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ECONOMICS LEGISLATION COMMITTEE

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MONDAY, 5 OCTOBER 2009

MELBOURNE

BY AUTHORITY OF THE SENATE

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SENATE ECONOMICS

LEGISLATION COMMITTEE

Monday, 5 October 2009

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

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

Senators in attendance: Senators Eggleston, Fielding, Joyce and Pratt

Terms of reference for the inquiry:

To inquire into and report on:

Banking Amendment (Keeping Banks Accountable) Bill 2009

WITNESSES

Committee met at 10.19 am

ACTING CHAIR (Senator Eggleston)—I hereby declare open this hearing of the Senate Economics Legislation Committee inquiry into the Banking Amendment (Keeping Banks Accountable) Bill 2009. On 12 August 2009 the Senate referred the bill to this committee. The bill would require banks to satisfy the Treasurer that in any decision to put up variable home loan interest rates by more than any change in the Reserve Bank's official interest rates (or not to follow an official interest rate cut) was not contrary to the public interest. If the Treasurer is not satisfied by their argument, any increase in interest rates would mean the bank concerned was no longer covered by the government's guarantee. The committee is due to report on 24 November 2009.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses 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 a committee and such action may be treated by the Senate as a contempt. It is also a 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 on which it is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may, of course, also be made at any other time.

[10.21 am]

SATHYE, Prof. Milind, Private capacity

ACTING CHAIR—Welcome. Professor Sathye, would you care to make an opening statement?

Prof. Sathye—Thank you for the opportunity to appear before this inquiry. In my submission to the committee dated 2 September and the supplementary submission dated 2 October, I have made two points regarding the proposed Banking Amendment (Keeping Banks Accountable) Bill 2009. First, I support the bill where the public wholesale funding guarantee is provided. This means that there needs to be a full pass-through of the quantum of the OCR reduction. The OCR, the official cash rate, is reduced to push more credit into the economy and raised to curb credit expansion. I would particularly support the bill when the OCR is being reduced to kick-start the economy. When banks do not do a full pass-through, the monetary policy, in my opinion, gets stunted, requiring the use of fiscal policy, which locks in the economy for a long term.

Second, I suggest that the penalty could be a financial impost, as suggested in my supplementary submission, rather than the withdrawal of the guarantee. The withdrawal of guarantee could send the wrong signal to the market and could harm other banks as well. In my opinion, clause 18F(1)(c) of the bill is redundant and may be deleted. I am happy to give any further clarification that the committee requires on my submission. Thank you.

ACTING CHAIR—Thank you, Professor. Why do you say that withdrawal of the guarantee as part of the legislation would send the wrong signal? Isn't that a very powerful kind of action to take if a bank fails to be reasonable about interest rates?

Prof. Sathye—There are two issues involved. One issue is that, when you give a guarantee and then you withdraw the guarantee, the decision of the investor who invested the money at the time when the guarantee was in place is now affected because of the withdrawal of the guarantee. The investor will not know at the time when he invests the money how the bank will comply with the requirements of the government.

Another thing that can happen is that it will impact the fundraising by other banks, because investors may then be wary as they may not know whether these banks will also be complying with the government rules or not and whether there is a risk of the guarantee being withdrawn. So in my opinion this is likely to affect the investor decisions. And from that perspective I feel that, instead of giving the signal to the market, it is always useful to keep it internal and impose a financial penalty rather than a withdrawal of the guarantee itself.

Senator FIELDING—In your supplementary submission you say at point 9 that funding cost considerations are often advanced as a reason for not giving full pass through but that the argument appears to be weak. Could you elaborate on that because I think it is an important point.

Prof. Sathye—Some of the factors that affect the bank lending rates, as I have indicated at point No. 7 in the supplementary submission, are the degree of competition, the riskiness of lending and the structure of interest rates on deposits and other funding sources. So far as the degree of competition is concerned, I think Australia is a highly concentrated market. Compare it with Canada, where the banks, as I mentioned at point No. 6, have reduced their lending rates to 2.25 per cent, so there is a mark-up of only two per cent above the official cash rate. Here, the rate has been about 5.64 or 5.74, depending upon which bank it is.

To come to the point of why the argument is weak, the Reserve Bank research on this, which was probably published in June this year, says that about 50 per cent of the funds of the banks are raised through deposits. We have a deposit guarantee in place and that really raised the deposit as a funding source of the banks. Earlier it was about 40 or 42 per cent and it has now become 49 per cent, which is a significant rise in the deposit balances of the banks, and because of that the cost of deposits has come down. So a major source of funding is available to the banks which is significantly at a lower cost. There is a submission by the National Australia Bank which says in relation to the deposit rate that the average cost has been about 75 basis points and the maximum cost was something like 1.50. That is what they have said, on page 4 of their attachment, are the main components of the bank's cost of funding.

So, firstly, the deposits were rising, so that is a cheaper source of funds for the banks. Secondly, if you look at the international market, where about 25 per cent of the long-term funds are being raised by the banks, the rates in that market have significantly reduced over a period of time but, though these rates have been reduced, the difference here between the OCR, the official cash rate, and the standard variable rate—as I have given you in the Excel spreadsheet attached to my supplementary submission—has still been rising. I cannot fathom the reason for that when the international market rates are coming down and the deposits of the banks, which is a quite competitive source of funds for the banks, are going up.

Another interesting thing is that in my submission dated 11 August, which I made to bank funding guarantee, I mention that the interest rate spread of the banks has actually gone up compared to 2008. That means you use the guarantee, you increase your deposits, your spread is going up, and at the same time you say, ‘My funding cost is going up and that is why I cannot afford a reduction in interest rates.’ I find a kind of inconsistency in this argument.

Senator FIELDING—One of the things you mentioned there was that over the years—and you have got the table here from April 2005—the official cash rates and the standard variable rates have increased up to a 2.8 difference, which is quite a significant difference, and you are saying that obviously Canada has a lot smaller difference—

Prof. Sathye—Yes. Especially when interest spread is rising I do not think that that difference has to be there.

Senator FIELDING—You are probably aware of comments by the former Competition and Consumer Commissioner, Stephen King, when he said that there was now a real question over the degree to which the big four banks were keeping one another honest, and also the former ACCC Commissioner Allan Fels expressing fears that genuine competition within the banking industry is at risk. Do you think that it is important to keep pressure on the banks with regard to keeping their standard variable rates in line with the official cash rate—with the variations?

Prof. Sathye—In times of emergency like the global crisis where public funding guarantees are provided at that point in time, especially when the OCR is being reduced by the Reserve Bank with the intention that more credit should be passed on to consumers, if the banks are not then reducing interest by the same basis points then the monetary policy objective of credit expansion is getting somewhat stunted or defeated.

However if it is the other way around and the OCR is being raised in order to curb credit expansion in the market and the banks end up trying to raise their lending rates above the OCR, then probably the monetary policy objective is being achieved through the banks’ actions. I have no problem with that, because then the monetary policy objectives and the banks lending rates are moving in line with each other. If the banks are raising their lending rates more than the OCR, then it is really making the Reserve Bank of Australia’s job easier because it does not have to raise the OCR because the banks are doing it themselves.

However in a situation like the global crisis where your objective is to push credit in the economy, then if the banks are not reducing their interest rates in line with the OCR, as I said earlier in my submission, the monetary policy is getting stunted and is becoming ineffective. Then the option open for the government is fiscal policy, that is, raising public spending, which is locking in the economy for a longer term. While monetary policy is more flexible you can adjust as the situation changes. From that perspective I will support this where (1) a public funding guarantee is provided, and (2) where the OCR is being reduced in order to push credit in the market. But as far as the other side is concerned, it is probably not very desirable in the sense that we do not want to go to a system of prescribed interest rates. So that is my position.

