

Other matters

Bank fees

- 3.1 The RBA, at the instigation of this Committee, collects statistics on bank fees (although responsibility for consumer protection, in the event that an individual bank's fees were considered inappropriate, would be a matter for the ACCC).⁷³
- 3.2 Since 1997 the RBA has undertaken an annual survey of fees earned by banks' Australian operations. The results of the 2002 survey were published in the April 2003 edition of the RBA's *Bulletin*. The main findings of the survey were that:
- growth in fee income from deposits, loans and transaction services was 10 percent, the smallest rise since 1997. This growth rate was a little below that in banks' domestic assets;
 - the major contributors to growth in fee income have been the rapid growth in housing finance and credit card spending; and
 - the increase in banks' fee income has offset only a small part of the reduction in banks' interest rate margins over the past decade.⁷⁴
- 3.3 Notwithstanding this last point, fees charged to households have increased from \$1.2 billion in 1997 to \$2.7 billion in 2002. Fee income from households accounted for 35 percent of banks' total fee income (households plus businesses) in 2002, compared to 30 percent in 1997.

⁷³ *Official Hansard*, 6 June 2003, Melbourne, pp.24-25.

⁷⁴ Reserve Bank of Australia, "Banking Fees in Australia", *Bulletin*, April 2003.

- 3.4 The Committee asked the RBA whether these figures reflect a capacity on the part of the banks to recoup reductions in business loan margins from the household sector, and whether this in turn indicates that the banks are not facing proper competitive pressure to keep fees down.
- 3.5 The RBA's Assistant Governor (Financial Markets), Mr Ric Battellino, advised that while total income from fees on households has risen faster than income from fees on businesses, this is due to a substantial increase in the volume of household transactions with banks, in particular housing loans and credit card transactions. The fees charged per transaction, particularly in the case of housing loans, have fallen in the 1997-2002 period. In the case of housing loans, the reduction in fees per transaction can be attributed to the entry of non-bank competitors.⁷⁵
- 3.6 However, recent reports suggest that this issue may need to be revisited, at least in relation to credit card fees. Analysis by BIS Shrapnel suggests that fee rises, together with increases in the loyalty points needed to redeem rewards, have led to increases in the cost of holding a credit card of between 35 and 75 percent, offsetting the expected loss in revenues rising from reductions in credit card interchange fees (see page 35).⁷⁶ The Committee will continue to pursue this issue in discussions with the banking sector, the RBA and other regulatory agencies.

Interchange fees

- 3.7 "Interchange" fees are paid between financial institutions of persons receiving payments and persons making payments in the four party credit card systems (Bankcard, MasterCard and Visa), the EFTPOS system, ATM networks and in BPay.
- 3.8 In a joint study with the ACCC in 1999-2000, the RBA examined the economic case for interchange fees in ATMs, EFTPOS and credit card services. These systems were chosen because they account for a very large proportion of retail payments in Australia and all have interchange fees. After analysing detailed data on costs and revenues,

75 *Official Hansard*, 6 June 2003, Melbourne, p.62. See also *Official Hansard*, 6 December 2002, Warrnambool, pp.24-27.

76 "Banks Pass Credit Card Costs on to Consumers", *The Australian Financial Review*, 1 November 2003, p.8.

the RBA concluded that there was no justification for an interchange fee in the EFTPOS system.⁷⁷

3.9 The Governor noted at the Melbourne hearing that the banks had put to the ACCC a proposal to abolish wholesale EFTPOS interchange fees. Mr Macfarlane referred to this proposal as “a very constructive step”, and expressed hope that the “elaborate procedures” that the RBA had been through in relation to credit card reform (see page 33), involving formal designation of payment streams, could be avoided.⁷⁸

3.10 However, in August 2003 the ACCC rejected the banks’ proposal, stating that:

The ACCC is concerned that the EFTPOS proposal addresses only one element of reform in this area – that is, the setting of wholesale fees. Without reforming access to the network and making it easier for new groups to enter and compete, consumers and small business may be disadvantaged by the proposal...

The ACCC is concerned that the proposed agreement is likely to increase the barriers faced by new entrants seeking to compete against the banks and other financial institutions in the EFTPOS network. It may also act to further entrench the already high level of concentration in the EFTPOS network (currently the four major banks issue about 70% of debit cards and provide about 85% of merchant services)...

