REGIONAL BANKS' SUBMISSION TO THE
FINANCIAL SYSTEM INQUIRY

LEVELLING
THE PLAYING FIELD

MARCH **2014**

Bendigo and Adelaide Bank is a full service community focussed retail bank with a national network of more than 500 company owned and Community Bank® branches. With 86,000 ordinary shareholders, almost 6,800 employees including Community Bank employees and over 1,500,000 customers, the strategy of the Group is built on a vision of being Australia's leading customer connected bank.

Established in 1874 as the first permanent building society in Queensland, BOQ today has 265 branches across every state and territory in Australia. With 3,000 employees serving over 800,000 customers across the Group, BOQ strives to prove every day that it's possible to love a bank.

Established as Super Member Home Loans in 1994, ME Bank received its banking license in 2001. Today ME Bank is 100 per cent owned by 30 of Australia's largest industry super funds who collectively have over $200 billion in funds under management. The Bank has over 280,000 customers and $20 billion in assets. Its unique workplace banking model provides customers with banking access conveniently in their place of work.

Originally founded as the Queensland Agricultural Bank in 1902, Suncorp Bank is part of the top-20 ASX-listed Suncorp Group and is an 'A+' rated regional bank serving more than 1,000,000 customers and employing more than 2,900 staff across 232 retail and business banking outlets and operations nationally.

31 March 2014

Mr David Murray AO

Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001
email: fsi@fsi.gov.au

Dear Mr Murray,

We are pleased to provide a submission to the Financial System Inquiry. Our submission is the collective effort of four Australian-owned regional banks: Bendigo and Adelaide Bank, BOQ, ME Bank and Suncorp Bank.

We see this as a unique opportunity to ensure that Australian consumers, businesses and economic prosperity are the central focus of our financial system. Banks are a major component of the financial system and best placed to assist in managing the flow of capital to consumers and business in support of Australia's economic growth.

These outcomes are best achieved through an efficient and competitive multi-tiered banking system in which each tier brings a different perspective and vigorously competes for customers on a level playing field. Regional banks have served their customers and communities well over time and provide vital competitive tension in the market.

The banking system is strong and stable and proved to be very resilient when tested during periods of financial stress such as the Global Financial Crisis.

Issues have emerged since the Global Financial Crisis that result in a significant competitive advantage for larger banks. Specific examples include:

- The disparity between the amount of capital required to support assets under the Basel capital adequacy framework that delivers a significant advantage to banks accredited under the advanced approach;
- The significant funding and cost advantage available to banks deemed systemically important;
- The higher cost for regional banks, in relative terms, of the constant flow of new regulatory and prudential requirements; and
- Increasing vertical integration of major players in the market.

The underlying premise of this submission is to maintain alignment between the needs of consumers, the community and shareholders, and make recommendations that are based on realistic and sound policy principles. The recommendations seek to reinstate a level playing field and ensure long-term competitive tension while preserving the stability of the system. Competition and efficiency drive productivity and economic prosperity.

The regional banks look forward to working with the Inquiry to further explore the issues raised in this submission and to develop solutions that provide genuine long-term benefits to the Australian economy.

Yours sincerely,

Mike Hirst
Managing Director
Bendigo and Adelaide Bank

Stuart Grimshaw
Managing Director & CEO
BOQ

Jamie McPhee
CEO
ME Bank

John Nesbitt
CEO
Suncorp Bank


GUMNUT
tradition meets creativity
GUMNUT

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1 EXECUTIVE SUMMARY

This submission has been prepared by Bendigo and Adelaide Bank, BOQ, ME Bank and Suncorp Bank with the assistance of Pegasus Economics. The four banks collectively represent a perspective of Australian 'regional banks'. The need for a regional bank submission stems from the desire of these institutions to make a policy contribution with the aim of ensuring a healthy and sustainable future for Australia's financial system, with a particular focus on the banking sector. A healthy, multi-tiered banking sector is the best model to guarantee Australian consumers and business will be able to access innovative and better value financial products and services into the future.

A multi-tiered banking system in which each tier brings a different perspective and vigorously competes for customers, on a level playing field, will ensure consumer benefits are protected and enhanced. The regional banking sector has consistently delivered a better level of service for all Australians as reflected by superior customer satisfaction ratings. The regional banks bring essential competitive tension to the market through an extensive and complete range of quality products and services for consumers, business and regional communities. Regional banks provide genuine and credible choice for customers.

The regional banks believe the basic aim of this Inquiry is to put the end-users of financial products as the central focus. Banking system design must, to the greatest extent possible, identify what is best for the mums and dads, businesses and everyday Australians who rely on safe, efficient and innovative services: to save money, purchase a house, start a business and all the other hundreds of things that people need a banking system to assist with.

The banking system has generally served the market well over time. While other sectors of the financial system, such as superannuation funds, may play an increased role in the provision of capital to the economy in the future, the banking system will continue to play a significant and critical role in the intermediation of capital across efficient payment systems. Regional banks will also continue to contribute to this process by providing competitive tension in the delivery of quality products and services to consumers, small business, and regional communities.

The Global Financial Crisis (GFC) provides the main backdrop to the Financial System Inquiry (FSI). It was a pivotal event in the economic and social history of many countries. While the Australian economy and financial system proved relatively robust, the GFC has led to significant changes to the motivations and actions of consumers, businesses, financial institutions and government. In turn, these have re-shaped much of the competitive and regulatory landscape.

Up until the GFC, a relatively level playing field existed for large banks, regional banks, foreign-owned banks, credit unions, building societies and non-ADIs. However post GFC, regulation has tilted the playing field materially in favour of the large banks by lowering their capital costs, and relative funding and compliance costs.

1 EXECUTIVE SUMMARY

The current reality is that while there is competition in the market and there are many beneficial aspects to Australia's banking system, issues have emerged - the banking landscape is now characterised by a higher degree of market concentration, consolidation and increasing dominance of the large banks relative to other providers. While smaller banks and others provide customers with real alternatives and choice when it comes to financial services, these smaller participants do so at a distinct competitive disadvantage.

The regional banks believe now is the time to identify, acknowledge and discuss these issues in a constructive way with a view to improving the system for the future. The best means of mitigating the trend towards further dominance is to refocus banking regulation. Competitive neutrality is about ensuring all service providers compete on an equal footing and that regulatory arrangements do not favour some service providers over others. A small number of regulatory changes are needed to preserve customer value and choice to allow regional banks and other providers to compete more broadly for the benefit of consumers and the economy.

Submission outline

The submission is organised as follows:

Chapter 2 provides an introduction and background. It covers the role and importance of regional banks as competitors, makes high level comments on the GFC, and discusses the policy objectives commonly used to base financial regulation.

Chapter 3 identifies some evidence to indicate that efficiency and competition in retail banking is not optimal and thereby establishes a primary motivation for making improvements.

Chapter 4 outlines some reasons as to why efficiency and competition in retail banking is not optimal and makes recommendations for improving current arrangements. Specifically, this section identifies the capital adequacy regime, "too big to fail", the regulatory burden, and vertical integration in banking as factors undermining competitive neutrality.

Chapter 5 summarises the evidence presented and re-iterates the need to level the competitive playing field.

1 EXECUTIVE SUMMARY

1.1 Stability, efficiency and competition

The three policy principles most commonly associated with financial regulation are: safety, efficiency, and competition.

Public policy setting in financial services is often referred to as a balancing act between 'stability' and 'competition'. But financial stability and competition are not necessarily mutually exclusive or competing objectives. The real policy trade-off is between 'stability' and 'efficiency'.

This is a subtle but important distinction. Competition is not an end in itself, it is a means of achieving greater efficiency. Competition also compels firms to produce better and more innovative products and services.

Most public policy inquiries, such as the FSI, place considerable weight on identifying competition problems and seek initiatives to strengthen competition. However, it is important to remember the ultimate objective is that of efficiency and innovation.

1.2 Greater efficiency through strengthening competition

Given competition is one of the key drivers of efficiency, the regional banks see a strong public interest case in giving greater weight to competition considerations in financial services regulation, particularly in retail banking. While system safety (systemic risk) is a key issue in financial system design, it needs to be recognised that Australia has experienced a strong record of system stability. Indeed, the last financial system breakdown was probably the 1890s depression – 110 years ago. Our financial system in terms of stability has proven remarkably resilient.

1.3 Efficiency and competition issues in retail banking

The regional banks believe that with a long history of financial stability and further tightening of prudential rules since the GFC, regulatory focus should now re-balance towards matters of efficiency, competition and consumer benefit. As argued by both the Campbell Report (1981) and the Wallis Report (1997), the most effective strategy to do this is through strengthening competition and competitive neutrality.

There is evidence of efficiency and competition problems in financial services and retail banking. This evidence includes the following:

- Around 9% of total national income or GDP in Australia is spent on financial services. This is high by international standards.
  Refer to section 3.1 for detailed analysis.

- A high proportion of credit is being channeled into domestic housing. Small and medium-size enterprises (SMEs) seeking to innovate, cite a lack of access to funds as a significant barrier to economic growth. Concerns do exist, therefore, that there has been some problems in terms of allocative efficiency.
  Refer to section 3.2 and 3.3.

- The four largest domestic banks continue to increase their market share and are very profitable by international standards. Market concentration is significant in most markets and return on equity (ROE) is high for the larger banks, despite the heavy asset weighting towards low-risk domestic housing assets. Currently, margins in housing lending are high by historical standards.
  Refer to sections 3.5-3.10 for detailed analysis.

1 EXECUTIVE SUMMARY

1.4 Factors impacting competitive neutrality in retail banking

Consumers and businesses in Australia, and the efficiency of the economy generally, could materially benefit from greater competition and competitive neutrality. The regional banks believe there are various reforms needed to increase competition and provide greater scope to expand the capital available to generate economic growth. The four broad areas are:

1. The dual nature of the capital adequacy regime which enables 'advanced' banks to hold much less capital against a housing loan than other banks using the 'standardised' approach. With a lower capital requirement, housing lending for advanced banks yields a significantly higher return on equity (ROE). Housing lending is a very profitable activity for large banks and, not surprisingly, the proportion of lending to housing has increased significantly since 2007.

   The housing capital anomaly is having a significant and pervasive effect. With strong ROEs for the 'advanced' banks in housing loans, there is a strong incentive to allocate a higher proportion of funds into this sector, at the cost of other areas such as SME finance. Levelling the playing field in terms of capital requirements in housing, will create significantly more competitive tension. This will improve incentives to offer more SME finance.

2. Banks that are deemed systemically important enjoy implicit taxpayer support which allows them to secure funding cheaper than other banks. An obvious example is that Standard & Poor's, an international rating agency, increases the ratings of systemically important banks by two rating notches in recognition of the implied Government support, providing a significant funding advantage in domestic and offshore capital markets. Apart from this funding advantage, the recognition of institutions as being deemed 'too big to fail' (TBTF) can, in the long-term, increase systemic risk through moral hazard, and create resource allocation distortions. As with the capital adequacy anomaly, the TBTF funding subsidy has a pervasive impact on the competitive playing field. Large banks already enjoy the cost advantages of scale and scope in production, but having taxpayers underwrite lower funding costs for the major banks gives them a decisive advantage.

3. The fixed-cost nature of the regulatory burden. The introduction of new regulation and prudential requirements invariably come at a significant cost to banks. This comprises both fixed and variable costs. Larger banks have the advantage of spreading fixed costs over larger asset bases resulting in higher unit costs of implementation for smaller banks. Governments and prudential regulators should assess the impact on new provisions, in particular for smaller banks, prior to increasing the burden for banks, through robust Regulation Impact Statements.

4. The increasingly vertically integrated banking system where the large banks are now starting to dominate areas such as financial advice and mortgage broking platforms. This vertical integration can impact the competitive playing field because, for example, mortgage brokers may be incentivised to direct customers towards the products offered by the broker's owner. Effective disclosure rules are needed to address this issue.

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1.5 Recommended actions

To address the issues identified above, the regional banks make a series of recommendations to the FSI Panel to remedy the situation. The following table summarises these recommendations:

ISSUE	RECOMMENDATIONS
The disparity between the risk-weighting on residential mortgages under the standardised and advanced prudential capital adequacy frameworks	Consider whether a risk-reflective capital treatment for residential mortgages under the 'standardised approach' should be implemented. This suggests 20% as opposed to the 35% under the existing 'standardised' approach. This 20% risk-weight could be used as a transitional weighting while regional banks go through the advanced accreditation process. Reconsider the current approach that Basel II advanced status be achieved in credit, operational risk and market risk before enabling a bank to rely on an internal assessment of any individual risk, particularly credit risk. This would significantly reduce the time and expense associated with full Basel II accreditation for regional banks. **Refer to section 4.1 for detailed discussion**
The funding advantage for banks which are deemed systemically important	Recognise that funding cost advantages are given to banks deemed systemically important and that this should be addressed on competitive neutrality grounds. Options for consideration are outlined in Section 4.2.4 **Refer to section 4.2 for detailed discussion**
One-size-fits-all regulation that doesn't recognise the costs and competitive impacts of change	Review whether the cost/benefit assessment obligation in Regulation Impact Statements should address the competitive impacts. If the cost/benefit process cannot be improved, the Inquiry should look at other means of ensuring regulators factor costs into their decisions, such as Statements of Regulatory Intent. Consider the potential benefits of consolidating current regulatory structures and licensing regimes in order to remove red tape and reduce duplication, such as incorporating AUSTRAC into ASIC. **Refer to section 4.3 for detailed discussion**

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ISSUE	RECOMMENDATIONS
Market concentration due to increased levels of horizontal and vertical integration	To ensure consumers are informed of incentives that may influence product offerings, consider whether the following disclosure principles should be provided to every potential customer. (Note – mortgage brokers are used for illustration, but the principles are generally applicable): • The mortgage brokers' ownership structure; • The range of issuers and products offered by the mortgage broker; • The fees and commissions attached to each product offered; • The proportion of loans brokered that go to their owners (if applicable) and basic risk information about the loans, such as average Loan to Value Ratios. (This disclosure would be aimed at identifying whether brokers are sending the best credit risks to their owners). Consider commissioning ASIC to undertake a market survey to assess whether the multi-brand strategy of banking institutions is causing confusion in the minds of consumers as to ownership. If it is found that confusion does exist, then a strong disclosure obligation must be introduced to ensure customers are making informed decisions. **Refer to section 4.4 for detailed discussion**
Low take up of bank account switching	Consider whether the New Payments Platform could make account switching more convenient, by removing the need for customers themselves to identify direct debits and credits linked to all of their accounts, and enable an acquiring bank to complete the required actions with a simple authorisation process. **Refer to section 4.5 for detailed discussion**
Small business (start-ups) financing	Consider options to support small business start-ups. **Refer to section 4.1 for detailed discussion**

2.

INTRODUCTION AND BACKGROUND

2 INTRODUCTION AND BACKGROUND

The aim of this submission is to represent a regional bank perspective on the financial system and make recommendations on how the system can be improved. The four banks that have prepared this submission are Bendigo and Adelaide Bank, BOQ, ME Bank and Suncorp Bank. These four banks are taken as a proxy for the term 'regional banks'.

The regional bank business model is highly dependent on customer satisfaction as they do not have the same scale as the four domestic systemically important banks (D-SIBs) [1], and the recommendations in this submission are fully consistent with ensuring Australian consumers and business have access to highly competitive and innovative banking products into the future.

The regional banks agree with the view that Australia's financial system has performed well through the GFC compared to the United States and many European countries. Many reasons have been put forward to explain this: the Government's liability guarantees; the Australian Government's stimulatory spending; China's demand for raw materials; sound prudential regulation, and good bank management. The likelihood is that it is a combination of these, and other, factors.

There is a common view that because Australia did not experience deep financial crisis, that any changes to the regulatory settings of Australia's financial system should be minimal. From the regional banks' perspective, this view risks missing opportunities to make beneficial changes. There are real opportunities to improve competitive neutrality and therefore enhance competitive outcomes for consumers and business.

The case for change in the financial sector goes wider than financial stability - competition and efficiency should be given appropriate weight. The history of financial regulation in Australia demonstrates the negative consequences of putting too much emphasis on financial stability.

In the period between WWII and the 1970s, Australia's financial system was stable, yet it was riddled with inefficiencies and inequities. These led to perverse outcomes such as the rationing of credit, making it very difficult for women or low-income earners to access credit. It took the 1979 Campbell Inquiry to highlight the social and economic costs of this inefficiency.

While Australia's financial system today is more flexible and dynamic, the apparent push by governments and regulators around the world to place financial safety well above other policy principles risks a long-term descent into further concentration, inefficiency and lack of innovation.

[1] The D-SIBs are the ANZ Bank, the Commonwealth Bank of Australia, the National Australia Bank and Westpac (Australian Prudential Regulation Authority, 2013).

2 INTRODUCTION AND BACKGROUND

2.1 REGIONAL BANKS

The history of regional banks goes back almost to the founding of the Australian Federation in 1901. Nearly all domestically-owned banks in Australia either commenced as regional banks, building societies or credit unions.

Regional banks compete in all markets but have the greatest presence in retail banking, servicing household demand for: deposit accounts; credit cards; housing loans; personal loans; and SME products. They are less represented in institutional and large corporate financing, although most regional banks have some large corporate customers. Most regional banks have competitive agribusiness product offerings.

Regional banks have distinguished themselves over a long period of time with customer satisfaction levels that far exceed the major four banks. Customer satisfaction surveys from a range of independent research firms regularly rank regional banks ahead of the rest of the market on a range of customer satisfaction metrics. Scores for the broader industry have been trending higher in recent years, demonstrating the value of competitive tension in driving improvements in customer satisfaction.

This achievement is significant when seen in light of the funding and scale advantages of large institutions. The regional banks in Australia have managed to achieve strong customer support through management cultures that understand the importance of customer service to long-term success.

Another closely related feature of regional banks is how they have innovated in corporate structure to embed the philosophy of customer service and develop niche roles in retail banking. Examples include Bendigo Bank's Community bank model and BOQ's Owner-Managed branch model.

A summary of the general benefits of regional banks was given by Ben Bernanke (2009), former Chairman of the US Federal Reserve, in comments to a US community bank forum in the midst of the GFC:

> *Communities all over America are trying to cope with the economic consequences of the most severe financial crisis since the Great Depression – high unemployment, lost incomes and wealth, home foreclosures, strained fiscal budgets, and uncertainty about the future. Because community banks are integral to local economies, you have been on the front line, so to speak, deeply engaged in confronting those problems and uncertainties. Your commitment to your communities, including your willingness to provide credit and services supporting small businesses, home purchases, and commercial development, is reason to be optimistic about our nation's ability to meet the current challenges and return to economic health.*
>
> *One of America's economic strengths is its relatively greater reliance on bottom-up rather than top-down growth and development, in which individual creativity, local knowledge, and the trust born of longstanding relationships help foster economic creativity and progress.*
>
> *Of course, it is precisely the ability to foster bottom-up growth, building on local knowledge and relationships, that sets community banks apart from other financial institutions. It is important for our economic health to maintain a diverse and resilient financial system in which community banks play an important role.*
>
> *As the crisis has shown, one of the greatest threats to the diversity and efficiency of our financial system is the pernicious problem of financial institutions that are deemed "too big to fail".*

2 INTRODUCTION AND BACKGROUND

2.1.1 Bendigo and Adelaide Bank

The Bendigo and Adelaide Bank Group is a community focused retail bank that commenced operations in 1858. In 2007 Bendigo Bank merged with Adelaide Bank to form Bendigo and Adelaide Bank Limited, now the fifth largest domestic retail bank in Australia with a credit rating of at least "A-" from all three international rating agencies.

The strategy of the Bendigo and Adelaide Bank Group is built on a vision of being Australia's leading customer-connected bank. This is based on focusing on the success of all stakeholders of the Bank including shareholders, customers, our people, partners and communities.

The principal activities of the Group are the provision of banking and other financial services including lending, deposit taking, transaction banking, leasing finance, margin lending, superannuation and funds management, insurance, agribusiness, treasury and foreign exchange services (including trade finance), financial advisory and trustee services.

The retail banking businesses operating under the Bendigo Bank brand provide a full suite of traditional retail banking, wealth and risk management services to customers through a national network of more than 500 company owned and Community Bank® branches. The Group's customer facing brands also include Rural Bank (a wholly owned subsidiary with a separate banking licence), BendigoWealth (incorporating Sandhurst Trustees and Leveraged Equities), and DelphiBank.

Bendigo developed the innovative Community Bank® model over 15 years ago to partner with discrete communities to provide retail banking services and enable their sustainability. DelphiBank provides retail banking services to Greek and Cypriot communities in Australia.

2.1.2 Suncorp Bank

Suncorp Bank was founded in 1902 as the Queensland Agricultural Bank and has provided banking services to individuals, SMEs and agribusiness in regional communities of Australia for more than 110 years. As an Authorised Deposit-taking Institution (ADI) regulated by Australian Prudential Regulation Authority (APRA), Suncorp Bank is Australia's leading regional bank and is part of the Suncorp Group, a top 20 Australian Securities Exchange (ASX) listed Company.

With a network of over 200 branches, agencies, business banking centres, over 2000 ATMs across Australia, and employing approximately 2,900 staff, Suncorp Bank services more than one million individual, agribusiness, small-to-medium businesses and commercial banking customers with a strong suite of financial services and simple banking products, which include:

- Personal banking, including home and personal loans, savings and transaction deposit accounts, margin lending, credit cards and foreign currency services;
- Small business banking, including financial solutions for SMEs with borrowing requirements of up to A$1 million;
- Commercial lending, including financial solutions for SMEs with borrowing requirements of more than A$1 million; and
- Agribusiness lending, including financial solutions and serviced relationship management for rural producers and associated businesses in rural and regional areas.

2 INTRODUCTION AND BACKGROUND

2.1.3 Bank of Queensland

The Bank of Queensland (BOQ) was established in 1874 as the Brisbane Permanent Benefit Building and Investment Society, the first of its kind in Queensland. In 1887 it converted into a bank but did not become a trading bank until 1942. In 1970 it officially became the Bank of Queensland and was listed on the ASX in 1971. Throughout the 1970s and 1980s the bank continued to grow, and in 1985 it began to open regional branches.

BOQ prides itself on its commitment to customer service, delivered through a range of channels including its unique Owner-Managed branch (OMB) model. It offers a full range of simple, easy to understand banking products and services to individuals and businesses.