Senator FIELDING—I do not think anyone is asking for prescribed interest rates, but there are real concerns about genuine competition. People that really understand Australian competition laws have clearly said that they are concerned about the concentration of the market, especially in the global financial crisis. Do you think there is a need to hold the banks accountable in terms of their reasons for moving outside the official cash rate? I am not saying they should not be able to do it, but do you think more pressure should be put on them to justify why they move or hold interest rates relative to official cash rate changes?

Prof. Sathye—Yes, I would support that. It may be necessary to hold them accountable, especially in situations like the global crisis where the OCR is being reduced. We also need to put it in the context of banks using the guarantee to make extra profits. As I said in my 11 August submission, as per the KPMG Financial Institutions Performance Survey there is a significant jump in the interest rate spread from the end of December 2008 to the end of June 2009. So the argument that ‘the funding costs are too much for us, so we can’t bring them down’ is probably not supported by the data.

Senator PRATT—Your executive summary raises problems with the bill. Does that mean you do not support it in principle?

Prof. Sathye—What I tried to say in the executive summary is that some of the issues that are not clear in the bill need to be made clear. For example, the use of the phrase ‘or at all’ is something that needs to be made clear, because it is quite possible that banks could engage in the kinds of interest rate games I explained. We would also need to define what we mean by ‘funds’.

Senator PRATT—You have highlighted difficulties with particular clauses that you would like to change, but you do not seem to have a clear statement about the merits of the bill in terms of its objective and whether it would meet such an objective were such flaws in the bill corrected.

Prof. Sathye—Insofar as the merit of the bill is concerned, in my supplementary submission I say in the conclusion that I see merit in the bill in certain circumstances. Where there is a public wholesale financial guarantee in place I see merit in the bill. There are two sides to it: one is keeping the lending rate in line with OCR when the OCR is rising, and the second situation is when the OCR is falling. I am particularly in support of the bill when the OCR is falling.

Senator PRATT—What research have you done that demonstrates the extent to which banks’ interest rates vary substantially from what the Reserve Bank officially sets interest rates at? Of course they might move in opposite directions at various points, but who has the most substantive body of knowledge that compares what is going on with both official interest rates and what banks are actually doing?

Prof. Sathye—I would say that APRA and the Reserve Bank of Australia are the best organisations to do that kind of research and get that kind of information, and they have done it.

Senator PRATT—Did you consider that information in putting your submission together?

Prof. Sathye—Yes, I did consider that information, although I have not referenced it here. There is a paper by Philip Lowe that is about a decade old. There are also papers from the Reserve Bank of New Zealand. I was reading one while flying to Melbourne by David Tripe of the Centre for Banking Studies in New Zealand. There are several papers in this area which I am aware of and which I have used, although I have not referenced them because I did not think they need to be directly referenced in here.

Senator PRATT—If banks feel that measures like this were to impact on their profitability and bottom line, to what extent might we just be moving the problem elsewhere in terms of other fees and charges?

Prof. Sathye—I do not think we will be moving the problems elsewhere in the sense that one of the things that is important to note in this bill is that it is where a public funding guarantee is provided. When there is no need for a public funding guarantee, the normal market mechanism will work. The government is not interfering in that normal market mechanism. In some of the submissions I found the case being made that this is direct intervention in the market, which is not the case, because the amendment bill makes it very clear that where the public funding guarantee is there then the amendment comes in the picture.

The question of public funding guarantee arises in difficult situations, like the global financial crisis. Why should the banks have any problems with this, especially at a time when they are making use of the guarantee to increase their interest rates? I have made some calculations in my submission dated 11 August to the other committee that over a three-year period they are likely—and of course this is a ballpark estimation—to make a profit of something like $1.34 billion.

Senator PRATT—I think it puts the Treasurer in a pretty difficult position in terms of politicising interest rates to the extent that we have sought to have got good downward pressure on interest rates but realising that to a large extent the government cannot control them, Treasury has some influence and the Reserve Bank tries to influence them as much as it can. I would have thought that it puts the Treasurer in a position of responsibility without not very much actual control over the outcomes.

Prof. Sathye—I would have thought that at the Reserve Bank of Australia and APRA level this kind of monitoring would be done. In the June 2009 RBA bulletin there is an article about the funding costs of banks. I was expecting in that paper that they would go further and say that, when these are the funding costs, how they stack up again the lending rates that are being used by the banks and how they stack up against the OCR. I would like that kind of information to be generated by these agencies and put forward to people.

If you find that the banks are recalcitrant in not going with the flow of the monetary policy intentions, which are to kick-start the economy by pushing the credit, then I think that in the public interest it is the duty of the government to step in. What is more, the banks say, ‘It is no longer possible for us to reduce our interest rates any further.’ That is the statement that has been made by the major banks in the press. Well, it is possible for the banks in other countries. In Canada, which I would say has been more severely affected than Australia, competition is more or less like competition in Australia; it is rather fiercer than in Australia. They can reduce it to 2.25, giving a mark-up of two per cent over the official cash rate. Our official cash rate is three per cent, so adding a similar mark-up, assuming all other conditions are the same, gives a five per cent rate that the banks could easily have gone to. That is where I am coming from. When the banks are making more money through the higher interest rate, why is it that they are still raising the argument of higher bank funding cost?

Senator PRATT—Have you thought through the implications of such a policy for the wider economy? Keeping interest rates low is very important, but we have seen a lot of inflation in housing prices, where housing affordability for many Australians is now out of reach. In part low interest rates make housing affordable, but to some extent they also contribute to high levels of inflation in housing prices, which means that Australia has some of the most expensive housing in the world. We need to be careful that we are not stimulating the economy just to benefit people who own multiple houses and can get the benefit of that while other people are locked out of housing affordability. These are some of the balancing acts that need to be taken into consideration when considering interest rates. Overpoliticising it by putting an emphasis on the role of the Treasurer in that debate is something that I believe could be quite problematic.

Prof. Sathye—There are two issues here. Coming to the politicisation part of it, when a public guarantee is provided one can interpret that as a political action. If you have provided a public guarantee, you probably have a moral obligation to ensure in the public interest that the interest rate reduction is passed on by banks to consumers. That is one side of the story. The second side of the story is that, if they do not pass it on, to stimulate the economy the government will then be required to push public spending, so that again the inflationary impact will be there. It will be harder for you to reverse the inflationary impact having done the public spending, but it is easier for you to modify the interest rates if you feel that inflation is rising. There is already a discussion going on about whether the Reserve Bank may raise the interest rates tomorrow. So it is easier to do that manipulation of the interest rates, depending on how the economy is working, rather than keeping the interest rate where it is and making the government do a lot of public spending, raise a lot of public debt and lock us in for the longer term. In my opinion, this course of action is more flexible than the other course of action.

Senator PRATT—Are there better solutions to this problem than the kind of mechanism that is pointed to in this bill, such as perhaps making it easier for customers to switch lenders et cetera?

Prof. Sathye—There are two issues. No. 1 is switching cost.

Senator PRATT—Yes, that is what I mean. Besides being easier it needs to be less expensive and those costs need to be taken out.

Prof. Sathye—One of the things that happen in the Australian marketplace is that, although there may not be actual collusion, there is kind of an implicit understanding of what the interest rate level could be.

Senator FIELDING—A cosy pillar?

