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

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I make this supplementary submission to correct a few errors (shown in red colour font) in the submission made by me on 02 September 2009 and also to raise a few additional points that the Inquiry may like to consider.

Corrections

1. 'Bank**ing** Amendment (Keeping Banks Accountable) Bill 2009'.
2. In point 6.2 'The operating expenses *ration* (**ratio**) was about 2 percent'.
3. In point 7: than the t**h**reat of withdrawal.
4. In point 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 **reduction** minus the actual rate **reduction** charged **(delete 'charged')** by the bank) multiplied by the total **mortgage** loans and advances outstanding'.
5. The above change means if there is a 50 basis point reduction in official cash rate (OCR) but banks pass on only say 30 basis point reductions then the difference 20 basis points multiplied by the total mortgage loans and advances outstanding could be the financial penalty assuming the intention is only to confine the amendment to mortgage finance.

Additional points

6. In Canada when the OCR was reduced to 0.25 percent, the bank lending rate was reduced to 2.25 percent. So it is possible for the Canadian banks to operate with a mark up of 2 percent above OCR. The reduction in OCR reduces the funding cost of banks anyway. Using the same analogy, in the Australian context with the OCR of 3 percent, bank lending rate could have been 5 percent instead of 5.64 or 5.74 percent.
7. Bank lending rates are typically affected by three factors: degree of competition, riskiness in lending and structure and interest rates on deposits and other funding sources. The interest rate spread (difference between average lending rate and average funding cost) has actually increased during the half year ended June 2009 compared to 2008 which provides weak support to the higher competition and higher funding cost argument. The deposit structure and interest rates argument is also not relevant. Because of the financial claims scheme deposits actually gravitated to banks leading to lower deposit interest rates. The only relevant factor is then the riskiness of lending. As I pointed out in my earlier submission, the difference of 1.64% (between floor rate of 4 percent and actual lending rate of 5.64%) could be attributed to risk cushion in an uncertain lending environment.
8. In the submission dated 11 August 2009, that I made to Senate Inquiry (Bank Guarantee), I estimated that banks would make a profit of $1.34 billion over a three year period from the public wholesale funding guarantee. Against this background, not keeping lending rates in line with OCR is not desirable.
9. Funding cost considerations is often advanced as a reason for not giving full pass through but the argument appears to be weak. The attached Excel spreadsheet shows

the difference between the OCR and bank standard variable home loan rate (SVR). It shows that the difference which remained at 1.80 during May 2005 till December 2007 started widening from January 2008. This can be attributed in part to tighter conditions in funding market internationally (LIBOR can be an indicator of such conditions). However, the OCR-SVR difference continued to widen even after January 2009, the month from which the LIBOR substantially declined. The LIBOR, according to Bloomberg, was 4.05 percent in September 2008 (one year prior) was 1.21 (six month prior), 0.60 (3 month prior) 0.35 (one month prior) and 0.29 (current). Even if one considers a more appropriate measure of credit risk in inter-bank market – the OIS-LIBOR spread – then as per Bloomberg the spread declined significantly since January 2009. 'Credit markets spreads are normalizing amid signs of an economic recovery. The Libor-OIS spread, a gauge of banks' reluctance to lend, has narrowed to 10 basis points from as high as 3.64 percentage points in October' (2008. source: http://www.bloomberg.com.au/apps/news?pid=20601087&sid=a39V5tRet2yo). Given this the funding cost argument appears to be weak.

10. When Mr Glenn Stevens made the statement in March 2008 that it was unrealistic to expect bank lending rates to be in line with OCR, public wholesale funding guarantee was not in place. The guarantee came into place in October 2008. Also the governor's statement needs to be considered in the context that the RBA wanted rates to rise so that credit contracted (the OCR was raised from 7 in Feb 2008 to 7.25 in March 2008). When banks raised rates more than cash rate the need for RBA to raise OCR further was no longer there. Consequently, on the Treasurer's comment that ANZ should have kept lending rates in line with the OCR, the governor expressed an opinion to the contrary.

11. But after the collapse of Lehman Brothers on 15 September 2008, the need was for reducing the OCR and in turn the need for banks to reduce lending rates too to ease credit crunch. If that didn't happen then it means the monetary policy instrument (OCR changes) became ineffective. Alternatively it means that in Australia monetary policy becomes ineffective once cash rate touches 3 percent and the only way out is fiscal policy. But when Canada reduced its rate to 0.25 percent Canadian banks reduced rates to 2.25. Canadian banks too raise funds in the same international wholesale market where Australian banks do and competition is fiercer in Canadian banking industry than in Australia.

12. In December 2008 when the OCR was reduced by 100 basis points the Governor is quoted as saying *'Given trends in money market yields, most lending rates should fall significantly and will also reach below-average levels."* (http://www.finda.com.au/story/2008/12/02/reserve-bank-interest-rates-rba-cut-loan-home-cash/). Consequently, to cite the Governor's statement in March 2008 in support of the argument that bank lending rates need not be in line with the OCR appears to be out of context.

13. A stunted monetary policy would mean that the government has no other recourse than fiscal policy to stimulate the economy. This would raise public debt burden. OCR and other interest rates can change as conditions improve but debt once incurred would be a long term commitment. Consequently, it is in the interest of Australians that in situations like the GFC, where public wholesale guarantee is

provided, banks keep their lending rates in line with the OCR.

14. I don’t accept that the Amendment would lead to politicisation of interest rate if the Amendment is made applicable in situations where public guarantee is provided to banks for wholesale fund raising and in abnormal situations like the GFC where the objective is to kick start the economy.

Conclusion

Based on the submission made on 02 September 2009 and the current submission (02 October 2009), I support the Amendment provided it is used when public wholesale financial guarantee is in place and the circumstances are exceptional (GFC, for example).