In the past 15 years, BOQ has undergone considerable expansion, both organically and also through the acquisition of various businesses including, most recently, Virgin Money Australia.

BOQ is now a large regional bank with assets of $42.5 billion. Its OMB model, a franchise model which means the branch is owned and managed by people who live locally, know their customers well and are willing to go the extra mile to ensure that they always receive exceptional personal service. This relationship based distribution approach extends across BOQ's entire business, including Retail and Online Banking, Business Banking, Agribusiness and Financial Markets, Equipment, Debtor & Vendor Finance and Insurance.

Currently BOQ operates 265 branches across Australia, and provides fee-free access for its customers to over 3000 ATMs nationally.

In 2013 the website Mozo, which focuses on banking and insurance comparison, voted BOQ one of Australia's top five banks based on retail customer feedback. As BOQ has been expanding its Business Banking presence, including a move into agribusiness, it has topped the East & Partners business banking customers' satisfaction survey for the five straight years up to and including 2013.

2.1.4 Members Equity

ME Bank was founded by Australia's industry super funds in 1994 as Super Member Home Loans with the primary purpose of providing low-cost home loans to Australians belonging to industry superannuation funds. In 2001 ME Bank received its banking license.

Today it is 100 per cent owned by 30 of Australia's largest industry super funds who collectively have over $200 billion in funds under management and more than 5.5million members. ME Bank is headquartered in Melbourne and has offices in every capital city throughout Australia. Having begun as a home loan originator, ME Bank offers personal banking products including credit cards, personal loans, novated car leasing, transactions and savings accounts and term deposits. ME Bank also offers a range of finance solutions for businesses including loans and asset financing as well as investment and term deposits. Today ME Bank has over 280,000 customers and $20 billion in assets.

ME Bank's unique business model centres around its customer-first philosophy and, due to the backing of some of Australia's funds, has the strength and capability of a commercial bank. ME Bank's current strategic priorities leverage its unique business model as the bank that provides "genuinely fairer banking". These are:

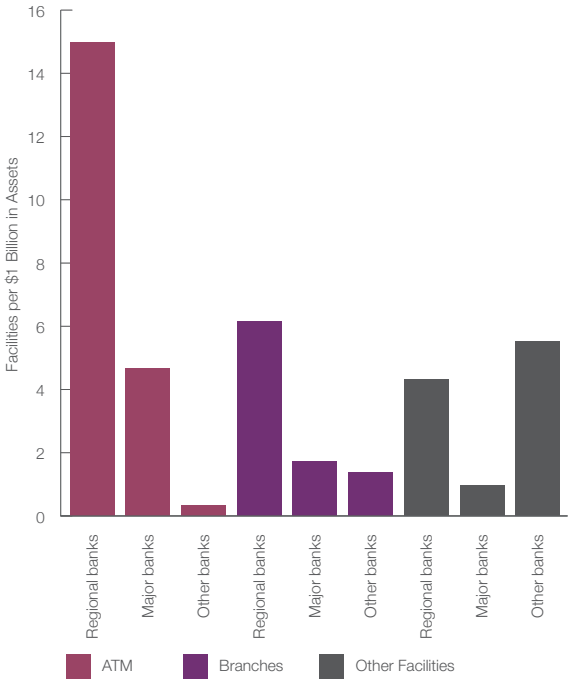
- WORKPLACE BANKING
  Build the largest 'branch' network in the country, right where our customers are – in their workplace with currently almost 100 outlets.
- MASS CUSTOMER ACQUISITION
  Become the primary bank for industry super fund and union members through the integration of fund and union distribution channels.
- NETWORK DEPOSITS
  Become the major provider of cash and fixed term interest products to industry super funds, unions and their members.

2 INTRODUCTION AND BACKGROUND

2.2 REGIONAL BANK ACCESS INFRASTRUCTURE

The regional bank business model relies on high levels of customer satisfaction. One means of achieving this is to provide convenient and safe facilities for undertaking payments. The data shows that regional banks make relatively large investments in banking infrastructure. This can be seen from Figure 2.1. The chart provides some simple ratios of the number of banking facilities offered by the category of bank and then divides that number by the total domestic assets of that institution. [2]

Figure 2.1
Banking facilities as proportion of bank size - type of bank comparison



Source: APRA's Points of Presence data; APRA's monthly banking statistics; Pegasus Economics calculations.

Other facilities includes other face-to-face fcilities but do not meet the criteria of a branch.

EFTPOS members have been excluded due to classification issues.

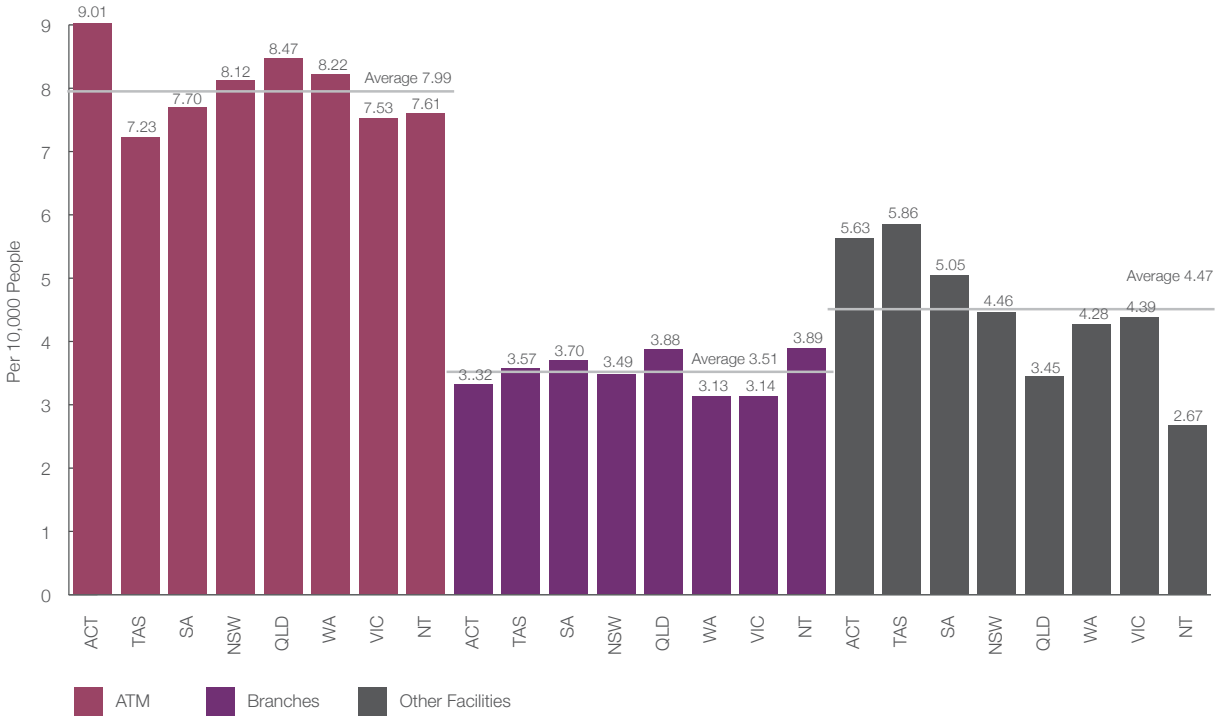
[2] Domestic assets was chosen because it was not possible to get quality customer numbers due to the problem of double counting.

2 INTRODUCTION AND BACKGROUND

Three measures were chosen – ATMs (full service), Branches, and a catch-all category of 'other facilities'. [3]

As the chart shows, regional banks have invested heavily in both ATMs and branches – the two key physical banking facilities used by customers today.

Figure 2.2
Banking facilities per 10,000 people - State comparison



Source: APRA Points of Presence Survey; ABS Catalogue No 6202; Pegasus Economics calculations.
Other facilities includes other face-to-face facilities but do not meet the criteria of a branch.
EFTPOS numbers have been excluded due to the high number that are not classified on a state basis.

There is also some evidence that competition from regional banks helps drive greater investments in banking facilities within a state's border. Figure 2.2 gives a state breakdown of ATMs, Branches and other facilities as a proportion of total population. Queensland does particularly well in both categories. This is probably has a lot to do with the fact there are two long-established regional banks that compete vigorously in the various retail banking markets.

[3] This latter category did not include EFTPOS terminals as the data showed large numbers of EFTPOS terminals were not properly classified.

2 INTRODUCTION AND BACKGROUND

2.3 CUSTOMER SATISFACTION

Regional banks have distinguished themselves over a long period of time with exceptional customer satisfaction levels. Since 1990, the average customer satisfaction levels of the regional banks have been around 80%, considerably higher than other banks. Roy Morgan Research (2014) found for January 2014 that 16 smaller banks scored higher in terms of personal customer satisfaction than the four largest domestic banks. East & Partners (2014) Business Banking Index has continued to show that smaller regional banks such as BOQ and Suncorp Bank enjoy better customer satisfaction rankings than the four largest domestic banks. While there has been recent progress by other banks, the long period of high customer satisfaction levels is a significant achievement when seen in light of the funding and scale advantages enjoyed by large institutions. Size provides a significant advantage in product development and pricing.

2.4 SMALL BUSINESS – ENGINE ROOM OF THE ECONOMY

The banking sector has a special role in supporting Australia's small business sector. The small business sector is the largest employer in Australia and it is the primary source of innovation. Due to the smaller scale nature of their operations and information asymmetry, typically it is not cost-effective for small business to secure debt financing directly from wholesale markets. In addition, small businesses are large users of payment services, requiring facilities to accept payments by cheque, cash, debit card, credit card, Internet and phone.

Integrating these services into convenient and efficient product offerings can uniquely be provided by deposit-taking taking banks. Furthermore, small businesses express a strong desire for high levels of relationship banking, where banking professionals in business banking centres or branches form a long-term partnership with business owners. These partnerships give rise to efficiency in that small business owners do not have to repeatedly explain their business requirements to new staff. As shown in Section 2.3 on customer satisfaction data, the regional banks have performed very strongly in serving small business customers.

2.5 SUPERANNUATION

Superannuation has evolved rapidly since the mid-1980s when it became available to all working Australians. Prior to this superannuation was largely the preserve of the public sector and private sector executives.

Superannuation has grown to the point where Australia is one of very few countries where pension assets are greater than GDP. The Australian model of universal compulsory superannuation was intended as a supplement to the aged pension to improve the retirement incomes of working people in a financially sustainable manner.

The Australian superannuation savings pool at $1.75 trillion is in absolute and relative terms among the largest in the world.

Although still maturing, annual superannuation retirement benefit payments are now twice the age pension outlays. Superannuation has also had a profound and positive effect on the Australian financial system. Household assets are now higher and more broadly diversified. Rather than a narrow and restricted exposure to property (ie domestic residence), families through their superannuation savings now have a broader asset base including equities, infrastructure and fixed interest - this diversity providing improved risk adjusted returns.

2 INTRODUCTION AND BACKGROUND

The superannuation system provides a strong and stable base upon which to deliver a lasting and meaningful retirement incomes for many Australians and is a critical component in any policy response to the ageing of the population.

2.6 THE GLOBAL FINANCIAL CRISIS

The GFC provides the main backdrop to the FSI. It was a pivotal event in the economic and social history of many countries. While the Australian economy and financial system proved robust, the GFC has led to significant changes to the motivations and actions of consumers, businesses, financial institutions and governments.

Consumers in Australia and around the world responded to the GFC by increasing their savings levels. From the consumer perspective, savings are deferred expenditure. When savings levels rise sharply as they did in 2008, it indicates a heightened fear over job security and future income-earning potential. The GFC has reminded people there is a need to make greater provision for future consumption. Associated with higher savings rates, is less current consumer spending on goods and services and less employment for people whose jobs depend on this discretionary consumer expenditure.

Businesses also responded to the GFC with greater caution. Revenues for many businesses depend upon consumer confidence. As consumers demand less, businesses respond by adjusting production and inventories to match falling demand. A key issue for business is whether the change in consumer behaviour (as represented by the higher savings rate) is a permanent or temporary change. Since the GFC, there has been low business credit growth.

The GFC has had major impact on governments around the world, both in terms of their active involvement in crisis management, fiscal outcomes and regulatory philosophy. Crisis management took many forms, including governments taking direct ownership stakes in large distressed banks and insurance companies. Most governments, including the Australian Government, announced blanket guarantees of financial institution liabilities, including unsecured debt holders. Central banks reduced interest rates and expanded their balance sheets to inject more liquidity into their economies. Most governments also announced large stimulus programs.

Without these measures, the severity of the GFC is likely to have been far greater. In Australia's case, the liability guarantees were necessary to ensure confidence and prevent liquidity strains materialising into potential failures. The Australian Government's initiative to have the Australian Office of Financial Management (AOFM) purchase Residential Mortgage Backed Securities (RMBS) kept that market functioning.

Notwithstanding world-wide efforts to stabilise economies, most countries experienced falling asset prices, rising unemployment, and higher public debt. These outcomes created social stress and many countries experienced strong backlashes against incumbent governments. As a consequence, the G20 political group was established to provide leadership in undertaking the necessary regulatory reforms to prevent such a crisis emerging again.

2 INTRODUCTION AND BACKGROUND

2.7 BALANCING POLICY OBJECTIVES – SAFETY, EFFICIENCY, AND COMPETITION

Public policy is defined as the over-arching principles that define a society's laws, rules and conventions. These have the effect of regulating the actions of individuals and businesses with the aim of increasing the general welfare of the population. The three principles most commonly associated with financial regulation are: safety, efficiency, and competition.

2.7.1 Safety

The principle of 'safety' refers to the avoidance of major or even catastrophic events that significantly impact the well-being of a society, a community segment or even an individual. Governments will use this principle to base many laws, including prohibitions against violence, workplace safety, aviation regulation etc.

In financial services, the principle of safety has a number of different concepts. Firstly, there is the safety of an individual's savings, such as the safety of a deposit held in a bank. Secondly, the safety of a person's investment or, more specifically, the need to ensure risks are properly disclosed and understood before an investment is made.

Thirdly, safety in financial services encompasses the idea of systemic risk. This is the risk of a major disruption in financial services leading to socially destructive outcomes in the wider economy, such as mass unemployment. When the financial sector fails to function normally, households and businesses may be constrained in accessing credit or financial services needed for commerce.

It should be recognised that Australia has not experienced a systemic financial crisis since the 1890s depression. Some smaller Australian banks failed in the 1930s depression but this was contained and depositors lost a very small proportion of their savings. Throughout the 1970s, a number of financial institutions failed or were merged with strong institutions, but none of these events caused a systemic crisis. In the early 1990s, as a result of a deep recession, a number of state government-owned banks failed and Westpac and ANZ reported losses. Yet, these events did not spiral into a systemic financial or banking crisis.

Australia avoided any financial instability associated with the Asian financial crisis in 1997 and 1998 and avoided instability associated with the tech bubble crash in 2000. Similarly, Australia managed to avoid any major systemic problems throughout the GFC. Given this very long period of safety, we should have some confidence that safety and stability will not be jeopardised by efforts to improve efficiency and competition.

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Table 1
Regulatory infrastructure to protect deposits

Depositor protection	Vehicle	Description
Depositor priority in an insolvency	The Banking Act 1959	The Banking Act establishes (indirectly) deposits as the priority to be paid in the event of an ADI failure.
Explicit deposit guarantee	APS 910	Deposits in Australia up to a maximum of $250,000 are explicitly insured through the Financial Claims Scheme.
Prudential regulation	APRA prudential standards	APRA is commissioned by the Banking Act to protect depositors. In doing this they enforce 26 prudential standards on ADIs.
Mergers and acquisitions	APRA/Reserve Bank	A practical means of protecting depositors in Australia and minimising financial disruption is through the mechanism of merging weak institutions with stronger ones.

Table 1 provides a summary of regulatory devices used to protect bank deposits. Runs on bank deposits are viewed as a classic channel by which a financial crisis can originate. The Australian regulatory system places considerable importance on depositor protection.

2.7.2 Efficiency theory – allocative, productive and dynamic

Efficiency is an overarching guiding principle for public policy. Hence, government programs and policies are generally evaluated against the criterion of efficiency (Productivity Commission, 2013, p. 2). Overall economic efficiency is achieved when individuals in society maximise their utility, given the resources available in the economy.[4] An increase in economic efficiency improves the wellbeing of community members — the ultimate goal of most policy or regulatory endeavours.

Efficiency is a powerful guiding principle because it focusses policy attention on how best to harness resources and the need to remove distortions that may prevent their optimal use.

The pursuit of overall efficiency requires the achievement of allocative, productive and dynamic efficiency (Productivity Commission, 2013, p. 2):

- Allocative efficiency is achieved where resources used to produce a set of goods and services are allocated to their highest valued uses (i.e. those that provide the greatest benefit relative to costs) (Hilmer, Rayner, & Taperell, 1993, p. 4).
- Productive efficiency exists when all goods are produced at the minimum possible total cost so that there is no possible re-arrangement or alternative organisation of resources (such as labour, raw materials, and machinery) that could increase the output of one product without necessarily forcing a reduction in output for at least one other product (Kolasky & Dick, 2003, p. 244).
- Dynamic efficiency refers to the efficiency benefits achieved through research, development, and innovation, including the diffusion of technology to produce new products and processes (Fox, 2008). Dynamic efficiency brings benefits to consumers either through the introduction of improved new products that buyers value more highly ("product innovations"), or through the use of new, lower cost ways of producing existing products ("process innovations") (Commerce Commission, 2003a, p. X).

[1] This is what is known as Pareto efficiency which exists when it is not possible to change the allocation of resources in such a way as to make some people better off without making others worse off.

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It is important to be clear about the role of financial services in achieving efficiency. The financial services sector not only uses resources itself – such as employees, land, and savings – but is also involved in the channelling of these resources to other parts of the economy. The financial system is, in essence, involved in gathering the pool of savings and then transferring those savings to individuals, home buyers and entrepreneurs. When investors get loans, they use that money to employ staff, buy equipment and purchase land. So, the financial sector, through the allocation of savings process, also influences how other (non-'savings') resources are utilised in the economy.

2.7.3 Competition – theory & previous inquiries

Competition is a process of rivalry between firms, each seeking to win a customer's business. The primary objective of competition policy is to promote efficiency which in turn boosts and stimulates economic growth. According to the 1993 independent committee of inquiry into National Competition Policy (Hilmer Report):

> *Competition policy is not about the pursuit of competition per se. Rather, it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives. (Hilmer, Rayner, & Taperell, 1993, p. xvi).*

For merchants, the retail price of a product they charge is brought into some kind of relationship with cost through the competitive process (Adelman, 1957, p. 266). As the 1997 Financial System Inquiry (Wallis Report) observed:

> *In markets where the degree of competition among suppliers is high, prices are likely to reflect the underlying cost of production. Suppliers pricing above this cost will be undercut by other suppliers, thereby losing market share. (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 601)*

Thus competition forces prices down towards the cost of production which enhances allocative efficiency.

Competition promotes productive efficiency by forcing firms to cut their costs in order not to lose sales to more efficient rivals (Kolasky & Dick, 2003, p. 208). If firms cannot maintain productive efficiency with their rivals, they risk losing market share and possibly going out of business altogether. It has been recognised in the economic literature that competition plays an important role in preventing productive inefficiency.

Competition also provides a spur for dynamic efficiency. Firms undertake innovation through research and development (R&D) to improve their competitiveness. R&D can help a firm lower its costs of production and/or produce better products giving it a competitive advantage over its rivals in the market place. The benefits which firms seek to capture through R&D, namely lower costs, higher productivity and better products, if realised, will ultimately generate higher rates of economic growth.

Because of the demonstrated success of competition in driving economic efficiency and, therefore, rising living standards, governments frequently champion its importance and use it as a primary principle to guide decision-making. The current FSI has identified competition as a key objective as did the two previous financial system inquiries.

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The 1981 Australian Financial System Inquiry (Campbell Report) (Campbell, et al., 1981) and the 1997 Wallis Report (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997) placed considerable weight upon the importance of competition as the most efficient means of organising financial activity. In addition to the general concept of competition, they advocated the need to achieve competitive neutrality. These perspectives are summarised in Table 2.

In the recommendations of both the Campbell and Wallis reports, the authors recommended policy initiatives to bring about genuine improvements in the competitive operation of markets. The Campbell Report ushered in the floating of the Australian dollar, competitive tendering for government debt, deregulation of deposit and loan interest rates, and the entry of foreign banks.

The Wallis Report led to the wholesale re-structuring of financial regulation, establishing a dedicated prudential regulator, the Australian Prudential Regulation Authority (APRA), and a dedicated regulator to supervise market disclosure and conduct, the Australian Securities and Investments Commission (ASIC).

Both inquiries also recommended against allowing a financial system to have intermediaries that are "too big to fail".

Table 2
Previous inquiries - perspectives on competition

	Competition	Competitive Neutrality
Campbell Report	The Committee start from the view that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention.(p1)	…the principle is clear – investor protection arrangements, including Reserve Bank liquidity support arrangements, should aim to involve the minimum disturbance to competitive neutrality. (p.289)
Wallis Report	The efficiency of the financial system affects every business and individual in the nation. There are very large efficiency gains and cost savings which could be released from the existing system…Markets can only deliver these outcomes where competition is allowed to thrive and where consumers have confidence in the integrity and safety of the system.(p.2)	The principles of regulation which have guided the Inquiry are competitive neutrality, cost effectiveness, transparency, flexibility and accountability (p.176)… Competitive neutrality requires that the regulatory burden applying to a particular financial commitment or promise apply equally to all who make such commitments. (p.196)

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2.7.3.1 Market structure in the Australian Banking System – theoretical framework

This section establishes the theoretical framework that in turn will be used with the available evidence to assess the state of competition in the Australian banking system. As well, it defines market power and briefly touches on oligopoly theory along with coordinated effects. It also discusses how market power is identified in practice.

The economic and legal literature provides several definitions of market power. A commonly-used definition is the following:

> *A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions. (Kaysen & Turner, 1959, p. 75)* [5]

Another definition of market power is "the ability of a firm to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded" (Landes & Posner, 1981, p. 937).

