the increasing difficulties experienced by many banks with non-performing loans and bad debts. In particular, the difficulties of the State Bank of South Australia and the apparent gap in the supervisory structure revealed, encouraged the Committee to give much greater emphasis to issues of safety and soundness.

1.57 The Committee also appreciated the point made by consumer organisations that it was difficult to talk of banks in isolation from other players in the financial system. There is a trend towards financial conglomeration with an increased blurring between banking and other activities of financial intermediaries. While this trend may promote greater efficiency (through economies of scale and scope), it raises concerns about other objectives of the financial system such as competition and safety and soundness.

1.58 The emergence of these perspectives resulted in a marked shift in focus of the Committee's inquiry. The shift was not at the expense of the early concerns with banks' profitability and margins, the competitiveness of the banking industry and the benefits of deregulation for consumers. Rather it resulted in an inquiry that was broader in scope than originally had been envisaged.

1.59 In this report, the Committee will return continually to those themes or objectives within the financial system that have been identified in this chapter - efficiency, competition, safety and soundness and consumer orientation. The Committee's judgement of the appropriate balance between these objectives provides the basis for its assessment of the achievements of financial deregulation.

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8 Evidence, p. 431.

9 Evidence, p. S3007.

CHAPTER TWO

HISTORICAL BACKGROUND

2.1 It has been said that those who do not learn from history are doomed to repeat it. Looking at the history of Australian banking, it is noticeable how many of the issues raised before this inquiry were live issues as far back as the mid-nineteenth century. Another point to emerge is the significant role that government bodies have always played in the financial system. Comparison of the three main banking crises, those of the 1840s, the 1890s and the 1930s, is instructive. The second of these was the most severe, largely because of the lax lending standards and lower capital of the banks at that time. Indeed the experiences of the 1890s were to shape the banking environment for much of the twentieth century.

The early years

2.2 In the earliest days of European settlement the financial system was rudimentary in the extreme.[1] The First Fleet's equipment did not include any money. The closest New South Wales came to a bank was the Government stores which issued receipts which circulated widely as an internal currency.

2.3 As the free settler component of the colony grew, so did the call for a banking system. Soon after his arrival, Governor Macquarie foreshadowed his plan for a government bank, but was informed the Colonial Office had many, unspecified, objections to his plans.

2.4 The first Australian bank was the Bank of New South Wales, established in 1817 with the support of Macquarie, who gave it the privilege of limited liability. Challenged on his capacity to do this by the powers in London, Macquarie raised an issue that still remains live today: he asserted 'no one in this colony has been impressed with the idea that the bank was in any manner guaranteed by government'.[2]

2.5 The first instance of banking instability occurred in the early 1820s. When news leaked out of fraudulent entries being made in the bank's books by the cashier, a run on the 'Wales' (as it had become known) ensued. Fortunately the bank was very liquid at this time, with most of its assets in coin and Treasury bills, and confidence was soon restored.

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1 The discussion from here to 2.14 draws heavily on the definitive analysis by S.J. Butlin (1953).

2 Macquarie to Bathurst *Historical Records of Australia* I, ix, pp. 840-1.

2.6 The Wales' first competitor was the Waterloo, an early conglomerate which started corporate life as a flour mill but added banking to its activities in 1822. A more substantial competitor emerged in July 1826 when the Bank of Australia commenced operations and provoked a short-lived reduction in interest rates charged on loans. The Wales lost significant deposits to its new rival, at a time when other economic forces were putting the bank under pressure. After an inquiry, Darling publicly announced approval of a loan to the bank. The announcement in itself restored confidence. A second such rescue occurred in 1828.

2.7 For the most part, the Wales and the Australia were concerned with the needs of commerce rather than those of the small saver. In 1819 a group of leading citizens, again under the patronage of Macquarie, established the New South Wales Saving Bank, more commonly known as Campbell's Bank, so called after its secretary and principal worker.

2.8 In time Campbell's Bank grew to a size where some in the community expressed concern about one individual effectively having an unregulated monopoly over their savings. In 1832 the Legislative Council passed an act to establish the Savings Bank of New South Wales, which took over the operations of Campbell's Bank. The act claimed:

> it is desirable for the encouragement of frugality that persons possessing small sums of money beyond what they require for the supply of their immediate wants should be afforded an opportunity of depositing the same on good security, to accumulate at compound interest and to form a provision for themselves and families.

2.9 The Port Phillip Savings Bank, later called the State Savings Bank of Victoria, opened in 1842. Savings banks were established in the other colonies over the next two decades.

2.10 The pastoral expansion of the 1830s, the boom that followed the gold rushes of the 1850s and the steady expansion of the 1860s further developed the market for banking services. Only a few minor Australian banks emerged to meet this need. Instead British investors established banks such as the Union and the Bank of Australasia which spread branches across the country.

2.11 The Bank of Australasia was the first large bank to offer interest on current deposits, paying 4 per cent, which was followed by the local banks. With loan rates still around 10 per cent banking remained profitable but its character changed. A much larger proportion of banks' funds came from deposits rather than capital, in turn making banks more vulnerable to runs.

2.12 The economic slump of the early 1840s took its toll on the banking system with the Bank of Australia, the Sydney Banking Company and the Port Phillip Bank failing. As they were generally well-capitalised, their depositors lost little.

2.13 The New South Wales Legislative Council established the 'Select Committee on Monetary Confusion' to investigate the role played by the banks in the slump. Although a fall in export prices and the loss of convict labour were cited as causes of the slump, one banker appearing before the committee spoke of a 'wild spirit of speculation ... which unhappily was fostered and encouraged by the banks and by the government' and admitted the banks had 'participated in the general delusion.'

2.14 In 1840 and 1846 the British government circulated to colonial governors sets of Colonial Bank Regulations including the following requirements: non-deposit debts owed by the banks were not to exceed three times their capital, a bank could not hold its own shares or lend against them, loans to directors or officers must not exceed one-third of total loans, dividends could only be paid from profits and prescribed returns were to be supplied half-yearly for publication. The extent to which these prudential guidelines were heeded varied among the colonies but New South Wales had substantially adopted them by 1850.

2.15 Concern continued to be expressed about access to banking services for a broader range of the community. The Savings Bank of New South Wales had only grown to 16 branches by 1870, in large part because of onerous strictures on its operations. To fill the gap a number of 'Penny Savings Banks' were established in various suburbs around the mid 19th century.[3] These sought to encourage thrift among the young and the poor but their future was questionable once their original sponsors retired. For this reason, among others, the NSW Government established the Government Savings Bank, which took over the penny savings banks and eventually merged with the Savings Bank of New South Wales.

2.16 In 1888 there were 43 banks operating in Australia.[4] The 33 trading banks had total liabilities of around 100 million pounds and they paid interest on about two-thirds of their deposits. Ten savings banks, the majority of which were owned by the state governments, had total liabilities of only 13 million pounds. The four largest banks had about a third of the market between them. About 30 per cent of bank assets were controlled by banks with head offices outside Australia. Unlike some other countries, notably the United States, by this time many Australian banks had already developed branch networks. In some cases this reflected British banks following the practice in their home country. This diversification stood them in good stead in competing with some of the small local banks established in regional areas, many of which they subsequently absorbed. In the case of savings banks, the widespread branch structure often reflected their ownership by government.

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3 The last survivor of these still operates in Cairns.

4 As there were no bank licences or restrictions on the use of the term 'bank' at this time, the numbers in this paragraph are not precise. The judgements of Butlin, Hall & White (1971) as to which institutions to include have been followed and their work is the source of the data.

The move to a regulated system

2.17 The 1880s were a time of excessive optimism on the part of bankers and their customers but harsh realities emerged in the early 1890s. While external factors were important, a large measure of the blame for the collapse of Australian financial institutions lay with their lax lending standards.[5] Professor Butlin comments:

> the simple explanation was that a boom, which had disregarded all caution, had out-built conceivable demand, and, stoked as it had been by blind assumption of continually rising prices, it crumpled when that assumption was first clearly falsified in 1888.[6]

2.18 Only nine banks remained open continuously through the 1890s. Some of the others failed outright, some were absorbed and others re-opened and survived, although often with depositors 'reconstructed' into reluctant shareholders. The fringe financiers fared even worse; thirty-five 'mortgage and land banks' closed, 'most of them permanently and most in discreditable circumstances. The worst and most extensive failures were in Melbourne'.[7] A number of building societies also collapsed.

2.19 These events had long-lasting effects. Boris Schedvin comments:

> The bank failures of 1893 and the spurious reconstructions which followed permanently tarnished the reputation of the banking community. They lost the high position of political, commercial and social prestige that they had enjoyed before the crash ... the great wave of antagonism towards the banking system in the 1930s had its origin in the 'nineties.[8]

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5 Manning Clark describes it thus; 'all through the 1880s government and private enterprise expanded economic activity recklessly ... the colonial governments raised loans in London in excess of their immediate requirements, and their ultimate capacity to pay, to build railways, roads, schools, and other public works. Investors advanced money to joint stock companies. Companies were formed in the wake of the boom in Melbourne to invest in real estate that was quickly forced up much beyond its real value ... In July and August 1890 a financial crash occurred in Argentina, which had been a centre of world speculation. In November Barings failed in London and this in turn led to the rapid withdrawal of deposits from Australian financial institutions. Public works stopped, as did most private building ... in the country districts the farmer and the squatter were hard hit by falls of up to fifty per cent in the prices of their produce'. Clark (1986), pp. 150-1.

6 S.J. Butlin (1961), p. 280.

7 S.J. Butlin (1961), p. 280.

8 Schedvin (1988), pp. 80-81.

2.20 The collapse of so many banks gave a great impetus to calls for reform of the financial sector. With federation the Australian Government now had power over banking. Perhaps surprisingly, no early moves were made on banking reform. During this period, the main advocate for the creation of a Commonwealth Bank was King O'Malley, a colourful Labor MP. He presented the first comprehensive programme to the 1908 Labor Party Conference. Under his scheme the Bank would act as a commercial and savings bank, issue legal tender, act as banker to governments and undertake central banking responsibilities.

2.21 The Fisher Labor government established the Commonwealth Bank in 1911.[9] It was, however, only half the bank that O'Malley had envisaged. It had trading and savings bank functions but did not act as a reserve bank, nor did it (at that stage) control the note issue. It was little different to the existing private trading banks and the state savings banks. Fisher himself showed little revolutionary fervour: 'in a country like our own which is growing in wealth and population, there is ample room for the establishment of another bank. A new bank has not been established in Australia for a long time'.[10] The bank was not an aggressive competitor, setting deposit rates below those of the private banks and not encouraging staff to actively court the private banks' customers.

2.22 The savings bank arm of the new bank was given access to the post office network as agents. This was expected to give it a great competitive advantage over the state banks. Fisher himself said 'I believe that the passing of this Bill will mean that there will be ultimately only one savings bank in Australia'.[11] The Commonwealth Bank did take over the state savings banks in Tasmania and Queensland early on, and those in New South Wales and Western Australia during the depression, but it was to wait 80 years before absorbing that of Victoria.

2.23 Central banking become a topical issue in the early 1920s. International conferences recommended that every country should have a central bank. The Bruce government introduced legislation in 1924 with the declared objective of the 'complete transformation of the Commonwealth Bank ... into a central bank'.[12] The legislation gave the Bank control over the note issue and required the trading banks to settle through accounts with the Bank. However, as Dr H.C. Coombs, a former long serving governor, argues 'a central bank cannot be created merely by legislative fiat'.[13] Professor Giblin, an outstanding economist and former member of the Board, commented 'with the powers given to the Commonwealth Bank in 1924 progress towards effective central banking was likely to be slow'.[14]

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9 O'Malley's role in its creation has been subject to much dispute. One side of the argument is put by O'Malley's biographer Catts in her 1957 book and the other in the article by Beazley (1963).

10 *Commonwealth Parliamentary Debates* Vol. LXII, p. 2650.

11 ibid, p. 2648.

12 *Commonwealth Parliamentary Debates* Vol. CVI, p. 1292.

13 In his preface to Giblin (1951).

14 Giblin (1951), p. 23.

2.24 In 1929 the Australian economy entered the Great Depression. Economic historians are in general agreement there was no way Australia could have avoided being swept into the international economic maelstrom. Real national income fell by almost 10 per cent in 1930/31. It did not to return to 1926/27 levels until 1934/35. This reflected in widespread unemployment; by some estimates a third of the workforce was without jobs.

2.25 By the end of 1929 the banks faced an acute liquidity crisis as deposits dried up and loan defaults rose. Their response was to restrict lending. While this was an entirely appropriate and prudent response for an individual bank, when adopted by all banks it further depressed economic activity and worsened their overall position.

2.26 The attitude of the Commonwealth Bank board has been called 'intransigent conservatism'[15]. Its members were as wedded to ideas of 'sound money' as the boards of the private banks. The chairman of the Commonwealth Bank board, Sir Robert Gibson, was far from the figurehead many envisaged the position to be. Despite his limited economic and financial expertise, he imposed his will on the Bank and would have no part of suggestions of expanding credit.

2.27 Gibson's obstinacy spurred the Scullin government on to attempt reform of the Commonwealth Bank. The *Central Reserve Bank Bill, 1930* envisaged separating the central banking functions of the Commonwealth Bank into a new Central Reserve Bank and leaving the former to compete with the private banks in ordinary banking business. The private banks came out against the bill and it was referred to a Senate Committee, which although not expressing itself hostile to the concept of a central bank, was critical of a number of aspects of the bill.

2.28 Many banks came under pressure during the Depression but there were not the many failures of 1893. In part this reflected the lessons the banks had learnt from those years and the subsequent caution they had shown.[16] The most significant closure was that of the Government Savings Bank of New South Wales. In 1931 there was a run on the bank. Although it was guaranteed by the State Government, with whom it had placed large sums, when the crunch came the State Government was itself short of funds. The bank suspended repayment of deposits for eight months.

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15 Schedvin (1988), p. 83.

16 In 1928 the shareholders' funds of the trading banks were equivalent to 17 per cent of their total liabilities to the public, according to the Royal Commission on Banking (1937).

2.29 There has been much argument about whether the Commonwealth Bank could or should have saved it.[17] In the event the bulk of its business was taken over by the Commonwealth Bank. The remnants, mostly the rural loan book, were re-constituted as the Rural (later State) Bank of New South Wales. The Commonwealth also took over the operations of the Savings Bank of Western Australia but without the rancour which occurred in New South Wales. Three smaller banks also disappeared during the depression. The Primary Producers' Bank was wound up, the Australian Bank of Commerce was absorbed by the Wales and the Federal Deposit Bank was taken over by the Brisbane Permanent Building and Banking Company.

2.30 Banks continued to be unpopular during the 1930s in part reflecting:

> bitter resentment of the part allegedly played by the banks in the collapse of the Labour governments in New South Wales and in the federal parliament, the hostility of every debtor who believed his fate could have been avoided with proper bank aid, and of every sufferer from depression who at least half-believed that, even if had not been caused by the banks, its worst severity could have been averted but for their wickedness or stupidity.[18]

2.31 The Tasmanian Parliament appointed a Select committee in 1934 to review the monetary system. It brought down an idiosyncratic report, influenced by the theories of the Douglas Credit movement. Its main finding was that 'people are being prevented from ... enjoying the increase in wealth ... [by the] shortage of purchasing power in the hands of the community as a whole and this can be effectively remedied only by restoration to the sovereign community of effective control over money in all its forms'. They were critical of the 'monopoly of finance as represented by the private banks and their subsidiaries' whose 'chief source of profit is the issue of credit'. They believed 'the injustice of this has become apparent'.

2.32 The Federal government also responded to the ground swell of discontent with banks by establishing a Royal Commission into the Monetary and Banking System, chaired by Justice Napier and including Ben Chifley. It collected evidence through 1936 and reported in 1937. The report concluded 'the most desirable banking system is one which includes privately owned trading banks ... [and] in which a strong central bank regulates the volume of credit and pays some attention to its distribution'.[19] Accordingly it recommended the Commonwealth

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17 Then NSW Premier Jack Lang was critical of the 'treacherous part played by the Commonwealth Bank in its anxiety to seize the cadaver [of the G.S.B.] and expropriate the assets in order to strengthen its own savings bank division'. Lang (1970), p. 119.

18 S.J. Butlin (1961), p. 406.

19 Royal Commission into Monetary and Banking System (1937), paragraph 669.

Bank be given wider powers to conduct monetary policy, such as being able to compel the trading banks to place a specified proportion of their deposits with the Bank. While the commission noted 'it is unusual for a central bank to carry on trading bank activities and to control a savings bank, we consider it desirable that the Commonwealth Bank should do both ... [as its banking] activities add to its ability to regulate the volume of credit'.[20] While according the Bank some independence, in the event of irreconcilable differences the commission believed 'it is the duty of the bank to carry out the policy of the Government' although 'the government should give the Bank an assurance that it accepts full responsibility for the proposed policy'.[21]

2.33 The Commission believed the Commonwealth Bank should have a responsibility for the stability of the financial system. They stated 'the failure of one bank to meet demands for the repayment of its deposits, even though it may have ample assets with which to meet all its liabilities if allowed time, may bring about a condition which may seriously threaten the stability of the whole system'. Accordingly the Report recommends 'in the public interest the Commonwealth Bank should take control of the affairs of any bank which is unable to meet its immediate obligations and should be given any additional powers which it may require for this purpose'.[22]

2.34 Restrictions on organisations conducting banking business were recommended. It was suggested that licences from the Treasurer should be required but that all existing banks should receive one. Only organisations with a licence (and State banks) could use the name 'bank'. The Commission was critical of the information the banks disclosed (or rather failed to disclose) in their annual report. It recommended balance sheet and profit and loss data in a standard format be published in the *Government Gazette*.

2.35 The recommendations of the Commission were widely debated during 1938 with the banks vigorously opposing any extension of the Commonwealth Bank's powers over them. A bill was prepared in early 1939 but was then overtaken by the outbreak of war and changes of prime minister, and later government.

2.36 In October 1941 the Curtin ministry took office and the new government used the National Security Regulations to licence banks, require them to place funds in Special Accounts with the Commonwealth Bank, supply it with information and comply with its policy on advances. The rate of interest paid on the Special Account was set by the Commonwealth Bank having regard to preventing banks' profits from exceeding the levels of the pre-war years. In February 1942 the Bank was given powers to set maximum interest rates.

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20 Ibid, paragraph 577.

21 Ibid, paragraph 530.

22 Ibid, Recommendation 16 in paragraphs 612-7.

2.37 These regulations were only constitutionally valid under the defence powers. At the end of the war they had to be replaced with specific legislation. The *Banking Act, 1945* reflected the wartime regulations (with the exception of the limitation of banking profits), which were themselves largely modelled on the recommendations of the 1935-7 Royal Commission. The Commonwealth Bank was re-organised with the Board replaced by an advisory council, giving the Governor a freer hand. Chifley chose not to adopt a suggestion by Dr Coombs that a parliamentary committee on banking be established to confer regularly with the Bank.[23]

2.38 In March 1947, following a successful high court challenge to part of the banking legislation, the Government announced that action would be taken to nationalise all the private banks. The banks responded with 'probably the most intense and concentrated campaign ever experienced in Australia'.[24] In August 1948 the High Court declared vital sections of the nationalisation legislation invalid, a decision upheld by the Privy Council on appeal. The defeat of the Chifley government in 1949 removed bank nationalisation from the agenda.

2.39 As well as regulation to implement monetary policy and to protect depositors, governments were also concerned with consumer protection. The Australian states introduced individual legislation based on the British *Moneylenders Acts, 1900, 1927.* These required licensing of some categories of credit providers and gave the courts power to vary contracts where the interest was excessive and the transaction harsh and unconscionable. There were complaints from lenders that penalties for inadvertent breaches were excessive.

2.40 The incoming government repealed the nationalisation legislation but did not attack the fundamentals of the 1945 legislation. Even the banks seemed to have reached a grudging acceptance of the legitimacy of the central banking function.

2.41 Since the 1890s there had been a gradual contraction in the number of banks operating in Australia. Since the Commonwealth had been founded there had been no new banks formed. Mergers resulted in some rationalisation of duplicate branches, a practice encouraged by a 1942 wartime programme. In 1955 there were 20 banks operating in Australia. These comprised the Commonwealth Bank, eight private trading banks, three small foreign banks, five banks owned by state governments and two trustee savings banks in Tasmania. The four largest banks held around two-thirds of the market, double their share in 1888. The government-owned banks controlled almost half the assets.

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23 The suggestion is contained in a memorandum to Chifley quoted in S.J. Butlin (1983). It is not known whether Coombs pursued this suggestion after he became Governor of the Bank himself.

24 S.J. Butlin (1961), p. 430.

2.42 Interest rates in Australia were quite low in the period after the war. There was 'an almost universal dogmatic adherence to the view that interest rates should always be very low'.[25] There were a variety of reasons for this. Government had large debts and wanted to keep down the cost of servicing it. A rise in rates would mean capital losses to those patriotic citizens who had subscribed to war bonds. There was a need to speed reconstruction. Few seemed concerned that low rates could discourage saving and few believed that raising rates was a desirable method of reining in excess demand.[26] Regulation was required to maintain a regime of low interest all around. Banks were limited in the rates they could charge and pay. In particular the trading banks were prohibited from paying interest on current accounts. One reason for this was to enable them to charge lower rates for advances.[27] Arrangements were put in place to form a captive market for government securities to keep rates on them down as well.

2.43 A recurrent gripe of the private banks had been that the Commonwealth Bank was both a competitor and a regulator. In response there was a re-arrangement within the Bank, making a sharper distinction between its General Banking Division and its central banking role. These reforms did not satisfy the private banks. The newly-formed Australian Bankers' Association launched a strong campaign in 1954 calling for the separation of the central banking functions from the Commonwealth Bank. Governor Coombs preferred the existing arrangements which enabled those formulating monetary policy to be in closer contact with the economy, draw on staff with commercial banking experience and directly use the trading sections of the Bank to influence economic activity. Ultimately the banks had their way. The renamed Reserve Bank of Australia had its general banking functions split off into a new Commonwealth Banking Corporation from January 1960. Its stated goals were lifted from those given to its predecessor in the 1945 legislation. The Bank was to aim for:

> the stability of the currency of Australia, maintenance of full employment in Australia and the economic prosperity and welfare of the people of Australia.[28]

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25 S.J. Butlin (1983), p. 139.

26 For example, Arndt (1957), p. 211 comments 'While higher advances rates could be expected to have some deterrent effect on the marginal borrower - not necessarily the borrower whom it would be most desirable to deter - they could never take the place of credit rationing'.

27 Grenville (1991) suggests 'there may also have been some theoretical notion of a distinction between money (non-interest-earning) and near-money (interest-earning), with monetary policy operating on the relative returns on these two types of financial assets'.

