Submission to the
Senate Committee on Bank Amendment
(Keeping Banks Accountable) Bill 2009

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Executive Summary

The Secretary of the Senate Committee on Bank Amendment (Keeping Banks Accountable) Bill 2009 invited me to make a submission on the proposed amendment of the Banking Act 1959.

The proposed *Amendment* is beset with several problems as outlined in this submission, primarily these are as under:

Definitional issues: Do 'funds' refer to deposits or wholesale funds or both? It appears funds refer to deposits only. In that case withdrawal of guarantee for non-compliance with the proposed *Amendment* may lead to a run on the bank which the government can ill afford. Given the predicament of the government, banks may not comply with the *Amendment.* Also a deposit guarantee of upto $20,000 would always remain in place. It means banks would always be required to keep their interest rates in line with official cash rate which tantamount to prescribed lending rate regime- something that may hamper operation of free markets.

Types of advances: The proposed *Amendment* is applicable to mortgage interest rates only which means banks could still make private profit on other types of loans using guarantee.

Penalty provision: The current penalty of withdrawal of guarantee is not practicable due to reasons given above and instead it is suggested that there should be a financial impost on erring banks.

Interest rate cut gaming: The words 'or at all' need to be deleted in 18F (1a) as they may lead to interest rate cut games as explained in the submission.

Micro-managing the banks: This argument if made by the industry could be questioned on the basis of ground level realities.

Bank profit margin issues: There is a floor interest rate (approx 4 percent) below which bank profit margin may get eroded. Consequently, it may be hard to implement the decision that ground level interest rates should be in line with official cash rate.

The Secretary of the Senate Committee on Bank Amendment (Keeping Banks Accountable) Bill 2009 invited me to make a submission on the proposed amendment of the Banking Act 1959. I offer my comments below:

1. Issue about definition

1.1 18B (1) mentions guarantee of ‘funds’ but doesn’t offer a definition thereof in the definition section 18 D. Do ‘funds’ refer to deposits or wholesale funds or both? A clarification is necessary.

1.2 From 18 H it appears that the ‘guarantee of funds’ refers to deposits guarantee as a reference is made to Financial Claims Scheme (FSC). The FSC is currently applicable to deposits below $ 1 million for free. For deposits in excess of $ 1million and for wholesale funding, the Large Deposits and Wholesale Guarantee Scheme (LDWGS) –with fee - is currently in place.

1.3 The *Amendment* proposes that the Treasurer would have power to revoke the guarantee. Such a power in my opinion would be hard to exercise in practice. Withdrawal of deposit guarantee for whatever reason would result in a run on that financial institution which the government could ill afford. A bank may *not* set mortgage interest rates in line with the official cash rate as it knows that the government can’t revoke guarantee due to financial stability considerations. The proposed *Amendment* then is ineffective and is only a paper tiger!

1.4 It has already been proposed to withdraw the FCS and the LDWGS. However, the government may decide to continue with FCS albeit with a lower limit of say $20,000 as recommended by the Davis Committee Report 2004. It means the proposed *Amendment* would be applicable automatically to all Authorised Deposit -Taking Institutions (ADIs) and would become a permanent feature of our system so long as the FCS is in place.

1.5 In effect it would be going back to the system of prescribed interest rates – the pre Campbell Committee years - as the banks would be required to keep their interest rates in line with the official cash rate every time. I guess this is not the intention of the proposed *Amendment*. It will take away the freedom of banks to set interest rates and interfere with the operation of free markets.

1.6 Consequently, it will make sense to define ‘guarantee of funds’ to include only the **wholesale funding** guarantee and make the proposed amendment applicable where such guarantee is provided.

2. Type of loans and advances

2.1 It is proposed to apply the *Amendment* to mortgage interest rates only. Mortgage advances (total housing loans) constitute about 52 percent of total loans and advances of Australian banks (APRA, 2009). The proposed *Amendment* excludes the other half – personal and commercial advances – and as such banks would be free *not* to adjust their lending rates in line with the official cash rate for these types of advances. Banks could continue to make private profits out of the public guarantee on this portion of total loans and advances. The purpose of the proposed *Amendment* would be defeated partially at least by non inclusion of personal and commercial advances.

2.2. Funding guarantees are generally given in difficult economic situations (such as the global financial crisis) and the objective is to enable banks to raise wholesale funds so as to on-lend to businesses and consumers and mitigate the credit crunch. If the credit needs of this sector are to be met effectively during crisis times then it is important that the interest rates applicable for this sector also be brought in line with official cash rate just as it is proposed for the mortgage advances. The private profits on the personal and commercial advances segment of total advance are also undesirable and the *Amendment* proposed may need to capture this issue.