Prof. Sathye—I do not know the exact words to use here, but what I am trying to convey is that when one bank gives a price signal the other banks will take their cues from that price signal and go along similar lines. The differential is not so large that a customer will then decide to go to another bank. That is how it is operating in the market.

Senator FIELDING—You have raised a couple of interesting points there, which is quite good. The banks are going to come here this afternoon, probably through the Bankers Association, and say, ‘Competition is fine; there is not a problem. It is best to leave it to market forces’. On the other hand, you have the Treasurer of the day saying, ‘There is nothing I can do.’ What we are trying to do here is to put something in place that holds the banks accountable so that they explain why they are withholding interest rate cuts and putting interest rates up beyond an increase, that makes sure that they do not use the same excuse twice and that adds a bit more scrutiny. I can understand that maybe this should apply more when there is a funding guarantee provided, but ultimately it is a game that is played between the big banks and the Treasurer of the day, who says that there is nothing they can do. This is one way of actually holding the banks to account. I am not saying that the Treasurer cannot approve a rate change, but it would mean that the banks would have to explain in writing why they are going to withhold cuts. Someone told me that withholding an interest rate cut, for example, costs billions of dollars to the economy when it could be stimulating it. What are your thoughts on holding the banks to account a bit more? Do you think that we need to do that sort of thing or not?

Prof. Sathye—In normal circumstances I would not recommend that. I would probably say, ‘Let market forces operate.’ Market forces have been operating and the banks have generally been giving reasonably good outcomes in terms of efficiency, so in normal circumstances I would probably not interfere with the market forces. But, when the situation becomes abnormal and where the government intervention is there in the form of the public funding guarantee, at that point in time I would be disturbed if the banks continued to make higher profit margins and still made use of the public funding guarantee. That is the situation that particularly perturbs me. But in normal circumstances, where no such guarantees are in place, I would probably recommend allowing market forces to operate.

Senator FIELDING—Have you done any work on the costs of switching between banks? It is said that people can shop around with home loans. Very few people do it. It sounds easy to swap banks, but by the time you change your credit cards, change your banking accounts and set your computer up the switching costs are quite high—not monetary but in time for most people. Most people think, 'Oh, they're all the same; I'm not going to switch.' Do you have any knowledge about the switching costs—not the monetary switching costs but the hassle factor for people: the reason why people do not switch banks for their home loans?

Prof. Sathye—The literature that I have seen in this area seems to suggest that the switching costs in Australia, financial or otherwise, are really a barrier to the customer switching banks. We have switching in theory but there is no actual switching taking place in the marketplace. I have not come across a paper which captures the non-financial switching costs for bank customers in Australia.

CHAIR—There being no further questions, we will conclude this section of our hearing. Thank you very much, Professor, for being here.

Prof. Sathye—Thank you.

Proceedings suspended from 10.55 am to 11.18 am

BELL, Mr David Peter, Chief Executive Officer, Australian Bankers Association Inc.

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy, Australian Bankers Association Inc.

Evidence was taken via teleconference—

ACTING CHAIR—We welcome the Australian Bankers Association. Would you like to make an opening statement?

Mr Bell—Thank you very much. Firstly, I should disclose that Mr Hossack and I are on different telephones in different places. At Mr Hossack's end he is joined by Heather Wellard, who is our director of PR, but she is simply there to listen; she is not there to give evidence.

Thank you for the opportunity to appear before the committee regarding the Banking Amendment (Keeping Banks Accountable) Bill. The bill will allow the Treasurer to intervene in commercial decisions with interest rate changes. This would fundamentally and radically change the current regulatory approach to banking, which has served Australia well during the most profound financial and economic crisis since the Great Depression. During this difficult time it has been widely acknowledged that Australian banks have remained strong and secure. They have been among the best performers in the world. Currently, of the eight AA-rated banks in the world, four are Australian.

We believe the committee should recommend against the bill for the following reasons. Firstly, the bill is flawed in design. It assumes that changes in official Reserve Bank determined interest rates fully reflect changes in bank funding costs. This is incorrect, and the Reserve Bank governor has implicitly warned against drawing this conclusion. The bill politicises interest rate setting by giving the Treasurer the power to determine bank product prices through interest rate control. This is a form of price control which is inconsistent with a market based economy and has been rejected by the last two major inquiries into Australia's financial system, the Wallis inquiry in 1997 and the Campbell inquiry in 1980. One of the reasons why the Campbell inquiry rejected price control was that it ultimately proves unfair to low-income earners. Politicisation of interest rate setting is inconsistent with sound monetary policy, whereby it is recognised that interest rate setting should be independent of the political arm of government. This is why the government has exchanged letters with the Reserve Bank assuring the central bank that it should act independently in setting official interest rates. The same principle should apply to retail rates. Politicisation of interest rate settings means that uncertainty will be introduced into bank commercial decision making, which cannot be a positive development. For these reasons, the ABA urges the committee to recommend against the bill. We look forward to the committee's questions.

ACTING CHAIR—Thank you very much, Mr Bell.

Senator FIELDING—First of all, has competition in the banking industry over the last six months or so increased or decreased?

Mr Bell—It depends on how you regard competition. If you regard competition as a result of the number of players then you might well draw the conclusion that competition has lessened. But, if you look to interest rate margins, they have consistently been reducing over the past decade. Margins have decreased from about four per cent to two per cent over that period, and the long-term trend is down. They tick up and tick down, but the long-term trend is down. From that point of view and from the point of view of the great depth and number of products available, we would say that we still have a very competitive banking sector.

Mr Hossack—I will add to that answer. In late 2007, when the form and shape of the financial crisis were becoming more widely known, it was already clear that there was going to be strain in the mortgage lending market because of the problems in the securitisation market. It was predicted back then that interest rate margins would widen very quickly and that we would return to a situation similar to the early nineties. That has not happened at all. In fact interest rate margins, as David says, are very low and have ticked up very marginally over the last month.

Senator FIELDING—So generally you are quite happy that the competition is fine?

Mr Bell—That would be our conclusion. The fundamental state of the banking sector in Australia is both strong and secure, which sets us out against other countries in the world. Yes, from the point of view of both prices and products offered we have a very competitive banking sector.

Senator FIELDING—The reason I wanted to go through that is that there is a lot of expert commentary that is concerned about the banking industry. The former competition watchdog Allan Fels has expressed fears that genuine banking industry competition will be lost for decades. That general feeling is held by quite a few experts. It is just interesting that you folks, the Australian Bankers Association, do not have those same fears and concerns.

Mr Bell—Again, a lot of people have said those things. It is an easy thing to say, but you have to look at the evidence. The two clear pieces of evidence that we look at are long-term developments in interest margins—and they continue to go down—and the numbers of products available to consumers. Both of those things are looking very healthy.

Senator FIELDING—It has been reported that the percentage of the home loan market held by the big four banks has increased from 75.9 per cent to 86.6 per cent—so to nearly 90 per cent of the market—and that the value of total deposits held by the big four banks has gone up from 61 per cent to 77 per cent. These are sizeable increases and to me that says that competition has gone down, not up. Therefore, while your think everything is fine, I think things look pretty crook as far as competition goes. I am sure you will come back with your own comments on that. But I want to ask you if you think health insurance companies should be held to account on their increases to their premiums. At the moment they have to put in writing how they justify an increase in private health insurance for the following year. Do you think that is a good idea or a bad idea?

Mr Bell—I do not know the health industry well at all and I am sure it has got an entirely different structure to the banking industry. But I know when your question is leading, and that is: should banks be compelled to disclose why they are making certain commercial decisions? We do not think so. We think that banks already provide a lot of information to people about why prices go up and prices go down. There is a full and free flow of information. Unfortunately, sometimes people do not pick that up. The banking sector does recognise that it needs to keep on explaining interest rate policy and interest rate decisions to its customers.

