COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Competition within the Australian banking sector

MONDAY, 13 DECEMBER 2010

SYDNEY

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SENATE ECONOMICS

REFERENCES COMMITTEE

Monday, 13 December 2010

Members: Senator Bushby (Chair), Senator Hurley (Deputy Chair) and Senators McGauran, Pratt, Williams and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Coonan, Cormann, Crossin, Eggleston, Faulkner, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Joyce, Kroger, Ludlam, Ian Macdonald, McEwen, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Stephens, Sterle, Troeth, Trood and Wortley

Senators in attendance: Senators Bushby, Cameron, Fielding, Hurley, McGauran, Pratt, Williams and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

Competition within the Australian banking sector, including:

(a) the current level of competition between bank and non-bank providers;

(b) the products available and fees and charges payable on those products;

(c) how competition impacts on unfair terms that may be included in contracts;

(d) the likely drivers of future change and innovation in the banking and non-banking sectors;

(e) the ease of moving between providers of banking services;

(f) the impact of the large banks being considered 'too big to fail' on profitability and competition;

(g) regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis;

(h) opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers;

(i) assessment of claims by banks of cost of capital;

(j) any other policies, practices and strategies that may enhance competition in banking, including legislative change;

(k) comparisons with relevant international jurisdictions;

(l) the role and impact of past inquiries into the banking sector in promoting reform; and

(m) any other related matter.

WITNESSES

Committee met at 8.45 am

CHAIR (Senator Bushby)—I declare open this first hearing of the Senate Economics References Committee inquiry into competition within the Australian banking sector. On 28 October 2010 the Senate referred this inquiry to the committee for report by March 2011. The inquiry will focus on the following aspects of competition within the banking sector: the current level of competition between bank and non-bank providers; the products available and fees and charges payable on those products; how competition impacts on unfair terms that may be included in contracts; the likely drivers of future change and innovation in the banking and non-banking sectors; the ease of moving between providers of banking services; the impact of the large banks being considered 'too big to fail' on profitability and competition; regulation that has the impact of restricting or hindering competition within the banking sector, particularly regulation imposed during the global financial crisis; opportunities for, and obstacles to, the creation of new banking services and the entry of new banking service providers; assessment of claims by banks of cost of capital; any other policies, practices and strategies that may enhance competition in banking, including legislative change; comparisons with relevant international jurisdictions; the role and impact of past inquiries into the banking sector in promoting reform.

To date the committee has received over 100 submissions, which are available on its website, and will hold public hearings today and tomorrow in Sydney and in Canberra on Wednesday. Further hearings are planned for Brisbane and Melbourne next month. These are public proceedings, although the committee may determine or agree to have a request to have evidence heard in camera. I ask everyone to ensure they have switched off their mobile phones. I also ask photographers and cameramen to follow the instructions of the committee secretariat and ensure that senators' and witnesses' laptops and personal papers are not filmed.

I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question the witness should state the ground upon which the objection is taken, and the committee will determine whether it will insist on an answer having regard to the ground which is claimed. If the committee determines to insist on an answer a witness may request that the answer be given in camera. Such as request may, of course, also be made at any other time.

[8.47 am]

DEBELLE, Dr Guy Lawrence Geoffrey, Assistant Governor (Financial Markets), Reserve Bank of Australia

STEVENS, Mr Glenn Robert, Governor, Reserve Bank of Australia

CHAIR—I welcome the Governor of the Reserve Bank of Australia, Mr Glenn Stevens, and the Assistant Governor, Dr Guy Debelle. Would you like to make an opening statement?

Mr Stevens—We have provided to the committee a submission, which you have. There is a lot of detail in there on lending, margins and fees and other factual material that the committee may find of some use. Obviously we will answer questions on that today if we possibly can.

I thought it might be useful to make two more general remarks about the issues before us. The first of those is that risk has been repriced since early in 2007. I think all of us are still getting used to that change and its various implications. Prior to then it was widely held, I think, that risk was underpriced—that it is to say, investors demanded relatively little compensation for risk in the returns that they required on investment. That meant that financial institutions of all types could get ample funding easily and cheaply. So they were able to pass that cheapness on to their customers.

Business models that took particular advantage of low-cost wholesale funding or securitisation were able to provide a very competitive edge to certain markets, particularly—though not only—markets for mortgage lending. But investors changed their behaviour in 2007-08. The compensation that they require for taking risk now is higher. Therefore, wholesale funding and securitisation are more expensive. In the case of securitisation, in addition costs have risen in part because certain investors completely exited that market and are very unlikely to return. So there has been an increase in the cost which has affected all financial institutions but to varying degrees. Therefore, because the degree varies, it has also affected the competitive landscape. Some business models that did well in the earlier state of the world of course find it hard now. Part of the competitive advantage that they had for a time has been eroded by changes in market conditions. The current relationship between variable mortgage rates in particular and market funding costs is making it harder than it used to be for those lenders that rely on securitisation or wholesale funding to compete with the major institutions that have a more diversified funding base.

The changed attitude to risk also affects the locus of competitive forces. Four years ago the competition was all in lending money. There was very intense competition to lend. But now there is very intense competition to raise money on the part of financial institutions. Other things have happened as well that affect the competitive landscape, but this is a very fundamental change in the state of the world. That said, the market, I think, remains more competitive than it was in the mid-nineties and borrowers have access to a larger range of products than they once did. The overall availability of finance to purchase housing, in particular, seems to be adequate.

The second theme, briefly, is that, with the market price of risk having risen, various players want the public purse to take on some of that higher price through various forms of support or regulatory change. There are a lot of ideas there and, as you say, Mr Chairman, there are 100 submissions. I have not studied them all, but I am sure that among them there will be various proposals to do one thing or another, and of course they ought to be assessed on their merits. But the high-level point is that, at least in some instances, it seems that the taxpayer is being asked to shoulder more risk, one way or another, in order to facilitate the provision of private finance. Whether that is a good idea and in which areas and to what extent it is a good idea and, if it is, how much might be charged for that public support is of course for governments and legislatures to determine. I think that is an issue to keep in mind, so, hopefully, your inquiries today and in the future will be able to assist in that process.

CHAIR—Thank you, Mr Stevens. I have a couple of questions arising from your opening statement. You mentioned that one of the basic differences between the banking environment now and in 2007 is that risk is now better priced. Do you think that investors, when pricing risk now, are accurately pricing risk, or are they still overpricing risk?

Mr Stevens—That is hard to say, isn’t it? What we saw for some years, up to late 2006, was very skinny compensation for risk, and a lot of people at the time said: ‘This doesn’t seem right. People are probably underestimating risk.’ It will not be surprising if, having had that environment, things swing a bit to the other extreme subsequently. Of course, people in the heat of the crisis would not take any risk at all, which is why governments and central banks had to do the things that they did, which were quite extraordinary. Things have calmed down a good deal now, but there is still a certain nervousness and cautiousness generally around the world, and there are things which give people reason for that caution in a general sense, like all the events we have seen in Europe, say, in the past month and earlier in the year, when the issues over Greece erupted. So these things occur and they are a periodic reminder to investors everywhere that the world is to some extent a risky place. It is very hard to say with any precision whether the exact compensation is accurate or not, but it is probably closer to the mark now than it was in 2005 and 2006, I would say.

CHAIR—One of the focuses of a lot of the submissions that have come in has been the costing of and access to funding and, as you mentioned yourself, the competition in gaining funds that you can loan out. One of the aspects of that has been to do with the securitisation market. I am curious about pricing the true value of risk. RMBS in Australia have been a very stable and safe investment and there have been no recorded incidents of any problems with RMBS in Australia. Clearly there were problems were similar securities in other jurisdictions, but in Australia they have been a very stable and secure investment. Do you think that investors, in choosing not to invest in the RMBS market in Australia, are accurately pricing the risk of that investment?

Mr Stevens—Investors are investing in it but price—

CHAIR—Not to the extent that they were and at higher price.

Mr Stevens—Well, actually there are a couple of things to say there. One is that a large part—probably half—of the flow of investment prior to the crisis was by foreign investors, many of whom were SIVs and conduits and so on. Those people actually had a very risky business model, which we all know now. Those people are not coming back, so we are not going to see that sort of investor demand from offshore again virtually at any price, I would say. With the onshore investors and the more well-structured offshore investors—and there are some of those—that market is actually recovering. I could get Guy to say a little more about that, because I think in a speech a week or two back he covered the detail. So there is some recovery going on. It has got a way to go yet, but I do not think I would agree if the argument is that there is no investment at all. There is some and it is gradually recovering. But it is taking time.

CHAIR—It was not so much an argument as a question, and that question is that there is a reduced appetite for RMBS—put it that way. It was certainly extremely reduced during the crisis peak but there still appears to be a reduced appetite, and that is reflected by the fact that the Treasurer, Wayne Swan, still feels that there is a need to put an extra $4 billion in to try and restart the market or move it on further. Is that because there is a risk in RMBS that investors are either pricing correctly or incorrectly or is it to do more with the factors that you are talking about, that there just are not the investment vehicles out there to actually lead to those investments, in which case why bother trying to restart it if there is nobody out there that is going to invest in it?

Mr Stevens—It is not that there is nobody, but a large class of investors were there who were really there on an unsound basis, and they are not coming back—and, really, you do not want them back, I do not think. The evidence on the returns on these assets over time has been pretty much unimpeachable for the better quality ones, certainly, by international standards. But I think what we are facing is that, as an asset class globally, mortgage backed securities have had a severe reputational hit. It is certainly true that the ones sold in this country are of fabulous quality but, as an asset class as a whole, unfortunately, there has been a reputational hit which will take time to be worked off. I would be confident that, over time, it will be, but it will take time. As I say, the recovery is happening but it is a gradual process.

CHAIR—But, at this stage, the pricing for risk, or the approach to Australian RMBS, is probably clouded to some extent by international experience.

Mr Stevens—I think it has to be; that is unavoidable.

CHAIR—Yes, but that is not reflecting the true value of the investments.

Mr Stevens—They are demanding a compensation for risk that is, to some extent, reflective of the reputational damage to the asset class as a whole. Do you want to add anything, Guy?

Dr Debelle—There is the brand damage aspect, but there is also the liquidity aspect. Glenn mentioned the higher price for risk, but there is a higher price for liquidity than there was pre the crisis so some of the change in price reflects that as well. If you look at securitisation as a share of housing credit, you can see that it is down to around 10 per cent, but it was much higher than that in 2007. A large part of the explanation for why it is lower now than three years ago is for exactly the reason that Glenn said: those buyers who were buying in 2007 just are not there anymore. So, at the moment, this year the flow of securitisation will be around $20 billion by the end of the year. That is not far short, probably only a few billion, of the amount which would allow securitisation to continue at roughly the share of housing finance that it is at the moment. So the market is getting close to being self sustaining. We have had a few deals in the last two months from some of the larger institutions which have not required AOFM support. While the AOFM is participating in some of these deals, 75 per cent of the money coming into the securities is still private money. The AOFM is providing some support for this money.

CHAIR—Would those deals be going ahead without the AOFM participating?

Dr Debelle—As I said, if you look at the fact that there have been private deals going through as well, it would suggest that there is some appetite for those unsupported deals. But some of the deals do require a bit of AOFM support as well, I think just to provide reasonable flow into the market. The amount this year is higher than it was last year, and I think the prospects are that that will continue next year. The market is just taking a bit of time to recover from that brand damage that Glenn was talking about.

CHAIR—I will move on from there. You also mentioned that the market is more competitive now than it was in the 1990s and that there are more products on offer. The 1990s were characterised by the non-bank financial institutions growing rapidly and becoming far more influential in the lending market, in particular. Given that a lot of the non-bank financial institutions are no longer as active because of events over the last couple of years, where is the competition being driven from and where does the RBA see the drivers of competition coming from?

Mr Stevens—What I am saying, Mr Chairman, is that, if you cast your mind back to the early to mid-1990s, there is more choice, more products, on offer now. There are lower net interest margins amongst the majors and so on than there were then.

CHAIR—Is that a legacy, though, of the period leading up to 2007, or is it a characteristic of the market that is likely to continue now?

Mr Stevens—It is a function of the ability of other lenders to adopt business models that took advantage of the conditions, and the conditions, as I said, are not as propitious for that today as they were at their peak. But those people are still in business and, if anything, the share of the non-major lenders in the flow of housing finance, at least in the past six months or so, has been tending to rise from the much reduced level that it reached—

CHAIR—But not with the non-bank financial institutions?

Mr Stevens—I think it is among them, at least partly, isn't it?

Senator McGAURAN—The credit unions and building societies—is that what you mean?

CHAIR—I meant non-ADIs.

Mr Stevens—Non-ADIs? I guess that is a different question.

CHAIR—Which is where a lot of the competition was coming from prior to 2007.

Mr Stevens—Do you mean mortgage trusts and fees?

CHAIR—Yes, Aussie and Wizard.

Mr Stevens—Mortgage originators are still there. They are still able to go about their business. Certainly, things are not as easy now, compared to how they were three or four years back. But those ways of doing business are still there. As I said, I think the evidence is suggestive in recent months that the very high market share of the five largest lenders is actually tending to come down a little. It still remains higher than it was.

CHAIR—I noted that in your submission. Just a final point: in your opening statement you commented on the taxpayer being asked to shoulder more risk in return for private credit provision. You raised this issue as being something that, presumably, the committee should be looking at.

Mr Stevens—I think it is something to keep in mind, because a number of proposals that one sees extend guarantees to this or that and suggest that, in some way, they will help this market et cetera. In a number of cases, it really amounts to the taxpayer taking some more risk. Maybe that is a good idea. I am not saying that that should be dismissed out of hand. But if such proposals were to be adopted, they should be adopted conscious of and taking account of the fact that you have—

CHAIR—Exposed taxpayers.

Mr Stevens—exposed the taxpayer to some more risk. That is a judgment call and should be done with due care. That is what I am saying.

CHAIR—I guess that, to an extent, the responsibility of a committee such as this is to look at those issues and to advise parliament.

Mr Stevens—I would think that is a consideration for your committee to keep in mind.

CHAIR—The flip side of that is that by government involvement in the provision of private equity, using the moral hazard argument, you can actually change the behaviour of the private institutions involved. Do you think there is any risk that the level of interference by government in the industry may lead to some changes of behaviour which may not be in the best interests of consumers?

Mr Stevens—You mentioned the provision of equity.

CHAIR—Sorry, private credit provision.

Mr Stevens—Let us see whether I can give you a particular example without giving an opinion about whether the proposal is good. One idea that one sees around is the extension of guarantees for mortgage-backed securities by the government, which is done in some other countries. Various people put forward arguments why that may be a good idea, and it may be. But if one were inclined to go down that track one would want to do it with great care because, when you think about extensive public intervention in housing markets, we do not need to look any further than the United States of America to see that that can go wrong if you are not very careful about the way incentives are designed. So my point is: take due care with all these ideas because with most policy interventions there can be—and usually there are—unintended consequences down the track. We should be quite careful how we assess these things. That is really my point.

CHAIR—I may come back to some more questions, but I will give other senators an opportunity.

Senator HURLEY—I would like to continue on that track. The RMBS has been referred to as a very safe investment in Australia. I am a bit concerned that that is not necessarily an inherent quality of the investment. If, for example, that became a much more attractive investment, is there the possibility that there may be a manipulation of that, such that the kinds of instruments we saw that led in some ways to the housing market collapse in the United States might happen here?

Mr Stevens—It all comes down to the underwriting standards. Is it still the case, Guy, that a rated tranche has not lost a dollar yet?

Dr Debelle—That is right. No-one has lost any money on RMBS in Australia to date.

Mr Stevens—Why would that be? I think that is principally because the underwriting standards by and large have been good. I think we were seeing some diminution in lending standards towards the peak of the boom and I think those loans are actually disproportionately represented among the areas where we see significant mortgage distress. But, by and large, underwriting standards in Australia remain pretty good. You have to keep that, obviously, for the quality of the securities to remain high. In fact, one of the thrusts of the global regulatory work that people are working on has been how to restart securitisation globally but on a basis which keeps the standards up, which keeps the incentives of the underwriters correctly aligned, and that is not easy to do. But that is the key thing: to keep the underwriting standards high. Most people seem to feel that one component of doing that is for the originator to keep a stake in the outcome rather than being able to shift all the risk away to the end investor, because if they are able to totally shift the risk then their incentive to keep the standards up is obviously weakened. So these issues of underwriting standards, incentives and so on I think are key in keeping these kinds of securities of the high quality that we have had to date in this country.

Senator HURLEY—When are those international discussions about the standards of mortgage backed securities likely to be concluded?

Mr Stevens—One would hope soon but, realistically, these things take some time. There is a very large agenda, as you would know, on regulatory reform right across the board; this is just one small part of it. Some of those discussions are, I think, going to be finished over the next several months, but then the implementation takes a long time. On securitisation per se, that is an ongoing issue but we probably will be, over time, heading to a world in the global regulatory architecture where it will be expected that the originating lender retains some so-called ‘skin in the game’ as a way of keeping the incentives correct. That of course lessens the amount of capital relief that the rules give them, but that is the balance we have to strike.

Senator HURLEY—How do covered bonds figure in that scheme of things?

Mr Stevens—Covered bonds basically take a part of a bank's assets, or the lender's assets, and say, 'This group of assets backs this particular debt issue.' They are commonly used in a number of other countries around the world and I think they have a place in the architecture, but the key thing is to think about the relative position of depositors and the covered bondholders in terms of their claims over the bank's assets. I think there will have to be some clarification in the Banking Act on that front for covered bonds to go ahead.

Senator HURLEY—Yes, because I think the discussion has been around the rating of the bonds—whether they are rated AAA or whatever—and who can invest in them. I am not sure how the rating will be done or what regulations will be around it.