28 *Reserve Bank Act, 1959,* section 10.

No guidance was given on the priorities to be attached to these arguably conflicting objectives. Under a revised Banking Act, the Reserve Bank was also enjoined to 'exercise its powers and functions for the protection of the depositors of the several banks' but not to guarantee those deposits.[29]

2.44 At this time the special accounts were replaced by Statutory Reserve Deposit (SRD) accounts. Each trading bank was required to place a certain proportion of their Australian deposits in these SRD accounts which paid a low rate of interest. Variations in this ratio were an important tool of monetary policy as they affected the ability of banks to lend. In 1956 the banks had agreed, under the Liquid assets and Government Securities (LGS) convention, to hold government securities and other specified liquid assets equivalent to 14 per cent (later 18 per cent and briefly 23 per cent) of deposits and this provision was continued. The Reserve Bank also continued to set maximum interest rates, by announcement rather than formal determinations, and direct the overall lending policies of the banks.

2.45 As the main banks had been concerned with the needs of commerce rather than small savers, the bulk of the 'savings banks' were owned by governments. Gradually the private banks realised the Commonwealth, which had operated a savings bank division for many years, was gaining a competitive advantage from this. Accordingly between 1956 and 1962 the larger private banks established savings bank subsidiaries. The licences issued to these banks required them to hold specified proportions of reserves and to invest in government securities; the proportions being initially based on those then pertaining in the Commonwealth Savings Bank.

The growth of non-bank financial intermediaries erodes the efficacy of regulations

2.46 The Capital Issues Regulations, a wartime power, had allowed the government to fix maximum interest rates for pastoral companies and building societies but with its expiry in 1952, there were only the powers under the Banking Act. These referred only to banks. So from this period on, there was a tendency for non-bank financial intermediaries, including some owned by the banks, to meet demand for credit unable to be satisfied by the banks.

2.47 Another part of the financial sector that grew rapidly in the post-war era was instalment credit. Rising incomes, a 'baby boom' and increased supplies of whitegoods and cars following the end of wartime austerity raised the demand for this type of finance. As the banks had relatively little involvement in personal

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29 Ibid, section 12.

lending, in part because of regulations designed to direct their lending away from such 'non-essentials', hire purchase schemes were a popular way of borrowing to buy household goods. In the 1950s about 40 per cent of new cars, 70 per cent of used cars and 73 per cent of household appliances were sold under hire purchase.[30]

2.48 During the 1950s most instalment credit was provided by the specialist finance companies for whom it provided 80 per cent of their business. Some of these companies were owned by retailers but many were independent. The largest, Australian Guarantee Corporation and Industrial Acceptance Corporation (IAC), had been operating since the 1920s. Following the lifting of wartime controls in 1950 the companies issued their first debentures. These soon replaced shareholders' funds and advances from banks as their main sources of funds.

2.49 The banks realised the less restricted finance companies were growing rapidly (at their expense) and wanted a slice of the action. In 1954 the National Bank bought a 40 per cent stake in the newly formed Custom Credit Corporation. The English, Scottish & Australian Bank (ES&A) formed a wholly-owned subsidiary, Esanda, in 1955. By 1959 all the private trading banks had acquired an interest in a finance company and by 1972 each had a controlling interest. The associations with banks allowed these finance companies to raise funds more cheaply, despite the bank not giving an explicit guarantee. A partly-owned finance company was also used by foreign banks such as Chase Manhattan (through Alliance Holdings) and Citibank (through IAC) to have an involvement in the Australian financial market.

2.50 Building societies also did well in the 1960s, meeting the demand for housing finance that interest rate limits and quantitative lending guidelines prevented the banks from serving. They could afford to charge a little extra for their loans and so tended to pay more on deposits. As co-operatives they could not be taken over by the banks.

2.51 The process of growth in financing outside the banking system continued through the 1970s. (Table 2.1) Building societies and credit unions grew very rapidly to meet demands for household finance while money market corporations, often called 'merchant banks' or 'development finance corporations', met the needs of corporate borrowers. As with the finance companies, both foreign and domestic banks often held large stakes in the money market corporations. In many cases these took the form of consortia to meet foreign investment guidelines. For example, for many years Partnership Pacific was one-third owned by the Wales, one-third by Bank of America and one-third by the Bank of Tokyo.

2.52 The first cash management trust was established in 1980. These institutions provided a conduit for household savers to the higher rates on the short term money markets. In this way they placed considerable pressure on banks' low-interest deposits from the household sector.

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30 Submission to the Vernon Committee by the Australian Hire Purchase and Finance Conference, cited in paragraph 10.18 of the Committee of Economic Enquiry Report.

TABLE 2.1: ASSETS OF FINANCIAL INTERMEDIARIES
(June, per cent of total)

	1929	1936	1953	1970	1980	1985	1991
Banks	94	95	88	70	58	59	72
Building Societies	2	2	3	5	12	10	4
Credit Unions	-	-	-	1	1	2	2
Money Market Corporations	-	-	-	3	6	11	10
Pastoral Financiers	4	3	4	3	1	2	-
Finance Companies	-	1	3	15	18	13	7
Other	-	-	2	3	4	3	5

Sources: Data from Butlin (1987); Royal Commission on Banking (1937); Butlin, Hall & White (1971); Foster & Stewart (1991); *Reserve Bank Bulletin* September 1991

Other developments 1960-1980

2.53 The question of foreign bank entry was raised in 1963. Government policy prevented a licence being granted to a foreign entrant. The proposal put on this occasion was for the Chartered Bank, based in London, to take over the ES&A Bank. The proposal was discussed by the Prime Minister and senior ministers, who declined to support it, apparently because 'an acceptance would create a precedent which might precipitate a rush of applications from foreign banks'.[31]

2.54 The expansion of consumer lending led to the introduction of hire-purchase legislation requiring agreements to be in writing and regulating repossession. Meetings of relevant ministers from the various states were held in the early 1960s to review consumer credit law in general and a uniform draft bill was prepared in 1962 but was abandoned.[32] Consumer credit legislation was the subject of four major reports between 1969 and 1973.[33] Legislation followed in New South Wales and Victoria in 1981 which had notable differences. Revised legislation in 1984 had more similarities.

2.55 In 1963 the Government commissioned an extensive review of the economy by a committee led by Dr James Vernon. One of its terms of reference was 'the availability of credit'. Most of the discussion on this topic was descriptive. The committee noted that the growth of non-bank financial intermediaries, particularly finance companies, reduced the effect of monetary policy decisions and accordingly 'a means of formal regulation should be devised'.[34] They observed that the existence of undrawn overdrafts makes the restraint of credit more difficult and suggest charges for undrawn advances. However they found 'no evidence to suggest that the general rate of growth of the economy has been held back by mismanagement of the credit machine'.[35] Their concluding recommendation was that 'the subject [of banking and finance] warrants a full-scale study in its own right ... [as since the 1936 Royal Commission] changes in the monetary field have been very marked'.[36]

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31 Merrett (1985), p. 248.

32 Duggan, Begg & Lanyon (1989).

33 By the Rogerson Committee in 1969, the Molomby Committee in 1972 and 1973, a Western Australian Royal Commission in 1972 and the Queensland Law Reform Commission also in 1972.

34 Committee of Economic Enquiry (1965), paragraph 10.59.

35 Ibid, paragraph 10.53.

36 Ibid, paragraph 10.96.

2.56 In 1970 the ANZ Bank took over the ES&A. In 1977 the combined bank switched its domicile from London to Melbourne. Between 1976 and 1981 the proportion of its shares listed on Australian registers rose from 3 per cent to 70 per cent. For the first time since ANZ's predecessors entered Australia in the 1830s, every large bank, and almost all the others, operating in Australia was Australian-owned.

2.57 The 1970s also saw the first near-failure of a bank since the Depression. The Bank of Adelaide had operated almost exclusively in South Australia since its foundation in 1865 and enjoyed local support but never had a national market share significantly above two per cent. Its problems arose from its subsidiary Finance Corporation of Australia (FCA), which it had allowed to be too large relative to the size of the bank. When FCA got into difficulties with property loans, replenishment of its capital would have meant the Adelaide breaching the Reserve Bank's guidelines. The RBA resolved the problem by arranging a sale of the Adelaide and its subsidiaries by tender, the ANZ emerging as the purchaser. Ironically the property market quickly recovered and FCA sold off its portfolio, bringing a handsome profit for the ANZ.[37]

2.58 In 1976, reflecting then fashionable monetarist theories, the government introduced monetary targets, euphemistically known as 'conditional projections'.[38] The targets were based on M3 - that is, currency plus all bank deposits. To the limited extent that the targets were met, it was often by other intermediaries bidding away banks' deposits. Banks also reduced the growth of M3 by avoiding the cost of SRDs through raising foreign deposits and providing credit by endorsement/acceptance of commercial bills. M3 became very difficult to interpret as banks were deregulated and hence able to win back business which they had lost to non-bank financial intermediaries (NBFIs) and direct financing in the regulated era. The entry of new banks, bringing some deposits from their former non-bank manifestations and bidding some away from existing banks, was set to further cloud the meaning of M3. For these reasons among others, targeting was abandoned in early 1985. Subsequently monetary policy has been set in a flexible response to a range of indicators, sometimes referred to as a 'checklist'.

2.59 The last move to reinforce the regulatory system was the passing of the *Financial Corporations Act, 1974*. It was becoming increasingly apparent that a system of implementing monetary policy through tightly regulated banks while there were relatively free non-bank financial intermediaries was leading to the banks losing business to their competitors. This was not only viewed as unfair to the banks but was weakening monetary policy. Many economists saw the solution in deregulating the banks and moving to a more market-based monetary policy. The logical alternative was to attempt to bring the non-banks within the regulatory net.

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37 Merrett (1985), p. 309.

38 The experience with monetary targeting, both in Australia and abroad, is discussed in Argy, Brennan and Stevens (1989).

This the Act could have done. However, it was decided to limit its operation to the collection of statistics and the sections covering the regulation of non-banks has never been proclaimed.

Deregulation

2.60 There had been some loosening of the restraints on the financial system during the 1970s. Some of the controls on interest rates for large loans and deposits were removed. Savings banks were given a little more discretion over the composition of their assets. Nevertheless the deregulatory process did not begin in earnest until the 1980s.[39] The Campbell Committee was established in January 1979 to inquire into the Australian financial system. The members of the committee had a strong background in finance, mostly in the private sector. Its terms of reference gave a broad hint of the direction it should take. They emphasised the 'Government's free enterprise objectives' and the 'importance of efficiency' but did not give emphasis to social equity issues. The Treasurer said 'the objective of the inquiry was not more regulation by the Government'.[40] After a mainly descriptive interim report in May 1980, the Final Report was delivered in September 1981.

2.61 The Committee believed:

> the community, while recognising a government responsibility to ensure stability and confidence, was nevertheless receptive to the prospect of a more open and flexible financial system, substantially free of intrusive government controls and regulations.[41]

2.62 It described its main concern as being 'to promote a financial system that is efficient, competitive and stable'.[42] In practice, its recommendations on removing regulatory controls - aimed at efficiency and competitiveness - attracted far more attention that its recommendations concerning prudential oversight - which aimed at stability.

2.63 The committee called for a phased withdrawal of interest rate ceilings, including the prohibition on paying interest on cheque accounts, and of restrictions on the types of lending, including lending to the government through purchases of government securities. They believed that monetary policy should be primarily implemented through open market operations. These had their effect more broadly

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39 Detailed chronologies of the deregulatory process are given in Evidence, pp. S1149-57 and in Battelino and McMillan (1989). Further details are given in a series of articles on 'Changes in Financial Arrangements' published in the *Reserve Bank Bulletin*.

40 Australian Financial System Inquiry (1981), p. xxvii.

41 Ibid, p. xxvi.

42 Ibid, p. xxvii.

across the financial market, rather than bearing most heavily on banks. The Campbell Committee believed foreign banks should be allowed to operate in Australia without any requirements for local equity although their rate of entry should be carefully managed.

2.64 On prudential matters, the Campbell Committee believed 'capital ... should be seen as the cornerstone of prudential regulation' and capital requirements should be related to the nature of a bank's assets. They recommended 'the supervisory efforts of the Reserve Bank should continue to involve close liaison with bank management and place particular emphasis on periodic in-depth examinations'. They also recommended 'a national framework for the prudential regulation of non-bank institutions which accept deposits primarily from households without issuing prospectuses should be developed'.

2.65 The Campbell Committee also recommended 'a regular decennial review of the financial system for the purpose of monitoring changes, obtaining the views of participants and making appropriate policy recommendations'. While the government gave no commitment on this proposal at the time, as events have transpired, this Committee's report will have met this recommendation.

2.66 While the Committee was deliberating, all remaining interest rate ceilings on all bank deposits were removed. After the report was released there were further changes. The Reserve Bank announced the end of quantitative lending guidelines. Trading banks were able to offer interest on some shorter-term accounts. The rate paid on SRDs was increased, although it was still well below market rates. There was further relaxation of the constraints on savings banks' portfolios.

2.67 Through the 1970s and early 1980s banks continued to expand their operations outside 'traditional' banking. Given the constraints on their core banking operations, it was argued 'it was only by moving farther into the international field and entering the finance and insurance company markets that the private banks were able to buttress their position'.[43]

2.68 The authorities facilitated the move towards the formation of financial conglomerates by raising the maximum shareholding a bank could hold in a merchant bank from 33.3 per cent to 60 per cent in May 1980 and later allowing them to be fully owned.

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43 Blainey & Hutton (1983).

2.69 While deregulation was giving banks more freedom on setting interest rates, there was also more scope for varying other charges and moving towards a 'user pays' regime. The system by which most fees were set by consultation within the Australian Bankers' Association had been ended by the passage of the *Trade Practices Act, 1974*.[44] However, customer resistance, and caution on the part of the banks, meant that adjustments of fees towards reflecting costs was a slow process.

2.70 The change of government in 1983 was widely regarded as likely to slow, or even to reverse, the deregulatory thrust. In May 1983 the new government appointed the Martin Review Group to assess the Campbell recommendations 'having regard to the Government's social and economic objectives'. In its December 1983 report, the Martin Review Group broadly endorsed the Campbell recommendations. They commented:

> the experiences of recent years underline the importance of a responsive and adaptive financial system for the meeting of community needs. The period has demonstrated the benefits which can be secured from the removal or relaxation of unnecessary or out-dated official constraints ... Market-oriented policy ... is seen as having considerable advantages for monetary policy purposes over the use of controls which bear directly on specific financial institutions ... the Group does not consider controls over bank interest rates as appropriate for either monetary policy or prudential purposes.[45]

2.71 Following receipt of the Review Group's report, the Government removed all remaining restrictions on bank deposits in August 1984. Banks were now free to pay interest on call money as they saw fit. While the lifting of the interest rate ceiling on certificates of deposit in 1973 had reduced the passivity of banks in their deposit raising, they were now fully able to manage their liabilities rather than merely accepting whatever deposits came in through the doors.[46]

2.72 Having freed deposit rates, the remaining ceilings on all but owner-occupied housing loans were removed in 1985 and that on new housing loans in 1986. The distinctions between trading and savings banks were removed. All banks were required to meet a Prime Assets Ratio; that is to hold government securities and other prime assets equivalent to 12 per cent (later reduced to 10 and then 6 per cent) of their liabilities. This replaced the LGS convention and the asset restrictions on savings banks. The SRD requirement was replaced with a less onerous 'non-callable deposit' arrangement.

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44 Merrett (1985), p. 305.

45 Australian Financial System Review Group (1984), pp. 358-361.

46 The implications of liability management are discussed in Battelino and McMillan (1989).

2.73 A vast increase in the array of products offered by banks occurred in the 1980s.[47] These came under four broad categories. Firstly, there were those products that developments in new technology had made possible. Automatic Teller Machines (ATMs) first became widely available in banks in 1980, having been introduced to Australia by a credit union. Electronic Funds Transfer at Point of Sale (EFTPOS) followed in 1985. Australians have been enthusiastic users of these services and market penetration here is now among the highest in the world. The next step is probably the introduction of 'smart cards' which contain a micro-electronic chip embedded in the plastic rather than a simple magnetic stripe. Better computer systems in banks allowed selective use of automatic sweep accounts to be introduced in 1984. Advances in data processing and telecommunications enabled banks to offer home banking (for personal customers) and cash management systems (for corporate customers) which allow customers to undertake banking activities from their home or office. In 1987 the larger banks introduced the Bank Interchange Transfer System, an interbank electronic funds transfer mechanism for high-value transactions. Banks have also been offering electronic data interchange services to corporate customers from 1988. These services link companies, their customers and their bank so that on completion of a payment, remittance details are automatically sent to the receiver and payment confirmation and audit details to the sender.

2.74 The second category of new products are new financial packages using existing technology. In the early 1980s this involved offering many variants of deposit accounts and in the late 1980s offering a simpler consolidated account. Other new products offered included low-start and other variable repayment home loans. Increasingly bill payments could be made over the telephone by quoting a credit card number. Specialised rural and small business centres were established by many banks on a regional basis.

2.75 These two waves of innovation were not directly related to the process of financial deregulation. However, measures taken to increase competition in the system may have led to banks embracing new technology and developing new products more swiftly.

2.76 The third category of innovation was the offering of new products that was made possible by deregulation such as interest-paying cheque accounts, a wider range of term deposit facilities and fixed-rate home loans.

2.77 A fourth category was the new products offered by bank branches on behalf of affiliated parts of the corporate group. During the 1980s insurance, superannuation, approved deposit funds and other managed funds products became more important, in part due to encouragement by government.

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47 A listing of these new products, compiled by the ABA, is at Evidence, p. S104.

2.78 With the removal of many of the shackles from the banking system, the Reserve Bank needed to give more thought to the supervision of banks. During the 1980s it established a separate supervision department and in 1985 published documents on its general approach and its framework for monitoring the adequacy of banks' capital. Statements on monitoring large exposures and arrangements to liaise with banks' external auditors followed in 1986. Legislative changes in 1989 supported these initiatives.

2.79 The Australian Payments System Council was established in 1984 to oversee the evolution of the payments system, having regard to competition and the stability of the financial system. The council is chaired by the Reserve Bank and membership is drawn from the finance industry, consumer groups and the Treasury. A major task undertaken by the council has been implementing standards for retail electronic funds transfer (EFT).

2.80 The move to a deregulated financial system also led to renewed attempts at uniform credit legislation by the states. Lenders sought less prescriptive requirements. Consumer groups were more concerned with adequate disclosure and redress. Draft bills were released for comment in 1989 and 1991.

2.81 Invitations were called for foreign bank entrants in September 1984. The general expectation at the time among the 42 applicants was that only four to six new licences would be issued and that no further licences would be forthcoming. Many of the overseas banks believed their chances of receiving a licence would be enhanced if they had some local equity participation. In the event, 16 applications were accepted, although one bank chose not to proceed, much to the dismay of some applicants who had been confident they would have been included in a smaller number. The new banks commenced their operations between September 1985 and May 1986. They built up a market share of around 10 per cent by 1991 but a significant proportion of this came from transferring business from their existing non-bank operations in Australia and they made only small inroads into the retail market.

2.82 At the time, many believed the foreign banks would do much better, particularly in the corporate lending area, and the domestic banks were willing to fight hard to protect their market share. Many would argue the Australian banks during this period placed an excessive emphasis on market share rather than prudence or even profitability. The second half of the 1980s saw credit growing very strongly.[48] Surprisingly to some, this did not result in an increase in inflation or the growth of nominal income.[49] The faster growth in credit was not accompanied

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48 The average annual growth rate of bank credit in the period 1978-83 was 16.4 per cent but in 1983-88 it rose to 23.8 per cent. For all financial institutions' credit, the comparable figures were 15.8 and 21.6 per cent. Source: Macfarlane (1989).

49 Indeed income and the prices of goods and services grew more slowly. Nominal income decelerated from 12.2 per cent in 1978-83 to 12.0 per cent in 1983-88 while inflation, as measured by the CPI, fell from 10.0 per cent to 7.6 per cent. Source:

by a fall in its price: both nominal and real interest rates were at historically high levels in the second half of the 1980s.[50] This implies there was an increase in the demand for credit as well as the supply. The increase in demand came mostly from the business sector and well outpaced the growth in fixed investment.[51]

2.83 Part of the explanation seems to be 're-intermediation'; business making more use of intermediaries rather than direct financing. Partly it appeared to result from a desire by business, especially the so-called 'entrepreneurs', to increase their debt-to-equity ratios. An Assistant Governor at the Reserve Bank has suggested another factor:

> after nearly two decades of relatively high inflation, the community has concluded that the road to increased wealth has been to become the owner of assets that increase in value ... the way to maximise the rate of return on holding these assets has been to gear up and so the desired extent of borrowing or the degree of leverage has increased ... the deductibility for tax purposes of the full amount of interest costs, including the inflationary component, confers a major tax advantage of debt over equity.[52]

2.84 Both causing and resulting from this increased credit was a rapid increase in asset prices. They grew much faster in both real and nominal terms over the period 1983-88 than 1978-83.[53] The growth in asset prices was unsustainable. In 1987 there was a sharp correction on the stockmarket. A reversal in the prices of much commercial property followed a couple of years later. Once asset prices started to decline, highly-geared investors found increased difficulties in meeting repayments and accordingly bad debts of the banks rose significantly. Their position was exacerbated when the economy moved into recession in 1990.

2.85 As well as the entry of foreign banks, the first new general domestic

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50 Macfarlane (1989).

51 The average interest rates on 90 day bank bills rose from 13.0 per cent in 1978-83 to 14.1 per cent in 1983-88. When deflated by movements in the CPI over the two periods, real rates were 3.1 and 6.4 per cent respectively. Source: Macfarlane (1989). Of the 16 per cent average annual growth in credit during 1978-83, housing contributed 4 per cent, other personal lending 2 per cent and business finance 10 per cent. Over the period 1983-88 the 22 per cent average annual growth was comprised of 4 per cent for housing, 1 per cent for other personal lending and 17 per cent for business finance.

52 Macfarlane (1989), p. 30. Until the introduction of dividend imputation in July 1987, the double taxation of dividends provided an additional incentive for debt.

53 See the figures in Macfarlane (1990), p. 29.

banks since the war were formed in the 1980s.[54] The Australian Bank was formed from scratch in 1981 and Macquarie Bank from Hill Samuel's Australian operations in 1985. Between 1985 and 1989 a number of building societies converted to bank status.

