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Banking Competition: The Rhetoric and the Reality

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Banking Competition:
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Overview

Introduction

The decision by the Big 4 banks to raise home loan interest rates by substantially more than the 25 basis th November 2010 triggered widespread outrage across the community despite previous warnings by the banks that interest rates were going to have to rise faster than the cash rate due to the increase in funding costs that banks have faced since the onset of the GFC. The outrage was reflected in public comments made by members of both the Government and the Opposition and reflected the public

Banks have faced higher funding costs across all types of funding.

Despite higher funding costs, higher interest spreads have led to a rise in the net interest income of the Big 4 although net interest margins have not recovered their pre-GFC levels.

Net interest income for the other domestic banks has not recovered its pre-GFC level.

The securitisation market has all but collapsed making it more difficult for regional banks and other financial service providers which rely more heavily than the majors on the wholesale market to secure funding.

Less funding at higher cost is making it more difficult for the regional banks and other financial service providers to compete with the four majors.

The sixth and seventh points are the most important in terms of increasing competition between the four major banks and the other lenders including the regional banks, mortgage originators and building societies. The smaller lenders had a much greater reliance on securitisation as a source of funding and it was the rapid growth of the securitisation market that enabled them to increase their market share in the years leading up to the GFC. Policy responses to support access by the regional banks and the mutual sector to the securitisation and wholesale markets are key to driving competition in the banking sector.

Figure 4
Return on equity: major banks

Source: KPMG, *Major Australian Banks, Year End: Financial Institutions Performance Summary*, www.kpmg.com.au

Another major performance indicator for banks is the return on assets (ROA) which is a measure of after-tax profits per dollar of assets held by

In contrast to the perception engendered by the absolute magnitude of bank profits, the fall in the ROE since 2007 and in the ROA since 2005 suggests that the profit performance of the banks has not been all that stellar in recent years. The Big 4 have massively stepped up the level of competition in the retail market since the Senate Inquiry was announced and the aggressive discounting that is currently occurring may put significant downward pressure on the ROE and ROA should it be maintained which may be of benefit to bank customers but will be of concern to shareholders.

2. Interest spreads: are banks gouging borrowers?

The public perception is that the banks are gouging bank borrowers by

loan interest rates is that they themselves face higher funding costs as they compete with each other to attract deposits by offering higher term deposit rates and they convert some less expensive short-term funding raised in the capital markets to more expensive long-term funding to ensure more stable sources of funding. The composition and cost of bank funding will be considered further below.

All of the banks argue that they have had to increase the spreads on borrowers because of the rise in their own funding costs. Figure 7 which illustrates the interest expense of the four majors by category supports the argument that there has been a rise in funding costs. There has been a very marked rise in interest paid to depositors but also some increases in interest paid on borrowed funds and on other interest-bearing liabilities over the past several years.

Figure 7
Interest expense of major banks by category

Source: APRA, *Quarterly Bank Performance*, www.apra.gov.au

Net interest income is the difference between the interest earned by making loans and investing in securities, and the interest that must be paid to secure the funding with which to make those loans. If it is the case that banks have been gouging borrowers in recent years, one would expect to observe a marked rise in net interest income earned by the banks. An increase in interest revenue matched by an increase in funding costs would lead to no change in net interest income, whereas if funding costs are rising faster than the interest income earned by the banks one

For the major banks, net interest income rose from $8,493 million in the June 2008 quarter to $11,546 million (a rise of 36 per cent) in the June

Despite

margin has risen since 2008[8] (see Figure 10). In the several years leading up to the GFC, net interest margins fell. KPMG reported the main factors driving the fall were more expensive funding, an asset mix with relatively lower margin products, and most importantly and the biggest driver of the fall, competition with interest rate spreads on credit cards, mortgages and business lending all coming under pressure. From 2008, the key contributor to the rise in the net interest margin was re-pricing for risk especially in the commercial and industrial portfolios tempered by increased competition in the market for retail deposits and the rise in funding costs as short-term debt was replaced by long-term debt in the wholesale market.