The ACCC considers that a proposal that included reform of access that would increase competition between banks in the EFTPOS network would be more likely to be in the public interest.⁷⁹

3.11 The RBA has subsequently stated that it “encourages the industry to take up the ACCC’s invitation to also address access to the EFTPOS network”.⁸⁰ Further progress on reform of interchange fees will be closely monitored by the Committee in future discussions with both the RBA and the ACCC.

77 RBA, Submission No.3 (answer to question taken on notice at the 6 June 2003 public hearing) at www.aph.gov.au/house/committee/efpa/rba2001-02/RBAresponse.pdf (as at September 2003).

78 *Official Hansard*, 6 June 2003, Melbourne, p.64.

79 ACCC, “ACCC Proposes to Deny EFTPOS Price-Fix” (media release, 8 August 2003) at http://203.6.251.7/accc.internet/digest/view_media.cfm?RecordID=1088 (as at September 2003).

80 Reserve Bank of Australia, *Annual Report 2003*, p.19.

Interchange fees: BPay

- 3.12 One particular interchange fee of interest to the Committee is that applied to payments made through BPay. BPay is a bill payment system owned by a group of Australian banks including the four major banks. It began operation in 1997. About 10 million transactions are made through the system each month (compared with total non-cash retail payments of about 350 million a month). BPay allows consumers to pay billers using the telephone or the Internet by accessing funds in either their savings account or credit card account.⁸¹
- 3.13 The Committee is concerned that the interchange fee of 59 cents on BPay payments from savings accounts seems to have evaded serious scrutiny. BPay was not included in the joint RBA/ACCC study of interchange fees “as it had only been operational for a couple of years and accounted for a very small number of transactions”.⁸² While the ACCC examined BPay last year, it made the legal judgement that the current arrangements:
- ...do not breach the [Trade Practices] Act because these arrangements do not have the effect of controlling or maintaining the fees charged by banks to billers for BPay services.⁸³
- 3.14 The RBA provided the following response to a question about BPay taken on notice at the June public hearing:
- Even though they both originate payments from savings accounts, EFTPOS and BPay payments are very different and conclusions about costs and revenues from one system may not apply to the other... BPay is a system built for bill payments by phone or using the Internet in which both customers and billers pre-register information. By contrast, the EFTPOS system was primarily designed for transactions at the point of sale... When used for bill payments, the EFTPOS payment is done “over the counter” either directly at the institution doing the billing or more commonly at an agency appointed by the billing institution such as a post office. The EFTPOS system cannot currently be used to make payments over the telephone or Internet.

81 RBA, Submission No.3.

82 RBA, Submission No.3.

83 “ACCC Concludes Investigation into BPay Scheme” (media release, 21 February 2003) at http://203.6.251.7/accc.internet/media/search/view_media.cfm?RecordID=960 (as at September 2003).

With the two processes being so different, we would not necessarily expect institutions' costs and revenues to be the same and thus the case for interchange arrangements to be the same...

As it does with all aspects of the payments system, the Bank will continue to monitor BPay to see whether further detailed study is required.⁸⁴

- 3.15 The Committee is concerned by the apparently high level of the BPay interchange fee. The Committee is of the view that the RBA should undertake an immediate review with the objective of ensuring that BPay interchange fees are reduced to a reasonable level.

ATM interchange fees

- 3.16 An overhaul of ATM interchange fees is the "third plank" in the RBA's reform agenda for card payment networks (following proposed reforms to EFTPOS and credit cards). ATM interchange fees arise when cardholders of one institution use an ATM owned by another institution. The fees are paid by the card issuer to the ATM owner, and are determined by bilateral negotiation.⁸⁵
- 3.17 This Committee's predecessor recommended in June 2001 that the RBA give the same priority to "...ATMs and EFTPOS fees, including loyalty programs, as it gives to credit card fees".⁸⁶
- 3.18 The joint RBA/ACCC study referred to at page 28 found that cardholders using another institution's ATM are liable for fees that are considerably more than the cost of providing the service, and that competitive forces are not working to bring ATM fees more into line with costs. As explained by the RBA's Payment Systems Board⁸⁷:

The interchange fee arrangements effectively prevent ATM owners from competing on the basis of price or services provided, since they do not receive any more or less revenue from users for changes in the quality of service or the cost of providing it. The study considered an alternative pricing regime – that of "direct charging" – that would encourage

84 RBA, Submission No.3.

85 Payment Systems Board, *Annual Report 2002*, p.17.

86 House of Representatives Standing Committee on Economics, Finance and Public Administration, *The Centenary of Federation Hearing: Review of Reserve Bank Australia Annual Report 1999-2000*, June 2001, p.32.