Dr Debelle—The structure of covered bonds globally has been well established. In fact, they have been around in Germany, for instance, for about 150 years. The structure is fairly well established as to how they work and there are fairly clear guidelines on what is required to have a covered bond rated AAA. So I am not sure that there would be too much uncertainty around that. The area where there is uncertainty, which comes back to what Glenn is talking about, is the extent to which one can use covered bonds before it starts to impinge on depositor protection, basically.

Senator HURLEY—Can you tell me, if you able to say, whether mortgage defaults that occur in Australia—and I agree that they are at a fairly low level still—mostly come from mortgages originating with the big four banks, the smaller banks or the non-ADIs?

Mr Stevens—In the broad, you get higher defaults when there is high unemployment and vice versa. So the fact that unemployment is low obviously is a major help there. I think the evidence would show that, for the sort of lending which is more low doc, less conforming, higher loan to value ratio et cetera, the default experience is higher. Of course, it was always expected to be higher. These are more risky loans but they are priced accordingly, and the real question is whether they are priced appropriately for the risk that is faced. It has to be true, doesn't it, that as you go down the risk spectrum and you get to people who are genuinely a more risky proposition you should expect the loss experience to be greater. It does not mean you should not do the business; it just means that you should price the risk appropriately. I think it is true that the default experience amongst those loans clearly is greater. The majors did a little bit of that sort of lending but proportionately not very much. It was more prominent among some of the non-bank originators than among the majors.

Senator HURLEY—I think we have the balance here, as there always is in the markets, of allowing people who are on lower incomes, who are perhaps riskier, to have access to housing finance, not to unduly keep them out of the market, but then to try to help them make a proper assessment as to whether they can actually afford the loan. Of course, if they are at a higher interest rate because they are a riskier proposition, they are even more at risk. That is one of the key points.

Mr Stevens—I agree. That is why underwriting standards are so important. We did not see very much of this here, but in the US they patently had a lot of lending to people who never had a hope of making good.

Senator HURLEY—So in terms of the argument about lowering interest rates we should clearly listen to people who are suffering from higher interest rates but not get into a position where people take on loans that they cannot afford.

Mr Stevens—It is a hard balance to strike, isn't it? As you say, you do not want to say to people in some overly nanny state sort of way, 'You can't have this loan.' You certainly do not want them to be in a position where they have taken on a commitment without fully realising what is actually involved. That is the balance to strike.

Senator HURLEY—Thank you. I think that comment about fully understanding what they are taking on is a key one.

Senator XENOPHON—When you appeared before the House of Representatives committee last month you said, 'If my choice is between banks with good profits and banks with no profits then I choose the former every time.' Is there a choice between banks that are fairly cosy that could quasi-collude with high profits and actively competitive banks with low profits? Is there scope for competition in the banking sector that would increase competition and lower those profits?

Mr Stevens—I suppose my question is this: is the degree of profitability itself the main metric that we ought to use to assess competition in the system? It clearly is one. I am not sure I would agree with it being the only one. I would assess the current state of profitability of the majors as good. They are earning quite a healthy rate of return on their equity, though not at this point at the same rates they were up to 2006 or 2007. The reason you do want banks earning decent profits is that you want these institutions to be able to grow their capital base and provide credit on appropriate terms for the economy's growth—that is their function. I can assure you that banks that are struggling to make a decent profit are not thinking about fulfilling that role; they are thinking about survival. This has been the state of banks in so many other countries in recent years and we do not want to be in that position. I am not arguing for excessive profitability, by any means, but, as somebody who is concerned for the stability of the financial system and for the ongoing capacity of that system to do its job in helping the economy, you want a reasonable rate of return being earned by those entities.

Senator XENOPHON—I guess the issue is to what extent is that rate of return unreasonable if there is a lack of competition in the market place.

Mr Stevens—That is a fair question.

Senator XENOPHON—When it was announced in the mid-80s that 16 foreign banks were to be given banking licences there were hopes it would increase competition. It seems now that the four big banks have a larger market share than they did then. What went wrong—in the sense that we were supposed to have a new era of competition 25 years ago?

Mr Stevens—We did have competition. Competition is cyclical, to some extent. Competition is at its most intense usually around the peak of the business cycle when the risk that everybody is taking on is actually much greater than they think. Subsequently, the nature of those risks become clearer and people retreat from risk taking and the competition to lend, as I said earlier, abates considerably and the competition to raise funds and shore up balance sheets gets much stronger.

So we did have very intense competition in the system in the eighties mainly chasing corporate lending. Some of that came to grief with the excesses of the late-eighties. A number of the foreign lenders were, in fact, disproportionately represented amongst the group that lent to the entrepreneurs who subsequently came to grief. In the nineties and 2000s there was some resumption of that kind of competition in the business space and the competition to lend to some of the more highly geared entities that came to grief two or three years back involved foreign lenders as well.

We also had more competition in the mortgage space though a lot of that was more domestic in nature and it came from non-bank lenders and originators and so on who were able to take advantage of the particular market conditions that I described earlier and that competition. It is harder to compete in that way today than it was three or four years ago. So these things have a certain cycle, and I am not sure that I would describe the opening of the system to foreign lenders as having failed to generate competition. It did generate it but competition waxes and wanes with the economy, the economic cycle and the international financial cycle.

Senator XENOPHON—So, as for what we are seeing now, are you saying that we are seeing greater competition for borrowings rather than for lending in a sense?

Mr Stevens—Yes. I am sure the banks will tell you, when they come along to see you today or tomorrow, how intense the competition to raise deposits has been. It has been much more intense than I can recall in a very long time. Why is that? It is because the strong reliance that many of our institutions, including the major banks, had on wholesale funding—a lot of it from offshore—came to be seen as something of a vulnerability. They felt that themselves. They were under pressure also—from rating agencies and from supervisors and this is everywhere in the world, not just here—to have a higher share of the assets funded by deposits, which are thought to be more stable. One could debate the extent to which that is true but that is the thinking—so there is less reliance on wholesale funding and so we have seen a lot more competition in the deposit space. So in a way the locus of competition has migrated from the lending side to the deposit side because of the nature of the situation that people face. I think that is a very clear feature of the way things have turned out in the past couple of years.

Senator XENOPHON—Is the fact that a number of European governments will need to refinance their sovereign debt next year an elephant in the room when it comes to the impact it could have, the flow-one effect it could have, here in Australia?

Mr Stevens—That is a pretty big question. There are serious fiscal issues in Europe and they are intertwined with banking stresses as well, which is what makes it so hard. I think as to the way in which events in Europe could have an adverse impact on Australia's financial system if it occurred—I am not saying it will, but if it did—it would probably be via some kind of event which catalysed a broader withdrawal from risk-taking in the global financial system. Again, like we saw a few years back, that would raise costs and lower availability for everybody, not just for us. But if there were an effect on Australia that is probably how I would envisage it working out. Whether it will occur we cannot know. It is a risk that we have to be cognisant of.

Senator XENOPHON—You have said in terms of banks' profitability that it is in line with other major companies' in Australia, I think, in terms of the rate of return. Is there an argument, however, that the rate of profitability of banks, by virtue of the bank guarantee and by virtue of the fact that they are almost seen as quasi-utilities, is unreasonable in that context given the level of government support and given the issue of the highly regulated nature of our banking system?

Mr Stevens—Should they been seen as utilities: that is an argument that people have. I am of two minds about that. Basically, these are private companies and private shareholders put their capital at risk to own these companies. They are highly regulated because they raise deposits from the public and banking by its nature is a highly leveraged business; that is what banking is. And they are highly regulated because a failure of a bank is not quite the same as a failure of a regular industrial company, because of the spillover. So that is why we have the regulation.

There are arguments about whether in the fullness of time—in a new regulatory world where banks, particularly globally, hold a lot more capital and are inherently therefore less risky—equity holders ought to expect a lower rate of return because of a lower risk profile. That is quite an interesting question and I think if things do turn out that way it is going to take a long time.

Senator XENOPHON—By 'a long time' do you mean the next decade or so?

Mr Stevens—I would say at least that long. These things take a long time. That question is really far more pertinent to some of these very large, globally active banks whose common equity as a share of their assets is only one per cent or two per cent, so they are actually very highly geared and therefore have in fact been quite risky. These issues can be posed in Australia but they are much less than acute compared with these other countries.

Senator XENOPHON—Thank you.

Senator WILLIAMS—Mr Stevens, in your submission you say:

Australian borrowers have enjoyed ready access to credit, with credit growing at about three times the pace of nominal GDP over the past 25 years.

How does this compare with other countries with the rate of credit growing in Australia compared with other countries over those last 25 years? Have you any idea of that?

Mr Stevens—It will vary by country, but—

Senator WILLIAMS—The point I make is: are we out of the normal or is that normal practice for other countries? Is it concerning or are we living on credit? That is the reason for the question.

Mr Stevens—This is something that has been debated over much of those 25 years—how much is too much and how long can this go on. Clearly we cannot keep raising the size of credit compared with the economy indefinitely. I think if you looked at English-speaking countries in particular you would find that our experience is not especially different from theirs. In terms of the housing debt, we were probably at the low end of the pack 20 years ago. We are not anymore; we would be up near the top, and that is a function of competition in the system to lend, innovation and also the structural decline in interest rates that came with the transition to low inflation, which basically allowed people to borrow more. So I do not think we are alone. I think if it kept going like that we might find ourselves rather alone in the next 10 years. I do not think it is going to actually.

Senator WILLIAMS—So there is a warning there.

Mr Stevens—I am not among those who have been preachers of doom over the size of debt we have had, but my view—and I have put this publicly—is: we have managed this fairly well but I do not think we should push our luck too much from here in terms of gearing up further. I do not think that would be very wise, and frankly I think households actually understand that quite well and their behaviour shows a different trend now.

Senator WILLIAMS—I want to take you to the issue of exit fees—on variable loans only, of course. Do exit fees stifle competition in the finance industry?

Mr Stevens—The argument is that barriers to exiting one loan make it harder to take another one. The difficulty really is of course that there are actually costs to the lender in both establishing and terminating the loan that they are going to feel they need to cover. It is a difficult area, and I cannot really offer a terribly well-informed opinion on the extent to which such fees are a serious impediment. You can see the logic as to how they could be. In actual practice, how big that is I cannot really judge, to be honest.

Senator WILLIAMS—In my personal experience it is to me because I have to pay an exit fee if I wish to get out of my bank to go to a cheaper interest rate offered to me by another bank, and by the time I pay the exit fee I am behind anyway. I want to take you to the government backed guarantees for deposits that the government introduced some time back. The government underwrote those investments in registered ADIs but not in other companies covered by ASIC that were not registered ADIs. Is it correct that in New Zealand the government underwrote both—the registered ADIs and the smaller companies as well?

Mr Stevens—I am not—

Senator WILLIAMS—I ask the question on the grounds that I discussed this privately with Senator Nick Sherry at the time they were bringing this guarantee in and I said to him, ‘If you guarantee the deposits in this sector, the registered ADIs, and not in the smaller companies, the secured investment companies et cetera, people will withdraw their funds from those smaller companies and place them in the institutions with government backed guarantees—the ADIs,’ and that is exactly what has happened.

Mr Stevens—Yes.

Senator WILLIAMS—That has had a huge effect on reducing more competition. We could not go public on this very issue for fear of causing a run on those smaller companies. Hence the government action in itself, which I did bring to the attention of the government—and Senator Cameron might attack me in a minute—

Senator CAMERON—What?

Senator WILLIAMS—That surely had an effect. I know companies that with companies such as the Provic group in Victoria and Bidgee Finance people withdrew their funds at a time of nervousness and panic.

Mr Stevens—That is right. The question really is: can you guarantee everything?

Senator WILLIAMS—Yes. 'Unsecured', I should say.

Mr Stevens—My view would be that you cannot. In a situation such as the one that we faced in October 2008, I would argue for stabilising the core of the system.

CHAIR—As more important than competition at that point?

Mr Stevens—The key thing is you have a potential threat to the stability to the core part of the financial system. I do not think you can let that go unaddressed. You cannot guarantee everything in the economy—that is taking more risk onto the public purse than really should be done—but I think you have to act to try to stabilise the core. And that is essentially what was done, and I think it was right.

Senator WILLIAMS—One of the big arguments has been about the cost of funding going up for the banks and hence the movement, on 2 November, outside the Reserve Bank cash rate movements. You say in your submission:

Since mid 2009, the major banks' overall funding costs are estimated to have moved broadly in line with the cash rate, reflecting offsetting factors.

So why are the banks moving outside the rate? You are saying, on page 14 of your submission, their short-term rates are actually cheaper.

Mr Stevens—Yes.

Senator WILLIAMS—Surely one of the questions, when the banks have moved their margins greater than the Reserve Bank movements, which have been traditional for some 15 years or so, is: why?

Mr Stevens—The broad issue here is that over time, over short periods, we form an estimate of things moving or not. But since the middle of 2007 there clearly has been an increase in their overall costs of funds relative to the cash rate. That has been reflected in the widening of the margins. It has also been reflected in the cash rate being roughly, I would say, about 100 points lower than it would have been, to take account of that margin change and roughly—not exactly in any given month but roughly speaking—offset it so that the loan rates in place in the economy are, roughly speaking, about where we think they ought to be for the macroeconomic management needs that we have. We cannot finetune this on a month-to-month basis; we could not claim to do that. But over time, in the broad sweep, the big amounts, roughly speaking, have been offset by different behaviour by us on the cash rate compared to what we would have done otherwise.

Senator FIELDING—It is good to see Mr Stevens again. Most Australians feel that they are being ripped off by the big four banks. Should Australians feel ripped off by the big four banks with regard to interest rates on loans, bank penalty fees and ATM fees?

Mr Stevens—I cannot really tell people how they should feel and I am not here to defend major banking institutions—they will be along here to defend themselves later on I expect. There has been, as I said, some increase in overall funding costs by not only major banks but other lenders as well, many of whom have raised their rates more than the cash rate. That is something which has been basically handed to us by the global financial system. As I said, the Reserve Bank have fully taken account of that in our own behaviour in setting the cash rate.

On penalty fees I really do not have much comment to make. We have some factual information in the submission.

On ATMs my point would be that there has been considerable reform in this space, driven by the Payments System Board, the other board in the Reserve Bank. Some reforms came in here earlier in the year. The result of that seems to be that you are faced with much clearer information about what the fees will be before you actually carry out the transaction as opposed to getting it subsequently in your statement—and that is how things used to be. You found out about foreign fees and so on when the statement came along, but now you see it on the screen before you press the buttons ‘yes’ or ‘no’ and you have the option of continuing or not. By the way, these reforms also abolished interchange fees between institutions on these transactions.

Faced with that information, people use their own banks more and pretty much most people can get a fee-free transaction from their own institution or from a network that that institution is connected to. They are using their own bank more and foreign transactions less and they are saving collectively across the community about $120 million a year compared to the previous situation. To my mind, that is a significant improvement. So I do not think people have to feel ripped off by ATM fees actually. It is open to them to avoid those fees most of the time and the evidence is that they are.

Senator FIELDING—Coming back to the issue of Australians feeling that they are being ripped off, do you think that the big four banks are ripping off Australians with interest rates on loans?

Mr Stevens—That is a very pejorative way of putting the question, isn’t it? I am not going to invite people to feel either ripped off or not. There are a set of facts about what has happened to funding costs. There is an explanation of that that we have given multiple times. There is an explanation of how our behaviour has been different in response to that so that the overall level, of particularly housing rates, is about where we feel it should be for the economy. Should people feel ripped off by all that?

Senator FIELDING—I suppose my question was: what do you think? The reason why I raise this important issue is the Treasurer has effectively said that we are being ripped off. I listened to the Treasurer’s statement yesterday and he said that there was no justification for lifting interest rates above the official cash rate increase that was done in November. I am interested to know what you think. Australians actually do trust you and they are trying to get a feeling for what you think.

Mr Stevens—I am not going to comment on things that the Treasurer says. That is not appropriate. He is the Treasurer and, if you do not like what he says, you have to talk to him, and I am sure you will.

Senator FIELDING—Do you think the banks were justified in increasing their interest rates above the official rate increase by the Reserve Bank in November?

Mr Stevens—Whether they are justified or not, they did it. We expected that they would do something like that, because we read the newspapers and we saw the things that they were saying. One of the things that they have in their mind is that their funding costs on the offshore part of it, the long-term part, where you borrow at five years—so every year one-fifth of that funding is replaced. The cost of what you borrowed five years ago is 'down here'; the cost of what you are borrowing to replace it with is 'up here'. So, as each month goes by, a little bit of the old stuff rolls off and the new stuff rolls on. How big a quantum that is is a matter of estimation—an empirical estimation, of course—but my guess is that one of the things that is in their mind is that this is happening each month and, as each month goes by, there is that small squeeze on their margins. What you will see is that every so often there is a bit of a catch-up and then a gradual erosion and they will be looking at that—so I think that is probably one of the things that has been in their minds. Whether that is fair and adequate, people will debate.

Senator FIELDING—The reason I asked the question is that most Australians do feel that, and they are wondering who they should ask, as an honest broker: are the banks charging more than they should with regard to interest rates? I feel that you are not able or willing to answer that question—

Mr Stevens—You are trying to put words—

Senator FIELDING—Who should we ask that question of?

Mr Stevens—The manner in which the question is asked is going to paint me as defending the major banks and that is not my role. This relates to what all banks are doing—all institutions, all lenders. It is not just the majors, actually, who raise rates. Some of the other lenders also raised by more than the cash rate. Why is that? It is because they all face the same phenomenon—that market funding costs do not move in this environment one-for-one with the cash rate. In fact, the period of time in which they did was historically rather unusual. It lasted 10 or 12 years. But if you went back prior to that period the association of mortgage rates with the cash rate was actually much looser. All these institutions face these market dynamics, and they are all trying to work out where to pitch the rate at which they lend, compared with the rate at which they borrow. That is a feature of the international financial situation that we face, and it has been now for several years, and we cannot make that go away. The best we can do is try to be clear on what the facts are, which is what we have tried to set out here, and be clear in the way in which the Reserve Bank has taken that into account in setting our policy rate, and I have repeated that multiple times.