Figure 10
Net interest margins: major banks

Note: Fiscal years ended 2005 & 2006 include St George amongst major banks.
Source: Source: KPMG, *Major Australian Banks, Year End: Financial Institutions Performance Summary*, www.kpmg.com.au

The four major banks have engaged in intensive price competition in relation to housing loans and business loans in recent months. As a consequence of this and because of higher funding costs, UBS has forecast the margins of the Big 4 to fall to 2.25 per cent in 2011 and to fall significantly further to 2.13 per cent in the next two years.[9]

3. Bank funding

3.1 Composition of bank funding

n the RBA cash rate has been that their funding costs have risen. Funding costs depend on the composition of bank funding and how much the banks have to pay for each source of funds. The majority of funding for the major banks and the regional banks come

between June 2007 and October 2010. Figure 11 also shows that prior to
-term debt
than from long-term debt, but post-

however, deposits and long-term funds are more expensive for the banks to raise than are short-term funds.

Access to funding is vital to the stability of the Australian banking sector; long-term funding increases stability relative to short-term funding but long-term funding comes at higher costs which are then passed on to bank customers.

Figure 12
Composition of bank funding excluding equity and securitisations

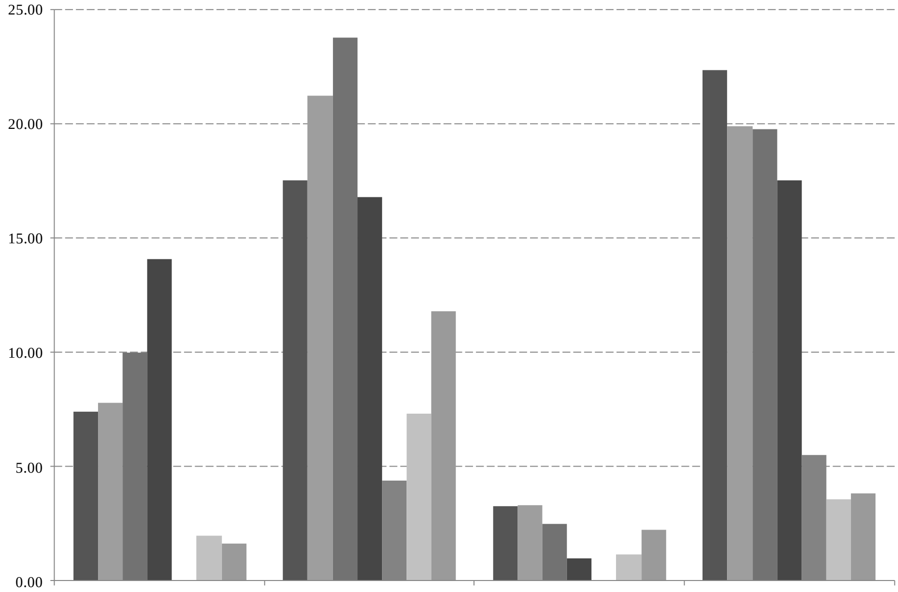
Source: ABS, *Financial Accounts, Australian National Accounts*, Cat. No. 5232.0, www.abs.gov.au

3.2 Securitisation

Prior to the GFC, the development of the securitisation market in Australia was a prime driver of competition between the large banks and other financial institutions, especially in the home loan market. Securitisation refers to the pooling and sale of loan assets by financial institutions which sell those loans to a special purpose vehicle (SPV) set up for the specific purpose of issuing securities (bonds) backed by the underlying loans into financial markets.

In Australia, most of the loan assets which are securitised are home loans. These are known as residential mortgage backed securities

Figure 13
RMBS issuance by originator



Source: Data obtained on request from RBA.

Other types of loans including commercial property, automobile, and credit card loans can also be securitised. Securitised loans are more generally referred to as asset backed securities (ABS). Payments to investors in RMBS or other types of ABS depend on the underlying borrowers making their repayments as they fall due.[10] RMBS and other forms of ABS are amortising securities, i.e., repayments of both principal and interest are made to investors throughout the life of the security. Financial institutions of various kinds are the principal investors in securitised loans.

Securitisation is an additional source of funding for banks and other financial institutions. By selling some of their loan assets they raise monies which can be used to make more loans. The GFC led to the near-collapse of the securitisation market so that the smaller banks, CUBS and mortgage originators have not been able to raise much funding through the issue of ABS since 2008 (see Figure 13). The money that has been raised has largely been with the support of the Australian Government.

4. Funding costs

4.1 Deposits

Deposits are the major source of funding for the major banks and for the

Senate Inquiry states that the more expensive savings, online and term deposits account for around 70 per cent of total balances and the typically low interest transaction accounts constitute approximately 30 per cent of total deposits.

