

Chapter 9

Bank mergers and new competitors in the banking market

Merger policies generally

9.1 The Senate Economics Committees have examined mergers policy in a variety of contexts in recent years. They have generally concluded that the current regime is excessively permissive of mergers and has allowed undesirable concentrations of market power in a number of sectors. Some conclusions from those earlier reports are:

The Committee believes concerns about the impact of 'creeping acquisitions' on competition are valid. It agrees that the current provisions of section 50 of the *Trade Practices Act* are insufficient to address the problem adequately.¹

The Committee recommends that the Government retain the 'four pillars' policy of not allowing a merger between any of the four major banks.²

The Committee recommends that a moratorium be placed on approval of any further takeovers in the banking industry for one year, unless the bank being taken over is at imminent risk of failure.³

The Committee reiterates its recommendation that the *Trade Practices Act* be amended to inhibit firms achieving market power through takeovers or abusing market power and that 'market power' be expressly defined so that it is less than market dominance and does not require a firm to have unfettered power to set prices. A specific market share, such as, for example, one third (set based on international practice), could be presumed to confer market power unless there is strong evidence to the contrary.⁴

ACCC approval of mergers

9.2 Section 50 of the *Competition and Consumer Act 2010* (formerly the *Trade Practices Act 1974*) states that mergers which have the effect of 'substantially

1 Standing Committee on Economics, *Trade Practices (Creeping Acquisitions) Amendment Bill 2007 [2008]*, August 2008, p 9.

2 Senate Economics References Committee, *Aspects of Bank Mergers*, September 2009, pp 15-16.

3 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

4 *Access of Small Business to Finance*, June 2010, p 56. A similar recommendation appears in Senate Economics References Committee, *Milking it for all it's worth – Competition and pricing in the Australian dairy industry*, May 2010, p 60.

lessening competition' are prohibited unless the Australian Competition Tribunal authorises them on the grounds that they give rise to a public benefit. The ACCC's position is that a lessening of competition is substantial if it creates or confers an increase in market power on the merged firm and/or other firms in the relevant market that is significant and sustainable.⁵

Reviews of mergers

9.3 A review of previous merger decisions may lead to improved outcomes. At a hearing, an academic expert on competition, Professor King, saw considerable merit in this suggestion:

...one of the things that would be desirable is an ex post review of mergers more generally in Australia...That sort of exercise would allow us to, in a sense, check that our laws are appropriate. We have a particular set of tests in Australia relating to a substantial lessening of competition in a market. Is that the appropriate test? The best way of working that out is to look at the decisions that have been made.⁶

9.4 Reflecting later, he added:

This type of retrospective study represents best regulatory practice. The U.S. antitrust authorities have carried out this type of study....The benefits of such a study are clear. It allows feedback to both the regulators and the legislature about our competition laws and their implementation. If the federal government made the resources available to do this exercise (and required relevant businesses to provide relevant data, such as retail scan data) then this would be a good outcome.⁷

Mergers among banks

9.5 As noted in Chapter 2, and illustrated by the 'family tree' diagrams there, the current market situation is the result of a large number of bank mergers in Australia. The Chairman of the Australian Prudential Regulatory Authority (APRA), Dr Laker told the Committee:

There certainly has been a narrowing in the number of authorised deposit-taking institutions in Australia over the course of the last 20 years. That consolidation has mainly taken place at the smaller end of the market through the merger and exit of credit unions; that has been a pronounced downward trend.⁸

5 ACCC, Submission to Senate inquiry into Aspects of Bank Mergers, *Submission 4*, p 3.

6 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 109.

7 Professor Stephen King, 'Retrospective merger analysis', *Core Economics Blog*, 22 January 2011, <http://economics.com.au/?p=6638> (accessed 27 March 2011).

8 Dr John Laker, *Committee Hansard*, 14 December 2010, pp 11–12.

9.6 The Committee found in its 2009 report into bank mergers that there are essentially four main views about the motivations for bank mergers:

- the first is that it is about improving the efficiency of banking by realising economies of scale and economies of scope or allowing banks to meet the borrowing needs of increasingly large corporations;
- the second is that it is motivated by increasing market power (and hence profits), which will be reflected in lower interest rates on deposits and/or higher interest rates on loans;
- the third motivation is that banks may seek to merge in order to reach a size at which they are 'too-big-to-(be-allowed-to)-fail'. There is evidence that ratings agencies and markets believe that large banks are more likely to be assisted in a crisis than small banks; and
- the final view is that mergers are largely ego-driven, with bank management seeking the greater prestige and salaries that come from running a larger organisation. (There are also defensive advantages in getting larger. It makes the bank less likely to become a takeover target itself, thereby protecting the CEO's position.)⁹

9.7 The Committee noted that it is only if the first reason is dominant that mergers may be in the public interest rather than just in the interests of the bankers.