An oligopoly is a market structure characterised by a few participants. It may include a "competitive fringe" of numerous smaller sellers who behave competitively because each is too small individually to affect prices or output (Areeda, Solow, & Hovenkamp, 2002, p. 9). The provision of financial services in Australia – that is dominated by the four large banks – could be characterised as an oligopoly that is supplemented by a competitive fringe that includes regional banks and customer owned banks (credit unions and building societies).

A number of theories of oligopoly predict that once firms recognise their interdependency, their most rational course of action would be to behave in a manner reminiscent of a monopoly. The outcome from these models has been described as tacit collusion, also known as coordinated effects. While firms are not necessarily part of a formal cartel arrangement, the firms are able to coordinate their conduct so that an outcome similar to cartel or monopoly is achieved.

However, just because a market is characterised as having an oligopoly structure does not necessarily mean that it will be prone to coordinated effects and the abuse of market power. Identifying firms that have substantial market power enables one to distinguish between conduct that might harm consumers and conduct that cannot (Bork & Sidak, 2013, p. 511). Unfortunately, there is no definitive test. Instead, one must rely on a series of partial indicators in order to determine whether firms participating in a market are exercising market power. According to competition law expert Robert Bork and Professor Gregory Sidak of Tilburg University (2013, p. 512):

> *Courts and competition authorities around the globe typically rely on indirect evidence of market power, such as market share and barriers to entry.*

While market concentration can provide guidance as to which markets are likely to raise competition concerns, it is certainly not the be all and end all of the matter. Market concentration is only one of a number of factors that should be relied upon in determining whether a market is likely to result in any abuse of market power. These other factors include the height of barriers to entry and the extent of sunk costs incurred by new entrants.

[5] This definition has been used by the Australian Competition and Consumer Commission (2002, p. 64) and cited with approval by Dawson J in Queensland Wire Industries Proprietary Limited v The Broken Hill Proprietary Company Ltd and Anor (1989) 167 CLR 177 at 200.

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Prominent industrial organisation economist Joseph Bain (1956) considered the force of potential competition as a regulator of price and output is just as important as actual competition. Bain focussed on the height of barriers to entry as the critical determinant of the price level. According to Bain, the extent of barriers to entry in an industry indicated the advantage that existing sellers enjoyed over potential entrants.

Any entry cost that is unrecoverable is a sunk cost. The need to sink costs into a new firm imposes a difference between the incremental cost and the incremental risk that are faced by a new entrant and an incumbent firm (Baumol & Willig, 1981, p. 418). In the case of an incumbent, such funds have already been expended and they are already exposed to whatever risks the market entails. In contrast, the new firm must incur any entry costs on entering the market that incumbents don't bear.

The entry of new firms into a market can provide an important source of competitive constraint on incumbents (Australian Competition and Consumer Commission, 2008, p. 38). If new entrants are able to offer customers an appropriate alternative source of supply at the right time, any attempt by incumbents to exercise market power will be unsustainable since their customers will simply switch to the new entrants. The existence of sunk costs, which increases the risks of, and costs associated with, failed entry, may deter new entry altogether.

2.7.4 Safety and efficiency – the real policy trade-off

It has been argued the presence of market power actually increases the stability of the financial system. While there is plenty of literature in support of this view, more recent literature suggests that competition actually increases the stability of the financial system.

Leading on from the literature that market power increases financial stability, there is a view that the key policy trade-off in financial services regulation is that of financial safety versus competition. According to Professor John Boyd of University of Minnesota and Gianni De Nicolo of the International Monetary Fund (IMF) (2005, p. 1332):

> *… we believe there is a widely held view among policy makers that reduced competition in banking is not necessarily bad because, other effects not withstanding, reduced competition results in a more stable banking industry…*

There is not strictly a trade-off because unlike the policy principle of 'safety', competition is not an end-goal in itself. Competition is the tool to achieve efficiency. Therefore, the real trade-off between policy objectives is that between safety and efficiency. Confusion on this arises because competition is so closely associated with efficiency and any attempt to increase efficiency usually involves taking measures to increase competitive pressure.

2.7.5 There is a case for increasing efficiency in the financial services sector

There is a case to re-balance regulation in Australia towards promoting efficiency over that of financial stability. Australia has not had a financial crisis since 1890s, yet there is evidence of significant inefficiencies inherent in both the size of the financial sector and the allocation of resources that flows through that system. This is further examined in the next chapter.


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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

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As discussed in chapter 2, the regional banks believe at a high principle level there is a case for shifting banking policy towards efficiency and competition. Australia's history of financial stability and the recent strengthening of prudential regulations give us confidence that reforms to improve efficiency and competition will not compromise stability objectives.

The purpose of this chapter is to provide further evidence to the FSI Panel of the merits of giving efficiency and competition greater weight in policy and regulation. The chapter looks at a range of indicators which suggest considerable scope exists to improve efficiency and competition outcomes.

3.1 GROWTH AND SIZE OF THE FINANCIAL SECTOR

Strong growth or size of any sector can be an indicator of inefficiency. The financial services sector, which is dominated by banking, but also includes insurance, and superannuation, has emerged over the last thirty years to be Australia's second largest industry.

In the mid-1970s, financial services accounted for four per cent of Australia's gross domestic product (GDP) – in that year it was the ninth largest industry sector. The common metric used to determine relative size of industries is gross value added (GVA) which is an estimate of the amount of wages and profits attributable to that industry. This is a proxy for contribution to GDP.

Since the mid-1970s, the financial sector has grown rapidly, increasing its contribution to GDP to around 9%. Today it is the second largest industry behind mining. In 2007, it was Australia's largest industry sector according to the National Accounts published by the Australian Bureau of Statistics (ABS) (2013).

As a percentage of GDP, financial services has been flat since the GFC in 2007 but has increased about two percentage points of GDP since the Wallis Report in 1997.

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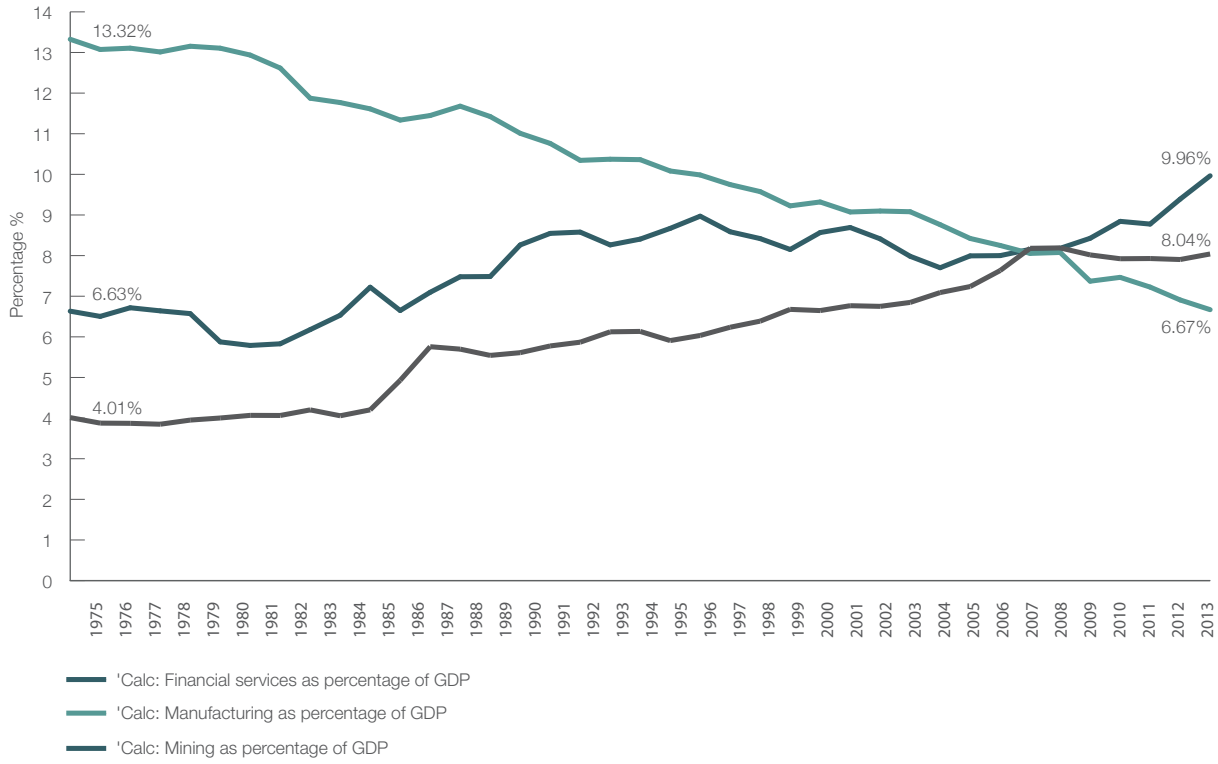
Figure 3.1 Financial services as a percentage of total value added



Source: ABS data; Pegasus Economics.

A key period of growth was in the years following financial sector deregulation in the mid-1980s, up until the recession of 1990.

After the 1990s, growth was flat for a few years before increasing at a steady rate until 2007. Growth in Australia's financial system appears to be related to deregulation in the 1980s which freed banks from price and lending controls.

A notable feature in Australia is the performance of the sector since the GFC. Unlike in most countries, Australia's financial system has not materially contracted as a proportion of GDP.

Figure 3.1 traces contribution of financial services to GDP and compares this growth with that of mining and manufacturing.

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3.1.1 International comparison

Comparisons with other countries is often problematic difficult due to data limitations. However, the available data suggest Australia's financial system is comparatively large. One means of assessing this is to compare GVA between countries which, as mentioned above, is essentially the amount of money paid to employees plus the industry's profits which are returned to shareholders and tax.

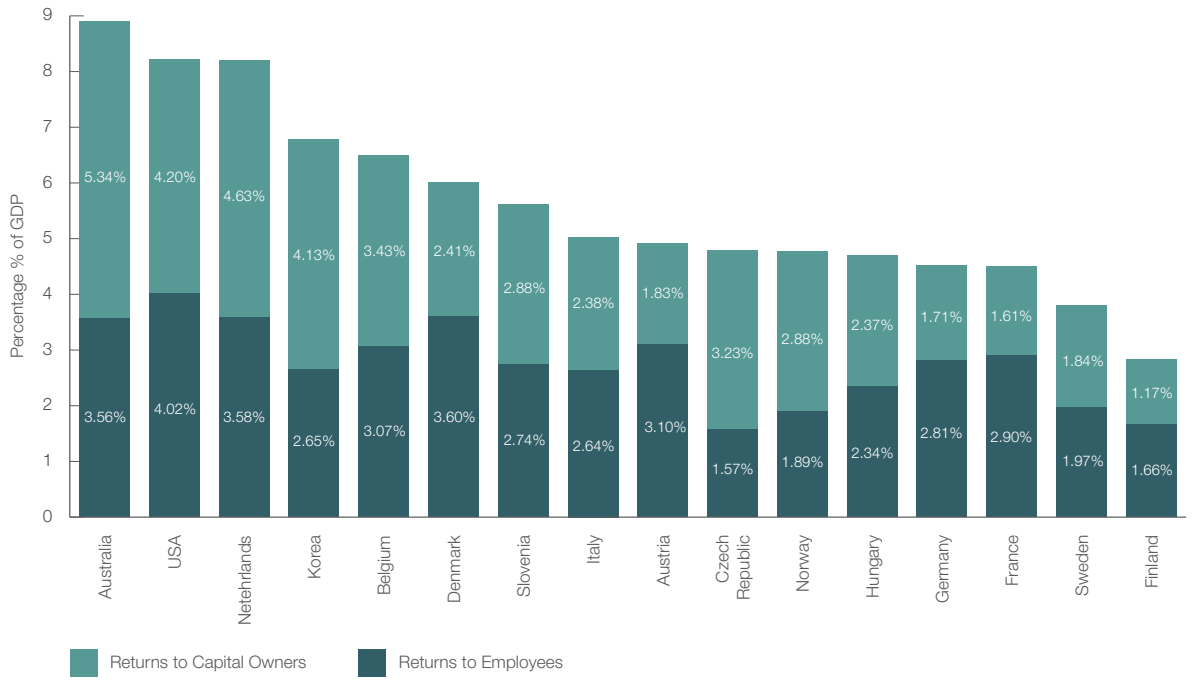
The ABS publishes estimates for Australia and the Organisation for the Economic Co-operation and Development (OECD) collects and publishes data from its member countries. Figure 3.2 shows estimates across sixteen countries. In the latest year for which a comprehensive dataset is available, 2011, the chart reveals the Australian financial system accounts for 9% of GDP, greater than all the other surveyed countries.

Another way to think about this is that Australia uses more of its total income paying for financial services than do all the other surveyed countries. The size of Australia's superannuation savings pool contributes to the comparatively large size of the financial system. However, Australia's financial system relative to GDP still exceeds countries with a sizeable private pension pool, such as the USA and Netherlands.

In other words, the cost of getting funds from savers to those who need capital is equal to 9% of total income earned.

There is insufficient data to be definitive as to why Australian consumers and businesses are paying more for financial services than other countries. One possible explanation is that Australians get better quality services than people in other countries and are willing to pay for them. Another explanation is that Australian consumers demand a greater number or greater volume of financial services. Another is that there is a lack of competitive tension to drive costs down.

Figure 3.2 Relative size of financial sectors



Source: ABS; OECD; Pegasus Economics calculations

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3.2 CREDIT INTO DOMESTIC HOUSING - EFFICIENCY

There are also concerns that too much bank credit has been directed into residential real estate. This issue is discussed more fully in the section 4.1 on capital adequacy, however, the essential story is outlined here. The amount of credit flowing into housing raises allocative efficiency questions given that excessive housing investment is generally less productive than business credit.

Since the early 1990s up until today, the growth of housing credit has been nearly double that of business lending. There is evidence that this growth in housing credit (and associated increase in household debt) has not resulted in beneficial social outcomes. This raises allocative efficiency concerns.

The ABS (2013b) publishes an annual progress report on Australia which rates Australia's progress against key social goals. The ABS had this to say on the level of home ownership in Australia:

Tenure, as measured by the level of home ownership in Australia, has regressed since 1995

…Australians told us that having secure tenure is an important aspect of home. Tenure not only refers to a person's legal right to occupy a dwelling but the stability and security that it provides. Tenure can include owning (with or without a mortgage) a dwelling and /or land; and renting, with a formal lease or similar arrangement. Those who own their own homes are widely considered to have greater security in being able to stay in the dwelling, freedom to modify it and the ability to use it as a substantial financial asset. However, there are benefits of renting as well, including; a smaller financial commitment, opportunity of making financial investments in other assets and the flexibility to move elsewhere.

…We have decided tenure in Australia has regressed since 1995 because the proportion of households that own their home (with or without a mortgage), our progress indicator for tenure, has decreased.

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On affordable housing, the ABS commented:

> *Affordable housing in Australia has regressed since 2004*
>
> *…Housing affordability is most often seen as the capacity of households to meet their current and future housing costs from their own economic resources. Those resources are mainly their current and future incomes, but may also include assets. Many households exercise choice in making their consumption, savings or investment decisions, including for housing. Housing affordability measures should shed light on the economic circumstances of households that may experience difficulty entering or remaining in the housing market, because of their limited economic resources or changing circumstances.*
>
> *…We have decided affordable housing in Australia has regressed since 2004 because rental costs as a proportion of household income for low income rental households, (our progress indicator for affordable housing) have increased.*

On the adequacy of the housing stock, the ABS states:

> *Adequate housing in Australia has not changed greatly since 2004*
>
> *…Housing adequacy is a relative concept and can be considered in a number of ways depending on peoples' views of what is adequate. For this element, housing adequacy is defined as the suitability of a home to permit a reasonable quality of life, with adequate access to employment and education; health and community services and public amenities. This covers aspects such as whether a home is of sufficient size so that its occupants are not living in overcrowded conditions; whether a home is in reasonable repair; provides the basic amenities; and is located to allow access to essential services.*
>
> *…We have decided adequate housing in Australia has shown little change since 2004 because the number of households living in overcrowded conditions (our progress indicator for adequate housing) hasn't moved much.*
>
> *In 2011-12, the proportion of households living in overcrowded conditions was 3%, which was unchanged since 2003-04.*

Households' housing debt in 1995, as a proportion of disposable income was 55% (Reserve Bank of Australia, 2014). Today it is 133%, almost a three-fold increase.

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3.3 IS SMALL BUSINESS GETTING SUFFICIENT ACCESS TO BANK CREDIT?

Allocative efficiency questions also arise in the context of lending to SMEs. The main question is whether banks have allocated sufficient lending to this sector. SME representatives often cite the difficulty in obtaining finance and/or the stringent collateral requirements that apply as a barrier to growth and innovation.

Since 2007, business credit has barely grown. Debate often centres around the issue of whether this is due to lack of business demand for credit, a tightening in supply, or a combination of both. What is clear from the available data examined is that businesses have a strong perception they cannot obtain sufficient funds to operate their businesses, particularly smaller businesses seeking to innovate.

The ABS (2013c) surveys businesses for its annual publication of business characteristics. It classifies businesses by size of employees. There are four size buckets: (a) 0 – 4 employees; (b) 5-19 employees; (c) 20-199 employees, and (d) 200 + employees. For the purposes of analysis for this submission, all businesses with employee numbers under 19 are considered 'small businesses'. Those with 20-199 and 200 + are considered medium and large businesses respectively.

Apart from splitting businesses into size categories, the ABS also classifies businesses as being "innovative-active" and "non-innovative active". Combining both of these groups gives an estimate for "all businesses". Innovative active businesses are those companies that are actively seeking to improve their products and production processes. Furthermore, the ABS survey divides barriers to businesses from two perspectives – barriers to (i) general business performance, such as profit, and (ii) barriers to innovation.

The data used in this submission is based on annual surveys going back to 2007. Earlier surveys are available but the formats are materially different and more difficult to compare from year to year. In any event, the ABS does warn against annual comparisons given the nature of the sample. To aid analysis, three time periods are chosen. The years 2007 and 2008 are defined as 'pre-GFC'. While September 2008 saw the collapse of Lehman Brothers and the commencement of the deepest part of the crisis, the ABS's 2008 year survey was based on 12 months of data up until (at the latest) 30 September 2008.

In terms of the barriers to general business performance, the lack of access to additional funds (credit and debt) does not appear to be a priority issue for either large, medium or small business since 2007. This can be seen from Table 3 where of the ten barriers surveyed, the highest ranking given to lack of access to additional funds is by small businesses in the depths of the GFC period of 2009/10/11, where, on average, surveyed small businesses revealed it was the fourth most significant barrier to performance.

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Table 3 Barriers to business performance – ranking of issues

			Category detail (group) / GFC period buckets								
			Large Business			Medium-size Business			Small Business		
Business perspective	Innovation status	Barrier type	Pre-GFC period - 2007/08	GFC period 2009/ 10/11	Post-GFC 2012	Pre-GFC period - 2007/08	GFC period 2009/ 10/11	Post-GFC 2012	Pre-GFC period - 2007/08	GFC period 2009/ 10/11	Post-GFC 2012
Barriers to general business performance	All businesses	Lower profit margins to remain competitive	3	3	1	3	1	1	1	1	1
		Lack of customer demand for goods or services	9	4	5	9	4	5	7	3	2
		Outstanding accounts receivable limiting cash flow	10	9	10	6	6	7	4	5	6
		Lack of access to additional funds	8	6	7	8	5	8	6	4	5
		Lack of skilled persons: in any location	1	1	3	1	2	2	2	2	3
		Cost of inputs	5	5	2	7	9	6	8	8	4
		Government regulations and compliance	6	8	4	5	7	4	9	7	7
		Lack of skilled persons: within the labour market	2	2	5	2	3	3	3	6	8
		Lack of skilled persons: within the business	4	7	8	4	8	9	5	9	9
		Environmental factors	7	10	9	10	10	10	10	10	10
	Innovation - active businesses	Lower profit margins to remain competitive	3	2	1	3	1	1	1	1	1
		Lack of customer demand for goods or services	9	4	6	9	6	8	8	5	2
		Outstanding accounts receivable limiting cash flow	10	9	10	6	5	6	5	4	3
		Lack of access to additional funds	8	6	7	8	4	6	4	2	4
		Lack of skilled persons: in any location	1	1	3	1	2	2	2	3	5
		Cost of inputs	5	5	2	7	9	4	6	6	6
		Government regulations and compliance	6	8	4	5	8	5	9	8	7
		Lack of skilled persons: within the labour market	2	3	5	2	3	3	3	9	8
		Lack of skilled persons: within the business	4	7	8	4	7	9	7	7	9
		Environmental factors	7	10	9	10	10	10	10	10	10

Source: ABS Business Characteristics Survey, various issues; Pegasus Economics.

Business size determined by numbers of employees: Large business (>200); medium (20-199); small (0-19).

For those small businesses identified as "innovative-active" lack of access to funds was a more significant issue during the GFC years. These businesses revealed that it was the second most material barrier after the need to lower profit margins to maintain competitiveness. For innovative-active large and medium businesses, the lack of access to funds during the GFC years was ranked 6 and 4 respectively (out of ten factors).

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While not seemingly a critical problem facing businesses in achieving general business goals, the data shows that a lack of access to additional funds is the most significant barrier to innovation, particularly for small business. For those small businesses wanting to innovate and are classified as innovative-active businesses, lack of access to additional funds was recorded as the number one barrier for not only the GFC period but also the post-GFC period (2012). For medium-size businesses, lack of access to funds is identified as the second most significant barrier. These rankings can be seen in Table 4.

The story implicit in the ABS data is the real issue in terms of lack of finance is in relation to small and medium-size businesses that are seeking to innovate. These business probably represent a greater risk to lenders, but they are regarded by governments and policy makers as critical to driving productivity and long-term improvements in living standards.