2.86 While the new banks' entry meant that Australia had more banks than it had had since the nineteenth century, this did not translate into less concentration as there were mergers between the larger banks. These mergers were motivated in part by a concern about competing with larger overseas banks that were about to enter the Australian market. The ANZ had been the first to take this view. Back in 1966 their senior management had seen the potential entry of foreign banks as a prime reason for pursuing the merger with the ES&A.[55] Around this time there were discussions about further mergers but it was not until between 1981 and 1983 that the Wales merged with the Commercial Bank of Australia to form Westpac and the National Bank merged with the Commercial Banking Company of Sydney to form a bank later called National Australia Bank (NAB). ANZ took over the global operations of Grindlays while NAB bought four regional banks in the United Kingdom and Ireland. Australian banks also have significant operations in New Zealand, Papua New Guinea and the Pacific islands. A further significant merger occurred in 1990 when the Commonwealth Bank took over the troubled State Bank of Victoria. The end result is the existence of four banks of comparable size who between them account for about three-quarters of the banking industry.

2.87 This trend caused some concerns about concentration within the finance industry. When ANZ sought to merge with National Mutual, the Treasurer's consent was not given.

2.88 In 1990 the effects of the extravagant lending of the banks during the preceding decade began to emerge in their balance sheets. There were marked increases in bad debts and non-performing loans resulting from the injudicious 'name' lending to prominent speculators. As the effects of the recession spread during 1991, further provisioning became necessary covering small business and farmers.

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54 And only the fifth bank of any kind this century (the others being the Commonwealth Bank, the short-lived Primary Producers' Bank and the specialised Australian Resources Development Bank and Primary Industry Bank of Australia).

55 Merrett (1985), p. 256.

Themes

2.89 A number of themes emerge from this review which will be taken up later in the report. One is the relationship between governments and banks. The status of government guarantees for their own banks, and perceptions of government support for, or supervision of, private banks, have been important factors in the community's confidence in banks. The importance of banks holding adequate capital is shown by the contrast between the 1840s and 1930s when few depositors lost their funds and the 1890s. Governments have also sought to ensure fair dealing with consumers by legislation governing the provision of credit to them.

2.90 The people have also looked to governments to rein in the excesses of banks. Banks have been prone to over-react in both booms and busts. Imprudent lending fuelled the speculative mania of both the 1880s and the 1980s. Excessive contraction of credit worsened the slumps of the 1890s and 1930s. Many believe this pattern is repeating itself in the early 1990s.

2.91 In many cases, changes in government controls over the financial system followed major public inquiries. One method by which governments could exercise control over banks is by the creation of a central bank. Once seen as a radical move, this is now universal practice. Other steps include regulation. This has moved in a cycle. A lack of regulation contributed to some banks and NBFIs collapsing in the 1890s. This led to tight regulation being imposed on banks. As a result NBFIs were able to grow more rapidly and became more prone to problems than the banks. Recently regulations on banks have been eased and those on NBFIs are in the process of being tightened.

2.92 The establishment of savings banks last century was a response to the neglect by most banks of the needs of small savers. Some in the community believe this problem has now resurfaced.

2.93 There has been a general tendency for increases in concentration within banking this century. There have been large mergers and banks have spread into related areas to form financial conglomerates. The exception to this period was the mid-1980s when a number of new domestic and foreign banks were formed.

CHAPTER THREE

THE AUSTRALIAN BANKING INDUSTRY IN 1991

Structure of the banking industry

3.1 Australia's financial system can be divided into five main categories:

- Australia's central bank (the Reserve Bank of Australia);
- the banking industry;
- non-bank financial intermediaries;
- the insurance and superannuation industry; and
- the securities industry.

3.2 While the main focus of the inquiry was the banking sector, consideration was given to the relationship between all five components of the financial system. That relationship is relevant to many of the issues which were before the Committee, particularly with the growth of financial conglomerates in Australia in recent years.

3.3 As a result of deregulation, the landscape of banking in Australia has altered considerably. A number of new banks have entered the market, including foreign banks and new domestic banks, formed principally through the conversion of permanent building societies.

3.4 The banking industry itself can be classified into four main categories:

- nationally operating banks (often referred to as the major banks);
- State banks;
- regionally operating banks; and
- foreign banks.

3.5 The nationally operating banks have extensive branch and agency networks and operate throughout Australia. State banks are government owned and their branch networks are located principally in their own States. The regionally operating banks are generally building societies which have converted to banks, and tend to focus their activities in a niche market.

3.6 Foreign banks operating in Australia historically can be divided into two groups. First, there are banks which pre-date the previous restrictions on foreign bank entry and which operate as branches of their parent bank. Secondly, there are banks which were invited to operate in Australia following the removal of restrictions on foreign bank entry as part of the deregulation process. Those operate as subsidiaries of their parent bank.

3.7 A total of thirty one banking groups operate in Australia. There are:

- four nationally operating banks;
- three State banks;
- seven regionally operating banks; and
- seventeen foreign banks (three of which operate as branches of their parent bank, and fourteen of which operate as subsidiaries).

3.8 The banking groups operating in Australia are listed at Figure 3.1.

Definition of a bank

3.9 A bank is an institution which is either licensed under the Banking Act or created under State legislation to conduct banking business. Although the term banking business is not defined in legislation, it generally means accepting deposits and making loans. While banking business, by this definition, is carried on by a variety of financial institutions, only those institutions which have met the necessary conditions and have been granted a banking authority may call themselves a bank.

3.10 As there is no legislative definition of the term banking business, case law has been required to establish a definition. In *Commissioners of the State Savings Bank of Victoria v Permewan Wright and Co Ltd* (1914) 19 CLR 45, Isaacs J stated:

> The essential characteristics of the business of banking ... may be described as the collection of money by receiving deposits upon loan, repayable when and as expressly or impliedly agreed upon, and the utilization of the money so collected by lending it again in such sums

as are required. These are the essential functions of a bank as an instrument of society. It is, in effect, a financial reservoir receiving streams of currency in every direction, and from which there issue outflowing streams where and as required to sustain and fructify or assist commercial, industrial or other enterprises or adventures

Isaacs J held:

> If that be the real and substantial business of a body of persons, and not merely an ancillary or incidental branch of another business, they do carry on the business of banking. The methods by which the functions of a bank are effected - as by current account, deposit account at call, fixed deposit account, orders, cheques, secured loans, discounting bills, note issue, letters of credit, telegraphic transfers, and any other modes that may be developed by the necessities of business - are merely accidental and auxiliary circumstances, any of which may or may not exist in a particular case.

3.11 This definition was applied by the High Court in *Australian Independent Distributors Ltd v Winter* (1964) 38 ALJR 330.

3.12 In *Bank of New South Wales v The Commonwealth* (1948) 76 CLR 1, Justice Dixon stated:

> I am unable to accept the view that the word 'banking' should have ascribed to it anything but the wide meaning and flexible application of a general expression designating, as a subject of legislative power, a matter forming part of the commercial, economic and social organisation of the community ... To give an inclusive definition of such a conception as banking is almost impossible. The theory and practice of banking have varied from age to age.

3.13 Previous committees of inquiry into the Australian financial system, in considering the nature of banking, identified a number of formal characteristics of a bank, including:

- incorporation as an enterprise primarily engaged in lending and borrowing money;
- a special relationship with the Reserve Bank, stemming from the Reserve Bank's responsibilities to protect bank depositors;

- observance of relatively stringent prudential standards in respect of their capital structure and in the management of liquidity and depositors' funds; and

- possession of legal authority to deal in foreign exchange and to issue cheques.[1]

3.14 Those committees supported the continuation of a basic distinction between banks and non-bank financial institutions.[2]

3.15 In the aftermath of deregulation, though, it has become more difficult to differentiate between banks and non-bank financial intermediaries. The traditional lines of demarcation have become imprecise. On the one hand, banks have diversified into activities previously undertaken by non-bank financial intermediaries, such as finance company operations, superannuation and insurance. They also are lending to a wider range of customers, some of which would be classified in a higher risk category. On the other hand, non-bank financial intermediaries are performing various bank-like functions, such as provision of credit cards and cheque facilities, as well as commercial lending and lending for housing.

3.16 This trend has raised a number of issues relevant to the nature of the industry which is emerging. In the ensuing chapters of the report, a number of these issues have been examined, including the competitive effects which are being realised, the increased risks which are involved, and the prudential and supervisory arrangements which are in place.

3.17 In considering these issues, the Committee identified two threshold questions relevant to the concept of banking in a deregulated environment:

- whether smaller non-bank financial intermediaries, which for all practical purposes are conducting banking business should be allowed to become banks if they so desire; and

- whether non-bank financial intermediaries which are large enough to impact on the stability of the financial system should become authorised banks.

3.18 These questions are explored in further detail in Section III.

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1 Campbell Committee, p. 428, and Martin Review Group, p. 52.

2 ibid.

FIGURE 3.1

BANKING GROUPS IN AUSTRALIA IN 1991

Advance Bank Australia Limited	Deutsche Bank Australia Limited
Australia and New Zealand Banking Group Limited	HongkongBank of Australia Limited
Bank of America Australia Limited	IBJ Australia Bank Limited
Bank of China	Lloyds Bank NZA Limited
Bank of Melbourne Limited	Macquarie Bank Limited
Bank of New Zealand	Metway Bank Limited
Bank of Queensland Limited	Mitsubishi Bank of Australia Limited
Bank of Singapore (Australia) Limited	National Australia Bank Limited
Bank of Tokyo Australia Limited	NatWest Australia Bank Limited
Bankers Trust Australia Limited	R & I Bank of Western Australia Limited
Banque Nationale de Paris	Standard Chartered Bank Australia Limited
Barclays Bank Australia Limited	State Bank of New South Wales
Challenge Bank Limited	State Bank of South Australia
CHASE AMP Bank Limited	Trust Bank Tasmania
Citibank Limited	Westpac Banking Corporation
Commonwealth Bank of Australia	

Conclusion

3.19 It is evident that there is some confusion about the difference between financial intermediaries which are authorised as banks and financial intermediaries which simply conduct banking business. The blurring of traditional boundaries between banks and non-bank financial intermediaries following deregulation has contributed to a degree of misunderstanding within the community about the riskiness or otherwise of particular financial institutions. It also has given rise to concerns that non-bank financial intermediaries which conduct banking business but which are not supervised by the Reserve Bank are discriminated against.

3.20 While the Committee accepts that it would be virtually impossible to provide a definition of a bank which would embrace all areas of banking activity, the Committee is of the view that a more comprehensive definition of a bank than is provided in the Banking Act is required. It should be the responsibility of the Reserve Bank to provide such a definition, taking into consideration those elements which clearly distinguish banks from non-bank financial intermediaries, including prudential and supervisory requirements, particular legislative requirements, such as the statutory priority of deposits, and the risk spectrum of a bank's operations.

Recommendation

3.21 **The Committee recommends that:**

1. **the Reserve Bank develop a definition of a bank for inclusion in the *Banking Act 1959* and other relevant legislation.**

Banking operations

3.22 The expansion in the activities of Australian banks following deregulation has been evident at both the domestic and international level.

3.23 Within Australia, deregulation has enabled banks to offer a broader range of banking products within their traditional areas of activity, ie accepting deposits and making loans. A new and much wider range of deposit and loan products is available to various sections of the community, including retail customers and the business sector.

3.24 Banks also have diversified their operations into other areas of financial activity beyond traditional boundaries, including funds management, financial planning and advice, life insurance, stockbroking, trust services and travel. Such diversification has spawned banking conglomerates, and even alliances or arrangements between banks and entities conducting other forms of financial business. The recent alliance established between Westpac and the Australian

Mutual Provident Society, and the attempted merger between ANZ and the National Mutual Life Association, are two examples. Banks also have developed their own funds management operations. Issues relevant to banking conglomerates are discussed in Chapter 11.

3.25 At the international level, banks have expanded their operations through foreign exchange trading, acquisition of foreign financial intermediaries, and expansion of overseas representation. Australian banks are now represented in over 50 countries.[3] By 1989, the four major Australian banks held between 13.9 per cent and 38 per cent of their assets in overseas branch and subsidiary operations.[4] Unlike banks from many other western countries, though, Australian banks have not become involved to any great extent in Third World countries, and have not been exposed to debts arising from such involvement.

3.26 Technological change also has impacted on banking operations in the deregulated environment. While physical branch networks traditionally have been the mainstay of the banking industry, the availability of suitable technology has enabled banks to develop new channels of access and distribution. A network of approximately 4400 automatic telling machines has been established, along with a national electronic funds transfer system at retail outlets.[5] In addition, technological advances have resulted in the introduction of home and office banking facilities. They also have facilitated the widening of interchange agreements between banks.

3.27 Developments in technology also have had implications in terms of access to the payments system. Direct access has been restricted to banks on the basis that a high level of confidence and stability in the payments system is required. However, a rapid growth in the range of payments instruments, many resulting from new technology, has led to increasing demand for access to payments services by customers of both bank and non-bank financial intermediaries. The issue of access to the payments system is discussed further in Chapter 9.

Assets and market share

3.28 The banking industry has remained the key institutional group within the Australian financial system. As at June 1990, the total assets of banking groups operating in Australia amounted to around $326b, which was approximately 45 per cent of the total assets of the financial system. In comparison, the assets of non-bank financial intermediaries amounted to around $150b. The assets of life offices and superannuation funds also amounted to around $150b (Figure 3.2).[6] The level of bank assets reflects the increased involvement by banks in activities which were previously the domain of non-bank financial intermediaries.

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3 Evidence, p. S69.

4 Industry Commission, *Availability of Capital*, Draft Report, 1991, p. 48.

5 Evidence, p. 65.

6 Reserve Bank Bulletin, December 1990.

3.29 In the late seventies and early eighties, as the processes of deregulation were set in train, banks lost some ground in market share, mainly due to the increased popularity of unit trusts. A low point was reached in 1983, when banks accounted for only 40 per cent of the assets of all financial institutions. Much of that lost ground has now been regained, although the market share of banks has not returned to the level of the immediate post-war years.[7]

3.30 The banking industry on a national scale continues to be dominated by the four major banks, which account for around 72 per cent of market share. This compares to 11 per cent accounted for by the three State banks, 10 per cent by foreign banks, and seven per cent by regionally operating banks (Figure 3.3).[8]

3.31 A significant factor which has assisted the four nationally operating banks to continue their dominant position in the Australian banking industry is the banks' extensive branch and agency networks. The four major banks operate 5650 branches out of a total of 6917 branches in Australia (82 per cent), and 5665 agencies out of a total of 7300 agencies (78 per cent).[9]

3.32 At the regional level, a somewhat different picture of market share emerges, principally as a result of the competition provided by State Banks and some of the newer regionally operating banks. State Banks retain the highest percentage of market share of any individual bank in South Australia and Western Australia, while the State Bank of New South Wales occupies third position in that State. Similarly, in the Australian Capital Territory and Tasmania, local banks have a higher percentage of market share than any single nationally operating bank. It is only in the Northern Territory, Queensland and Victoria that the dominance of the four major banks at the national level is mirrored at the regional level (Figure 3.4).[10]

3.33 As for foreign banks, market share figures indicate that, while they have made noticeable inroads in the wholesale sector, they have had limited impact in the retail area. In terms of overall market share, inroads have been made only by a handful, with New South Wales, Victoria, Queensland and Western Australia being the only States in which their combined market share has arisen above seven per cent. The largest impact has been made in New South Wales, where their combined market share has reached 17 per cent. Individually, the foreign bank with the largest slice of the market, Citibank, only has 3 per cent of overall market share at the national level, rising to 4 per cent in New South Wales, Queensland and Western Australia, but dropping to 2 per cent in Victoria.[11]

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7 Evidence, p. S1129.

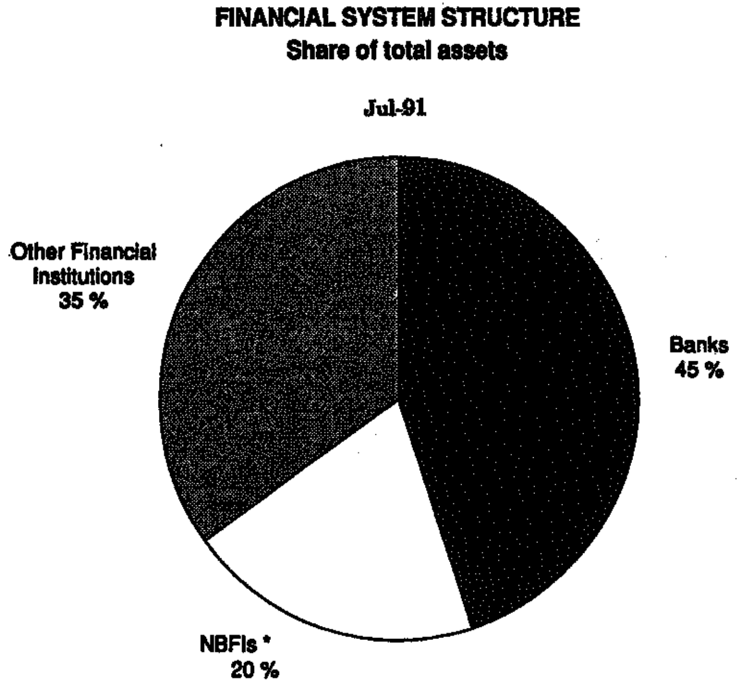
8 Reserve Bank Bulletin, October 1991.

9 Reserve Bank Bulletin, September 1991.

10 Reserve Bank of Australia, Australian Banking Statistics, July 1991.

11 Reserve Bank Bulletin, October 1991.

FIGURE 3.2



* Intermediaries registered under the Financial Corporations Act.

FIGURE 3.3

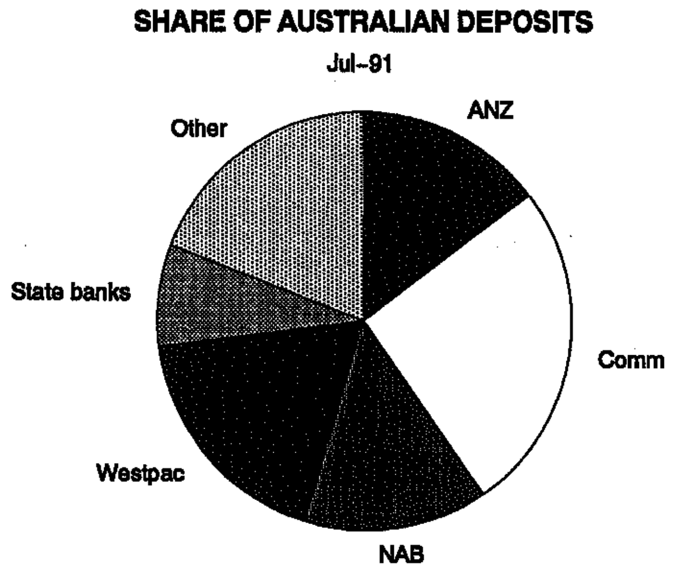
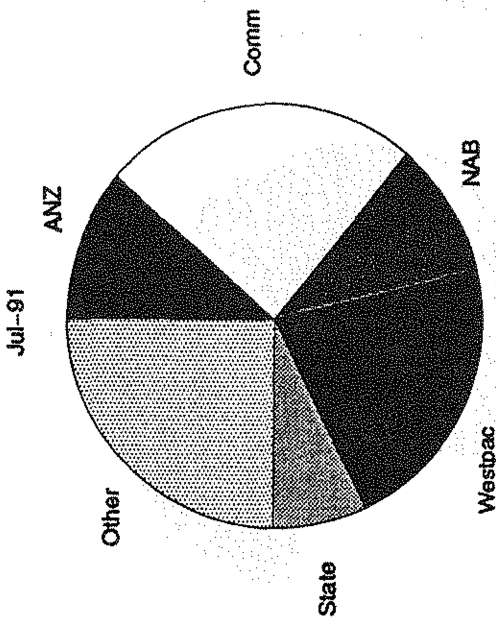
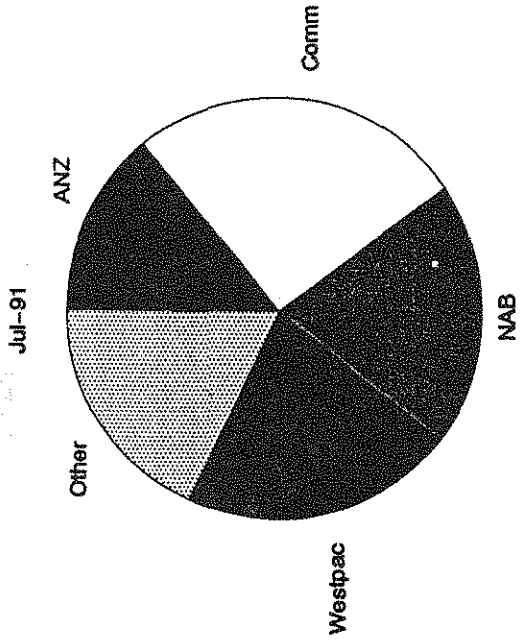
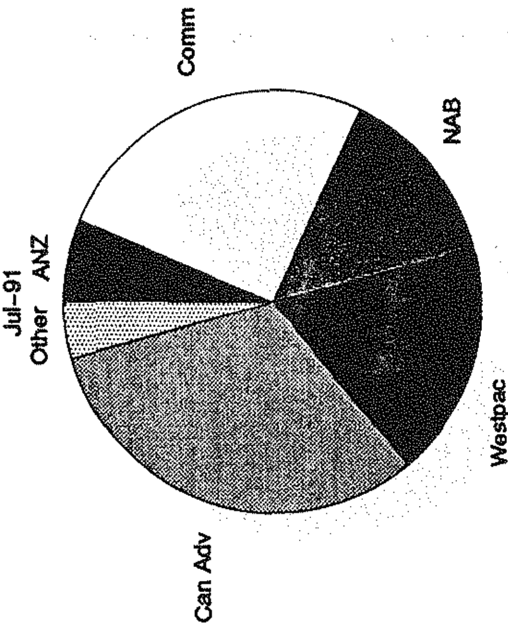
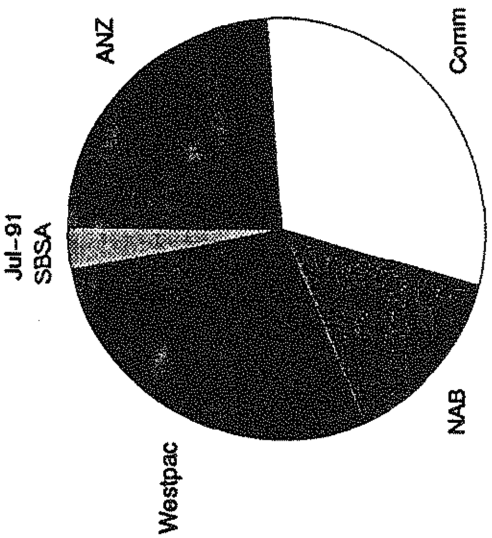