Mr Hossack—If I can add to David's comments, as he mentioned we are not experts on the health insurance industry, but one obvious difference is that there is a very large proportion of health insurance which is covered by the federal government, which is insured directly by the federal government, so it is a very different market than the banking market here, where pretty close to 100 per cent of products are issued by a privately owned companies.

Senator FIELDING—So if there was still a bank held by the government you would be quite happy to disclose your movements of interest rates outside the Reserve Bank's official cash rate? If there was a similar situation, if there was one government owned bank, the banks you represent would be happy to explain to the public or to the Treasurer to justify why their interest rates have gone up or down outside the official cash rate?

Mr Bell—Banks already do that, Senator. They do provide a lot of information out there. Unfortunately, people sometimes do not hear that information or for various reasons do not want to hear that information. So that is happening already.

Senator FIELDING—We have the National Australian Bank here a bit later so I will go through that with them, from that point of view. But if you are already doing it why would you be against it? You just made it clear that you do not think you should have to disclose why your interest rates have changed outside the changes made by the Reserve Bank official cash rate. Why would you not want to share that, if you say you already do that?

Mr Bell—There are two essential components to the bill. One is the mandatory disclosure of information. The other provides—

Senator FIELDING—I am sorry, I am not interested in the other part of the bill; we will come to that in a moment. You made it quite clear that you do not think that the banks should have to publicly disclose their commercial decisions on their interest rates. You have said that. I am just interested to know why on one hand you say they should not have to do it but then you say that they do explain their reasons why they are not passing on the full rate cut or they are putting up their interest rates beyond the increase in the official cash rate. Why would you say on one hand that you already do it and on the other hand be against it?

Mr Bell—To be clear, the majority of my remarks were directed towards the compulsion aspect of your bill in relation to setting interest rates. We also believe that there should be no legislated compulsion to explain—

Senator FIELDING—I am sorry to interrupt—I know it is difficult doing this by teleconference—but my bill does not dictate where interest rates will be. It asks the banks to justify their changes outside the official cash rate. So do not start to say that there is price control. You cannot say that. The bill does not do that. You need to be clear that the bill does not do that. The bill actually holds the banks accountable to explain any change in their interest rates outside the official cash rate.

Mr Bell—I must have misinterpreted the bill, then, because under section 18G(2)(b) it makes it clear that the Treasurer can direct a standard variable rate.

Senator FIELDING—They can, but that is on the basis that the banks have not justified why, within reason. Treasurers can; it is not that they will. The banks have to put forward justifiable reasons for why they are withholding or putting up their interest rates beyond the official cash rate. Any person on the street would say that is fair enough.

Mr Bell—Again, Senator, as I have said before, banks do provide this information. I cannot think of one instance where a bank has not provided information to its customers as to why interest rates are moving one way or the other, and in recent times the explanation from banks has been quite fulsome: it has been directed towards the funding of banks. Funding has been dramatically affected by the global financial crisis.

Senator FIELDING—So why is it that, from time to time, treasurers say, 'I don't think withholding these rates has been justified'? That has been said publicly. So even the Treasurer has not been convinced.

Mr Bell—I think there are two things here: (1) is whether information has been provided to the public and (2) is whether or not people think the decision that the bank or another ADI has taken is fair.

CHAIR—We might go to Senator Joyce for questions now.

Senator JOYCE—Mr Bell, for the purposes of the *Hansard* and for the purposes of those listening, can you briefly explain how Reserve Bank rates work in regards to determining or otherwise the direction of commercial bank rates.

Mr Bell—I am not an expert on this, but essentially the Reserve Bank cash rate reflects the overnight funding rate—that is, the rate that is used to settle funding differences between banks overnight. In Australia, banks source about 53 per cent of their funding from Australian deposits. The remaining amount is sourced from wholesale markets, including overseas markets, and that means that the Reserve Bank official cash rate, which we just talked about, has little if any effect at all on the retail rates that banks charge.

Senator JOYCE—I should declare my interest here; I worked for Suncorp for five years. So really the rates of the bank are determined by the price you can borrow the money at.

Mr Bell—That is correct. It is a business input cost. The fact is that roughly half of the money that banks borrow to lend to people here in Australia is sourced from outside depositors. It is sourced from the wholesale markets both here in Australia and overseas; it is sourced both long term and short term. That means, as I said before, that the cash rate has little if any effect on the costs that banks have to pay to source their money to lend to people.

Senator JOYCE—There is transparency. If people really want to, they can see what they can deposit the money at the bank for and they can add a couple of per cent, and that is going to be roughly the short-term rate at which they are going to be able to borrow the money—otherwise they will not be able to operate the bank.

Mr Bell—In very rough terms you are correct because, as I mentioned before, bank interest margins, across the board and very roughly, have come down from four per cent to two per cent. That is the difference between what banks borrow money for and what they lend it for.

Senator JOYCE—I was actually present when those margins were going through, and we had pretty strident competition between the banks. There is obviously a sense in the community, though, that the banks are having a lend of people, such as in the area of administration and other fees that seem to have grown and grown and grown and are an appendix to the rates. Do you have any comments on that? Have the banks of their own volition decided that these administration fees, which seem to really collect the ire of the public, are detrimental to people's overall view of banks?

Mr Bell—There is no doubt that there have been recent concerns about interest rate changes. It has been very hard to explain to people that banks source half their funds from outside the deposit base. It has been very hard to explain to people that, as a result of that, there has been significant pricing pressure on banks. In terms of fees, yes, they are a difficult matter to explain to the public. For the last two or three years, banks have taken quite a number of steps to explain fees and also to reduce them. In recent times you would have seen various announcements from various banks indicating that exception fees are being reduced. Banks are very mindful of fee levels. They are very mindful that some people do not understand what those fees are for and, as a result, they have tried their very best to explain what they are for and also, to their great credit over the past two or three years, reduce some of those fees.

Senator JOYCE—Where people get upset is when they see almost a unilateral variation of contracting fees. Fees are changed or amended and the consumer really does not have any say in that whatsoever. Fees from autotellers—the hole-in-the-wall fees—is an area of concern.

Moving along, if you were to be more scrupulous in your capacity to borrow or if there were a rate determination by the Treasurer at which you could lend out money, how would that actually work? Would it mean that people overseas would sell you money at a cheaper rate or would they not bother selling it to you at all?

Mr Bell—If a form of price control were put in place, as has been described, I think a number of things would happen. You would have instant price distortions. You would have mortgage rates and lending rates on other products going up. I think you would stifle innovation. You would also have the potential for reduced competition. If you start to interfere with the pricing mechanism, I think you would have those unwelcome results. One of the products of that, as we mentioned in our opening statement, is that people at the lower socioeconomic end of the scale would be disadvantaged because they are the ones who would probably feel it.

Senator JOYCE—There is a general desire to move away from smaller deals to bigger deals because the administration costs are less. I think it is something that the banks should be very mindful of. Governments in the past have been involved in the banking sector. It is only in the recent past that they have not been involved in the banking sector. If the government could go to the market in the belief that they could borrow money and lend money out and do it cheaper than a commercial enterprise, would you have an issue with that, as long as there were no tricks to it and they were borrowing it in the marketplace, like you borrow in the marketplace?