9.8 The Finance Union of Australia argued the need for tighter merger regulations in the banking sector governed by a stricter public interest test.¹⁰ In the case of the Westpac takeover of St George:

We had very vigorous exchanges with the ACCC around that, particularly the St George merger. We made it crystal clear to everybody we spoke to and particularly the ACCC that if they green-lit that merger they would essentially end competition against the big four... We had a fifth pillar; it was called St George, and Westpac were allowed to purchase it. We think that the ACCC completely went missing at a time when they needed to stand up...A thousand people lost their jobs as a result of that merger, and there are probably 2,000 or 3,000 more people who are going to lose their jobs. With the fall of St George, we have lost the only genuine competitor to the big four...No-one has won out of that.¹¹

9.9 Other witnesses shared this view that the takeover of St George represented a significant diminution of competition:

9 Senate Economics References Committee, *Aspects of Bank Mergers*, September 2009, pp 15-16.

10 Mr Leon Carter, Secretary, Finance Union of Australia, *Committee Hansard*, 14 December 2010, p 44.

11 Mr Leon Carter, *Committee Hansard*, 14 December 2010, p 50.

There is absolutely no doubt in my mind that the St George acquisition by Westpac was a huge mistake. It was the beginning of the end. It was the tipping point. St George was an intensive competitor, particularly in relation to small businesses....the four big banks basically took out one significant threat to them overnight.¹²

9.10 Even mergers with a smaller national footprint can have a significant effect in the relevant state:

Senator PRATT—I am interested to know whether there was any perceivable difference in the small- to medium enterprise sector in Western Australia on banking competition when BankWest was taken over by the Commonwealth.

Mr Canion—We were particularly disappointed by the outcome that that has delivered for the competitiveness of the sector. It has again reduced the options available to small business. There was a discernible effect, I would say, on the ability of businesses to get loans at a good price.¹³

9.11 The impact of merger activity is felt by a range of companies, including mortgage brokers. The Mortgage Finance Association told the Committee:

The mergers that have taken place certainly have not been good from a mortgage broker point of view...The offer that the mortgage broker makes to the consumer is: 'Come to me. I can go through a whole range of different lenders and a whole range of products and find the most appropriate deal for you.' So the fewer lenders there are in the marketplace lessens the attraction of the broker and the pressure they can bring in terms of competitive forces in the industry.¹⁴

9.12 A number of submitters wanted the major banks to be prohibited from making further takeovers of smaller banks:

...there should be rules governing takeovers of smaller competitive financial institutions, which the big banks continually do to get rid of their competition. There has been an increase in takeovers in recent times, and enables the big banks get even bigger...¹⁵

...the Government should rule out any significant future merger and acquisition activity in the Australian retail banking system and the wider

12 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, pp 60-61.

13 Mr Andrew Canion, Manager, Western Australian Small Enterprise Network, *Committee Hansard*, 21 January 2011, pp 114-115.

14 Phillip Naylor, Chief Executive, Mortgage Finance Association of Australia, *Committee Hansard*, 14 December 2010, pp 75-76.

15 Mr Murray Withers, *Submission 99*, p 1.

financial services sector which would consolidate the dominance of any one of the four major banks.¹⁶

Four pillars

9.13 For two decades, there has been bipartisan opposition to a merger between the four major banks. In 1990, the Treasurer the Hon. Paul Keating announced the 'six pillars' policy opposing any mergers between the four largest banks and two largest insurance companies.¹⁷

9.14 Some witnesses expressed concern that while the four pillars policy is what currently prevents mergers among the four major banks, it is only a policy and is not enshrined in any legislation.

...if there were not a four-pillar policy, the four major banks would seek to merge with one another... My deep concern is that it is only a policy. It could at any point in time be changed at the whim of a particular government in power, the suggestion being that the particular government may justify the removal of a specific four-pillar policy by simply saying that there are competition laws that would prevent mergers between the four major banks. I have a lack of confidence in those competition laws...¹⁸

If companies are run by people whose objective is to maximise the financial interest of their shareholders... it is inevitable that it would tend towards monopoly, because of the enormous economies of scale and the enormous profits that come from a combination of economies of scale and market power.¹⁹

9.15 The four pillars policy seems well supported, by both business and trade unions:

The NSW Business Chamber supports the current four pillars policy, and is concerned about the potential for further mergers to reduce the number of second tier and regional banks. While acknowledging that some consolidation of the banking sector was necessary to stabilise balance sheets during the global financial crisis, further consolidation of market power within the major banks should not be allowed in the current environment.²⁰

16 Australian Chamber of Commerce and Industry, *Submission 37*, p iv. A similar view was expressed by the Chamber of Commerce and Industry Queensland: *Submission 43*, p 19.