FIGURE 3.4



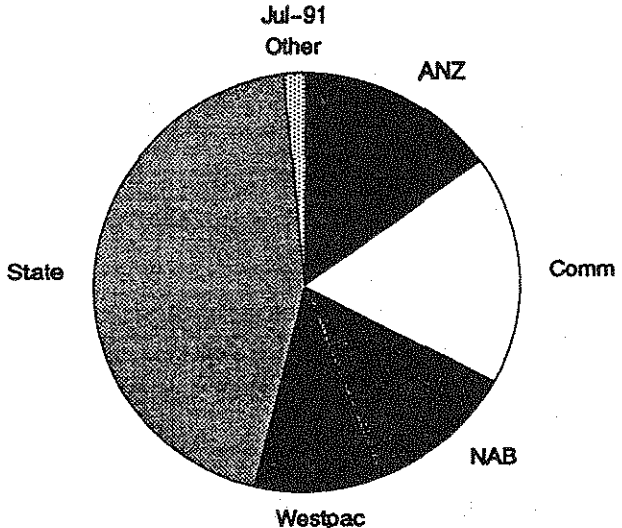






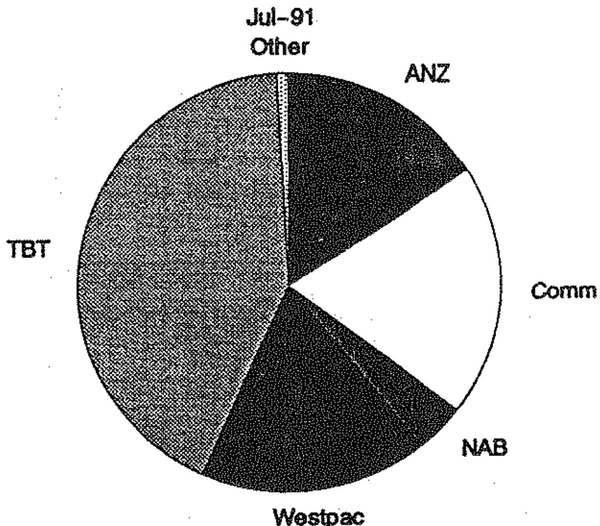
SHARE OF SOUTH AUSTRALIAN DEPOSITS

Jul-91



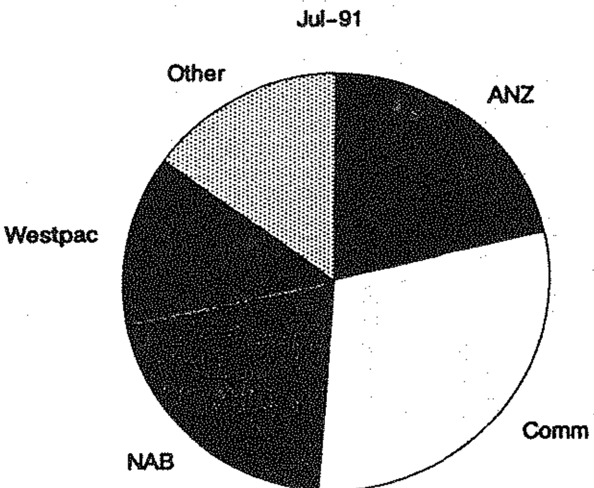
SHARE OF TASMANIAN DEPOSITS

Jul-91



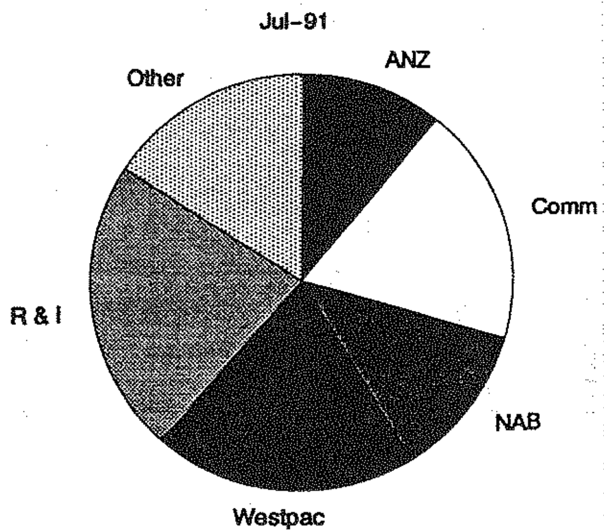
SHARE OF VICTORIAN DEPOSITS

Jul-91



SHARE OF WESTERN AUSTRALIAN DEPOSITS

Jul-91



Ownership

3.34 The Australian community retains a considerable stake in the banking industry, through government ownership of banks and through shares held in publicly listed banks, both privately and through superannuation funds and unit trusts.

3.35 Government owned or controlled banks, including the three State banks and the Commonwealth Government's 70 per cent ownership of the Commonwealth Bank, account for approximately 31 per cent of assets attributable to the banking sector.

3.36 Under section 10 of the *Banks (Shareholdings) Act 1972*, individuals and corporate entities can own up to 10 per cent of shares issued by the publicly listed banks. This can be increased to 15 per cent with the permission of the Treasurer.

3.37 The four major publicly listed banks have the following number of shareholders:

- ANZ - 83,300;
- Commonwealth Bank - 210,178;
- NAB - 71,000; and
- Westpac - 104,000.[12]

3.38 While no individual owns a significant volume of shares in any of the publicly listed banks operating in Australia, sections of the community collectively own large parcels of bank shares through insurance and superannuation funds. Featured among the top shareholders of each bank are funds managers such as the Australian Mutual Provident Society and the National Mutual Life Association.

3.39 Foreign banks operating in Australia are owned exclusively by overseas interests. The origins of these banks are:

- four each from America and Britain;
- three from Japan; and
- one each from China, France, Germany, Hong Kong, New Zealand and Singapore.

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12 Evidence, p. S29 and Commonwealth Bank 1991 Annual Report, p. 130.

3.40 Within the industry, banks themselves are shareholders of other banks, in accordance with the 10 per cent rule on ownership of bank shares. Cross-ownership is relevant in considering the issues of market concentration and dominance. These are discussed in Section II.

International comparisons

3.41 On the basis of size, Australia's four major banks are ranked among the top 100 banks in the world (Westpac at 39, NAB at 52, ANZ at 59 and the Commonwealth Bank at 89[13]). Five other Australian banks are included in the top 1000 (State Bank of New South Wales at 245, State Bank of South Australia at 309, Challenge Bank at 833, Macquarie Bank at 858, and R & I Bank of Western Australia at 901).[14]

3.42 In relation to banking infrastructure, comparisons with eight major economies indicate that Australia has per million inhabitants:

- the third highest number of branches behind Germany and France;
- the fourth largest branch network, including post offices, behind Germany, France and the United Kingdom;
- the third highest number of automatic teller machines behind Japan and the United States;
- the second highest number of electronic funds transfer outlets behind France; and
- the second largest overall banking distribution network behind France.[15]

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13 The Commonwealth Bank's position does not take into consideration its absorption of the State Bank of Victoria.

14 The Banker, July 1991.

15 Evidence, p. S63.

Banking, the economy and society

3.43 The banking industry plays an important role in the economy and Australian society from a number of perspectives:

- banks provide a myriad of financial services to the community, ranging from the traditional activities of accepting deposits and lending money, through to risk management and activities which previously were not the domain of banks, such as selling of insurance;

- banks are essential to the integrity and stability of the payments system, as they are the only institutions with direct access to that system; and

- banks are major employers in the community.

3.44 Approximately 95 per cent of the Australian adult population has an account or some form of relationship with a bank. Approximately 4 out of 5 use a bank as their main financial institution. Around 40 million accounts are held with banks.[16]

3.45 The extensive network of bank branches and outlets is available to the community on a daily basis. The high volume of transactions handled by banks on a given day indicates the importance of the industry in satisfying the daily financial requirements of the Australian population.

3.46 Banks play a significant role in the provision of housing for the community, through direct lending as well as participation in both government sponsored and co-operative housing schemes.

3.47 Around 167,000 people, representing approximately two per cent of the total workforce, are employed in the banking industry.[17] Banks spend considerable resources in training these employees. The ABA indicated that banks' expenditure on training exceeds the government's training levy requirement.[18] Issues relevant to training are considered in Chapter 19.

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16 Evidence, pp. S18 and S26.

17 Evidence, p. S28.

18 Evidence, p. S28.

3.48 Banks also have an important role to play in the development of Australia's economy. Industry restructuring, aimed at improving the efficiency and competitiveness of Australian industry, depends to a large extent on the ability of Australian businesses to obtain finance at appropriate prices. This does not necessarily mean that banks always direct funds to the most productive areas of the economy. Nevertheless, a competitive financial system is an important requirement of the processes of industry reform.

3.49 Prior to deregulation, competition in the provision of foreign capital was restricted. Exchange rate controls limited the ability of importers and exporters to obtain the required volumes of funds at appropriate prices. As a result of deregulation, banks not only have been able to offer a broader range of services to Australian businesses, but also have become exporters themselves. Financial services provided overseas by Australian banks are an important source of export income for Australia. In addition, banks play a major role in facilitating overseas investment in Australia.

3.50 Banks are one vehicle used by government in the collection of a range of taxes and charges. This role extends to the policing and administration of various aspects of taxation and other legislation, including the cash transaction reporting requirements. Banks also are used in the distribution of social security benefits.

Conclusion

3.51 There can be no doubt about the importance of the Australian banking industry, not only with regard to the proper functioning of the financial system, but also in relation to the operation and development of the Australian economy as a whole. In the report, though, the Committee's main aim has not been to reaffirm the position and status of the banking industry within Australian society, but, more importantly, to assess how the industry has responded to deregulation, and to make recommendations which will assist the industry to meet the needs of the Australian economy and Australian society leading into the next century.

Banks and economic activity

3.52 The ABA noted that the profitability, growth and bad debt experience of banks is closely related to economic conditions. It stated:

> ... cycles in bank profits. growth and bad debts closely follow those in economic activity.[19]

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19 Evidence, p. S22.

3.53 According to the ABA, links between banks and economic activity have become closer since deregulation, as banks have been given the freedom to respond to changes in the demand for finance. While indicating that banks do not determine cycles in the economy, the ABA argued that, in a competitive market, banks must follow those cycles. It suggested, for example, that banks which choose not to respond to an increase in the demand for funds will lose business to their competitors.[20]

3.54 From a similar perspective, the Reserve Bank stated:

> Economic cycles occur for all sorts of reasons including domestic and external factors and shocks, but the banking system is important in both trying to accommodate and to minimise those cycles and to take some of the fluctuation out of them. The authorities use the banks as the main mechanism through which monetary policy is exercised.[21]

3.55 Through 1991, the Australian banking industry operated within an economic cycle characterised by a slowing in the rate of growth of the world economy and a contraction in economic activity at home. That contraction, which can be dated from around the middle of 1990, was brought about through a tightening of monetary policy aimed at restraining rapid growth in domestic demand and reducing the rate of inflation. The result was an inflation rate by mid 1991 of about 4 per cent. However, the costs included an unemployment rate of around 9.5 per cent.[22]

3.56 An easing of monetary policy, which commenced in January 1990, continued through 1991. Interest rates, which are the main instrument of monetary policy, were lowered in response to changes in the economic cycle. By June 1991, short-term interest rates were 7.5 percentage points lower than 18 months earlier.[23]

3.57 In assessing the impact of financial deregulation on the banking industry, the Committee took into consideration the economic circumstances which prevailed. On the one hand, it can be argued that the problems which have been encountered by the banking industry in adapting to deregulation, as highlighted in various chapters of this report, were exacerbated by the economic environment both at the international and domestic level. On the other hand, it can be argued that the lending decisions of banks helped to aggravate the conditions which eventually led to the tightening of monetary policy and the consequential economic downturn.

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20 Evidence, p. S23.

21 Evidence, p. 433.

22 Reserve Bank 1991 Annual Report, pp. 4, 7 and 9.

23 Reserve Bank 1991 Annual Report, pp. 3 and 12.

3.58 In its 1991 Annual Report, the Reserve Bank stated:

> If, as expected, the result is a more competitive and responsive financial sector compared with a decade ago, the costs of adjustment will have been worthwhile.[24]

3.59 In this report, the Committee has considered both the nature of the industry which has emerged in the wake of deregulation and the costs which have been incurred along the way. It also has made recommendations to ensure that the financial sector on the whole and the banking industry in particular meet the expectations of being more competitive and responsive.

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24 Reserve Bank 1991 Annual Report, p. 5.

CHAPTER FOUR

OVERSEAS BANKING ISSUES

4.1 The Committee was aware that it could not view the Australian banking industry in isolation. Australia can learn from developments and approaches being pursued overseas, both for directions for the future and pitfalls to avoid. There is an increasing trend towards globalisation in financial markets and services. Proposals have been made for international standards for banking institutions (through the Basle requirements). There is also pressure for a liberalisation of trade in financial services as part of the negotiations taking place under the General Agreement on Tariffs and Trade (GATT).

4.2 With these factors in mind, the Committee was keen to gain an understanding of the international banking scene. The Chairman had the opportunity to travel to the United Kingdom (UK) and Europe in June 1991 and hold discussions with senior people concerned with the banking and finance industries.

4.3 In August\September 1991, the Chairman and Deputy Chairman visited the United States of America (USA) and Canada to investigate banking and financial issues. The USA and Canada were of particular interest for comparative purposes. The USA, because it has such a different banking and governmental structure, provided the opportunity for contrast with Australia. Also, it was often referred to by consumer organisations as having features from which Australia could learn. Canada has similar banking structures, governmental systems, economic problems and recent financial history to those of Australia and consequently provided an opportunity for close comparison with the scene in Australia.

4.4 The details of comparative observations made during these visits and discussions are recorded at Appendix 7. The information contained therein does not pretend to be a definitive comparison of international banking structures. Rather its content reflects the discussions in the particular countries visited. It also concentrates on those issues that the Committee identified as being of significance for its inquiry into the Australian banking industry. A summary of comparative information on the banking industries of countries visited is at Table 4.1. The Table also includes Japan although it was not among the countries visited.

TABLE 4.1: BANKING SYSTEMS - INTERNATIONAL COMPARISONS

	AUSTRALIA	BELGIUM	CANADA	FRANCE	GERMANY	JAPAN	SWITZERLAND	UK	USA
Population (mill)[1]	17	10	26	56	61	123	7	57	246
Consumption per capita (US $'000)[1]	8	8	11	8	8	8	10	8	13
Number of banks in World Top 1000[2]	10	10	11	24	84	109	32	35	202
Number of banks in World Top 20[2]	-	-	-	4	1	9	2	2	-
Bank supervisor[3]	CB	O	O	O	CB&O	CB&O	O	CB	CB&O
Persons per ATM[4] ('000)	4.1	10.9	2.9	4.3	6.7	1.6	3.4	3.6	2.9
Persons per EFTPOS[4] ('000)	1.5	0.4	6.2	0.4	5.7	73.7	3.1	0.8	4.9
Persons per branch[5] ('000)	1.8	0.7	2.0	1.3	1.0	1.9	0.8	1.3	2.2
Cheques: % of payments[4,6]	40	27	69	60	10	11	11	53	84
Credit cards: % of payments[4,6]	8	2	26	-	1	19	4	12	14
Direct debits: % of payments[4,6]	20	8	2	10	38	37	3	12	1

NOTES:

1. Private consumption per capita based on PPP's rather than current exchange rates. Source: OECD (1991b)
2. Ranking is by capital. Source: The Banker July 1991.
3. CB: Central Bank O: Other
4. Source: Group of Experts on Payments Systems (1991), Australian Payments System Council (1991)
5. All financial institutions. Source: Australian Payments System Council (1990) Appendix 5.
6. Percentage, by volume, of non-cash payments.

4.5 The observations in the Appendix are made in the context of an international banking scene that is under stress. In a number of the countries visited proposals for 'reform' of the banking and financial industries are under consideration because of recent problems. The trend towards globalisation of financial markets has perhaps created some of these problems. International economic factors also have assisted in creating uncertainty. But the special role of banks within the financial system appears to be increasingly under question as blurring occurs in the roles played by financial intermediaries. Banks worldwide have been experiencing significant problems and it is not clear whether these problems reflect short term difficulties or long term trends.

Issues to emerge

4.6 Many of the issues that are on the international agenda in relation to the banking and finance industries are similar to those being debated in this country. In this section the Committee highlights some of the broader issues that are of particular significance to Australia.

4.7 In some countries, such as the United Kingdom and the USA, the central bank has responsibilities for both the implementation of monetary policy and the supervision of the banking system. However, many countries have divided this responsibility - while the central bank is responsible for monetary policy, a separate body performs the role of prudential supervision of the banks. It should be noted that, where such a division is made, the central bank, because of its role as lender of last resort to banks, generally is consulted by the supervisor about supervisory issues.

4.8 The reasons why countries have adopted one or other approach appear to be influenced by history. The authorities in each country defended their model and had sound arguments for why it was a valid approach to their countries' banking and financial structures. A consideration of this issue in Australia should recognise the historical development of the approach to monetary policy and prudential supervision and the requirements of the banking and financial structures while also acknowledging that there could be much to learn from overseas experiences. The issue is discussed in Chapter 14.

4.9 The difficulties experienced in the banking industries in many countries have focussed attention on the issue of prudential supervision. In many a strengthening of prudential supervisory approaches and requirements is being considered. The gradual implementation of the Basle capital adequacy and other supervisory standards are having their impact on banks internationally. Some banks in some countries are experiencing difficulty in meeting these capital adequacy requirements.

4.10 Supervision in most of the countries visited involves a capacity for the supervisor to conduct on-site examinations of banks, particularly in terms of assessing the quality of a bank's assets. While the ability to conduct on site examinations has not prevented the failures of some banks, all the supervisory authorities with such a capacity commended its usefulness in giving an insight into the management approach and practices of the bank and the quality of its books. The Committee will address this approach to supervision in Chapter 13.

4.11 In many countries there is a system of deposit guarantee or protection. These vary greatly. Some are statutory, while others are a combination of private (bank industry association-administered deposit guarantee schemes) and government policy approaches that handle insolvencies in a way to prevent losses to depositors. There are also varying degrees of coverage with the most extensive being 100 per cent coverage of deposits up to $100 000 in the United States. A number of the schemes involve borrowers accepting some of the risk in relation to their deposits. Deposit insurance was not raised as a significant issue in the inquiry. However, the experience in other countries indicates that it should be put on the agenda as an issue for wide discussion. The Committee examines some of the arguments for and against deposit insurance in Chapter 13.

4.12 There is a world-wide trend towards the establishment of financial conglomerates. Increasingly there is a blurring of the activities of banks and other financial intermediaries. In recognition of this change, some countries are moving to facilitate the involvement of banks in a wider range of activities through the use of subsidiary companies. This trend raises important supervisory and competition issues which have relevance to Australia. The Committee examines the competitive issues raised by financial conglomeration in Chapter 11 and the prudential issues in Chapters 13 and 14.

4.13 A number of countries permit foreign banks to enter as branches. This issue is one that has been raised in the inquiry. A strong view was expressed in Europe that branching should be permitted in Australia to ensure a free trade in financial services. On the other hand, discussions in Canada (which insists on foreign banks entering as subsidiaries) highlighted the important prudential concerns that arise from allowing foreign banks to enter as branches. The Committee discusses this issue in Chapter 10.

4.14 Many of the concerns of consumers in other countries are similar to those in Australia. There is concern about the greater disclosure of information by banks and other financial institutions, a desire to either legislate or self-regulate codes covering banker customer relationships, including concerns about privacy, and an interest in the effect on consumers of a greater mixing of bank and non-bank business. These issues are addressed by the Committee in Section V.

4.15 Finally, the Committee was interested in the role played in some countries, notably the USA and Canada, by parliamentary committees in the review of the banking industry. While the Committee's inquiry has provided an opportunity for closer parliamentary scrutiny of the industry, the question arises as to whether a continuing capacity for parliamentary review of the industry is required. The Committee leaves its consideration of this question to the last chapter.

SECTION II

COMPETITION

One of the principal objectives of financial deregulation was to promote 'healthy competition between a range of institutions for the borrowing and lending business of both the relatively small retail customers and the relatively large wholesale customers'.[1] The underlying theme of deregulation was that, in the long run, the community as a whole would be better off if financial markets were allowed to operate more freely and with less direct government intervention, subject to there being effective competition and observance of basic prudential standards.[2]

In the Committee's assessment of the Australian banking industry following deregulation, competition issues featured prominently. The major themes underpinning the inquiry's terms of reference included the degree of competition in the banking industry and the effects of that competition.

In this section (Chapters 5 to 11), the Committee has examined many of the issues relevant to competition raised during the inquiry. Some competition issues relating to sectoral finance, such as retail banking, as well as banking and the business and rural sectors, are considered in the specific sections of the report dealing with those sectors.

One of the main difficulties was measuring the competitiveness of the banking industry. The Committee agrees with the Campbell Committee that:

> Any views about whether Australian financial intermediaries are adequately competitive must involve an element of judgment. Hard evidence on the degree of competition is very difficult to come by.[3]

In dealing with this issue, the Committee has focused on the following indicators of competition:

- competitive performance, including the profitability of banks;

- industry structure, including number of competitors, market share and market concentration; and

- industry conduct, including behaviour of market participants and barriers to competition.

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1 Campbell Committee, p. 531.
2 ibid, p. 531.
3 ibid, p. 529.

The differing views expressed during the inquiry on the extent to which deregulation has brought about increased competition, and who has benefited, are considered in the context of the above indicators.

In this section, the Committee also has examined issues relevant to the rise of banking conglomerates, particularly the implications, from a competition perspective, of banks undertaking a broad range of activities beyond traditional banking business.

CHAPTER FIVE

COMPETITION POLICY

The principles of competition

5.1 In simple terms, competition is the rivalry between two or more market participants for market share. In practice, it is a complex set of processes through which market participants attempt to exploit their position in a market for their own advantage. In this chapter, the generally accepted principles of competition and their relevance to the processes of financial deregulation are examined.

5.2 In its 1979 report on concentration and competition policy, the Organisation for Economic Co-operation and Development (OECD) noted:

> ... the expression 'competition' is multidimensional and includes not only factors such as the number of firms, and price and output levels, but also others such as inequality of firm sizes, innovation and barriers to entry of new firms.[1]

5.3 In this context, it is important that competition is considered in terms of the market for a particular product or service, rather than simply the rivalry between market participants.

5.4 The degree of competition in a market depends on a number of determinants. Of particular importance are:

- the structure of the market, including the number and size of competitors, the availability of substitutes, and the ease of entry;

- the incidence of restrictive trade practices, such as restrictive agreements between market participants; and

- the adequacy and availability of market and product information.[2]

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1 OECD, *Concentration and Competition Policy*, 1979, p. 12.