Table 4 Barriers to business innovation - ranking issues

			Category detail (group) / GFC period buckets								
			Large Business			Medium-size Business			Small Business		
Business perspective	Innovation status	Barrier type	Pre-GFC period - 2007/08	GFC period 2009/ 10/11	Post-GFC 2012	Pre-GFC period - 2007/08	GFC period 2009/ 10/11	Post-GFC 2012	Pre-GFC period - 2007/08	GFC period 2009/ 10/11	Post-GFC 2012
Barriers to innovation	All businesses	Lack of access to additional funds	6	4	6	4	2	2	4	2	1
		Lack of skilled persons: in any location	1	1	2	1	1	1	1	1	2
		Cost of development or introduction/implementation	4	3	1	6	6	6	5	3	4
		Uncertain demand for new goods or services	7	6	3	7	7	7	7	7	3
		Lack of skilled persons: within the business	3	5	6	3	4	5	3	4	7
		Government regulations or compliance	5	7	4	5	5	4	6	6	5
		Lack of skilled persons: within the labour market	2	2	5	2	3	3	2	5	6
		Lack of access to knowledge or technology	8	9	9	8	9	9	8	9	8
		Adherence to standards		8	8		8	8		8	9
	Innovation-active businesses	Lack of access to additional funds	6	4	7	4	2	2	2	1	1
		Lack of skilled persons: in any location	1	1	2	1	1	1	1	2	2
		Cost of development or introduction/implementation	4	2	1	5	5	6	5	3	3
		Uncertain demand for new goods or services	7	6	3	7	7	7	6	5	4
		Lack of skilled persons: within the business	3	5	6	3	4	3	4	4	5
		Government regulations or compliance	5	7	4	6	6	5	7	6	6
		Lack of skilled persons: within the labour market	2	3	5	2	3	4	3	7	7
		Lack of access to knowledge or technology	8	8	9	8	9	9	8	9	8
		Adherence to standards		9	8		8	8		8	9

Source: ABS Business Characteristics Survey, various issues; Pegasus Economics.
Business size determined by numbers of employees: Large business (>200); medium (20-199); small (0-19).

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

Since 2008 when Basel II commenced, banks have collectively increased their portfolio lending to housing and decreased their exposure to small and large businesses.

Table 5 provides more granular detail on these changes. Aggregate bank lending is broken down into key categories, including seven industry sectors, personal/household lending and lending to government. Further, the industry categories are split between lending to SME businesses and that of large businesses. These are defined as those businesses with loans under $2m and those with loans above $2m respectively.

Table 5 Changes in bank lending portfolio structure since 2008

		Date	
Loan category	**Industry category - detail (group)**	**2008 Q1**	**2013 Q3**
Agriculture, fishing, etc	SME Business	2.24%	1.54%
	Large business	1.36%	1.23%
Construction	SME Business	0.89%	0.80%
	Large business	1.25%	0.48%
Finance & insurance	SME Business	0.61%	0.71%
	Large business	8.03%	4.48%
Manufacturing	SME Business	0.81%	0.59%
	Large business	2.28%	1.20%
Mining	SME Business	0.14%	0.13%
	Large business	0.74%	0.98%
Other industry	SME Business	6.37%	5.56%
	Large business	13.60%	10.73%
Wholesale trade, retail trade and transport & storage	SME Business	2.50%	1.90%
	Large business	3.37%	2.91%
Personal / household	Housing	46.87%	54.86%
	Personal loans - fixed	3.60%	1.69%
	Personal loans - variable	4.08%	2.87%
Government	Government securities	0.97%	6.64%
	Other	0.29%	0.72%

Source: The underlying data for this table is from the Reserve Bank's Statistical Table D5 and D7. SME is defined as businesses with loans under $2m, large business is defined as having loans greater than $2m. Aggregations and calculations undertaken by Pegasus Consulting.

3 EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

The results show that in nearly every lending category other than housing and lending to government, banks have collectively either reduced their portfolio weighting or increased very marginally.

3.4 BARRIERS TO ENTRY AND SUNK COSTS IN AUSTRALIA

Available evidence suggests that barriers to entry and sunk costs are high in the provision of financial services.

In the first place there are a number of regulatory barriers to overcome in order to become a provider of financial services. Parties wishing to become an Authorised Deposit-taking Institution (ADI) need to apply to APRA for a licence. Once parties have obtained a licence to become an ADI, they then need to comply with various prudential and capital adequacy requirements. According to the Australian Competition and Consumer Commission (ACCC) (2008a, p.13):

> *Regulatory barriers are significant for authorised deposit-taking institutions but also appear to be high for specialist credit card institutions. Both types of institutions are required to comply with a host of prudential regulations, including large capital requirements.*

The ACCC (2008a, p.13) also considers that the high degree of customer 'stickiness' for many retail banking products may further increase barriers to entry. It has been estimated that switching rates for transaction accounts are around 8-10 per cent per annum (Fraser, 2011, p.4). Low levels of switching rates can create a barrier to expansion for other providers as transaction accounts serve as a 'gateway' for the provision of other financial services (UK Office of Fair Trading, 2010, p.10).

Another barrier is the capital costs associated with creating a physical presence for those products that require a physical presence to attract market share (Australian Competition and Consumer Commission, 2008a, p.13). Back in 2008, the ACCC assessed that it would cost in the order of $70 million to roll out a branch and ATM network of a size sufficient to attract a transaction account market share of at least 10% in a state market the size of WA, and that cost of establishing a bank branch was $800,000 while the cost of a new ATM was $45,000.

Branding can also be considered to be another barrier to entry in the provision of financial services (UK Office of Fair Trading, 2010, p.11). The UK Office of Fair Trading has found consumers in the UK are wary of switching across to an unknown banking brand.

The UK Office of Fair Trading (2010, p.11) found that when switching, branding and branch network together are taken together, that customer inertia remains a key barrier for potential entrants and smaller firms to attract customers and achieve sufficient scale to be able to recover costs, many of which are sunk.

In order to be able to effectively provide retail financial services to customers, firms require IT systems. According to the UK Office of Fair Trading (2010, p.8), the development of IT systems involve a substantial cost for a new entrant, much of which is likely to be sunk and not recoverable in the event of market exit.

The presence of high barriers to entry coupled with high sunk costs in banking means there is the potential for the exploitation of market power in the provision of financial services.

High market-to-book ratios (as discussed later) are also an indication of high entry barriers.

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

3.5 BANK PROFITABILITY

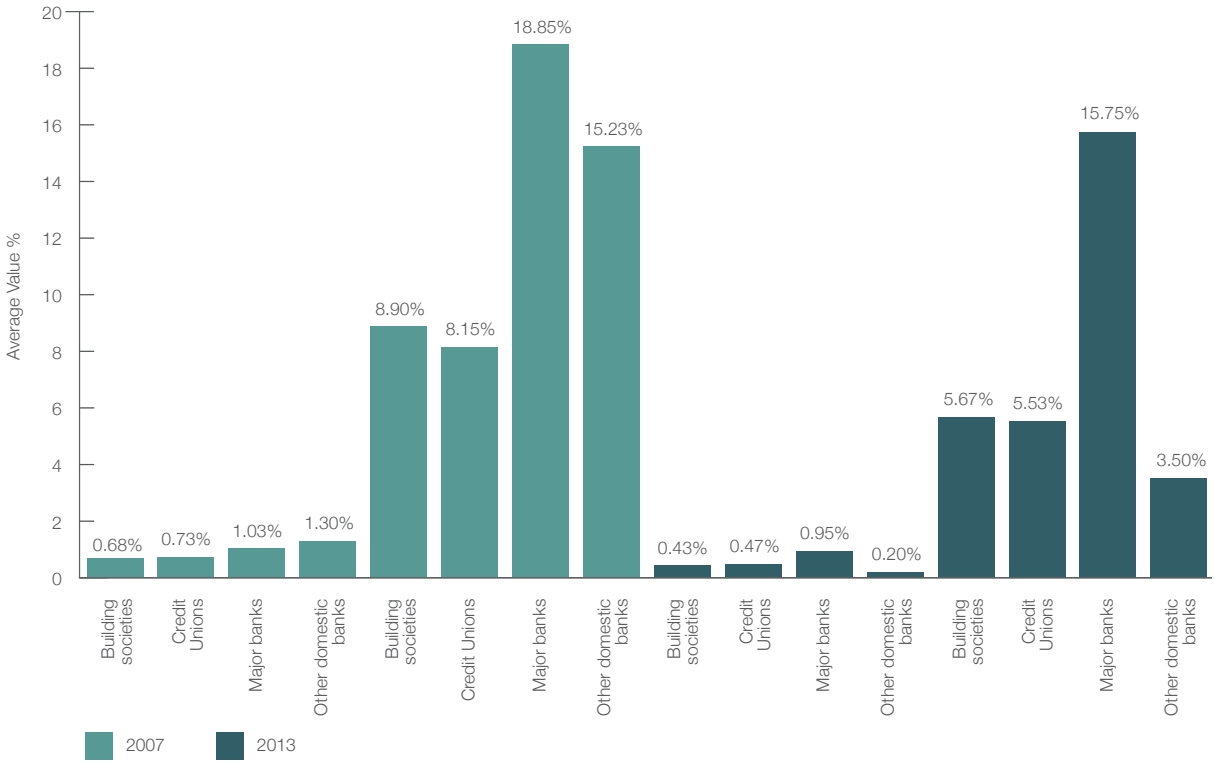
Excessive profitability over a period time is one sign that competition problems may exist in a market or industry, as explained by the Wallis Report (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 605):

> *The profitability of industry participants and the pricing of their products are sometimes used as an indicator of the underlying level of competition in a particular market.*

Figure 3.3 summarises return on equity and assets for two periods, pre-GFC (2007) and post GFC (2013). Return on equity is calculated as after-tax profit divided by shareholder's equity.

Return on assets uses the same numerator, after-tax profits but divides this by the bank's total asset base. This measure gives an indication of how effectively management is maximising returns from the businesses' assets and it is not impacted by changes in a banks' capital levels. APRA's quarterly performance data gives time-series profitability data for categories of financial institutions, including building societies, credit unions, major banks and other domestic banks. APRA's data is consolidated data from across all banking businesses, including overseas operations.

Figure 3.3
Return on equity and assets – domestic comparison



Source: APRA quarterly performance survey; Pegasus Economics

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

Before the GFC in 2007, profitability of most institutions was greater than it was in 2013. In 2007, the four large banks recorded return on equity (ROE) of 18.85% compared to 15.75% in 2013. Data for other domestic banks show considerably greater volatility with 15.23% ROE in 2007 and just 3.5% in 2013.16.

On return on assets (ROAs), other domestic banks recorded 1.3% in 2007, compared to just 0.2% in 2013, a considerable decline. In contrast, the major banks have slipped marginally from 1.03% in 2007 to 0.95% in 2013.

Differences between the profitability of major banks and other banks reflect differences in the cost-base of the smaller institutions relative to the large institutions. These higher costs reflect, in part, regulatory factors as discussed in chapter 4.

Over many decades, the major banks have produced strong ROE results, both pre and post-deregulation in the mid-1980s. Only in the deep 1990s recession were profit levels materially impacted with a negative ROE recorded in 1992 as a result of a spike in bad debt charges. Even after that event, ROEs returned within a few years to their long-term trend of around 15%.

During the GFC, returns to shareholders remained above 11%. This is considered a very strong result given the turmoil that beset most banking systems in the US and throughout Europe.

Since 2002, the major bank's ROEs have averaged just over 15%. The peak of 18.7% average ROE across these banks was achieved in 2007 and the low-point of 11% was recorded in 2009. The data in the APRA's June 2013 performance survey shows the four large banks' ROEs – on average - have increased above the decade long trend, a notable performance given continued sluggishness in credit growth. More recent data released by individual banks shows 2013-14 is likely to be another high return year. The CBA's half-year to December 2013 recorded an ROE of 18.7%. [6]

3.5.1 International comparisons

International comparisons of profitability can be problematic due to differences in definitions of profit and accounting treatments. However, the evidence available suggests Australia's largest banks appear comparatively very profitable.

The Bank of International Settlements (BIS) produces comparative profit estimates in its annual reports. The estimates use the Bankscope database. Estimates included in the BIS's 2013 annual report are reproduced in Figure 3.4. There are two profitability indicators published. The first is pre-tax profits as a proportion of total assets. This is similar to the ROA referred to above, the difference being that the BIS estimate uses pre-tax profit.

Pre-tax estimates wash out the influence of an individual country's tax policies on profit estimates. This enables a purer assessment of each country's banking system in generating underlying profit.

The chart shows that in the pre-GFC period 2000 to 2007, only the United States' banking system recorded a higher profit than Australia's (excluding developing countries).

In the years 2008-11, roughly aligning to the period of the GFC, Australia recorded the highest profits of all the modern industrialised countries surveyed, including Canada, which is often identified as a country with a comparable banking system to Australia's and similarly had relative stability during the GFC.

In 2012, a year in which financial stability returned to most countries, Australia's major banks once again recorded the highest profits of the modern industrialised countries surveyed.

[6] https://www.commbank.com.au/about-us/shareholders/financial-information/results.html

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

Figure 3.4 International comparisons

Profitability of major banks - international comparison - BIS data

As a percentage of total assets

	Period / Profit indicator					
	2000-07		2008-11		2012	
Country	Net interest margin	Pre-tax profits	Net interest margin	Pre-tax profits	Net interest margin	Pre-tax profits
Australia	1.960	1.580	1.810	1.070	1.820	1.180
Brazil	6.560	2.230	4.770	1.610	4.420	1.500
Canada	1.740	1.030	1.570	0.800	1.650	1.070
China	2.740	1.620	2.320	1.560	2.390	1.830
France	0.810	0.660	0.960	0.290	0.900	0.190
Germany	0.680	0.260	0.810	0.060	0.830	0.090
India	2.670	1.260	2.350	1.340	2.900	1.450
Italy	1.690	0.830	1.860	-0.030	1.650	-0.060
Japan	1.030	0.210	0.920	0.360	0.840	0.560
Russia	4.860	3.030	4.700	1.460	4.090	2.390
Spain	2.040	1.290	2.310	0.940	2.360	0.080
Sweden	1.250	0.920	0.930	0.560	0.920	0.680
Switzerland	0.640	0.520	0.520	-0.050	0.600	0.030
United Kingdom	1.750	1.090	1.140	0.190	1.080	0.200
United States	2.710	1.740	2.530	0.420	2.340	0.960

Source: Bank of International Settlements (BIS) (based on Bankscope data). See Table V.1 of BIS annual report 2013 and data description.

3.6 MARGINS

The other profitability indicator assessed by BIS is the net interest margin (NIM). This is a ratio of total interest received minus total interest paid, expressed as a proportion of total assets. NIM is often viewed as an indicator of competition because it is the effective price of intermediation services charged by banks.

The BIS data shows that in the 2000-2007 period, only the US and Spain had a higher average ratio than Australia. In the period 2008-11, three modern industrialised countries exceeded Australia, although Canada was still significantly lower than Australia. In 2012, the net interest margin in Australia was higher than all modern industrialised countries other than the US and Spain.

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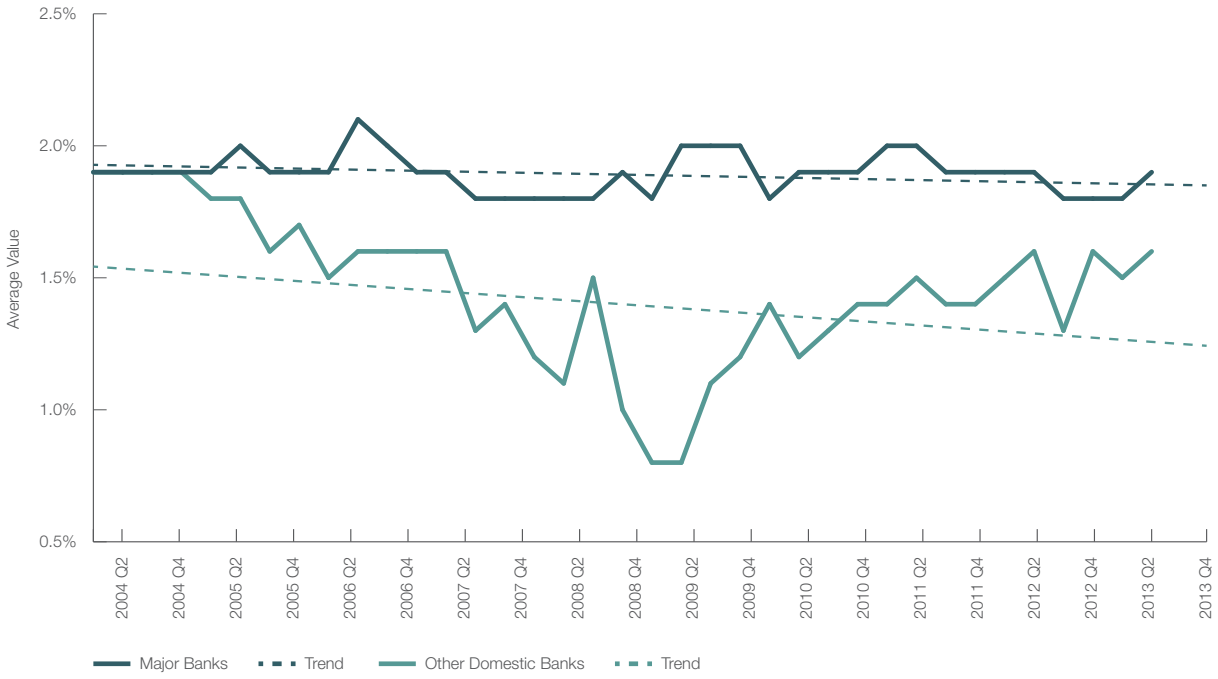
EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

Figure 3.5 Net interest margins



Source: APRA quarterly performance survey; Pegasus Economics

The performance of the major banks in generating strong net interest margins (NIM) needs to be considered in light of their balance sheet structure.

Australia's largest banks are unusual compared to banks in most other countries because of the size of their mortgage lending books relative to total assets. The equivalently sized banks in most other countries have a much higher proportion of commercial lending which is riskier than mortgage lending and would be expected to result in a higher net-interest ratio.

S&P regard the Australian banks as amongst the top five most stable in the world.

This implies the pricing power (as indicated by the NIM) of the major banks is even stronger than that suggested by the BIS data. See Section 3.10 for UBS analysis of margins in the housing finance market. Figure 3.5 demonstrates the resilience of the major bank's NIMs. Even through the GFC, margins remained reasonably stable, especially when compared to other banks.

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

3.7 PRICE-TO-BOOK RATIOS

The price-to-book ratio of firms, also known as Tobin's q ratio, indicates the extent to which equity investors believe in the future performance of the stock. This is often viewed as an indicator of market power and therefore an indicator of competition problems.

This ratio is derived by dividing the market value of company, calculated as the number of shares multiplied by the listed price of those shares, divided by the value of the firm's net assets as estimated in their financial statements.

A high ratio, materially greater than one indicates investors are confident the business is sufficiently well positioned to produce superior future results. For this reason, commentators' view it as an indicator of market power. In theory, at least, in a competitive market a company's net assets (equity) as disclosed in its balance sheet statement should be roughly equivalent to the market value of its shares.

According to Lindenberg and Ross (1981, p. 2)

> *The essence of the argument is that for a competitive firm, one would expect q to be close to one, and as we examine firms with increasing monopoly power (increasing ability to earn above a competitive return), q should increase. If a firm's q is greater than one, the market value of the firm is in excess of its replacement cost. If there is free entry, other firms could enter the industry by purchasing the same capital stock as the existing firm. Furthermore, they would anticipate an increase in value over their investment because its market value would exceed its cost. Thus, in the absence of barriers to entry and exit, q will be driven down to one as new firms enter (or existing firms expand if average and marginal q coincide)… A monopolist, however, who can successfully bar entry and is not adequately regulated will earn monopoly rents in excess of the ordinary returns on the employed capital. The market will capitalize these rents, and the market value of the firm will exceed the replacement cost of its capital stock, that is, q will persist above one.*

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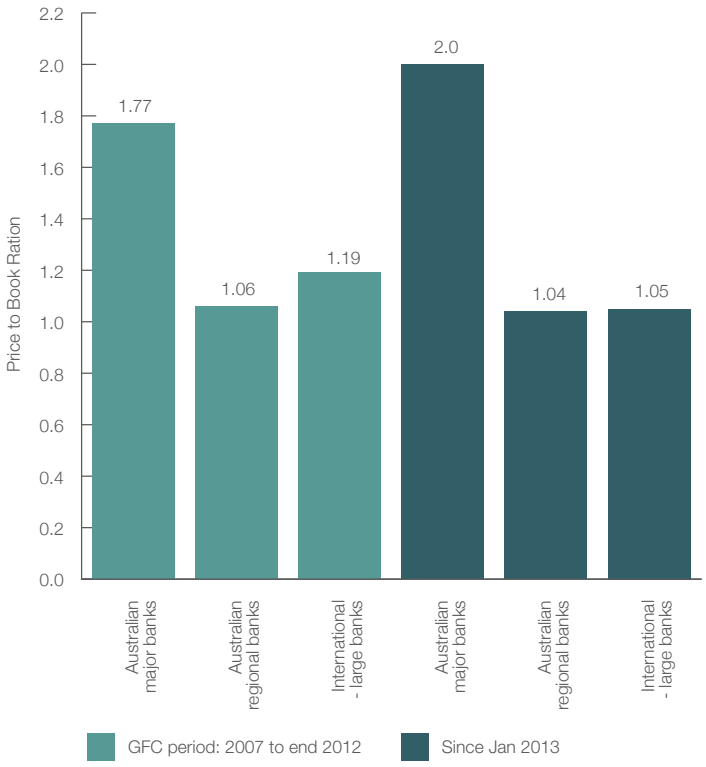
EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

According to Michael Keeley (1990, p. 1186) q appears to be useful proxy for market power. Table 6 below compares the major banks' price-to-book ratios with Australian regional banks and with a series of large international banks. The data results show that the major Australian banks have recorded materially higher ratios than other Australian and international banks. The selection of international banks includes institutions from North America, Europe and Asia.

In the last twelve months, the average q ratio of the major banks has been 2.0, meaning investors believe that the value of these banks is twice what is recorded in their financial statements. This compares to an international average of 1.05 – therefore the major banks' market-to-book ratio is twice that of comparable banks overseas. The Australian regional banks have recorded an average q-ratio of 1.04 which is consistent with the international average. During the GFC period from 2007 to 2012, the average q ratio for the four major banks was 1.77, compared to large banks overseas at 1.1 and Australian regionals of 1.05.