Mr Bell—That goes to the very heart of what I think the bill is referring to, which is a people’s bank. It has been floated before. It is something that we do not support. We note that the credit unions and the building societies also do not support it. We already have a very competitive banking sector here. The system has not broken down; there is no market failure. I cannot imagine why the government would want to get involved in that sort of business, why it would want to expose its balance sheets, if you like, when we have a system here that works very well. My colleague Nick Hossack may wish to add some comments to that.

Mr Hossack—I have just a couple of comments to add to what David has said. Firstly, the announcement of the government guarantees in September last year was, in effect, the Commonwealth government contracting out or selling its AAA rating to the domestic banks here, and obviously for a fee. There is certainly a lot of discussion about whether the fee was too high or too high for some. We have made comments in other inquiries about that. In effect, the Commonwealth government did get involved in the provision of funding. That was appropriate because the current account deficit in Australia, which Australia runs typically every year, has to be funded and, at the moment, that is funded primarily through the banks. That is a government issue rather than a banking issue. So it was appropriate that the government ensure that the current account deficit funding was maintained.

In terms of government involvement in retail, as David said, there will be different views on some sort of government owned bank. I suppose, pointing to history, governments have not had a great track record in running retail banks, particularly state owned banks. We think that the private sector in Australia has done a pretty good job at retail banking and, obviously, as David mentioned, the evidence that we came through the global financial crisis in good health, plus we still have a competitive system, is a pretty good testament that the banks have done a good job.

Senator JOYCE—I tend to disagree with you on that one. If a government wants to go into the banking field and it thinks it can be more competitive than the people who are there, and it has the capacity to be more commercially competitive, then that is the marketplace at work. Unfortunately, banking licences are terribly prescriptive, so it is not a case of ease of entry, ease of exit. To get a banking licence is virtually mission impossible, so really governments are one of the only mechanisms that have the capacity to properly set up a bank—and, if they choose to privatise it later on, well, that is their choice. I cannot set up a bank and, to be honest, none of the people speaking in this teleconference would have the capacity in their own right to set up a bank. It needs an immense capital inflow.

But don’t you have concerns for the future? There are going to be further wash-outs of things. I am sure that banks are very aware of the provisions they have set aside. For instance, the demise of the Murray-Darling Basin and the immense exposures that will become apparent there—how are you going to price that into your facilities? What provisions have banks made for their rural portfolios and extensions to their rural portfolios when they start to be called into question by yet another year where people have not had a crop—when they owe the National Australia Bank, Westpac and a number of other banks a bucket load of money?

Mr Bell—Just a couple of answers and then I will let my colleague Nick respond. In terms of the rural portfolio, my understanding is that it is about four per cent of the banks' total portfolio, so it is not an overwhelming proportion. Secondly, banks, when they lend, do lend very conservatively and they make sure that there are buffers in place which take account of the fact that some people may not be able to repay their loans or may have some difficulty in doing so. Thirdly, and most importantly, we are prudentially supervised by APRA. APRA has got a very good regime in place. It is recognised right around the world as being one of the contributors to the fact that the Australian banking system has done so well. So we think there are sufficient checks and balances in place and there is also a proven track record of banks making appropriate lending decisions here in Australia.

Senator JOYCE—This discussion about bank margins hinges on the fact that people think there are not enough competitive pressures between the banks. Shouldn't that lead even you as an organisation to say openly, or maybe you foresee that it is not possible that this could happen, 'The government wants to come in and open up a bank; as long as they're borrowing the money like we borrow money, not doing it be quantitative easing or some completely unfair mechanism, and if they think they can come into the market and be successful, could luck to them, but if they can't, well, that, ipso facto, is a statement that we're doing an efficient job'?

Mr Bell—The fact that the government has not entered the banking market at the retail end—it has in a sense at the wholesale end—probably answers that question, I think, Senator, and that is that it has recognised that not only are Australian banks safe and secure but there is an appropriate level of competition here.

Senator JOYCE—Well, anyway. Going back to the statement that the government is not efficient in banking, the Commonwealth Bank was once a government bank, so was the Queensland Industry Development Corporation and so was the State Bank of New South Wales. I know some of them, like the State Bank of South Australia, were a disaster, but there have been others that have been effective. They might have grown as private enterprises, and so they should, but governments have had a role in banking in the past; why would they not have a role in the future, if required—if there was the overwhelming sentiment in the community that the competitive pressures were not there?

Mr Bell—Technically speaking, any institution can have a role in the future, so long as they enter, if you like, the competitive arena in a way that does not unfairly disadvantage the existing players—in other words, they do not bring some special consideration or factor to the market which disadvantages the existing players unfairly.

Senator JOYCE—I thank you, Mr Bell, for your overriding endorsement of my position on why state owned enterprises should not be involved in our nation. Thank you very much.

Mr Hossack—Could I just add one point. When we did see a material number of government owned banks involved in the provision of retail banking services, interest margins were very high compared to where they are today. If we go back to 1993, roughly, when CBA was privatised, or the first part of it was privatised, interest margins in housing lending were four per cent. Today they are under two per cent. So I do not think there is evidence in the past that government provision of banking services has been of benefit to consumers.

Senator JOYCE—Thank you very much for that. I am going to have to start driving back to St George now, so I will probably call back on a mobile phone as I go along.

ACTING CHAIR—Thank you, Senator Joyce. We will now go to Senator Pratt.

Senator PRATT—Your submission points to the Wallis and Campbell inquiries of some time ago. Can you point to issues that the findings of those inquiries raised that are consistent with the critique of the proposal that is currently before us?

Mr Bell—Senator, are you referring to the impact on low-income earners?

Senator PRATT—Your submission does not make it clear what those impacts are. It just says:

> This … form of price control … is inconsistent with a market-based economy and has been rejected by the last two major inquiries …

It goes on to say that one of the reasons was that price control impacted on low-income earners, but I assume there would be a number of reasons.

Mr Hossack—I have got the Campbell inquiry's report in front of me now; it is probably one of the few remaining copies. I will quote from it in relation to low-income earners, as that might be the most useful thing to do. On page 728 it says:

The committee is conscious that low-income earners face special difficulties in obtaining access to the financial system. For example, in housing finance, despite active competition for business, many people are unable to qualify for savings bank and building society loans. This does not of course represent a failure of the financial system per se, and government intervention in the system is not the appropriate response. But, indeed, government intervention has in many ways compounded the problem for low-income home seekers. It is argued in chapter 37 that the existing portfolio and interest rate controls give rise to a number of distortions including perverse effects on lower income groups. The committee has suggested removal of the controls.

That is an excerpt, and there is obviously a lot more in the book. But I thought that neatly captured what the Campbell inquiry view was. They were recommending deregulation or removal of the controls—that they thought the existing system of controls was working against low-income people.

Senator PRATT—You might like to take this on notice because you might not have the detail within those inquiries, but does the inquiry point to why that was the case?

Mr Hossack—I can get you considerably more detail on that. Essentially, if you have a control and you are restricting the bank in recovering costs then the bank looks for other ways to cover those costs, such as doing more business with those who have got high levels of collateral or who have got higher offsetting balances in deposit accounts. These tend to be people who are wealthier. So you can have these unintended consequences when you get into interest rate and price control which are not foreseen at the time. I think that Campbell identified that the purpose of the controls were fine but the consequences were unintended and regressive.

Senator PRATT—Do you know what the key reasons were that the Wallis inquiry rejected similar proposals?

Mr Hossack—Yes. The Wallis inquiry was strong on the view that the best financial system was underpinned by a principle of competition, so it therefore followed through on a whole series of recommendations which sought to build a strong competitive framework which was also underpinned by a prudential safety net. It viewed the government provision of banking services and indeed even things such as moral suasion on banks to change their prices as inconsistent with that competitive principle.

