

SENATE ECONOMICS REFERENCES COMMITTEE INQUIRY INTO COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR –

QUESTIONS ON NOTICE

How important are economies of scale in retail banking, and in participating in international lending? Does this constitute a barrier to entry and a force for concentration?

- While a larger bank can, in principle, spread fixed costs across a greater range of activities, thereby taking advantage of economies of scale, larger institutions also suffer some diseconomies of scale (e.g. difficulties associated with governance).
- Studies of economies of scale in banking tend to be inconclusive. One study, which is now quite dated – Berger et al. (1999) – summarises that most estimates of maximum efficient size lie in the range of \$100 million to \$25 billion of assets. However, Wheelock and Wilson (2001) note that firm conclusions on economies of scale for larger banks are difficult as there are few institutions, and a recent review by the Committee on the Global Financial System of the empirical literature suggests that there is little evidence for the existence of scale or scope economies in international banking.¹
- Prior to the onset of the financial crisis, the entry and growth of a number of smaller lenders, including non-ADIs, suggests that there were not significant barriers to entry into the Australian market.

Charts on pages 20 and 21 of your submission show bank interest margins and spreads gradually narrowing after deregulation but widening somewhat in recent times. The Governor has referred to this as a ‘small backtrack’. Might it reflect reduced competition since the GFC?

- As noted in the Bank’s submission, the major banks’ net interest margins had contracted from around 5 per cent in the mid 1980s to about 2½ per cent in 2007. Margins were further compressed following the onset of the financial crisis, reaching a low of about 2¼ per cent in 2008 as the early stages of the financial crisis saw funding costs rise more quickly than lending rates. Subsequently, margins have fluctuated within a narrow range of between 2¼ and 2½ per cent, i.e. they remain no higher than before the onset of the GFC.
- The small increase in margins following their trough in the financial crisis is likely partly to reflect the removal of those temporary factors that caused that margin squeeze. Other factors that can affect the behaviour of margins include:

¹ Committee on the Global Financial System, (2010), ‘[Long-term Issues in International Banking](#)’, Paper 41.

- higher risk margins on lending, which have been encouraged by supervisors, will have boosted net interest margins (given these do not adjust for either expected or actual losses of principal);
- an increase in the amount of equity funding is likely to have boosted banks' margins (equity is a non-interest bearing liability that increases a bank's interest earnings);
- derivatives to hedge interest rate risk can have a substantial effect on banks' margins over short periods of time; and
- some institutions may have shifted the balance between fee and interest income.

Charts on page 20 of your submission show interest margins consistently wider for the major banks than for other banks. Why is this?

- A few factors might explain why the major banks have, on average, wider margins than the regional banks. These include:
 - The higher credit ratings of the major banks allow them to raise wholesale debt on less expensive terms than the regional banks.
 - Differences in the composition of the different banking sectors' assets and funding liabilities.
 - While deposit liabilities comprise a greater share of the major banks' funding liabilities than they do for regional banks, relatively expensive term deposits make up a considerably greater share of regional banks' funding liabilities (28 per cent) compared with the major banks' funding liabilities (20 per cent). This would be offset, somewhat, by the fact that the regional banks have a greater share of equity funding.
 - Lower margin household lending makes up a greater share of the regional banks' assets than it does for the major banks' assets. Likewise, regional banks are relatively underweight in the credit card market, a relatively high-risk and high-margin product.
- Moreover, different banks can offer customers different fee and interest rate combinations. Consequently, one institution might report a higher net interest margin but lower fee income than its competitors.

Would bank account number portability increase competition? Would it cause any practical problems?

- Conceptually, bank account number portability could improve competition to the extent that it eliminated the need to have direct debit and direct credit payments redirected to a new account when a customer changes financial institutions. As you would be aware, former RBA Governor Fraser has been asked to investigate the feasibility of account number portability and report by mid 2011.

How good an indicator are the 'headline' home loan interest rates of the rates actually paid? Do many customers instead pay a lower rate for a 'basic' or 'no frills' loan? Are many customers able to negotiate a lower rate with their branch manager?

