COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Aspects of bank mergers

WEDNESDAY, 1 JULY 2009

BRISBANE

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SENATE ECONOMICS

REFERENCES COMMITTEE

Wednesday, 1 July 2009

Members: Senator Eggleston *(Chair)*, Senator Hurley *(Deputy Chair)*, Senators Bushby, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Eggleston, Hurley and Joyce

Terms of reference for the inquiry:

To inquire into and report on:

(a) the economic, social and employment impacts of the recent mergers among Australian banks;

(b) the measures available to enforce the conditions on the Westpac Banking Corporation/St George Bank Limited merger and any conditions placed on future bank mergers;

(c) the capacity for the Australian Competition and Consumer Commission to enforce divestiture in the banking sector if it finds insufficient competition;

(d) the adequacy of section 50 of the *Trade Practices Act 1974* in preventing further concentration of the Australian banking sector, with specific reference to the merits of a 'public benefit' assessment for mergers;

(e) the impact of mergers on consumer choice;

(f) the extent to which Australian banks have 'off-shored' services such as credit card and loan processing, information technology, finance and payroll functions;

(g) the impact 'off-shoring' has on employment for Australians; and

(h) alternative approaches to applying section 50 of the *Trade Practices Act 1974* in respect of future mergers, with a focus on alternative approaches to measuring competition.

WITNESSES

Committee met at 9.47 am

CHAIR (Senator Eggleston)—I declare open the third hearing of the Senate Economics References Committee into aspects of bank mergers. On 24 November 2008 the Senate referred to us a range of matters relating to bank mergers and the practice of offshoring jobs. The committee is due to report to the Senate on 17 September 2009. This inquiry will investigate the economic, social and employment impacts of the recent mergers among Australian banks, with a particular focus on the Westpac-St George merger. The inquiry will also investigate the sufficiency of the measures available to enforce any conditions placed on merger parties by the Treasurer, the ACCC's power to force divestiture and its methods for measuring competition, and the adequacy of section 50 of the Trade Practices Act in preventing further concentration in the banking sector, with particular reference to the merits of a public benefits test. The inquiry will also investigate the extent to which Australian banks have offshored back office services and the impact of this practice on employment for Australians.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera and may determine that certain evidence should be heard in camera. I remind all witnesses appearing today that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to the committee and any such action may be treated by the Senate as contempt. It is also contempt to give false or misleading evidence to a Senate committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answers or answer be given in camera. Such a request may, of course, also be made at any other time.

[9.50 am]

KANGATHARAN, Mr Ram, Group Executive and Chief Financial Officer, Bank of Queensland Ltd

CHAIR—I welcome the representative from the Bank of Queensland. I invite you to make an opening statement.

Mr Kangatharan—I think the challenges that the global financial crisis has brought about are pretty well recorded, especially as they impact on financial institutions. The liquidity pressures arising from the closure of traditional funding markets—namely, securitisation for residential mortgage backed securities, RMBS, asset backed securities or leasing equipment securitisation—has particularly had a fairly harsh impact on the smaller players.

We saw significant volatility even in the retail deposit markets as late as October last year when there were concerns about the security of banks generally and we also saw some dysfunction in the marketplace where especially the larger banks were playing up security concerns to take advantage of the retail fund flow. The subsequent introduction of the government guarantee on deposits and wholesale debt has put a floor under the market and given a level of confidence that allows these markets to start to normalise.

We have consistently seen a very volatile equity market since the beginning of 2008. In particular, for financial institutions we have seen a significant contraction in P/E multiples, which has increased the cost of capital for those financial institutions, and within that again the smaller financial institutions have borne the brunt of that. Whereas in the past regional banks were trading at anywhere between a 10 and 30 per cent premium on a P/E multiple basis versus the majors they currently now trade at a 10 per cent discount, which again has increased the cost of equity and therefore the ability to expand credit.

The increased regulatory requirements have driven up compliance costs, and that has been a secular trend for the best part of the last 10 years. That continues. During this economic slowdown all banks have seen significant impairment of loans, especially for the larger banks in the corporate sector. For the smaller banks, property related lending has started to produce some losses which both restricts their ability to generate organic capital to grow and affects their profitability.

All of these factors have led to a large-scale consolidation across the financial services landscape globally, and Australia is no exception. As part of this consolidation the majors in Australia have been able to further increase their dominance of the Australian banking landscape through the acquisition of St George and Bankwest. This, in combination with the impact of the departure of non-bank lenders mainly as I mentioned earlier from the closure of the RMBS markets mainly and the exit of foreign banks as they withdrew to focus on their home markets, has in our opinion resulted in significant diminution in competition.