Table 6 Price to book ratio - international comparisons since GFC



Source: Datastream sourced via a regional bank. Other banks category includes: Wells Fargo, US Bancorp, Bank of America, TD Bank, RBC, Capital One Financial, Santander, BBVA, Deutche Bank, BNP Paribas, Danske, Barclays, Lloyds, RBS, OCBS, DBS, ICBC, Bendigo, BOQ, ANZ, NAB.

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

3.8 MARKET SHARES AND CONCENTRATION TESTS

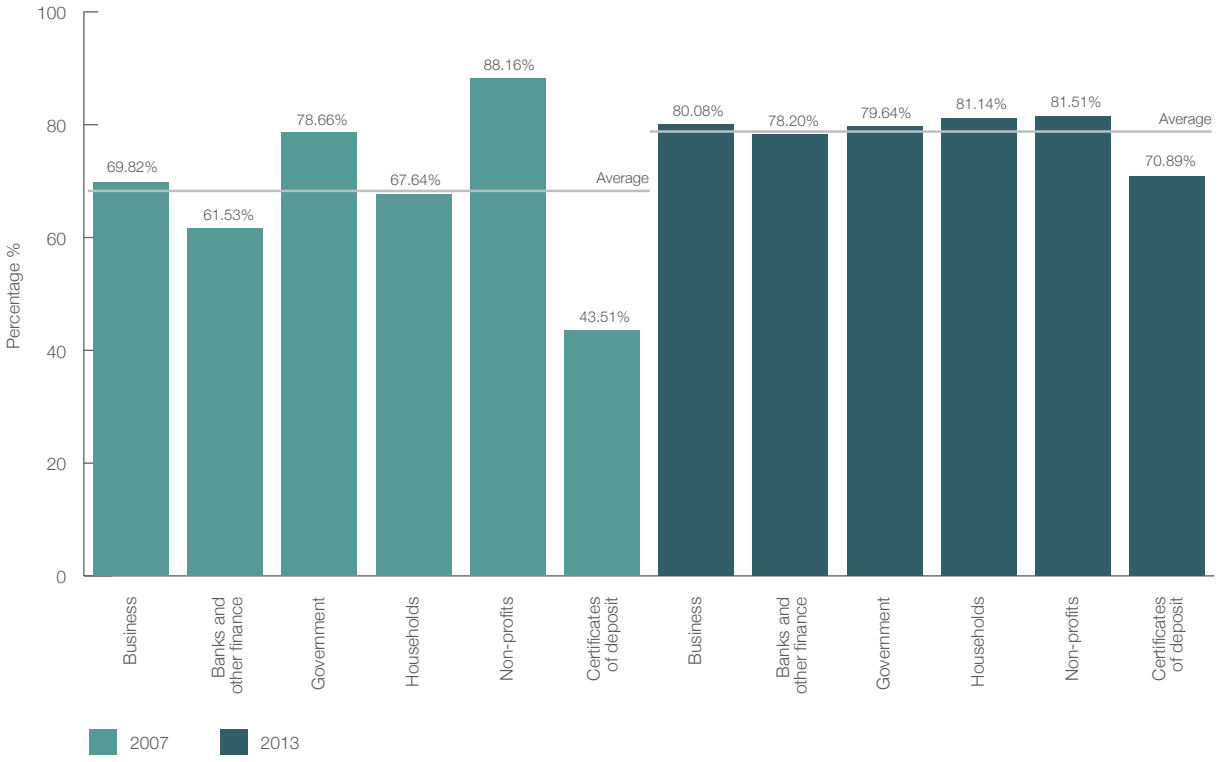
Information on market share can be a useful first step in a competition analysis to provide guidance as to whether a particular market is more likely to raise competition concerns in relation to the abuse of market power. According to the UK Office of Fair Trading (2004, p. 11):

> *In general, market power is more likely to exist if an undertaking (or group of undertakings) has a persistently high market share.* [7]

According to the OECD (2006, p. 8):

> *Market share data continue to be the "high priest" in assessing whether a firm has substantial market power, although the limitations of market shares as proxy of market power are widely acknowledged.* [8]

Figure 3.6 Major bank's share of key deposit product markets



Source: APRA; Pegasus Economics

[7] An undertaking covers any natural or legal person engaged in economic activity, regardless of its legal status (Office of Fair Trading, 2004, p. 2n).

[8] The limitations of market concentration have previously been discussed above.

3 EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

3.8.1 Domestic deposit market

The four largest banks have almost 80% of domestic bank deposits, an increase of nearly 20% of the total market since 2007. This has been primarily been driven by mergers and acquisitions.

In the five years up to 2007, the non-major banks were able to secure 40% of the domestic deposit base. Since then, the non-major bank share has roughly halved to around 20%.

Breaking down the relative shares, it is clear that not only have the largest banks increased their overall share, but there is less variation in the share along product lines. This can be seen from Figure 3.8.

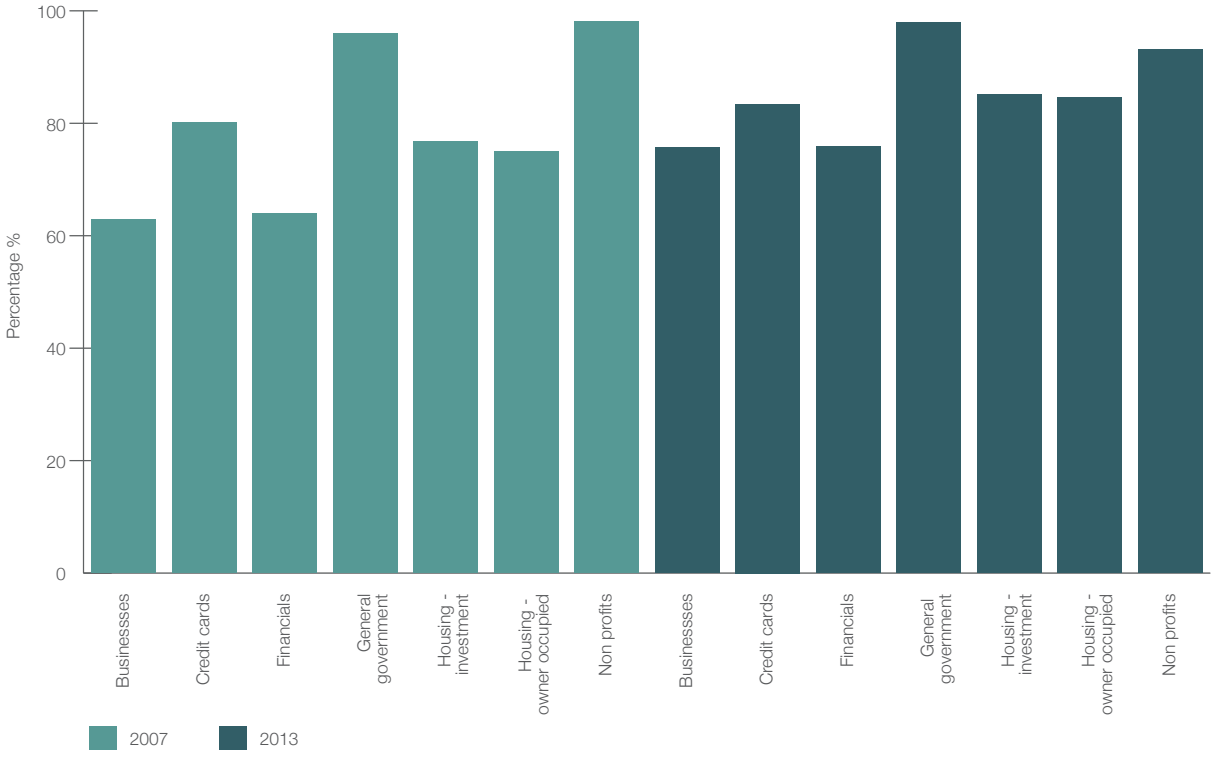
3.8.2 Domestic loan market

The market share of the four largest banks is also evident from the domestic loan market, with a collective share of just over 80%. Market share was altered significantly by the acquisition of St. George Bank by Westpac and the acquisition of BankWest by CBA.

3.8.3 Loan market – market shares of key products

The aggregate loan market can be divided into similar categories to that of deposits, with business and housing loans being the most significant in terms of size (see Figure 3.7).

Figure 3.7 Major bank's share of key loan markets



Source: APRA; Pegasus Economics

The four largest banks have secured 85% of owner occupied, investment housing and credit card lending.

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EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

3.9 HERFINDAHL-HIRSCHMAN INDEX

Another measure of concentration is that provided by the Herfindahl-Hirschman Index (HHI).

This concentration test is commonly used by competition law enforcement agencies around the world, including the ACCC.

The HHI is calculated by adding the sum of the squares of the market share of each firm in the relevant market, thereby giving greater weight to those firms with higher market shares. (Australian Competition and Consumer Commission, 2008, p. 37). The possible values of the HHI range from zero for a market with an infinite number of tiny firms to 10,000 for a single firm monopoly market (Salop S. C., 1987, p. 6). In general, the fewer the firms and the more unequal the distribution of market shares among them, the larger the HHI (Shughart II, 2008).

The HHI has two distinct advantages over simple concentration ratios (Shughart II, 2008). First, it uses information about the relative size of all participants in a market. Second, it weights the market share of the largest market participants more heavily.

As part of its process for examining the competitive effects of a merger or acquisition for compliance with section 50 of the Competition and Consumer Act 2010, the ACCC (2008, p. 37) will generally be less likely to identify competition concerns when the post-merger HHI is less than 2000. [9]

The HHI methodology was used to assess concentration in the key loan and deposit markets in Australia. Data for these domestic markets was sourced from APRA's monthly banking statistics which details individual banks' market share positions going back to 2002. While APRA's monthly banking statistics do not include data for building societies and credit unions, the absence of this data is unlikely to materially alter the results given the relatively small market share positions held by any non-bank ADI. Figure 3.8 summarises the results as of 2013.

The chart also features two horizontal lines to indicate threshold levels. The first horizontal line stems from 1500 on the left vertical axis. This represents the threshold used by the US Department of Justice (DOJ) to indicate a moderately concentrated market. A second horizontal line extends from the point of 2000 on the left vertical axis. This is the threshold used by the ACCC to indicate a high level of market concentration.

If the 1500 benchmark is used, the chart shows that most of Australia's domestic banking markets are moderately concentrated. If the ACCC's benchmark is used, then four domestic product markets fall into the category of high concentration.

Of these, one of the most significant to consumers is that of investment housing finance. While a number of key markets are yet to record concentration levels above the ACCC's threshold, most of them are close to doing so.

[9] Section 50 of the Competition and Consumer Act 2010 prohibits mergers that have the effect, or likely effect, of substantially lessening competition in any market.

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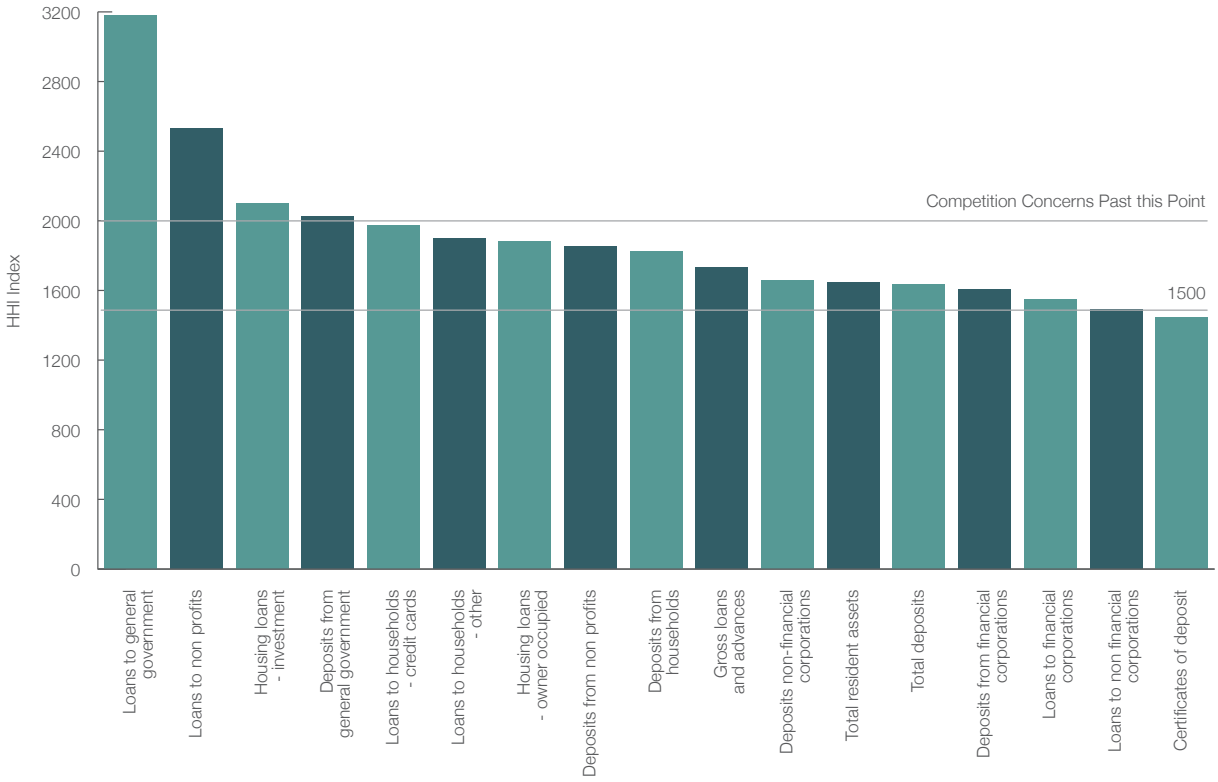
EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

Figure 3.8 Summary of HHI tests



Source: Pegasus Economics calculations; Underlying data is APRA's monthly banking statistics

3.9.1 Housing investment finance – HHI tests since 2002

It is also instructive to view individual market HHI scores over a time-period. The APRA data goes back to 2002, so this enables an eleven year run of results. Figure 3.9 traces HHI scores for the housing finance market and credit card lending. In terms of housing finance, from 2002 to 2010, the HHI results in a flat line at around 1600.

While 1600 still indicates concentration in the market, the relative stability of the score indicates there is no real tendency in the market for greater concentration. In 2010 (the year St.George's market share data is included as part of Westpac's market share), the chart shows a significant increase in concentration. Indeed, it immediately exceeds the 2000 threshold.

Notably, after the merger, the market tended towards less concentration with the HHI returning to the 2000 level. But it jumps up again when BankWest's market positions are rolled into CBA's data. Recent results show it is reasonably flat, indicating concentration is high and stable.

3.9.2 Credit card lending – HHI tests

HHI test results for credit card lending is also included in Figure 3.9. The results show that concentration in the market is yet to reach the 2000 level, although it is trending in that direction. The chart shows this latest trend appears different to previous market dynamics. While it has always been a concentrated market, never dropping below an HHI of 1800, up until the St.George merger the market appeared to be trending towards less concentration.

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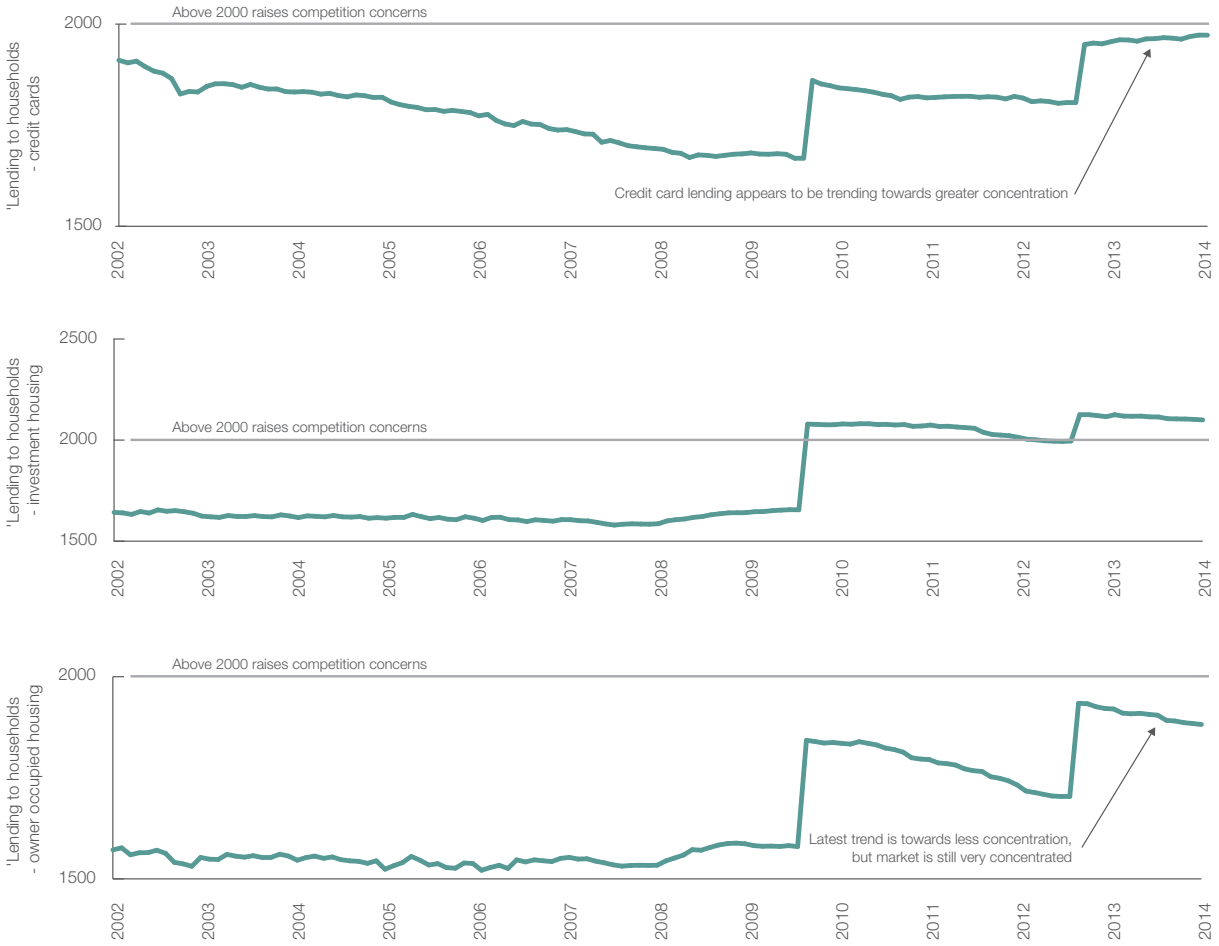
EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

Figure 3.9 HHI over time for three household lending markets



3.9.3 Owner occupied housing finance – HHI tests

According to the HHI results, owner-occupied housing is less concentrated than either credit cards or housing investment lending. From 2002 to the St.George acquisition by Westpac, the HHI was stable at under 1600.

Even though the BankWest acquisition by CBA pushed the HHI close to 2000, there appears to be a tendency in the market for less concentration.

Owner-occupied housing lending is probably more competitive than investment housing finance. The HHI results in this chart give some weight to that view, although it should be noted that the index is still currently above the 1500 mark. Further, some caution is needed in assessing any trend given the conversion of former credit unions into banks post 2009. As discussed in the next section, there is evidence that large banks have considerable pricing power in the mortgage market.

3

EFFICIENCY AND COMPETITION ISSUES IN RETAIL BANKING

3.10 Margins, profits in housing finance – UBS Analysis

Evidence of the capacity of the large banks to offset higher deposit and wholesale funding costs through loan re-pricing is shown by UBS analysis (Mott, Williams, & Lee, 2014), published in March 2014. Since 2007, the profitability of new housing loans has increased markedly, increasing from between 10 and 20 basis points before the GFC, to around 67 to 89 basis points today, depending on the methodology used. This has coincided with greater concentration in the provision of housing finance for owner occupiers and investment.

The UBS analysis focuses on CBA data given that CBA reports more granular data than do other banks, but the authors believe the results generally apply to the industry.

The UBS report states (Mott, Williams, & Lee, 2014):

Assessing the profitability of a new mortgage – The Bank of England Methodology

Over the last few years we have published a number of reports looking at the profitability of writing a new mortgage. These studies were based on the methodology used by the Bank of England.

This methodology decomposes the lending rate on a new mortgage into:

- *The banks' funding costs;*
- *Credit risk, comprising both the expected loss from impairments as well as the capital charge;*
- *The residual – which can then be broken into the banks' operating costs, tax and profit.*

Based on this BOE methodology we have found that the residual component and banks' profit from writing new mortgages is highly volatile over time. However, as a result of the improvement in debt markets, and a series of mortgage repricings, banks are now making elevated levels of returns from new mortgages.

We estimate that the major banks are currently generating around 79bp in profit from writing a new mortgage. Although this is down slightly from 89bp in May 2013 this still remains elevated, especially compared to the 10-20bp generated on originating a new mortgage prior to the GFC.

BOE Mortgage profitability using a blended deposit and wholesale funding mix

One criticism of the BOE methodology is that it assumes that the banks finance a new mortgage solely with wholesale funding. In reality banks would use a mix of deposits and wholesale funding to finance a home loan. For comparison purposes we have repeated the analysis of the profitability of writing a new mortgage, but have used a blended funding of term deposits and wholesale debt. The weighting has increased towards term deposits through the period, in line with the banks' improving funding mix.

Incidentally, this blended funding cost reconciles very closely with our estimate of CBA's transfer price, which is calculated from CBA's Average Balance Sheet and Divisional disclosure.

Based on a blended funding methodology we estimate the Banks Profit on originating a new mortgage is currently 67bp. Given the falling Term Deposit funding costs over the last twelve months this level of profitability is at near record levels.


4

COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4

COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

In chapters 2 and 3, evidence was presented as to why there is a public policy case to give greater weight to efficiency and competition objectives. Australia has enjoyed a long history of financial stability and this is likely to continue for the foreseeable future. In contrast, the evidence suggests efficiency and competition should be pursued.

The purpose of this chapter is to identify regulatory and other factors which are causing or contributing to competition problems. Specifically, the chapter identifies factors which are undermining competitive neutrality.

Competitive neutrality is about ensuring all service providers compete on a level playing field and that regulatory arrangements do not favour some service providers over others. In the absence of competitive neutrality, the playing field will become distorted and competition problems will occur as some market participants prosper largely due to favourable regulatory arrangements.

This chapter highlights the lack of competitive neutrality embedded in existing regulatory arrangements. It also makes recommendations on how various problems can be addressed.