17 Fear et al (2010, p 13).

18 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 58.

19 Dr Richard Denniss, Executive Director, Australia Institute, *Committee Hansard*, 15 December 2010, p 24.

20 NSW Business Chamber, *Submission 84*, p 11.

...the Australian Government must continue to ban any merger between the big four banks. It is significant that the overwhelming majority of commentators, policy makers, academics and regulators now credit the maintenance of the 'four pillar' policy, at least in part, as having contributed to Australia's banking sector avoiding the worst ravages of the Global Financial Crisis.²¹

9.16 There are two means by which mergers between the four majors may be stopped. Section 50 of the *Competition and Consumer Act* prohibits any acquisition of shares or assets which is likely to have the effect of substantially lessening competition in the market. It would be a matter for the ACCC and courts to determine whether a merger between two of the four major banks would have such an effect.²²

9.17 Secondly, there is the *Financial Sector (Shareholdings) Act 1998*, which requires the Treasurer's consent for any acquisition of shares in a financial institution beyond the order of 15 per cent. This Act allows governments to maintain the 'four pillars' policy.

9.18 Last year the Committee made the following observation:

The Committee is concerned that takeovers of regional banks by major banks are not only reducing the number of competitors but are specifically removing those banks most interested in lending to small business. Given the evidence it has seen in other inquiries, most recently into the dairy industry, the Committee is concerned that the existing provisions of the *Trade Practices Act 1974* may be insufficient to prevent further undesirable takeovers in the banking industry.²³

Divestiture

9.19 The issue of divestiture has been raised as a possible option to strengthen competition in the banking sector. Certainly the natural tendency of the sector has been to consolidate, as the charts in Chapter 2 illustrate. One witness considered that this might be reversed:

...an oligopoly might change its mind and embrace new entrants, as we have seen in other industries like the pharmaceutical industry. The fact of the matter is that new companies and new entrants bring the really new ideas and the really new business models. There can be a model in an

21 Finance Sector Union, *Submission 80*, p 4.

22 The ACCC were understandably reluctant to express a view at the hearing; Mr Graeme Samuel, Chairman, ACCC, *Committee Hansard*, 25 January 2011, p 34.

23 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 56.

industry where the bigger institutions actually benefit from that instigation to innovation.²⁴

9.20 The more common view is that direct action may be needed to force change on the oligopoly. Some witnesses called for the ACCC to be given greater powers to force divestiture, and pointed out it exists overseas:

Where we see a major concentration in the market—for example, with particular superannuation and other investment platforms—we would think that the ACCC should be able to continually assess how the market is working where those levels of concentrations are and, where it is required, seek that there be divestiture by the parent body.²⁵

9.21 Virgin Money Australia told the Committee that:

Australia is a polarised market. The major banks have more than 80 per cent of the market share and the rest of the market is in the balance. I think that was reinforced during the global financial crisis with the acquisition of a number of challengers, including BankWest and St George. As a result of that it is more difficult for new entrants and regionals to acquire scale. One of the recommendations we have put forward is that it is worth considering requiring the major banks to divest some of those assets now that we are through the GFC. That is as simple as, ‘Would those transactions have been approved in a stable economic environment?’ The answer to that is no. Overall we think that is a measure that would shift the dial. It probably sounds extreme, but we think these are extreme times.²⁶

9.22 Currently the ACCC has only a very limited divestiture power: within three years of a merger it can force a reversal if it can establish that it was deliberately misled when initially reviewing the merger.²⁷

9.23 The Finance Sector Union of Australia has recommended that the ACCC be given divestiture powers. It told the Committee:

Where we see a major concentration in the market—for example, with particular superannuation and other investment platforms—we would think that the ACCC should be able to continually assess how the market is