We feel that the current framework for assessing competition by reference to a relevant market where a merger is proposed is a static and a point-in-time approach. It fails to capture the long-term impact of market and merger strategies employed by the major banks which have an effect on eroding competition over a period of time. What has become obvious during this financial crisis is that the most basic requirements in banking, which are mainly securing access at a reasonable price to funding and access to equity capital to support the expansion of credit—and that is basically driven by the regulatory requirement to hold capital against every dollar that you lend—are emerging as really the biggest differentiators between the major banks and other participants in the Australian banking market.

If we focus on the competitive dynamics of banking market alone, I think we would ignore the concerted effort made by the major banks to penetrate the wealth management business that extends to everything from funds management, financial planning and distribution of wealth, to general insurance and life products. All of the major banks today control wealth management businesses that are the largest in their field, and this gives them an advantage in terms of their ability to generate surplus organic equity capital to grow their banking businesses at a time when the cost of equity is so high, especially for the regional banks.

More important is the control of so large a proportion of the banking and superannuation savings of Australians in the hands of the four majors. I think this, coupled with the focus on growing into financial planning and distribution, creates opportunities for anticompetitive behaviour where the parent bank's products and services are bundled or priced to exclude alternatives. At the macro level, the current crisis in availability of loans to the corporate sector again gives the majors a unique opportunity to bundle their service offerings. You will notice a shift in the language of most relationship managers at the major banks—they have gone from talking about 'share of wallet' to 'all of wallet', so the provision of refinance or lending is now coming at the cost of having to move your staff superannuation, banking payment platform et cetera to the majors.

We believe the competition framework needs to address the concentration of wealth management services in the hands of the major banks. The banking regulator, Australian Prudential Regulation Authority, needs to ensure that the captive wealth management businesses do not hold the banking parent's debt instruments or equity in their portfolio above minimum benchmarks. The Australian Competition and Consumer Commission should have the power to monitor post-merger business behaviour and, where bundling or cross-subsidisation is apparent, it should have the power to force divestiture or restructure governance to create transparency in order to avoid concentration of market power in the hands of a few.

We are on the public record saying that the government should consider a flat cost for government guarantee to all banks and it should substantially increase its support for the securitisation programs sponsored by the Australian Office Financial Management. These initiatives will re-establish competitive sources of funding and capital for the smaller financial institutions with different customer propositions. This is about real customer choice, if you like. We note in the submissions to the Senate standing committee that there is an underlying thesis, especially from the Australian Bankers Association, that the four major banks in Australia have enhanced stability due to their size. We beg to differ. Recent experience is littered with examples of highly rated, very large banks—some considered too big to fail—needing rescue. It is always the case that any institution considered too big to fail will lose internal discipline whilst parties dealing with that institution act as if that institution has a guarantee from the government. This becomes a self-fulfilling prophecy, with that institution gaining an unfair advantage in the risk-return tradeoffs, while its internal disciplines deteriorate until we have a situation like the recent US or UK experience.

For our part, we at the Bank of Queensland aim to provide a real alternative for consumers through the provision of choice and competition. Our ambition is to become the fifth bank through expansion of our proven owner-manager distribution model and maintaining our low risk focus on housing and SME lending. Late in 2008 we commenced a strategic review program called Project Pathways, which seeks to identify options for continued growth and to bridge the gap that exists between the majors and the regional banks.

An option open to us under this program is complementary M&A opportunities. We believe these will provide us with scale benefits, leading to increased profitability, enhanced returns to shareholders and greater choice of product and availability of credit for consumers. Alternatively, we would look to a strategic investor to provide ongoing capital funding and ratings support to overcome the gaps that we see between ourselves and the majors in the current market.

CHAIR—I have read an article in the *Sydney Morning Herald* on 1 June which refers to your managing director David Liddy commenting on the impact of the global financial crisis. He says that a repricing risk is present in that borrowed money has pushed the cost of long-term debt way above what regionals can really afford and has stifled their ability to compete. Would you like to comment on that and any other impacts?

Mr Kangatharan—Without having read the whole of that article, I think that would be a reference to two things. One is that the availability of term debt in the current markets is very much subject to the debt being government guaranteed. The government has imposed a cost of guarantee which differentiates between the majors and the regionals. All of the regionals are BBB, the majors are AA and the cost of the guarantee is a difference of 0.8 per cent. If you look at the credit markets pre crisis, they have never differentiated between the credit ratings BBB and AA to the extent of 0.8 per cent. So what the government guarantee has, I think, inadvertently done is create a gap in the cost of funding between the majors and the regionals that did not exist pre crisis. What we also see happening in the market place right now is that the investor base is looking through the government guarantee. The underlying issue is credit rating, so it is almost like a double dip—the investor is charging the regionals a higher cost of funds looking at the underlying rating, and the government is then differentiating again on the basis of that same rating, which means that the overall difference can be up to 1.2 per cent, and that places the regionals at a significant competitive disadvantage.