- As noted in the Bank's submission, it has become commonplace for banks to offer borrowers discounts on indicator rates. Indeed, banks have been advertising these discounts for a number of years, resulting in almost all borrowers obtaining a discount of some size. These discounts have increased over time and, on average, are currently around 60 to 70 basis points. It has become more common over recent years for borrowers, particularly those taking out bigger loans, to negotiate larger discounts than those that are advertised. As such, indicator rates are not a good measure of the rates borrowers actually pay on standard variable rate loans, but movements in indicator rates can be used to measure *changes* in the rates borrowers pay, as the discount does not change throughout the life of the loan.
- The commercial banks are likely to have the most comprehensive and up-to-date information on the share of customers who pay a lower rate for a 'basic' or 'no frills' loan product.

Your submission refers (page 15) to discounts of 60 to 70 basis points on housing loans. Is there any form of undesirable price discrimination involved in this? Or would it be desirable for home loan interest rates to discriminate more between lower and higher risk customers?

- A number of factors will influence the size of any discount offered to a potential housing loan borrower. The average, currently around 60 to 70 basis points, masks a wide range, upwards to around 90 basis points. Lenders finance a wide spectrum of credit risks so it is appropriate that borrowers with varying risk characteristics are charged different rates. The size and prevalence of discounts will also reflect the profitability of the customer's current and potential relationship with the lender, as well as credit conditions at the time of origination.

Given that there appears a widespread belief that home loan rates are tied to the cash rate but this is not the case, would it be more transparent for banks to offer an additional home loan product where the interest rate was explicitly tied to the cash rate? Your submission (page 17) refers to such 'tracker' products being available in some other countries. If this became a popular product, would it make monetary policy more powerful and easier to calibrate?

- There are no impediments to lenders offering tracker products. Between 1997 and mid 2007, mortgage rates either broadly tracked or moved in lock-step with the cash rate. As such, households are unlikely to have perceived any significant benefit from a ‘tracker’ product relative to the current ‘discretionary’ variable-rate products. Recent developments may have increased households demand for ‘tracker’ loans and at least one institution has announced plans to begin offering such a product. Were lenders to offer such products, they are likely to carry a slightly higher interest rate as compensation to the lender for taking on the risk that funding costs might rise more quickly than the cash rate (that is, the lender is providing the borrower with an option).
- Monetary policy is set with regard to the interest rates actually paid and received by borrowers and lenders, as opposed to the level of the cash rate *per se*. Consequently, the presence of tracker products is unlikely to affect the efficacy, or ease of calibration, of monetary policy during the ‘normal course’ of events. During periods of significant financial turmoil, mandating lenders to tie tracker products explicitly to the cash rate might weaken financial stability and make calibration of monetary policy more complex, especially if, as in some other countries, tracker products had special clauses like ‘floors’.

What proportion of home loans are at fixed rather than variable rates? Are these typically only fixed for a few years? Why are Australian home loans predominantly at variable rates whereas in the US, Canada, NZ and much of continental Europe fixed rates are more common? Your submission (page 17) refers to home loan interest not being tax-deductible in Australia as a possible factor – can you elaborate on this?

- Historically, more than three-quarters of housing loans have been written with a variable interest rate, and most of the remaining loans have rates that are fixed for less than five years. As banks offer both types of loans generally at similar spreads to their respective market benchmarks, this bias towards variable-rate loans is likely to be a reflection of household preferences.
- Despite considerable research it is not clear why households in some countries prefer housing loans that are at variable rates while in other countries housing loans are predominately fixed rate. However, Australian households have typically shown a tendency to pre-pay their housing loans, and variable-rate loans provide the greatest flexibility to do so.
- Regarding the role of taxation, Ellis (2006) notes that:

‘Mortgage interest deductibility affects the capacity to service debt and the incentives to repay principal. This in turn affects incentives to take mortgages with fixed versus variable interest rates. When interest payments are not deductible, mortgage borrowers are effectively paying their mortgage out of post-tax income. This implies that the post-tax return to paying down the mortgage will generally exceed the post-tax return on investing in financial

assets, providing an incentive to pay down the mortgage rapidly if possible. Such an incentive encourages the use of variable-rate mortgages, which are less likely to involve prepayment penalties.’²

- Lenders will be able to provide the most up-to-date and detailed information on the value of fixed-rate loans made for different maturities.