Senator PRATT—I certainly agree that interest rates should not be politicised. Can you highlight for us why that might not be in consumers' interests?

Mr Hossack—It is simply for the reasons that I have discussed and which Campbell found: that the interest rate controls in the end were regressive for low-income earners because of the consequences that they had. We think that those findings still hold in that if you have interest rate controls and you have situations where banks cannot recover their costs then you can have unintended consequences. As Campbell found, they tend to be regressive.

Senator FIELDING—There has been a submission this morning that it is estimated that the banks will make a profit of $1.34 billion over a three-year period from the public wholesale funding guarantee. Is that around the right figure?

Mr Bell—That figure puzzles me because, in fact, banks are paying for the privilege of the government's wholesale funding guarantee. I do not have the exact number with me, but they would have paid the government and hence the taxpayers of Australia many hundreds of millions of dollars for the use of that triple-A facility—which is fair enough.

Senator FIELDING—I fully understand that they pay for it through a higher percentage point. But I am saying that there has been a claim made that you are making a profit on that. It is a windfall gain. It is not deliberate—well, I do not know if it is deliberate; I will not go there. But it is a windfall gain that you can make out of this, and the claim is that it is $1.34 billion. So do not go into the costs that you pay for it. I fully understand that it comes at a premium, but you can make money on that particular rate guarantee.

Mr Bell—I am not aware of that figure. We would have to check it and come back to you. I guess you have to look at the alternative scenario—

Senator FIELDING—No, no. Is there an estimated figure that you know of?

Mr Bell—No.

Senator FIELDING—Do not try to get around it by saying that you are paying for it. I understand that you are paying for it, but there is actually profit on top of that. Thank you.

ACTING CHAIR—We thank the ABA for appearing.

[11.53 am]

MUNCHENBERG, Mr Steven, Group Manager, Government Affairs and Public Policy, National Australia Bank

SALAMITO, Mr John, Executive General Manager, Consumer Production Solutions, National Australia Bank

WARD, Ms Sarah, Manager, Government and Regulatory Affairs, National Australia Bank

ACTING CHAIR—We welcome the witnesses from the National Australia Bank and invite you to make an opening statement.

Mr Munchenberg—I would like to make a short statement setting out our position and reasons for appearing today. I thank the committee for the opportunity to appear. As outlined in our submission, NAB supports the need for greater transparency around the commercial setting of interest rates. We believe that NAB customers and the wider community should hear directly from us about the factors that influence their home loan repayments. To this extent, we agree with the intention we understand is behind the bill under consideration. We also believe that better public information and understanding of the full range of factors affecting commercial interest rates is in the interests of all stakeholders: customers, the media, government and the banks themselves. Having said that, we also firmly believe that interest rates should be set by markets and should be based on a full consideration of funding costs, risks and competitive conditions.

Since August last year, National Australia Bank has provided detailed information on funding costs to our customers, the media and other stakeholders. This means that each time the NAB has adjusted its variable mortgage rate we have made available details of how our overall funding costs have impacted our decision. We hope providing this information goes some way to addressing customer and public concerns and confusion over the difference between the Reserve Bank's cash rate and the actual costs of funding credit. In our written submission we provided examples of how we have presented this information to our customers and the public. In addition we have provided our customers with information on managing repayments, including fixed rate and early repayment options. We also advise our customers who may be experiencing financial difficulty how to contact the bank for assistance. Today we would like to provide updated information to the committee on funding costs. This material provides the latest historical data on the costs of funds as well as our current best estimates of likely future funding costs. I apologise for not providing this additional information ahead of the hearing but would be happy to take senators through the information and to answer any questions.

We would also like to suggest that the RBA itself continue to play a role in increasing information and education on the factors affecting interest rates, as it did with its analysis published in its June bulletin on the costs of funds. The analysis concluded that the major banks had 'cut variable housing loan rates more than the fall in their cost of funds'. We believe that more of this type of information from the RBA would make a significant and positive contribution to public transparency and understanding of the factors affecting interest rates. Finally, given our commitment to improving the transparency around interest rate decisions, we would be interested to hear from the committee any suggestions for further strengthening transparency in the material that we provide. In terms of the bill under consideration, while we support greater transparency and believe banks are under an obligation to explain their decisions, we do not believe that regulatory intervention is necessary.

ACTING CHAIR—Thank you.

Senator FIELDING—Could you outline and table the information you provided on why you withheld interest rate cuts from the Reserve Bank at various times? We heard from the Bankers Association that it is very transparent and that there already is disclosure. I would like to see exactly what your bank put out publicly to various players on each occasion. Could you provide that for the committee?

Mr Munchenberg—Indeed we can, and I believe we have as part of our submission. Additional material was provided with our submission which provided—

Senator FIELDING—So that is all you gave to customers.

Mr Munchenberg—No. We have provided graphs, charts and explanations associated with what funding costs are actually doing. We have provided additional and more detailed information, and they were attachments to our submission. I am happy to provide the committee with all that information again, of course.

Senator FIELDING—On how many occasions has the National Australia Bank withheld?

Mr Munchenberg—From memory there are only two occasions, possibly three. Regardless, with each of the movements since August last year we have provided that information.

Senator FIELDING—Could you table that information?

Mr Munchenberg—Yes.

Senator FIELDING—Is there anything publicly available to different clients?

Mr Munchenberg—That is all publicly available. That information is provided via our website but is also provided to the media, so we proactively send that out through the media. Whenever we make a rate movement decision, we make the head of our retail bank available to the media to answer questions on that decision.

Senator FIELDING—Are you aware of any public comments by the Treasurer that there was concern about the banks withholding on any of those occasions?

Mr Munchenberg—The government has made a number of statements indicating that it would like the banks to pass on as much of official rate cuts as is possible, and we believe we have done that.

Senator FIELDING—There have been concerns raised that there has not been justification for passing on full interest rates. Are you aware of any?

Mr Munchenberg—We are aware that different people have different views on what the banks should have done. We have made our decisions and passed on more than 90 per cent of the interest rate cuts to date. We have provided information to try to explain that and we have made ourselves available to answer questions from parliamentarians but also, more importantly perhaps for the customers, through the media as well.

Senator FIELDING—When do you expect the difference between the official cash rate and the standard variable rate to close back down to a normal sort of level?

Mr Munchenberg—I honestly cannot tell you that. I am happy to discuss why we see interest rates as not being determined directly and solely by the RBA cash rate, but at the moment funding costs, which come from three different sources, remain very volatile. We are living through very uncertain times when it comes to international finances. It is very difficult, although we have attempted in the pack that we have given you to forecast as best we can from this point in time, but we also know that over time that will change because of the volatility in funding costs.

Senator FIELDING—You must do a fair bit of budgeting and forecasting yourselves internally. I imagine you would have a whole team working on this, for example. If you look at what was submitted to us this morning, in April 2005 the official cash rate was 5.25 and the standard variable rate was 7.3. In July 2005 the official cash rate was 5.5 per cent and the standard variable was 7.3, so the difference was 1.8 per cent. Today the difference between the official cash rate of three per cent and the standard variable rate of, say, 5.8 per cent has crept up to 2.8 per cent. That has progressively gone up quite rapidly.

Mr Munchenberg—It has.

Senator FIELDING—Do you have any forecasts in your bank that have that coming back down to a normal level over any period of time?

Mr Munchenberg—I think honestly, Senator, the only way I can answer that question is to delve into what we see as the various components of the costs of funds, because there are three components and they do not—

Senator FIELDING—You can go through that in a second but do you see that figure coming down or do you expect it to stay at that figure for one year, three years, five years? You must do some forecasting.