24 Mr Jost Stollmann, Chief Executive Officer, Tyro Payments, *Committee Hansard*, 21 January 2011, p 38.

25 Mr Leon Carter, National Secretary, Finance Sector Union, *Committee Hansard*, 14 December 2010, p 51.

26 Mr Matt Baxby, Managing Director, Virgin Money Australia, *Proof Committee Hansard*, 4 March 2011, p 29.

27 Mr Graeme Samuel, Chairman, and Mr Brian Cassidy, Chief Executive Officer, ACCC, *Committee Hansard*, 25 January 2011, p 37.

working where those levels of concentrations are and, where it is required, seek that there be divestiture by the parent body.²⁸

9.24 Professor Milind Saythe also supported the introduction of divestiture powers. He noted that measures to break banks up have been suggested in the US and in the UK and 'Australia too needs to ensure that the financial system does not develop pockets of dangerous concentration'. He told the Committee that while:

It would be a radical move...there is nothing in place at the moment which really can work as a sort of deterrent to the major banks acting against the interests of the community and producing suboptimal outcomes.²⁹

9.25 It is worth noting that the recent interim report of the UK's Independent Commission into Banking, released in April 2011, has recommended further divestiture of assets of Lloyds TSB, which is already under an EU requirement to divest 600 branches.³⁰

9.26 Associate Professor Frank Zumbo argued the need for Australia's regulators to have a divestiture power similar to those available in the United States and the United Kingdom. He recommended that, as a practical way forward:

The Senate Economics Committee request within 3 months of the date of the request a report pursuant to s 29(3) of the *Trade Practices Act* as to circumstances under which the ACCC would apply for a divestiture order pursuant to s 81 of the *Trade Practices Act*.³¹

9.27 However, the ACCC noted that the divestiture power in the United States targets a specific form of anti-competitive conduct:

Divestiture is not a remedy in relation to cartel conduct in the US. It is a remedy for monopolisation.³²

9.28 Virgin Money told the Committee that the banks should divest some of the assets they accrued during the global financial crisis (GFC). It noted that given the high concentration of market share between the majors and the other banks, which was reinforced during the GFC, the majors should be forced to divest.³³

9.29 Others queried the need for a divestiture power. Treasury told the Committee that mergers in Australia have in fact supported the stability of the financial system. It

28 Mr Rodney Masson, Director, Policy and Communications, Finance Sector Union of Australia, *Committee Hansard*, 14 December 2010, p 51.

29 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 41.

30 Independent Commission on Banking (2011, p 5).

31 Associate Professor Frank Zumbo, *Submission 56*, p 14.

32 Mr Brian Cassidy, Chief Executive Officer, ACCC, *Committee Hansard*, 25 January 2011, p 56.

33 Mr Matt Baxby, *Proof Committee Hansard*, 4 March 2010, p 30.

noted that it is a basic strategy for governments to merge entities which are faltering so that consumers do not lose out, and there is no contagion in the system. Accordingly, Treasury argued that:

...it would be better to get more competitive competition into the system so that we benefit from having a stable financial system, we benefit from having that stable platform which the four majors give us. Whether there would be a fifth pillar or not, what we want to get back to is a stable platform and a competitive system. I do not know whether divestiture is the way to go or is it to actually try to get others to be more competitive.³⁴

9.30 As has been noted elsewhere in this report, the Committee considers that there is a need to consider the appropriate balance between stability and competition. There is no question that a monopoly bank would tend to be very stable. But it would also likely fail to deliver the most attractive options for consumers. As such, Treasury is right to argue mergers are likely to increase stability. The question is their impact on competitive outcomes.

Encouraging new entrants

9.30 Another issue raised during this inquiry was whether the 1980s reforms to open the Australian market to foreign banks were of lasting competitive effect. The Committee asked the Governor of the Reserve Bank what had gone wrong since these reforms. He responded:

...we did have very intense competition in the system in the eighties mainly chasing corporate lending. Some of that came to grief with the excesses of the late-eighties. A number of the foreign lenders were, in fact, disproportionately represented amongst the group that lent to the entrepreneurs who subsequently came to grief. In the nineties and 2000s there was some resumption of that kind of competition in the business space and the competition to lend to some of the more highly geared entities that came to grief two or three years back involved foreign lenders as well.³⁵

9.31 The Governor added:

It was always going to be a tall ask for foreign institutions to come in and compete with the size of that branch structure. That said, there are today some foreign institutions that offer retail products—Citibank and ING, for example. But were there prohibitions put on various things? I do not know. Not that I am aware of, but that was 25 years ago.³⁶

34 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 40.