87 The Payment Systems Board has a mandate to promote safety, efficiency and competition in the payments system in Australia and, since 2001, to promote the safety of systems that clear and settle securities transactions in Australia's wholesale financial markets.

competition and greater transparency in the pricing of ATM services. Under this regime, there would be a direct relationship between the ATM owner and cardholders wishing to withdraw cash. The ATM owner would charge customers of other financial institutions a transaction fee which would be clearly be posted at each ATM.

...a direct charging regime will result in lower and more transparent fees on “foreign” ATM transactions and, over time, an expansion in the quality and the range of ATM services available to consumers.⁸⁸

- 3.19 Following consultation with the banking industry, and a proposal from the banks themselves for a direct charging regime, the Payment Systems Board indicated in its 2002 *Annual Report* that it “sees no compelling reason why the industry could not finalise the proposed reform in 2003”.⁸⁹
- 3.20 As at September 2003 the proposed reforms have yet to be finalised. The Committee will pursue this matter, and other aspects of card fees generally, in its hearings for the RBA’s *Annual Report 2003*.

Credit card reform

- 3.21 During 2002 the RBA’s Payment Systems Board finalised reforms to credit card schemes in Australia. As explained in the Board’s 2002 *Annual Report*:

The Board has, since its establishment, expressed concern about the structure of price incentives in the card payment market in Australia, which clearly favour the use of credit cards over debit cards. Credit card users are effectively “subsidised”, in the sense that they are charged less than the cost of the credit card payment services they use (or are even offered rebates in the form of loyalty points). Banks and other deposit-taking institutions promote the credit card most actively because it is the payment service for which they receive the highest return, even though it is one of the most expensive for merchants to accept. The Board’s concern about this structure of price incentives is that it is not the result of normal competitive processes. Rather, it is the consequence of the restrictions imposed by the credit card

88 Payment Systems Board, *Annual Report 2002*, pp.17-18.

89 Payment Systems Board, *Annual Report 2002*, p.18.

schemes and their members and the fact that it is the same group of banks and other deposit-taking institutions that sets the fee structures for credit cards and the other main payments systems in Australia.

...The pricing of credit card services, in which interchange fees and restrictions on merchant pricing play an integral role, is sending consumers a quite misleading signal about the cost to the community of different payment methods, while barriers to entry are quarantining the credit card schemes from competitive pressures. Overall, the community is paying a higher cost for its retail payments system than is necessary.⁹⁰

- 3.22 The RBA/ACCC joint study of interchange fees found that in 1999 the average fee per transaction received by card issuers was 0.95 percent. Merchant service fees averaged 1.78 percent of the value of each transaction.
- 3.23 The study also found that both card issuing and acquiring are very profitable. In the case of card issuing, costs averaged \$1.93 per transaction but total revenues averaged \$2.69, a mark-up over costs of 39 percent. In the case of credit card acquiring, costs averaged 43c but fee revenues averaged 72c, a mark-up of around 67 percent.⁹¹
- 3.24 In April 2001 the RBA designated the Bankcard, MasterCard and Visa “four party” credit card schemes in Australia as payments systems subject to its regulation under the *Payment Systems (Regulation) Act 1998*. “Four party” schemes involve four parties in the payment process: the cardholder, the issuer, the acquirer and the merchant. These schemes differ from “three party” schemes (notably American Express and Diners Club) where the accounts of the card issuer and the acquirer are the same.
- 3.25 The four party schemes all provide for the payment of an interchange fee by the acquirer to the card issuer. The acquirer passes on this cost to the merchant as part of the merchant service fee. The interchange fee is a percentage of the value of the transaction, and is designed to encourage the issuance of credit cards by creating a revenue stream for issuers.⁹²

90 Payment Systems Board, *Annual Report 2002*, p.13.

91 See RBA and ACCC, *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees*, 2000, Chapter 5.

92 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank of Australia Annual Report 2000-01*, August 2002, pp.15-16.