Conceptually, in a competitive banking market, would you expect bank lending variable interest rates to follow movements in the banks’ *average* or *marginal* cost of funds? And should the interest rate on loans be moving with the costs of the average bank or the lowest-cost bank?

- How banks reprice outstanding loans is likely to be a significant determinant of whether the bank sets its loan rates on a marginal cost or average cost basis. In Australia, an increase in the indicator rate increases rates for both new and existing variable-rate borrowers. On that basis, we would expect that rates would be set with average funding costs mainly in mind. In contrast, loans that did not reprice as interest rates move could be expected to be set with a view to the marginal cost of funding. Moreover, since the onset of the global financial crisis, banks have become more concerned about how they fund an increase in their balance sheets, thereby putting more emphasis on using a marginal funding cost benchmark to assess a loan proposal.

For about what proportion of banks’ funding sources does the cost vary closely with the RBA’s cash rate? What proportion comes from household transaction accounts that pay no or minimal interest?

- Details of the costs to banks of different forms of funding are provided in the Bank’s submission (see section 3). This includes a discussion of the funding rates that tended to move closely with the cash rate prior to the crisis, as well as the subsequent increases in these rates relative to the cash rate.
- Transaction deposits, broadly defined as those deposits that pay no interest, or a relatively low and stable interest rate, are estimated to account for a little under 10 per cent of the major banks’ debt funding. This is estimated using APRA data and information obtained from liaison with these banks. Individual banks may be able to provide data on the share of their funding from these types of deposits.

Are funds borrowed offshore either borrowed in Australian dollars, or hedged so as to be effectively be in Australian dollars? Is the cost of short-term offshore funds then close to the RBA cash rate?

- Funds borrowed by Australian banks in offshore markets are either borrowed in Australian dollars or hedged into Australian dollar exposures using derivatives. In particular, the ABS’s 2009 Foreign Currency Exposure release, undertaken on behalf

² Ellis, L, (2006), ‘[Housing and Housing Finance: The View from Australia and Beyond](#)’, RBA Research Discussion Paper 2006-12.

of the RBA, showed that Australian banks hedged almost all of their foreign currency liabilities.³ The few unhedged liabilities were potentially fully hedged ‘naturally’ as they were more than offset by the banks’ unhedged foreign currency debt assets and foreign equity investments. After hedging, banks actually held a small net foreign currency asset position.

- Hedging converts the interest rate on offshore debt back to an Australian dollar interest rate, which, if it were a floating rate, would be influenced not only by the cash rate but also by changes in the cost of hedging.

How does the cost of funds vary across the major banks? Even if they have the same credit rating and so would pay very similar rates for a given type of fundraising, do they differ much in the extent they rely on short- and long-term funding, retail versus wholesale funding etc?

- There is some variation in the cost of funding across the major banks. First, there are differences in funding composition across these banks. Second, there are some differences across the banks in the rates paid on particular funding sources; these differences can reflect factors such as timing of bond issuance, or how strongly a bank is competing for a particular type of deposit.
- The major banks’ financial results show that for the 2010 financial year, the average interest rates on the interest-bearing liabilities of these banks’ Australian operations was between about 4 and 4.7 per cent, a range of about 70 basis points.

There are odd spikes in the rates banks offer retail customers on term deposits; ‘specials’ as you term them. For example, they may offer 6 per cent for a 7 months maturity but only around 3 per cent for 6 months or 8 months. Is this an example of price discrimination, trying to attract interest-sensitive customers but paying a poor rate to less sophisticated customers who just allow term deposits to roll over automatically on maturity? Is it an indicator of lack of competition, or just depositor apathy, or both? What proportion of funds raised as term deposits attract the ‘special’ rate?

- Spikes in the term structure of deposit rates are used to attract new interest-rate sensitive deposits but reduce the cost to the bank of offering higher rates at all terms. Such pricing has been common practice for a number of years.
- In analysing the cost of banks’ term deposit funding, the Reserve Bank focuses on the ‘specials’, as these represent the predominant rate paid by banks on these deposits. That is, over time the banks vary the terms for which a ‘special’ is offered, but the large majority of customers initially invest in a term deposit at a ‘special’ rate roll over their deposit into a new ‘special’ (possibly for a different term).