2 Economic Advisory Planning Council (EPAC), *Promoting Competition in Australia*, AGPS, Canberra 1989, pp. 1 and 10.

5.5 The principles of competition are based on the premise that competitive markets lead to a more effective allocation of resources, as well as more efficient and cost-effective production and provision of goods and services. Perfectly competitive markets are characterised by the following conditions:

- a multitude of market participants, all too small to have any individual impact on market price;
- market participants aiming to maximise profit;
- market participants having the ability to enter and exit the market in a costless manner;
- adequate readily available information on the basis of which consumers can make informed and rational choices; and
- the product or service traded being uniform in nature.[3]

5.6 In terms of market structure, an important consideration in determining the competitiveness of an industry is the degree of concentration in that industry. Where there are high levels of concentration, adverse consequences, including higher prices, lower output and collusive behaviour, are more likely to occur. As noted by the OECD:

> It is more likely that prices will be set at levels which allow the least efficient firms to survive, than at levels which would be suitable to the most efficient firms, since producers have a considerable degree of freedom in setting their prices.[4]

5.7 High concentration, though, does not necessarily involve inefficiency or anti-competitive practices. It can result in economies of scale and allow market participants to devote greater attention and resources to research and innovation. However, in the absence of competition, there is no guarantee that this would occur, or that the benefits would be passed on to consumers.[5]

5.8 Competition policy is aimed at promoting competition by limiting market power. It reflects the reality that effective competition is not always evident, but often needs to be encouraged and, where necessary, protected.

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3 EPAC, p. 41, and OECD, *Competition in Banking*, 1989.
4 OECD (1979), p. 14.
5 OECD (1979), p. 15.

5.9 The *Trade Practices Act 1974* (TPA) is the cornerstone of competition policy in Australia. The objective of the TPA is to establish an efficient and fair market place through the promotion of competition. By prohibiting restrictive trade practices, the TPA is aimed at deterring market participants from abusing their market power. The TPA also contains provisions for the protection of consumers.

5.10 Competition, though, can be limited not only by market participants, but also through regulation of specific areas of economic activity. Such regulation often can be counter to the intentions of competition policy. It was in this context that the processes of financial deregulation were set in train.

5.11 Of course, it should be recognised that a degree of regulation is required to ensure that the competitive processes do not lead ultimately to a lessening of competition.

The principles of financial deregulation

5.12 While promotion of competition was one objective of financial deregulation, the underlying aim was to increase the efficiency of the financial system. In this regard, Australia has reflected the trend in other OECD countries.[6]

5.13 Since the early 1960s, financial policies adopted in OECD countries have been increasingly focused on improving the efficiency of the financial system, without neglecting the other main objectives of ensuring the soundness and stability of that system, and maintaining an adequate level of investor protection. In its 1989 report on competition in banking, the OECD noted:

> Competition policies have become a major, although not the only, policy tool for improving the efficiency of national financial systems.[7]

5.14 The measures adopted in Australia to stimulate competition in the financial system have mirrored steps taken in other OECD countries. The measures introduced in other OECD countries have included:

- widening the scope for price competition through deregulation of interest rates and fees and commissions for financial services, and prohibiting cartel agreements in this field;

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6 OECD (1989), p. 12.

7 ibid.

- increasing the number of competitors in various sectors of the financial service markets by providing more scope for diversification, and by removing obstacles to the domestic and cross-border expansion of banking networks;

- increasing investor and borrower choices through encouraging the creation of a wide range of new financial asset and debt instruments;

- removing obstacles to free lending and investment decisions of banks and other financial institutions by abolishing, or easing, direct lending controls and mandatory investment regulations;

- improving the visibility of financial service markets through better information; and

- forestalling anti-competitive concentration movements in banking and finance by merger and ownership control.[8]

5.15 Underpinning these reforms in other OECD countries has been the widely accepted view that certain conditions need to be fulfilled if market forces are to work properly and if competition is to be maintained. These conditions or principles are that:

- there should be competitive neutrality, ie market participants should compete on equal terms and conditions so that there is equality of opportunity;

- competition should be subject to agreed rules of market practice;

- arrangements among and between market participants should not give rise to anti-competitive practices; and

- the anti-competitive effects arising from concentration and the dominant positions of market participants should be avoided.[9]

5.16 The extent to which these conditions are satisfied is an indication of the level of competition which has been achieved. The Australian experience in this regard is discussed in later chapters.

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8 ibid.

9 ibid, pp. 13-14.

Competitive efficiency

5.17 In assessing the impact of financial deregulation on the banking industry, it is important to consider not only the level of competitiveness which has resulted, but also the degree of efficiency which has been realised.

5.18 As noted at paragraph 5.12, the efficiency of the financial system has been one of three broad objectives of financial policy. In this context, an efficient financial system is one which adequately satisfies, in the most cost-effective manner, the financial service requirements of an economy and its participants.[10]

5.19 In terms of the banking industry, the Campbell Committee indicated that efficiency can be assessed against the following criteria:

- the extent to which the operations of industry participants are being conducted at least cost;
- the extent to which the resources of the industry are being put to the most productive use; and
- the extent to which the industry is adaptable to changes in economic conditions, technology and market practices.[11]

5.20 The question of efficiency is discussed further in Chapter 8.

5.21 The pursuit of efficiency, though, often needs to be weighed up against other public policy considerations, including issues such as the stability of the financial system and social equity. In this regard, the Committee concurs with the Campbell Committee's view that:

> *Competitive efficiency must ... be pursued within the constraints imposed by other valid objectives of public policy.*[12]

5.22 Such objectives have been taken into consideration by the Committee in the formulation of its recommendations.

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10 ibid, p. 9.

11 Campbell Committee, p. 522.

12 ibid, p. 523.

CHAPTER SIX

THE PROFITABILITY OF BANKS

6.1 According to the ABA, 'the dollar sizes of profits ... can often be misunderstood'.[1] The major banks are among the twenty largest companies in Australia. Accordingly, even modest rates of profit will translate into what appear to be very large absolute amounts of dollars. The level of bank profits would generally be expected to increase with inflation and growth in the economy. It is therefore nothing remarkable when a bank posts a 'record profit'. An assessment of whether profits are 'excessive' requires them to be related to the size of banks and returns on other investments.

Measures of profitability

6.2 The most commonly used measure of profitability is after-tax Return on Equity (ROE). This measure is derived from banks' balance sheets as after-tax profit for the year as a percentage of shareholders' funds. Generally an average of the capital at the beginning and end of the year is used as a proxy for average capital throughout the year. ROE is a measure of the return to shareholders and can be compared with returns from other investments. One useful benchmark is the return on government bonds, a low-risk investment.

6.3 Another measure which is often employed is Return on Assets (ROA). It is also based on after-tax profits but with assets rather than capital as the denominator. This measure has the advantage that it can be more readily dissected into interest margins and other components but it is harder to compare with returns available elsewhere. Figures 6.1 and 6.2 show trends in ROA and ROE respectively over time. The movements are similar, which is to be expected as banks' gearing (assets/equity) is constrained by Reserve Bank guidelines.

6.4 As both ROA and ROE are measures of returns to the holders of the bank's capital, they are normally expressed in after-tax terms. This is unlikely to make much difference when looking at trends over time. It may be inappropriate when conducting international comparisons as it could be argued that differences in tax rates do not reflect the efficiency or competitiveness of banks and so may distort the comparison.

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1 *Evidence*, p. 7.

FIGURE 6.1

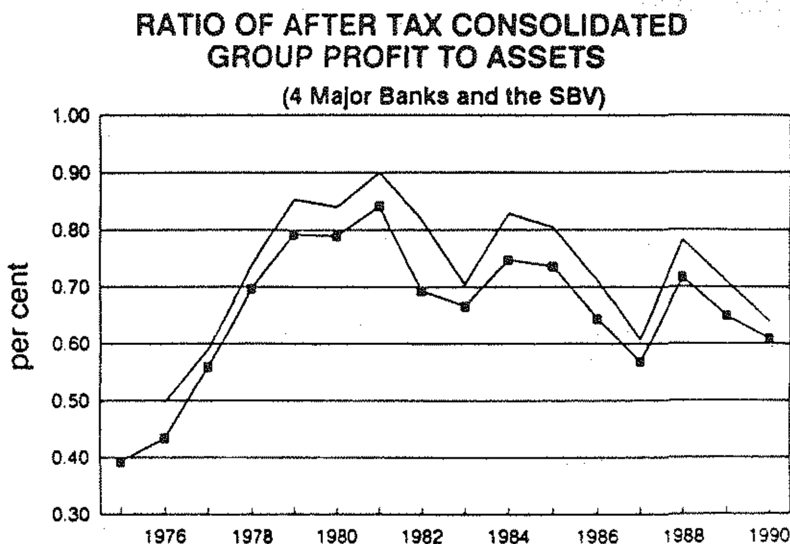
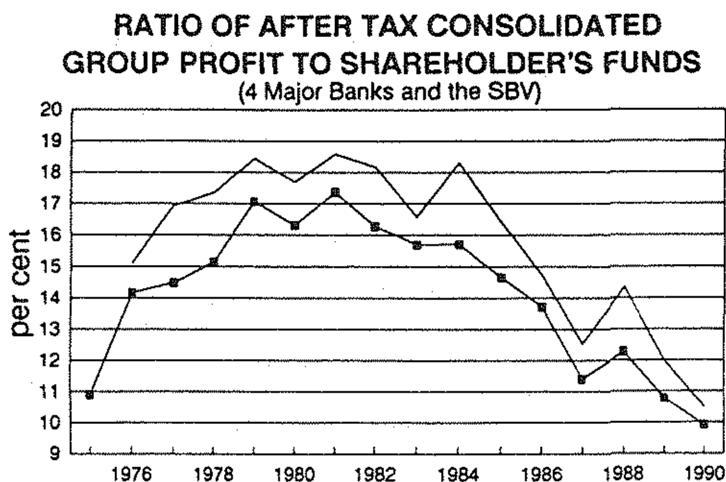


FIGURE 6.2



Source: ABA Evidence, pp. S31-2. (The lower line in each graph relates profits to year-end capital while the upper lines relate it to average capital.)

6.5 It has been put by the State Bank of New South Wales that *pre-tax profits are a more relevant basis for comparing the profitability of individual banks*. The State banks pay their 'tax' to their shareholders so have no incentive to structure their operations to reduce tax payments. The State Bank of New South Wales' preferred measure of *profitability is the Internal Rate of Return* (IRR).[2] It is calculated by assuming that a bank is 'bought' for net tangible assets in a base year and 'sold' for net tangible assets in the latest year. Allowance is made for dividends and rights issues throughout the period and the rate of return calculated. The State Bank argued that this measure is superior to ROE as it includes capital gains which are not reflected in the Profit and Loss Statement (such as property revaluations). It more accurately allows for the timing of equity injections and withdrawals and facilitates comparisons over longer time periods.

6.6 The above measures are based on accounting data. While the banks under the Banking Act are obliged to provide the Reserve Bank with information on their income, expenses and profits, this information is not published. Calculations on profitability are therefore based on banks' annual reports.

6.7 *Such accounting data may understate changes in profitability:*

> The nature of core banking activities is such that, in comparison with securities business, profit and loss statements tend to reflect changes in underlying profitability with a lag. Because of the limited information available it is particularly difficult to assess the current value of loans. Banks inevitably exercise a certain amount of discretion in the timing and extent of recognition of losses. Consequently, recorded profitability tends to exhibit considerable inertia and signs of potential stress are less visible when loan books are growing rapidly: when the deterioration occurs, it can be quite swift.[3]

6.8 Another measure of bank profitability is the Return to Shareholders (RTS), derived from sharemarket data. This is the sum of the average increase in the price of bank shares plus the average dividend yield on them, measured by an 'accumulation index'. This measure has the disadvantage that it is only available for listed banks and therefore cannot be calculated for banks holding about 40 per cent of assets.[4] Unlike the accounting data, the share price will instantly reflect changes in the market's expectations of future profits of the banks.

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2 Evidence, pp. S2923-42.

3 Bank for International Settlements (1991), pp. 109-10.

4 These include the Commonwealth Bank (now listed but not for long enough for meaningful calculations to be done), the State banks, Trust Bank Tasmania, the subsidiaries of foreign banks and their branches.

Trends in profitability

6.9 Whilst information on profitability is contained in the annual reports of the individual banks, there are no regularly published official statistics on bank profitability. The Committee notes that this has impeded public debate on the issues. The Reserve Bank prepared Figure 6.3 for the inquiry. It compares the ROE of the major banks with the government bond rate.[5] Commenting on this graph, the Reserve Bank said:

> returns fell sharply over 1985, 1986 and 1987 - both in absolute terms and relative to bond yields - following the progressive moves towards deregulation, including the licensing of new banks. Profitability rose in 1988 and 1989 due largely to the reduction in banks' costs of funds resulting from the 'flight to quality' by investors after the sharemarket crash of 1987. However, it again fell in 1990, as these effects passed and banks were burdened with large volumes of bad and non-performing loans. This followed the sharp expansion in their loan portfolios in earlier years.[6]

6.10 There have been marked differences in the profitability of the different classes of banks. The average ROE for the major banks was 10.8 per cent in 1990 and 14.1 per cent in 1989. Similar performances were recorded by the domestic regional banks. The State banks' (excluding the State Bank of Victoria) ROE in the two years was far lower and represented an unsatisfactory rate of return: 2.6 and 2.8 per cent respectively.[7] The foreign banks as a group incurred large losses in both years.[8]

6.11 There have also been differences, although less marked, in the profitability of the individual major banks. Their relative performances reflect a myriad of influences, from strategy and managerial ability to reputation and even good luck. (Figure 6.4.) A major factor in recent times has been the mix of large corporate and retail business. The Commonwealth, and to a lesser extent NAB, lagged in the early 1980s due to their greater retail presence but this has made them more profitable in recent years.

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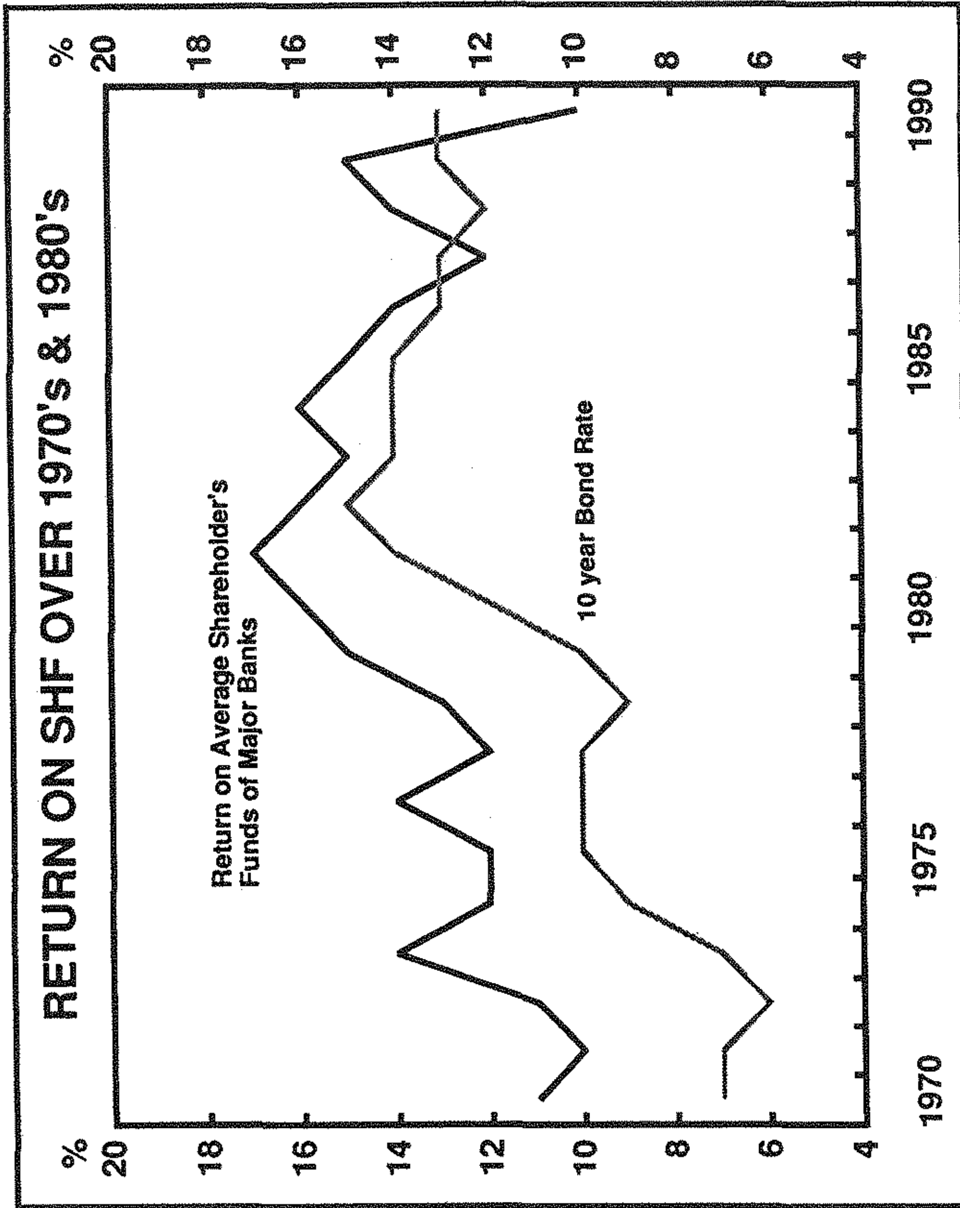
5 ROE for all banks would show similar movements but the average level would be lower as the State banks and most overseas banks have been less profitable than the majors.

6 Evidence, p. S1134.

7 Much of the difference between the major and State banks' performance is removed if the IRR approach, discussed above, is employed instead of ROE.

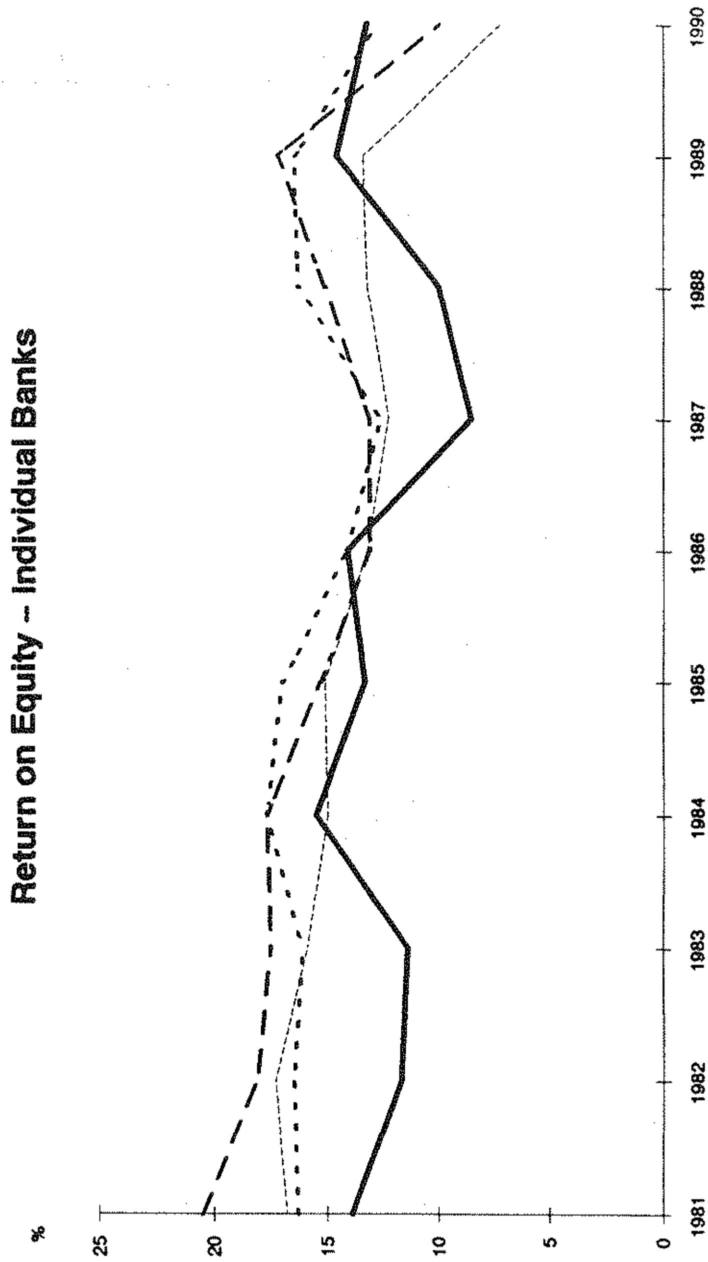
8 Figures in this paragraph are taken from KPMG Peat Marwick (1991).

FIGURE 6.3



Source: Reserve Bank of Australia Evidence, p. S1135.

FIGURE 6.4



Source: Data from Banks' Annual Reports

Comparison with other industries

6.12 One method of assessing the profitability of banking is to compare it with other industries. The Reserve Bank commented:

> in the first half of the decade, banks were among the most profitable companies listed on the stock exchange but, in the second half, they fell in the middle of the field.[9]

6.13 Using the RTS measure, the return to various classes of investors from holding bank shares are compared to that from holding other shares in Table 6.1. The calculations allow for the effect of dividend imputation where applicable.[10] Over the period 1982-90 the RTS for banks was higher than that for the 'all ordinaries' but below that for the 'all industrials', although the differences were not large. Banks appeared to offer more consistent returns.[11] While they lagged behind the market prior to the 1987 'crash', they were not badly affected by it.

6.14 Assessing what constitutes a reasonable return for shareholders in banks requires a measure of the riskiness of holding bank shares. Modern finance theory says the relevant measure is the correlation between the return to holders of banks' shares and the return on a diversified portfolio of shares. The basic argument is that all other risk can be diversified away.

6.15 Harper and Scheit (1991) calculated this measure of risk for Australian banks. They found that the return on bank shares was less variable than that on shares in general, which they attributed to Reserve Bank supervision limiting the riskiness of their activities. Given the degree of risk, the returns earned by banks were not excessive.

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9 Evidence, p. S1137. See also the graphs on p. S1138. A similar conclusion is reached by Ackland and Harper (1990), reproduced in Evidence, p. 632.

10 The returns were calculated assuming that all dividends were re-invested and that tax payments (or rebates) were met by selling (or purchasing) shares at the close of each period.

11 The difference between the comparison with 'industrials' and 'all ordinaries' reflects the relatively poor returns from resources stocks over this period.