Senator FIELDING—I will not go down that track but there is a question that I think the general public would like to get a bit of a feeling for. As you know, the Reserve Bank did a study on the average cost of ATM transactions. It cost the banks about 75c—and I know that you referred earlier on to quite a bit of reform that has gone into that area. From my recollection, I have not seen the fees come down very far from about $2 on ATMs. With all that regulation in place—and I fully understand that there may be more ATMs out there and they may be more readily available—there has not been a lot of change in that sort of price and the competition of pricing.

Mr Stevens—On the reforms, basically if you own the machine, you can charge the price you think you should. Bear in mind that about half the ATMs in Australia are not owned by the major banks; they are owned by the independents.

The previous system was that you as an independent deployer and me as your bank and that I would tell you what you could charge and what your revenue would be. It seems to me quite an unsatisfactory business model for you. What we faced there was: 'Your costs are going up over time and the bank is telling you what you can charge and they are also, by the way, your competitor.' This doesn't seem a very satisfactory situation. The system that we thought it made sense to move to was: 'You own the machine. You're setting a price in a competitive market and you can choose your price because, after all, it's your machine.' Unless we have that, then eventually we are going to face a situation where the independent deployers start to withdraw from the market because they cannot cover their costs. We do not want that because what we want is availability for people around the country, so we let them charge.

Many predictions were made that fees would skyrocket. There would be time-of-day charging and all this stuff. For the most part not very much of that has happened. Where we seem to have ended up is: if you use a foreign machine, it is still $2, which is what it used to be; if you use your own bank's machine, which most people do, it is free. There are six per cent, I think it is, more machines in the country than there were, and the independent deployers will continue to provide a competitive service where it is profitable for them to do so. To my mind, that is a good position to be in.

Senator PRATT—Mr Stevens, you mentioned in your opening remarks that the business models for the banks—I think post-GFC—took advantage of conditions. In your view, what are the characteristics of those business models?

Mr Stevens—The people I have in mind are those who had a strong focus on wholesale funding or who rely extensively on being able to securitise. That was a viable business model at the set of prices and costs that were in place at that time. Those people were amongst the group that could provide a competitive edge in some of these markets, particularly for mortgages. That business model became more risky, less profitable, especially post the Lehman event but even a bit before that. The institution that had that business model par excellence was Northern Rock, and they failed for want of being able to get secure funding. I think that was the signal that that business model needs some amendment. It is not totally invalid but it needs some adjustment and that is what has been occurring.

Senator PRATT—The securitisation and the entry of foreign banks as a driver of compression in major bank net interest margins before 2004—to what extent did those factors drive compression?

Mr Stevens—They were important. The advent of mortgage originators who could fund at a margin above the wholesale market rate and compete with majors was one of the factors that brought down the net interest margins, especially on mortgages, over 10 years or so.

Senator PRATT—What effect did the collapse of the securitisation market have on the provision of finance by major banks in your view? This is a well-recognised issue, but were they able to increase their margins because of a reduction in competition for that finance?

Mr Stevens—The closure of securitisation markets briefly, and impaired functioning, subsequently made it harder for those lenders that relied on that channel to lend. One of the things that happened there was that the majors lent more, which frankly we needed them to. That was the thing that helped stabilise the economy. They had a different balance sheet structure. They had greater financial strength relatively in that particular environment and they stepped into the gap. I think we should be happy that they did, even though that meant their market share rose. It is not to say that you want that as a permanent state of affairs, but I think that was stabilising at the time. The evidence on net interest margins is in the submission, which is that they today are about where they were in 2005, which is a little bit higher than they reached at the low point and materially lower than they were in 1990. Do you want to add something?

Senator PRATT—But largely it is because of a bigger balance sheet as opposed to an increase in margins?

Mr Stevens—No. I do not think the balance sheet per se is—a lot of things go into the net interest margin too. It is not just the gap between the rate you lend at and the rate you borrow at. It is also what is happening to impaired assets and the provisions you have to make and so on. All those things go in here, and probably at the moment, among many institutions, one of the things that are helping the net interest margin a little is that the flow of provisions for bad loans is abating because the economy is improving.

Senator PRATT—Given the impacts on competition, can you weigh up for us why it was in fact still prudent to charge different fees to different banks based on their size to let them use the wholesale funding guarantee?

Mr Stevens—The government was going to provide effectively a guarantee on wholesale obligations. The question is: should that be done without any regard to the rating of those entities or not? The decision was taken—in my view, correctly—that the fees should be related to the strength of the institution. We used publicly available credit ratings in order to do that. I think that was appropriate. It is still the case that, even for those institutions that are paying the higher fee, they have been able to borrow using the guarantee and paying the fee more cheaply than they otherwise would have.

Senator PRATT—The government's $16 billion investment in the residential mortgage backed securities market helped the market recover. Can you tell us what this did for the ability of smaller lenders to compete? Is this what you mean by the extent to which public support for private finance is justifiable and, in a sense, the extent to which you see a public benefit from that public finance?

Mr Stevens—The thrust of those transactions has been to act as a cornerstone investor in some of these issues and to assist the market in that way. I think of late it is true, isn't it Guy, that the AOFM has taken some of the slightly longer tranches in order to facilitate the shorter ones being taken up by others? We would say, wouldn't we, that that has had some beneficial effect on the market?

Dr Debelle—For the smaller lenders, the securitisations they have been able to do have certainly cleared up balance sheet space, which would be allowing them to lend more than they otherwise would. You can see in the most recent lending numbers that the regional banks have increased their lending share of the market. The credit unions and building societies have increased their share of the lending market over the last six months or so. Some of that I would say would be because they have got more balance sheet space to lend because they have been able to securitise some of those loans.

Mr Stevens—The taxpayer takes on some risk. Doing it this way it is confined, the securities are being managed by people who have got expertise, so I do not have a problem with that; I think it was a sensible trade-off.

Senator McGAURAN—Mr Stevens, the touchstone of all competition in all sectors is the number of players: the more players, the more competition. I want to ask three questions that go to that dictum, if you like. The first one is mergers. I will cut straight to the point of it all. Mr Samuel said on *Lateline Business* in May 2009 that, given the advice from the Reserve Bank and APRA, he really had no choice but to approve the merger of Bankwest. I take it that he was regretful of that. Whether he was or not, I sense the market, or the consumers, are, as they are of the St George merger. I sense that it has not been good for competition. My question to you is: what advice did you give them that gave Mr Samuel little choice; would you give the same advice today; and do you think mergers have reached their limit? I say that with the backdrop of a very strong regional Bendigo Bank, if it is ever targeted.

Mr Stevens—No comment on future mergers because in normal times that is a matter for Mr Samuel and his colleagues.

Senator McGAURAN—But you do offer advice to Mr Samuel.

Mr Stevens—Not normally on these things.

Senator McGAURAN—You did on that.

Mr Stevens—What we said—and I do not disclose in public forums all the details of what I say to people privately in a condition of crisis—

Senator McGAURAN—It was not a formal submission to him then? It was private, was it?

Mr Stevens—Bankwest was in a situation where it had a struggling parent. It was going to be sold one way or another. In the environment that we were in, you do not want an institution with a weakened parent to be sort of twisting in the wind while they work out in the UK what they are going to do. That was the situation that we were facing. They found a suitor and, in my opinion, in the conditions of that time—this was October 2008, if I recall—stability was key. Were I to be faced with that situation again, yes, I do not think you have much choice but to err on the side of stability in those circumstances. In normal circumstances, we have the luxury of debating competition. I am happy to have that debate and to leave it to the ACCC to opine. That is their job. In situations of potential crisis, it is our job to try to preserve stability, which is what we sought to do.

Senator McGAURAN—So you cannot say you cannot comment on mergers, because in fact you gave significant advice on the matter.

Mr Stevens—We gave an opinion to Mr Samuel by phone, as I recall, on that occasion in the circumstances that we faced then. If they ask advice on whether a particular merger has any systemic implication, we would give it—if they ask it. But I do not think we are in a position where we weigh in with gratuitous advice normally.

Senator McGAURAN—Do you think the takeover of St George has diminished competition in the banking sector?

Mr Stevens—It is not for me to judge, is it? That is the ACCC's call.

Senator McGAURAN—Did you proffer an opinion on St George?

Mr Stevens—I cannot recall that I did.

Senator McGAURAN—Can you take that on notice?

Mr Stevens—Yes.

Senator McGAURAN—If you say that you cannot recall, I do not take that as a no.

Mr Stevens—I do not recall whether we did or not.

Senator McGAURAN—Take it on notice.

Mr Stevens—We certainly did not give any in the way that we did on Bankwest.

Senator McGAURAN—Finally, just on that point, I have three questions to do with the number of players. Have mergers reached their limit generally speaking? We think of Bendigo every time we think of this.

Mr Stevens—It would depend on merger with whom, wouldn't it?

Senator McGAURAN—I would not like to see Bendigo merge with anyone. I think that is the general market opinion too, if we hold to the dictum 'more players, more competition'.

Mr Stevens—I have not got a view to offer on the potential or otherwise for Bendigo to merge with anyone.

Senator McGAURAN—But you may be asked by Mr Samuel.

Mr Stevens—If I am asked about it at the time, I will give him my best advice, but I am not going to foreshadow advice on a hypothetical situation in a public place. I do not think that would make sense.

Senator McGAURAN—I want to go to the question of foreign banks, which Senator Xenophon brought up. I thought your answer was rather nonchalant. When the licences were issued to these foreign banks in the eighties and nineties, there was almost an air of excitement that real competition was coming—more players, more competition and downward pressures. They failed and have failed—and, frankly, as far as I can see, they have gone. You were rather nonchalant. You sort of said, ‘Well, competition comes; competition goes.’ But real competition is a number of players. Foreign banks are big players against our four domestics. What really went wrong, particularly in that they never set up in the retail sector? Did we place too many hurdles in their way on the ground that we were trying, at least in the retail aspect, protect our four?

Mr Stevens—Back in 1986, not as far as I know.

Senator McGAURAN—Can we do it better? How can we get them back?

Mr Stevens—It was always going to be a tall ask for foreign institutions to come in and compete with the size of that branch structure. That said, there are today some foreign institutions that offer retail products—Citibank and ING, for example. But were there prohibitions put on various things? I do not know. Not that I am aware of, but that was 25 years ago.

Senator McGAURAN—I have one quick question on the four pillars. Again using the dictum, more players more competition, would you support the four-pillar policy?

Mr Stevens—I do not have a problem with a four-pillar policy but it is not my call to support or otherwise that policy. That is a government policy; it is not a Reserve Bank policy.

Senator McGAURAN—You can certainly be asked your opinion. You opinion is valued.

Mr Stevens—I have not been asked my opinion by the Treasurer or the former Treasurer about that.

Senator CAMERON—Governor Stevens, Senator McGauran has raised the issue of competition in numbers. Hasn’t this issue of numbers in terms of competition been a longstanding debate going back to the power of big corporations in the US after the war and when JK Galbraith came up with the theory of countervailing power? Is there not another way to look at this?

Mr Stevens—I am not sufficiently expert in Galbraith’s theories to give you an informed response in those terms, but a key thing I think is contestability, not just the number of existing players but how easy it is for another player to come into the system. There do remain substantial numbers of non-bank competitors to banks. The question is, I guess, their financial strength and their ability and willingness to enter particular spaces of competition in particular markets.

Senator CAMERON—Isn't the government's three streams that it announced yesterday—that is, empowering consumers to get a better deal; supporting small lenders to compete with the big banks; and securing the long-term safety and sustainability of our financial system—an exercise of countervailing power by government in terms of some of what is perceived as the lack of competition in the banking industry?

Mr Stevens—It is hard to argue against the notion of consumers having more and better information. If that can be done, that is a pre-condition for competitive forces doing their work. As for supporting other types of lenders, it is possible that some of these measures will do that—and that is their intention. It is up to a government to decide, as I said at the beginning, how much risk it should take on, what other regulatory things it should do and what potential unforeseen consequences may come from these interventions into the marketplace designed to improve competition.

Senator CAMERON—The Productivity Commission pointed out that executive salaries in the banking industry were aligned to the US banking industry, whereas generally in Australia executive salaries were aligned to European salaries. What is the economic basis of salaries in the banking industry being linked to Wall Street when some of the bankers are saying that workers' salaries should be linked to Bangladeshi salaries? I am a bit confused about this. Can you tell me the economic basis of this?

Mr Stevens—I am not sure that I can offer you much economic analysis in defence of anybody being linked to Wall Street salaries, really. I am not really prepared to defend that one, if that is the proposal. Isn't that about empowering shareholders?

Senator CAMERON—We hope so. The last issue is ATMs. In my past career as a union official, I remember in the eighties sitting down with employers and doing a productivity trade-off in terms of getting cash salary and moving to electronic funds transfer. There was even an analysis of how much this would increase productivity, and you can go back to that period and see the increased productivity for employers on that basis. I am a bit concerned that we have lost that foundation. This was about improving productivity. We now just seem to think it is all about competition and private ATMs. If you go back, this was really about workers accepting a productivity trade-off, that they would not get cash and they would be given extra money for the inconvenience of going to an ATM. I am wondering when the workers are going to start saying, 'We've lost that benefit and we need to get some more from the employer to make up for the rip-off that has gone on at the ATMs.'

Mr Stevens—I am wondering in what sense they have lost the benefit. There are more ATMs now. I do not think the fees are actually higher, are they?

Senator CAMERON—For some of the lower income people who do not have access to their own bank's ATM and can only take out a small amount of money, every time they go it is quite a hefty slug. You and I will not worry about it, but the ordinary punter, a working class person, can worry about these things.

Mr Stevens—I guess so, but the vast bulk of people do have access to a fee-free transaction, as far as we can tell. I cannot say that is true for every person. Obviously it is not.

Senator CAMERON—The figures I have seen say that 30 per cent still do not. You just cannot dismiss 30 per cent.

Mr Stevens—I do not dismiss 30 per cent. I have not seen that figure, so I will follow that up.

CHAIR—To wrap up, I have a couple of questions. During the course of the last hour and a half or so, you mentioned the Swan competitive and sustainable banking system reforms, about which you were asked in passing. To what extent was the Reserve Bank consulted on those reforms?

Mr Stevens—There have been discussions about various ideas over some months. We were aware of the general way this was shaping up within the past couple of weeks.

CHAIR—So you were consulted on all aspects of it?

Mr Stevens—We were aware of a number of the proposals.

CHAIR—Did you provide any formal advice on any or all of the proposed reforms?

Mr Stevens—No, not in writing—not as far as I know.

CHAIR—So there were just verbal discussions. Did you have formal meetings?

Mr Stevens—The Council of Financial Regulators had a phone hook-up with the Treasurer a few weeks back and some of the things in the package were briefly touched on.

CHAIR—Some of them, but not all of them?

Mr Stevens—We did not have the final document, as it was released yesterday. We had a preliminary version of it.

CHAIR—So, prior to its release, you had not seen the final proposed reforms?

Mr Stevens—I had it on Friday.

CHAIR—But it was a fait accompli at that point. It was not provided to you with a view for further tweaking?

Mr Stevens—It is broadly in line with the preliminary version that we saw a few weeks ago.

CHAIR—During the course of seeing the preliminary version and having discussions about it, did you express any reservations about any aspect of it?

Mr Stevens—For a meeting that we had with the minister, a phone hook-up, I really do not want to canvass all the things that were said. I do not think that is appropriate.

CHAIR—Earlier in evidence that you gave today you indicated that you thought there were positive outcomes as a result of some of it, particularly the extent to which greater consumer awareness is of benefit to competition. So you are willing to venture forth some positive thoughts about it but if you have any negative thoughts you are not prepared to put those forward?

Mr Stevens—I do not want to offer detailed comments on the package. It has just come out and is the subject of considerable debate in today's media, and I am sure you will talk about it with the bankers when they come in. I do not really want to offer a comprehensive response to it.

CHAIR—Okay. One aspect of it, which I think is of particular relevance to the Reserve Bank, is the proposal to explore the idea that all ADIs could call themselves banks. Acknowledge that that is to be explored rather than being a firm proposal now, do you see any issues at this stage in allowing ADIs to change the way they describe themselves and be called banks?

Mr Stevens—They can change if they want to. If they have $50 million in capital they can ring John Laker and—

CHAIR—They can do that now, and as I understand it there are 27 credit unions and buildings societies that could claim that right as of today.

Mr Stevens—They could, and they choose not to.

CHAIR—It seems strange, given that there are 27 institutions now who can claim the right to call themselves a bank but have not, that we are talking about the possibility of exploring the right of all ADIs, including some that have capital bases of less than $2 million, to call themselves banks.

Mr Stevens—Whether they could or not would ultimately be a function of whether APRA is prepared to lower the $50 million minimum capital limit, and that will be their call.

CHAIR—Thank you, Mr Stevens and Dr Debelle, for your time today.

Proceedings suspended from 10.17 am to 10.32 am

BECKETT, Mr Ian, Principal Adviser, Banking, Financial Systems Division, Department of the Treasury

DIETZ, Mr Andrew, Manager, Infrastructure, Competition and Consumer Division, Department of the Treasury

DOUGLAS, Mr Justin, Principal Adviser, Financial System Division, Department of the Treasury

LOAN, Mr Nick, Banking Competition Unit, Financial System Division, Department of the Treasury

MURPHY, Mr Jim, Executive Director, Markets Group, Department of the Treasury

CHAIR—I welcome officers from the Department of the Treasury. Do you have an opening statement?

