Chapter 2

Background - the Australian banking market

Australia has strong banks

2.1 There is much to be proud of in Australia's banking system at present, especially contrasting the performance here with how other countries' banking systems have fared during the global financial crisis (GFC):

> The Australian banks…are well capitalised and highly rated. They have benefited from years of rigorous supervision by Australia’s world-class financial regulators, and this is no accident. An important feature of our regulatory infrastructure for many years is a common understanding between governments, the regulators and the industry on the importance of prudential regulation. No Australian bank has collapsed post the GFC. No banking firm has needed to be bailed out through the use of taxpayers’ money. The Australian banking system has emerged from the GFC in a stronger position relative to banking systems in many other countries and for that good reason is highly regarded around the world.[1]

2.2 As the Committee noted in 2009, many wish to claim the credit for this:

> Views differ about the reasons for the recent relative strength of the Australian banking system. The banks themselves regard it as a vindication of good management. The supervisors believe it reflects their good work. There is some truth in both these views; Australian banks have largely eschewed the practices such as 'low doc' and 'no recourse' lending which generated large bad debts in the domestic lending of American banks. There was also an element of good luck. As Australia is a net borrower, banks here were concentrating on raising funds overseas to lend in Australia. This meant that unlike countries which generated excess savings, Australian banks were not looking to buy foreign securities, many of which had a complexity which disguised their low quality.[2]

2.3 The Committee also noted in its earlier report the long history of strong banks and good regulation:

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1 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 25.

2 Senate Economics References Committee, *Report on bank mergers*, September 2009, p 4.

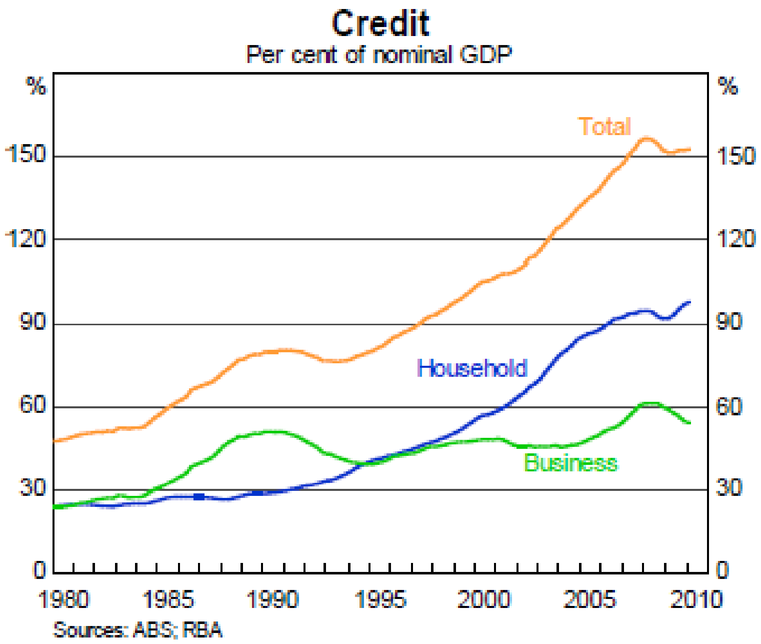
> It has been notable that the collapses and near-collapses of financial intermediaries have occurred among the unregulated non-bank intermediaries.[3]

> …since the 1890s depression…there is only one example of bank depositors losing money in an Australian bank, and that was a small rural bank in the 1930s when the depositors lost one cent in the dollar. In our research we have found no example of when taxpayers' money has been used to bail out any Australian private bank.[4]

2.4 There does not seem to be an overall problem of lack of access to credit (Chart 2.1). The Reserve Bank comments:

> Australian borrowers have enjoyed ready access to credit, with credit growing at about three times the pace of nominal GDP over the past 25 years.…A significant increase in demand, mainly from households, was accommodated by an increase in supply through new participants, more diverse products and some easing in lending standards.[5]

Chart 2.1



Source: Reserve Bank of Australia, *Submission 41*, p 2.

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3 Examples include 'merchant banks' such as Tricontinental, Nugan Hand, and Rothwells; Pyramid Building Society (in the period before building societies were supervised by APRA), and finance companies such as FCA. Senate Economics References Committee, *Report on bank mergers*, September 2009, p 3.

4 Mr Nicholas Hossack, Australian Bankers' Association, cited in Senate Economics References Committee, *Report on bank mergers*, September 2009, p 3.