CHAIR—Yes, that is what Mr Liddy says. He talks about, and he complains of, an uneven playing field in which the federal government is charging the big banks less for the guarantee than the smaller banks. That obviously must put you at a competitive disadvantage. I am a little surprised that they are doing that. The other thing, I gather, is that the major banks, having taken over St George and Bankwest, for example, are still preserving those brands in the market, so giving the impression of competition. Would you like to comment on that, since in fact Bankwest and St George are now part of the bigger banking group?

Mr Kangatharan—On the face of it, on the way the current competitive framework tries to monitor the commitments made, it is very much about controlling and monitoring, if you like, the points of presence or the points of delivery of services to the customer—be it number of ATMs, number of branches, number of brands maintained et cetera. What I think that framework fails to achieve is to look behind the scenes at how, if you like, the services have been consolidated in the back end. So, for instance, you could still have the same number of branches et cetera but, say, in business banking, where you had a personal business banker dealing directly with a small or medium enterprise, in a big bank model usually that is done through a call centre. You could maintain your points of presence and you could maintain your access points, but your fundamental model and the way that you service your customer base could still change pretty dramatically. The other impact that goes largely unnoticed is that, with these consolidation plays that we have seen with St George and Bankwest, effectively we have seen the removal of two very highly differentiated banks from the marketplace. St George was very much a customer-value proposition based on that retail and SME segment—a highly differentiated brand that was seen as a challenger brand to the majors. Bankwest had a distinctive position in the retail savings segment. We see the removal of those two brands as a significant, if you like, change in the landscape. I think the effects of that will come through in a number of years. It is not a point-in-time effect that needs to be watched.

CHAIR—If the banks that have bought them—the Commonwealth in the case of Bankwest—are preserving the brands of Bankwest and St George then, if a customer goes to them, they will get a loan at a cheaper rate, won’t they, than if they go to you? Isn’t that in effect anticompetitive behaviour on behalf of the parent banks?

Mr Kangatharan—Effectively it is an arbitrage on the value that those brands have in the marketplace, where there are seen as different to the majors. So you are taking advantage of that differentiated brand value for a period of time until the consumer figures out that they are not doing business with Bankwest but they are actually doing business with the Commonwealth Bank of Australia; they are not doing business with St. George but with Westpac. It affords the acquirer a period of time where the brand positioning that was built up over a number of years can be exploited, where they are matching a different value proposition perceived by the customer with cheaper costs of funds at the back end because they are now part of larger banks. It makes it harder for the regionals that are left and are trying to compete on service but with a much higher cost of funds. That does play itself out as having a pretty big impact on us in terms of competition.

Senator HURLEY—Continuing in that competition area, apart from the global financial situation at the moment, do you think there is anything about government regulation that stifles competition?

Mr Kangatharan—Some of these trends that we are seeing are probably changes that are best described as once-in-a-generation, where the existing frameworks are actually not sufficient to capture what is going to happen over the next five years. That is where we think, even if you look at how you define the banking market, you would notice that all four of the major banks have very, very significant wealth management businesses that seek to access and control the superannuation related savings of Australians. When we define the market and the products in the constructs we have had in the past, I think there is a tendency to miss how the advantages gained from another subsegment of the financial services business can cross-subsidise and give the majors a competitive advantage that they can use to clear the field of the smaller competitors.

Senator HURLEY—Are you saying that you cannot compete because you are not big enough?

Mr Kangatharan—We are not big enough and we do not have the diversity of services, especially in things like wealth management, general insurance et cetera.

Senator HURLEY—So you, in fact, would like more regulation?

Mr Kangatharan—We think competition regulation needs to be wary of cross-subsidisation. We would not recommend a heavy-handed approach to regulating those business services per se, but where cross-subsidisation effects are being monitored or observed we certainly think the ACCC should have the power and the influence to make changes.

Senator HURLEY—Why would that be? Apart from size and the ability to diversify there is nothing to stop anyone from entering into the wealth management sphere. Why should the ACCC stop a burgeoning part of someone’s business?

Mr Kangatharan—It is not about stopping the development of those businesses per se, but it is about how those businesses are used to disadvantage smaller players in the banking market for instance. To give you an example, if you control 30 per cent of the financial planners in the country because you are in the wealth management business and they are tied advisers, it gives you a unique opportunity to bundle those services with banking products and to price it in a manner that effectively excludes competition in the banking market. What that effectively would be is an abuse of the competitive advantage in one area and cross-subsidising into another. We are not advocating any sort of restrictions in terms of the growth of these diverse businesses within a banking business, but there needs to be a recognition that, where that results in a massive concentration of either financial planning capabilities or pools of investable funds or access to equity et cetera, those advantages should not be used to stifle competition.