6. Switching providers: Is it too difficult?

Competition is increased when consumers can easily switch providers. An issue for borrowers has been exit fees. The regional banks and mortgage originators compete with the major banks by offering lower upfront costs for borrowers but they charge higher exit fees.

Exit fees are otherwise known as deferred establishment fees and are intended to compensate lenders for not charging the full costs of establishing loans at the outset. Lenders expect to recoup some of their establishment costs from ongoing fees and interest rates charged on loans, but early prepayment on loans can leave lenders out of pocket.

PART TWO
POLICY RESPONSES

1. Supporting alternatives to the Big 4

1.1 Supporting the development of the fifth pillar: the mutual sector

One of the planks in the *Competitive and Sustainable Banking System* package is to build a new pillar, the so-called fifth pillar, by supporting the mutual sector (credit unions and building societies or CUBS) to ere eligible and by educating the public about the safety and competitiveness of mutual lenders. Credit unions and building societies are similar to banks in that they are authorised deposit-taking institutions (ADIs) and so are supervised by APRA, but differ in that they operate on a not-for-profit co-operative basis where depositors are members of the society or credit union to which they belong. In contrast, banks are in business to make profits and shareholders are not necessarily depositors in the banks in which they hold shares. All ADIs are supervised by APRA and deposits in banks and CUBS are protected under the Financial Claims Scheme.

five building societies and 20 credit unions that could seek approval to

to date. These building societies and credit unions are already authorised by APRA to carry on banking business and, in addition, have at least $50 million in Tier 1 capital, which is the minimum requirement set by APRA for an authorised deposit-taking institution (ADI) to seek approval

Capital provides a buffer against unanticipated losses. It means the shareholders rather than the depositors absorb the losses (at least until capital is exhausted). One of the reasons no Australian bank failed during the GFC is that Australian banks were well capitalised relative to their overseas peers. Dilution of the capital requirement would mean that it is more likely less well capitalised banks or other financial institutions would fail in the future which could lead to contagion effects to other financial institutions and widespread instability in the financial sector. More highly capitalised institutions are better protected from failure.

Most credit unions and building societies are not as safe as banks simply because they do not hold as much capital. However, depositors in the mutuals are protected by the Financial Claims Scheme and so their deposits are as safe as those in the banks. The push by some of the mutuals, e.g., CUA, to change the classification of Authorised Deposit Taking Institutions to Australian Banking Institutions would seem to send the wrong signal to consumers. Mutuals are regulated by APRA in a similar way to banks but it is less likely that the Government would bail-out a mutual that was failing simply because its failure would not have the same implications for financial stability as would the failure of matter what the authorities now say.

For the Government to suggest mutuals will become a fifth pillar in the banking system any time soon is misleading. Between 2004 and 2010, the total assets of all building societies and credit unions as proportion of the combined assets of banks and CUBS never exceeded 2.7 per cent. However, the origins of many mutuals lay in providing home loans to their members but even on
value of housing loans provided by banks and the CUBs has not exceeded 5 per cent since 2004. The *Competitive and Sustainable Banking System* package (p. 17) states that mutuals account for around 9 per cent of *new* home loans and offer discounts up to 1 percentage point lower than the standard rates offered by the major banks, but without noting that most of the new home loans offered by the major banks are also at substantial discounts to their standard variable rates.

1.2 Supporting the growth of foreign banks in Australia

The GFC led to a decline in the presence of foreign banks in Australia. After rising from a 14.9 per cent share in the second half of 2004, the total combined assets of foreign bank branches and subsidiaries located in Australia fell from a peak of 19.1 in the September 2007 quarter to 12.9 per cent in the September 2010 quarter (see Figure 17). Several submissions to the Senate Inquiry (e.g., Australian Bankers Association, Chamber of Commerce & Industry Queensland, HSBC, ING Direct) have advocated both the immediate abolition of interest withholding tax and the LIBOR cap as measures that could provide a more level playing field for foreign banks operating in Australia and therefore bring more competitive pressure to bear on the domestic banks.

Figure 17
Foreign bank assets as a share of total assets of banks operating in Australia

Source: APQ4 411.P420( )-8

Subsidiaries of foreign banks operating in Australia are currently required to pay 10 per cent interest withholding tax (IWT) on the interest they pay for funds borrowed from their parents or non-resident affiliated banks and Australian branches of overseas banks are required to pay 5 per cent IWT. Any bank operating in Australia which takes retail deposits from offshore depositors and on-

The LIBOR cap artificially inflates funding costs, especially longer-term funding costs for branches of foreign banks which source some of their funds from parent banks relative to the funding costs for domestic banks. Interest expenses are fully tax deductible for domestic banks but not for foreign banks domiciled in Australia because of the LIBOR cap.