Mr Murphy—I would like to make a few comments. Our submission to the inquiry only arrived in the last day or so. The submission was largely dependent on the government's release of its banking competition and sustainability package so that is the reason for its lateness. What I can do is offer to meet with the committee again after you have had time to analyse our submission and the banking package if you think that would be useful.

CHAIR—It probably will be useful and probably will be taken up.

Mr Murphy—I want to give an opening presentation of about four things. The first is to give some background as to the Treasury's current policy thinking on the Australian banking sector. Secondly, I would like to talk quickly about what we see as the indicators or competition in the banking sector. Thirdly. I will take you to the framework on competition which we have been using and which, to some extent, was built on what the OECD did—and that is in the submission. Finally, I will make some brief comments on the banking package.

In regard to our current policy thinking, we note it is a topical matter among policymakers, industry participants and the community generally. That level of interest in the banking sector reflects the fact that the competitive dynamics in the industry have undergone substantial change in recent years. It also reflects concerns about rising interest rates and views about appropriate levels of profitability of the industry. While we are looking at these matters, it is the instability of the banking system that is of prime interest in most other advanced countries. So I suppose it is a huge difference for us. Notwithstanding its proven robustness, the Australian banking system is facing its own challenges in this post-global financial environment. These challenges must be of interest to policymakers focused on enhancing consumer welfare. That is a particular concern for the Treasury.

In this post-GFC environment, those interested in banking policy are grappling with issues relating to the trade-off between a regulatory framework that ensures that the banking system is safe and stable and a case for policy adjustments to stimulate competitive pressures in the industry. A safe, stable and competitive banking system is critically important for community wellbeing given the role it plays in people's lives and in the economic fortunes of Australia. The importance of a safe and stable banking system for sustainable economic growth has been brought into sharp focus in recent years. Countries with weak banking systems have experienced a severe downturn in economic activity in the period following the crisis. Notable examples are the United States and the United Kingdom. Economic downturns associated with financial crises tend to be more severe and prolonged.

The Australian banks, on the other hand, are well capitalised and highly rated. They have benefited from years of rigorous supervision by Australia's world-class financial regulators, and this is no accident. An important feature of our regulatory infrastructure for many years is a common understanding between governments, the regulators and the industry on the importance of prudential regulation. No Australian bank has collapsed post the GFC. No banking firm has needed to be bailed out through the use of taxpayers' money.

The Australian banking system has emerged from the GFC in a stronger position relative to banking systems in many other countries and for that good reason is highly regarded around the world. That said, the Australian banking system is facing significant structural challenges in this post-GFC environment. One such challenge concerns the banking system's capacity to raise funding on cost-competitive terms in an environment of continuing volatility in offshore markets, particularly in Europe, and the continuing subdued recovery in the domestic securitisation market following its severe disruption during the GFC.

A second challenge is to foster a competitive banking environment for consumers of banking services, particularly at the retail level, in an industry that has become more concentrated as a result of the GFC. A third challenge is to implement the G20's international regulatory response to the GFC. This response is designed to strengthen the global banking sector, taking heed of the lessons learnt from the GFC. The challenge here is to implement the G20's regulatory forms while taking account of Australia's unique circumstances and avoid unhelpful impacts on credit flows to this country.

The second point that I would like to dwell on, and it will be very briefly, is what we in Treasury look for as indicators of competition in the Australian banking market. There is a range of quantitative and qualitative indicators that are useful in assessing the state of competition in the banking sector. These include market share, pricing, profitability, market contestability and product innovation. An assessment of the state of competition in banking requires consideration of all these indicators, and none of these indicators should be used individually as an exclusive and definitive indicator of the state of competition in the banking sector. Further, in order to develop a fulsome view of the competitive dynamics in the sector, it is important to have a historical appreciation of how competition has developed in recent decades in order to place current discussions regarding banking competition in context. That was taken from our submission but I thought I would just raise it with you given it is late.

The second-last point that I wish to raise is a framework for competition in banking. In a 2009 paper, the OECD identified a number of factors that it considered important for promoting competition in the banking sector. Whilst some of these factors relate to the unwinding of government interventions during the financial crisis, as you would expect, three have much broader relevance.

The first is the importance of maximising contestability and minimising barriers to market entry. At present in Australia a key barrier to increased competition is the difficulty experienced by small ADIs and non-bank lenders in gaining access to competitively priced funding for investors. This suggests that addressing funding pressures should be a focus of government policy.

The second point raised by the OECD is the importance of consumer mobility and choice. The OECD argues that this is essential to stimulate competition in retail banking. Customer mobility may be hampered by the existence of significant switching costs that prevent customers from moving their business between financial institutions to take account of lower prices or better service. For this reason the OECD argues that switching costs constitute an importance source of market power in retail banking.

The OECD suggested three ways in which governments can facilitate increased switching. Briefly they were consumer education and financial literacy; the importance of reducing eliminating obstacles to switching imposed by financial institutions to retain customers; and, lastly, that governments should explore the use of account number portability and recognise that this may be a longer term option due to complexities associated with this implementation.

The third major point, other than contestability and the importance of customer mobility, the OECD raised was the importance of robust competition and financial services laws that can be used to protect the interests of consumers by preventing anticompetitive conduct as well as ensuring that competition produces beneficial outcomes for consumers by promoting high business standards.

I go now to the Treasurer’s package. You can see the lines of thought that the Treasurer has embarked upon in terms of his three streams. One was to empower consumers to get a better deal. The second was to support smaller lenders to compete with big banks and the third was to take some steps towards ensuring longer term safety and sustainability of our financial system by seeking to introduce diversified funding sources. Those are some initial comments.

CHAIR—Thank you, Mr Murphy. There is one thing I neglected to do when introducing you. I remind members of the committee that the Senate has resolved that departmental officers shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to superior officers or to a minister. This resolution prohibits only asking for opinions on matters of policy and does not preclude questions asking for explanation of policies or factual questions about when and how policies were adopted.

Mr Murphy, in the red book advice that you provided to the government, you indicated that the banking industry was oligopolistic in nature and that this could potentially have consequences. Would you care to outline your thoughts on the degree to which the banking industry is currently oligopolistic; and what potential consequences, particularly adverse ones, could flow from that if action is not taken?

Mr Murphy—The banking sector, like a number of other sectors in Australia—maybe because of size and population—have those tendencies of oligopolistic markets. In the red book we were bringing to the notice of government—probably they were already aware of it—that we should continually keep such markets under surveillance or oversight to ensure that consumers get the best results or outcomes from those markets.

In terms of the banking sector, yes, we have four large major players but at the same time we have numerous other entities—about 120 financial institutions of various sizes. The thinking behind the Treasurer's announcement is that he is seeking to facilitate competition to the major banks and enhance the role of the non-major banks. What we were really saying to the government in the red book was: You need to keep a wary eye on how these markets develop.

CHAIR—You also indicated in your opening statement that the system is facing some structural challenges, in particular one of those was the fall in the competitive environment or the increase in concentration. What factors do you believe have led to the increase in concentration in the banking industry?

Mr Murphy—There are a number of factors, and largely it is a result of the global financial crisis. It made it much more difficult for smaller lenders, especially nonbanks, to be able to raise funding—

CHAIR—When you say nonbanks, are you talking about non-ADIs?

Mr Murphy—I am talking about non-ADIs and non-major banks. It made it more difficult for them to raise funding and to conduct their businesses. Also, we saw a withdrawal of some foreign banks from Australia and a reduction in their banking, and just the general restriction on credit availability across international markets made it that those who may have been more dominant going into the crisis could exercise more market power during the times when others had to withdraw their services.

CHAIR—That is a fairly general indication of your thoughts on that. We have heard already today from the Reserve Bank that measures were taken during that period of the global financial crisis by the government which had as their primary objective the stability of the system. I guess that as a consequence the competitive impacts were of less relevance or less importance and were prepared to be sacrificed to some extent in order to ensure stability.

Mr Murphy—At the time of the guarantees—and I worked on the guarantees for the government—it virtually was a time of emergency. As the governor commented, the No. 1 priority was the stability of the financial system. The financial system affects everyone's daily life. It would very much be a matter of great concern to governments if there was a shock to the financial system. The wholesale funding guarantee and the deposit guarantee ensured that that did not happen in Australia. That said, it is an international phenomenon that there has been a contraction in most financial systems in terms of competition. As I said in the opening statement, there is going to be a trade-off there between ensuring a safe, secure and stable financial system versus competition. At the time I think the measures taken by the government in the wholesale funding guarantee and the deposit guarantee actually applied across the board to all ADIs and actually were of great benefit—and sometimes it is overlooked—to the smaller entities, especially the deposit guarantee.

CHAIR—To the smaller ADIs?

Mr Murphy—Yes, because we thought there would be a significant drift of deposits out of the smaller ADIs into the majors.

CHAIR—Some of the evidence we have received on that particular point suggests that a drift of money back into the ADIs, deposit-wise, from other forms of holding investments was happening before the deposit guarantee was actually put in place. That certainly reinforced it, but the flight to quality was already seeing people moving money out of shares, or whatever alternative ways they may have had of holding their funds, into deposits. We have had some evidence showing that the introduction of the guarantee just reinforced that and made it happen.

Mr Murphy—I do not wish to dispute that, but I would say that there was no real option for the government than to move to impose a deposit guarantee—

CHAIR—I am not arguing that it was not the right thing to do. My side of politics actually called for it publicly before the government did. I am also not arguing that there was not a need for the government to take action. You can argue about the action that was taken and the way that that action was implemented, but ultimately what I am getting to under the terms of reference of this inquiry is the impact that that had on competition. It may well have been a deliberate decision to put stability ahead of competition, which at the time may well have been the correct thing to do. Nonetheless, there are impacts that have flowed. What we need to look at here is what those impacts are, what the consequences are and how we move forward from there.

Mr Murphy—Yes. In relation to impacts, I think the deposit guarantee did stabilise the system. The best advice I can give would be that at the time, on the information we had, we felt it had to happen and it had to be done quickly. That was done in discussions with the government and with advice from the Chairman of APRA, the Governor of the Reserve Bank and the Secretary of the Treasury. That was advice to the Prime Minister at the time and the Treasurer.

CHAIR—There was some speculation about how those discussions occurred, and particularly the Reserve Bank governor’s involvement at the time, but we will not go over that now.

Mr Murphy—Well, I was briefing him on the weekends and I had a number of phone discussions with the governor. Major banks, all the ADIs, were looked after. The issue is, I suppose, whether the guarantee should have been extended to finance companies and other mortgage providers. The governor said that they needed to draw the line somewhere and his primary aim was the financial system. We agree with that and that was the thinking behind it. All I can say is that, yes, we understand the hardship for some people in finance companies who had their investments locked up, and there was a freeze on mortgage providers, and we got action from ASIC so that those in hardship could have their money out earlier. Since then the money has been gradually unfrozen that was frozen in these accounts.

CHAIR—Very gradually.

Mr Murphy—Very gradually, I know. There were a lot of elderly people and retirees who had put their money in because those types of investments were offering a better return than they would get in deposit rates at that time. We understood that. But my understanding is that no-one has actually lost capital coming out of that. Notwithstanding that the funds were frozen, and we can see the difficulty and inconvenience, no-one lost capital.

CHAIR—I understand that, and in previous inquiries we have probably gone over the consequences of that in some detail. But what I am really getting at here is that the bottom line is that one of our terms of reference is to look at the decisions that were made over the last couple of years and what the impact they have had on competition and, whether for good reason or otherwise—and I hear your argument that it was for good reason—decisions were made which had as a consequence a lessening of competition, whether it be the guarantees or the approval of Bankwest being taken over at the time in circumstances that would not necessarily have been so compelling at other times.

Mr Murphy—The reason—and it goes to your terms of reference—is that the reason you give the deposit guarantee and the reason you give for some of these mortgage funds being frozen is that what leads to instability are massive outflows of funds, whether sensibly or whether people are just scared of losing their money. Although you could say the government did not move to extend the reach of its guarantee deposit, sensibly these funds were frozen so that you did not have any aspect of contagion around the system. If you guarantee part of the system and do not act in the others—and we knew that these funds would be frozen because they had the power to freeze their funds—there would be a problem. I hark back to history when we had a major problem in the late 80s and early 90s and the government froze unlisted property trusts. The reason we did it was that they were closely connected to the banks. There again, the money was frozen and the money was released after things had settled.

CHAIR—In terms of public confidence, a freezing of a mortgage trust is not going to create the same degree of panic as a bank having a run.

Mr Murphy—Exactly.

CHAIR—This brings me earlier that I was intending to the banking reform package. Currently—and the figures seem to differ between the reform package papers and Abacus's submission—Abacus is saying that there are currently 27 credit unions and building societies that could, as a right, call themselves banks with APRA approval almost immediately.

Mr Murphy—Yes.

CHAIR—But the reform package also involves exploring how you would define what an institution would need to do to call itself a bank, so extending it below, presumably, the $50-million threshold.

Mr Murphy—Yes.

CHAIR—There are credit unions and building societies that have less than $2 million in capital—and I am not at all for a moment suggesting that any of them have any issues. I understand that one of the reasons why you would quarantine the use of the term 'bank' is because, as we just said, if a bank has a run it would create a far higher problem with public confidence than if another institution, say, a mortgage trust, but particularly even a building society or a credit union, had a run. If you allowed them to call themselves banks, don't you actually increase the risk to public confidence in the banking system?

Mr Murphy—No. The size at which an institution can call itself a bank is a matter for examination by the government. At the moment, as has been noted this morning, there is a requirement that the institution have $50 million in capital. The Treasury will be working with APRA to see whether that requirement should be reduced. More importantly, as stated in the government's package, the Financial Claims Scheme—that is, the government guarantee—will apply to any financial institution, any ADI. So it would not matter—

CHAIR—It does currently.

Mr Murphy—Yes. Both you and I have worked on banking issues, but out amongst the general public there may not be an awareness that the government is guaranteeing all these financial institutions. What the Treasurer has announced in his package clarifies for the general public that their money, whether it is in a very small credit union or in one of the major four banks, is guaranteed by the government.

CHAIR—I do not mean to argue this point but not that long ago in your evidence today you indicated that one of the major benefits of the guarantee scheme was that the smaller operators managed to attract deposits because people knew they were guaranteed. But now you are saying we need to fix that because people do not know.

Mr Murphy—No, I am saying that when the government guaranteed deposits it removed any doubt in people's minds. If we are looking at competitive and sustainable banking, a major thrust is to better inform consumers as to the nature of the banking system and how they should invest their money—to empower them to increase their financial literacy. We need to clarify for people that this will enable them to deposit in a credit union if they wish—they might get better service there—or, alternatively, deposit in a major bank. I think that clarification is very important.

CHAIR—To what extent did the non-ADI financial providers drive competition in the banking industry in the nineties?

Mr Murphy—We have seen that they were significant players. In some charts in our submission we have tried to show the competitive dynamic of major banks and the second tier non-ADIs. They were competitive players. The issue is that funding sources were clearly available prior to the GFC and relatively cheaper than what they may end up being now. So, at the time, Australia benefited from the competitive stimulus of the non-ADIs—the mortgage originators and smaller institutions. What we have seen in following the GFC is that that competitive stimulus has diminished somewhat, and the government is seeking to restore that competitive stimulus in a measured way.

CHAIR—So what in the reform package actually assists non-ADIs get back to the competitive strength that they had prior to the GFC?

Mr Murphy—There are various measures. In general terms, improving the funding sources available in the system would assist non-ADIs. Some of the non-ADIs do not raise money in the wholesale markets directly; they raise it through financial institutions, which then lend it to them.

CHAIR—It is very difficult for small players to raise funds; the quantities involved are large.

Mr Murphy—Yes. Some of these smaller institutions, these mortgage originators, are actually derivatives of other larger financial institutions—so, by improving the system and the funding arrangements, that can flow through. Also, initiatives to support residential mortgage backed securities—that is, securitisation—would assist in terms of funding sources. In my view, there is no direct thing to assist mortgage originators, but improvements in the overall system and improvements in the diversification of funding sources would assist.

CHAIR—Is there anything in there that you think would actually detract from their ability to reinstate themselves to where they were, or something similar, particularly the guarantee being made permanent and not applying to them?

Mr Murphy—I think they have always wished to distinguish themselves as being nonbanks. I think that was a branding initiative that stood them in good stead. The government has taken account of that. Not wishing to discriminate between lending sources, the government's response has been to provide a safe and secure banking system. If there are other funding sources and competition in the system, we wish to cultivate that, foster that.

CHAIR—I can understand you were in the midst of the grip of the GFC, why the need was there and that you had to draw the line somewhere, but by putting in place a permanent guarantee you actually put in place a structural disadvantage for non-ADI lenders in terms of being able to attract funds to borrow out.

Mr Murphy—In this package you are guaranteeing the financial system. People want to have security and safety. If people choose to take more risk—

CHAIR—This is being sold as part of a competition package. It is all about competition, a competitive and sustainable banking system. By putting in place a structural disadvantage against a part of the financial system that was providing strong competition in the nineties and early 2000s, you are removing the ability or decreasing the ability of that part of the industry to actually provide competition.

Mr Murphy—A lot of the non-ADIs are not going to be deposit taking institutions; they are mainly going to be mortgage providers.

CHAIR—That is because of the way things have transpired in the last two years and also, to a large degree, because of the way the government has approached that part of the industry. They were deposit taking institutions. That is why there are so many people who cannot get their money out.

Mr Murphy—We discussed with some of these finance houses and some major institutions whether they would wish to convert to ADI status, and they were reluctant to do so.

CHAIR—Well, there are challenges and prudential regulation. It becomes expensive for small players.