Senator HURLEY—I want to deal briefly with a couple of the other areas that we have been asked to look, and they are the question of employment and offshoring. Does the Bank of Queensland do any of its work offshore currently, or has it ever?

Mr Kangatharan—We do not directly. We do have an outsourcing relationship for large parts of our back office processes and IT. All of those services are onshore. We have a strategy of using product alliance partners—for instance, we use leveraged equities for our margin lending product, we use Vero, CGU and QBE for our insurance products and we use Citibank for credit cards. As part of the provision of those services, where effectively we brand the BOQ product but those alliance partners sit behind the product, they may use offshoring as part of their service proposition.

Senator HURLEY—But you do not keep any records of that or know what the percentage is?

Mr Kangatharan—No.

Senator HURLEY—In terms of employment, do you have a large number of branches? How would you see your employment ratios as compared to those of the major banks?

Mr Kangatharan—We have close to 285 branches, which is small by comparison to the majors but is one of the largest distribution networks in the non-majors category. The employment ratios would be pretty standard. The standard branch configuration would be five to six staff members, and that would not differ from the majors. In terms of the outsourcing relationship that I mentioned, we have an outsourcing relationship with EDS, which provides all of the IT services to the CommBank and all of the loan processing to Westpac. Effectively what we have tried to do is gain some scale advantages even though we are a much smaller player.

Senator HURLEY—How do you operate in terms of expanding your base? Is it because you are in more remote towns and people use the Bank of Queensland or, given that you have difficulty competing on the rate of loans you can offer, is it because of service or opportunity? How do you see the Bank of Queensland growing?

Mr Kangatharan—What is unique about our model is the owner-managed branch network that we have where effectively the branch manager owns the branch and the service provision from that branch. We own the balance sheet, we make the credit decision, we own the brand and we provide the funding. What that means is that the owner-manager is highly incented to gain and retain customers. Usually they do this through their own personal and business networks. Our distribution model on average is, we think, about 64 per cent more productive than the average branch of the majors simply because of that incented behaviour from the owner-manager. That really is the basis on which we hope to compete with the majors and to grow our business at a faster rate than system growth, which we have been able to do consistently over the last seven years.

Senator HURLEY—That personal connection, the personal service and attention, enables you to compete. If that disappeared and people got cheaper loans would it be a disadvantage?

Mr Kangatharan—We could deal with a small premium on pricing because customers are willing to pay for that personal relationship and that sense of certainty that you get through dealing with someone you have known for a long time and who has actually got their own small business and so understands the needs of small business. But where the discrepancy on pricing starts to get more than, say, half a percentage point I think the customer value proposition starts to erode.

Senator JOYCE—I want to go through a few things. I was interested in your comments about divestiture on page 23. As you know—and you put it in your report—Australia has very limited divestiture powers. They are really only applicable in the period after a merger or an acquisition. You have said in this report that you think they should be strengthened. You have also outlined in the report the static you are getting from major institutions who see divestiture as the sword of Damocles that will hold them to account if they play up. Do you want to elaborate on that a bit?

Mr Kangatharan—Sure. This should not be taken lightly. Effectively, it poses a number of issues in terms of the certainty with which shareholders can deploy their capital and expect a return from the investments they have made if there is a general power of divestiture resting with the ACCC. So we are not recommending this lightly, but we do agree with the existence of that power and that there should be a good framework for monitoring the accumulation or concentration of market power over a period of time. Where it is misused, really we are talking about an extreme case. Every enterprise should be allowed to accumulate its sources of competitive advantage over time to build a more robust business, but where those competitive advantages become of such a concentrated nature and where they are used to unfairly restrict competition in certain markets by cross-subsidisation or creating barriers to entry in the way things are bundled, we think the existence of that power would act as a deterrent. So, hopefully, it is one of those things where you have that power but you never have to exercise it.

Senator JOYCE—That is the sword of Damocles principle—that it is a deterrent. If the market are aware that the ACCC or the government has those powers then they are less likely to engage in guerrilla like tactics against you because there is always the possibility that they could be broken up. That possibility is not there at the moment, so they really have free rein. You are relying on their sense of fair play, but in the corporate sense they have a duty to their shareholders not to show you that. Their duty to their shareholders is to get rid of you.

Mr Kangatharan—Yes.

Senator JOYCE—You said that we have problems because under section 51 of the federal Constitution there would have to be fair compensation for divestiture powers. The argument put up by the major banks is that if you have divestiture powers you have to bring in fair compensation for the effects of those divestiture powers. Could a state government bring about divestiture powers? Of course, they do not have to compensate.

