Summary and recommendations

An observed reduction in competition in Australia's banking sector in the wake of the global financial crisis (GFC), combined with the public outcry over a number of high profile decisions by the major banks, prompted this inquiry.

The global financial crisis: stability and competition

This report is being written in the aftermath of the GFC. In most respects the Australian financial system has recovered from the GFC better than those is many comparable countries. There does not seem to be an overall problem of lack of access to credit, although some banks may still be excessively cautious in certain areas, such as lending to small business, and borrowers that formerly relied on non-bank lenders funded through securitisation markets may be having difficulty finding finance, despite strong credit records.

As usual with financial crises, investors and customers showed a 'flight to quality', moving to longer established and larger financial intermediaries as they perceived these to be safer. At the same time, policymakers in Australia, as prudence demanded, accorded greater priority to the immediate stability of the financial system. The net effect, together with other forces at play during this period (including the relative inability of smaller insitutions to access funds at a competitive price) has led to a more concentrated banking market than existed prior to the financial crisis, with the 'big four' banks increasing their dominance across most if not all banking markets.

The committee considers that this increase in concentration has the potential for consequent undesirable impacts on competition.

Accordingly, as the threat to stability posed by the GFC subsides, it is appropriate that priority turn more to achieving an appropriate longer term balance between stability and competition. The Committee notes that the need to do so is a matter of public debate and that the Government has taken some steps in this direction but the Committee considers additional steps are required and this report describes some further measures that could be implemented. Action should be taken to remove obstacles to increased real competition and to facilitate opportunities for new and existing players in the banking markets to compete actively for business.

To that end, the Committee believes that, in general, competition rather than regulation will generate improved outcomes for customers. It agrees with Treasury that:

> Competition is the cornerstone of efficiency and productivity in any market. It promotes fair prices, enhances living standards and ensures that scarce resources are allocated to their highest value uses.[1]

Having identified some shortcomings in competition, the Committee suggests remedies. There is no 'silver bullet'. No single recommendation will transform the banking sector into a paragon of competition. Rather, a number of smaller recommendations are made, each of which will, if implemented, work to improve the competitive pressures within the banking market.

A broader inquiry into the financial system

Nor does the Committee believe that its recommendations, which focus on *competition*, exhaust all the possible useful reforms to the financial ssytem. The Committee supports a broader independent inquiry. Such an inquiry's work would be facilitated by more information being provided on bank profitability.

A model for such an inquiry could be provided by the five main inquiries into the Australian banking system described in this report; namely the 1937 Royal Commission, the Campbell Committee, the Vic Martin Review Group, the Stephen Martin Report and the Wallis Report.

Recommendation 1

3.91 The Committee recommends that a broad ranging inquiry into the Australian financial system be established, modelled on that conducted by the Campbell Committee. The terms of reference should be broad, covering the role of banks and other financial institutions in a post-GFC financial environment. The inquiry should be well resourced and have its own secretariat, independent of government departments.

Recommendation 2

4.111 The Committee recommends that the Reserve Bank publish further regular information on banks' interest margins and returns on equity; and compare these to returns in other industries to allow an assessment of whether risk-adjusted returns in the banking sector are sufficiently high to suggest that competition is inadequate.

Banks' home loan interest rates

There is a widespread belief that the banks' variable home loan rates should follow (and only follow) movements in the Reserve Bank's policy rate (the 'cash rate'). This belief has been reinforced by the banks generally behaving in this way for a number of

1 Department of the Treasury, *Submission 102*, p 1.

years and a consequent mis-belief that the banks' costs of funds is directly and significantly dependent on the cash rate.

The banks' costs of funds do not, however, always move in line with changes in the Reserve Bank's policy rate. Decisions by the Reserve Bank to change the cash rate are made solely to attempt to deliver inflation outcomes within its statutorily defined target range. These changes will have some impact on the cost of banks' funds but are not necessarily a primary driver of those costs, which are subject to many influences other than the Reserve Bank's cash rate.