4.1 CAPITAL ADEQUACY

4.1.1 Capital adequacy

APRA makes and enforces the rules which govern the capital adequacy of Australian banks (Gorajek & Turner, 2010, p. 43). APRA's capital standards for ADIs follow closely those set by the Basel Committee on Banking Supervision (Basel Committee) (Australian Prudential Regulation Authority, 2012). [10] In 2008, APRA introduced the International Convergence of Capital Measurement and Capital Standards (Basel II). Under Basel II, there are three methods for calculating minimum capital requirements:

1. the standardised (externally set) risk weights;
2. foundation internal ratings basis (FIRB); and
3. advanced internal ratings basis (AIRB) (Terry, 2009, p. 27).

Under the standardised approach, risk-weights are prescribed for each risk category, where the risk of each is rated by the borrower's externally-determined credit-rating agency (Terry, 2009, p. 27). The value of the loans in each category is multiplied by the prescribed risk weight and the product is multiplied by the target capital ratio to determine the minimum capital requirement.

APRA (2007, p. 3) has categorised the FIRB and AIRB as advanced approaches which rely on an ADI's own internal risk-assessment and measurement methodologies. The AIRB uses internal estimates of loss given default (LGD) and the other risk components (effective maturity and the exposure at default) in a prescribed formula to determine the risk weight and hence capital charges.

Three banks, CBA, Westpac and ANZ, were given approval to use the AIRB from January 2008 while NAB was given permission to use the FIRB (Terry, 2009, p. 29). NAB (2008) subsequently received approval to use AIRB as from 1 July 2008. Macquarie Bank has also received accreditation for FIRB.

4.1.2 The Regulation Impact Statement (RIS) process

In applying the advanced approaches, APRA (2007, p. 7) indicated there was little need for the regional banks to seek advanced status:

> *The larger Australian banks are among the global banks that commenced developing sophisticated risk management systems and internal economic capital models prior to the release of Basel II. This gives those banks a foundation on which to base the advanced Basel II methodologies. The small ADIs do not have the resources, or indeed the need, to implement the advanced approaches and will implement the standardised approaches.*

[10] The Basel Committee provides a forum for co-operation on banking supervisory matters. The Basel Committee operates under the auspices of the Bank for International Settlement with the objectives of enhancing understanding of key supervisory issues and improving the quality of banking supervision worldwide. (Australian Prudential Regulation Authority, 2007, p. 1)

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Despite this, some smaller banks also wanted to seek advanced accreditation:

> *A small number of banks ranked behind the four majors in terms of asset size have also indicated a desire to implement the advanced approaches. Any such decision must be made by an ADI's board and management team. (Australian Prudential Regulation Authority, 2007, p. 7).*

The final Regulation Impact Statement (RIS) for the implementation of Basel II was prepared by APRA (2007) in November 2007. The final RIS did not address the potential competitive disadvantage of smaller banks under Basel II even though APRA was required to complete a competition assessment under the RIS guidelines.

Competition anomalies have arisen in the capital setting between 'advanced' banks and 'standardised' banks. According to UBS Securities Australia (2013, p. 17):

> *The introduction of Basel II advanced accreditation, and the Internal Ratings Based approach to risk weightings brought with it a level of flexibility for banks to model their own risk weights (with regulator-approved models).*
>
> *Certain banks have done particularly well in 'optimising' risk weighted mortgage assets. For example, the Norwegian banks operate with average risk weights across their IRB mortgage portfolios of 12% - not far ahead of [Westpac] at 14.5% and CBA at 15.2%.*

Under the advanced accreditation arrangements, UBS Securities Australia (2013, p. 17) estimates the four big Australian banks hold on average 1.3 cents of capital against each $1 of mortgage credit.

BOQ Managing Director and Chief Executive Officer Stuart Grimshaw (2013) has observed the current regulatory risk-weighting regime for residential mortgages requires banks operating under the standardised accreditation to hold up to three times more capital for the same loan. Similarly, the Chief Executive Officer of Suncorp Bank, John Nesbitt (2013), has commented:

> *The very advantageous capital requirements of major banks versus smaller institutions further undermine competition and the future of regional and smaller banks.*

In relation to the RIS that APRA prepared on the implementation of Basel II it appears there was insufficient consideration and weight given to the impact of Basel II on competitive neutrality.

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4.1.3 Bias towards housing lending

Since the introduction of Basel II and the GFC there has arguably been a further lending bias towards the household sector (Healy, 2010). See also Section 3.3 above.

While demand-side policies encourage housing lending such as the first home owners grant scheme and tax advantages associated with negative gearing, Basel II may have contributed to the re-direction of bank capital into the higher return/lower risk retail banking market for home lending and away from business lending. According to Joseph Healy (2010), the Group Executive of Business Banking at NAB:

> *… the bias towards home lending has clearly been influenced by the international Basel II capital adequacy rules which took effect in Australia in 2007-08.*
>
> *These rules implicitly encourage banks to favour residential mortgage lending over business lending as residential mortgages attract a lower capital charge under both standardised and advanced accreditation frameworks.*
>
> *This means that banks can do on average three to four times more mortgage lending relative to business lending in terms of capital management. All other things being equal, we have a system that makes it more attractive for banks to lend the marginal dollar on a weekend holiday home than to a small business! One could reasonably regard this outcome as perverse.*

In turn, this bias towards housing lending may increase systemic risk to the Australian financial system through bank lending fuelling rapid asset price increases. In this regard, the IMF (2013, p. 10) has warned that where low official interest rates are consistent with low inflation, they may still contribute to excessive credit growth and asset bubbles.

Figure 4.1 shows that regional banks are now directing proportionally more of their domestic loans to businesses than are the largest four banks. This is a significant change in emphasis given the traditional role of the major banks in commercial finance prior to the 1990s. The current predisposition of the major banks toward housing lending has prompted former NAB Chief Executive Officer Don Argus to warn:

> *I think the Australian banking sector has gone too far. You can look at some of them now as giant building societies. (Maiden, 2010)*

The current bias towards housing lending risks misallocation of resources. Given an economy's stock of physical capital, labour, human capital, and knowledge, the way in which those aggregate quantities of inputs are allocated across households, firms and industries determines the economy's overall level of production (Jones, 2011, p. 2).

The optimal allocation of resources maximises welfare and long-term economic growth. Other allocations result in lower levels of output and show up in the aggregate as lower multi-factor productivity (MFP).[11] Productivity growth, which essentially means producing more output with fewer inputs, is a crucial determinant of national living standards.

A study released by Industry Super Australia (2013) measuring the value of economic resources allocated to financial services, and comparing it to capital formation attributable to financial services revealed the efficiency of the financial system has declined over time.

In 1990, for every $1 of economic resources — labour and capital — allocated to finance, there was about $3.50 of capital formation (Industry Super Australia, 2013, p. 19). By 2012, efficiency in this respect had declined to just 50 per cent of 1990 levels, such that for every $1 of economic resources allocated to finance, there was around $1.50 of capital formation.

[11] MFP is the ratio of output to the combined inputs of labour and capital. MFP is a more comprehensive productivity measure because it identifies the contributions of both - capital and labour - to output.

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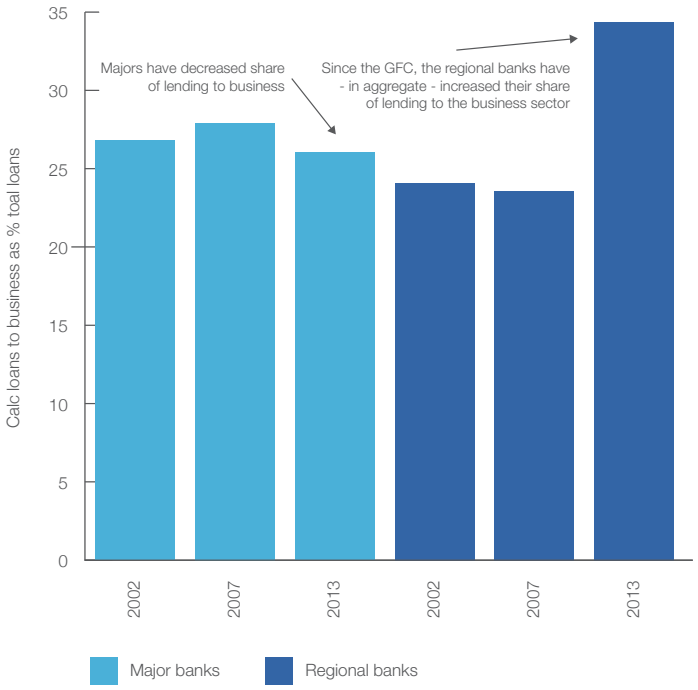
Figure 4.1 Portfolio allocation of business loans



Source: APRA monthly banking statistics; Pegasus Economics.
Regional banks are: BOQ, Suncorp, ME Bank, and Bendigo and Adelaide Bank. The chart reflects the full purchase of Rural Bank by Bendigo and Adelaide Bank.

4.1.4 Mortgage risk-weighting

Recent Pillar 3 disclosures by the 'advanced' banks demonstrate why mortgage lending is an attractive market. Housing loan defaults have traditionally been very low in Australia, even during times of stress. Households demonstrate a determination to pay off loans ahead of other expenditures. The incentives to repay a loan are also stronger here than in other jurisdictions, such as many states in the US, because housing-related debt is not extinguished on sale of the property, the debt instead stays with the borrower.

The latest disclosures demonstrate how relatively little capital 'advanced' banks can hold against mortgage loans and, therefore, how profitable this lending can be, as seen in Figure 4.2.

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Figure 4.2 Mortgage risk weights - implications of different levels for leverage and ROE

Institution category	Institution name	Risk-weighting approach	Percentage risk weight	Implied leverage for $1.00 of capital	Implied leverage multiple	Implied ROE for a 50 basis point spread
Major banks	ANZ	Advanced	17.90%	$70	70	34.92%
	CBA	Advanced	17.60%	$71	71	35.51%
	Macquarie Bank	Advanced-FIRB	22.90%	$55	55	27.29%
	NAB	Advanced	19.94%	$63	63	31.34%
	Westpac	Advanced	14.40%	$87	87	43.40%
Regional banks	Bank of Queensland	Standardised	44.10%	$28	28	14.17%
	Bendigo and Adelaide Bank	Standardised	39.00%	$32	32	16.03%
	Suncorp Bank	Standardised	39.60%	$32	32	15.78%
Regulatory	APRA	APS 112	35.00%	$36	36	17.86%
		Recommended to Basel in 2001	20.00%	$63	63	31.25%
	Basel Committee	Basel 1	50.00%	$25	25	12.50%
		Basel 2	35.00%	$36	36	17.86%
		Basel 3	35.00%	$36	36	17.86%

Source: Bank pillar 3 disclosures; APRA's monthly banking statistics; liaison with banks; APRA's 2001 submission to the Basel Committee; other public documents.

Percentage risk weight estimated by dividing mortgage RWA by total on balance sheet mortgage assets. Implied leverage for $1.00 capital derived by dividing $1 by the risk weight multiplied by 0.08. Implied Return on Equity (ROE) is the return on capital given a 50 basis point spread.

Figure 4.2 shows the major banks have mortgage book risk weights ranging from 14.4% for Westpac to 19.94% for NAB. Macquarie Bank has a risk weight of 22.9%.These contrast with 'standardised' banks that have a minimum of 35% under Basel 3 and, after various adjustments to reflect the nature of their loan exposures, average around 39%.

These estimates enable a series of implied calculations.

At a risk weight of 39%, housing lending yields a return on equity of around 16%, all things being equal. This is one third of Westpac's implied ROE of 43%. Even Macquarie which faces the highest risk-weighting of the 'advanced' banks, has an implied ROE of 27%. These figures are based on an assumption that the after all costs spread on housing loans is around 50 basis points.

The current differential risk weighting for residential housing imposed on non-advanced banks is applied despite APRA's (2013a, p. 54) acknowledgement that housing lending is a low risk asset class across-the-board:

> Housing lending has historically been a low-risk asset class for ADIs in Australia. The quality of ADI housing lending portfolios has proven very resilient during the global financial crisis, particularly compared with the experience of some of the crisis economies. This positive outcome owes much to the generally sound housing lending standards applied by ADIs, including their assessments of a loan applicant's debt servicing capacity. The targeted review confirmed that the ADIs surveyed had policies and procedures for evaluating loan serviceability that were subject to board oversight.

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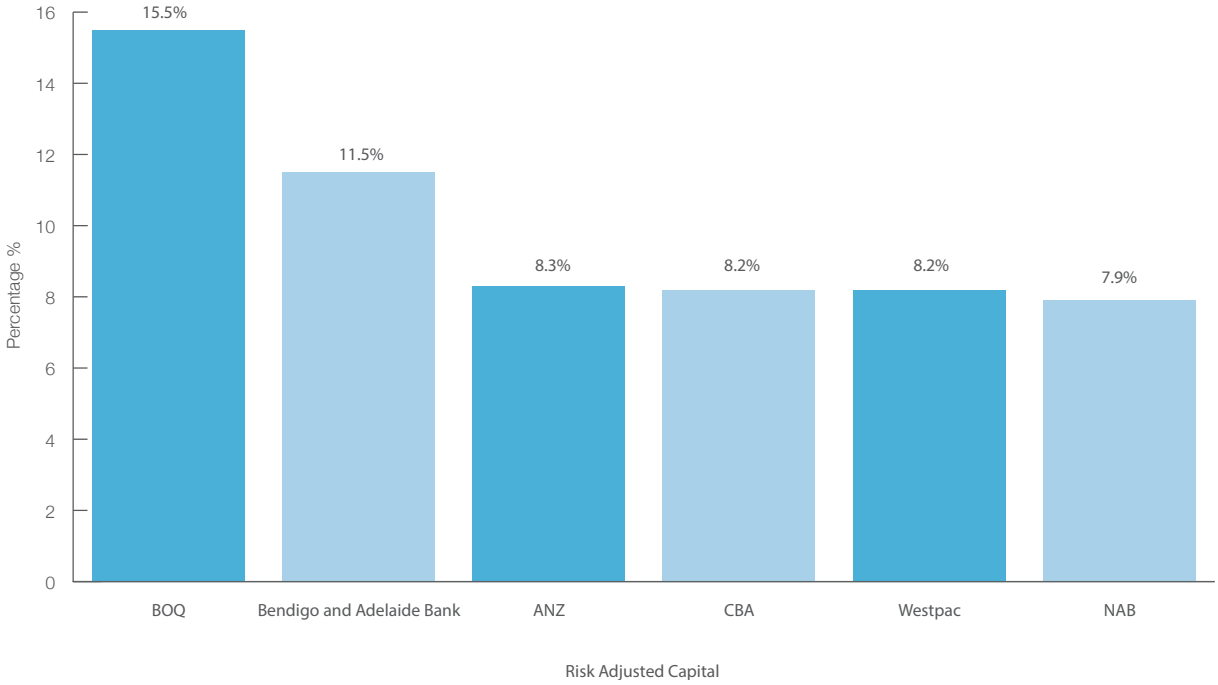
Figure 4.3 Capital comparison using S&P risk-adjusted comparison



Source: Bendigo and Adelaide Bank & BOQ's 2013 profit announcements

Figure 4.3 illustrates the capital disadvantage facing regional banks. Using Standard & Poor's standardised risk-adjusted capital position, the chart shows that Bendigo and Adelaide Bank and BOQ have materially more capital – adjusted for risk - than do the major banks.

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Figure 4.4 Additional capital needed by major banks if they faced a 40% risk-weighting for mortgages

Banks	CET1	Mortgages balance ($m)	Risk-weighted mortgages ($m)	RWA ratio	Increase in RWA due to reweighting ($m)	Increase weighted assets if 40% weighted ($m)	Change in capital required with new 40% weighting ($m)
ANZ	7.90%	282,271	49,396	17.50%	63,512	112,908	5,017
CBA	8.50%	385,146	67,797	17.60%	86,261	154,058	7,332
NAB	8.43%	298,529	59,527	19.94%	59,885	119,412	5,048
WBC	9.10%	423,719	61,020	14.40%	108,468	169,488	9,871

Source: CET1, Mortgage Balance, Risk-weighted mortgage sourced from latest major bank Pillar 3 disclosures (as of February 2013); Pegasus Economics calculations.

Figure 4.4 shows how much additional capital the four 'advanced' banks would need to raise if they faced a 40% risk-weight for residential mortgages, roughly the percentage that regional banks confront. CBA would need an additional $7.3 billion, NAB $5.0 billion, ANZ $5.0 billion and Westpac $9.8 billion. In aggregate, the additional capital needed by the majors is $27 billion, equivalent to around 24% of current Tier 1 equity levels.

Another shortcoming of the current regulatory approach is the requirement that to become an 'advanced' bank, APRA requires banks to meet the requirements of advanced credit, operational risk and market risk. This is not a Basel Committee requirement. It is not clear from a risk perspective why there needs to be a linkage between these risk requirements.

4.1.5 Recommendation – reduce mortgage risk-weight to 20%

The Government needs to urgently address the capital anomaly associated with 'advanced' and 'standardised' banks. We recommend the following approach:

- APRA implement a risk-reflective capital treatment for residential mortgages under the standardised approach. This suggests about 20% as opposed to the 35% under the existing approach. A 20% risk weight could be used as a transitional weighting while regional banks go through the Basel II advanced accreditation process.
- The FSI Panel should also consider the current approach that Basel II advanced status be achieved in credit, operational risk and market risk before enabling a bank to rely on an internal assessment of any individual risk, particularly credit risk. This linkage is not universally applied by other jurisdictions as part of the Basel II or Basel III framework. This would significantly reduce the time and expense associated with full Basel II accreditation for regional banks.

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The 20% risk weight recommendation is consistent with the advice given to the Basel Committee by APRA (2001, pp. 6-7) back in 2001:

> *One area where we consider that modification is necessary is the standardised risk weight applied to exposures secured by residential property.*
>
> *As detailed in our submission on the first consultative paper, the existing 50% risk weight for housing loans is high when compared to actual credit loss experience in many countries, including Australia…*
>
> *Moreover, the QIS data are indicating that IRB housing loan risk weights will be around 5-10%. These IRB housing loan risk weights, which are based on the Committee's own proposed risk weighting function, fall within the ball park of banks' internal economic equity and general provisioning calculations as well as some of our own figuring based on historical loss rates. Not only do the IRB risk weights support a lower standardised risk weight based on relatively low housing (PD and LGD) loss experience, but maintenance of the 50% risk weight could introduce a major source of competitive inequality among institutions operating under the standardised and IRB approaches. The prospective risk weight differential equates to a potential earnings/pricing advantage for IRB institutions of as much as 30 basis points for what is a major lending activity of most Australian deposit-taking institutions…*
>
> *APRA therefore strongly recommends that the Committee reconsider its position on the standardised housing risk weight. A lower standardised risk weight for housing loans would be more consistent with the Committee's objectives of better aligning regulatory capital requirements with actual risk relativities and of promoting enhanced competitive equity. Given the importance of housing lending in regulated institutions' portfolios, a lower standardised risk weight would also go a long way towards addressing (though not completely) the broader calibration issues outlined in the previous section.*
>
> *APRA suggests lowering the proposed standardised housing risk weight to 20%...*
>
> *From the regional bank's perspective, this is an urgent matter. While it is acknowledged the Basel Committee has set a 35% risk weighting, the high concentration of mortgage lending amongst banks in Australia means that differences in regulatory treatment will have greater consequences than most other countries.*

4.1.6 Small business aspects to capital adequacy

The housing capital anomaly is having a significant and pervasive effect. With excess profits for the 'advanced' banks in housing loans, there is a strong incentive to allocate a higher proportion of funds into this sector, at the cost of other areas such as SME finance. Levelling the playing field in terms of capital requirements in housing, will create significantly more competitive tension and erode the historically high margins being earned. This will improve incentives to offer more SME finance.

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Yet, there are other issues that also need to be examined, such as concerns that prudential regulation is insufficiently flexible to encourage lending to company start-ups. This is well explained by the Small Business Minister, Bruce Billson (2014) in his comments to the Institute of International Finance and Regulation in February 2014:

> *Prudential regulation affects access to finance. We need to get the balance right between entrepreneurship and regulation. Whilst the risk weight for residentially secured small business loans is up to $1 million and are treated the same as home loans - the banks still charge more for a small business loan. Banks need to ensure that they are appropriately pricing risk, but let's not have a predetermined view about small business and the risks that accompany their entrepreneurship.*
>
> *In our country APRA's standardised risk rates for unsecured business loans are the same for the large corporates with a similar credit rating. That sounds encouraging but let's look a bit deeper because APRA itself has noted that small businesses are at a disadvantage because most small businesses don't have a credit rating. The small banks and the non-bank lenders have been hit hard during the GFC. Since the GFC non major bank lending share of business in Australia has fallen by around 10 per cent. We need to ensure second tier and non-bank lenders are not unfairly disadvantaged by prudential requirements including capital requirements. Banks require proven financials when they provide finance. How do we do that for a start-up? Where are those proven financials? It is a start-up and this makes it hard for start-ups to generate finance and more so is a constraint on the entrepreneurial spirit. Well just under 90 per cent of small business finance applicants are accepted and gain access to the finance they are seeking. This could be much lower, around 70 per cent for start-ups and that inability to secure finance is a strong disincentive for anyone looking to start a business.*
>
> *The good news is in Australia our major banks are alert to the opportunity, the delicious world of opportunity in the sector. They are indicating a greater preparedness to lend to small business including start-ups. Now we need more competition in this space to bring down the cost of finance for small business. Crowd sourcing equity funding is another option to potentially increase the available pool of funding for small business.*
>
> *But this method of capital raising can be shaped, we think, to give investors more opportunities to make longer term investments in small enterprises and start-up firms. Encouraging small business loan securitisation could also prove to be an advantage in terms of access to finance in the small business community. But it is currently difficult to attract investors. Small business securitisation products struggle to obtain those all elusive credit ratings.*

Minister Billson's identification of start-ups as facing a particular problem in demonstrating proven financials is consistent with the evidence presented in Section 3.3. ABS data shows consistently the number one ranked barrier to innovation facing small businesses is the lack of available funds. This is a major issue requiring attention given the importance of entrepreneurship to long-term productivity and growth. Arguably, there is a market failure at work.