Mr Kangatharan—Again, it is problematic in the sense that if you have a source of competitive advantage which is being misused, usually it means that that business has significant value on its own which would result in fair value being gained on divestiture. So we are really dealing with the case where that does not happen, for whatever reason. It may be a question of timing or it may be just a question of whether you are getting the optimum price for that part of the business that has been divested. In terms of the compensation framework, I think that avenue should exist. I am not qualified to talk about what sort of framework would work best.

Senator JOYCE—It is a point of history that, especially in this state, vegetation laws were changed on a state basis so that they did not have to compensate and that is why the farmers never got compensated for the theft of their property. You hear in the media all the time that the Prime Minister says that Australia is in a wonderful position because we have four banks that have AAA ratings and our banking sector is extremely strong. This seems to disavow any purpose to you being in the banking sector. Do you think it is a fair argument to say that other, smaller banks are allowed to be walked over for the sake of having four strong pillars?

Mr Kangatharan—We would disagree with that view. The stability in the system, actually, is first a function of good regulation preventing some of the adventures that some unregulated entities overseas took in terms of the assets they held on their balance sheet. The second factor—which is often undervalued, I think—is the impact of competition and the diversity of players in the environment. If you look at our four major banks, you have two that are mainly focused domestically—in Australia and New Zealand—and have built very large customer franchises focused almost exclusively on building wealth management and on housing and corporate lending. We have had two of the majors with overseas ambitions because, as competition in the domestic market heated up, they felt the need to look for other sources of growth. Within all of that you have had specialist niche players catering to mortgage lending, small business lending or disintermediating the banks from the provision of corporate lending when public markets were working well. All of those dynamics helped provide stability to the system by diversifying the exposure of these banks to various segments with their different risk return profiles.

What we are starting to see with the exit of the overseas banks, as well as the non-bank lenders, is that the majors are also now starting to refocus on the domestic market because the overseas adventures have soured somewhat, except for the ANZ. All the majors are starting to look the same. There are splits between mortgage lending, corporate lending and small- to medium-enterprise lending. The composition starts to look very familiar, which means the risk profile that they are all carrying starts to look very familiar. The same thing with wealth management—they have all bulked up on their wealth management businesses and they all start to look very much the same. What that means is that in any future shock to the system—the systemic issues that are caused by any one of those segments incurring losses or some sort of impairment—all four major banks are going to be crunched at the same time. So we would actually argue that what is in train today is probably a trend that we may yet live to regret.

Senator JOYCE—I want to go to monetary policy. As we seem to get an increase in the centralisation of the banking industry, we seem to get more of a discrepancy between federal monetary policy and how the banks are actually determining their interest rates. It would appear that monetary policy by the Reserve Bank is becoming less and less relevant to them. Can this be exacerbated if we further centralise our banking system? Do the banks move into a position where they do not care what the Reserve Bank says—they can play their own game regardless of what the Reserve Bank says?

Mr Kangatharan—What we have seen in the last 12 months has largely been a function of the wholesale markets being risk averse and charging a premium over the cost of funds available through the cash system that the Reserve Bank controls. There are two aspects to how that then translates into the banks' ability to recover that cost via higher pricing on the asset side. Customer acceptance of the rates falling by less than what the Reserve Bank cash rate would indicate has allowed the banks to pass on less of the rate cuts. Going forward, I think it is purely going to be a function of the competition landscape.

Senator JOYCE—I will declare my interest. I used to work for Suncorp for five years. Big banks—and we were bigger than the Bank of Queensland at the time—would say, 'We go out to regional areas and you don't. You complain about cross-subsidisation but where the rubber hits the road, where you have representation in regional towns, the Bank of Queensland is not there and we are.' What would be your answer to that?

Mr Kangatharan—We would argue that in terms of points of representation the big banks have to search for incremental growth by expanding further and further afield. We are in exactly the same boat. As growth becomes tougher, we try to identify niches of unserviced needs and we try to enter those markets. So the dynamic is exactly the same. What the big banks can and should be able to afford is that their threshold for minimum business to maintain a branch should be lower because most of their shared services, that process if you like, are centralised and leveraged and have a much bigger volume base than the smaller banks. The desire to get into unserviced areas is exactly the same. They just happen to have a smaller, if you like, hurdle because of that much larger volume of business that already goes through their system.

Senator JOYCE—On cross-subsidisation, they would say, 'You complain about cross-subsidisation, what do you think Coles and Woolworths do in a big shopping mall? They are in there at $150 a square metre and another person in the shopping mall is in there at $4,000 a square metre doing exactly the same job and a butcher's shop is $1,600 a square metre. That is market power, tough luck, that's how it works.' If you are in a strong position, you exploit your position to the betterment of your shareholders; that is your duty of stewardship. If other people go broke, that's not your problem.