35 Mr Glenn Stevens, *Committee Hansard*, 13 December 2010, p 10.

36 Mr Glenn Stevens, *Committee Hansard*, 13 December 2010, p. 20.

9.32 Professor Sinclair Davidson argued that the signal for a foreign bank to enter the Australian market is where Australian banks are earning supernormal profits. He added:

So if banks in Australia are not turning supernormal profits there is no incentive for foreign banks to enter. If foreign banks are not entering into Australia that is because they are not perceiving there to be unusually high profits in Australia. So our banking system is profitable, sure, but it is not what economists might call a supernormal profit.³⁷

9.33 However, other submitters identified systemic barriers to foreign banks competing in the Australian market. Most notably, foreign banks that come into Australia as branches are not allowed to compete for retail deposits of an initial balance below \$250,000.³⁸ This restriction does not apply to subsidiaries.

9.34 This prohibition reflects Australia's unusual system of depositor protection which, instead of explicit deposit insurance, has relied on depositors having priority over other claimants and the ability of the Reserve Bank to direct the operations of a bank in a crisis. These protections are much more effective with a bank that is separately incorporated in Australia rather than operating as a branch.

9.35 Another discouragement to foreign bank entry is interest withholding tax on banks borrowing from foreign parents. This issue is discussed in more detail in Chapter 15.

9.36 Treasury noted that the global financial crisis had had an effect on the foreign bank market in Australia. It told the committee that the GFC:

...made it more difficult for them to raise funding and to conduct their businesses. Also, we saw a withdrawal of some foreign banks from Australia and a reduction in their banking, and just the general restriction on credit availability across international markets made it that those who may have been more dominant going into the crisis could exercise more market power during the times when others had to withdraw their services.³⁹

9.37 One submitter believed the division of responsibilities between regulatory agencies was not conducive to encouraging new competitors:

APRA are the regulator but seem only interested in the prudential health of the industry, not competition. The ACCC handle competition but will only act where a breach of the *Trade Practices Act* occurs; they do not proactively pursue a competitive banking environment. The Australian Payments Clearing Association (APCA) run the majority of payments

37 Professor Sinclair Davidson, *Committee Hansard*, 25 January 2011, p. 65.

38 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 63.

39 Mr Jim Murphy, Executive Director, Markets Group, *Committee Hansard*, 13 December 2010, p 27.

systems and are effectively an industry collective making their own rules. The RBA espouse goals of decreased barriers to entry and increased competition (for the benefit of the Australian people) but seem limited in their ability to tangibly support new entrants. Treasury actually have a 'Bank Competition Unit' but, while being supportive of new ideas, are limited by a need to remain neutral. Then there's the ABA who valiantly espouse the benefits of competition yet are unable to point to any active or past initiatives on the topic.⁴⁰

Mutuals as a 'fifth pillar'

9.38 There are around ten building societies and over 100 credit unions, collectively known as 'mutuals', which have 4.5 million members across Australia and collectively account for around a tenth of household deposits and home loans.⁴¹ As their industry body explains:

Mutuals offer consumers a different model of banking - a model where the customers own the credit union or building society. This allows credit unions and building societies to put their customers first, without the conflict that listed banking institutions face in providing shareholders with dividends at the expense of customers....Customer-owned banking institutions are not motivated to maximise profits or engage in irresponsible lending to drive up returns to shareholders.⁴²

9.39 Suncorp Bank advocated a multi-tiered structure to compete with the major four banks. It told the Committee:

Our belief is that a strong multi-tiered banking system is the right model for the country. It provides a good competitive dynamic, good choice for consumers and business customers and good options for investors in terms of choice of different institutions. So, across a whole number of bands, we believe that a multi-tiered structure provides the best balanced outcome across the board. By supporting a fifth pillar alone, whilst there would be some benefits for that organisation in the near term, recreating the competitive environment that existed prior to the GFC, a multi-tiered structure would achieve that.⁴³

9.40 Yellow Brick Road Wealth Management was guarded about the prospect of a fifth pillar to rival the major four banks. It argued that in the current environment in Australia, it is:

...very difficult to build a fifth pillar today. You might have the opportunity to bring a big foreign bank in to do something like that but I would say big

40 Accounts4Life, *Submission 128*, p 2.

41 Abacus, *Submission 53*, p 6; Australian Prudential Regulation Authority, *Submission 57*, p 3.

42 Abacus, *Submission 53*, pp 3 and 6.

43 Mr David Foster, Chief Executive Officer, Suncorp, *Committee Hansard*, 9 February 2011, p 6.

foreign banks would not want to come here to take on Australian banks today in this environment.⁴⁴

