

Key differences between CBA's funding costs and the average funding cost analysis submitted by the Reserve Bank of Australia (RBA)

In section 3 of the RBA's Senate Inquiry submission it makes reference to a calculation of Major Banks' Average Funding Costs. There are three key reasons why this analysis differs to CBA's funding cost analysis:

- 1. CBA has a more conservative funding mix than the industry average used by the RBA**
The RBA uses an industry average funding mix as per Table 2, Section 3.1 of its submission. CBA's funding mix has a higher customer deposit component than the industry average (55% versus industry average of 50% at October 2010) which drives CBA's funding costs higher given the increased cost of customer deposits. CBA also has a lower proportion of equity funding (6% versus industry average 7% at October 2010) and this is the most expensive form of funding.
- 2. CBA pays deposit customers bonus, introductory and special interest rates on savings products which are higher than the headline advertised rates used by the RBA in its calculation**
The RBA specifically excludes these bonus, introductory and special interest rates offered to deposit customers as per the footnote to Graph 11, Section 3.2.1 of its submission. These bonus, introductory and special rates add to CBA's funding costs, particularly during this period of high price competition for domestic deposits and strong customer preference for bonus, introductory or special rate products
- 3. The RBA analysis includes the dilutive impact of cheaper short-term debt funding – CBA does not fund long term assets (such as home loans) with short-term debt**
The funding costs relevant to CBA's pricing of long term home loans exclude cheaper short-term debt.

Additional questions

- 1) Do you have any measure of the return on equity or return on assets on your home lending book compared to your overall operations?**

Return on equity (ROE) is only calculated at a CBA Group level. We do not allocate shareholders' equity to any specific lines of business.

ROA on mortgages is well below the Group's ROA on domestic banking of 0.7%- 0.8%].

- 2) How important are economies of scale in retail banking? Does this constitute a barrier to entry and a force for concentration?**

All organisations strive for economies of scale to bring the marginal cost of any additional activity down so that this can be used to invest in more competitive pricing or for the benefit of shareholders.

One particular expense where economies of scale exist for large banks is in compliance costs. Although change management activities associated with new compliance measures are significant (given the large footprint and customer base of larger banks), the analysis, design and implementation costs of all changes can be spread over a larger customer base.

As a full-service provider with a long history of service provision the CBA also has diseconomies of scale. When changes are made or new products are introduced the impacts on all other products, processes, distribution channels and a wide range of legacy systems need to be considered. There are additional significant costs in providing a full range of services and maintaining these over extended periods.

We do not believe that even if there are economies of scale in retail banking they constitute a barrier to entry. The evidence of this is seen in the wide range of new entrants targeting niche product propositions and then widening their product offering. We have seen players like ING (online banking) and Citi (credit cards) introduce efficiently run products in the domestic market. These new entrants

do not have the legacy or the complexity of being a full service provider and so can provide cost effective products and services successfully. They can also leverage scale in other markets and the strength of parent companies when accessing sources of funding (if required). Once successful at an appropriate scale they look to expand their product offerings.

3) Your submission (page 7) argues the current return on equity is below the long-term average. This is probably unsurprising emerging from a recession. But is the long-term average itself high for such a business which you yourself say generates unusually stable returns?

As stated in CBA's submission the Group competes for equity against other listed companies from within and outside the banking sector. If banks generate an inadequate return (as judged by investors) they will attract less shareholder capital and consequently have to constrain their growth (e.g. have to provide less new lending). Lower returns could also jeopardise the high credit ratings of the Australian banks, which underpin the banks' ability to access wholesale funding to continue lending. There would be the obvious flow-on effects to lower economic growth.

Our submission does not state that the returns of the banking sector are "unusually stable"; our submission states that the returns of the major banks are "more stable" than the returns of other S&P/ASX20 companies based on historical performance since 2000 – when the S&P/ASX indices began - and as shown in Figure 3 of our submission. Committee members may be interested to know that the data underlying Figure 3 is that the average ROE for the major banks since FY00 is 18.2%, compared with the average ROE of the S&P/ASX20 ex major banks of 19.3%.

4) Have you considered lowering the amount you charge other bank customers for using your ATMs as a way of attracting more people to use them? How does the cost of providing and replenishing ATMs vary from those outside a suburban branch to those in remote locations?

The rationale for investing in ATM infrastructure is to meet customer service needs, provide convenient banking and select positions that differentiate us from our competitors to attract and retain customers. Currently, almost all of our ATMs do not cover their costs through the ATM direct charge; however, the direct charge does assist in assessing the investment case for additional infrastructure. Without the ATM fee or with a reduced fee the infrastructure may not be available to our own customers (our major objective) and it would discourage investment as others would free-ride on that investment.

The cost of any ATM is a complex mix of rent and transaction mix (which drives servicing costs, cash replenishment costs etc). One main driver of difference is whether the ATM is in a branch or in a non-branch location. Non-branch sites are more expensive (by an additional 50%) due to the floor space rental costs. Many of the costs associated with ATMs rise annually (labour, site rental, cash management etc) creating further pressure on maintaining the existing level of fees.