Mr Kangatharan—Obviously the issue is if enough people go broke basically you are then left with monopolistic powers in terms of your ability to price way above fair value for your services. Everything is a judgment on at what point have you established a concentration of market power that allows you to act as a monopoly or an oligopoly. I guess in banking our contention is that we are moving very close to that latter situation.

Senator JOYCE—I will ask the obvious question: what is wrong with monopolies?

Mr Kangatharan—Effectively I think over time you will find with any monopoly effectively you have a subeconomic outcome for customers, especially in banking services which is the lifeblood of the economy you will find that the flow-through effect in terms of the competitiveness of the Australian economy starts to diminish over a period of time. You can contemplate a monopoly in a number of segments but to have it in the banking sector I think would be disastrous for the economy.

Senator JOYCE—On page 11 of your submission, you have a table to do with concentration of banking markets. It appears that Belgium, Canada, Australia and France are virtually on a par with the Netherlands. The UK and the United States have the least concentration along with Japan. Can you tell me, is there an advantage that Japan, the United Kingdom and the United States have that Australia, Belgium, Canada or the Netherlands do not have? We will take out the Netherlands because that is the European Bank, people just go across the border and go somewhere else. Let us look at Australia and Canada being geographically isolated. What could Japan, the United Kingdom and United States offer that you could not get in Australia or Canada?

Mr Kangatharan—This really goes to the heart of what we have said here today. Any sort of on-the-surface analysis of concentration in the banking market alone we think is misleading. It is really about the concentration of market power on both the wealth management side as well as the banking market that potentially leads to cross-subsidisation issues and to concentration of market power that could create barriers to entry.

It is not just about: we have a high concentration, therefore we are stable and therefore it is good. We disagree with that. Equally, we would disagree that just because there are a huge number of banks—8,000-odd in the US—that means that is a better banking market. That is not necessarily the case. You need to look underneath that to see the provision of services, how things are bundled, how that is delivered to different segments of the market, to really determine whether you are meeting a diversity of needs in the marketplace that is resulting in a more competitive outcome for the economy. We think the current trend is a worrying one, but it does not lend itself very easily to analysis just by looking at how many banks we have in the Australian economy versus the US or the UK. It really is about: what is the nature of services that are being accumulated under these four majors, how are those services being marketed, how are they being bundled and how are they being priced to prevent new competition from coming into the field?

Senator JOYCE—You talked in your report about creeping acquisitions. From what I have seen you believe that the legislation, as it is, is inefficient and ineffective and needs to be strengthened. Is that correct?

Mr Kangatharan—Yes, we think there should be powers to monitor the slow accumulation of market power. Usually you can pick that up pretty early. It just requires monitoring where that concentration becomes a barrier to competition.

Senator BUSHBY—A lot of my questions in relation to competition have been dealt with but I would like to delve a little bit deeper. On two occasions at least you mentioned that the effects of a lessening of competition would become apparent over time. You also said you thought that monopolistic behaviour in the banking industry in particular would be bad. What are the effects that could occur if we ended up in a situation like that?

Mr Kangatharan—If you look at the current regional banking model, what you see is that, pre crisis, the securitisation markets were the great levellers of the playing field in terms of cost of funds. Where the banks had a ratings advantage and cost of funds advantage, that was equalised back by the issue of the AAA paper backed by mortgages or equipment finance leases. But something that was not discussed very much was the capital benefits that the regional banks got from that securitisation issue. What it actually did was make the regionals both competitive on a funding basis but also competitive in terms of an access to capital and a cost of equity, which effectively meant that the size advantages that the majors had was largely diminished. When you add to that regional preferences and customer service propositions, the smaller financial players were far more nimble and far more effective at gaining market share. You saw that basically result in a reduction in mortgage margins for the banks from around 3½ per cent to less than one per cent at the peak of that competitive tension.

Going forward, the issue that will emerge is that there is now such a large concentration of both low-cost funds within the big banks as well as access to organic generation of equity capital—that is, through having things like the wealth management business, which does not require regulatory capital to grow—that there is an ever larger advantage to the majors in the provision of banking services because of that access to the cheaper equity as well as funding. What that means is that all that competition that drove down the margins in the banking business is now going to start to come back in. That is where the rate competition does not exist anymore because the smaller players are unable to undercut the majors because of their cost of funds and cost of equity.

Senator BUSHBY—You are saying that we are looking at not so much a monopolistic but an oligopolistic situation where competition has already been lessened, and that is having flow-on consequences for rates already.