The essential problem is that lending to start-up companies is very risky and this uncertainty probably biases banks against lending to start-ups (particularly given the profitability of mortgages). It is likely that a form of market failure exists where the true benefits of start-up companies are not being properly factored into loan approval decisions. When a bank assesses an application, it is primarily undertaking an assessment of credit risk and not considering the wider society benefits of encouraging innovative start-ups.

4

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4.1.7 Recommendation - Small business (start-ups) financing

The FSI Panel should consider options to support small business start-ups.

4.2 FUNDING ADVANTAGE PROVIDED TO BANKS DEEMED "TOO BIG TO FAIL"

Since the Wallis Report and the GFC, the financial services sector has increased in size and scale. As with most other countries, Australia has large institutions that are considered to be too big to fail. This poses a serious policy challenge.

4.2.1 Consequences of "too big to fail"

Late last year, APRA (2013) announced that four banks were domestic systemically important banks (D-SIBs) in Australia, thus acknowledging that they are "too big to fail" (TBTF) in terms of their impact on the Australian economy.

There are two key effects of TBTF institutions. Firstly, they can increase systemic risk through moral hazard. Secondly, TBTFs distort the competitive playing field. There is a wealth of academics, policy makers, central bankers and politicians who are concerned over the existence of TBTF banks.

The former Chairman of the US Federal Reserve Ben Bernanke (2010, p. 20) has stated that TBTF encourages banks to engage in excessive risk-taking (Financial Stability Board, 2013, p. 2). The UK Office of Fair Trading (2010, p. 164) has made a similar comment:

> *One consequence of the implicit guarantee by Government to rescue banks that are 'too big to fail' may be the creation of a moral hazard in banking.*

According to a Bank of England Financial Stability Paper, a pernicious spiral can develop, where the existence of an implicit guarantee encourages banks to take more risk, raising the likelihood and cost of bank failure, thus increasing the subsidy (Noss & Sowerbutts, 2012, p. 4). One of the outcomes of such a process is that bank executives and investors will capture the upside benefits, while taxpayers will bear the downside risk (Fisher, 2013).

According to Richard Fisher (2013), President of the Federal Reserve Bank of Dallas, implicit government guarantees provided to TBTF banks exempt them from the normal processes of bankruptcy and creative destruction. According to Fisher (2013), viable business models should be given the opportunity to compete and prosper on their own merits, while unattractive strategies should be allowed to fail.

Another problem is that public guarantees distort competition in the banking sector (Gropp, Hakenes, & Schnabel, 2010, p. 1). According to Bernanke (2010, p. 21):

> *A second cost of too-big-to-fail is that it creates an uneven playing field between big and small firms. This unfair competition, together with the incentive to grow that too-big-to-fail provides, increases risk and artificially raises the market share of too-big-to-fail firms, to the detriment of economic efficiency as well as financial stability.*

An RBA Research Discussion Paper noted in 2001 that:

> *Another difficulty with the systemic-risk approach is that it risks fostering the presumption that certain institutions are too big to fail. This creates a competitive distortion favouring larger banks over smaller banks. (Fitz-Gibbon & Gizycki, 2001, p. 8)*

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By virtue of being TBTF, banks receive implicit guarantee at the taxpayers' expense that they do not have to pay for (Dudley, 2013). This creates a competitive distortion. They can refinance operations on more favourable terms than non-TBTFs. (Gropp, Hakenes, & Schnabel, 2010, p. 1).

TBTF banks are able to raise bond finance and wholesale funds on money markets more cheaply than smaller banks which can be allowed to fail (Mullineux, 2012, p. 156). According to William C. Dudley (2013), President of the Federal Reserve Bank of New York:

> *The fact that firms deemed by the market to be too big to fail enjoy an artificial subsidy in the form of lower funding costs distorts competition to the detriment of smaller, less complex firms.*

According to the UK Independent Commission on Banking (Vickers, Spottiswoode, Taylor, Winters, & Wolf, 2011, p. 160):

> *If one bank is seen as more likely to receive government support than another this will give it an unwarranted competitive advantage. As creditors are assumed to be less likely to take losses, the bank will be able to fund itself more cheaply and so will have a lower cost base than its rival for a reason nothing to do with superior underlying efficiency.*

This funding advantage creates incentives for TBTF banks to become bigger and more complex (Dudley, 2013). As a result, the funding benefit of being seen to be TBTF causes the financial system to become skewed toward larger and more complex TBTF banks in ways that are unrelated to true economies of scale and scope. In turn, this creates a positive feedback loop. As the banking system becomes more concentrated and complex, that just increases the financial stability risks, making the TBTF problem even more acute. TBTF banks will also enjoy an unfair advantage in raising deposits as investors will regard them as safer. (Mullineux, 2012, p. 156).

Recent academic literature suggests TBTF banks could, in fact, be undermining the stability of the financial system. Government guarantees to TBTF banks, irrespective of whether the guarantees are transparent or implicit, lead to higher risk-taking among the protected bank's competitors (Hakenes & Schnabel, 2009). Lower re-financing costs induce the protected banks to behave more aggressively (for example, by raising deposit rates or lowering loan rates) that in turn increases competition and decreases margins for the competitor banks, and pushes these banks towards higher risk-taking (Gropp, Hakenes, & Schnabel, 2010, p. 1).

A key principle stemming from the G20 meetings post-GFC was to eliminate the problem of TBTF as the existence of large institutions that could not be allowed to fail, was seen to be a major contributing factor to the financial instability.

The Campbell Report stated:

> *…financial intermediaries should be allowed to fail, in the same way as non-financial companies… (Campbell, et al., 1981, p. 779)*

The Wallis Report noted:

> *If there is a general perception that a particular group of financial institutions cannot fail because they have the imprimatur of government, there is a great danger that perception will become reality. Transparency of regulation requires that all guarantees be made explicit and that all purchasers and providers of financial products be fully aware of their rights and responsibilities. It should be a top priority of an effective financial regulatory structure that financial promises (both public and private) be understood. (Wallis, Beerworth, Carmichael, Harper, & Nicholls, 1997, p. 197)*

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.2.2 What is the funding benefit of TBTF?

Apart from APRA's D-SIB declaration, there is clear market-based evidence that TBTF banks are operating in Australia. Rating agency reports note that major bank credit ratings are uplifted two notches due to implicit government support. According to Standard & Poor's Rating Services (2013b, p. 5):

> *Standard & Poor's criteria for rating banks provide scope for lifting ratings from an [authorised deposit taking institution's] stand-alone credit profile assessment to account for extraordinary government support. To qualify for rating uplift from government support under our bank rating methodology the government's tendency to support private sector commercial banks must be assessed as at least "supportive" or "highly supportive", and the bank's systemic importance (as described in Standard & Poor's methodology) must be assessed as at least "moderate" or "high"…*
>
> *We classify the Australian government as being "highly supportive" of the country's banking system, reflecting our expectation of the government's timely financial support to ensure the stability of the financial system, if needed.*

Standard & Poor's Rating Service (2013b, p. 5) states that six financial institutions enjoy a ratings uplift due to extraordinary government support: the CBA, Westpac, NAB, ANZ and Macquarie Bank all receive a ratings uplift of two notches and Cuscal receives a ratings uplift of one notch.

An IMF Working Paper estimated the size of TBTF subsidies embedded in credit ratings was 60 basis points at the end of 2007, rising to 80 basis points at the end of 2009 (Ueda & Weder di Mauro, 2012). Applying this estimates to major bank liabilities gives a figure of between $5.9 and $7.9 billion. [13]

If left unchecked, TBTF banks can grow so big they start becoming too big to save. (Vickers, Spottiswoode, Taylor, Winters, & Wolf, 2011, p. 125). In turn, government commitments to shore up the banking system can come at the expense of weakening the creditworthiness of the state itself. A related problem is that implicit subsidies provided to TBTF banks are not recognised in the Commonwealth Budget statement.

The GFC saw the merger of weaker with stronger banks, often encouraged by financial authorities in a number of countries (Mullineux, 2013). This had the effect of aggravating the TBTF problem and further reducing competition in banking. In the Australian context, the GFC saw the acquisition of St George by Westpac and BankWest by CBA.

The academic literature points to the risk of moral hazard in driving risky behaviour. In terms of Australia's major banks, however, there is not much evidence to support that view. These banks have conservative asset profiles. For example, they did not have the substantial holdings of toxic assets that many American and European banks did. The more pressing problem in Australia relates to the TBTF impact on competitive neutrality.

4.2.3 Recommended action on TBTF

That the FSI Panel explicitly recognise that TBTF gives funding cost advantages to banks deemed systemically important and that this should be addressed on competitive neutrality grounds.

[13] Includes other short-term borrowings, long-term borrowings, and creditors and other liabilities but excludes deposits as these are guaranteed under the Financial Claims Scheme. Figures sourced from APRA (2014).

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.2.4 Remedies for too big to fail – possible options

The UK Independent Commission on Banking (Vickers, Spottiswoode, Taylor, Winters, & Wolf, 2011, p. 14) has declared that solving the TBTF problem is good for competition.

An ideal solution for TBTF is for government to forswear any bailouts and therefore end the implicit subsidy. However, evidence and experience have shown that a no-bailout policy lacks credibility (Acharya, Anginer, & Warburton, 2013, p. 27).

The essential problem is that whenever a government is capable of providing financial support to a bank's liability holders in the event of a failure, those liability holders will factor in that implicit support. The larger and more connected the institution, the more confident investors will be of their implicit support. The political fallout from allowing losses is too great.

This essentially means the problem cannot be solved directly. It is inconceivable that a government would arrange to constitutionally bind itself against the option of protecting the national interest from a large bank failure. Solving the problem, therefore, makes policy makers examine options that address it indirectly. Six policy options are discussed below.

4.2.4.1 Option 1 – Apply a levy on TBTF banks to the value of the implied benefit

According to Stephen Cecchetti (2011), formerly the Economic Adviser and Head of the Monetary and Economic Department at the Bank of International Settlements, one should take a conventional economic approach to solving the externalities of TBTF institutions by forcing them to internalise their externality:

> *We cannot and should not merely cope with institutions that are too big or too interconnected to fail. Rather, we should force these institutions to internalise the externality they are creating and to face head on the associated systemic risk. While firms are free to choose their business models, they should be compelled to pay for the externalities they create.*

This form of levy is also known as a Pigouvian tax. The calculation could be based on estimating how the two-notch credit rating enhancement reduces the cost of securing wholesale funding and large deposits that are not covered by the Financial Claims Scheme (FCS). The estimate could be a simple multiplication of the interest rate differential by the amount of funding. The levy could be levied through APRA's financial sector charges or the Australian Taxation Office (ATO) could set up a special arrangement.

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.2.4.2 Option 2 - Higher capital charges only

APRA's approach to dealing with TBTF is to impose an additional capital charge of 1% (referred to as the higher loss absorbency (HLA) capital requirement) on the four D-SIBs banks.

As an option for TBTF, APRA's framework appears to have a number of shortcomings. Firstly, it can be argued that having now explicitly identified the TBTF banks, the non-TBTF banks are also identified by their exclusion from the list of D-SIBs. This is welcome from a clarity perspective, but it also needs to be acknowledged there are now two very different categories of institutions which makes resolution of this issue even more pressing.

Secondly, APRA (2013) implies that it is "reasonable" for banks to operate with lower management capital buffers from the date in which the HLA takes effect. On the surface, this reads as if APRA is comfortable with TBTF banks simply offsetting any HLA charges with lower management charges.

If this interpretation is correct, then this is a genuine weakness in APRA's approach. It will mean the TBTF banks not only officially get the D-SIB status, they have an option of offsetting the HLA by reducing management buffers. From a competitive neutrality perspective, this is a worse situation than what prevailed before APRA's D-SIB announcement.

Further, as explained by Andrew Haldane (2012) from the Bank of England, there is a concern that the imposition of capital surcharges at modest levels would leave a large chunk of the systemic externality untouched and has warned that systemic surcharges offer only a partial solution to TBTF. At 1%, APRA appears to be at the lower end of international experience with the Swiss Government imposing a much higher charge – 5%.

4.2.4.3 Option 3 - Let non-TBTF banks pay for a government guarantee

As part of the APS 210 liquidity standard, the RBA will provide a Committed Liquidity Facility to banks to effectively wrap eligible liquid assets that do not fall within the APRA defined Tier 1 asset class (effectively government and semi-government bonds).

The banks pay 15 basis points for access to this facility. Eligible securities for the CLF include RMBS, as well as internal RMBS repo structures.

A potential alternative model to address funding distortion between TBTF and non-TBTF banks would be for non-TBTF banks to have access to a government guarantee provided by the RBA on AAA rated RMBS. The access to the government guarantee is in effect what is implicitly provided to the D-SIBs for no fee.

This guarantee could, for example, be available for up to a certain percentage of any AAA rated RMBS tranche, say for example, 75%. This would ensure a meaningful component of each deal (e.g. 25%), would be priced subject to market pricing disciplines as to pool origination characteristics, collections practices and experience, rating agency tranching and previous pool performance.

Guaranteed RMBS could be placed as a Level 1 Basel III liquid asset, increasing the pool of eligible Level 1 assets and reducing the amount of liquid assets for which the RBA will need to provide its liquidity facility and receive its 15 basis points fee. The fee on the guaranteed portion could be simply the difference between the pricing on the unguaranteed portion and the pricing the issuer achieves on the guaranteed tranche, potentially adjusted to cover issuing costs or enhance wider market competition.

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

For illustration, AAA RMBS issuance for a regional bank would cost about 90 basis points today. Let's say a guaranteed component prices at 10 basis points, the government would receive 80 basis points. It's very similar to the RBA government guarantee facility put in place post GFC, however, better in that the guarantee is secured against residential mortgages and utilises a market-based pricing discipline to determine the fee.

In essence, this system would shift the current direct contingent liability that the government holds on the CLF for which it receives 15 basis points to a direct government guarantee for which the RBA would receive 80 basis points.

The benefits of this model are:

- The market prices both the government guaranteed and unguaranteed portions of each AAA rated RMBS tranche - and at the same time commercially prices the fee then paid to the RBA for the guarantee;
- Providing the guarantee only to non-D-SIBs will ensure strong interest in regional bank RMBS pools; and
- It would be a strong provider of liquidity to the regional bank sector given the regionals are not able to tap wholesale funding markets on an equal footing to the D-SIBs.

4.2.4.4 Option 4 – Divestiture

Professor Andy Mullineux (2013) of Bournemouth University Business School has suggested that the most direct solution would be to break up the big and complex banks into smaller and simpler units that can be allowed to fail. There is precedent for breaking up monopolistic corporate entities in US competition (or antitrust) law.

However, history suggests that divestiture has generally not proven to be effective as a remedy in monopolisation cases in terms of increasing competition, raising industry output, or reducing prices for consumers (Davey, 2012).

The future effects of divestiture on the market place is, at best, a plunge into the unknown (Cleary, 1981, p. 121).

4.2.4.5 Option 5 – Contingent capital instruments

Contingent capital instruments have gained increasing support as a potential option to reduce the need for public bail-outs (Pazarbasioglu, Zhou, Le Leslé, & Moore, 2011, p. 4). Contingent capital proposals have been popular among both academics and policymakers as way to limit systemic crises and TBTF expectations (Acharya, Anginer, & Warburton, 2013, p. 28). Contingent capital instruments is a form of debt that converts automatically into equity as credit quality deteriorates, thus ensuring a fresh injection of capital and, in turn, reducing the likelihood of default when an adverse shock occurs.

By imposing losses on creditors, contingent capital would partially restore market discipline and reduce the need for government intervention (Acharya, Anginer, & Warburton, 2013, p. 28). However, the contingent capital solution suffers from an important limitation. Beneath contingent capital will remain debt that is implicitly guaranteed by the government.

4.2.4.6 Option 6 – No bank can fail

There is a view amongst many in the market the Government would not let any bank to fail. While this may be the case, it is clearly not the view of credit rating agencies, and therefore is not reflected in funding costs for all banks. The Government could consider making clearer its likely actions in the case of any bank failure to ensure there is not a disproportionate impact on funding costs. This would have the advantage of entirely removing the funding advantage currently received by the D-SIBs and thus levelling the playing field. It would also have the advantage of making any government guarantee to ADIs transparent.

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.2.5 Recommendation – FSI Panel to examine the lowest-cost means of removing the funding advantage of the TBTF problem

The regional banks believe considerably more work is needed before settling on a solution to the TBTF problem. The objective is clear, that of ensuring the funding advantage of TBTF is removed. How this is achieved in practice is work-in-progress.

4.3 REGULATORY BURDEN – DISPROPORTIONALLY IMPACTS SMALLER BANKS

Another factor impacting on competition is the fixed costs associated with government regulation and compliance. It costs smaller ADIs the same to respond to regulatory change and then make recommended changes to product documentation. Smaller banks have fewer customers over which to spread those fixed costs.

Aside from the competitive perspective, heavy regulation of the financial sector has wider economic implications. The former Chairman of the Productivity Commission, Gary Banks (2010, p. 84), warned of the dangers of imposing additional regulation on the financial sector in the wake of the GFC:

> *The third area where we need to be careful to get the balance right in any new regulation is the finance sector. Regulatory failings in the United States were clearly implicated in the global financial crisis. While Australia did not share those failings — on the contrary — there is considerable pressure for us to impose 'stricter' regulation. There is much at stake in getting this right. Financial regulation needs to steer a course between the risks and costs of financial instability — and its potential contagion effects on the real economy — and the risks and costs of stultifying competition, innovation and ultimately the productivity of this key sector — and the adverse economy-wide impacts that these too would have.*

The cost of additional regulation imposed on the financial sector since the GFC has been large, both in terms of staff that work on it, boards that monitor and implement it, IT departments that make system changes, legal teams that review document changes, marketing, staff education etc. Evidence for this is hard to calculate because regulatory burden is imposed on existing directors, executives and staff in banks. Excessive regulation changes work priorities.

The real cost, therefore, is the opportunity cost of having senior board members, executives and staff doing compliance work as opposed to improving products and services. Innovation is the casualty from excessive regulatory burden, yet it is near impossible to measure innovation benefits foregone.

While estimating benefits foregone is problematic, there are proxy indicators. The ABS (2013c) does an annual business characteristics survey which asks businesses to identify barriers to both general business performance and also to innovation. The results show that regulatory and compliance barriers are higher in the financial services industry than any other industry, including utilities like water and electricity.

As part of its business characteristics survey, the ABS categorises businesses as either 'innovative-active" or "non-innovative active". Table 7 presents survey results for "innovative-active" businesses on an annual basis starting in 2007, roughly the time GFC problems emerged. Table 7 shows that in 2012, 34.3% of financial services businesses identified government regulation or compliance as a barrier to innovation. This was up significantly from the 21% reported in 2007, although materially down from the 41.7% recorded in 2011.

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

Table 7 Barriers to innovation - regulation and compliance

Business perspective	Category	Category detail	Innovation status	Barrier type 2007	2008	2009	2010	2011	2012
Barriers to innovation	Industry	Financial and Insurance Services	Innovation-active businesses	21.00	14.80	15.70	24.80	41.70	34.30
		Electricity, Gas, Water and Waste Services	Innovation-active businesses	12.10	18.70	19.80	21.50	21.30	24.20
		Rental, Hiring and Real Estate Services	Innovation-active businesses	10.20	6.60	20.80	18.10	12.70	23.20
		Transport, Postal and Warehousing	Innovation-active businesses	20.40	20.10	20.00	35.20	25.10	23.10
		Wholesale Trade	Innovation-active businesses	12.70	13.40	11.70	16.60	10.50	22.10
		Administrative and Support Services	Innovation-active businesses	5.30	17.70	12.90	23.50	20.00	20.80
		Manufacturing	Innovation-active businesses	9.70	12.30	14.50	15.30	17.90	20.20
		Construction	Innovation-active businesses	12.70	17.60	17.80	28.00	17.00	19.70
		Accommodation and Food Services	Innovation-active businesses	17.00	21.50	24.70	25.70	22.90	17.00
		Health Care and Social Assistance	Innovation-active businesses	18.00	24.20	17.50	19.30	10.90	16.90
		Agriculture, Forestry and Fishing	Innovation-active businesses				31.20	27.50	16.30
		Retail Trade	Innovation-active businesses	5.40	10.70	15.40	14.20	17.50	16.20
		Arts and Recreation Services	Innovation-active businesses	10.90	15.50	8.20	17.30	8.90	15.80
		Other Services	Innovation-active businesses	10.00	13.30	12.20	11.70	12.30	14.40
		Mining	Innovation-active businesses	13.70	23.40	18.90	18.90	25.30	13.20
		Professional, Scientific and Technical Services	Innovation-active businesses	16.40	13.20	8.70	15.90	9.80	13.10
		Information Media and Telecommunications	Innovation-active businesses	4.10	11.60	7.00	15.60	11.20	9.70
		Total	Innovation-active businesses	12.70	14.90	15.00	20.30	16.50	18.00

Source: Australian Bureau of Statistics, Business Characteristics Survey; Pegasus Economics.

In addition to this, the ABS survey lists other identified barriers to innovation. The next most commonly identified barrier after government regulations or compliance is lack of skilled persons (in any location) – 27.3% (See Table 8).

Liaison with regional banks suggests that around 30% of IT and project budgets are allocated to compliance and regulation.

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

Table 8 Barriers to innovation

Business perspective	Category	Category detail	Innovation status	Barrier type	Date 2007	2008	2009	2010	2011	2012
Barriers to innovation	Industry	Financial and Insurance Services	Innovation - active businesses	Government regulations or compliance	21.00	14.80	15.70	24.80	41.70	34.30
				Lack of skilled persons: in any location	28.90	24.20	16.50	23.30	34.30	27.30
				Cost of development or introduction/implementation	9.00	17.60	19.40	19.00	7.80	20.70
				Lack of access to additional funds	12.70	20.20	35.50	24.50	21.10	19.80
				Lack of skilled persons: within the business	22.10	20.20	13.50	20.60	28.30	19.70
				Uncertain demand for new goods or services	5.80	16.10	12.00	11.00	7.70	16.80
				Lack of skilled persons: within the labour market	17.40	13.50	4.50	10.80	10.40	13.70
				Lack of access to knowledge or technology	8.50	2.70	5.70	6.90	4.60	10.60
				Adherence to standards			1.40	5.40	6.00	7.60

Source: Australian Bureau of Statistics, Business Characteristics Survey; Pegasus Economics.

