

Submission to the Senate Economics Committee Inquiry into 'Competition within the Banking Sector'

Let me start by start by making a number of assertions which will also act as an Executive Summary of my views:

Assertion 1: When people talk about 'competition' they really mean 'lower mortgage rates'.

Assertion 2: It is pointless and dangerous to consider banking competition without considering the impact on financial stability in the banking sector.

Assertion 3: The UK - and the British taxpayer - would swap their 2007 highly competitive banking industry for the Australian 2007 cosy cartel in a heartbeat.

Assertion 4: The assumption inherent in this Inquiry - that increased competition (and hence lower mortgage rates) would be to the general benefit of the Australian public and Australian nation - is fundamentally flawed.

Assertion 5: If anything, mortgage spreads need to increase rather than decrease.

Assertion 6: Banking is a natural oligopoly.

"I don't give a stuff about competition, I just don't want to pay more for my mortgage!" Anon

It cannot be coincidental that this Inquiry was commissioned in the middle of a vigorous public debate following CBA's 45bp increase in mortgage rates on Melbourne Cup Day. It would seem churlish for the Senate to deny that the sub-context of the Inquiry is a wish to exert downward pressure on the spread above the RBA's Overnight Cash Rate that the Big 4 banks charge for their Standard Variable Rate mortgages.

It is a truism that if you ask an Australian voter if they think that they should be paying less for their mortgage, they will say "yes". The Senate comprises elected representatives of the people but it also has a fiduciary duty to avoid populist measures that might inflict severe long-term damage on the national economy.

How would greater competition manifest itself in the mortgage market?

It has been pointed out that a housing loan is a fairly commoditised product. In order to compete (i.e. increase its market share of housing loans) a lender need to do one or more of the following:

- a) Compete on price, either by offering lower interest or lower fees than its competitors;
- b) Compete on risk appetite, either by allowing higher LVRs or a lower level of proof of stable earnings than its competitors;

- c) Compete on product features, generally by offering the customer embedded optionality in the product;
- d) Offer giveaways, promotions or discounts on other products; or
- e) Engage in an expensive advertising and marketing campaign.

All of these boil down to the lender accepting:

- a) A lower net return on the same loan than its competitors;
- b) A higher risk than its competitors for the same return; or
- c) Both of the above.

As a result of this, increasing banking competition decreases net returns to the banking sector. This in turn decreases the stability of the banking sector. It is worth noting that the current UK parliamentary inquiry into banking considers this aspect in a way that this Inquiry does not. I believe that you cannot divorce consideration of competition from consideration of stability, given the obvious impact of one on the other.

Would you rather pay \$10 extra a month now or \$10,000 in 5 years' time?

The causes of the GFC are much debated. The impacts of it are much easier to measure. I would argue that the countries that were the most heavily impacted by the GFC fell into two broad categories:

- i. Countries where the aggregate banking sector debt was high relative to national GDP (e.g. Iceland, Ireland);
- ii. Countries with highly competitive banking industries (e.g. USA, UK).

The Republic of Ireland has just announced an emergency rescue package of up to €90bn. According to the BBC website, the debt owed by Iceland relating to Icesave depositors to the UK and Netherlands alone amounts to £10,000 for every Icelandic taxpayer. UK and US taxpayers will be paying off the debts incurred in the GFC for 30 years to come.

There are a number of reasons why Australia avoided this fate (such as low government debt, a strong resources sector and a resilient housing market) but I would argue that one of them was the comparative lack of banking competition in Australia. Decent margins, high fees and a captive customer base helped ensure that all of the Big 4 remained AA-rated throughout the crisis.

Of course there was some competition in 2007. The most obvious manifestation of this was RAMS Home Loans. It was highly competitive and acted to drive mortgage spreads down. It is generally agreed that the GFC began in earnest in August 2007. On 2nd October 2007 - less than 2 months later - RAMS announced its enforced takeover by Westpac. So the great competitor survived barely 6 weeks of rough market conditions. If that doesn't demonstrate that it was woefully underpricing for risk, then I don't know what does. RAMS would have needed to charge at least

50-100bp extra to have had any chance of surviving the GFC. Instead it competed itself out of existence. So much for the marvellous benefits of competition!

Next time round it might not be RAMS going broke; it might be one of the Big 4 fatally weakened by severe margin compression. Like it or not the nation would have to bail them out. The bill could run into the hundreds of billions of dollars. So taxpayers should see mortgage spreads as being akin to an insurance premium. Unlike classic insurance, however, the more they pay now the less likely they are to face a huge bill in the future.