³ ABS, (2009), ‘[Foreign Currency Exposure](#)’, Catalogue Number 5308.0, March 2009.

- Evidence supporting this was provided in an ASIC study.⁴ The study reports that, during their sample period of May and June 2009, ‘98 per cent of investor funds were first lodged in term deposits paying a high interest rate’. In addition, only a small proportion of retail investors are estimated to have received a low (non-‘special’) interest rate after rolling over their deposit. This suggests that most customers are cognisant of the fact that they need to actively manage their money.
- ASIC also found that most ADIs surveyed send a letter to investors before the maturity of their deposit. This letter informs the investor that if no instruction is provided to the ADI, the funds will automatically roll into a new term deposit of the same maturity at the prevailing rate. Half of the ADIs surveyed also include with the letter a table of term deposit rates currently on offer by the ADI.
- ASIC will review the term deposit market in 2011.

Do you have any information about what proportion of credit card applicants *expect* to pay interest (as opposed to paying off their balance in full each month) and what proportion *actually do* pay interest? If there is a significant difference, could this be leading to a lack of competition in the credit card market, and so explain why the interest rates are so high?

- We do not have information on the number of credit card applicants who expect to pay interest. One proxy might be the number of credit card accounts that are ‘low rate’ accounts. These are targeted at ‘revolvers’ (cardholders who do not pay off their balance each month) and typically apply an interest rate that is around 6 percentage points lower than standard cards. Some preliminary survey data provided by Roy Morgan Research indicate that around 15 per cent of accounts are low rate accounts. The same source suggests that around 40 per cent of credit card holders claim that they sometimes pay interest on their credit card. These data should be treated with a degree of caution, but it seems likely that many cardholders at times pay interest when they had not initially expected to do so and that such customers are likely to be less sensitive to the level of credit card interest rates when they are in the process of looking for a new or alternative credit card option.
- However, competition in the credit card market cannot be judged solely from the pricing of the credit function of those cards. The payment function of credit cards tends to be subsidised for cardholders in order to support the flow of interchange fees to the issuer. This subsidisation primarily occurs via the provision of reward points to cardholders, along with an interest free period for those cardholders who pay off their monthly balance. Competition among credit card issuers may therefore be reflected in the annual card fee, the availability and generosity of a rewards program, the availability of an interest free period and the interest rate on outstanding balances. In general, credit cards applying a ‘standard’ credit card interest rate offer a rewards program, whereas ‘low rate’ cards do not.

⁴ ASIC, (2010), [‘Review of term deposits’](#), Report 185, February 2010.

Should a small business loan secured by a mortgage over a house bear the same interest rate as a home loan secured over the same house?

- Banks charge different interest rates on housing and small business loans secured by residential property. The type of collateral is only one of the factors that is taken into account in pricing a loan. In particular:
 - The interest rate must cover the expected loss of making a particular loan. The expected loss is, in turn, largely determined by a borrower's *probability of default* and the *loss given default*. In the first case, rough estimates suggest that small business borrowers are more than twice as likely as standard mortgage customers to default. In the second case, once a default has occurred, APRA statistics suggest that a lender is likely to lose close to 30 per cent of the small business loan's value, compared with 20 per cent for housing loans.
 - While spreads are designed to help cover *average/expected losses*, capital is designed to cover losses in excess of this amount in most circumstances. Lenders do, however, have to earn a return on this capital and, reflecting the underlying risk, are likely to hold more capital against residentially secured small business loans than housing loans.

What criteria do you apply to determine the securities you will accept as eligible collateral for repurchase agreements? How much more attractive is a security with this status to investors?

- The criteria the RBA applies to determining repo eligibility is set out in detail on the RBA website at <http://www.rba.gov.au/mkt-operations/tech-notes/eligible-securities.html>

Repo eligibility is attractive for at least some investors given the applications and enquires we receive from issuers. It is not possible to determine with any accuracy how eligibility affects the yield on an asset. For some investors, it is seen as providing some 'insurance' of being able to temporarily access funds in stressful conditions. In any event, the degree of attractiveness (and its relative yield to other non-eligible assets) will change over time.