3.26 In relation to the formal designation of the credit card schemes, at the Melbourne public hearing the Governor noted that:

The quickest solution – the lighter touch solution – is actually to go through the ACCC. That is how, if you remember, the credit card reform started. But then it got bogged down when it became clear to us that the authorisation procedures of the ACCC were going to be very time consuming. The ACCC cannot say, ‘You are doing it this way; you have to stop doing it that way; you now have to do it this way under authorisation.’ All they can do is say, ‘What you are doing at the moment is not in the public interest. Go away and come back with another proposal which we may then decide is in the public interest.’ That procedure depended very much on the cooperation of the institutions involved and they were not giving it on credit cards [unlike EFTPOS], so both we and the ACCC decided it was much more effective to go down this so-called designation path.⁹³

3.27 The RBA announced at the time that it would proceed to establish, in the public interest, a standard for the setting of interchange fees and, if necessary, a standard for merchant pricing of credit card purchases, as well as a regime for access to these credit card schemes.⁹⁴ In August 2002 the RBA announced its reforms.⁹⁵ These involved:

- a standard on interchange fees that involves an “objective, transparent and cost-based” benchmark against which interchange fees in the three designated credit card schemes can be assessed;
- a standard on merchant pricing that removes the restriction imposed by the international credit card schemes on merchants passing through to cardholders the cost of credit cards; and
- an access regime that allows specialist credit card institutions authorised and supervised by APRA to apply to participate in the designated credit card schemes.

93 *Official Hansard*, 6 June 2003, Melbourne, p.64.

94 Payment Systems Board, *Annual Report 2002*, p.13.

95 For further detail on the preceding consultation process, see House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank Annual Report 2000-01*, August 2002, pp.15-19.

- 3.28 The RBA claimed that the reforms will give a boost to competition in the sector, and cited the experience of the residential mortgage market in asserting that the arrival or the threat of new entrants will put pressure on credit card issuers to keep fees to cardholders down.⁹⁶
- 3.29 Bankcard, MasterCard and Visa opposed each of the RBA's proposed reforms during the early consultation process, claiming them to be unnecessary and not in the public interest.⁹⁷ In September 2002, MasterCard and Visa filed applications in the Federal Court to have the reforms overturned, for reasons including that the RBA had allegedly exceeded its powers under the Payment System (Regulation) Act. The applications were rejected in September 2003. MasterCard has subsequently lodged an appeal to the Full Bench of the Federal Court, and taken separate court action in relation to the RBA rejecting its calculation of a cost-based fee level for MasterCard's member banks.⁹⁸
- 3.30 Banking industry sources have been quoted as suggesting that when the relevant reforms take effect from 1 November 2003, interchange fees on credit card transactions will fall to a weighted average of approximately 51c per \$100 transaction, from about 95c now.⁹⁹ The RBA has indicated that it will monitor whether the banks pass on the estimated \$400 million in annual savings expected to flow from the wholesale credit card fee reductions. At its next hearing with the RBA the Committee will ask the Governor for an update on the RBA's monitoring role and anticipated progress with the reforms.
- 3.31 In relation to credit card fees and interest charges to consumers, at the Melbourne hearing the Committee asked the RBA whether the ACCC should be given a reference to examine bank fees and charges overall. Committee members also expressed concern at the social impact of households and consumers being encouraged to use credit cards as their primary form of payment, and asked whether there should be some regulation in this regard.

96 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank of Australia Annual Report 2000-01*, August 2002, p.36.

97 Payment Systems Board, *Annual Report 2002*, p.14.

98 See "MasterCard Battles RBA Over Fees", *Australian Financial Review*, 23 October 2003, p.17. Visa lodged a similar appeal to that of MasterCard but withdrew the appeal on 29 October 2003.

99 "Customers May Pay For Losses From Card Reforms", *Australian Financial Review*, 10 October 2003, p.62.

3.32 In response, the Governor made the following comments about credit card reform and regulation of bank fees generally:

The thing about the regulation of credit cards was that we did not seek to regulate any fee a bank charges its customer. We rely on the market to put some discipline there. You can argue one way or another whether there is enough discipline. The only fee we were involved in was a fee which was not set in the marketplace but which was set collectively by providers of the product [the interchange fee]. That was not a market set fee. It was not a market price. It was determined collectively.

On your second issue of why so many payments are being made with credit cards, some of that is starting to change, partly because merchants now have more freedom to accept or reject a credit card. More particularly, they have the freedom to pass on the costs that they got hit with from the bank to the customer and therefore give the customer the option of using a more efficient and cheaper form of payment than the credit card. We are starting to see some signs of that coming through – not on a big scale, but we have seen signs of that happening. That was one of the purposes of the reform of credit cards – to give the merchants back some of the power that had been taken away from them.¹⁰⁰

3.33 In response to further questioning from the Committee as to why there has not been an overall review of debit cards, ATMs, credit cards and BPay, instead of “ad hoc little inquiries” into each, the Governor stated:

The reason is that we thought – and we still do – we could get the sorts of reforms that the community needs voluntarily on EFTPOS and on ATMs. But we clearly were not going to get that on credit cards. Credit cards are a much more difficult issue. You can see that by the fact that we are now involved in a very long court case with Visa and MasterCard, who play either no role or only the tiniest role in the EFTPOS or the ATM issue. The credit card issue is going to be a much bigger issue to crack than the other two.¹⁰¹

100 *Official Hansard*, 6 June 2003, Melbourne, p.63.