5 Reserve Bank of Australia, *Submission 41*, p 1.

2.5 The challenge is to maintain the strength of the system but also to:

> …foster a competitive banking environment for consumers of banking services, particularly at the retail level, in an industry that has become more concentrated as a result of the GFC.[6]

2.6 Choice expressed what they believe to be a common view:

> …there is public recognition that politicians did the right thing at the time of the global financial crisis to ensure financial stability, but that the actions taken then have reduced competition now.[7]

2.7 The Committee believes competition is good. It should result in intermediation services being provided at low cost, finance being directed to where it can be best used and consumers and small business being able to access it on fair terms.

2.8 It notes, however, that some submitters are concerned that in an environment of strong competition, some lenders can become overenthusiastic, leading to excessive debt and asset price bubbles.[8] Allowing the benefits of competition to emerge without such a loss of stability is the role of the authorities. Prudential supervision is discussed in Chapter 11.

A short history of Australian banking competition[9]

2.9 The first bank in Australia, the Bank of New South Wales founded in 1817, obviously had a monopoly position. Its first substantial competitor was the Bank of Australia, established in 1826.

2.10 These two banks mainly catered to commercial customers. The New South Wales Saving Bank (more commonly known as Campbell's Bank) was established in 1819 to cater for the needs of households and to encourage thrift. By 1832 there were concerns about a private bank having a virtual monopoly over the colony's savings and the Legislative Council established the Savings Bank of New South Wales, which took over Campbell's Bank. Over the next couple of decades savings banks were established in other colonies around Australia.

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6 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 25.

7 Mr Nick Stace, Chief Executive Officer, Choice, *Committee Hansard*, 14 December 2010, p 27.

8 Associate Professor Steve Keen, *Submission 63*; Mr Andrew Selby Smith, *Submission 65*; Mr George Ivanov, *Submission 124*.

9 The main sources for this section are House of Representatives Standing Committee on Finance and Public Administration (1991), Butlin (1953) and Butlin, Hall and White (1971).

2.11 The demand for commercial banking grew with the pastoral expansion of the 1830s, the gold rushes of the 1850s and the long boom of 1860-1890. British interests established banks such as the Union and the Bank of Australasia whose branches spread across the continent.

2.12 By 1888 there were over forty banks operating in Australia. The 1890s depression brought the greatest banking crisis Australia has ever seen.[10] While external factors played a role, lax lending standards were the primary cause:

> …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.[11]

2.13 Only nine banks remained continuously open through the 1890s, with many failing or being absorbed by their rivals.

2.14 A desire to improve competition was one of the motivations for the Fisher Government establishing the Commonwealth Bank in 1911:

> It was not established as a central bank; it was established to counter private banks. It was a publicly owned bank to compete against the private banks…the Labor Party in particular wanted a publicly owned, commercial bank to compete against the private banks.[12]

2.15 It was not, however, a particularly aggressive competitor, setting deposit interest rates below those of the private commercial banks and not encouraging staff to entice customers away from them.

2.16 The savings banks which survived the 1890s were mainly those run by the state governments. With the post office network as its agents, the Commonwealth Bank was a substantial competitor in this area. It took over the state savings banks in Tasmania and Queensland early on and those in New South Wales and Western Australia during the 1930s depression.

2.17 From the 1920s to the 1940s the Commonwealth Bank took on more of the characteristics of a central bank. This led to complaints from the private banks that the Commonwealth Bank was both player and umpire and in 1960 the central banking powers were placed with the new Reserve Bank of Australia.

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10 It still resonates with at least one submitter: Mr Andrew Oliver recalls 'I remember my Nana telling me her father was almost ruined by bank failures in Australia in the 1890's'; *Submission 1*, p 2.

11 Butlin (1961, p 280).

12 Mr Selwyn Cornish, *Committee Hansard*, 13 December 2010, p 118.

2.18 In the first half-century after federation no new private banks were established and there continued to be mergers. By 1955 there were twenty banks. The four largest held around two-thirds of the market, double their share in 1888.

2.19 From the late 1950s the larger private banks established savings bank subsidiaries which although required to hold substantial amounts of government bonds also became significant home mortgage lenders.

2.20 Wartime controls on banks were made permanent in the *Banking Act 1945*.[13] The controls reduced competition between banks by placing ceilings on interest rates and prohibiting the payment of interest on current accounts. The controls on banks also led to them establishing non-bank subsidiaries (such as finance companies and merchant banks) and faster growth of less controlled mutual financial intermediaries such as building societies and credit unions. These met some of the demand for credit, notably personal loans, unsatisfied by the banks. The *Financial Corporations Act 1974* would have allowed the non-bank financial intermediaries to be brought under the regulatory net but was never fully implemented.