Mr Munchenberg—Yes, we do. We have an indication in the material we have provided you which goes out for a year.

Senator FIELDING—That is only a year. You would do forecasting on a five- and 10-year basis, wouldn’t you?

Mr Munchenberg—The main driver of—

Senator FIELDING—Are any of your longer forecasts for three or five or seven years?

Mr Munchenberg—If your question is when will interest rates again move consistent with RBA cash rates, I do not know.

Senator FIELDING—No, my question is that there is a difference between the official cash rate and the standard variable rate that has blown out quite substantially and I am interested to know from your forecasts when you expect the conditions that drove that up to change and for it to come down over three, five, seven years. I know about banks and the financial market pretty well.

Mr Munchenberg—I understand that. As I understand it, we do not see that time in our current forecasts—

Senator FIELDING—What basis is that forecast over?

Mr Munchenberg—The only information I am aware of is out a year. We do forecast longer than that because we need to determine fixed costs out to five years, for example. But at this point we do not see a particular point in time when we are confident we can say that that part of official rate cuts that have been withheld by the banks will be passed on in full.

Senator FIELDING—What I am going to do is take the information—I do not want new stuff, but the stuff that you gave out—on where you are withholding interest rate cuts, I am going to look at the reasons you have given publicly and then I will be interested going forward over the next one, three, five and seven years to see, when those conditions change, that that gap is reduced. That is what I am after, because there seems to my eyes to be a lack of justification. I am surprised that you do not have more than one year out—

Mr Munchenberg—I do not know whether that is the case.

Senator FIELDING—on when you see those conditions changing enough to reduce that margin between what the banks get their official cash rate set at and their standard variable rate.

Mr Munchenberg—Senator, I am sure you will not be surprised when I say that we do not agree that the RBA cash rate is the sole determinant of interest rates anymore. And to the extent that it ever was it was because we did not see the sort of volatility and higher prices in actual sources of funding that we did previously. There may come a day when that situation returns. It is very hard to forecast at the moment.

The other factor we are seeing at the moment is about one-quarter of our funding comes from what is long-term wholesale funding, so we are currently renewing that. That is funding that we took out prior to the financial crisis where margins of the spread were very narrow. We are having to renew that at a much greater cost, so the average cost of term funding continues to rise, as we have indicated in the chart we have provided. I do not accept and the bank does not accept that the RBA sets home mortgage rates by virtue of movements in the cash indicator rate.

Senator FIELDING—Has the NAB met directly with the Treasurer at all over the last year and a half?

Mr Munchenberg—We meet with the Treasurer, his advisers and Treasury officials regularly.

Senator FIELDING—Have there been discussions about withholding some of those rate cuts between the Treasurer and the National Australia Bank?

Mr Munchenberg—The Treasurer has certainly made his view that the banks need to pass on as much of the RBA cuts as possible to mortgage holders very clear to us both publicly and privately.

Senator FIELDING—As part of those discussions were there any presentations or documents passed to the Treasurer?

Mr Munchenberg—Not beyond the ones that we have made publicly available that I recall. I can check that point.

Senator FIELDING—Could you check that for us? If you could provide on notice, as I said, for each of the occasions where you have withheld interest rate cuts and where you have put up interest rates above the Reserve Bank over the last—

Mr Munchenberg—The first movement was January last year.

Senator FIELDING—Yes. I was wondering where the one up was because there were also some the other way around. I would be very interested to see exactly what was provided publicly.

Mr Munchenberg—I can tell you now that where we have provided substantial information we started that in August of last year and since that time we have provided information—

Senator FIELDING—Previously, before August?

Mr Munchenberg—Before August when we did move rates up outside of the RBA we provided very general information but, when it became apparent that it was going to be some time before the two rates moved in synchronisation again, we realised it was incumbent upon us to provide greater information to our customers, and we have been doing that for the past year.

Senator FIELDING—Could you provide both then—the ones before and the ones after?

Mr Munchenberg—Yes, we will provide all information that we have provided.

Senator FIELDING—There is no other public documentation you have provided to business clients that is different to what you have provided to consumers?

Mr Munchenberg—Not that I am aware of, but I will check that and confirm that.

ACTING CHAIR—I want to ask you a question or two about bank interest rates and why they change. I see that in your submission you say:

Interest rates change for a combination of reasons, including:

- movements in the Reserve Bank of Australia's official cash rate;
- the cost of funding a loan from the wholesale money market in Australia and overseas;
- the cost of attracting customer deposits; and
- the overall competitive market.

Do you want to expand on those factors and explain to the committee for the record which really is the most important in terms of you not necessarily following changes in the interest rates from the RBA?

Mr Munchenberg—There are really three factors that we take into account when determining the mortgage rate. They are the actual cost of our funds, the risk that we perceive in the environment we are lending into and also, obviously, we are looking at remaining competitive with other providers of credit. The main factor within that would be the cost of funds, and that in itself is broken down into three areas. About half of our funding, like most major banks in Australia, comes from depositors; about half of the remaining 50 per cent comes from short-term wholesale funding; and the final 25 per cent comes from long-term wholesale funding.

Now the prices in those three areas do not move entirely independently—they do move differently. For the moment, for example, we are seeing short-term funding costs coming down. The main reason for that is that short-term funding is largely drawn from Australia and we are seeing that as some certainty returns to the world globally international markets are starting to open up again so we are now able to source more funding offshore. Therefore that has taken some of the competitive pressure off our short-term market and the price has consequently fallen.

Deposits remain highly competitive because they are still the most attractive source of funding to all of the banks. We are seeing that rates the banks are paying on deposits have not fallen as much as they would otherwise have been expected to given the cut in the cash rate. While that has meant that our funding costs have remained slightly high, it has at least buffered to some extent those that rely on deposits for income from the full impact of recent cuts. Then, as I mentioned to Senator Fielding, long-term funding still remains much more expensive than it was prior to the crisis—and this is typically funding that we have over three to five years. So we are currently renewing what was once very cheap money with more expensive money and that has the effect of increasing the average costs of our long-term wholesale funding.

In terms of the RBA cash rate, the RBA cash rate effectively influences our baseline interest rate. So when the RBA moves up or down 25 basis points, it moves the baseline up or down 25 basis points. Prior to the financial crisis, the additional factors on top of the RBA cash rate tended to be very stable so that the final price that we were charging for mortgages, the final interest rate, tended to mirror what the RBA did. Since the financial crisis, however, those costs that we put on top of whatever the baseline is—the wholesale funding costs, the consumer deposit costs, the risks—have all become much more volatile and therefore you have seen that decoupling between what interest rates are charged in the market and what the RBA cash rate does. The RBA is fully cognisant of this and understands this when it is setting its interest rates and no doubt takes these factors into account itself.

ACTING CHAIR—Thank you. I am quite interested in the medium- and long-term borrowing, which you seem to largely obtain from offshore sources. Is that correct?

Mr Munchenberg—Yes. It is mixed but largely from offshore.

ACTING CHAIR—That market, I gather, has been somewhat constrained, if not very difficult, because of the global financial crisis—is that not the case?

Mr Munchenberg—That is the case, and the price we pay for wholesale funding offshore is still more than we do in Australia. I refer you to slide 3 of the slides that we provided: the dark blue line there is the actual costs that we have paid for long-term funding and you will see that they are a number of spikes there. That tends to be the cost where we have raised money offshore. More recently we have been able to raise money in

Australia and, hence, that sharp fall in the price. But our forecast, which is that we will continue to raise money onshore and offshore, shows that that price still remains very high.