The Big 4 Australian banks face huge challenges in the years ahead. A decline in the resources sector at some point is inevitable. Also inevitable is a softening of the residential housing market. As we will discuss shortly, funding their assets will be problematic. Regardless of what the crisis is or its exact timing, when it happens we will want our banks to be strong, stable and profitable. Otherwise we will all end up paying through the nose. I would argue that the mortgage spread needs to increase by at least another 25-50bp if we are to avoid this eventual fate.

Ask yourself the question: if you could turn the clock back to 2007 and offer the UK government to swap our banking sector for theirs, would they take it? Of course they would. Now ask yourself: why?

The Funding Challenge

Australians have a fondness for personal debt, largely because they believe they have an inherent right to own their home. Partly as a result of a willingness to spend every cent they have on their house, Australians also have a notorious aversion to personal saving. Put simply, Australians are happier to borrow a lot more than they are to lend. This creates a systematic gulf in banks' balance sheets.

If these loans aren't financed by savings, then how are they financed? The funds are sourced primarily by wholesale borrowing offshore. Just because the banks want or need to borrow doesn't mean that investors will always lend to them. Key to that decision-making process is the bank's credit rating. Put in simplistic terms, 4 AA-rated banks borrowing \$40bn each is not the same as 8 A-rated banks borrowing \$20bn each. Firstly, they will have to pay a greater credit spread. Secondly, there is no guarantee that the aggregate credit risk appetite amongst investors is the same. Large, stable AA-rated banks attract a disproportionately high amount of investor appetite. For this reason, driving down mortgage spreads and decreasing the aggregate market share of the Big 4 is not in the Australian national interest.

As wholesale borrowing becomes increasingly difficult and expensive, the banks will rely on deposit funding more and more. The Basel Committee on Banking Supervision has proposed new liquidity measures, including a Net Stable Funding Ratio ('NSFR'). Integral to the NSFR is the concept of the 'sticky' deposit - that is a deposit which is not withdrawn even when a bank is under pressure. Some of the measures discussed as part of this Inquiry (most notably portable bank account numbers) have the sole and express purpose of making deposits more flighty and less sticky. The potential impact on banks and how they fund themselves is enormous. If deposits become inherently more flighty then it will no longer be prudent to fund long-term assets (such as home loans) with deposits. That will lead to a radical shrinkage of Australian bank balance sheets with all the economic

and social consequences that that would entail. I would argue most strongly that any measures aimed at increasing the ease of customers switching bank accounts is definitely not in the national interest.

Make Room for the New Guy?

Finally, I would like to argue that banking is a natural oligopoly. We may not wish that this was so but that doesn't make it any less true.

Banking - like warfare - is not kind to the small, the inexperienced and the under-equipped. The potential pitfalls and risks are many, varied and large and the returns are not often great. Much of the Credit Union and Building Society sector is currently struggling to break even despite having been in the game for decades. Specialist lenders - like RAMS - are one-trick ponies that soon learn why scale and diversification are essential for long-term viability.

Regulatory and compliance burdens are huge and the processes are long and complicated. Simply to take \$1 of retail deposit, I would need to start by applying to APRA to become an Authorised Deposit-Taking Institution. If I were to set up my own bank without an ADI license I would be prosecuted and jailed. Those barriers to entry aren't just pointless red tape - they are there for a very good reason. Banking can't be undertaken by bucket-shop operations with 3 blokes in Bazza's garage and a laptop computer.

In order to survive in the long term, banks need a certain scale to dilute their fixed costs and they need effective diversification both of assets and liabilities to ride out the peaks and troughs of the business cycle. This becomes a virtuous circle, with large & diversified banks rewarded by better credit ratings that more enable them to expand further. A viable bank is naturally a big bank. As a result, banking is a natural oligopoly. Given the size of the Australian economy, 4 banks seems about right. It would not be wise to tinker with the current situation.

Conclusion

The potential long-term consequences of a deliberate attempt to increase competition in the Australian banking sector must be carefully considered. We must make sure that the cure is not worse than the disease. Swapping one unpalatable situation for another more unpalatable situation just to win a few votes at the next election is not responsible government.

Nick Palmer

[Please note that this submission is as a private individual rather than in any professional capacity or as a representative of any institution]