Abolition of IWT and removal of the LIBOR cap would put funding costs for foreign banks on a more level playing field with domestic banks and hence increase competitive pressure in the Australian banking market.

1.3 Legislate the four pillars policy

Some submissions to the Senate Inquiry expressed concern about the consolidation of the Big 4 that occurred as a result of the acquisitions of BankWest by the Commonwealth Bank and St George Bank by Westpac in 2008/09. These mergers almost certainly contributed to the stability of the Australian banking sector at what was a very difficult time but the feeling is that they would not have been approved under more normal circumstances. Section 50 of the Trade Practices Act 1974 Act prohibits an acquisition if it would be likely to have the effect of substantially lessening competition in a market.

Concerns were also raised about the four pillars policy which bans mergers between any of the Big 4 banks. A number of submissions deposits in mutuals are guaranteed in the same way as bank deposits and that the bank regulator, APRA, also regulates banks. The Government hopes that the advertising campaign will attract depositors to the mutual sector which will increase deposits as a source of funding for the sector which can then use them to compete against the Big 4 banks in making loans.

2. Supporting access to funding

2.1 Government support for securitisation provided through the Australian Office of Financial Management

The Treasurer has directed on several occasions that the Australian Office of Financial Management (AOFM) invest in RMBS in an effort to revive the securitisation market.[17]

to a fixed schedule throughout the life of the security but the repayment of principal is made in a lump- the end of the life of the security). This means that the issuer (the borrower) has access to the borrowed monies for a longer period than if they had issued traditional RMBS.

Whether the issuance of bullet bonds will favour regional banks and the non-bank deposit-taking institutions is a moot point. As noted in the *Competitive and Sustainable Banking System* document, the Australian Office of Financial Management has supported the first bullet RMBS issuance by a smaller lender (Bendigo and Adelaide Bank) but a recent Commonwealth Bank issuance also included a bullet tranche. Part of the additional $4 billion dollar support by the Government through the AOFM for RMBS is to be made available where required for investment in bullet RMBS. For the regional banks, credit unions and building societies, the longer-term success of bullet RMBS will depend on the ability to attract investors other than the Australian Government through the AOFM.

2.4 Covered bonds

The Government announced as part of its *Competitive*

Covered bonds can be issued with a higher credit rating than the credit rating of the issuer. Thus the major banks with their AA credit ratings are likely to be able to issue covered bonds backed by housing loans with a higher AAA credit rating. The higher credit rating means that the banks will be able to obtain longer-term and thus more stable funding, typically in the 5- to 10-year range,[18] at lower interest rates than they though the guarantee is no longer available on new debt, it is still payable on debt that was issued under the guarantee.

equal to the benchmark interest rate plus some specified margin where the loan interest rate is reset at pre-specified intervals in line with changes in the benchmark interest rate. This has the advantages for borrowers of limiting the rise in their home loan rates to the rise in the benchmark interest rate, i.e., borrowers know what the margin on their home loan will be from the outset, and they have advance knowledge of when their loan interest rates are likely to be changed. Caps can be applied to ARMs which limit the frequency of changes in interest rates, limit the size of any increase in interest rates and limit the total change in the interest rate over the life of the loan.

Some banks and policy analysts may be wary of introducing and promoting ARMs in Australia because the majority of sub-prime loans in the US that led to the GFC were of this type. However, the fault did not lie with the use of ARMs *per se*. The fault lay with the woefully inadequate assessment of the creditworthiness of prospective borrowers and the lack of transparency surrounding the securitisation and issue of RMBS that followed. In contrast, Australian lenders applied stricter credit criteria to loan applicants, perhaps partly in response to

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loans in the United States). Thus, although loan defaults rose during the

loan books.

Although ARMs have not been proposed as an alternative to standard variable or fixed rate loans, it might be a worthwhile exercise for the Government or the Reserve Bank to undertake some research into whether the banks should be encouraged to offer these types of loans in Australia given their popularity in overseas markets.