101 *Official Hansard*, 6 June 2003, Melbourne, p.64.

- 3.34 The Committee remains of the view that an integrated inquiry into the payments system may be beneficial. Such an inquiry could assess how Australia measures up in international terms in moving to more efficient payment methods such as direct-debit¹⁰², and would also provide an opportunity to clarify regulatory responsibilities, given that the ACCC and ASIC, rather than the RBA, are responsible for competition matters and consumer protection.

Credit card fraud

- 3.35 At the Warrnambool hearing the Committee questioned the Governor on the increasing practice of credit card “skimming”, whereby the details contained on a credit card are fraudulently stored after swiping, and the extent to which banks could be forced to update their systems. The Governor responded that:

This reminds us that the credit card is a very old-fashioned and quite primitive payment system. It is a technology that goes back to about 1952, and it has not become all that much more sophisticated since then. There are much more modern and sophisticated transaction methods available. For example, the EFTPOS card is much more sophisticated. It is protected by a PIN number, and that is one of the reasons why you do not hear of [fraud] to anywhere near the extent of credit cards. Similarly, electronic debiting and crediting, which is the way forward, the modern way of doing things, is that you use these sophisticated and much more secure ways of making payments.¹⁰³

- 3.36 The Reserve Bank’s then Assistant Governor (Financial System), Dr John Laker, noted that while the global credit card industry is moving to a more secure “chip and PIN” system, the roll-out will take several years.¹⁰⁴

102 For background, see Reserve Bank of Australia, “The Changing Australian Retail Payments Landscape”, *Bulletin*, July 2003, pp.1-9.

103 *Official Hansard*, 6 December 2002, Warrnambool, pp.27-28.

104 *Official Hansard*, 6 December 2002, Warrnambool, p.28.

Prudential regulation

- 3.37 A major topic of public debate at the time of the release of the RBA's *Annual Report 2002* was the adequacy of prudential regulation by, in particular, the Australian Prudential Regulation Authority (APRA) in the wake of the collapse of the HIH insurance group.
- 3.38 APRA was established on 1 July 1998 as a result of the March 1997 report of the Financial System Inquiry (the Wallis report). The Wallis report had recommended that an integrated regulator be created for the prudential supervision of all financial institutions, including banks, building societies, credit unions, superannuation funds, friendly societies, life insurers and general insurers. APRA was created through a merger of the former Insurance and Superannuation Commission (ISC) and that part of the RBA that had previously undertaken financial supervision of the banking industry.
- 3.39 APRA was established with a Board including two representatives of the RBA. The Wallis report had stated that substantial board cross-representation on the part of the regulatory agencies would encourage co-operation and foster a common perspective about the financial system.¹⁰⁵
- 3.40 The report of the Royal Commission into the collapse of HIH was released on 16 April 2003. While the Commissioner, Justice Neville Owen, was not critical of APRA's Board, he recommended that it be replaced by an executive group (or Commission) and that direct involvement of the RBA and ASIC in the governance of APRA be discontinued:

While the [Wallis Report's] aim of promoting cooperation and a broader perspective was laudable, the concept of the representation of agencies at board level was, I believe, misconceived... Requiring a person who is responsible for running one regulatory agency to become involved in the governance of another agency can only tend to cloud and complicate his or her focus. In my view the APRA model also places the chief executive of APRA in a difficult position. Not only does the chief executive have to account to a board, as well as the Treasurer, but there is a co-agency executive assessing conduct.

There is also a risk that the participation of RBA and ASIC representatives on the APRA board may impede as much as

105 Financial System Inquiry, *Final Report*, March 1997, p.536.

improve coordination between the agencies at working level.

There was some indication in the evidence I heard that staff may have assumed that necessary exchange of information would be occurring at board level obviating the need for communication at a working level.¹⁰⁶

3.41 At the June hearing in Melbourne, the Governor indicated that he agreed with the Royal Commissioner's conclusions and was comfortable with the recommendations.¹⁰⁷ Legislation giving effect to Justice Owen's recommendation that APRA's Board be replaced by an executive group was passed by the Parliament in June 2003.