Mr Kangatharan—Absolutely.

Senator BUSHBY—We have a separate inquiry coming up, which you are no doubt aware of, into the effect of bank deposit guarantees. You mentioned that bank guarantees have actually contributed to the lessening of competition by regional banks with the majors.

Mr Kangatharan—Yes. It is probably worth reiterating. We do think that the introduction of the guarantee—

Senator BUSHBY—That was clear from your opening statement as well, but there are flow-on consequences. Is that really what you are saying?

Mr Kangatharan—Right. We were very supportive of the introduction of the guarantee on deposits and wholesale term debt. We think it was necessary and it would have placed Australia at a disadvantage had it not been introduced. What we disagree with is differential cost between the majors and the regionals, which is arbitrarily set and artificially high, which creates that unlevel playing field.

Senator BUSHBY—So to the implementation, rather than the need for it, is the issue.

Mr Kangatharan—Exactly and, to be fair, at the time of the introduction I do not think it could have been seen that the investor market would have looked through the government guarantee at the underlying issuers credit rating anyway. So I think it was an inadvertent outcome that needs to be fixed going forward.

Senator BUSHBY—Bankwest and St George have been taken over. You are touted as probably the next main target. Do you think that there is a risk that Bank of Queensland could be targeted for a takeover? You are talking about wanting to become the fifth major. If you do what you do as well as you are doing now and plan to do in the future, it is going to make you even more attractive and even more of a threat.

Mr Kangatharan—I am sure St George and Bankwest would have given you exactly the same line before they were taken over. But we do feel that our service proposition and the way we deliver our services to our retail network is pretty unique. The owner managed model does not lend itself very well to a big bank command and control structure. It really is a far more empowered model where the owner managers often tell us in head office what we are doing wrong. That does not sit very well with the command and control structures of the big banks.

Senator BUSHBY—But that might present you as more of a threat to them because you are doing something differently that might be working.

Mr Kangatharan—Sure.

Senator BUSHBY—So their motivation for a takeover might be to remove the advantages that you might have.

Mr Kangatharan—Sure. That is always a possibility. But the best form of defence for us is to outperform—

Senator BUSHBY—I am not suggesting you should not be doing that!

Mr Kangatharan—We think we have a unique proposition. It has shown its ability to outgrow the major banks, even with some of the disadvantages that have been in play through this crisis. Our intention certainly is to take the fight up to the majors by gaining scale and challenging them as the fifth bank.

Senator BUSHBY—Thank you.

Senator JOYCE—Any marketplace works on the principle of ease of entry, ease of exit and a multiplicity of players. Otherwise you do not have a marketplace; you have a monopoly or, worse, a monopsony. Possibly that is where we are heading in Australia—the licensing of a monopoly position. Just for the record, do you think it is possible for there to be a domestically grown new entrant into the banking market that could achieve that position without government sponsorship of some form? We all know that many of the banks are former vestiges of state government organisations. If I had won Powerball last night and found myself with $100 million, would I have a snowflake’s chance in Hades of ever opening a bank, or is it impossible? Does the market absolutely preclude domestic new entrants?

Mr Kangatharan—The interesting thing is that gaining access to customers is probably easier than ever before. The real barrier to entry today is the cost of funds and the cost of capital to have a sustainable and viable banking business. It is not inconceivable. Look at the ING Direct business in terms of deposits and mortgages. They have been able to rapidly grow that business from a standing start through the internet channel. So access to customers is better than ever, but the key barrier to entry is the cost of funds and the cost of capital, and that is where we are starting to see this very worrying trend of those advantages for the majors being enhanced again and again through this crisis. That is going to be the hard part.

Senator JOYCE—Why don’t we see more entries into the banking market?

Mr Kangatharan—We are in this unique position where all the international players who were very interested in entering the Australian banking market have turned their attention to fixing their backyard. So we are in this time frame where the natural competition that should have come from international players with global ambitions has been put on hold. We think that in the next 12 to 24 months you will start to see far greater interest from the Indian and Chinese players, but that is by no means certain. That is yet to be seen.

Senator JOYCE—You should hang around for the next inquiry.

CHAIR—Isn’t it also the case that some of these non-banking financial institutions have grown up from building societies and so on and in the current climate it is going to be very difficult for those sorts of organisations to become big enough to become second-tier banks?

Mr Kangatharan—Yes. It is the fuel that is missing—again, that cost of funds and cost of equity precludes them from competing as vigorously as they did, which was the great equaliser before. Pre crisis the small players in fact had an advantage and therefore the majors were under extreme pressure to defend their market share and consumers got a great deal. That dynamic has completely reversed.