9.41 Mr Bouris noted that a large foreign bank would 'just become part of the oligopoly' in Australia. Rather, he envisaged that a fifth pillar might be:

...a collective of smaller to medium players. I do not mean 120; we are talking about 20 or 25 medium-sized players who could all, in an ideal world, have one per cent each of the market share. An 80-20 split would be about the right percentage between the big banks and the smaller collective because that is enough to make the banks consider market share instead of profitability. When they think of market share, they start to reduce their margins and try to attract more borrowers. That reduction in margin ultimately is where we want to be because that flows on to the consumer as the better interest-rate price.⁴⁵

9.42 Mr John Symond of Aussie Home Loans dismissed the idea of the mutuals forming a fifth pillar. He told the Committee:

...to suggest that the mutuals can become the fifth force in banking, quite frankly, is a joke. They are small corner stores, they do not have infrastructure, they do not have technology, they do not have the clout and reach.⁴⁶

9.43 The Committee is aware that a particular challenge for the mutuals is growing their capital base to underpin an expansion of market share. As Mr Jonathon Mott, a banking sector analyst, told the Committee:

...if they go from around four per cent to 10 per cent market share, which is what the government is intending, the amount of capital in the system for the building societies and the mutuals would need to rise from \$6 billion to around \$10 billion to \$12 billion, and maybe even a bit more. A couple of things worth remembering are, firstly, that mutuals do not have access to the capital markets, by definition. If a bank needed that they could go to shareholders and raise equity. Secondly, the return on equity in the mutuals is about eight per cent versus around 16 per cent in the major banks, so they do not generate enough capital organically to be able to do that. The only alternative would be to go to their members and ask them for capital. If you are a member of a building society or a credit union, I do not think you will be too happy...⁴⁷

44 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 111.

45 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 111.

46 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, p 108.

47 Mr Jonathan Mott, Bank Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 148.

Credit rating agencies

9.44 Institutional investors and international banks are familiar with the major Australian banks and can easily form a view about the quality of their paper or the risk involved in having them as a counterparty. (As discussed further in Chapter 11, the perception that governments regard them as 'too big to fail' means they are perceived as very low risk). Life is harder for most ADIs which have a smaller profile. They are more dependent on assessments by credit rating agencies.

9.45 Unfortunately for the mutual ADIs, the rating agencies appear to accord too much attention to size and not enough to the underlying quality of assets:

This reliance we have on the rating agencies is a little interesting, if I can put it that way. That was one of the core components of the GFC: the very poor underwriting standards globally, specifically in the US. These bonds were rated AAA, and we all know how that panned out. Therefore, it is curious that, on the one hand, we say that the rating agencies did not coat themselves in glory and, on the other hand, we base a whole system around validating the rating agencies' methodology.⁴⁸

Local councils trusted the opinions of credit rating agencies rather than Australia's prudential regulatory system and chose to invest in AAA-rated exotic securities when they would have been better off depositing funds in an unrated mutual ADI.⁴⁹

This [US financial] crisis could not have happened without the rating agencies.⁵⁰

I do not think the rating agencies' methodology has covered itself in glory. There is a good argument that turns around and says: some of the simpler organisations that borrow funds from their local community, invest in their local community, know their local community and invest in solid assets called housing are very, very safe institutions because they are not buying CDOs and they are not trading foreign exchange...If you ask me: 'Do I think there is a bias against smaller organisations?' yes, I do, because the answer keeps coming back to your capital base...I disagree with that. I think what you need to do is understand the underlying risks of the business and make sure your capital supports the underlying risks of the business. I would say that some credit unions are very, very safe organisations.⁵¹

48 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 114.

49 Abacus, cited in Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector—The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 18.

50 National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, 2011, p xxv.

51 Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 115.

It is not clear that a small institution with a diversified portfolio of financial assets would have a higher risk than a large banking institution.⁵²

I can very easily mount a case that a \$50 million credit union is not as risky as the Commonwealth Bank: they do not invest in CDOs, they do not have international operations, they do not have business banking. But they will never be able to get a AA rating because they are simply not big enough...⁵³

Proposals for a new government bank

9.46 A number of submitters essentially called for a new bank along the lines that the original Commonwealth Bank was established around a century ago:

Create an Australia Bank, owed 100% by the people of Australia through the Government of the day...Australia Bank...will be owned by the people ...Centrelink benefits...will be paid directly into it the Australia Bank and will not have any fees for deposits or withdrawals. The Australia Bank will have a Home Loan rate set at a maximum, of 5% and be competitive against any other financial institution for business and investment. It will be the benchmark competitor that others will have to rise to the occasion, thereby creating 'real' competition.⁵⁴