It is reasonable that banks should be able to set their lending rates taking into account their overall cost of funds. When events such as the GFC, or a prudent move towards seeking longer-term and more stable funding, pushes up their cost of funds at a faster pace than the Reserve Bank is increasing the cash rate, it is understandable that banks will seek to increase their lending rates by more than official cash rate increases to cover those costs. A truly competitive market, however, will limit the extent to which banks can increase their lending rates and other fees to recover such increases in costs plus a small profit.

Similarly, as banks replace expensive borrowings during the GFC with cheaper funds (which may already be occurring), their average cost of funds will fall and, in a competitive market, customers should expect to see a reflection of this in lower home loan interest rates (or increases below those made to the Reserve Bank's policy rate).

For borrowers with a strong desire for their home loan rate to have an explicit linkage to the Reserve Bank's policy rate, the Committee welcomes the initiative by some lenders to provide 'tracker loans' which provide this certainty.

But importantly, if the banks increase their loan rates by more than the Reserve Bank's adjustment to its cash rate, it does ***not*** mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target. If the banks expand their margin over the cash rate, then the Reserve Bank will set a lower cash rate than they would otherwise have set.

Profitability and concentration in the banking industry

Even during the period of the GFC, when the real economy slowed markedly, the profits of the major banks held up well. The returns they offer investors more than match those from other comparable industries, despite the explicit and implicit government support they receive and the expectation by the market that they are 'too big to fail' which makes banking a less risky activity.

While the Committee prefers banks to be profitable rather than unprofitable, their very high profits are ultimately paid for by households and small businesses. They are also a reflection that competition is not as keen as it should be. This conclusion was reinforced by the finding that the Australian banking market is highly concentrated.

The Committee would accordingly be concerned if there were any further increase in concentration. The Committee therefore strongly supports the retention of the 'four pillars' policy preventing any merger between the four major banks. It also urges the Australian Competition and Consumer Commission (ACCC) to take a strongly sceptical view towards any proposal for one of the four major banks to take over one of the remaining regional banks.

The Committee views forced divestiture as a major intervention in a free market and regards it as a 'last resort' approach to increasing competition. The Committee prefers other means of increasing the number of players in the market. With the change to an explicit form of deposit insurance, a consideration of impediments to foreign banks offering stronger competition, such as the preference for foreign banks to operate as subsidiaries rather than branches, could be reviewed as part of the broader review of the financial system. This same review could also examine means whereby current non-banks could more directly compete with banks. This could include an examination of the restrictions on ownership arrangements for financial intermediaries.

Reducing barriers to customers moving between financial intermediaries

The costs and other impediments to moving between banks are important factors with the potential to weaken competition significantly. One such impediment is excessive exit fees on variable rate home loans. The Committee notes the importance of fees in underpinning the business models of non-bank lenders which bring competitive pressures to the market and that an outright ban will reduce competition from this sector. The Committee believes that banning exit fees may lead to higher upfront fees, including for borrowers who currently never incur exit fees. It is notable that the only financial intermediaries that openly welcomed the abolition of exit fees were the major banks.

Rather than moving to an immediate ban, the Committee favours giving the new consumer protection provisions a chance to work. These provisions, which restrict exit fees to reasonable amounts, only came into effect less than a year ago and are not yet well known or well utilised.

It is important, however, that borrowers are made fully aware of the extent of exit fees at the time they take out their loans.

Recommendation 4

7.34 The Committee recommends that the Government reconsider its decision to ban exit fees, before the amended regulations come into effect, with a view to allowing enough time for the effectiveness of the existing ban on unfair and unconscionable exit fees (as implemented through ASIC Regulatory Guide 220) to be assessed. If it proceeds with the ban, it should only apply to authorised deposit-taking institutions.

Recommendation 17

10.33 The Committee recommends that the Government introduce regulation of mortgage early exit fees (including deferred establishment fees), requiring disclosure of these fees upfront in a simplified and comparable format.

Recommendation 5

7.35 The Committee recommends that lenders be required to inform borrowers when they take out a loan of the provisions of the *National Consumer Credit Protection Act 2009* which relate to unconscionable charges.