3. Penalty provision

3.1 The penalty provision proposed is revocation of public guarantee by the Treasurer. However, the official interest rate cuts may not coincide with wholesale fund raising (with public guarantee) by banks. It is possible that a bank may raise funds with public guarantee and but may refuse to bring the interest rates in line with official cash rate subsequently. When this happens, it may be hard for the government to then revoke the guarantee already given as it may send a contrary signal about Australian government guarantee. Investors may not know at the time of investing whether there is a possibility of government revoking the guarantee. It may impact the wholesale funds raising by other banks too.

3.2 An alternative could be to insert a penalty provision which could require erring banks to pay to the government a penalty equivalent to (official cash rate minus the actual rate charged by the bank) multiplied by the total loans and advances outstanding. This will take away the incentive for banks not to keep interest rates in line with official cash rate.

4. Interest rate cut gaming

4.1 18 F(a) uses the words ‘or at all’. Imagine a situation where there is only a part pass through of interest rates by banks. In that situation the bank would be protected by these words as it could contend that it has done pass through in part. It will reserve the unused pass through and when next official interest rate cut it announced use the ‘unused pass through’. Accordingly, it will continue to comply with this section and the government may not then be able to revoke the guarantee. In short, banks could play games with the government in interest rate cuts. In my opinion the words ‘or at all’ need to be removed which means there has to be full pass through if the bank wants to avoid the penalty.

5. Micro-managing the banks?

5.1 A possible objection from the industry would be that by introducing the *Amendment* the government is micro-managing the banks and interfering with free market. The industry may contend that customers of a bank that doesn't provide full pass through may gravitate to other banks that provide a full pass through. Consequently, the proposed *Amendment* is unnecessary.

5.2 In Australian context, however, we have experienced that when one of the major banks refused to pass interest rates cut, the others banks also followed suit (Danny, 2009). Though the banks may not actually be acting in collusion, competitive considerations would mean they would all keep their interest rates in line with each other rather than in line with the official cash rate. Consequently, the micro-management argument can be questioned from the experience at the ground level.

6. Bank profit margin considerations

6.1 Another argument could be that full pass through may actually impact bank profit margin. Assume a situation where official cash rates are as low as those in the US, which is, between zero and 25 basis points. In that case to expect banks to charge zero or say 25 basis points rate on loans would not only be counter-productive for profit margins of the banks but the banks may not be able to cover their operating costs. Such a situation would be unfair to the banks.

6.2 The operating expenses of Commonwealth bank in 2008 were $7,398 million as against this the total loans and advances outstanding were $361,282 million. The operating expenses ration was about 2 percent. As per the KPMG Financial Institutions Performance Survey 2009 the interest rate spread[1] was 1.67 percent in 2008 for major banks (KPMG, 2009). Consequently, a ballpark estimate of what the floor interest rate for bank lending would be is about 3.67 percent or say 4 percent. When the official cash rate was reduced by the RBA to 3 percent in April 2009, the National Australia Bank refused to lower its standard variable mortgage rate below 5.74 percent and the Commonwealth below 5.64 percent. These banks could have passed on the rate cut in full given that the floor lending rate without impairing profitability as calculated above is about 4 percent and there was a cushion of about 1.64 percent (5.64 percent minus 4 percent) available to the banks. The difference could be considered as risk cushion for banks in turbulent times like the global crisis. What this cushion should be is of course open for debate. But there is a case for full pass through at least to individual home owners and small businesses segment of bank advances.

6.3 Another issue to consider is even though the rate on borrowing from the central bank may get reduced those of other finance providers –particularly inter bank market – may continue to be high in tight market situation and consequently the overall borrowing cost for banks may still be high.

[1] Interest spread is as disclosed in the profit announcement and represents the interest rate received on interest earning assets less the interest rate paid on interest bearing liabilities (KPMG, 2009).

6.4 From the above discussion it would be clear that to expect a full pass through as suggested in the *Amendment* is divorced from ground level realities that banks face. Banks will not be able to lower lending rates below the floor of 4 percent without eroding margin.

7. Conclusion

The proposed Amendment to the Banking Act 1959 has some inherent difficulties in implementation. Certain terms need to be defined clearly and penalty provisions should be by way of financial impost rather than the treat of withdrawal of guarantee which will not be implementable under the financial claims scheme. Consequently, it may be restricted to only wholesale guarantee of funds.

References

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Notice

The views expressed in this submission are my own views and may not necessarily be that of my employer the University of Canberra.