I might just note in passing—although we will probably discuss it later—that increasingly funding offshore is unguaranteed. So in the course of this year we have moved up from having to be almost totally reliant on the guarantee to increasingly not needing to use the wholesale guarantee.

ACTING CHAIR—I see that there are a few ups and downs going back to December 2007, which preceded by a year the collapse of Lehman Brothers. What were the factors operating and that period? It came back to follow the trend again but after the collapse of Lehman Brothers the cost of such funding went right up. What was operating in this sector here and did that affect your decisions about interest rates?

Mr Munchenberg—It certainly did. The actual cost of funds is very salient to our decisions on interest rates. It was a little over two years ago that the global financial crisis, as we now know it, began, with the realisation that there were difficulties in different markets for derivatives. We saw the perceptions of risk in the market increase rapidly around that time and hence the cost of funds increased rapidly. That peaked in March 2008 when Bear Stearns collapsed. Following that, it appeared that we had passed the worst of the financial situation, but then matters rapidly deteriorated again midway through last year, ultimately culminating in the collapse of Lehman Brothers, which is now seen as the peak of the financial crisis—we hope. Allowing for the fact, Senator, that this is a mix of onshore Australian funding, where we have been less concerned about systemic risks, if you like, compared with overseas funding, following the collapse of Lehman Brothers and the uncertainties of the first half of this year we feel more confident that we understand where we are today and we hope that we are seeing a recovery which will continue. So those prices, because of risk coming down, are slowly coming down. But I do need to emphasise the point that, nonetheless, the price for wholesale funding remains considerably higher today that it was three years ago. So, as we renew that money, the average cost will continue to climb for that component of our funding costs.

CHAIR—Can you make any international comparisons—say, with the UK or other European countries, and perhaps with North America—in terms of what is happening with interest rates and how closely they are following the rates set by their central banks?

Mr Munchenberg—My understanding is that Australia is one of the countries where the bulk of the interest rate cuts have been passed on, significantly more than you will have seen in the US or the UK. There may be one or two other countries that have also passed on a significant amount. But, compared to other countries, it is quite unusual for banks to have passed on as much as 90 per cent plus of the official cash rate cuts, and it is for that reason, in part, that the central bank has only had to lower our rates to three per cent, which are above the rates in other countries.

CHAIR—Thank you. Senator Pratt.

Senator PRATT—Your submission highlights issues regarding the cost of funds, and many of your remarks warning have already gone to that point. Your submission also covers the closure of many markets and hence the increased cost. Can you unpack for us a little bit the changes in those markets, such as which ones closed and why, and give us just a bit more background.

Mr Munchenberg—I may need to take that question on notice. I am not an expert on our financial markets. I am more focused on the consequences of those markets and their performance. What I can say overall is that we are seeing those markets reopening and freeing up, certainly more quickly than we would have anticipated six months ago. But, to use the jargon that is around, they are early green shoots at this stage; those markets are far from fully operational, but the trend is in the right direction.

Senator PRATT—How does the cost of the funds available from those markets generally compare to the cost of funds available locally? You have passed some comment on that already this morning. Is it above, below? What is the general pattern there?

Mr Munchenberg—John, you may want to come in and correct me or supplement what I say. The most attractive source of funds for us in broad terms is consumer deposits, hence the strong competition in Australia for deposits, which has kept deposit rates much higher than they otherwise would have been. Short-term money was then attractive by virtue of its availability. People were more comfortable during uncertain times about making commitments over the shorter term providing funds. As some sense of normalcy returns to the world, we are now seeing those longer term markets starting to open up. So, where we can, we have been raising money onshore, but the bottom line remains that the structure of the Australian economy means that

Australian banks cannot totally fund themselves from onshore; we are reliant on international sources of funds to maintain the level of lending in Australia that we need. John, do you want to add to that?

Mr Salamito—I do not think I need to anything. Senator Pratt, your question was a local versus overseas one at its heart. Structurally, it is true that Australians are borrowing more than they save. Hence, the National Bank is reasonably typical in only being able to obtain half the money we wish to loan from the depositors in the bank. By its structural nature, unless we lend less we will have to continue to seek money offshore.

Senator PRATT—What is the difference between the interest rate on a $100,000 deposit in terms of what the depositor will earn in interest versus what your standard variable rate is?

Mr Salamito—The difference depends very much on the term of the depositor. Similar to the growth you have of term wholesale funding, interest rates for depositors have been extremely volatile over the last year. The slide you have on customer deposits shows the relativity on average between what a depositor receives versus the bank bill swap rate. The interesting feature of the graph is that around about a year ago the markets moved to a hitherto unknown state where depositors received a higher interest rate than the actual bank bill swap rate, which was a reasonably unforeseen circumstance. Typically, the cost of banking and competitive pressures mean that depositors receive less interest than the bank bill swap rate, and that has sort of reversed. While the numbers are very volatile, depositors receive, relative to things like the RBA cash rate, a much higher interest rate today than they were up till a year ago.

Senator PRATT—I want to ask about Australia compared to other countries. The Reserve Bank influences interest rates but, as you have highlighted, is largely only able to do that in relation to the domestic funds that are lent. To what extent are other countries also dependent on overseas borrowings versus local borrowings? One of the examples given this morning was Canada, and they have lower interest rates. I am not sure if that is because they have greater access to local money, but could you characterise some of the differences and where Australia sits within those kinds of debates in terms of our reliance on international funds?

Mr Munchenberg—I cannot give any precise answer off the top of my head. We can provide that information if you wish. My sense would be that Australia is towards the more highly reliant end.

Senator PRATT—Because we are not good savers.

Mr Munchenberg—And economies are at different stages and there are cultural differences. Some countries have a savings surplus and others have a savings deficit, and we fall firmly into that latter category. Consequently, we are more vulnerable to the price of money internationally, as we have seen over the last couple of years. It is probably pointless to speculate but, were we able to meet our full funding costs from local savings, we would expect to see less volatility in interest rates than is actually the case.

Senator PRATT—It is clear why those costs have risen. The Reserve Bank can influence interest rates, but there is a significant counterforce that is not really subject to that direction. That is the key thrust of your argument, isn't it?

Mr Munchenberg—That is correct. The Reserve Bank in setting the cash rate will be very aware of that. It is a very sophisticated operator and is able to take that into account. I am speculating pointlessly, but it may be that the Reserve Bank has in fact cut rates deeper here recognising that wholesale funding costs offshore remain very high, so some of those cuts are going to be moderated through that. The Reserve Bank has not said that, but it is reasonable to speculate that, in taking into account the actual higher costs of funding, that may well be the case.

Senator PRATT—Thank you.

Senator FIELDING—I asked before about what you provided to your customers, and you said it was in our pack. The only thing in our pack is one page and it does not explain a heck of a lot.

Mr Munchenberg—I do not understand that. If I go onto your website I can download at least three parts of our submission.

Ms Ward—To be clear, the submission consists of three parts, and two were slide packs, one from April earlier this year and the other one from February. I am happy to provide those now.

Mr Munchenberg—As you will see with each of those and today's information, we have advanced somewhat in the amount of information we are able to provide. It has been a learning experience for us as well.

Senator FIELDING—Has competition in the banking sector increased or decreased in the last year?

Mr Munchenberg—It is fair to say that while there is still clear competition—we can give you some evidence of that—the amount of choice available to consumers has decreased through the course of the global financial crisis.

Senator FIELDING—Thank you.

ACTING CHAIR—We thank you for appearing.

Committee adjourned at 12.26 pm