3.42 The Royal Commission envisaged an expanded role for the Council of Financial Regulators (a co-ordinating body for Australia's main financial regulatory agencies including the RBA, which chairs the Council) in strategic consideration of issues affecting the financial services sector. As explained by the Governor:

I think the point that Mr Justice Owen was making was that this was a very good body but it had been slightly sidelined by the fact that the members of it were also, by and large, members of the APRA board. So the work that they would normally have been doing at the quarterly meeting of the Council of Financial Regulators they were doing in their monthly APRA board meetings. So the APRA board had become, de facto, also the Council of Financial Regulators... Under the new arrangements, that will not be the case. The Council of Financial Regulators will be the peak body to make sure that coordination occurs at the highest level between ASIC, APRA and the Reserve Bank. I think that is a good solution.¹⁰⁸

3.43 The Council's most recent Annual Report states that the changes to APRA's management structure "will place even greater emphasis on the information exchange and co-ordination functions of the Council". Co-operative arrangements have been set out in agreements between the RBA, APRA and ASIC, covering such matters as information-sharing, prompt notification of regulatory decisions likely to impact on another agency's area of responsibility, consultation arrangements in the event of financial disturbances and

106 HIH Royal Commission, *The Failure of HIH Insurance*, Vol 1, Chapter 8, "Regulation of General Insurance", April 2003, see pp.206-226.

107 *Official Hansard*, 6 June 2003, Melbourne, pp.66-67.

108 *Official Hansard*, 6 June 2003, Melbourne, p.68.

establishment of Co-ordination Committees to avoid “overlaps and gaps in regulatory coverage”.¹⁰⁹

- 3.44 At the June public hearing the Committee also questioned the Governor on whether responsibility for prudential regulation of the banks should be returned to the RBA. Mr Macfarlane responded that “we have no desire to turn the clock back” and stated that bank regulation “has gone extremely smoothly”. He also noted that out of the Wallis report the RBA had gained a new responsibility – regulation of the payments system – which “has been, over the last 10 years, at least as intellectually demanding as bank regulation” and which involves constant contact between the RBA and the banks.¹¹⁰

Foreign investment

- 3.45 At the June public hearing the Governor was asked for his views on the trend, in recent years, for simultaneous large capital flows into and out of Australia. He noted that:

It is just part of the way modern developed economies behave in an integrated world... Over the last decade in Australia our liabilities to the rest of the world – because of money that has come in – have gone up by 47 percent of GDP. At the same time, our assets – what the rest of the world owes us because of what we have invested abroad – have gone up by 40 percent. So there are very big movements on both sides. Some people might be worried about that but, to reassure you, let us look at a few other countries. If we look at Germany, for example, the figures were 88 percent and 71 percent. If we look at the United Kingdom, the figures were 168 percent and 164 percent. This is just the nature of the way modern developed economies behave in an integrated financial world. We own a lot more of them than we formerly did. They own a lot more of us than they formerly did. I do not see that as in any way being an increase in risk.¹¹¹

- 3.46 In response to a query from the Committee as to the extent to which overseas borrowing by Australian banks is funding this investment overseas, the Governor noted that “a lot of what we are calling inflow

109 Council of Financial Regulators, *Annual Report 2002*, p.16.

110 *Official Hansard*, 6 June 2003, Melbourne, p.67.

111 *Official Hansard*, 6 June 2003, Melbourne, p.57.

into Australia is Australian banks borrowing offshore".¹¹² He indicated that it is presently cheaper for banks to borrow offshore in foreign currency, then swap that foreign currency back into Australian dollars so as to have themselves in a hedged position. This does not amount to the banks taking a foreign currency risk.

Credit derivatives

- 3.47 The Committee questioned the Governor about the rapid international growth in the use of credit derivatives (which in essence allow lenders to sell their credit risks to other parties).¹¹³ According to the Bank for International Settlements, the international value of such instruments has increased from US \$0.9 trillion at the end of 2000 to an estimated US\$2 trillion at the end of 2002.¹¹⁴
- 3.48 The Committee asked the Governor whether there is adequate disclosure of the level of credit derivatives being used by Australian financial institutions and the risks, if any, to the Australian economy.
- 3.49 The Governor responded that the growth in credit derivatives in Australia is happening on a smaller scale than in either the US or Europe. He noted that the RBA's Systems Stability Department deals with financial stability issues, examining the financial risks that occur in the community as a result of factors such as the changes in products, the growth of derivative markets and the growth of credit derivatives. The same department supports the Governor in his membership of the Financial Stability Forum, an international body which Mr Macfarlane advised is monitoring the use of credit derivatives.¹¹⁵

112 *Official Hansard*, 6 June 2003, Melbourne, p.57.