Mr Murphy—You have to hark back to first principles here in terms of prudential regulation. In terms of prudential regulation there are costs imposed on institutions to ensure that the government can guarantee these systems. The offer was made to some entities that the government was willing for them to become prudentially regulated, and they felt that they would be much happier being a more competitive force without prudential regulation. But they are regulated under ASIC.

CHAIR—Absolutely, but that is because there are consequences of becoming an ADI in terms of their operating costs and the way they do their business. They obviously have to weigh those things up. We will move on from the guarantee. The other aspect of the reform package, which I suspect makes it a bit harder for non-ADIs in particular, is the mandated removal of exit fees. A lot of the non-ADIs, in particular, tend to have the higher fees, which is abhorrent to a lot of Australians, and I can understand that, but nonetheless they cover a lot of their costs with that, which enables them to compete better on interest rates. By mandating that they can no longer charge exit fees, they will need to build those costs in elsewhere in order to survive, and if they have to put up their interest rates that will make them less competitive. Once again, that will work against that particular part of the industry, maintaining the competitive pressure that it once was able to maintain.

Mr Murphy—I am not sure if that is right. You yourself have said, Senator, that some of these fees are exorbitant and that no consumer should have to face these fees. Across the system the government is trying to empower consumers to do two things: one, that they know the transaction they are entering into and that there is better information on the table when they sign up for a deal—

CHAIR—Which I have no problem with.

Mr Murphy—Yes—and, two, enabling them to move if they wish to, if they feel, after a period of time, that they are unhappy with the service provided or with the deal they are getting. There are different views in the industry, but it has been put to us that the removal of exit fees would be a major boost to competition.

CHAIR—But the government has only just tasked ASIC with the responsibility of looking at fees, particularly exit fees, as to whether they are unconscionable. Surely if that were allowed to work, it would be able to weed out whoever is charging fees that are particularly high—doing so in a way that is genuinely covering their costs and in conjunction with the changes to make sure that consumers are aware what they are signing up to. Allowing that to work, to see whether it works, would be better because it would not necessarily create the structural disadvantage that the previously competitive section of the industry ought then face.

Mr Murphy—I do not see that this is going to be a major impediment to the non-bank sector—

CHAIR—But the government has just introduced this ASIC measure and has not allowed it to work through or even be tested.

Senator CAMERON—Point of order, Chair: can you let Mr Murphy answer?

Mr Murphy—We will have to see. I would have thought that exorbitant except fees should be banned. As well as that, the government is trying to inform consumers to understand their rights and to empower them vis-a-vis large financial institutions by putting a marker down as a matter of policy, trying to improve and empower consumers in shopping around for better financial services. It is internationally recognised that one of the impediments to getting better contestability and competitiveness in the system is exit fees and I think that the government’s policy initiative is a good initiative.

CHAIR—So is it an admission that the ASIC move was not going to work or did not work?

Mr Murphy—No. In terms of unconscionability, especially for existing mortgages—and I know some people have said there will be two queues of mortgages in Australia—exit fees for existing mortgages could be found to the unconscionable. So ASIC have admitted in their policy statement that they are going to take this very seriously and, under unfair contracts, push to challenge—

CHAIR—If it could work for existing mortgages, why could it not work for future mortgages?

Mr Murphy—Because it is a key thing going to competitive markets, and banning exit fees, as I said, is recognised widely as an initiative which would make consumers feel empowered, that they had benefits from the system. The government has put forward a lot of changes in this package. It is of interest that the only thing that seems to have captured people’s imagination is the banning of exit fees. For consumers out there, this may be the first thing in them increasing their understanding of the system.

CHAIR—It is certainly politically popular—I do not doubt that.

Senator HURLEY—I have only just seen your submission and have seen headlines about the government proposal. I do not understand the detail as yet, but it does seem to me that abolishing exit fees is probably a first step. But when people make the decision as to whether or not to change from one mortgage lender to another, they need to be sure that what they are doing is a good thing to do—that they will in fact be paying less overall or getting better conditions for their mortgage. It seems to me that that is very difficult at the current time because, quite apart from exit fees, there is a mixture of administration fees, monthly charges and quite different interest rates. We see in the headlines an interest rate quoted but that differs markedly between what kind of risk you are regarded and where you are in the cycle.

There are a number of different areas where there are different fees, charges and rates. I think it was mentioned that there would be some transparency about that. Could you go into how that might be done? It seems to me that that am a crucial part because, when people decide whether or not to switch, they might in fact be going from the frying pan into the fire.

Mr Murphy—As part of the initiative by the government there will be introduced a new mandatory key fact sheet for new home loan customers. If you wish to go and shop around, this will enable you in terms of what deal you can get. This is a simple document which would give you the terms and conditions for that loan. To me that is a huge advance. Some institutions may say that they are doing that now, but this will be a prescribed document and institutions will have to provide that information to a potential customer and the customer could then shop around and get comparable statements as to the terms and conditions.

Senator HURLEY—Would that be in the form of a net interest rate, for example—a netted out rate?

Mr Murphy—At the moment we have a proforma which we developed. It will give an interest rate and an all-in rate, including fees—which would give you the exact rate that you would be paying.

Senator CAMERON—Is Mr Murphy going to table that proforma?

Mr Murphy—This is just a consultation draft. It is on our website.

CHAIR—Would you mind tabling a copy of that?

Mr Murphy—Yes. We are consulting with the industry to ensure that people get the best information the can in the most digestible form.

Senator CAMERON—This is a draft?

Mr Murphy—It is a simple one-page document.

Senator HURLEY—Thanks, Mr Murphy. The other issue is home loan insurance and the charges associated with that. Naturally, of course, financial institutions insist on mortgage insurance for those borrowers who are most at risk. But the charges can be very high indeed, and if you want to switch you then incur further charges with different financial institutions. What is the government proposing to do about that one?

Mr Murphy—We are seeking to boost flexibility in that you will be able to transfer your deposits and your mortgages. Lenders' mortgage insurance is one thing that, when it is raised, is an impediment to people moving forward to seek to switch their accounts. We are working on that at the moment and looking at a process whereby lenders' mortgage insurance could be portable—could go with the mortgage. We have not finalised it yet but it is the clear intention of the government to introduce such a system.

Senator HURLEY—When you say 'portable', how would that work in practice? Would it be held by the government?

Mr Murphy—We will have to see whether the provider of the mortgage insurance can just transfer the payment and the service in a switch from one mortgage to another.

Senator HURLEY—Even if the risk assessment is different from institution to institution?

Mr Murphy—I am talking of comparable things. Possibly, if I took a bigger loan, for whatever reason, I might have to renegotiate the mortgage or top it up. It is the same with exit fees and lenders mortgage insurance. These are hurdles and obstacles to enabling consumers to exercise their preferences or their choice. The government is seeking not to turn the world upside down but to try to remove those impediments and empower consumers to provide a competitive stimulus to the system.

Senator HURLEY—Another impediment, I think, is the way institutions sometimes bundle their services. People might have a credit card linked to the home mortgage or an offset account, for example, where their income is paid into the mortgage account and so on. Has there been any discussion about that kind of arrangement, not so much around preventing the banks offering the service, of course—that is of benefit to the customer—but how it might work in allowing portability?

Mr Murphy—What you raise are the complexities of modern life and the complexities of financial institutions in people's lives. That is why the government has decided to ask the former Governor of the Reserve Bank Bernie Fraser to look at what we can do on account portability and the portability of those types of arrangements. All things said and done, it is of great benefit to a lot of individuals that they can tie their services into one credit provider. The government is not seeking to impinge upon that; what it is seeking to do is enable people to understand the arrangements they get into and, if possible, facilitate changing those arrangements. We will be looking at that—

Senator HURLEY—So Bernie Fraser is going to examine the whole range, not just the technological aspect of account portability?

Mr Murphy—Yes, it is the feasibility of all these things. And you are right: it does get into technological issues in terms of back office activities and so on. He will be looking at that. That is why the Treasurer made it very clear in his press conference yesterday that these are medium to longer term reforms around the portability issue. I suppose what we would like to do once we have done further in-depth examination would be to get an agreement with financial institutions that they could move towards some common system in terms of technology so that there could be more portability. These are major investments in IT and this could occur over time.

Senator HURLEY—The Australian Electoral Commission has a unique identifier for every person, yet within that a lot of confidential information gets shifted around when people move from state to state.

Mr Murphy—Another example that has been raised, as the Treasurer mentioned yesterday, is that mobile phone numbers can be transferred. It may not be beyond the wit of man to work out how to do it.

Senator HURLEY—I would hope so. Moving to another area, the Reserve Bank gave evidence today that the various ideas should of course be assessed on their merits but that an important high-level point is that, in some instances at least, it would appear the taxpayer is being asked to shoulder more risk one way or another in order to facilitate the provision of private finance. What is your comment on that?

Mr Murphy—I think what the governor was really saying was that the government has to be pretty careful in guaranteeing financial products and institutions. When the government seeks to intervene in some of these markets—and I suppose it is quite stark with what the Australian government has done post GFC, where there were not only guarantees but also intervention into the market by the AOFM in supporting the small lenders whether they were ADIs or not—the government assumes some risk that one of these institutions could fail and the government would have the liability. I think the governor was expressing what I would expect of him—

caution as to how far governments should get involved in private market practices. Treasury is very much in agreement with the governor on that, and I know the government is also very cautious in these areas.

Senator HURLEY—Would the changes to the Banking Act that would be needed for covered bonds and the other instruments be extensive?

Mr Murphy—Covered bonds have been a funding source for non-Australian financial institutions for a number of years and they are very well regarded in Europe and in other markets.

Senator HURLEY—Are they still operating in Europe?

Mr Murphy—Yes, and they are very much a popular investment vehicle for investors. They are very similar to government paper, so covered bonds are a very attractive investment. The government's position is that the introduction of the Financial Claims Scheme has opened the door for Australian institutions to have covered bonds.

Senator HURLEY—That would be a change to the Banking Act?

Mr Murphy—Yes, it would be a change to the Banking Act.

Senator HURLEY—What about the nonbanks? Would it be available only to banks?

Mr Murphy—It would be available to banks and all ADIs. But, that said, as with nonbanks, who will benefit from the larger funding sources coming through the system? If we have covered bonds and institutions can tap into international markets or, alternatively, domestic investors such as superannuation funds find covered bonds more attractive, it is another way of getting more funding into the financial system.

Senator XENOPHON—In relation to banning exit fees for new mortgages after 1 July, won't that be illusory in those states where stamp duty is still applicable on mortgages—as is the case, as I understand it, in Queensland and WA, for instance? Those fees can be very hefty. Unless those states come into line, people in Queensland and WA will still have a huge financial barrier to shift from one mortgage to another.

Mr Murphy—Discharge fees of a mortgage—and that is where you get stamp duty—would still be applicable. That is a matter of state government regulation.

Senator XENOPHON—It will still be a barrier, though, won't it?

Mr Murphy—It can be. Fees and charges are always a barrier, but sometimes they are very well justified. I cannot comment on the Queensland government or the Western Australian government's stamp duty proposals. It is for another day. Through the tax review we have recommended that some of these charges should be removed, but I cannot—

Senator XENOPHON—In the context of this package of reforms, that is something that would need to be considered, though?

Mr Murphy—It could be, yes, but it would not be a matter for the Commonwealth government; it would be a matter for state governments to agree to reduce stamp duty charges.

Senator XENOPHON—But in the absence of a reduction in those charges, that would itself be a barrier to switching.

Mr Murphy—It may be a barrier, but the exit fees are a barrier as well. Reducing that would be a significant benefit to people.

Senator XENOPHON—The Treasurer in his statement yesterday referred to the need to create a fifth pillar and the need for credit unions and building societies to be strengthened in the system to create a more level playing field, and I think that has been quite welcomed. But there is concern amongst the smaller banks, the regional banks—the Bank of Queensland, Bendigo and Adelaide—and some of the foreign banks here such as Arab Bank, Bank of Cyprus, HSBC and others that there is not much in this package for them. I think it was the Bendigo and Adelaide Bank's CEO who said, 'This is going to set us back 15 years.' How do you respond to that from a policy point of view? Have they been left behind in these proposed reforms?

Mr Murphy—I really do not think so. If you look at these reforms—and I appreciate that the committee has not had a lot of time to reflect on them—you will see there is a lot that goes to working on diversification of funding sources. That will benefit the whole system—

CHAIR—Some more than others.

Mr Murphy—and I think that is a very good initiative by the government. We have discussed these issues with industry, post-GFC, for 18 months to two years now. What has been put to us is that the government should move down certain paths, and it is very pleasing from the point of view of Treasury that the government has decided to do these things. In terms of specific things for the broad range of, say, non-major banks, there is the AOFM funding, another $4 billion has been provided, which is a major decision announced by the Treasurer to support smaller lenders. We are trying to reinvigorate the securitisation market. I know this morning it was said that there are signs of life, that it is picking up. That is still not good enough and, given that securitisation was a major funder of institutions such as the Bank of Queensland and Bendigo and Adelaide Bank, the government feels that more needs to be done on securitisation to make it a more vibrant market. So that is a benefit for them.

Covered bonds could also be a benefit for them. The key thing, and it is the last in this, is trying to get a corporate bond market going in Australia, which is something that has been recommended. The Johnson report from the Australian Financial Centre Forum recommended that we get a corporate bond market going. The government has at last taken the decision to list Commonwealth government securities, on a securities exchange still to be decided. These are the types of things that the market, through our consultations, has been telling us the government should be doing.

Senator XENOPHON—You do not think it is justified when one of the major regional banks says that 'this is going to set us back 15 years'?

Mr Murphy—No, I do not think so. I saw that comment and what I thought is that it actually reflects competition, and everyone who comes before this committee from an institution will be talking about competition from their point of view. Those comments were from one institution, and I think if they look at the whole package they will see that there is significant benefit for them. They might not get exactly what they want. The other comment I want to make is that everyone coming before this committee will like something in this government initiative and dislike something else.

Senator XENOPHON—Sure. I want to go to the issue of giving more information to consumers and informing them. There is a macro level in that as to whether there would be benefit in either Treasury or the Reserve Bank giving details on a regular basis, such as regular reporting on bank net interest margins, including both for home lending and for small businesses, on returns on equity, and on profitability. Has that been considered as a monitoring mechanism so that, every quarter those details can be published and an apples-to-apples comparison given?

Mr Murphy—I think you will find that Choice does some of this work. They have a website that will provide some of this information. Whether it is a role for government—

Senator XENOPHON—The Reserve Bank publishes occasionally.

Mr Murphy—The Reserve Bank now publishes a lot of information.

Senator XENOPHON—Can I emphasise that we are not suggesting 'Bankwatch'.

Mr Murphy—I will not comment on that. One of the things announced by Treasury yesterday is an awareness campaign to be launched by the government early in the new year to better inform consumers on their rights in terms of choice. Perhaps that may lead to greater interest in looking at various competition and mortgage rates. At the moment, we are not doing that.

Senator XENOPHON—Finally, banks cite the increased costs of funding to justify interest rate increases above the RBA's rate rises, most notably just a month ago. Yet the banks are still making very healthy profits. There is an argument out there that others are tightening their belts but not the banks. In terms of that comparison or that link between the banks being able to pass on their increased costs of funding in a way that other companies and individuals cannot, there has not been equity in terms of that belt-tightening. Is there a view from Treasury in relation to that?

Mr Murphy—There are a number factors that you need to take into account, and some of those were discussed this morning. The banks have reached profitability. It is back down to where it was over preceding years. The cost of funds has increased; we cannot get away from that. I think one also has to factor in government support in terms of the guarantees. In our submission we said that we are not concerned about profitability. What we are concerned about is competition in a market. Competition in a market needs to be looked at in terms of a number of factors. I think that people should look at the factors that we put forward and look at all that evidence, and then make their own call as to whether they feel that profit levels are appropriate or inappropriate for the Australian community. It is not a matter for government to judge these things—

Senator XENOPHON—You should take into account the bank guarantee though—

Mr Murphy—I have mentioned that along the way, yes. I think it is a matter for the Australian community as to whether they support the institutions or they do not. There are various factors that can be brought to the surface, and then you say, ‘But that leads you to this conclusion.’ That is what we have tried to do in the Treasury submission. We have tried to say, ‘You have got to take into account a number of things and then make your own judgment.’

Senator XENOPHON—Thank you.

Senator WILLIAMS—Mr Murphy, you were just saying that you recognise that the cost of funds for the banks has increased. Is that correct?

Mr Murphy—Yes.

Senator WILLIAMS—Does that justify their position to raise their interest rates outside the Reserve Bank cash rate movement?

Mr Murphy—No, I do not think it does. The cost of funds has risen significantly from, say, pre GFC. It went up dramatically during the GFC and it has dropped back down. One of the issues is: what is the time frame in terms of when costs of funding should be looked at? I think you should talk to the bank CEOs about that. The Treasurer does not see it as justifiable. What we have tried to do is put all the evidence on the table and people can make their own judgments as to whether large movements outside the cash rate are justifiable—in all the circumstances.

Senator WILLIAMS—We have seen two banks—NAB and ANZ—already remove their exit fees.

Mr Murphy—Yes.

Senator WILLIAMS—Yet I notice the bigger banks, Commonwealth and Westpac—the largest banks—which have the highest interest rates and the biggest share of the whole home loan industry, do not remove their exit fees. It is a question for them, obviously.

Mr Murphy—It is a question for them, and that is why I think, with a lot of these issues which the government has announced, we could all say, ‘We were all going to go down that path anyway,’ but I think it is a clear statement by the government that it wants to do certain things.

Senator WILLIAMS—Getting back to competition in the banking industry, that has been a major role of this committee over the years, with the State Bank of New South Wales, the Commercial Bank years ago, St George took over Advance Bank, NRMA Building Society, CBA of Bankwest, and RAMS and Aussie Home Loans tied up to the big banks. The ACCC has obviously approved all of these amalgamations and takeovers. Is that correct?