Recommendation 6

7.36 The Committee recommends that borrowers be required to sign off on a form clearly disclosing any exit fees applicable to their home or small business loan before making any commitment.

Recommendation 7

7.37 The Committee recommends that lenders charging exit fees be required to explain on their website how the exit fee relates to relevant costs.

As well as excessive exit fees, the Committee identified other barriers to customers moving between lenders, which it believed should be addressed.

Recommendation 8

7.49 The Committee recommends that lenders mortgage insurance always be made either pro-rata refundable or transferable and that this be made clear to borrowers.

7.50 As an alternative, lenders mortgage insurance should be payable by instalments (eg. monthly, quarterly or annually) rather than as an upfront lump sum payment (as occurs in other jurisdictions).

Recommendation 11

7.73 The Committee recommends that the Government ask Treasury to investigate the feasibility of personal credit ratings to facilitate borrowers moving between lenders.

Recommendation 13

7.99 The Committee recommends that the abolition of stamp duties on refinancing of mortgages be placed on the agenda for the forthcoming tax forum and that the agreement on their abolition be implemented.

Allowing customers to readily transfer their saving and transactional banking between banks and other deposit-taking institutions is also important.

Recommendation 14

7.131 The Committee recommends that a scheme based on those in Europe be introduced requiring a bank, upon being advised that a customer has left for a new bank, to reroute all direct debits and credits for 13 months and provide the new bank with details of those direct debits and credits.

Greater disclosure of information

The Committee believes better disclosure of information would help make the banking market more competitive.

Recommendation 9

7.69 The Committee recommends that the Reserve Bank and the Australian Prudential Regulation Authority draw on their data collections to publish regular information about the total cost of home loans (based on standardised assumptions on the average size and term) for the twenty largest ADI home mortgage lenders.

Recommendation 10

7.70 The Committee recommends that a working group be set up including Treasury, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Australian Competition and Consumer Commission, the Reserve Bank, the Financial Ombudsman Service, the Australian Bankers' Association, Abacus, consumer representatives and relevant academics to develop standardised words for financial products and their characteristics to allow consumers to more readily compare offers from different financial intermediaries.

Recommendation 12

7.93 The Committee recommends that banks should be required to contact customers before the expiry of term deposits advising them of the rate that will apply if they are automatically renewed and the current 'special' rates available.

Promoting more competitors

In terms of institutions, the most promising approach would be to enhance the ability of existing Australian non-bank institutions to compete with the banks and to facilitate further competition from foreign banks. Some of these measures involve easing taxes on them, and so will have an impact on revenue. But the Committee regards these measures as more effective than creating a development or rural bank or converting Australia Post into a bank. The Committee appreciates Australia Post's role in delivering banking services to some rural and regional areas. It is commendable that it provides services on behalf of a number of financial intermediaries and thereby promotes competition. Australia Post should continue to seek opportunities to improve access to financial services.

Recommendation 18

11.73 The Committee recommends that mutual financial intermediaries be allowed to refer to themselves as a 'mutual bank' or 'approved banking institution' and use terms such as 'credit union bank' in their name.

Recommendation 36

15.24 The Committee recommends that the Government require Treasury to review the GST input tax arrangements for mutual financial intermediaries having regard to the comments in the Henry Tax Review.

Recommendation 37

15.33 The Committee recommends that the Government require Treasury to review the treatment of building societies and credit unions in the franking credit arrangements and report publicly on the advantages and disadvantages of various options.

Recommendation 19

11.78 The Committee recommends that financial intermediaries not supervised by the Australian Prudential Regulation Authority be required to state clearly that funds placed with them are 'not guaranteed by government' but otherwise should not be prohibited from applying familiar terms such as 'debenture' where this would not be misleading.

Recommendation 34

15.10 The Committee recommends that interest withholding tax be abolished as budgetary circumstances permit to increase the ability of foreign banks to compete in the Australian market.

Recommendation 38

15.37 The Committee recommends that the Government require Treasury to review the abolition of the LIBOR cap to the tax deductibility of interest paid by a foreign bank branch on borrowings from its parent bank.