113 For further information see Reserve Bank of Australia, "Credit Risk Transfer Markets: An Australian Perspective", *Bulletin*, May 2003, pp.55-62. See also "Pass the Parcel", *The Economist*, 16 January 2003, and discussion of collateralised debt in House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank of Australia Annual Report 2000-01*, August 2002, pp.21-22.

114 Working Group established by the BIS Committee on the Global Financial System, *Credit Risk Transfer*, January 2003, p.13 at www.bis.org/publ/cgfs20.pdf (as at September 2003).

115 *Official Hansard*, 6 June 2003, Melbourne, p.68 and pp.71-72.

Margin lending

- 3.50 Margin lending for investment in shares has increased substantially in recent years. At the June public hearing the Committee asked the Governor whether the RBA should be providing cautionary advice on margin lending, as it has for speculative investment in property. The Governor distinguished margin lending for shares from property investment in the following terms:

The difference is, No. 1, when you buy a share, you know the price of it every day. No. 2, if your gearing goes up because your equity is declining, your banker phones you up and makes you put in some more equity the same day. So it is exactly analogous to the negative gearing of property, but it is closely monitored on a day-to-day basis. The problem with the negative gearing of property is that you do not know what the thing is worth and maybe you are going to get a rude shock in two years time – but you will not know it until two years time. If it were a margin loan on shares, you would be reminded of it every day and you can cut your position whenever you want to.

...I think the orders of magnitude are quite small. They are nothing like what we are talking about on investment property.¹¹⁶

- 3.51 The RBA's Assistant Governor (Financial Markets), Mr Ric Battellino, reiterated this last comment and added that:

We started collecting data on this a few years back, because the industry started to grow. The thing that has come out of it is that the banks are really quite conservative in lending in this area. The maximum they will lend is 70 percent and, on average, the customers are even more conservative. The average they borrow against their shares is about 50 percent. We were worried about what would happen – this all started when the share market was going up – when the share market goes down. We have had some reasonable tests of that because a lot of these margin loans were against Telstra shares et cetera, which have gone down a fair way. It turns out that the customers have no trouble making margin calls at all. Even though the number of margin calls has gone up a lot, the system has worked very well. Nobody at this stage

116 *Official Hansard*, 6 June 2003, Melbourne, p.72. See also *Official Hansard*, 6 December 2002, Warrnambool, pp.33-34.

seems to be getting into big trouble on this thing, but it is something we are watching very closely.¹¹⁷

The international security environment

- 3.52 At the Warrnambool hearing the Committee asked the Governor about terrorism and money laundering. He noted that after the terrorist attacks on New York on 11 September 2001, the Government had implemented measures designed to identify bank accounts used by terrorists and related groups.
- 3.53 At that time, the only mechanism available to block bank accounts was the Banking Act's foreign exchange control mechanism, which was a partial solution as only international transactions could be blocked from the relevant accounts. The Governor explained that more effective new legislation (the Charter of the United Nations (Anti-terrorism Measures) Regulations), principally administered by the Department of Foreign Affairs and Trade, had been introduced. The regulations apply to any restrictions that are imposed through the UN framework, with the RBA retaining "a very small residual role" in freezing accounts where the decision is unilateral, rather than through UN co-operation.¹¹⁸

Foreign reserves

- 3.54 The RBA noted at the Melbourne hearing that about 18 months previously it had made a decision to increase the proportion of its reserves held in euro. Australia is now one of the few countries to have as many reserves in euro as in US dollars; the current ratios are 45 percent euro, 45 percent US dollars and 10 percent yen.
- 3.55 The Governor explained that the change was not driven by a desire to "play the market":
- ...the motive was a much longer run view of how the world might evolve over 20 years. In fact, that was part of the decision to reduce our holdings of yen – that was the main motivation for our change. We took what used to be in yen

117 *Official Hansard*, 6 June 2003, Melbourne, p.72.