Mr Murphy—Yes.

Senator WILLIAMS—So what divestment powers do we have in Australia if we see this in time as an overkill? In other words, the ACCC allows these amalgamations, these takeovers.

New Zealand, Europe and the United States have divestment powers so a body can say, ‘Okay, we have seen too much amalgamation, you will now separate.’ We do not have any of those powers in Australia. Correct?

Mr Murphy—That is correct.

Senator WILLIAMS—Should that be one of the things that should be looked at in our country?

Mr Murphy—It may be. A number of the mergers that occurred along the way have actually benefited consumers. They have also supported the stability of the system. It is a basic strategy for governments to merge entities which are not travelling too well so that consumers do not lose out, there is no contagion in the system.

Senator WILLIAMS—You are surely not suggesting that Westpac and St George were not travelling so well.

Mr Murphy—I am going back further to when especially some of the state banks were having difficulties. Yes, we have had a conglomeration and the aggregation of certain institutions, but that is the history. Whether you need to divest, but I would have thought it would be better to get more competitive competition into the system so that we benefit from having a stable financial system, we benefit from having that stable platform which the four majors give us. Whether there would be a fifth pillar or not, what we want to get back to is a stable platform and a competitive system. I do not know whether divestiture is the way to go or is it to actually try to get others to be more competitive. Being smaller, one can have lower costs, be more agile, quicker, faster, and provide more competition. That is what I think we have seen the credit unions have done: they have provided a competitive stimulus. In my view, the majors have improved their service to their customers over the last 15 years because of the credit union movement and because of the non-bank mortgage providers who made the majors get their act together to a great extent. And that is a good thing. So I would have thought that if we can stimulate more competition that might be a better way to go.

Senator WILLIAMS—I couldn’t agree with you more, but what we are doing by having the deposit guarantee with recent ADIs and not with those smaller companies that come under ASIC, that is exactly what you are not doing, by abolishing those smaller companies. Sure, some were debenture issuing companies that raised the funds and lent it to themselves and to commercial developments and they went bad and ASIC jumped on them, and so they should have. But there are secured investment companies out there that are not registered ADIs, you are not guaranteeing their deposits. I believe they have in New Zealand, both ADIs and non-ADIs. What you are doing by guaranteeing the small ADIs and the large ones and not that other sector is in effect destroying that other sector. We saw this during the guarantee.

Mr Murphy—As I mentioned earlier, the issue was discussed at the time. The guarantee was offered to these institutions, a few of them, in terms of whether they wished to become prudentially regulated and they chose not to.

Senator WILLIAMS—They went down that road and then they saw it could take up to 18 months to do it and the cost of it.

Mr Murphy—Yes, but trading off against the cost is the greater risk and the greater return which is the attraction for their investors. Because they have less costs in terms of meeting prudential requirements, they can provide a more attractive return on investment. Yes, it will come with some greater risk because it is not guaranteed by the government, but some people—and that is a good system—want to take that greater risk to get that greater return. My point is that even under our system they did not fail. I would say to you that in New Zealand it was just under a dozen finance companies failed in the global financial crisis.

Senator WILLIAMS—My final question on that point. Some of them did fail in Australia. I can name you finance companies that went down because of it. Try Bidgee Finance for one.

Mr Murphy—Yes.

Senator WILLIAMS—And others struggled because a lot of the money was withdrawn. People took it out of there because they considered the ADIs a safe haven. I imagine your guaranteeing of the investments would be $800 billion—it would be an enormous amount of money, okay?

Mr Murphy—Yes, it is in the trillions.

Senator WILLIAMS—Would you please look at those smaller companies that are not ADIs but are secured investments, that have LVRs of 40 or so, that are responsible people who invest money, and see if you can bring them under your umbrella. When these people advertise, they have to say at the end of the advertisement, ‘You may lose some or all of your money if you invest with us.’ That, to me, is a crazy addition to an advert; you do not have it on the banks, yet they are secured lenders.

Mr Murphy—I know some of them have grown up in regional centres and they do provide a very good service to community—

Senator WILLIAMS—And competition in regional centres, and they also fund people when some of the others do not, and that is why I am batting for them, because they are a vital part of regional Australia. If you could include them in your deposit guarantee, I think you would be doing a wonderful thing to promote competition.

Mr Murphy—I think that is a matter for the government, but you have put it on the table.

Senator WILLIAMS—It is on the record, yes.

Senator PRATT—We have had some discussion about the things that have been done to ban exit fees. I wanted to ask about the constitutional questions around being able to ban exit fees for existing home loans and why that is not possible.

Mr Murphy—It is largely constitutional issues that would be an acquisition of property. The property is the property of the financial institution. We took legal advice on that. The better approach is that if people feel they sought to renegotiate their home loan or sought to withdraw, if it was unconscionable, if it was at a high amount, they should talk to ASIC to see whether action could be taken against that institution. The first point was that it would be an acquisition of the institution’s property by the government—that is, that loan.

Senator PRATT—Yes, so it is unconstitutional for those reasons. Nevertheless, there are some things consumers can do to empower themselves. I would contend that most consumers just accept what their contract says.

Mr Murphy—Due to personal circumstances, I had to pay out a mortgage after four years, and the exit fee was significant.

Senator PRATT—My bank was quite good to me recently and let me refinance with them, even though I had an exit fee. I suppose they were not going to let me go elsewhere on the basis that I was still liable to an exit fee. Notwithstanding the fact that you cannot ban them for existing home loans, it will flow through at some point in that most of these exit fees expire after a certain number of years. What is that picture going to look like and when will the competition really intensify? The competition will be there from the new loans not being subject to this but then competition surely will really intensify as people start to come out of those time limits on their existing loans.

Mr Murphy—I think what the government is trying to do is empower consumers and I think this is just giving consumers more leverage when dealing with their institution. Whether the exit fee is banned or not, if consumers now are unhappy with their institution—probably the large majority are not—because the government has said it wants to ban exit fees on future things, you will find that the government has lifted up a bit the balance of power between the institution and the consumer.

Senator PRATT—In that sense, there will be a few consumers now who are out shopping for a home loan. At which point do we have big swathes of them come in? I would expect that it will start to intensify quite remarkably.

Mr Murphy—My understanding—and we will check this later and give you some information—is that, quite surprisingly, the majority of mortgages are renegotiated within a five-year framework. Generations ago, people took out a long-term mortgage. But it seems that because of changing circumstances the majority of people renegotiate over a short time—I am looking at five or six years. I would expect that, although this ban on exit fees is prospective, it is going to have a bigger pick-up than people imagine because of people renegotiating.

Senator PRATT—That was the point I was trying to get to, and that people are no longer subject to these exit fees over short periods of time. What is the general period for which the exit fee applies?

Mr Murphy—About four years.

Senator PRATT—So we should expect to see the majority of the market in quite a short period of time—

Mr Murphy—It may.

Senator PRATT—I would now like to ask about the RMBS market and the view that direct investment is more appropriate than a government guarantee. Why is that the case, and what is the significance of that?

Mr Murphy—With the AOFM, I think what the government's support of the securitisation market—there was $8 billion just after the GFC and then a further $8 billion, so that is $16 billion; and now the Treasurer has announced a further $4 billion in support—is trying to do is to get the securitisation market going by supporting the smaller lenders. We noted earlier that we appreciate a lot of the non-majors had relied heavily on the securitisation market. The governor and Guy Debelle this morning went through the issues relating to the brand damage that has occurred to the securitisation market and that, at the same time, the Australian mortgage market is gilt edged. It seems just on these figures that there is a very small delinquency rate. So from a policy point of view, we think it is very important to try to get the Australian securitisation market going at a much greater rate than it is at the present time.

Senator PRATT—The government, as I understand it, put in $8 billion initially to support that market and then a further—

Mr Murphy—Eight.

Senator PRATT—eight. And the recent announcement is for a further $4 billion. That is based on the fact that what was done in the past has worked and is strengthening investment. What kind of leverage are we seeing in terms of that investment? That is $20 billion worth of investment—

Mr Murphy—About $26 billion of leverage off that total figure. It has been significant and, realistically, it has kept some of the smaller players in the game.

Senator PRATT—So we are talking about supporting a fifth pillar in banking.

Mr Murphy—Yes.

Senator PRATT—It is one of the things underpinning that fifth pillar to a certain degree.

Mr Murphy—I think it is very important.

Senator PRATT—Okay. Finally, I want to ask in that context about the role of bullet bonds. I am just working out what a bullet bond is compared to other types of bonds.

Mr Murphy—It sounds dramatic, doesn't it? It is typical of financial markets to give a—

CHAIR—Not a silver bullet, though.

Mr Murphy—Touche. In relation to bullet bonds, it has been put to us in consultations that, if there were more changes in the design features of securitisation markets, they would be more attractive to investors. We have been working with ASIC and some private sector people who have expertise in this area and further work will be done on that, but primarily on the design features of that market. We think it can be one of the ways that the securitisation market can lift off a bit more.

Senator PRATT—It redefines the characteristics of that bond, and so there will be some specific banks that will be able to access funding because of that.

Mr Murphy—More likely than not, it would be available to everyone. Bendigo Bank and Adelaide Bank had a bullet bond securitisation issue last week. We think the corporate bond market, securitisation and covered bonds are major steps on diversification of funding sources for Australian financial institutions, given that we have relied very heavily—and we will continue to—on offshore financial markets for funding. The Treasurer agrees that it is prudent to start steps away from such heavy reliance on offshore financial markets, given the GFC. This is not going to completely change the funding mix, but over time we think that with these measures we will take the diversification steps that we need to.

Senator FIELDING—What analysis has Treasury done with regard to whether the banks were justified in lifting their interest rates above the official cash rate in November?

Mr Murphy—The analysis would be that we provide advice to the government on what has happened. We would be looking at the data that is provided to us by APRA, we would be looking at the market and we would make a general judgment as to whether such a movement was justified or not.

Senator FIELDING—Is that analysis done each time an interest rate increase is done by the banks?

Mr Murphy—Yes, some form of analysis would be done. We have been monitoring bank interest rate changes and bank fees. We have been monitoring this since the GFC. We have increased data coming to us from APRA so that we can give better advice to the government, because they have asked for it. That is what we do.

Senator FIELDING—I cannot ask about the detail of that advice. Was it in writing or was it a verbal briefing about the interest rate increases by the big four banks in November?

Mr Murphy—The majority of our advice to government would be done in written submissions. There would be meetings with ministers, but the majority of it would be written advice. You have to look at data, trends and statistics. As I said earlier, then you can come to a judgment. It is not a simple case of: here is the cash rate; one of the majors, in line with the cash rate, has moved further. You have to look at a number of factors. One of the key factors is the term over which you look at these changes. One of the issues has been the support the government has given. That is where the Treasurer is concerned. He moved to support especially the major banks with a wholesale funding guarantee. He appreciates that their cost of funds has increased, but he still feels that their movements above the cash rate are not justified in terms of the support that was given by the government.

Senator FIELDING—Is it Treasury’s view that the big four banks were not justified in their interest rate increase in November that was above the official RBA rate?

Mr Murphy—In terms of Treasury, we provide advice to the government. It is for the Treasurer to make that decision.

Senator FIELDING—Does Treasury have the same view?

Mr Murphy—I would say it is easy for Treasury to come to that view, but I do not think I should speak on behalf of the Treasurer; I speak on behalf of the government on this. He has taken the view that it is unjustified. As I said, there is a range of factors, and I see it easy to come to that conclusion. Put it that way.

Senator FIELDING—Is it Treasury's view, though, that the banks were not justified?

Mr Murphy—As I have said, it is the Treasurer's view, you take account of a number of factors and you can understand the Treasurer's view on that matter.

Senator FIELDING—Let's swap a little bit here. The ATM fee reform package has been going for a little while. Is that correct?

Mr Murphy—Yes. The Payments System Board, chaired by the government, did the reform package on the ATMs.

Senator FIELDING—Are you aware that in 2007 a Reserve Bank study estimated the average cost to a bank of an ATM transaction to be around 75c, which is well below the current predominant charge of $2?

Mr Murphy—Yes.

Senator FIELDING—The ATM fee reform package has been running for two to three years, and the fee has not dropped. So why would the public believe that the banking reform package is going to make a difference in what they will be paying in interest rates or other fees, such as penalty fees—

Mr Murphy—I think they should believe that. The fact is that, since the Payments System Board of the Reserve Bank and the government made these changes, the figures have shown that two-thirds of transactions on ATMs are free. Over the last 12 months, $120 million has been saved by consumers in terms of fees they have not had to pay.

Senator FIELDING—Consumers have changed their behaviour, but the fees of the banks have not changed. Two dollars is a huge mark-up from 75c.

Mr Murphy—Yes. But, as well as that, an increased number of ATMs have been provided. I suppose it is not a concern for people living in the cities, but people in regional areas need these ATMs. It is hard to judge whether or not the $2 is justified, but the fact is that they are not a free service. Technology is involved, and the majority of ATMs are owned not by the major banks but by private investors. So, all things considered, I know some exorbitant fees have been charged to Indigenous people—which is outrageous—but, at the same time, at least the service has been provided. Overall, I would think these reforms to ATM services would give you confidence in that the changes that you make in these areas can lead to changes in behaviour. That is a very good thing, because that is the market operating. The government cannot regulate all these things.

Senator FIELDING—I know, but can you see why there is this distrust when the cost to the banks in this area is 75c and they charge $2 and when the Treasurer says that the banks were not justified in increasing their rates back in November? Can you see why the level of distrust is going up? The question is: how can we be assured that this banking reform package is going to make a real difference on the ground, given that we have had two or three years of ATM reform and the fees have not changed?

Mr Murphy—I do not think that is looking at it objectively. People have benefited from the ATM changes, and I think the Treasurer has made a number of statements to show that he is very concerned about the rights of consumers and getting the best deal for them in terms of banking services. He has also shown, through this package, that he is concerned about the future of the Australian banking system. I would take the opposite view: I have great confidence that the government can deliver these things and improve the wellbeing of Australian people.

Senator CAMERON—Mr Murphy, Senator Bushby, in his earlier questioning, said that the government had put stability before competition. If there is no stability in the banking industry, can we have competition? Is this a chicken-and-egg thing? Tell me how this works.

Mr Murphy—It is easy to generalise these things, but you want a safe and secure system that feeds stability and you also want a competitive system so that people get the best and cheapest services they can. I think I mentioned earlier that a phenomenon of the GFC was contraction. For other institutions in Australia, the contraction may have been due to the fact that they could not raise the funds as cheaply as they previously did. But we are in a happy position. We have a secure and stable financial system. As I mentioned earlier, that is a credit to the financial institutions involved; maybe to government, in that they had the proper arrangements in place; and to the regulators. Maybe, also, the Australian community is more sensible in its investment patterns. We have moved on, and we have to get back to a competitive market, and that is what the measures that the government has enacted will try to do.

Senator CAMERON—I did ask the Reserve Bank governor about the experience in the US of the growth after the war of mega corporations and the theories of JK Galbraith. I am not sure if there is any Galbraithian economics left in the Treasury—

Mr Murphy—We have all read it.

Senator CAMERON—That is good. What he talks about is countervailing power. It seems to me there is a lack of countervailing power on the banks. Do you have any comment on that? You may want to take some of that on notice. It is a big issue.

Mr Murphy—It is an issue. There are measures here, for instance, the measure announced by the government on price signalling. I think we have to face the facts that the government wants the majors to be competing strenuously against each other and the smaller entities competing against the majors. If we could get back to strong competition between the major banks and strong competition from the non-major banks that is plenty of countervailing power. That is what we want and that is what we are aiming for.

Senator CAMERON—One issue that I think gives the banks a real bad name is executive salaries. The Productivity Commission report indicated that executive salaries for the finance sector, particularly the banks, are based on Wall Street salaries but for the rest of the economy they are more aligned to European salaries. Why would executives in this country be equating their salaries to Wall Street salaries when in Europe where there are bigger economies than ours their outcome is lower? This is a real problem for the banks and I wonder what countervailing powers there are other than some approach by the shareholders? How do you deal with this? What is the economic justification for Wall Street salaries for bank executives in Australia?

Mr Murphy—I do not know if salaries are based on Wall Street or not—

Senator CAMERON—According to the Productivity Commission they are?

Mr Murphy—Okay.

Senator CAMERON—Not that I quote the Productivity Commission too much, but this time I am.

Mr Murphy—I thought you were a great supporter of the Productivity Commission!

Senator CAMERON—I think you are stretching the truth there.

Mr Murphy—On salaries, the government has taken initiatives to ensure that banks are transparent about that—all companies are. Shareholders can vote down the remuneration packages if they wish and put the company on notice that they are unhappy with them. It seemed offshore that people were very concerned about the salaries being paid to financial executives because they felt that it encouraged excessive risk taking, and that was a major problem for some of these investment banks in the US and in some of the European banks. It does not seem to have occurred in Australia. If the shareholders accept that that is a reasonable salary for their CEO as well as public opinion—

Senator CAMERON—There is not much countervailing pressure from public opinion; they simply ignore it.

Mr Murphy—These are major institutions. People who head major organisations and they would be attuned to public opinion.

Senator CAMERON—On this one-third of Australians who do not use their own bank's ATMs, do you have any idea how much the banks are skimming off on fees from this 30 per cent? I have had a look at your chart 9 and it does not really tell me much.

Mr Murphy—Right. We will find that out. The Payments System Board may have that information. We could find that out for you.

Senator XENOPHON—Chair, could I ask a very quick question?

CHAIR—Okay, and I have a question as well.

Senator XENOPHON—Further to Senator Cameron's line of questioning, one of the complaints that have been made is that many people, particularly those on low incomes, simply want to access the ATM not to make a withdrawal but to see what their account balance is—

Mr Murphy—Yes, and they get charged for it.