Recommendation 33

14.82 The Committee recommends that the Government direct the Australian Competition and Consumer Commission to conduct an examination of barriers to competition in the Australian payments system and publicly report by the end of 2011 on any legislative or other reforms that would enhance competition and efficiency in the provision of payment, clearing and settlement systems.

The securitisation market

The contraction in the securitisation market has had adverse consequences for competition. It represents an over-reaction to the deficiencies in some areas of the market that became evident during the GFC. With private sector institutional investors becoming unreasonably risk averse, there was bipartisan support for the government, through the Australian Office of Financial Management, supporting the market by purchase of residential mortgage-backed securities. The Committee supports a continuation of this programme for now, although of course it should not continue indefinitely. The Committee is keen to encourage the securitisation market as a means of promoting competition and therefore endorses a number of suggestions made to it to strengthen the securitisation market.

Recommendation 22

13.29 The Committee recommends that the Government ask the Australian Prudential Regulation Authority to review aspects of its prudential framework to ensure that there are no inadvertent impediments to the issuance and trading of bullet bonds.

Recommendation 23

13.38 The Committee recommends that, in order to retain incentives for careful credit assessment, an authorised deposit-taking institution which securitises a loan portfolio be required to keep a proportion of the resultant asset-backed securities on its balance sheet and hold appropriate levels of capital. The proportion should be set by the Australian Prudential Regulation Authority in consultation with the Australian Securities and Investments Commission to balance incentives to maintain credit standards with the desirability of encouraging the recovery of the securitisation market.

Recommendation 24

13.42 The Committee, having more confidence in the Australian Prudential Regulation Authority's oversight than in the opinions of credit rating agencies, recommends that the Reserve Bank accept as eligible paper for repurchase agreements long term debt issued by any authorised deposit-taking institution rather than just those rated above A.

Recommendation 25

13.58 The Committee recommends that the Australian Office of Financial Management programme be expanded to include asset-backed securities based on assets other than home mortgages and to include securities rated AA or A (rather than just AAA) or issued by a financial intermediary supervised by the Australian Prudential Regulation Authority.

Recommendation 26

13.59 The Committee recommends that the Australian Office of Financial Management be given the discretion to purchase residential mortgage-backed securities issued by entities with a substantial bank shareholding where it judges this would promote a more competitive market.

Recommendation 27

13.76 The Committee recommends that the Government commission a survey of potential demand for types of asset backed securities.

Recommendation 28

13.77 The Committee recommends that the broader inquiry into the financial system investigate ideas that may further the participation of smaller lenders in the securitisation market, such as greater standardisation and disclosure, liquidity support for securities issued by mutual ADIs meeting certain quality standards and better co-ordination between regulators.

Recommendation 29

13.78 The Committee recommends that Treasury develop a plan to introduce a support programme for RMBS similar to that operating in Canada in case a future deterioration in the securitisation market requires its introduction.

Recommendation 30

13.107 The Committee recommends that the Government establish a working group with an independent chair, representatives from Treasury, the Australian Prudential Regulation Authority, the Reserve Bank, and the banking and superannuation industries, and also including academic experts, to explore and assess options that could promote investment in deposits and fixed income assets by superannuation funds and other funds managers.

Price signalling

Anti-competitive price signalling refers to a corporation conveying to its rivals its future price intentions. By so doing, the corporation eliminates uncertainty about the price of its goods or services, thereby reducing the risks of competition and impeding the functioning of a competitive market.

The Committee believes that there is a need to address price signalling through an amendment to the *Competition and Consumer Act 2010*. It agrees with the ACCC that the Act is currently inadequate to prohibit statements which relay to the market the future pricing intentions of a company. Care needs to be taken, however, that new legislation should not prevent legitimate communication of pricing information that is not anti-competitive in its intent or effect. The Committee believes that it is better for a bank engaging in anti-competitive price signalling to go undetected than it is for a bank conducting legitimate communications to be inappropriately penalised. In this vein, the Committee is concerned that the Government's over-reliance on the proposed new ACCC notification regime in its bill may be cumbersome and restrictive for the banks, as well as a burden on the ACCC. The far better alternative is to replace the prohibitions with a competition test that applies to both public and private communications.