3.2 Small business loan guarantee

ccess to finance has been proposed in several submissions to the Senate Inquiry (NSW Business Chamber, Chamber of Commerce & Industry Queensland) which have advocated a government provided guarantee on loans to small business. The guarantee would be similar to schemes already operating in the United Kingdom, Canada and the United States. Small businesses would be charged for the guarantee and so would only use it if they could not secure non-guaranteed funding. The revenue raised would go some way to offsetting the costs to the Government of calls on the guarantee. Banks would still be responsible for the assessment of loans to small business

guarantee being in place. To ensure that banks undertake appropriate risk assessments, the guarantee would cover less than 100 per cent of the loan amount, typically 75 to 85 per cent in the countries with small business loan guarantees in place. As access to small finance for business improves over time, the use of the guarantee would naturally decline.

The Reserve Bank is not in favour of a small business loan guarantee.

domestic markets operations, John Broadbent, told the Senate Inquiry the RBA had examined the schemes operating overseas and found they had achieved only mixed success because the fees imposed on small business led to a low take-up rate.[23] The RBA is also concerned that lenders will take greater risks with a loan guarantee in place.

Despite the moral hazard issue, the proposal to offer a government guarantee on small business loans appears to us to have merit in increasing small business access to finance without imposing unreasonable costs on taxpayers given that the guarantee would cover less than 100 per cent of the loan amount which should provide sufficient incentive for lenders to properly assess the creditworthiness of potential borrowers.

3.3 Make switching banks easier

In 2008, the Government announced a number of measures to make it easier for customers to switch banks that included a listing and switching service that requires banks to provide their customers with accurate information on all direct debits and credits to take to a new bank for easier transferral, a consumer complaints hotline and consumer education providing advice on how to switch. Consumer take-up, and perhaps consumer awareness of these measures has been low which suggests an improved education campaign to raise consumer awareness of this assistance could increase the level of switching and hence increase the level of competition between banks and between banks and other financial service providers.

As one element of its *Competitive and Sustainable Banking System* package, the Government is banning exit fees for new home loans from 1 July this year. Several of the Big 4 have already abolished exit fees and so have less to lose from this change. In terms of increasing competition between providers, the abolition of exit fees favours the large banks which charge lower exit fees in any case. In the absence of exit fees, regional banks and mortgage originators will most likely charge higher upfront costs for establishing loans or attempt to recoup the establishment costs by imposing higher loan rates on borrowers.

The Government has also appointed a former Governor of the Reserve Bank, Bernie Fraser, to examine the feasibility of implementing full account portability so that banking customers can easily switch both their deposit and loan accounts. Full account portability would require changing the current BSB (Bank, State and Branch) account numbering and specific account number convention. As the ANZ submission to the Senate Inquiry notes (p. 27), changing this protocol would be costly and would apply only to transaction accounts which are relevant for cash payments and direct entry payments, whereas two-thirds of non-cash retail payments rely on Card Scheme numbers and other reference developed by BPAY and PayPal. Similarly to ANZ, Westpac has concerns about account portability relating to the BSB code and the unique account identifier. As its submission (p. 35) notes:

> All payment, routing, settlement and existing systems infrastructure is built on this fundamental unit of identification.
>
> Industry-wide systems and mechanisms, including payment schemes, clearing houses, government bodies and APCA [the Australian Payments Clearing Association which is responsible for clearing cheques], are affected.

Although it may prove both technically difficult and very expensive to implement full account portability, the major banks have been exploring a BPAY-based account portability option for several years, MAMBO, (Me at My Bank Online). Customers would register for their own BPAY code which could then be transferred from bank to bank without the need for re-establishing direct debits or credits.[24,25] Westpac made reference to its active participation in the MAMBO project in its submission to the Senate Inquiry (p. 34). The other major banks made no reference in their submissions which suggests there may be some tensions about the MAMBO project.

Further proposals made in submissions to the Senate Inquiry in relation to switching suggest either making mortgages themselves portable or

debt.

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Chan, D., Schumacher, C. and Tripe, D. (2007), Bank Competition in New Zealand and Australia, Paper presented to the 12th Finsia-Melbourne Centre for Financial Studies Banking and Finance Conference, Melbourne, 24

End Notes

1 OECD (2009), Competition and Financial Markets, www.oecd.org, p. 8.

2 Derived from Australian Securities Exchange, Financial Sector Profile and Historical Market Statistics, www.asx.com.au.

3 esidents.
APRA and the RBA no longer publish total assets for the individual banks. Data on individual banks is required to calculate the market shares. In any case, using data on resident assets places the focus squarely on the activities of the banks in the domestic market.

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