Given Australia's small amount of government debt, there is a shortage of government bonds for banks to hold as liquid assets. Has the RBA considered issuing its own paper to provide such assets? Would this be a safer approach than counting RMBS as a liquid asset?

- The amount of Government debt outstanding is a policy issue for the Government. Any debt issued by the RBA would be very similar to that issued by the Government. If the RBA were to issue its own paper to provide banks with additional liquid assets, the RBA would need to consider which assets to purchase with the proceeds of that debt issue. This would likely involve purchasing private securities on an outright basis, thereby permanently increasing the credit risk that the RBA it is facing. In contrast, accepting private securities (including RMBS), on a repo basis provides an

extra degree of protection for the RBA. This is why counting RMBS as an eligible liquid asset in the commercial banks' portfolios is a less risky option than the RBA holding the paper outright.

The RBA is to be commended for its work in making ATM fees transparent. But are you disappointed that this does not seem to have been followed by banks competing by lowering ATM fees? Why do you think this has not occurred to any significant extent?

- The Bank has been pleased to see that the increased transparency promoted by the ATM reforms has resulted in consumers making much greater use of ATMs provided without charge by their own financial institutions. This has meant that consumers on average are paying less for ATM services, even though typical fees on foreign transactions remain similar to levels prior to the reforms.
- For the minority of transactions where a direct charge is applied, most ATMs currently charge \$2.00, but there is some variation around this. About 7 per cent of ATMs charge less than \$2.00 – most notably NAB applies \$1.50 charges across its network, while a number of smaller institutions apply charges of \$1.50 or \$1.75. A small number of ATMs owned by independent deployers apply even lower charges, including some for which no direct charge is levied at all, with the cost of the transaction being met by the site owner.
- While consumers are highly sensitive to whether or not they pay ATM fees, it is not clear that they are particularly sensitive to differences in the levels of foreign ATM charges applied by different owners. This may be because consumers are not sufficiently aware of these differences and must proceed a substantial way through entering a transaction before the level of the direct charge is revealed.
- As you would be aware, a joint RBA-Treasury taskforce will be considering whether there is scope to further enhance competition in the ATM system and will report in June.

The average ATM fee is about \$2 but the average cost to the bank of an ATM transaction is about 75 cents. Is this a sign of lack of competition? How do the costs of ATMs vary by type of transaction (eg checking account balance vs withdrawing money) and by location (at a bank branch vs in remote locations)?

- The average ATM fee is about \$2 for transactions where a fee is charged. However, fees are charged on only about one-third of all withdrawals. So the average direct charge across all withdrawals is of the order of 70 cents, or less than the estimate of the average cost.
- Our available information on the cost of ATM transactions comes from a study of payment costs undertaken in 2007 (predominantly based on 2005/06) data. This showed a weighted average cost to ATM owners/acquirers of 74 cents per cash withdrawal. There was significant variation in the average cost between ATM owners

and the average for each owner undoubtedly masks significant variation in the deployment costs of individual ATMs. Financial institutions typically levy direct charges to cover these costs only on other institutions' cardholders, while independent ATM deployers generally charge all cardholders.

It is likely that the cost of transactions is now significantly higher than 74 cents for many ATMs. First, we understand that rents on ATM sites have increased significantly over recent years. Second, now that owners can set the fee they receive, rather than receiving a fixed interchange fee of around \$1.00, they can deploy ATMs in locations where the average cost per transaction is higher – either because the cost of servicing that location is high, or because transaction volumes are low. We understand that competition for ATM sites has been strong, particularly among smaller independent deployers.

- Based on the information from the 2007 study, solely cash-related costs for an ATM withdrawal accounted for around 25 cents of the 74 cent average. This suggests that the costs that were common to both withdrawals and balance enquiries (e.g. equipment, site rental and transaction processing) averaged a little under 50 cents. At that time, 'off-site' rental costs added around 6 cents per transaction. We do not have specific information on the cost of deployment in remote areas, but we understand that maintenance costs in these areas can be particularly high. Cash restocking costs might also vary significantly from site to site, depending on whether the ATM is stocked by the site owner with recirculated cash, or externally by the ATM provider.

Reserve Bank of Australia
SYDNEY

18 January 2011