TABLE 6.1: RETURN TO SHAREHOLDERS
(Average Annual Rate)

	1982-90	1982-87	1987-90
Tax Exempt Investor			
Banks	23.0%	24.9%	20.0%
Industrials	24.3%	39.8%	2.3%
Ordinaries	20.7%	35.6%	-0.5%
Top Marginal Tax Rate Investor			
Banks	20.1%	20.6%	19.2%
Industrials	21.2%	35.7%	0.4%
Ordinaries	18.2%	32.3%	-2.0%

Source: ABA Evidence, p. S4468

Comparison with overseas banks

6.16 The measures of profitability discussed above can potentially be used to compare Australian banks with those overseas. However, there are many difficulties. The structure of banking, economic conditions, the extent of off-balance sheet activity, the tax system, the importance of international operations, the regulatory regime and the mix of household and corporate lending varies greatly as do accounting practices. Some recent international comparisons are summarised in the following paragraphs.

6.17 The OECD has published analyses of bank profitability from time to time, but unfortunately Australia has not been included. The Bank for International Settlements (BIS) recently published a comparison of bank profitability in 15 OECD countries which combined the OECD data with information from other sources. It included the tables reproduced as Tables 6.2 and 6.3. They show that, on a pre-tax ROA basis, Australian banks were the most profitable in the early 1980s. By the end of the decade they were vying with the Canadians for second place behind the Spanish banks. It should be noted, however, that the BIS calculations only include the major Australian banks, which are more profitable than the others and do not include the banks' 1991 results which are likely to show lower profits.[12] Also, BIS were using the figures to illustrate the global deterioration in bank profitability over recent years rather than comparing across countries so had little cause to standardise the figures.[13]

6.18 *The Banker* produces summary balance sheet data for the world's 1,000 largest banks every year. In the survey of 1990 profits, ten Australian banks made the listing. The four majors were all in the top third of the banks by ROE, but the State banks performed below average. Looking at the surveys covering profits from 1987 to 1990, the average placing of the four major Australian banks was 190.[14] The UK and Canada are generally regarded as having the most similar banking systems and general economic and political structure to Australia. The average position of the four largest British banks was 251 and that for the four largest Canadian banks was 365.

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12 Overseas it may well have been the case that the larger banks were less profitable as they were likely to have had more exposure to third world debt.

13 Professor Harper does not believe the table says much about the competitiveness of banking in the countries concerned. He points out that the table shows Japan as having relatively low margins and yet their banking industry is notoriously closed and uncompetitive by Western standards. Evidence, p. 3408.

14 If their profitability was in line with the average bank in the world, the average ranking would be 500.

TABLE 6.2

Profitability of major banks in 1989 and 1990[1]							
Countries	Number of banks	Return on assets[2]		Loan loss provisions		Net interest margin	
		1989	1990	1989	1990	1989	1990
		in percentages					
United States	15	0.90	0.73	1.35	0.90	3.08	2.95
adjusted[3]		*1.67*	*0.78*	*0.57*	*0.86*	*3.08*	*2.95*
Japan[4, 5]	12	0.82	0.58	0.07	0.22	0.96	0.78
Germany[6]	3	0.89	0.91	n.a.	n.a.	1.97	2.04
France[4, 5]	6	0.55	0.42	0.53	0.57	2.42	2.24
United Kingdom	4	0.04	0.51	1.81	1.05	3.25	3.00
adjusted[3]		*1.32*	*0.51*	*0.53*	*1.05*	*3.25*	*3.00*
Canada[5]	6	0.83	1.34	1.20	0.37	3.40	3.13
adjusted[3]		*1.78*	*1.32*	*0.24*	*0.39*	*3.40*	*3.13*
Australia[5]	4	1.67	1.03	0.70	1.06	3.77	3.50
Finland	3	0.44[7]	0.35[7]	0.33	0.42	1.58	1.65
Netherlands	3	0.61	0.57	n.a.	n.a.	2.11	2.08
Norway	4	0.26[7]	−1.05[7]	1.41	2.01	2.97	2.75
Spain	7	1.73	1.54	0.47[8]	0.41[8]	4.33	4.06
Sweden	4	0.95[7]	0.53[7]	0.16	0.51	1.90	1.95
Switzerland	3	0.71	0.56	n.a.	n.a.	0.94	0.92

[1] The data are not strictly comparable across countries. [2] Ratio of pre-tax profit to average total assets. [3] Results excluding provisions against lending to developing countries. [4] Half-year results at an annual rate. [5] Fiscal year. [6] Partial net operating profit, which excludes loan loss provisions, gains/losses on own trading and extraordinary items. [7] Net income before appropriations. [8] Six banks.

Source: Bank for International Settlements (1991), p. 104.

TABLE 6.3

Bank profitability in the 1980s[1]					
Countries	1980–82	1983–85	1986–87	1988–89	1989
United States[2]	0.83	0.78	0.44	0.93	0.64
Japan[2, 3]	0.40	0.46	0.56	0.55	0.46
Germany[2]	0.50	0.92	0.80	0.90	0.92
France[2]	0.34	0.21	0.31	0.35	0.34
United Kingdom[2]	1.04	0.92	0.68	0.74	−0.03
Italy	0.68	0.78	1.01	1.02	1.14
Canada[3]	0.63	0.76	0.86	1.03	0.72
Australia[3]	1.39	1.33	1.23	1.50	1.46[4]
Belgium[3]	0.34	0.35	0.41	0.27	0.19
Finland	0.49	0.48	0.54	0.51[5]	0.24[5]
Netherlands	0.31	0.61	0.73	0.63	0.66
Norway	0.63	0.85	0.22	−0.08	0.17
Spain[2]	1.09	0.91	1.10	1.72	1.77
Sweden	0.38	0.39	0.82[6]	0.52	0.46
Switzerland	0.65	0.69	0.71	0.69	0.74

[1] Ratio of pre-tax profit to average total assets of commercial banks. [2] Large commercial banks. [3] Fiscal years. [4] The ratio in 1990 was 0.94. [5] Estimated because of break in series. [6] Break in series.

Source: Bank for International Settlements (1991), p. 110.

6.19 A submission from the consumer movement cites a study by Salomon Brothers which found that in 1990, in terms of ROE:

> the large Australian banks have fallen below Spain, Canada, the United States and marginally below the German banks. However, they were still ahead of banks in Britain, France, Hong Kong, Japan and Switzerland.[15]

6.20 The Australian Bankers' Association concedes that 'the nominal profitability of Australian banks is above average' but they contend:

> Nominal profits can be a misleading indicator, particularly for enterprises with monetary assets and liabilities, which may have wide divergences in their respective rates of inflation. When account is taken of Australia's high level of inflation and interest rates (by using riskless government bonds as a proxy) returns to Australian bank shareholders are even more moderate.[16]

6.21 Table 6.4 compares the profitability of Australian banks relative to government bond rates, during the early and late 1980s, with the same figures for overseas countries. It shows that the additional return accruing to the owners of banks, to compensate for the risks involved, was above the average in comparable countries in the early 1980s but below it in the late 1980s.

6.22 Appearing before the committee, the Governor of the Reserve Bank expressed the view that:

> until recently our banks were doing marginally better than some other banks [overseas]. But all of them were showing the same sort of trend - a decline in profitability ... for basically the same reason - increased competition through deregulation, globalisation, technology.[17]

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15 Evidence, pp. S1449-50.

16 Evidence, p. S34.

17 Evidence, p. 597.

TABLE 6.4: BANK PROFITABILITY & BOND RATES

	1982-85			1986-89		
	Banks' ROE	Bond Rates	Difference	Banks' ROE	Bond Rates	Difference
AUSTRALIA	17.6	14.4	3.2	13.9	13.2	0.7
France	10.4	13.9	-3.5	12.4	9.4	3.0
Germany	8.2	8.0	0.2	10.2	6.5	3.7
Japan	11.1	7.2	3.9	12.4	4.6	7.8
Switzerland	8.4	4.6	3.8	8.5	4.4	4.1
United Kingdom	11.3	11.3	0	6.9	9.6	-2.7
United States	13.7	11.5	2.2	8.6	8.6	0

Source: Data from OECD (1991a), Salomon Brothers (1991)

Influences on profitability

6.23 The Reserve Bank submission included a dissection of bank profits contrasting the pre and post-deregulation halves of the 1980s.[18] This is reproduced in Table 6.5.

6.24 Banks' operating expenses are now a lower proportion of their assets. How this relates to questions of their efficiency is discussed in Chapter 8. Bad debts are discussed in the next section of this chapter while net interest income is discussed in the following section on margins.

6.25 The slight decline in non-interest income represents the net result of lower charges for some services for corporate customers (for example, typical bill acceptance fees for larger companies fell from 1.5 per cent in the early 1980s to 0.5 per cent by the late 1980s), increased use of fees and charges for retail accounts and changes in income from foreign exchange and money market trading and other fee-based activities.

Bad debts

6.26 Bad debts have increased markedly over recent years. While banks have probably now identified most of the losses from loans to asset-price speculators, if the recession continues bad debts would be expected to increase further.[19] It is worth noting in this context that 'of Westpac's bad debts in 1989-90, only 30 per cent are attributable to corporate borrowers. The largest category of bad debts relates to lending to small business'.[20] The trend is shown in Figure 6.5. All the major banks have been affected but those with a greater retail emphasis have suffered less.

6.27 Loans classified as 'non-performing' have also increased sharply; from around $16 billion in mid-1990 to $29 billion in mid-1991. After allowing for $8 billion of specific provisions for these loans, this is equivalent to about half of banks' total capital.[21] It must be stressed that many of these non-performing loans will never translate into bad debts because they will have been secured against solid assets.

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18 While the components add to total profit in a mathematical sense, it must be remembered they are interdependent. For example, a move by banks into riskier lending should lead to increases in interest margins offset by increases in bad debts. An increased emphasis on corporate business would be expected to reduce both interest margins and operating expenses.

19 Some analysts' estimates are given in Maley (1991).

20 Evidence, p. S249.

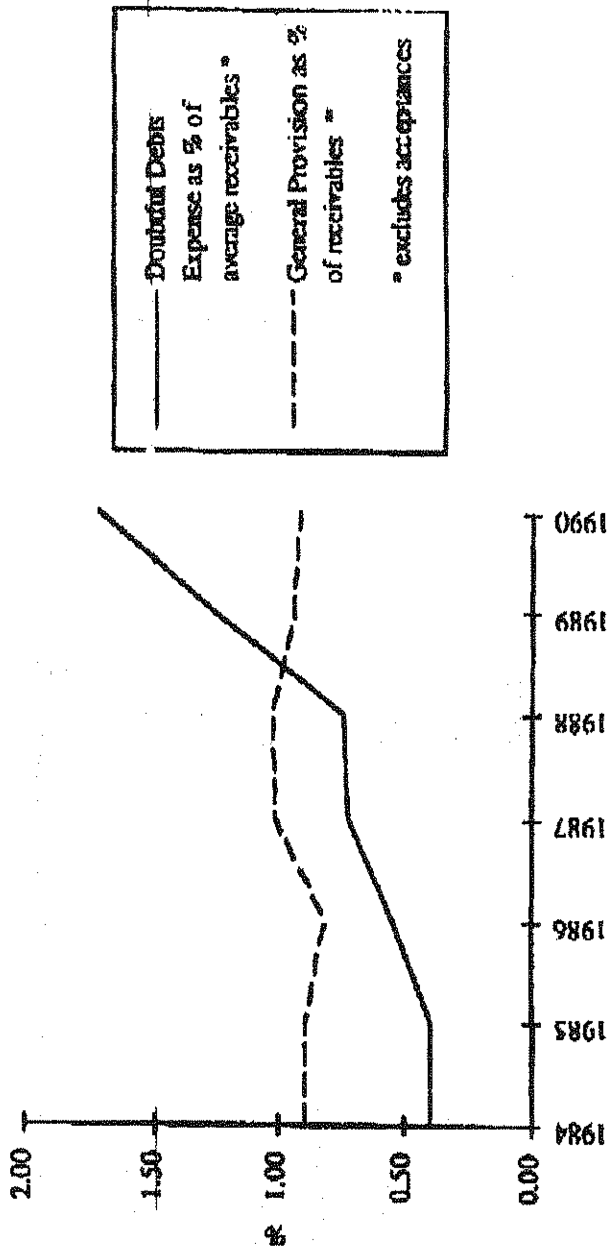
21 Reserve Bank of Australia (1991), p. 34.

TABLE 6.5: COMPONENTS OF PROFIT FOR MAJOR BANKS
(as per cent of total assets)

	1980-85	1986-90
Net Interest Income	3.7	3.3
Non-Interest Income	1.8	1.7
Operating Expenses	3.9	3.2
Bad Debt Expense	0.2	0.5
Tax	0.6	0.6
Profit After Tax	0.8	0.7

Source: Reserve Bank of Australia, Evidence, p. S1137

FIGURE 6.5



Source : KPMG Peat Marwick, based on data from banks' annual reports.

6.28 Some of the rise in bad debts would be attributable to the recession but, especially considering the lags between a drop in economic activity and loan defaults, the 1990 accounts should not be reflecting much of it. Furthermore, bad debts were a greater proportion of assets in every year since 1986 than they were in the recession year of 1983.

6.29 Deregulation could have been expected to lead to some increase in bad debts. When banks were regulated, credit was rationed and so only the best risks got loans. Others may have been shunted onto finance companies or merchant banks. The ABA put it as follows:

> Funding for bad and doubtful debts as a percentage of assets has increased from a very low base which would be expected as the banks move from the rationing of funds to the very best credit risks to providing credit more broadly to the community.[22]

6.30 Once they ceased to ration credit, and charged those who are riskier a correspondingly higher margin, banks could have reasonably expected higher interest income and a commensurate increase in bad debts. Banks should have started making higher general provisions in their accounts to allow for this. Figure 6.5 shows they did not do so. It would appear that they were excessively influenced by the buoyant economic conditions of the time.

6.31 The bad debts are not merely the result of a move away from credit rationing. An extraordinary number of 'entrepreneurs' seemed to believe that asset prices could increase without limit.[23] The ABA submission suggests:

> the combined effects of expansionary macroeconomic policy over the period (this helped condition firms to believe that asset price growth would continue indefinitely) and the interaction of Australia's tax system and inflation promoted investment in assets such as property for speculative reasons rather than more productive assets.[24]

6.32 These factors may explain the demand for finance but what many commentators found unusual was the zeal the banks displayed in lending to these investors. The banks appeared to share the view of the entrepreneurs that asset

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22 Evidence, p. 12.

23 The experience of the 1980s is discussed in more detail in the latter part of Chapter 2 and the articles referred to there.

24 Evidence, p. S39.

prices only rose. Table 6.6 shows the widespread exposure of banks to some of these entrepreneurs. Whether they knew it or not, the banks were, in a number of well publicised instances, partners in the greed of the 1980s.

6.33 This promiscuous lending has been attributed to fear of competition from foreign banks, leading to a misplaced concern about protecting their market share. It has been suggested banks had difficulty in adjusting to the new deregulated environment. The Governor of the Reserve Bank said:

> There were mistakes made by bankers. The bankers ceased to be bankers, I suppose, in that environment. Commonsense, conservative banking practices went out the window in the mad scramble that was going on at that time, for market share and preserving market share, financing borrowers who were pursuing properties, property developments, property takeovers, company takeovers, mergers and acquisitions and share acquisitions ... the banks themselves, in the early stages, did not have good information systems. They did not have good risk assessment and credit monitoring arrangements.[25]

Many would say there also were mistakes made by the Reserve Bank. They should have taken a less passive role during this period.

6.34 The ABA told the committee that 'compared with international experience, bad debt ratios of the Australian banks are still very low'.[26] The statistics from the Bank for International Settlements in Table 6.3 do not suggest that Australian banks have had relatively low write-offs in the last two years. However, it is widely believed to have been the case in earlier periods as overseas banks were more involved in third world debt problems than Australian banks. NAB suggested 'LDC debts, high leveraged transactions, management buyouts and property' were the 'three (sic) reasons why the US and the UK banks and some European banks have problems'.[27]

6.35 Table 6.5 shows that the increase in bad debts in the second half of the 1980s was greater than the fall in profit. The burden of poor lending decisions has therefore been, at least partly, passed onto other borrowers and depositors. Statements by the banks that 'the burden of loan losses has fallen on profitability' are misleading.[28]

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25 Evidence, pp. 451-3.

26 Evidence, p. 12.

27 Evidence, p. 237.

28 Westpac Annual Report 1990, p. 5.

TABLE 6.6

Financial Intermediary	Bond Corp	Qintex	Hersfield	Linter Group	Interwest Group
AEFC (CBA)			√		√
AIDC	√				
American ExpressBank	√				
AMRO Australia				√	
ANZ Bank		√	√	√	
Bank of America		√		√	
Barclays Bank	√	√	√	√	
BNZ	√			√	
CBA	√	√	√	√	√
Chase AMP		√		√	
CIBC			√		
Drexel Burnham	√			√	
Elders Finance			√		
First National	√				
HongkongBank	√	√	√	√	√
Indosuez Bank	√		√		
Merrill Lynch	√				
Midland Bank	√				
National Australia Bank	√		√		
National Mutual Life			√		
NatWest			√		√
R & I (WA)	√			√	
Societe Generale	√	√	√	√	√
Standard Chartered	√				
State Bank NSW	√	√			
State Bank of SA	√		√	√	√
Sumitomo		√		√	
Tricontinental	√	√	√	√	√
SBV: Bank only	√			√	
Westpac Banking Corp	√		√	√	√

Source : KPMG Peat Marwick. Evidence, p. S3328.

6.36 The crucial question is to what extent the decreased profitability resulting mainly from the increase in bad debts is the result of the ending of credit rationing - and so likely to be permanent - or the spate of poor lending decisions in the late 1980s - and so likely to be temporary. The Governor of the Reserve Bank was asked about bad debts and replied that when the:

> problems are digested and worked their way through the system, we would expect that profitability to recover somewhat, but not, as I say, to those earlier levels because of the increased competition.

He welcomed this prospective increase in profitability:

> we think that there needs to be some recovery in the profitability of banks to enhance the strength of the banking system because we do need a strong banking system[29].

Interest margins

6.37 The issue of banks' interest margins had aroused public concern in 1990. It was the subject of a report to the Treasurer and one of the motivating factors behind the establishment of this inquiry. It was evident from a number of the individual submissions and letters received by the Committee that many in the community believe that banks charge excessively high rates. Interest margins are the most important component of banks' profits and the most visible to the community. Recent falls in interest rates have reduced some of the media attention given to the issue.

6.38 The Committee has defined 'margin' to mean the difference between interest paid and received. Because the term has been used in a number of ways by various witnesses, care has been taken in this chapter to use different terms when referring to the different concepts of margins. Banks set a base rate which they charge their most credit worthy customers.[30] The differential added to this, designed to reflect risk, is sometimes called a 'margin' but the Committee has preferred the term 'risk loading'.

6.39 The main influence on margins is the degree of competition for providing deposits and loans in a given market. However, as the scope of the banking market has broadened over the 1980s, a finding that interest margins have increased somewhat would not necessarily imply that borrowers are being exploited.

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29 Evidence, p. 596.

30 The base rate is referred to by different names by various banks. Other terms used are 'prime', 'reference', 'benchmark' and 'indicator'.

It may be a reflection of banks lending for riskier proposals now that they are no longer rationers of credit. These riskier proposals may previously have been funded by finance companies or money market corporations.

6.40 The measure of interest margins preferred by the Australian Bankers' Association is the aggregate interest margin. It defines this as the difference between *interest received and interest paid expressed as a percentage of total assets.* The measure is derived from the annual reports of banks so is neither frequent nor timely. For many purposes, it is not conceptually desirable for assets to be used as the denominator. For example, a bank increasing its capital would report an increase in its aggregate interest margin, other things equal, just because it would have fewer deposits on which to pay interest. Similar arguments apply to a bank replacing fixed assets with interest-earning assets (such as by the sale and leaseback of branches) or reducing its use of bill finance (as bill finance adds assets to the balance sheet but no interest). However, unlike some other measures, the aggregate interest margin captures the effect of changes in the composition of bank deposits (as shown in Figures 7.2 and 7.3).

6.41 Westpac's submission uses a modified measure of the aggregate interest margin. It claims to:

> correctly adjust for the impact of non-performing loans, and is defined as net interest income expressed as a percentage of average income earning assets, excluding non-performing loans.[31]

This has the effect of reducing but not removing the impact of non-performing loans on the aggregate interest margin. On this measure Westpac's interest margin rose between 1983 and 1988 and has more recently fallen back to the level of 1983.

6.42 The aggregate interest margin discussed above looks at margins from the banks' perspective. It tells whether banks have been receiving a smaller or larger contribution to their profits from net interest. It does not indicate whether customers are getting a better deal. An alternative measure which does answer this question is the difference between interest paid as a percentage of deposits and interest received as a percentage of interest-earning assets. This is known as the interest spread.

6.43 The Reserve Bank told the Committee:

> When we talk about margins we talk about interest spreads: that is, the difference between average interest rates paid and average interest rates received, rather than any particular categories of loans and deposits.

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31 Evidence, p. S246.

> Those average interest spreads ... [were] 4.9 per cent in the first half of the 1980s on average, down to 4.4 per cent in the second half of the 1980s.[32]

6.44 In their annual report, the Reserve Bank updated these figures, saying 'in the past two years, it [the interest spread] is estimated to have declined to little more than 4 per cent'.[33] Figure 6.6 shows that the aggregate interest spread has been on a downward trend during the 1980s, interrupted only by the rush of funds into the banks after the 1987 sharemarket crash. The magnitude of this decline, however, has not been dramatic. The Committee again notes that the public debate would be assisted by such information being collated more frequently.

6.45 However, even interest spreads do not tell the whole story as there is evidence that banks are increasingly applying quasi-interest fees and charges not included in stated interest rates.

6.46 The above discussion has concentrated on average margins over a number of years. Over shorter periods there will be fluctuations in margins. In particular, banks' lending rates tend to lag behind movements in short-term market rates, such as the 90 day bank bill rate. Banks sometimes respond to a cut in market rates with an announced cut in their loan rates which does not take effect for a few weeks. This leads to a widening of margins when rates are falling and a contraction when rates are rising.[34]

6.47 There are three reasons why banks may do this. First, banks' *customers do not want excessive variation in rates so banks will wait to assess* whether a movement in market rates is sustained before responding. Second, market rates represent banks' marginal cost of funds but their average cost of funds will move more slowly as banks raise substantial amounts of funds at fixed rates and it takes time to roll these over.[35] Third, banks wanting to recover from bad and doubtful debts will lag adjustments downwards.