Senator XENOPHON—Should there be a differential cost for those who simply want to access their bank account balance?

Mr Murphy—Okay. We will take that on board. We may have to refer those to Reserve Bank, because they have responsibility for the Payments System Board—but we can look at those, yes.

CHAIR—I have one final question. In respect of the deposit guarantee, is it intended that when it is made permanent it will remain at $1 million; also, will it continue to be free?

Mr Murphy—The government has announced in its package that the financial services guarantee will continue and will apply to all consumers for their total deposits, but the parameters of that have yet to be decided by the government.

CHAIR—So, presumably, it could be a different scheme, maybe even an insurance scheme where you might pay a premium. All options are open at that point in terms of how it might actually be put together.

Mr Murphy—A lot of work has been done on it through the Council of Financial Regulators, but the Treasurer has not signed off on that. Advice has not been put to him yet—it will be in the new year—as to the particular elements of the financial system guarantee. However, the Treasurer has announced that it will apply to depositors. That is the important thing, that people—

CHAIR—Yes, but only for—

Mr Murphy—From the institution point of view, he has not made the decision.

CHAIR—Has he announced that it will only apply to ADIs?

Mr Murphy—Yes. It will only apply to ADIs.

CHAIR—So the details yet to be determined do not include that?

Mr Murphy—Yes, in terms of whether there would be a pre-registration fee and whether there would be a $1 million cap or whatever.

CHAIR—Okay. Thank you. Senator McGauran has one more question.

Senator McGAURAN—There is always one. I really like that Galbraith term 'countervailing'.

Mr Murphy—Countervailing powers.

Senator McGAURAN—Yes, 'countervailing powers'.

Senator Cameron interjecting—

Senator McGAURAN—Well, I have never read the book, I have to admit. Anyway, we must not waste time. That encapsulates what these reforms ought to be able to achieve. You yourself, in your red book, set it all up in regard to the oligopolist behaviour of the big four. We look to these reforms to loosen that grip, to introduce countervailing powers. So where in particular do the two key items of covered bonds and exit fees support or help the smaller or second-tier banks, outside the oligopoly of the big four, and non-bank behaviour? Where do those two policies act as a countervailing power, on the grounds that they are open to the big four too and arguably help the big four more than the others?

Mr Murphy—I would say the whole thing is a set-up. If you want a countervailing power, is it another major institution or is it actually consumers exercising their rights? This is a market economy, and it is a very good thing that people have the freedom to exercise their rights and make their own choices. To me, that as a countervailing power is coming from smaller institutions, and I think they are being supported here and coming from the end consumers. Also, in terms of enabling institutions to issue covered bonds and trying to stimulate the corporate bond market and securitisation, you could easily brand that as the development of a countervailing power to enable people who are smarter and wiser, more agile and possibly more competitive than major institutions to provide a service at a lower cost to Australians.

Senator McGAURAN—Exit fees, countervailing power?

Mr Murphy—Again, that is just helping individuals. As I said, from our analysis, in terms of trying to get a competitive market, the OECD said the best thing you can do is try to get your consumers empowered and get them exercising choice.

CHAIR—Thank you, Treasury.

Proceedings suspended from 12.10 pm to 1.00 pm

CLYNE, Mr Cameron, Managing Director and Chief Executive Officer, National Australia Bank

JOINER, Mr Mark, Executive Director, Finance, National Australia Bank

McINERNEY, Mr Dallas, Group Manager, Government Affairs and Public Policy, National Australia Bank

CHAIR—Welcome. Thank you for attending today. I invite you to make a statement if you choose to do so.

Mr Clyne—I will not make an opening statement. I think your questions are obviously more important. I will just say that there is a lot of interest in this sector at the moment and I think we welcome these sorts of forums. The more we can have discussions about what the industry structure is and what some of the factors are driving the industry the better. On that basis I am happy to throw it straight to questions.

CHAIR—My first questions rise out of some of the evidence we have received this morning. Earlier on the Reserve Bank governor indicated that in his opinion the cash rate would be about one per cent higher than it currently is if the banks had not independently increased their interest rates. If the cash rate had been allowed to rise by, say, one per cent, would that have actually covered the increase in your bank's costs?

Mr Clyne—There are a lot of moving parts when it comes to funding. The two key drivers of funding are really what we pay for customer deposits and what we are paying for term funding. They are the key drivers, so you would have to equate how would they have moved in line with how the RBA would have moved. There is no question the RBA does obviously look at what the banks' variable mortgage rate is. We have a unique structure in this market where some 85 per cent of mortgages are variable, so it is very sensitive to movements in that rate. It is a little difficult to equate that, had they moved the OCR, the official cash rate, by another 100 basis points, where that would have correlated to us not doing rate rises above them.

CHAIR—The increases in the cash rate quite clearly have an impact on your costs. If they do an increase in the OCR then that would have had an impact on the costs that you would have then had to take into account in order to determine where you would set your interest rates.

Mr Clyne—Yes. Mark, you will add to that?

Mr Joiner—Our wholesale lenders basically look for a premium above the OCR. If the Reserve Bank had gone an extra 100 basis points, we still would have been paying a premium on top of that. So we would have been in a very similar situation. Similarly our deposit rates would have risen. What we have seen is cost of retail deposits go from below wholesale to above wholesale because of Basel III. That still would have happened. So I think if the Reserve Bank had gone an extra 100 basis points we would have had the same pressure to go higher that we have had in the current environment.

CHAIR—And it would have resulted in a similar independent increases over and above the OCR.

Mr Clyne—Correct. Which comes back to my earlier comments. The real drivers here are the cost we pay for retail deposits and the cost of wholesale term debt. They are the real drivers of our funding.

CHAIR—Quite clearly the reason that the Reserve Bank changes the cash rate is to impact on economic growth and ultimately to help it deliver its mandate of maintaining inflation within a certain band. Your interest-rate settings are quite a different perspective, which is to do with commercial reasons in terms of running a large commercial bank. But decisions you make actually impact on outcomes that the Reserve Bank is seeking to deliver. What you are telling me there is that increasing the cash rate does not necessarily provide you with the increasing revenue that you need to cover increased costs and in fact actually increases your costs and so potentially provides a double-whammy for the consumer.

Mr Clyne—Clearly the Reserve Bank's cash rate does have an influence on the market, so it does set a trend for where rates will go, particularly in the short-term market. The real issue, I think, and I have been very upfront about this over the last year and a half, is that the main driver of bank interest rates is not the Reserve Bank cash rate. The banks have made a problem for themselves here by continually moving in line with the Reserve Bank. When spreads were very narrow, you must bear in mind that pre the global financial crisis we were borrowing in the spread range of perhaps 15 to 20 basis points over a benchmark. When that blew out to 250 basis points in the crisis, it was clearly even a broader disconnect, if you like, between our funding costs and the RBA.

I have got a lot of empathy for the public who say, 'Hang on a second. For 15 years you have moved your rates in line with the RBA up and down. Suddenly there's a disconnect there. In some way you're taking a profit because you're not borrowing at that point in time.' The reality is that that is not the driver of our funding but we have, for many, many years, created that perception in the public's mind, so we have got to face the fact that this is something we have created through our own poor communication on the issue. I am hoping that, as we start to have these sorts of discussions going forward, people will start to see there is a different driver of funding. But I certainly do not blame the public at the moment for being upset about moves they see as not in line with the RBA.

CHAIR—I will change the line of questioning. Yesterday the Treasurer released a new package of reforms in a statement called 'A competitive and sustainable banking system'. To what degree was the National Australia Bank consulted regarding those reforms prior to their announcement?

Mr Clyne—Not on the specific nature of the reforms. Obviously, there is confidentiality there. But I think the government has been quite consultative over the last 18 months—in fact longer. Going right back to the GFC and about how would deal with some of the potential offshore threats and the need for wholesale guarantees, retail guarantees and things like that, I found the government to be quite consultative. As for the initiatives that came out yesterday, none of them was particularly surprising. It had been flagged for some months about these. You never know the final make-up, and obviously you will always get some issues but the reform on exit fees has been discussed and has been floated for some time—and the covered bond issue too. As for everything we saw in that package, whilst we were not consulted—because it was a confidential decision—there was nothing that we did feel we did not have input into or some opportunity to—

CHAIR—So in a general sense you had some input, but in terms of the actual package you had not been specifically consulted on what it was likely to contain and how it would work?

Mr Clyne—Not on the specific package, but on every element in the package I can certainly say that we had had discussions with Treasury and the government over the last six to 12 months about the nature of the industry. We were not consulted on the specific package but I do not feel there is anything in there that we did not have an opportunity to provide input on. As to whether it was taken into account, that is a separate story.

CHAIR—Looking at your submission—and thank you for that; it is a very good submission and very comprehensive—you note in it that throughout the GFC you continued to support Australia’s small businesses. Could you expand on that and explain what you mean? We have had a lot of anecdotal evidence plus actual evidence to the committee which suggest that during the global financial crisis small business was effectively abandoned in terms of finance and that particularly the cost of doing business with financial institutions increased dramatically for those that actually did manage to get some assistance from banks. Could you expand on what you mean by your comment that you continued to support small business during the GFC?

Mr Clyne—Certainly. Over the last 18 months to two years there has been a substantial amount of capacity withdrawn from lending to the small business sector. I think our estimates—and perhaps you can clarify this when APRA present to you because we are basing these on their statistics, so these are our statistics off their data—would suggest that about $40 billion of capacity was withdrawn from the market over about the 18 months till now. During that time we increased our lending by $1.9 billion. So when the market was withdrawing capacity we were adding capacity to the market. That is evidenced by the fact that in the system over the last 12 months business credit shrank by 3½ per cent. We in fact grew lending by, I think, 2½ per cent in that time frame. So we are demonstrating that as the largest business bank in the country we were very much open for business. In some cases some of that capacity withdrawal came from parts of the sector that were influenced by other factors, so foreign banks were withdrawing capacity at points in time and the absence of the securitisation market and the commercial mortgage backed security market also withdrew capacity. So there was a range of reasons why that capacity was going, as opposed to necessarily a reluctance to lend, but we are just trying to make the point in our submission that we were a very active lender throughout that. On the price issue, that really reflects the increased premium for risk and the increased cost of funding that we were recovering through that period of time, so price is a separate issue. I acknowledge that and I am happy to discuss that. But on the capacity issue we were just trying to demonstrate that we were an active lender through that period.

CHAIR—But the NAB, like other financial institutions, re-priced for a perceived higher risk for small business?

Mr Clyne—That is correct. We priced for both the cost of funding, as it was related to, and what we thought was an appropriate risk premium for whatever sector of the market we were lending into.

CHAIR—But at a higher level than existed prior to the GFC?

Mr Clyne—Yes. I think we all recognise that risk was mispriced, and that is one of the reasons we had a GFC.

CHAIR—I had a discussion this morning with the Reserve Bank governor about whether he thought risk was now at an appropriate level or whether it was still overpriced in response to the concerns of the GFC. I do not know that we really got to the bottom of it, but what is the NAB opinion on that?

Mr Clyne—I think it is a question that you have to look at almost by customer and by lending product. That is a very unique situation because you are trying to equate what the particular nature of the customer's risk profile is. Some customers are securing their debt, others are obviously lending on an unsecured basis, some are lending short term, some are lending long term and some are lending on a cash flow basis. So each product and each customer is a unique set of circumstances, and I think what we have tried to do is appropriately reflect the risk associated with each customer and each product type.

CHAIR—In talking about risk, particularly in terms of business, a lot of business lending is secured with favourable loan devaluation ratios and presents a fairly sound long-term investment in terms of what may happen between now and the ability to actually call on the collateral that is secured against. Given that the security in those cases is as good as security in a residential mortgage, how do you price differently and what sorts of factors do you take into account?

Mr Clyne—Security is one component of it but, at the end of the day, you have to look. Is it a situation where they are using their personal home as security or where they are using business premises as security? Those factors have to be taken into account. Ultimately, as with any loan, including a residential mortgage, you have to look through the security. The security is not something you should be relying on. The security is there and it is an important component, but you have to look through that to the underlying fundamentals of the business, particularly the ability to service the debt. The security is in there and it can have an influence, but, really, it comes down to whether we are given capital relief under the regulatory rules as well as to whether the security actually does that.

CHAIR—I understand. That is a separate issue, particularly if NAB—

Mr Clyne—That is right. But that is quite important.

CHAIR—What is the risk that you are pricing for? Is it that ultimately you will not get your money back, or does it include an element of pricing for the risk of the cost of chasing it if something goes wrong in the meantime? How do the different elements of pricing for risk come together so that you end up with a perspective where you might be paying two or three per cent higher for a fully secured business loan compared to a similar, fully secured residential loan?

Mr Joiner—It is timeliness as well. In a business situation it could take quite a bit of time to unwind security, or you have to have a business plan prepared to see whether the business can trade through and so you might be working against a couple of scenarios for a while. So there is a timeliness element to it, and then there is cost of recovery.

CHAIR—But surely when you set up your contracts you set them up with appropriate terms to ensure that you can recover the costs of all that—ultimately, if need be, out of the value of the security?

Mr Joiner—Yes, but you will not get your money on a timely basis.

CHAIR—You should get interest?

Mr Joiner—That is true.

CHAIR—Do you get penalty interest and things like that which would help offset? I am just trying to get my head around where the additional cost is in the end, even if you do have to go through all that, if you have security that will cover all those costs, plus your interest in the meantime.

Mr Joiner—You might be asking the question from the assumption that business lending is more profitable than retail lending; in fact, that is not the case. Business spending has a lower return on equity than housing lending.

CHAIR—Why is that the case if you are charging a higher price?

Mr Joiner—Because the regulatory assumptions and the loss history models suggest you will have a lot more problems on the business side than on the housing side. Australian housing has been an incredibly stable asset class.

CHAIR—Does that include unsecured business loans as well?

Mr Joiner—Yes.

CHAIR—So that might have a degree of impact. My question is specifically about fully secured business loans where, ultimately, if you need to you can take a bite out of the value of the security to cover not just the principal and interest due but also penalty interest and the cost of recovery and all those things in contracts.

Mr Joiner—The basal two models are driven very much from history. History says that you have earned this much, it is has cost you so much to administer the portfolio and this is the return you ultimately get. That drives the amount of capital that you have to hold against it. Occasionally a regulator will override that.

CHAIR—I acknowledge that the capital holding required is actually an additional cost that is structural and you cannot avoid it, but Mr Clyne himself mentioned that there is pricing for a risk, and it is the pricing for risk that I am trying to understand given that, particularly in those secured instances, you have ultimately got a full recourse for all costs, including penalty interest, which would hopefully cover some of those timeliness issues.

Mr Clyne—You cannot divorce capital and risk, because the capital we have to hold is a function of the long-run risk models. Long-run risk models look at what the likely loss you are going see in a portfolio is. The long-run loss rates in small business are significantly higher than in housing. That dictates that we have to hold greater capital against—

CHAIR—That includes unsecured business loans as well, though, doesn't it?

Mr Joiner—Yes, but you can lose money on secured as well.

CHAIR—I am sure you can, particularly where there are problems with valuation and things like that.

Mr Joiner—Yes, so we were basically losing a billion dollars every six months.

CHAIR—In secured or unsecured?

Mr Joiner—Both.

Mr Clyne—In an economic downturn the critical driver of residential mortgage default is in fact unemployment. The reason you get such a long-run low loss rate in residential mortgages is that we have had a relatively benign period of unemployment. We have certainly had peaks; obviously if you go back to the peaks in the early nineties, where it peaked at 11 per cent, you do see a correlation with foreclosures. In a relatively benign economic environment where unemployment is low, you have some specific individual triggers that will drive mortgage foreclosure. Probably the most significant mortgage foreclosure driver is in fact some form of family breakdown that requires some division of assets. You can have, as we have actually had over the last couple of years, relatively low unemployment and therefore you are not seeing foreclosures on the residential side, but you can have difficulties in retail, in tourism and in export sectors and therefore problems in commercial property prices. Even though you have it secured against a property, you may in fact be experiencing quite a substantial downturn in the value of that property so therefore the security does not count for it. That is when you go back and look at the long-run models that say that you could in fact, even though it is secured, have a worse outcome from secured—

CHAIR—Do you experience more losses amongst the secured loans against commercial properties than you do when they are secured against residential?

Mr Clyne—Commercial property has proven to be more volatile in valuation than residential property over time. That will depend on what the original loan value was at and also the maturity and the seeding of that loan. So we would generally experience greater losses, yes, in a commercial secured than a residentially secured property.

CHAIR—Also in your submission you state that NAB believes transparency should be a guiding principle in looking at the funding of the Australian banking system. Where has transparency been missing up to this point? Is it not a transparent system?

Mr Clyne—No. I think the issue, as I alluded to earlier, is that there has been strong belief in the public's mind that our funding models have been based on the Reserve Bank so there has not been a good job from the industry in terms of putting the drivers of the model out there. We believe transparency is very important. We made a commitment in April last year that following every interest rate decision, by either the RBA or ourselves, we would publish our funding data on the web and show what the drivers of our funding were—how the cost of customer deposits is moving, short-term wholesale funding, long-term wholesale funding and the cost of liquidity that we are required to hold. We have continued to publish that and we think that is important so that people can see and we can be questioned about whether or not those are the drivers of our funding. So we think transparency is very important.

CHAIR—You also mentioned that you consider:

… there exists considerable concern about some bank behaviours and practices; in many instances, this community concern is well founded and has existed for a number of years.

What sorts of behaviours and practices do you consider have led to the well-founded concerns?