Recommendation 15

8.95 Subject to the release of the Government's independent legal advice, the Committee recommends that the *Competition and Consumer Act 2010* be amended to include a provision which states that a corporation engages in price signalling if it communicates future price-related information to a competitor, and the communication of that information has the purpose, or has or is likely to have the effect, of substantially lessening competition.

Recommendation 16

8.97 The Committee recommends that an amendment to the *Competition and Consumer Act 2010* to introduce a price signalling provision should be accompanied by ACCC guidelines providing:

- **examples of the type of communication that would fall foul of this provision;**
- **examples of the type of communication that would not fall foul of this provision; and**
- **the protection offered by the exemptions.**

Supervision of the financial system

There is much to be proud of in Australia's financial system at present, especially contrasting the performance here with how other countries' banking systems fared during the GFC. A strong supervisory system made an important contribution. But this should not be regarded as a reason for complacency. The proposed independent review of the financial system should include an examination of the extent to which the good performance reflected the structure of the Australian Prudential Regulation Authority, its current personnel or an element of good luck.

Automatic teller machines

The Committee commends the Reserve Bank for requiring ATMs to display fees before the customer completes the transaction. The Committee hopes this will in time lead to greater competition and ATM providers will advertise machines with lower fees. Measures to cap ATM fees would be counterproductive as they would lead to ATMs being removed from some remote locations.

Recommendation 31

14.45 The Committee recommends that the Australian Payments Clearing Association and the Australian Bankers' Association encourage their members to have their ATMs screens display a real-time warning to consumers where a penalty fee will be imposed if a particular transaction goes ahead.

Ensuring adequate community access to financial services

The Committee recognises that banks are accorded a special status and given special privileges. In exchange they have social obligations to provide banking services to the broad community. These are obligations that the banks should meet voluntarily rather than compulsorily. In areas where there are unmet demands for basic banking services which the government believes on social grounds should be provided to disadvantaged members of the community, the government should invite banks to tender to provide the services and the government pay to ensure they are provided.

Recommendation 32

14.46 The Committee recommends that the government deal with the problem of excessive ATM fees in remote indigenous communities by tendering for an ATM provider to install a network of ATMs in these areas which make specified minimal charges for balance enquiries and low charges for cash withdrawals.

Government guarantees for the financial system

The Committee believes providing temporary guarantees for bank funding was the correct response to the GFC but it could have been introduced more adroitly. The differential pricing for the gurantees exacerbated the 'flight to quality' to the major banks and had an adverse impact on competition.

Recommendation 20

12.36 The Committee recommends that, to increase the competitiveness of smaller lenders, the Government immediately standardise the fee for all borrowers under the wholesale funding guarantee to a uniform rate of 70 basis points.

Recommendation 21

12.53 The Committee recommends that the financial claims scheme should be retained in its current form pending the outcome of a full inquiry into a deposit insurance scheme, possibly charging risk-related premia. The inquiry should also examine the issue of guaranteeing non-ADI products that are close substitutes for deposits, with a view to being better placed to provide such a guarantee as future need arises.

The Committee supports the introduction of the 'Government Protected Deposit' symbol as a means of allowing mutual and smaller ADIs to compete on a more equal footing.

Taxation and related measures

Some other changes that could also foster competition were identified.

Recommendation 35

15.18 The Committee recommends the taxation arrangements applied to bank deposits and mutual ADI deposits should be reviewed by the inquiry into the financial system.

Recommendation 39

15.48 The Committee recommends that the Government require Treasury to review the operation of the First Home Savers Accounts scheme and report publicly on the advantages and disadvantages of various options.

Small business finance

Since the GFC, finance for small business has become more expensive, both absolutely and relative to housing loans. This appears to reflect a mix of banks more prudently acknowledging the risks in various types of lending and some reduction in competition.

Recommendation 3

6.42 The Committee recommends that the Australian Bankers' Association meet with small business representatives to develop a code of practice specifically relating to lending to small business.