...the government simply introducing a new bank offering low fees and reasonable interest rates. This new bank would be need to be government-owned...Its charter would prohibit the bank from charging interest rates greater than 2% above the then prevailing Reserve Bank rates, with any shortfall in funds (not funded by retail deposits) to be borrowed from the Reserve Bank. This should guarantee a reasonable profit for the bank, which can be used to fund expansions to the bank network, with the excess to be paid to consolidated revenue. In residential lending, the bank should be a specialist bank which only lends to owner-occupiers (i.e. for people buying their own homes) but not investors. With business lending, it should only lend to small business.⁵⁵

It is time the federal government and the Opposition stopped talking about how they might tackle the banks ripping of their customers and to act to reduce their power. How? By setting up another government-owned bank to act as a brake to the soaring interest rates, excessive profits earned by banks, egregious fees and the excessive remuneration packages paid to our bank CEOs...There's only one way to create serious competition to such a strong banking cartel: do what Prime Minister Andrew Fisher did in 1911

52 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 100.

53 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 80.

54 Mr Mal McCullough, *Submission 10*, p 1.

55 Mr Suryan Chandrasegaran, *Submission 4*, pp 4-5.

when he set up the Commonwealth Bank of Australia as a government-owned competitor. We need to set up another similar bank.⁵⁶

...it makes sense to consider policy action to promote access to safe and convenient basic banking. To ensure that guaranteed low-risk banking services are universally available, government should consider the establishment of a publicly-owned savings bank similar to the New Zealand Kiwibank.⁵⁷

It is recommended that Government consider the establishment of a Development Bank or SME Bank either as a Government Owned Bank or a Government and Private Enterprise Joint Venture, so to support appropriate styles of borrowing structures as needed for SMEs to maintain and grow their businesses, and so to be able to continue to employ our consumer borrowers.⁵⁸

9.47 A related suggestion was for the Reserve Bank to provide basic banking accounts for individuals.⁵⁹

9.48 A survey of Queensland businesses found that almost half supported the government setting up a new bank to promote competition.⁶⁰

9.49 Another view was that it was at least an idea worthy of further consideration:

...a public bank is something that is worth looking at. Do I have a strong argument in favour of a public bank? No, but it is something that an inquiry could consider.⁶¹

9.50 Further parallels were drawn with the New Zealand government-owned 'Kiwibank':

The bank is both successful and popular, and continues to fulfil its mandate of making banking services accessible to members of the public at reasonable rates.⁶²

Australia Post

9.51 There have been calls for Australia Post to form the basis for a strong competitor to the major banks:

56 Mr Richard Talbot, *Submission 51*, p 1.

57 Professor John Quiggin, *Submission 103*, p 6.

58 Finance Brokers' Association of Australia, *Submission 133*, p 5.

59 Mr Chris Webbe, *Submission 11*, p 1.

60 30 per cent of respondents disagreed with the idea. Chamber of Commerce and Industry Queensland, *Submission 43*, p 16.

61 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 106.

62 Mr Suryan Chandrasegaran, *Submission 4*, p 5.

Australia Post already has substantial and permanent distribution outlets that handle a wide variety of financial services transactions presently, and with little modification could handle banking business in open style shopfronts.⁶³

The most obvious opportunity is for Australia Post to follow the German example and set up a PostBank, purely focusing on retail consumer banking. This will [be] the most efficient and effective way to stimulate competition [in] the banking industry.⁶⁴

9.52 Associate Professor Zumbo argued that the government should explore opportunities for Australia Post to offer basic banking services using its extensive branch network. He noted that this could involve asking the Productivity Commission to undertake a feasibility study into Australia Post offering basic banking services and to review the overseas experience with national postal services offering banking services.⁶⁵

9.53 A survey of Queensland businesses found that 45 per cent supported Australia Post being used as a distribution channel for smaller lenders.⁶⁶ However, other submitters were less enthusiastic:

...the idea has drawbacks. Though the availability of multiple outlets has appeal, one can't readily graft a bank onto a post office. It would be a savings bank at best, and there are already adequate options in the savings bank domain.⁶⁷

9.54 While APRA were not asked specifically about Australia Post, their general requirements to allow an organisation to become an ADI were set out as follows:

It needs to have adequate capital for the sort of business that it wants to take on. It needs to have a strong and robust board if it is coming into Australia and we are presuming it is here already but wants to be a locally incorporated ADI. It has to have strong risk management systems and strong personnel that can run those systems...It is a tough test to get past.⁶⁸

9.55 However, the Australian Bankers' Association points out that Australia Post already plays a role in providing:

...agency facilities for banking transactions for at least 100 years and already acts as a distribution point for more than 70 banks and other

63 Mr Mervin Reed, *Submission 5*, p 11.

64 Mr Dinesh Warusavitharana, *Submission 98*, p 3.

65 Associate Professor Frank Zumbo, *Submission 56*, p 8.

66 About 15 per cent of respondents disagreed with the idea. Chamber of Commerce and Industry Queensland, *Submission 43*, p 16.