Financial services businesses are probably subject to a heavier regulatory barriers than other industries because they have more regulators. These include APRA, ASIC (for credit), the Australian Transaction Reports and Analysis Centre (AUSTRAC) (anti-money laundering) and the Financial Ombudsman Service (FOS). The Office of the Australian Information Commissioner, while not an industry specific regulator, is a critical agency for banks given the confidential nature of financial information and data.

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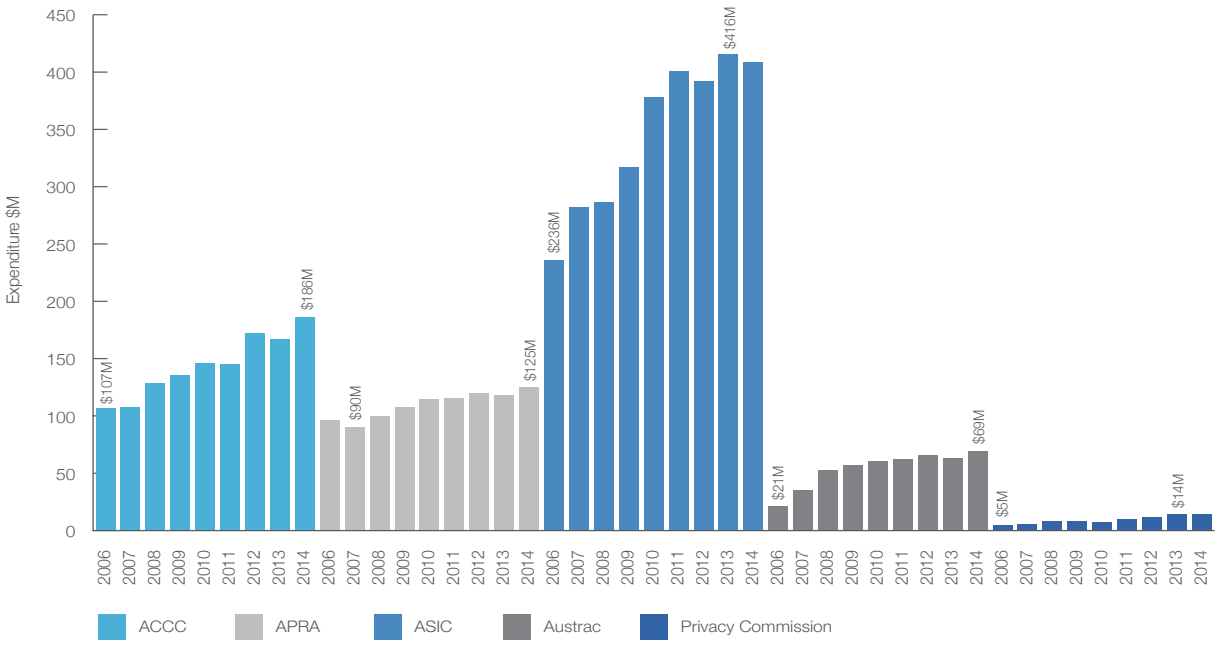
COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

Figure 4.5 Government agencies involved in financial services regulation



Source: Commonwealth Government, Portfolio Budget Statements from Attorney General's, Department of Prime Minister and Cabinet and Treasury; Pegasus Economics growth calculations.

2014 is a budget forecast.

Figure 4.5 presents annual operating budgets for key regulators over the last eight years. The regulator with the most significant growth in budget is ASIC. Since 2006, ASIC's budget has grown by 73% in nominal terms, compared to 29% for APRA. ASIC's staffing budget has grown even stronger at 81%, compared to APRA's at 45%.

While growth in regulatory budgets does not per se imply an increasing regulatory burden on businesses, it may be a reasonable proxy for that. More staff expenditure may suggest more supervision and an associated increase in the compliance burden. In the case of ASIC, the growth in budget does appear consistent with increased compliance demands on banks. In recent years, ASIC has implemented the National Consumer Credit Protection Act 2009 and the debt collection guidelines. ASIC also oversees codes of practice, including the Code of Banking Practice (CBP).

4.3.1 Recommendations – Regulation Impact Statements

Fixing the regulatory burden problem is one of the most vexing challenges we face. We are living in a time when risk aversion is running high and the community wants politicians to be 'doing things' to address perceived concerns, even when the most sensible course is to do nothing.

One obvious area of improvement is in relation to the RIS process. The cost/benefit assessment obligation in these assessments must address the competition angle as already discussed. This could be achieved simply by ensuring the RIS guidelines are properly enforced. If this proves too difficult, then other mechanisms are worth exploring such as requiring proponents of regulation to prepare a Statement of Regulatory Intent (SRI).

4 COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.3.2 Recommendation – Remove red tape and reduce duplication

The FSI Panel should consider the potential benefits of consolidating current regulatory structures and licensing regimes in order to remove red tape and reduce duplication. Given the overlap in regulatory functions between ASIC and AUSTRAC in protecting the reputation of Australia's financial system, one means of removing red tape and reducing duplication is incorporating AUSTRAC into ASIC.

Another concept worth investigating is a 'one stop shop' licence for banking businesses instead of the current system whereby ADIs are licenced by APRA and are therefore subject to extensive prudential controls and oversight, but also need to satisfy licencing requirements of numerous other regulators and agencies for various aspects of their business, including duplicated regulatory oversight for subsidiary companies.

4.4 HORIZONTAL AND VERTICAL INTEGRATION

With the major banks now dominating retail domestic banking markets, their reach into other financial services has increased and is likely to increase further. The major banks are now large players in superannuation, wealth management, stock broking and insurance. Figure 4.6 traces merger activity involving the major banks since 2002.

In 2007, ANZ bought E*Trade Australia which gave it greater exposure to broking and other financial services. In 2009, it made an investment in ING's private wealth and insurance business. In 2010, it purchased Landmark Operation which had operations in agribusiness banking.

Figure 4.6 Merger Activity

Acquirer(s)	Target(s)	Industry	Outcome of assessment	Date completed	Days taken to reach decision
ANZ	E*Trade Australia	Broking and financial services	Not opposed	28/02/2007	8
	ING Australia	Private wealth management, insurance	Not opposed	29/10/2009	48
	Landmark Operations	Agribusiness banking products	Not opposed	10/02/2010	43
CBA	AHL Investments	Banking	Not opposed	30/09/2008	14
	Count Financial	Financial planning, wealth management	Not opposed	17/11/2011	45
	IWL	Stockbroking services	Not opposed	10/10/2007	31
	St Andrews Australia & Bank of Western Australia	Banking	Not opposed	10/12/2008	25
	Wizard Home Loans	Banking/Home Loans	Not opposed	24/02/2009	21
NAB	Aviva Australia Holdings	Insurance	Not opposed	28/07/2009	22
	AXA Asia Pacific Holdings	Banking	Opposed	9/09/2010	24
		Wealth management, superannuation, insurance	Opposed	19/04/2010	60
	Cash Services Australia (CSA)	Cash transportation and processing services	Opposed	25/11/2005	
	Challenger Financial Services Group	Mortgage management	Not opposed	7/10/2009	34
	Goldman Sachs JBWere Private Wealth Management	Stock broking and wealth management	Not opposed	1/09/2009	19
Westpac	Cairns Airport and Mackay Airport	Investment (Airport)	Not opposed	2/12/2008	16
	Lloyds International (CFAL & BOSI)	Finance	Not opposed	4/12/2013	39
	RAMS Home Loans	Banking	Not opposed	19/11/2007	19
	St George Bank	Banking	Not opposed	13/08/2008	52
Major banks joint acquisition	National E-Conveyancing Development	Banking	Not opposed	19/10/2011	35

Source: ACCC website: www.accc.gov.au

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CBA has completed five significant domestic deals over the last decade, all of which were undertaken against the turmoil of the GFC. In 2007, CBA purchased stockbroker IWL. In September 2008, CBA made a 33% investment in Aussie Home Loans, a major mortgage securitiser and provider of loan broking services. The deal took the ACCC only fourteen days to informally clear. CBA has subsequently increased its investment to 50%. This merger was significant in that Aussie Home Loans was a high-profile competitor to the banks and had significant market share. It should be noted that Aussie Home Loans provides a platform service whereby it offers customers a wide range of housing loan options. Since the investment in Aussie, CBA has increased the percentage of its loan book growth from the broker channel.

The approval of this investment is, in some respects, inconsistent with the ACCC's opposition to NAB's proposed purchase of AXA. This was opposed on the grounds that AXA provided a platform service and that ownership of the platform could undermine competition.

On 10 December 2008, CBA announced the acquisition of BankWest which was previously owned by UK-based HBOS. Within two days the Australian Government announced its formal bank liability guarantee scheme. The acquisition of BankWest was a major event in retail banking. The regional bank was a material competitive constraint on the major banks, as it provided very competitive deposit rates and had a popular business banking franchise.

Three months after the acquisition of BankWest, Aussie Home Loans and CBA acquired Wizard Home Loans, another successful mortgage securitiser that was victim to the closure of securitisation markets. In 2011, CBA acquired Count Financial, a provider of Wealth Management and financial planning services. Count also had a stake in Mortgage Choice, so CBA's acquisition of Count gave them equity in Mortgage Choice as well.

These mergers and acquisitions assisted CBA to build its retail banking market presence materially. Overall domestic assets accounted for just over 17% in 2008 and then rose to around 23% in 2013, a 6% increase. In the highly lucrative mortgage financing market, CBA increased its market share from 17.5% to a high of 28.5%, making it the largest housing lender in Australia. Deposit share increased by seven percentage points from 17.5% to around 25%.

Westpac was also a significant beneficiary of the industry consolidation that took place during the GFC. Its major acquisition was St. George in August 2008. St. George had a significant consumer and business finance presence and was the fifth largest bank in Australia at the time. It had strong customer satisfaction, consistent with regional banks generally. Subsequent to the merger, St. George still trades under its pre-acquisition name, as part of Westpac's multi-brand strategy.

The other significant retail banking purchase by Westpac was that of mortgage securitiser RAMS. RAMS was another successful housing lender that was disrupted by the closure of securitisation markets. More recently, Westpac announced the acquisition of the Australian assets of Lloyds International.

As with the CBA, these mergers and acquisitions have materially increased Westpac's domestic market share. In 2007, Westpac's share of total domestic assets was around 14%. Today, the Group's market share is over 23%, a very significant increase of 9%. Westpac's market share gain in owner-occupied housing currently stands at over 24%, a large gain from the 15% held prior to the GFC. Along with this growth in share of lending has been an increase in the share of local deposits from 14.5% to 22%.

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

NAB's record of mergers since the GFC has been mixed, with the ACCC opposing its proposed acquisition of AXA in 2010. In addition, it has not managed to secure any material acquisition of banking assets. However, in 2009, the acquisition of Challenger Financial Group gave NAB a strategically important access to mortgage brokers through Challenger's aggregations business. Challenger had secured three significant aggregators in previous years: PLAN Australia, Choice Aggregation Services and FAST. (Rogers, 2009). This purchase materially increased the broker-originated lending for NAB. In acquiring Challenger, NAB not only acquired the distribution capability of one broker, but also a network of platforms responsible for approximately 40% of sales in mortgage products by mortgage brokers.

In 2009, NAB also bought the insurer Aviva and Goldman Sachs JB Were Private Wealth Management.

Given NAB did not acquire any significant banking assets in the GFC period, its market share gains in domestic markets have been less than that of Westpac and CBA. NAB has actually experienced a decline in its share of domestic assets since 2003. It currently has around 18.3% of total domestic assets. This is an increase of 3% since the GFC, but down by around 2% from its peak in 2003.

NAB's share of owner occupied housing lending is currently at 18.3% which is only around 1% higher than it had in 2007, although up 3% from its position in early 2010. NAB's performance in deposits has been marginally better, increasing its share of this funding source from 14% in 2007 to 17.6% today, an increase of 3.6%.

Collectively, the major banks have emerged in a dominant position in all significant domestic retail product markets, and have made headway in dominating non-core markets as part of a push for greater vertical integration.

Chris Joye (2014), Director of Yellow Brick Road and Australian Financial Review columnist has made the following observations regarding vertical integration (speaking mainly in the context of financial planning and the Government's decision to reverse Future of Financial Advice reforms):

> *A critical issue is the link between the mounting "vertical integration" of Australia's financial system and the payment of product bonuses.*
>
> *Most planners now work for institutions that have their own in-house home loans, deposits, super funds, investment solutions and administrative platforms. They are end-to-end financial supermarkets with, in some instances, regulated comparative advantages.*
>
> *This was not always the case.*
>
> *As the four big banks came to control more than 80 per cent of the financial system, and struggled to expand more quickly than national income, they have hunted for growth in other non-core industries.*
>
> *One of the most striking vertical integration developments has been the acute consolidation of the once-independent financial advice sector…*
>
> *In 2007, only 27.5 per cent of all advisers worked for the big four banks and AMP, according to research house Rainmaker. By 2013 that number had jumped to almost 60 per cent. And if you include "affiliated" individuals, the major banks and AMP are believed to account for more than 70 per cent of advisers*
>
> *…The strategy should sound familiar. It is similar to the multibrand approach banks use via the likes of RAMS, BankWest, St George, UBank, and Bank of Melbourne to flog products through superficially independent channels that are wholly owned subsidiaries…*

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COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.4.1 Role of mortgage brokers

Mortgage brokers are intermediaries who both match potential mortgage borrowers and lenders and assist them in completing the mortgage transaction (Kleiner & Todd, 2007, p. 2). They provide advice on numerous home loans available usually collect a commission fee from lenders (Australian Competition and Consumer Commission, 2009, p. 4).

Mortgage brokers serve a useful function by making the complicated task of shopping and applying for the increasingly wide array of mortgage products more manageable and efficient for borrowers and lenders alike (Kleiner & Todd, 2007, p. 2). Mortgage brokers, by consolidating information on multiple products from multiple lenders, offer consumers a convenient way to examine a variety of home loans for which they are financially qualified.

Mortgage aggregators or broker platforms provide accredited brokers with access to the products of a range of lenders and also provide infrastructure (technology systems and software) and administrative support, education and training, communication and marketing assistance to member brokers (Australian Competition and Consumer Commission, 2009, p. 5). The aggregator organises a panel of lenders, facilitates processing of applications and enters into commission-sharing arrangements with broker members. Many mortgage brokers are aligned to a distribution platform/aggregator service. Broker platforms generally have commission-splitting arrangements with brokers and derive revenue by retaining a fee from brokers' commission payments.

In terms of origination of housing loans, it is estimated that over 40% of new home loans in Australia are sourced through mortgage brokers. The largest players in the mortgage broking market are AFG, Aussie Home Loans, Mortgage Choice and Choice Home Loans. Together they control around 45% of the mortgage broker market (IBISWorld, June 2011).

Despite the benefits that mortgage brokers bring, there is the potential for the exploitation of borrowers. Bank ownership of mortgage broking platforms is potentially a competitive distortion and has consumer protection implications. One reason prospective borrowers seek a loans from brokers is to receive an impartial offering of housing loan products, yet this is potentially compromised if the broker owner is also a housing loan issuer.

Ownership may exert pressure on brokers to allocate high credit quality customers to the owner, while sending lower quality customers to competitors. Even if pressure is not applied, the relationship between owner and broker may give the owner greater opportunity to tailor products to secure better customers.

This problem is not unique to Australia. In response to similar concerns in the United Kingdom, in late April 2014 the UK Financial Services Authority (2012) will implement changes whereby mortgage brokers will be required to disclose any limitations in relation to their product offering.

Much greater transparency is needed in the broker market to ensure consumers are aware of the incentive schemes, ownership structure and any limitations on the broker in providing an impartial offering of housing loans.

While this section has focused on mortgage brokers, there are many other parties that constitute the wider mortgage industry and financial services market more generally. In order to achieve genuine competition and competitive neutrality, it is critical consumers have clear and pertinent information at hand when making decisions. With structural changes in financial markets, such as increased vertical integration, new disclosures become increasingly important for consumers, such as disclosures of ownership structure.

4

COMPETITIVE NEUTRALITY - KEY ISSUES AND RECOMMENDATIONS

4.4.2 Recommendation – broking industry needs better disclosure

To ensure consumers are informed of incentives that may influence product offerings, the following disclosure principles should be provided to every potential customer (Note – mortgage brokers are used for illustration, but the principles are generally applicable).

- The mortgage brokers' ownership structure;
- The range of issuers and products offered by the mortgage broker;
- The fees and commissions attached to each product offered;
- The proportion of loans brokered that go to their owners (if applicable) and basic risk information about the loans, such as average Loan to Value Ratios. (This disclosure is aimed at identifying whether brokers are sending the best credit risks to their owners).

4.4.3 Confusion over ownership

Consumers may be confused over the ownership of various banking trading entities. St.George, BankWest, RAMS, Aussie Home Loans, and Wizard all trade under their original brand names despite being purchased by major banks.

4.4.4 Recommendation – ASIC to conduct survey into potential confusion over multi-brands

The FSI Panel should consider commissioning ASIC to undertake a market survey to assess whether the multi-brand strategy of banking institutions is causing confusion in the minds of consumers as to ownership. If it is found that confusion does exist, then a strong disclosure obligation must be introduced to ensure customers are making informed decisions.

4.5 SWITCHING BANK ACCOUNTS

One area of frustration for the regional banks is the inertia of customers switching banks. For decades the regional banks have recorded considerably higher customer satisfaction ratings but this has not resulted in the expected market share gains implied by this satisfaction gap. The hassle involved in switching accounts, particularly linked accounts that have existing debit instructions (such as scheme cards ie those with a Visa, Mastercard or Amex logo) has been a factor in this inertia.

Regional banks support measures to make switching banks easier. Although as a group the regional banks agree with the concept of bank account number portability, the costs of undertaking this initiative are prohibitive, as was found by former RBA Governor Bernie Fraser (2011).

There is some prospect that the New Payments Platform initiated by the RBA and the Australian Payments Council Association (2013) will in the long-term assist with switching bank accounts. The new platform is likely to enable customers to use convenient forms of addresses to route transactions, such as email and mobile phone numbers. If this comes to fruition it should enable customers to link regular payments to mobile phone numbers and email addresses and, therefore, make switching bank accounts easier.

4.5.1 Recommendation - New Payments Platform

The FSI Panel should recommend that the design of the New Payments Platform should incorporate the idea of facilitating bank account switching. This would result in a considerable consumer benefit.


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PULLING THE THREADS TOGETHER AND CONCLUSIONS – WHAT IS THE STATE OF COMPETITION?

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There are numerous indicators, as presented in chapter 3, that suggest there is inefficiency within Australia's banking system. While there is no suggestion of illegality or of unethical behaviour by the major banks (they are simply doing what they are paid to do and that is to maximise returns to shareholders), the structure is such that a form of coordinated effects is likely to have emerged.

This should not be a surprising conclusion when viewed in light of the facts. The basic elements exist that signal competition problems: high market concentration, high barriers to entry and large sunk costs, high profitability by institutions with the largest market shares, high margins and high price-to-book ratios.

One mitigating factor at the present time against the exercise of market power is the presence of a competitive fringe of smaller banks and other financial service providers, most prominently the four regional banks who have commissioned this Submission.

The margins maintained by the major banks are significantly higher than those for regional banks. This is primarily due to the major banks' cheaper funding costs rather than higher interest rates charged to borrowers. The interest rates charged in the market are similar between the major banks and smaller banks, whereas the deposit rates offered by the major banks are generally lower and the wholesale funding costs are materially lower.

The available evidence suggests the competitive fringe imposes a competitive constraint on the four major banks in some product categories, especially in relation to lending for owner-occupied housing. However, without change, customer choice in the provision of financial services in Australia is now in question. While there is no doubt as to the financial viability of the smaller ADIs, including the regional banks, the question is whether they can be sufficiently robust to represent a real competitive constraint on the largest banks. If the playing field is not levelled, then the competitive situation will decline further. Addressing costs is a key issue.

What sets the four major banks apart from most other financial service providers is the fact they enjoy lower capital requirements, a TBTF funding advantage, and relatively lower regulatory compliance costs. Given the major banks are not passing on these benefits to consumers, it suggests products are being priced at a level consistent with higher cost producers who represent the marginal source of supply.

This is consistent with the previous finding of the House of Representatives Standing Committee on Economics (2008, p. 23) that concluded in relation to mortgage lending:

> *While there is no doubt that the big four aggressively compete with the other players in the market, including foreign-owned banks, the credit unions, building societies and the non-banking sector, there is some uncertainty as to whether the big four are actively competing with each other.*

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PULLING THE THREADS TOGETHER AND CONCLUSIONS - WHAT IS THE STATE OF COMPETITION?

It would appear that regulation has tilted the playing field materially in favour of the major banks by lowering their capital costs and relative funding and compliance costs. In this case, regulation reduces majors' costs to the detriment of smaller ADIs and wider competition and in turn undermining competitive neutrality.

Without competitive neutrality, the provision of financial services may reach a tipping point where customer choice is significantly threatened.

In the event the competitive constraint imposed by the smaller providers is irretrievably undermined through a lack of competitive neutrality, this would leave the provision of financial services vulnerable to further exploitation from coordinated effects and potentially higher priced products for customers.

The pursuit of competitive neutrality as a policy goal through measures such as levelling the playing field in relation to capital adequacy requirements and reducing the overarching regulatory burden will lower the costs of smaller providers. By doing this, the competitive constraint of smaller providers will be increased and end users will reap the benefits. A level playing field is also likely to remove some distortions such as the bias towards housing lending in preference to small business.

[14] A tipping point is where a small change in the underlying parameter or shock can make a very large difference in outcomes (Gai, Haldane, & Kapadiaz, 2011, pp. 453-454). The important policy aspect is that it is not necessarily the firm, service or product providing the highest quality that becomes dominant (Claessens, Dobos, Klingebiel, & Laeven, 2003, p. 122).

[15] As a matter of economic theory, even a monopolist will generally be expected to pass along at least some portion of a reduction in marginal costs (Frankel, 2007, p. 47). Insights into the extent of the pass through to end users from lowering firms' costs can be obtained from tax incidence theory.


6

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