Profitability by sector

6.48 There is little publicly available information about the profitability of different sectors of banks' operations. For example, a decline in the interest spread tell us that bank customers as a whole have benefited but says nothing about which

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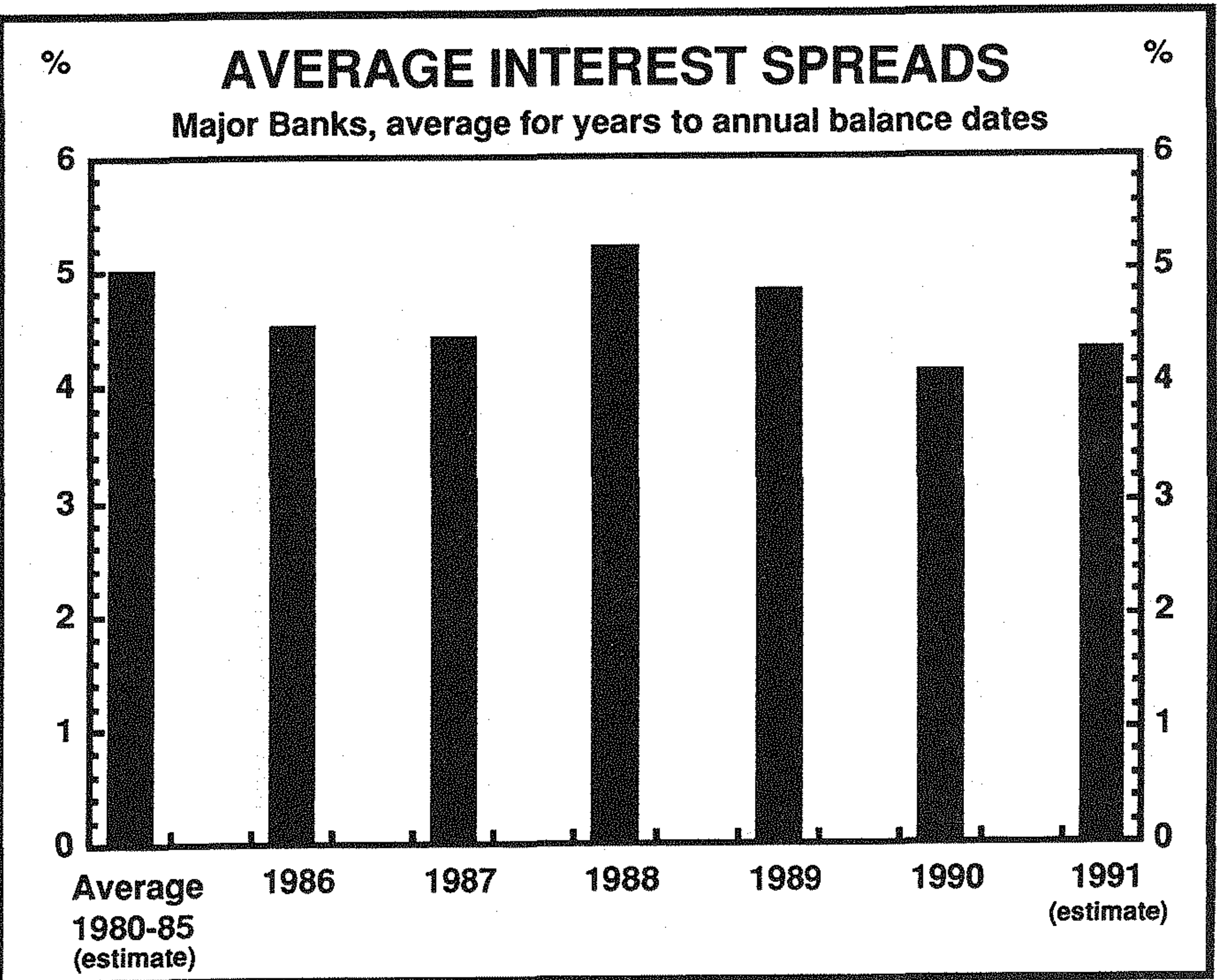
32 Evidence, pp. 598,604.

33 Reserve Bank of Australia (1991), p. 24.

34 The Reserve Bank provides an analysis of this in Evidence, pp. S2871-6.

35 Fixed deposits and certificates of deposit were 57 per cent of Australian deposits in July 1991. While most of the latter have a maturity under 6 months, the former may not mature for some years.

FIGURE 6.6



Source : Reserve Bank of Australia, Exhibit No. 56.

customers have benefited. The new foreign banks have been more active in the corporate market than the household area. It could be expected therefore that corporate customers are more likely to have faced lower margins through increased competition.

6.49 At an individual level it is likely that astute customers have benefited rather than inert customers but this is hard to measure. The main area of contention is whether interest margins in the domestic household area are now subsidising those in corporate and overseas operations.

6.50 Australian banks' overseas operations have become increasingly important.[36] There is evidence from around the world that banks generally operate more profitably in their home markets, in part because they can raise funds more cheaply there. This has certainly been true of almost all the foreign banks that have entered Australia. Changes in Australian banks' interest spread may therefore be attributable to the increasing proportion of their balance sheet that reflects overseas operations.

6.51 It has recently been possible to distinguish between domestic and overseas interest spreads from the major private banks' annual reports. Between 1987 and 1990 the average interest spread for domestic business was 4.5 per cent while that on overseas business was only 2.1 per cent which suggests this composition effect has been quite important.[37] It does not imply that the domestic operations are necessarily subsidising those overseas as the latter may be less costly. For example, they may involve a relatively small number of loans and no branch network.

6.52 On the question of domestic wholesale versus retail profitability, consumer representatives put to the committee that:

> The information that exists up to this time is that retail margins have been fairly stable over the 1980s, and are probably growing. Wholesale margins have declined. The limited information indicates that there is a cross-subsidisation of resources from the retail arena to the wholesale arena, where competition is greater and where the bargaining power of the borrowers is greater. Retail borrowers do not have bargaining power.[38]

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36 The major private banks now have about a third of their assets in, and income from, overseas operations.

37 As an illustration of the effect this could have; if these spreads are constant and banks moved from having 10 per cent of their operations overseas in the first half of the 1980s to 30 per cent in the second half, this would reduce the overall interest spread from 4.3 to 3.8 per cent. This is a similar reduction to that actually observed.

38 Evidence, p. 975.

6.53 The banks reject this charge, claiming that in a competitive market they would not be able to do this. Westpac said:

> we are in the marketplace with every other body in the marketplace that is seeking deposits. If you have got St George Building Society, which has not got any bad [*corporate*] *debts ... and if we are not paying the rate of* interest which attracts depositors, we lose them.[39]

The question of how competitive is the retail financial market is addressed in Chapters 8 and 19.

6.54 The Reserve Bank's submission warned of the difficulties of such exercises before cautiously suggesting 'margins narrowed for most, if not all, borrowers during the second half of the 1980s'.[40] Appearing before the committee, the Deputy Governor of the Bank said he 'cannot find any evidence across the range of banks that one group is being disadvantaged to the advantage of others'.[41] He does not believe that consumers are now subsidising loans to big business but deregulation has removed the 'heavy cross-subsidisation in banks that went the other direction'.[42]

6.55 A number of recent studies have used a series of item-comparisons of rates on specific deposit and loan products to assess the profitability of different sectors of banks' operations. These measures have the virtue of being contemporary and simple to understand but have been subject to criticism. The most commonly cited work is the study by Milbourne and Cumberworth (1990). They conclude that during the 1980s 'retail interest margins rose throughout the decade and were offset by a fall in margins in wholesale and off-balance sheet items.'

6.56 Figure 6.7 shows two examples of such item-comparisons, taken from the submission by Barrett. The 'household margin' line shows the difference between the housing loan rate and that paid on savings investment accounts while the 'commercial margin' line shows the difference between the rate charged on large overdrafts and that paid on certificates of deposit.

6.57 Figure 6.7 shows the margin in the retail market has widened considerably over recent years while the margin in the wholesale market has only risen by a small amount. It should be noted, however, that in the early years shown on the graph the housing loan rate was subject to a ceiling and while loans were

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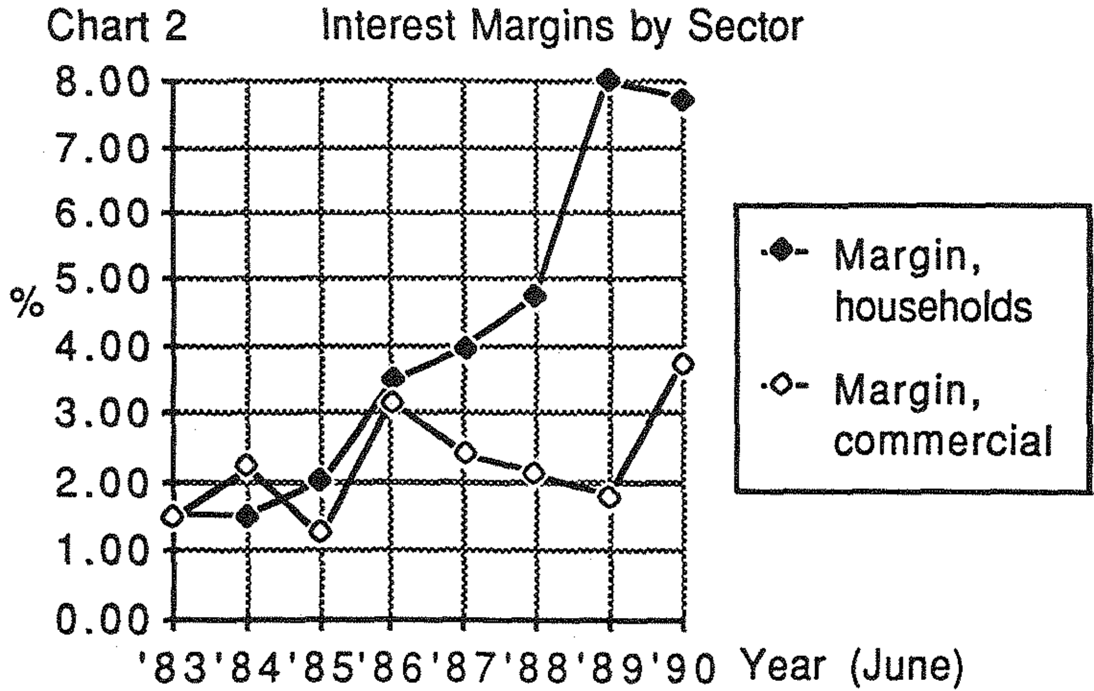
39 Evidence, p. 144.

40 Evidence, p. S1140.

41 Evidence, p. 609.

42 Evidence, p. 610.

FIGURE 6.7



Source: Barrett, based on Reserve Bank data. Evidence, p. S769.

cheaper they were harder to obtain. Many borrowers had to top up housing loans with expensive personal loan rates or loans from finance companies and so the average rate they paid exceeded the advertised housing loan rate.

6.58 Similar item-comparisons have been done to compare the experience of small and large corporate customers. A further difficulty arises in applying the item-comparison approach to the corporate sector. The published data on which such calculations are based refers to base rates charged to banks' best customers but most borrowers will pay a 'risk loading' above this rate which should reflect their credit worthiness. Examples of banks' advertisements of their corporate lending rates are shown in Figure 6.8. There is no certainty that these risk loadings will be constant over time. It has been claimed that small business has faced increased risk loadings in recent times, perhaps as a result of banks attempting to recoup losses from loans *to larger companies. This question is examined in Chapter 15.*

6.59 However, the Governor of the Reserve Bank's view is:

> there is no evidence to suggest that there has been any significant increase in average margins [ie. risk loadings] charged by the banks above their indicator lending rates.[43]

The Reserve Bank has information on these risk loadings but 'stopped publishing it because it was not totally reliable'.[44]

6.60 The item-comparison approach has been trenchantly criticised by the banks. The ABA said:

> it assumes that all of the loans in question are funded entirely out of the nominated deposits. This is not the case ... [it] also does not take account of the different maturity structures of assets and liabilities which can produce lags in adjustment, nor expectations of future interest rate movements.[45]

The former criticism is potent. The latter has some force when comparisons are made over short periods of time but such factors would even out when comparisons are made over a decade.

6.61 Another item-comparison commonly used in the media is the difference between the bank bill rate and the housing loan rate. In particular it is often noted that, during the recent easing in monetary policy, bill rates have come down by

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43 Evidence, p. 607.

44 Evidence, p. 610.

45 Evidence, p. S40.

FIGURE 6.8: EXAMPLES OF BANKS' ANNOUNCEMENTS OF LENDING RATES

Commercial Indicator Rate

13·25% p.a.

Effective rate from 1/10/91
This rate is used by Advance Bank Australia Ltd. as a reference for calculating interest on variable rate commercial loans over $500,000

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MELBOURNE (03) 642 1755 | PERTH (09) 322 2122

AVC 128.26.10

Prime Lending Rate.

Effective from 13.9.91

13.25 %PA

This rate is used to calculate interest on variable-rate commercial loans and commercial lending facilities
For more information telephone Challenge Commercial Banking Services:

CHALLENGE BANK

Sydney (02) 233 3522 Melbourne (03) 602 9709
Brisbane (07) 229 8127 Adelaide (08) 212 6483
Perth (09) 320 8511

BNZ BASE LENDING RATE		SMARTER MORTGAGE RATE	SMARTER CHEQUE RATE AND BNZ CASHLINK	
CORPORATE	CONSUMER		$50,000+	8.50% P.A.*
13.50% P.A.	14.75% P.A.	13.75% P.A.	$20,000 - $49,999	8.00% P.A.*
			$5,000 - $19,999	6.00% P.A.*
			$2,500 - $4,999	4.00% P.A.*
FROM 9/9/91.	FROM 30/9/91.	FROM 30/9/91.	FROM 4/11/91.	

Interest Rate Indications
(Source: PIBA, Primary Industry Bank of Australia)

TO THE INVESTOR	October 21 %pa	October 28 %pa
PIBA Term Deposits ($50,000 and over).		
3 months (interest paid on maturity)	8.80	8.80
6 months (interest paid on maturity)	8.80	8.80
1 year (interest paid six monthly)	9.05	9.05
3 years (interest paid six monthly)	10.05	10.05
5 years (interest paid six monthly)	10.30	10.30
Call free PIBA Money Market for firm quotes on 008 028 511.		
TO THE BORROWER		
PIBA Lending Rates *(Facility margin to apply, preferred minimum loan $250,000)*		
Prime (floating) Rate	11.25	11.25
Fixed rates		
180 days	9.00	8.85
1 year	9.30	9.50
2 years	9.60	9.90
3 years	10.10	10.15
4 years	10.35	10.30
5 years	10.35	10.50
Trading Bank Indicator (Prime) Rates		
Top rate	13.50	13.50
Lowest rate	13.25	13.25
Currencies		
AUD/US$	0.7980	0.7841
AU$/YEN	103.43	103.42
Trade Weighted Index	60.40	59.80

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almost 5 per cent more than housing loan rates. However, housing loan rates had not risen by the full increase in market rates after 1987. ANZ explained that they 'suffered some short term pain' in not raising housing loan rates but:

> once you got housing rates to 17 per cent the average person could not afford to borrow ... the other thing was it would have created enormous problems for banks by continuing to raise those rates in that you have a whole portfolio of people who in a short term could have got into serious trouble.[46]

6.62 The point is illustrated in Figure 6.9 which shows bill rates and housing loan rates over a full cycle.

6.63 *Rates charged to the household sector tend to be smoothed.* NAB told the Committee:

> we see housing lending as involving a long term relationships with customers and the household sector preferring a degree of stability in the interest rates which they face.[47]

Notification requirements are another factor dampening swings in consumer lending rates.

6.64 A preferable method of determining how the retail sector has fared from deregulation is to calculate interest spreads from retail deposits and loans. The Reserve Bank provided data on this from which Figure 6.10 has been constructed.

6.65 The Reserve Bank's conclusion was that:

> the changes in average deposit and loan interest rates facing retail customers are about the same.[48] Since the volume of retail loans is probably about the same as the volume of retail deposits, it might be concluded that the net interest position of retail customers overall has not changed much as a result of deregulation. But we estimate there are more retail depositors than borrowers

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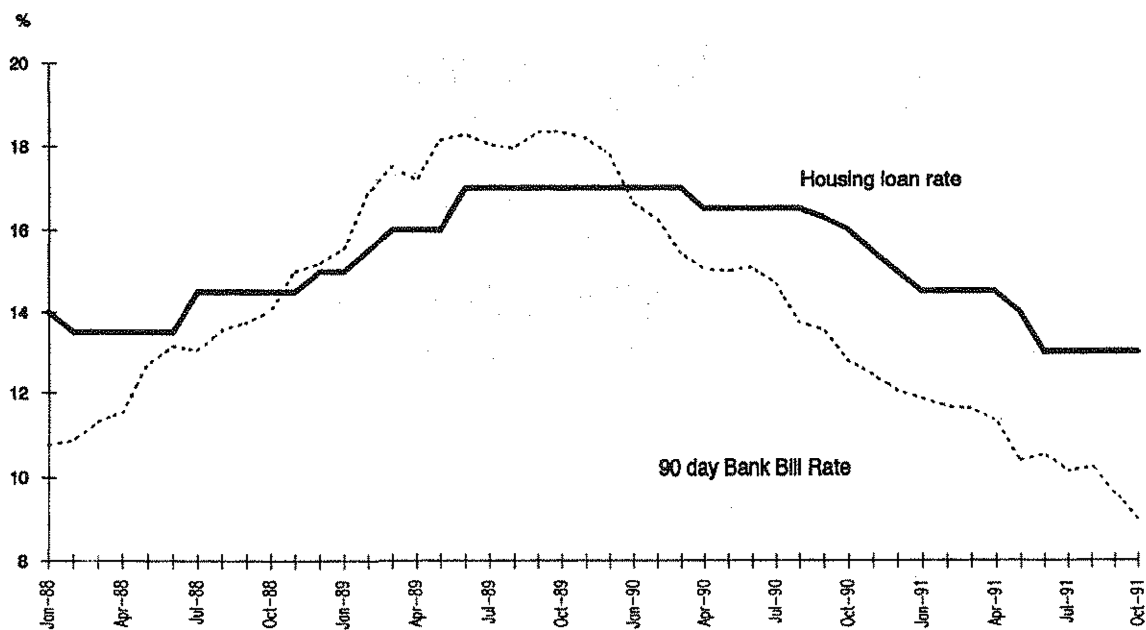
46 Evidence, p. 195.

47 Evidence, pp. 223-4.

48 Both rose following deregulation. Loan rates had been held down by regulation. With loans rationed banks could bestow them on those customers who had shown 'loyalty' by keeping funds in low-interest deposit accounts. Along with the prohibition of interest on cheque accounts, this kept the average rate paid on deposits down.

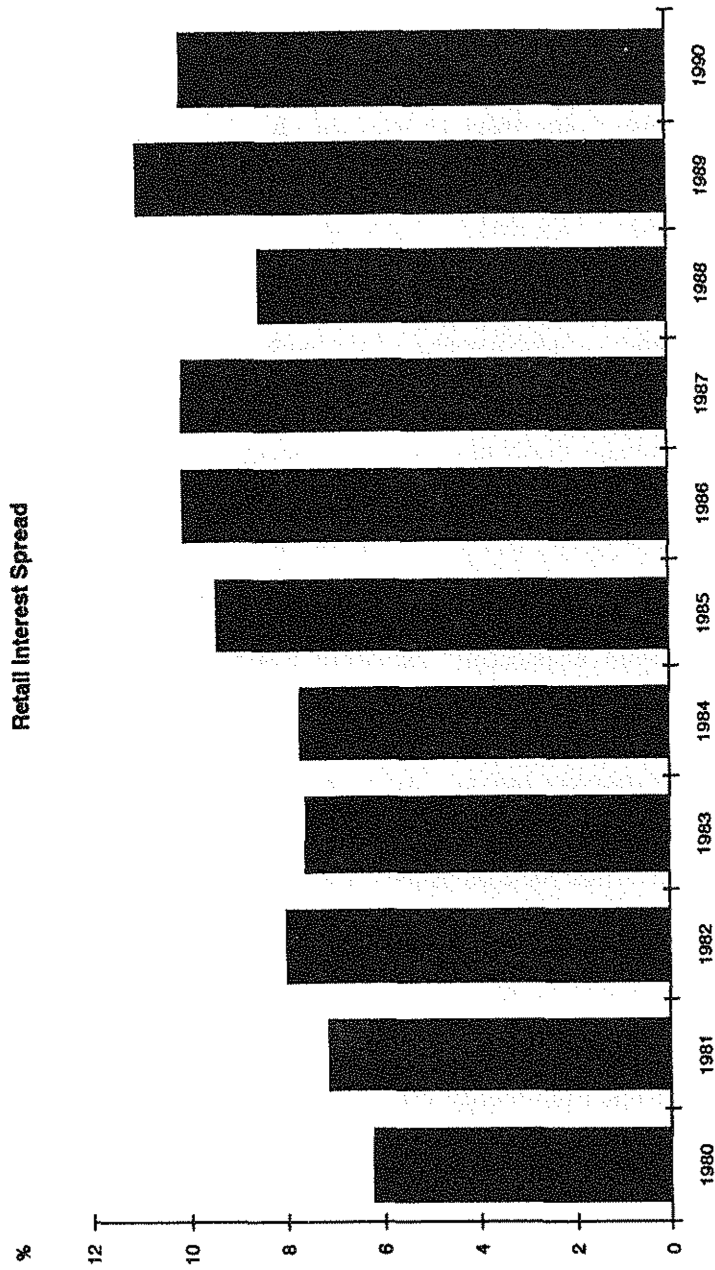
FIGURE 6.9

Housing rates and bill rates



Source: Data from Reserve Bank Bulletin.

FIGURE 6.10



Source: Data in Evidence, pp. S2900-1.

> ... and it thus might be concluded that the majority of retail customers have benefited rather than lost from deregulation.[49]

To the extent that more households have been able to borrow from banks rather than more expensive finance companies and other lenders since deregulation, their overall margins on total lending and borrowing from all financial institutions may have shown a greater improvement than the above calculations would suggest.

Conclusion

6.66 It is important to the Australian economy that banks are strong. In order to be strong, they must be profitable.

6.67 There is a misconception that banks' profitability has increased since deregulation. In fact it has fallen slightly. Had they not reduced their operating expenses, they would have been even less profitable.

6.68 Australian banks are not very profitable at present due to the current unusually high levels of bad debts. Bank profitability should be kept under review to monitor whether it remains within an appropriate range.

6.69 Deregulation removed many of the cross-subsidies between bank customers. Whilst no conclusive evidence was found that retail customers as a class have generally been subsidising corporate customers, anecdotal evidence has suggested that this has occurred when interest rates are falling or when extraordinary bad debts have been incurred.