67 Dr Evan Jones, *Submission 81*, p 6.

68 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 9.

financial service providers. It is open for other financial service providers to form the same commercial relationship.⁶⁹

9.56 Australia Post described themselves as 'an enabler of banking services' and referred to their current activities:

Australia Post operates Bank@Post, a trusted neutral intermediary service for the banking industry processing 125 million transactions per annum in the wider payments industry; Bank@Post provides personal and business banking services (deposit, withdrawal and enquiry) on behalf of 70 financial institutions...over 1,470 of our rural and remote outlets support Bank@Post providing accessibility for customers of financial institutions in all parts of the country, irrespective of whether a financial institution has a local presence or not.⁷⁰

9.57 Australia Post explained the role played by post offices overseas in banking:

Internationally, postal organisations are active in the provision of financial services. Some have been moving further into the space (New Zealand Post), whilst others have created new entities out of their banking operations (Deutsche Post). The models of operation vary greatly; for instance Japan Post (Post Bank) and New Zealand Post (Kiwi Bank) operate banks in their own right, whilst Post Italiane and Swiss Post operate as integrators of financial services. Other entities, such as Post Norden, have a similar set-up to Australia Post where they operate as an agent and aggregator of financial services for many providers.⁷¹

Development bank

9.58 Another option to help farmers and other small businesses is to resurrect an organisation like the Commonwealth Development Bank or the Primary Industry Bank. The Council of Small Business Organisations of Australia has argued the need for a small business development fund operated through a government agency.⁷²

9.59 The Committee has considered similar proposals in an earlier inquiry. Some witnesses to that inquiry suggested that competition from the development bank might lead the commercial banks to compete more aggressively in the small business market. Others noted that a development bank could also fill the gap during recessions through keeping credit flowing to businesses, farmers and for mortgages, should the commercial banks be forced to restrict lending.

69 Australian Bankers' Association, *Submission 76*, p 42.

70 Australia Post, *Submission 120*, pp 3-4. The Bank@Post arrangements are described in further detail at <http://auspost.com.au/personal/personal-banking-at-australia-post.html>.

71 Australia Post, *Submission 120*, p 7.

72 Mr Peter Strong, Executive Director, Council of Small Business Organisations of Australia, *Committee Hansard*, 15 December 2010, p 12.

9.60 However, Treasury warned that unless there is a specific market gap, such as that met by the Export Finance and Insurance Corporation, a development bank can lead to market distortions. Specifically, the development bank could assist lenders rather than borrowers by providing a cheap source of funding that can be lent onwards at normal market rates. It could also stimulate lending to borrowers who would not meet standard credit conditions, and who are not in a position to repay their loans. Business representatives also doubted the effectiveness of a development bank, noting that its creation would be a permanent solution to what is not expected to be long-term problem.⁷³

Committee view

9.61 Noting the evidence presented in Chapter 4 about the highly concentrated state of the Australian banking market, and the likelihood that it leads to bank customers paying more for banking services, the Committee would 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 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.

9.62 The Committee regards forced divestiture as a major intervention in a free market and regards it as a 'last resort' approach to increasing competition. Instead it seeks other means of increasing the number of players in the market. With the change to an explicit form of deposit insurance, 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 called for in Chapter 3. This same review could also examine means whereby current non-ADIs could more directly compete with ADIs. This could include an examination of the restrictions on ownership arrangements for ADIs.

9.63 There is also scope for a removal of some restrictions which are currently impeding mutual ADIs from competing strongly with banks. These are discussed in following chapters.

In 2010, the Committee concluded that the best way forward is to increase competition within the existing commercial banks rather than pursue a development or rural bank or to convert Australia Post into a bank.⁷⁴ The Committee still holds this view. It 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 ADIs and thereby promotes competition. It should continue to seek opportunities to improve the community's access to financial services.

73 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 59.

74 Senate Economics References Committee, *Access of Small Business to Finance*, June 2010, p 3.