2.21 Instead the banking system was progressively deregulated during the 1980s with interest rate controls gradually removed. New technologies such as ATMs and EFTPOS were introduced, along with new financial products.

2.22 Foreign banks were allowed to enter the Australian market from the mid-1980s but there was a:

> …surge of foreign bank competitors driven out after sustaining heavy losses…[14]

2.23 But while foreign bank entry opened up the prospect of an increase in the number of banks, mergers were working in the other direction. Some mergers were at the behest of the authorities as a way of dealing with banks at risk of failing -- 'subtle arranged marriages' as one submitter termed them.[15]

2.24 Two large domestic mergers saw the 'six major' banks become the 'four majors' in the early 1980s. As the bankers themselves remarked:

> If you look at the family histories of the major banks, there has been consistent growth through acquisition throughout their long histories.[16]

2.25 The succession of mergers over the past 150 years is illustrated in the 'family trees' in Charts 2.1 to 2.5.[17]

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13 A suggestion made at this time to establish a parliamentary committee on banking was not implemented.

14 Mr Peter Mair, *Submission 2*, p 6.

15 Dr Carolyn Currie, *Submission 114*, p 2.

16 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Proof Committee Hansard*, 14 December 2010, p 103.

2.26 A number of building societies transformed from mutuals to listed companies and were then taken over by the major banks. Indeed, the largest remaining mutual characterised demutualising as:

> …selling to an unknown buyer…in demutualising in all likelihood you are going to be bought.[18]

2.27 The four major banks are not just dominant in the banking market:

> …they are also now the biggest players in the insurance, wealth management and financial advisory markets.[19]

2.28 A temporary challenge to the dominance of the banks emerged in the 1990s as new non-bank home lenders, funded by securitisation of their mortgages, developed. There was also an increased role for mortgage brokers:

> The role of mortgage brokers has I think has been overlooked. As the mortgage brokers entered the market you had greater transparency in the market that helped customers shop around as well. I think that put a lot of competitive pressure on as well.[20]

The impact of the global financial crisis

2.29 A veteran of 43 years in the banking industry reflected:

> There is no doubt that the GFC was the toughest period that I have ever seen or experienced in the industry. Probably one of the most significant outcomes of the GFC has been the negative impact to competition in our industry.[21]

2.30 The GFC affected competition because its impact was harsher for the smaller banks and non-bank intermediaries than for the large banks. The 'largest of the smaller banks' commented:

> Pre-GFC, our cost of funds was only 10 or 15 basis points greater than the major banks. It is now up to 80 basis points more than what the major banks pay. The other regional banks pay an even wider differential on their funding...The gap between the cost of funds for major banks and that of all other financial services institutions has been greater in the past few years

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17 To keep the trees legible, some small savings banks and building societies, and acquisitions outside Australia, have been omitted.

18 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 88.

19 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 15.

20 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 14 December 2010, pp 89-90.

21 Mr David Liddy, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 14.

> than for decades prior to the GFC. It does threaten to drive further consolidation and a further reduction in competition.[22]

2.31 In the global financial crisis securitisation markets dried up indiscriminately:

> …due to poor underwriting standards for home loans in many countries, the securitisation markets around the globe stopped functioning as investors became nervous about the quality of the assets they were investing in. The market did not discriminate between countries in the respective quality of the securitisation issues but simply threw the baby out with the bathwater.[23]

2.32 With access to securitisation markets cut off, and consumers wary of depositing with less familiar names, the non-bank home lenders struggled. Some were taken over by the major banks while others just contracted their activities.

2.33 Even some large banks were forced to reduce their operations. Treasury note:

> …some foreign banks have exited the Australian market or significantly scaled back their operations here due to funding constraints. These competitors were particularly significant in providing corporate business banking services.[24]

2.34 On understandable grounds, the Government prioritised the stability of the financial system. But whether inevitably, or because of design flaws discussed in Chapter 12, some of the measures had undesirable impacts on competition. At the same time the major bank benefited from a 'flight to quality' by households, reflecting the same return to financial conservatism that has seen the household saving ratio move from being negative to around its highest level in twenty years. Shifting the balance back towards competition is a key focus of the rest of the report.

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22 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 1. In early 2011 the major banks are rated AA, Suncorp is rated A and the other regional banks are rated BBB.

23 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, pp 106-7.

24 Murphy (2010, p 47).