Senator BUSHBY—You have made a reasonably strong case today for the benefits of competition in the banking sector and the need to ensure that regional banks are not disadvantaged against the majors. The focus of the inquiry is on mergers. Is there anything that you see the government should be considering when it approaches potential mergers that it is not at the moment or anything that should be built into regulations or that should have greater emphasis in terms of ensuring that, when these issues do arise, they are properly looked at before any decision is made about approvals?

Mr Kangatharan—The key concern we have is the current approach to looking at the competitive set pre-merger and post-merger as a point-in-time view to determine if something is going to substantially lessen competition or not. We think that is too narrow a view and it does not really take into account all of the different competitive dynamics now affecting the banking market. In our view, over the next three years it is going to be all about the cost of funds and the cost of equity. The concentration of those two things is in the hands of the majors in an ever-increasing quantity, and they are now also starting to get a flight to quality because they are seen as having rescued Bankwest, St George et cetera. There is an underlying theme of security that is playing out in the media which we saw being encouraged by the majors in October when they ran full-page ads saying, ‘We are the most secure bank in Australia,’ and so on.

Senator JOYCE—That is almost cartel like behaviour!

Mr Kangatharan—All those things play into that competitive dynamic. What we require in the ACCC’s consideration is, if you like, a forward view of how this morphs into a competitive disadvantage to the remaining players. If I were a major, that is certainly how I would be planning my business. How do I, in five steps, get to a position that I was in 20 years ago before competition was seen in this market? That is what you need to anticipate and try to address, without, as I said, being overbearing in terms of taking into account your best interests.

Senator BUSHBY—Do you think that the regulations under which the ACCC assesses such things are sufficient in their direction to the ACCC in terms of what it looks at or do you think there needs to be greater direction to ensure that the ACCC does take account of the factors that you are raising?

Mr Kangatharan—We think the ACCC is too focused around the point in time when a transaction is put forward—maybe banking is a special case because it is so vital to the economy—whereas it should have a monitoring function and, if you like, a consistent framework for analysing competitiveness in the marketplace. Otherwise it is too arbitrary to say at a point in time whether something is going to change competition or not.

Senator BUSHBY—What you are saying is that you think there needs to be greater specific focus by the ACCC on what it should be doing when it looks at mergers in the banking industry.

Mr Kangatharan—Right.

Senator BUSHBY—Okay. Thank you.

Senator JOYCE—I am going to ask you one last question. Do you think the ACCC does not have the powers to look after you, do you think it does not have the desire to look after you or do you think it is a combination of both?

Mr Kangatharan—To be fair to the ACCC, I think the stability concern or the stability card was overplayed in the crisis that has passed us in the last 18 months. I certainly think they have a desire to make sure that the competition remains viable in banking. I think their framework, as I said, is a point-in-time analysis, so if you look at the—

Senator JOYCE—But do they have the power, even if they wanted to help you? What section of legislation would they use? They have not got it; that is the problem.

Mr Kangatharan—No, I do not think they have the power or the tools that they need today.

CHAIR—But I suppose that today, within their existing powers, their decisions would be more informed by what has happened now than perhaps previously. They could make a decision informed by the lessening of competition that has arisen from the mergers which have occurred and, I suppose, apply that experience to any future application for a merger. Would you agree with that, or do they actually need an expansion of the legislation and greater powers under the Trade Practices Act?

Mr Kangatharan—I think it is a little bit of a catch-21 in a sense. If I look at the St George-Westpac merger—

Senator BUSHBY—I have not read that book—*Catch-21*!

Senator JOYCE—I have read *Catch-22*.

CHAIR—It is the prelude!

Mr Kangatharan—The ACCC actually did not have any conditions on that merger, but the Treasurer had those 10 conditions. If you look at those 10 conditions, you see they are really about maintaining the points of presence and the points of service delivery to the existing St George customers and maintaining the brand and the management of that brand as it exists today. I think that signifies a fairly superficial view of competition. That really is about points of presence; it does not have anything to do with the underlying sources of competitive advantage and where those competitive advantages have grown to an extent where they are a barrier to entry. So the framework of reference that has been used in that deal, I think, is an example of the fact that the ACCC does not have a continuing monitoring obligation and does not have the obligation to, if you like, actually investigate the sources of competitive advantage and where it becomes a barrier to entry. If you had all those things working, I think you would find that, when a merger comes up, you would have a much more textured response than we have had so far. But, as I said, these two mergers happened at a point in time when the stability card was being played very strongly by the majors to their advantage, and hopefully it will not be repeated.

Senator JOYCE—Catch-21 must be, ‘You prove that you’re crazy, and I owe you one!’

Mr Kangatharan—That is it!

CHAIR—Thank you very much for appearing.

Committee adjourned at 10.49 am