118 *Official Hansard*, 6 December 2002, Warrnambool, p.34.

and put it into euro, which built the euro share up to the US dollar share.¹¹⁹

Transparency of the RBA

- 3.56 On the morning of the public hearing in Melbourne, *The Australian* newspaper carried a front-page article indicating that the RBA's Board was split on the need for a reduction in interest rates.¹²⁰ The article stated that Treasury Secretary and Board member Ken Henry had argued unsuccessfully for a reduction, reflecting Government concerns about the rapid rise in the Australian dollar, the impact of the drought and continuing doubts as to the strength of the world economy.
- 3.57 *The Australian* asserted that:
- Treasury and the Reserve Bank have been at odds over the dangers of a booming housing market and rising household debt levels... Treasury has been less worried about rising debt levels because of the steady increase in property values.
- 3.58 In response to questioning from the Committee, the Governor stated that differences of opinion between the RBA and Treasury at Board meetings are common, and asserted there is "absolutely no conflict whatsoever" between the RBA and the Government:
- I think what you have seen this morning is an overenergetic official somewhere in the bureaucracy who has tried to blunder into the debate; I am not suggesting for a minute that Dr Henry would be that official. This is not an example of conflict between the Reserve Bank and the government, and I think the government would be very irritated, just as I am rather irritated, when I see people blunder in that way.¹²¹
- 3.59 The transparency of the RBA and the decision-making process at Board meetings has been the subject of discussion between the Committee and RBA at previous public hearings.¹²² In its August 2002 report on the RBA's *Annual Report 2001*, the Committee noted that the US Federal Reserve Bank, for example, makes an

119 *Official Hansard*, 6 June 2003, Melbourne, p.65. See also *Official Hansard*, 6 December 2002, Warrnambool, p.13.

120 "Reserve Split On Need for Rate Cut", *The Australian*, 6 June 2003, pp.1-2.

121 *Official Hansard*, 6 June 2003, Melbourne, pp.49-50. See also pp.51-52.

122 See House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank Annual Report 2000-01*, August 2002.

announcement after every Board meeting. When it decides not to change interest rates it nevertheless states its reasons and indicates whether it is presently biased towards a later increase or decrease. The RBA, in contrast, only provides an explanatory statement of decisions on rates at Board meetings when the rate is adjusted.

3.60 At the May 2001 hearing, the Governor suggested to this Committee's predecessor that statements after every Board meeting were not required and that monthly statements would unduly concentrate debate on short-term monthly data. The Committee endorsed these concerns in its subsequent report.¹²³

3.61 This Committee, in its August 2002 report:

- noted comments by the Governor that a substantial amount of information is already available to markets;
- endorsed the one-line statements now posted on the RBA's website after Board decisions to leave the cash rate unchanged; and
- noted that the RBA's twice-yearly appearance before the Committee is a very effective means of making the RBA accountable to Parliament and the public.¹²⁴

3.62 Given the press commentary on the morning of the June 2003 hearing, the Committee again questioned the Governor on whether the RBA should release either minutes of Board meetings, or broader statements on decisions taken at the meetings. Mr Macfarlane remains unenthusiastic:

I do not think there is much value in doing that – other than enabling people to get a lot of stories about conflict. I do not think they are going to learn anything more about monetary policy by doing that.¹²⁵

3.63 In September 2003 the RBA's Deputy Governor, Mr Glenn Stevens, commented that:

...while it is natural for market participants and the media to want central banks to say more and more about their intentions... the future often turns up the unexpected – to which we need to respond by revising our intentions...

123 House of Representatives Standing Committee on Economics, Finance and Public Administration, *The Centenary of Federation Hearing: Review of the Reserve Bank of Australia Annual Report 1999-2000*, June 2001, p.28.

124 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of Reserve Bank Annual Report 2000-01*, August 2002, pp.22-23.

125 *Official Hansard*, 6 June 2003, Melbourne, p.74.

Secondly, because the future cannot be known, and because things can change quickly, people need some understanding of the principles which guide central bank behaviour. So there is probably more to be gained by continued efforts at articulating how our framework for policy works, than by providing ever more frequent commentary on events. [This] is the most helpful form of transparency – describing how we think about things and, within that framework, why we did what we did.¹²⁶

- 3.64 Mr Stevens added that the RBA's most recent *Statement on Monetary Policy* (August 2003) "goes a good deal further down this track" than most of its predecessors.
- 3.65 The interest generated by the story in *The Australian* does not persuade the Committee that its earlier judgements on the RBA's public pronouncements need to be revised. The Committee's ongoing public hearings with the Governor, as well as public speeches by the Governor and Deputy Governor and the RBA's quarterly *Statement on Monetary Policy*, will continue to provide substantial insights into the RBA's thinking on monetary policy and other matters.

David Hawker MP
Committee Chair
November 2003

126 Quoted in Reserve Bank of Australia, *Bulletin*, October 2003, p.15.