6.70 Deregulation has not led to a significant reduction in the average domestic interest rate margin. Any reduction has tended to benefit corporate customers rather than retail customers. The average interest margin for retail customers as a class has not changed significantly. However, certain types of retail customers, such as those who would have received cheap, rationed home loans or those who made large numbers of transactions, would be worse off as the subsidies they received are no longer available.

6.71 The profitability of banks is not only a matter of interest to banks' shareholders but also to the general community. If the community is to be better informed about bank profitability then more public information and analysis is required. The Committee notes that some banks, who file reports with the Securities and Exchange Commission in the United States, now include the additional information they provide to the SEC in their Australian annual reports.

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49 Evidence, p. S2901.

Recommendations

6.72 The Committee recommends that:

2. The information available to the Reserve Bank on, and their analysis of (a) bank margins and (b) bank profitability be made more widely available by the Reserve Bank publishing more in their annual report and/or monthly *Bulletin*.

3. All banks be required to include information in their annual reports on the profitability of various sectors of their operations and further information on non-performing loans and bad debts. The requirements of the Securities and Exchange Commission in the United States, which some Australian banks already meet, would provide a guide as to what is reasonable.

4. The Reserve Bank seek to have Australia included in the OECD surveys of bank profitability. The Reserve Bank should be actively involved in the preparation of data for these surveys. It should help in the development of international standards for comparable data in this area.

CHAPTER SEVEN

USER PAYS

7.1 The term 'user pays' refers to the general practice of charging consumers in such a way that the prices they face reflect the costs of providing the goods or services. The philosophy of user pays is not an end in itself but is held to lead to desirable consequences. It avoids (often arbitrary) cross-subsidies. It also increases overall economic efficiency as customers face appropriate price signals rather than being encouraged to overconsume some apparently 'free' services and underconsume others.

The extent of user pays in banking

7.2 The 'user pays' principle is increasingly being adopted by banks. One common example is retail deposit accounts where customers are being more explicitly charged for the costs of the transactions they make. There are differing views about the desirability of this move towards user pays pricing. The Department of the Treasury supports it on efficiency grounds and because it avoids hidden and unintentional subsidies. The Department also pointed out it avoids the tax distortions which arise from implicit interest being provided in kind.[1] On efficiency grounds, it should be applied by banks as users as well as sellers.

7.3 The pricing regime prior to the 1980s made relatively little use of user pays. A large part of this was due to regulations which restricted pricing. It also reflected more conservative management in banks and less demanding consumers.

7.4 This meant there were a number of cross-subsidies. As interest rates were held down, depositors were subsidising borrowers, especially those small businesses and home buyers who received the cheap, but rationed, loans. The general absence of activity fees meant that infrequent transactors were subsidising heavy transactors. Urban customers were subsidising geographically isolated customers as prices were not reflecting the greater costs for banks of operating in sparsely populated areas.

7.5 Opinions varied about whether, leaving aside the efficiency issue, cross-subsidies were desirable on social equity grounds. It has been argued that many cross-subsidies averaged out over a lifetime. The 'typical' family were savers initially, borrowers as they bought their home and savers in middle age. The inter-generational transfers involved were seen by some as a social good.

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1 Evidence, p. S3010.

7.6 The intent of many of the regulations was to help low income earners and households in general. However, there is evidence that this was not their outcome. Maintaining interest rates artificially low is not to the overall advantage of the household sector as it is usually a net lender to the financial system (Figure 7.1).

7.7 Other studies have shown that depositors with low interest rate accounts at banks have lower average incomes than borrowers and that the rationed home loans went disproportionately to higher income earners.[2] Higher income earners were also likely to make more transactions and therefore benefit from the absence of fees.

7.8 An important factor which makes user pays less attractive to household customers, and hence their banks, is the taxation system. Higher interest income is taxable but implicit interest in the form of 'free' services, is not. Similar considerations have made mortgage interest offset accounts popular. This raises important policy issues outside the scope of this report.

7.9 In the 1970s and 1980s the consensus about the social desirability of the cross-subsidised system appeared to erode.[3] Depositors, who had previously seemed content to accept low returns, found in the 1970s that the interest rates on many bank deposits were consistently less than the rate of inflation and in real after-tax terms heavily negative.[4] By this time they were able to express their dissatisfaction by moving funds to alternative deposit takers such as building societies and credit unions, whose balance sheets grew strongly over this period.

7.10 Deregulation has allowed banks to make greater use of user pays. Indeed, by strengthening competitive pressures, deregulation has forced a greater use of user pays. As the Commonwealth Bank put it:

> If you try to avoid user pays and others are using it or coming in to compete with you in areas where they do not have the same burden of transactions to service, then they can pay interest rates which will woo your customers away and leave you stuck like the proverbial shag on a rock with all the business that is costly.[5]

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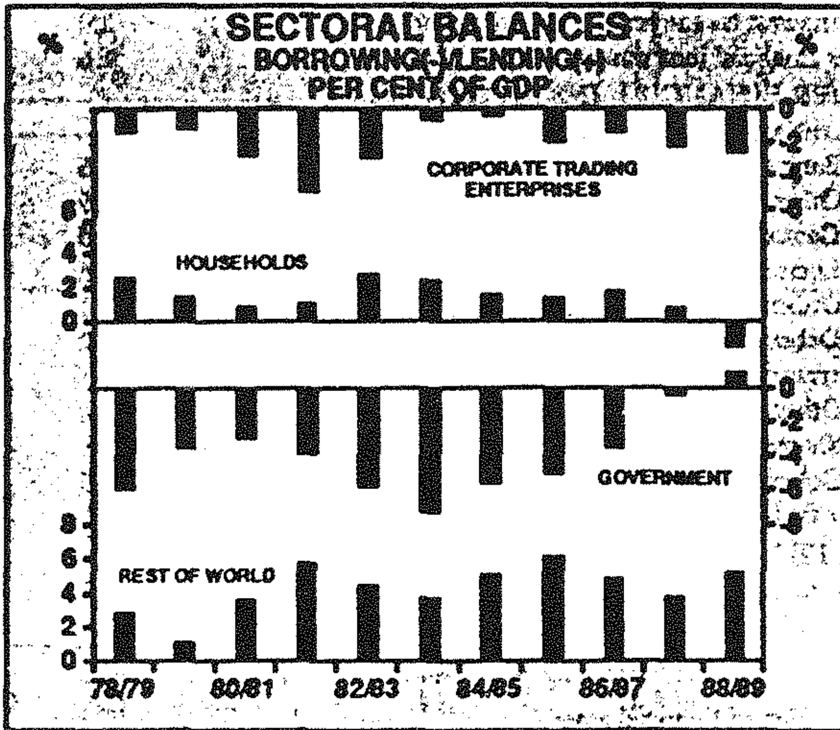
2 For example, Yates (1981).

3 To the extent that it was this developed a view rather than inertia and acceptance.

4 Earlier bouts of inflation, such as during the Korean War, were not sufficiently sustained to change entrenched attitudes.

5 Evidence, p. 72.

FIGURE 7.1



Source : *Reserve Bank Bulletin,* November 1989

7.11 An important factor spurring the adoption of user pays by the major banks is the reduction in the proportion of low-cost deposits held by them. A comparison of Figures 7.2 and 7.3 shows the change. This trend has been accelerated by the deeming provisions introduced for pensioners. The banks report that between a fifth and a third of their low-interest passbook deposits have moved into higher interest accounts since deeming was introduced.

7.12 As well as transaction charges for deposit accounts and establishment fees for loans, banks have increased the range and amount of other charges over the past few years.

7.13 However, the move towards user pays has not gone as far or as quickly as many might think. The ANZ told the Committee:

> Something of the order of $900m is actually [spent] in transaction servicing ... the opinion of most of our customers would be that we charge too much [for them]. The fact is that the income we get from transaction servicing fees, account maintenance fees and so on is only $200m. There is a net unrecovered cost of servicing transactions of enormous magnitude - give or take, $700m .... We can try to increase fees to customers, and that is extraordinarily difficult and does not get a lot of political support.[6]

Further evidence on cost recovery appears later in this chapter.

7.14 The ABA described the move to user pays as 'a slow and cautious process'.[7] Professor Ian Harper believes:

> no one bank wants to lead the charge ... I want to say that it [the incomplete use of user pays] is sub-optimal because this fear of any one bank being pilloried, especially by the political mechanism, has made them naturally reluctant. The awkward thing is that they pass that higher cost back to the community in forms which are not easily perceived and which, frankly, are inequitable.[8]

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6 Evidence, p. 166.

7 Evidence, p. 36.

8 Evidence, p. 3416.

FIGURE 7.2

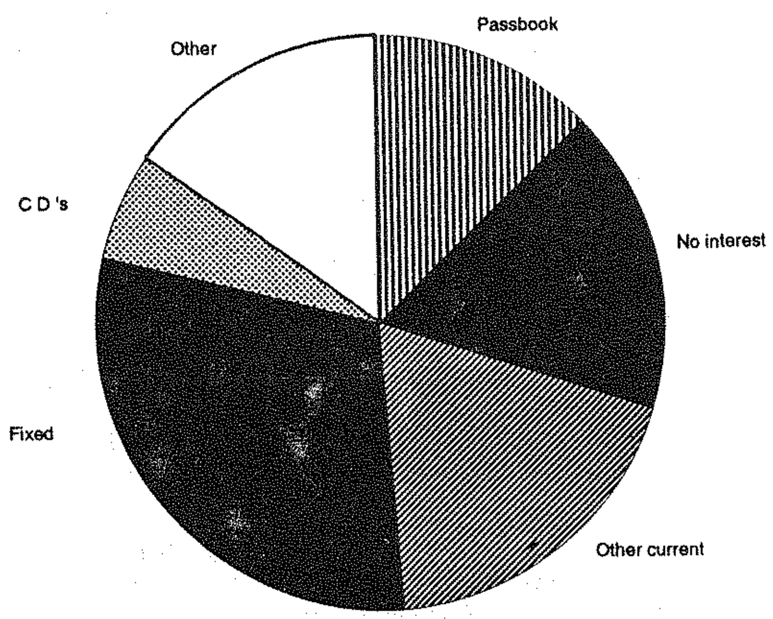
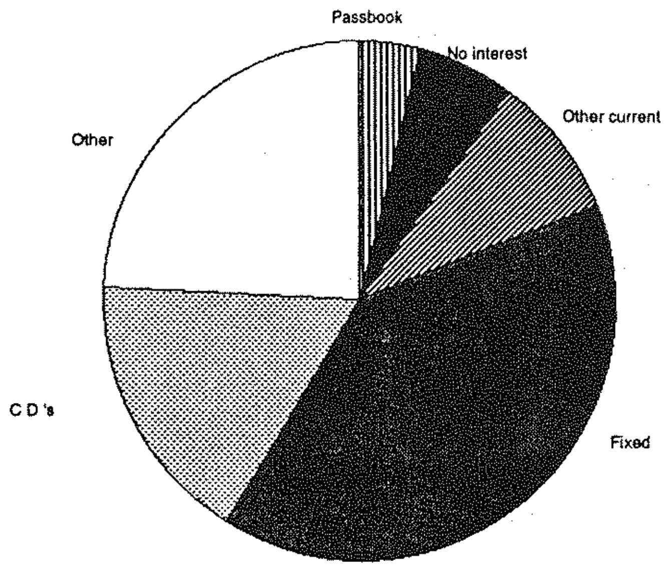


FIGURE 7.3



Source: Based on data from *Reserve Bank Bulletin*.

General criticisms of user pays

7.15 The Committee also heard from groups critical of 'user pays', or at least having serious reservations about its applicability in certain areas. In particular there is controversy about the imposition of fees for retail accounts used by low income earners and social security recipients. The consumer movement's submission was:

> premised on the view that: (a) every Australian citizen requires access to basic banking services, in order to participate fully in society, both in a financial and social capacity; (b) those services ought to be available on fair and equitable terms, at prices that are reasonable and which do not operate as barriers to access.[9]

7.16 There is room for much debate about what constitutes 'prices that are reasonable' and whether 'price' includes not just charges but the paying of below-market rates of interest. Earlier this year NAB attracted a lot of criticism for introducing charges for low-balance deposit accounts. They defended the charges as quite moderate:

> If the minimum monthly balance is less than $500, these accounts provide for eight paper based transactions per month, an unlimited number of [cash] deposits, unlimited use of ATMs for withdrawals or transfers and an unlimited number of EFTPOS transactions, and the charge is 46c per week, 3c more than the cost of posting a single letter.[10]

7.17 The Australian Consumers' Association commented on user pays in the following terms:

> With the many user pays charges that we now also have, there is discrimination in banking, but particularly against those with lower balance accounts .... Other retailers simply do not do this ... When I go into the corner store and just buy a box of matches ... I do not get some sort of charge on top of that because my transaction is too small .... there is a public good for everybody to have access to banking.[11]

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9 Evidence, p. S1493.

10 Evidence, p. 2314.

11 Evidence, pp. 954, 968, 969.

7.18 Some financial intermediaries, especially building societies and credit unions, have been more reluctant to introduce explicit fees for services than the banks. In part this appears to be a reflection of their co-operative ethos and a view that costs should be shared in an egalitarian manner. The Australian Federation of Credit Unions Ltd described the use of implicit pricing rather than fees as an 'article of faith'.[12] St George Building Society believe 'people should not be made to pay for the privilege of doing business with you'.[13] Building societies and credit unions have also used the absence of fees as a marketing device to portray themselves as less grasping and mercenary than the banks. Some examples of their advertising are shown in Figure 7.4.

The relationship of prices to costs

7.19 The introduction of more fees and charges by banks has been criticised by some who claim they bear little relationship to the relevant costs and so do not send appropriate signals.

7.20 In order to explore this relationship each of the major banks and a sample of two other banks was requested to complete a questionnaire from the Committee on pricing issues. Because of the commercial sensitivity of the information, five of the banks requested that their responses remain confidential. However, some general observations can be made.

7.21 The banks have reasonably advanced costing processes but there were differences of opinion on issues such as the extent to which costs were fixed rather than variable. The process of allocating costs is rendered imprecise by the high incidence of joint provision of services (eg. the same staff in the one branch building with the same management will handle both deposits and loan repayments and deal with both personal and business clients). The proportion of costs that could not be directly allocated ranged from 20 to 40 per cent.

7.22 It was also noted from the survey that, even when charges were made for transactions, they were often less than the cost of carrying them out. In many cases banks make no charge for establishing facilities (eg. opening accounts, instigating periodic payments) but then impose a charge for their use. This is in marked contrast to the life insurance industry where there are very large entry charges and smaller ongoing charges.

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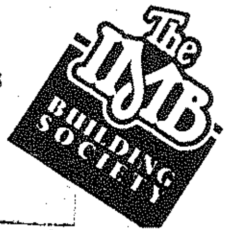
12 Evidence, p. 384.

13 Evidence, p. 869.

FIGURE 7.4: BUILDING SOCIETY & CREDIT UNION ADVERTISING

No charges to cheque with us.



	Your Cheque Account	The IMB Cheque Account
No regular account fees.		

Here's why Freedom has the edge...

Your money in a Freedom Account earns you daily interest. You won't pay any St.George account-keeping fees... nc even on personal cheques.

Enjoying life's great moments can be a whole lot easier with a helpful financial institution on your side. At the Queensland Teachers' Credit Union, you'll find us very easy to deal with when it comes to personal loans.

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- Earn up to 8½% p.a.
- Interest calculated daily on entire balance
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7.23 The survey also indicated that electronic transactions are cheaper than manual paper-based transactions. For example, the banks stated that the cost of an ATM withdrawal was between 30 and 60 per cent of that of a withdrawal over the counter. While banks sometimes charge differently for manual and electronic transactions, the difference is rarely as large as the difference in costs and so does not yet provide adequate incentives for customers to make efficient use of electronic facilities.

7.24 In many cases transactions charges are waived for accounts over a certain account balance. This practice is sometimes referred to as 'relationship pricing'. Banks usually justify this by arguing these accounts provide sufficient revenue to cover the cost of transactions. This is not, however, consistent with the user pays philosophy as it means high transactors are being subsidised by low transactors and have no incentive to economise on their transactions.

7.25 In their responses to the questionnaire, the banks all strongly stated that no prices are set in consultation with other banks.

7.26 The banks report that pricing decisions rest on a balance of many factors which in essence are arrived at from the interaction of market preferences and competition. For example, the factors cited as relevant in setting interest rates on deposits and loans included:

- official and wholesale market rates of interest;
- the bank's average cost of funds;
- the bank's particular funding needs, both today and in the future;
- competitors' interest rates and fees;
- expectations on interest rates and monetary policy generally;
- credit risk;
- cost of product delivery and administration;
- the importance of long term customer relationships;
- costs of complying with prime asset ratio, non-callable deposit and capital requirements;
- strategic objectives such as market share; and
- the need for a reasonable return on capital.

The weighting given to these various factors in the decision will vary over time. With minor exceptions, the banks do not fund particular types of loans from particular pools of deposits.

The price sensitivity of consumers

7.27 Another concern raised by the consumer movement is that customers may not respond to price signals because they do not understand them. It may be that allowing a greater mix of fees and interest rather than just interest would make it harder for consumers to compare products and blunt the competitive process. The issue of the adequate disclosure of information in a readily comprehensible and easily comparable form is addressed in Chapter 21. That chapter also assesses whether comparative tables of this information should be prepared and distributed by some organisation.

7.28 A further potential problem with the introduction of user pays fees and charges is that customers may not feel it is worth while shopping around because there is no guarantee the bank will maintain the pricing they had at the time the consumer makes the decision. Unlike most products, with many kinds of bank loans the price varies after purchase. The more common home mortgage contracts and credit card agreements allow the bank to vary the interest rate charged from time to time. There may also be increases in charges or changes to the basis on which they are calculated. Customers who wish to avoid the uncertainty this creates can often opt for different products. For example, fixed rate housing loans offer certainty. However, as many borrowers are now finding, they also mean that borrowers may miss out on the benefits of lower interest rates. It is important when banks have this discretion to vary prices that the market be competitive and that customers are free to move between institutions.

7.29 Concerns about a perceived lack of competition led the consumer movement to call for the question of banks' charges to be referred to the Prices Surveillance Authority.[14] However, as the pricing questionnaire showed that the majority of banks' charges are less than the relevant costs, it would be unlikely that the PSA would strike them down. Furthermore, there is a danger of PSA-sanctioned charges becoming a minimum as well as a maximum and being annually increased. This would neither enhance efficiency nor consumer choice.

The bank as user

7.30 The banks have also been criticised for not applying user pays in an even-handed manner. It is argued that they should be paying a higher rate on the $6 billion in passbook accounts. The cost of these funds is greater than the 4 per cent paid in interest because the banks charge for transactions less than the

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14 Evidence, p. 955.

cost of those transactions. However, for most of the past decade the average cost to the banks of these deposits has still been much less than that of funds raised on wholesale markets. With recent falls in market rates this gap has narrowed considerably.

7.31 The accounts have been regarded by many in the community as an important source of cross-subsidies applied elsewhere. The Committee concluded that the banks have been in no hurry to tell customers holding these accounts about their other opportunities.

Regulatory impediments to user pays

7.32 In some cases banks are being prevented from introducing user pays by government actions. Existing and proposed consumer credit legislation by the States prevents the charging of both interest and charges on credit cards. One bank has stated they would like to introduce a $30 annual fee for their cards and would cut the interest rate by 4 per cent. This is still not truly user pays as while the cost of sending out statements depends on the number of cards the vast majority of costs are determined by the number of transactions. When asked why the banks were not seeking a transaction fee, the ABA replied:

> the annual fee is simple to understand, it is international practice, it is common to charge cards ... you may find the vast majority of customers prefer an annual fee.[15]

7.33 The ANZ gave a different perspective and explained:

> We have become so sensitised on this issue ... that we have taken to saying 'charge an annual fee' as a sort of shorthand for 'give us pricing flexibility so that we can make reasonable decisions that will be different from each other, depending on the target markets that we are trying to reach'.[16]

7.34 The logic of user pays suggests that retailers should be free to recoup the fees charged by banks when customers pay with a credit card by charging these customers accordingly. The banks have included terms in their credit card contracts with merchants that prevent this application of user pays.

7.35 The issue of allowing greater flexibility in the pricing of credit cards is discussed in Chapter 19.

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15 Evidence, p. 41.

16 Evidence, pp. 2276-7.

7.36 Another impediment to user pays identified by the banks is the 13.5 per cent ceiling on interest rates applying to owner-occupied housing loans made by banks before April 1986. The banks were given freedom to set the rate on new loans after this time. During the 1989-90 period, when new housing loan rates peaked at 17 per cent, this ceiling was imposing a significant burden, part of which was being carried by new borrowers.

7.37 The banks have called for the abolition of the ceiling. One senior banker commented ironically:

> I am sure that all the people who qualified for that rate, by dint of having borrowed before a certain date, are estimable people, and much more deserving than the people who borrowed after that date and pay a higher rate.[17]

7.38 The Reserve Bank's view is also that the ceiling should be abolished:

> This is mainly because the ceiling provides a subsidy - in the form of a free interest rate cap - to an arbitrary group of housing borrowers, without economic reason.[18]

The ceiling also acts as a disincentive to customers switching business between banks.

7.39 As the interest rate on new housing loans is currently below 13.5 per cent, the ceiling is not imposing any cost on the banks at present. The Reserve Bank has advised the Committee that there is no obligation on banks to drop rates on their pre-1986 loans, although all chose to do so.[19] As old loans are repaid the proportion of loans subject to the ceiling is being reduced. In February 1991 the ABA estimated that about 20 per cent by value and 30 per cent by number of housing loans were subject to the ceiling.[20]

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17 Evidence, p. 86.

18 Evidence, p. S2903.

19 Evidence, p. S2903.

20 Particularly over the 1989-90 period when housing loan rates peaked at 17 per cent.

Specific pricing issues

7.40 There are certain areas where the Committee is critical of banks' pricing policies. These are discussed in Chapter 19 and include:

- *the practice of paying interest on only the minimum monthly* balance of deposit accounts; and

- the arbitrary nature of early repayment penalties imposed by some banks.

Conclusion

7.41 The Committee recognises that user pays pricing is likely to become more prevalent in the near future as banks endeavour to charge explicitly for the services they provide. As this occurs interest margins should narrow. If user pays practices are adopted they should equally apply to the payment of interest by banks. Ultimately it will be the consumers in the market place making choices between differing bank products that will determine whether user pays is fully adopted.

7.42 There are some areas where the Committee believes bank pricing policies are neither fair nor efficient, such as the way banks pay interest on some types of deposit account and the arbitrary nature of some early repayment penalties. Recommendations concerning these areas are made elsewhere in the report.

7.43 The Committee does not believe the gamut of bank charges should be referred to the Prices Surveillance Authority. It believes the competitive market will generally be the best arbitrator of what is reasonable.