Mr Clyne—The reason that we are having this inquiry is that, obviously, you are getting a lot of concern from your constituents—the fact they are not happy with the state of the banking system. On the other side of the equation the banks are legitimately saying that this banking system is the envy of the world. It is the envy of the world; there is no question about that. But many people in the public do not feel—

Senator CAMERON—There is not much competition out there internationally, is there?

Mr Clyne—Not at the moment. But I would rather be in the situation where we are the envy of the world than being a laughing stock. We definitely are the envy of the world, but the general public do not feel the benefit of that. They are sitting back there, saying, 'Hang on, you may say you're the envy of the world, but we do not feel it.' This is actually a deep-seated issue. In many respects, this goes back to when the banks, 10 years ago, clearly broke a bond of trust with the community when they closed branches. There is no question about that; it was a mistake. I cannot control what politicians or the media will say about the industry. But we can control the things we can do. The more we face into it, and ask, 'What are the things we as an industry have done—we are not going to be able to satisfy everybody—that have driven angst? Is it the way we have communicated things? Is it the closure of branches? Is it the nature of our products? Is it the pricing? The more we do that, then the more oxygen we can take out of the debate. I cannot control what you will say and I cannot control what the media will say, but I can control what we in the industry will do. That is why we have faced into it.

We were the first and only bank to completely abolish exception fees, which drove 50 per cent of complaints into the bank. We were the first and only bank to abolish account-keeping fees, which drove significant complaints into the bank. We have abolished mortgage exit fees. We run the largest microfinance program in the developed world, with over $130 million available on a no-interest basis. So we as a bank are going to go out there and we are going to take a proactive stance, by saying, 'We'll not be able to satisfy you on every front, but we as a significant participant in the industry will try to demonstrate that we are listening.' As I said, there will be some issues where, clearly, we will not satisfy the public. But the more we as an industry do that we will start to have a sense where people will say, ‘Actually, this industry is listening and responding,’ and we will be able to argue the points where we cannot meet their requirements a little more coherently.

CHAIR—You have elucidated how the banking industry is the envy of the world, but there are concerns in the community. In your submission you say that some of those bank behaviours and practices have led to well-founded concerns around them rather than to a misunderstanding of how the banking industry is viewed by the world. I suspect your comment about closing the branches is an example of one of those well-founded concerns?

Mr Clyne—Yes.

CHAIR—Are there other aspects of what banks have been doing that fall into the category of well founded, as opposed to perception wise?

Mr Clyne—I would put that one at the forefront of it. I am not averse to exploring all the other issues that you may have and debating whether or not they have some merit. But when I talk to customers and visit, particularly rural and regional areas, that issue is the one that continually comes up, by people saying, ‘That’s when we feel there was a strong bond of trust broken with the community.’ We did not face into that and really acknowledge that—up to that point there was always concern; we are large industries and therefore there will always be a sense of antipathy—that was a real breaking point. From that point we struggled to argue our case beyond that, and we have not argued it effectively. Off the top of my head, I do not have another aspect that I would say is also well founded. If you have one, you can add it. I am happy to debate it. I will let Mark have a go.

Mr Joiner—Going back to a point you raised, NAB got great momentum in business lending in the early nineties, partly through being in a position in the downturn then to stay open for business. It did not have the same issues to deal with. Coming into this crisis, we very deliberately set ourselves to stay open for business. In fact, a neighbour of mine is in commercial property—and that is always a good way to get data—and he said to me, ‘It looks as though NAB is keeping commercial property going on its own.’ There is also an element of trust there in a business relationship, that a business customer knows that you will be there for when they say, ‘It’s a rainy day, I want my umbrella back.’ So that is another example where you can let people down.

CHAIR—The reason why I asked that question is that there is a perception—and we have heard from Treasury earlier today confirming their view—that the banking industry in Australia is oligopolistic in nature. There is a view that, because it is oligopolistic, banks can put on new fees or close branches or do whatever they choose and try it on the community and basically see how much they can get away with until the community starts to squeal.

It terms of feeding concerns that are well founded, that is the perception. I am very interested to hear what your thoughts are on what were the well-founded things and what might have driven the banks to do that. Was it the fact that the industry is oligopolistic in nature and basically feels that it can get away with it or is there some other reason for the actions that have led to those well-founded concerns? I do not know if you would like to comment on that.

Mr Clyne—Once you have those significant points of dislocation—and Mark is quite correct; some of the banks were very heavy-handed in the early nineties recession in the way they pursued small business customers in particular, and I think that also led to some concerns—all we could really do was look after what we saw as the things we could control. We have taken very proactive steps. We were the leader on those steps, in many cases, not just in lowering fees but in abolishing them, which I think showed a real commitment. It is a track record that we are very proud of.

Senator WILLIAMS—What did it cost your bank when you abolished those fees?

Mr Clyne—As cost or loss of income? It was well in excess of $100 million from the fees we abolished. Actually, it was $220 million.

CHAIR—On that issue, in your submission you make it clear that the National Australia Bank has reduced or got rid of a lot of fees. You maintain your variable interest rate at the lowest level. You also note that you have the highest level of business banking of the four majors, which comes at a cost in terms of your capital requirements. A lot of those things suggest that you should not be making as much money as the other majors are, yet recent profit figures show that you are comparable. How are you managing to do that, given that you are cutting fees? Do you have lower costs in other ways that are not apparent?

Mr Clyne—No, we do not. I would indicate that in fact we make the lowest profit. You have opened up the profit question and I think that is a good place to get into it. The reality is that we are looking at two different numbers. We made $4.6 billion profit in the year ending 30 September. That is a big number; there is no question about it. I cannot sit here and say $4.6 billion is not a big number. But we look at it from the point of view of two critical measures, and this is how our investors look at it: what is the return on the equity that our shareholders have put into the business and what is the return on assets? We in fact generate the lowest return on equity of the big four and the lowest return on assets. That is the critical driver. When you are a big industry your numbers are always going to be significant. I cannot sit here and say that $4.6 billion is not a large number. Bear in mind that over 70 per cent of that is repatriated to shareholders through dividends and 75 per cent of our shareholders are Australian, so that money does cycle back in.

But the critical measure for profitability, at the end of the day, is the return on equity that you generate—what is it that you get off the shareholders' investment? If you were to say, 'I think $4.6 billion is too much; I'd like you to make $3 billion,' then obviously you engineer from there. A $3 billion profit would possibly mean that we would have to pay more for debt because we might have a lower rating and it would pay fewer dividends. You can drive into any outcome based on that, but you have to really base it on return on equity because that is the critical measure at the end of the day.

CHAIR—You just reminded me of something that I should have mentioned before I started, and that is that members of my family are associated with a family trust that owns shares in the National Australia Bank.

Senator HURLEY—Let us just continue on that profit figure. I think what is driving a lot of unhappiness is that, rather than continuing on their trajectory, many companies have had to accept a lower return on equity as a consequence of the global financial crisis. It is creating a lot of unhappiness in the community that banks seem relatively unaffected by that. Other businesses have had to lay off staff or have had to ask them to work fewer hours. People are putting up with rising costs et cetera, but the banks are sailing on, unconcerned.

Mr Clyne—Our return on equity has dropped substantially. In fact, there has probably been the best part of between 300 and 400 basis points of reduction in return on equity. I cannot speak to the other three banks' specifics, but the whole industry has experienced a significant drop in return on equity. Our return on equity is well below what it was.

Senator HURLEY—What is your return on equity?

Mr Clyne—Thirteen per cent.

Senator HURLEY—What was it in, say, 2007?

Mr Joiner—I would have to check, but I think it was about 16—maybe a bit higher.

Senator HURLEY—That reinforces my point: a lot of companies would be pretty happy with a return on equity of between 13 and 16 per cent.

Mr Clyne—Even at 16, you would find that the banks would fit about halfway down the ASX 100. As I said, we are going to get into the situation where we are obviously going to talk about a big number, but even 16 would not put us in the top ASX 100.

Senator HURLEY—So you are talking about mining companies and other large companies?

Mr Joiner—Supermarkets.

Mr Clyne—A range of people make it. We are a highly regulated industry. We have to hold a substantial amount of capital aside for the business. We have hundreds of billions of dollars in assets. Therefore the returns are naturally lower. We are a solid dividend-paying stock, and that is an important thing. Not everything has to be high returns on equity if you are able to pay a strong dividend, and that is what the banks have generally been doing. But 13 to 16 does not represent an excess by Australian return standards. On the issue of employment, we employ 25,000 people in Australia. We made a conscious decision that we wanted to try and stay open. We wanted to keep branches open during the crisis, and we also wanted to make sure we had business bankers able to support the crisis. We did not go through a process of excessive job reductions. We have to bear in mind that the big four banks employ 100,000 people in this country. That is an important driver of economic growth as well.

Senator HURLEY—Banks are also a little different from other companies in that what they do affects people who lend money from them—people who lend money for mortgages and people who lend money for their businesses. It is not just something that you consider by itself. What a bank does affects so many other companies hanging off it. That is one of the difficulties we see here: people see the banks maintaining their return on equity but causing other people to have problems with their finances.

Mr Clyne—But we did not maintain our return on equity. Had we tried to maintain our return on equity at the precrisis levels—that is, 16, and some appears at 18—we would have been pricing even more substantially than we have been. The 300 to 350 basis point drop in return on equity is a very significant drop.

Mr Joiner—There were two periods during the crisis when our credit rating was on negative watch. If we dropped out of the AA status, then the cost of funds and our access to funds internationally would have been severely altered. Then our ability to support the economy in the ways we described before—staying open for business and predictable for customers—would also have gone. We would have had to freeze our balance sheet growth and the like. While you probably do not want obscene amounts of profitability out of your banking system, it is good for everybody to have a strong banking system that supports a degree of economic self-determination and flexibility.

Mr Clyne—As we went to the crisis, we were in a situation where obviously, quite appropriately, investors and prudential regulators were seeking us to hold greater capital. We had to go to the markets. We went to the markets in November 2008 and in July 2009 and raised about $6 billion in equity. We effectively had to absorb that and suffer the drop in return on equity. Had we tried to maintain the same return on equity on the additional $6 billion in capital, prices would have been substantially higher. I do contest the fact that we maintained return on equity. We most certainly did not.

Senator HURLEY—All right. Let us talk about the most recent rate rise above the RBA cash rate. There is some view that that was not justified and other views that it was justified. At the time the dominant message coming from the big banks was that it was justified because the cost of funds was higher. Treasury says that it is not so. How do you account for that?

Mr Clyne—Not based on our figures. The cost of funds is substantially higher.

Mr Joiner—I think the Reserve Bank said the average cost of funding had risen 90 to 100 basis points. We are saying that it rose 110 to 120 basis points. They do not have all the information. They cannot see what we see on the deposit side. If you want a short-cut check, our net interest margin pre crisis and post crisis is almost the same number. So, in terms of the net as a percentage of our assets that we make after we take in funds and put them out is the same.

Senator HURLEY—So you would disagree with the Treasury view?

Mr Clyne—They do not have all the data that we can see. It is going to be unique to each bank, depending on the mix of customer deposits you have, the tenure of the long-term funding, how diversified your offshore funding portfolio is and the individual liquidity that you are required to hold. When we looked at it, our costs of funds are rising.

Senator HURLEY—Where is the cost of funds rising? Is in the wholesale funding offshore—not from Australia?

Mr Clyne—There has been a lot of discussion on this. The marginal cost has definitely come down. I referenced earlier that pre crisis we were borrowing at about, say, 15 to 20 basis points over a benchmark. In the heat of the crisis, it was in a spread of 200 or 250. It is now, I think, for three-year money about 140 to 145. that is better than 250, clearly. But I am rolling money, and the money I roll next month will be three-year money, for example, and they take off at 17 and I put on 145. So what is happening is the average cost of our funding book is rising because we are replacing cheap funding with more expensive funding—certainly, absolutely, very pleasingly, funding that is below the peaks but still substantially above the pre-crisis levels. Every time you have something like an Irish sovereign debt issue, you do see spikes. If you happen to need the funding during those windows, obviously that is going to increase the book as well.

Mr Joiner—There is a lot of focus on the wholesale cost of funds, but actually the largest driver of our cost of funds is what we pay for retail deposits. They have risen on average about 120 basis points pre crisis to post crisis relative to the cash rate.

CHAIR—But they have fallen recently.

Mr Joiner—They go up and down. There are periods of intensity and less intensity—normally to do with whether there are particular concentrations of maturities in term deposits. When there is a lot of money about to move the intensity goes up. So there has been a little bit of relaxation recently.

Senator HURLEY—In this $4.6 billion there is some profit from lending and borrowing, but there are other sources of income—for example, in your wealth management services. What proportion of your income is from those kinds of other services?

Mr Clyne—We make about 10 per cent of our earnings out of our wealth management business.

Mr Joiner—It was 10 pre-Aviva and it is—

Senator HURLEY—Is it 10 per cent of your profit or your turnover?

Mr Clyne—No, cash earnings. The $4.6 billion is our cash earning and we make roughly 10 per cent out of wealth management.

Senator HURLEY—Do you cross subsidise your departments, or is that kept in a—

Mr Clyne—No.

Senator HURLEY—Another strong criticism of banks is that when the RBA puts its rates up, rates go up pretty quickly—or have over the past, or for as long as I can remember—but, whenever the situation comes about that the RBA puts the rates down, the banks do not follow so quickly. That would be one of the other reasons that people do not have so much trust in banks.

Mr Clyne—I would put that in the category of the fact that we have consistently moved in line with the RBA. Those delays are, yes, delays that would concern people as to whether or not we have—

CHAIR—Well-founded concerns.

Mr Clyne—You can put that in that category.

Senator HURLEY—Are you proposing that you separate out rises and rates from the RBA, including both up and down movement? How are you proposing to address that?

Mr Clyne—Let me tread carefully because I am the first person to talk since the price signalling.

CHAIR—It is not long yet.

Mr Clyne—So I have got an amnesty period, have I? I think there is a case that if the banks continue to move in line with the RBA up or down then we are continuing to compound the view that in fact our funding is related to those moves in cash rates. I think there is some merit, depending on each bank individually looking at their own circumstances, in making interest rate moves independent of the RBA.

Senator HURLEY—Can you make it clear how the RBA movements affect you? That cash rate is the overnight rate—am I right? How much does that affect the cost of your funds? Can you give me a proportion?

Mr Joiner—We would almost immediately reprice our offer on term deposits and our call accounts. A lot of our wholesale debt is pointed at the official rate.

Senator HURLEY—You are saying that forms a basis and—

Mr Joiner—What we pay will be 140 basis points on top of whatever your Reserve Bank has as the rate—that will be what we might have agreed in raising the funds.

Senator HURLEY—So it is a benchmarking effect more than the actual—

Mr Joiner—Yes. A lot of things are pointed at that so that is why it very quickly finds its way into our economics when the Reserve Bank moves.

Senator HURLEY—When it goes down, why would there be or lag—or is there a lag?

Mr Joiner—We have not enjoyed a cut since you have been in the chair, I do not think.

Senator HURLEY—We are looking at some long-term—

CHAIR—The previous cuts were during the GFC.

Mr Clyne—There was, and there were 425 basis points of cuts and we passed on the most: 387.

Senator HURLEY—How quickly?

Mr Clyne—I do not recall the speed with which we did it, but we have the track record of passing on the majority—the most of the major banks—of the reduction and cash rate during that period.

Senator FIELDING—On that question: you obviously make more money if you delay that rate cut—don’t you; every day that goes on you do not pass on the rate cut from the official rate, you do actually make more money? I just want that point clarified.

Mr Clyne—On both sides: it costs money on the increase, and we do for a period make money on the other side.

Senator HURLEY—I want to go back to the retail side of it. What we have heard is that individual customers can negotiate on their mortgage rate. That immediately triggers a concern that perhaps less sophisticated customers are not able to negotiate the best rate that they possibly can; that they will just go in and accept the initial rate that they are offered. Firstly, there is that. Secondly, it is sometimes very difficult to compare rates because you have different levels of fees and charges so that you might have upfront fees and exit fee so that the interest rate can look lower. It is very difficult for people to calculate that. Could you comment on how you think that, particularly in light of the government’s proposed changes, might work in future?

Mr Clyne—It is a little bit early for me to get an assessment—obviously, it was only released yesterday—as to how that would work. I think there are two critical components to competition. It is not the number of players; in fact you can have three players in the market and have intense competition. Or in the US, because we have a small bank there, you can have 8,000 banks and have less competition than you have in Australia and that interest margin is 150 basis points higher. It is nothing to do with the number of competitors. The two key drivers of competition are search cost, so how long does it take in terms of time and what is the cost to find a deal—this applies to any industry—and, secondly, what is a switching in time and cost? They are the key drivers.

In terms of search cost, obviously there is a substantial number of resources out there that allow people to go out and find the rates. There are over 100 different mortgage rates available through a whole variety of providers out there. Mortgage brokers account for 50 per cent of flow into the industry, so 50 per cent of people go to a mortgage broker. When you look at what mortgage brokers’ business model is, they are there to try and provide a service and source a rate. Can more be done to help people in the search cost? We are not arguing against competition. I think that is fine. We have got the lowest rate in the market. If more people can find that, I am very happy. I am not going to stand in the way of people searching. That is the first critical equation to competition. The second one is switching: ‘How easily can I get from one product to another, in terms of the time it takes and the cost?’ A lot of what we have done in the last 18 months is try to help on switching, making customers more easily able to switch.

Senator HURLEY—How have you done that?

Mr Clyne—One of the reasons is we have abandoned exit fees in recent times. We have said we are happy to put those aside. Many of the fees we have taken are not fees that are in any way illegal; they are fees about which we say, in a competitive environment, ‘We want to put a better proposition out there to our customers.' That is an example of where we have reduced switching costs for our customers.

Senator HURLEY—So you have got no problem with the proposed requirement of the government to have a sheet describing what the loans are, what the conditions are and how they are comparable to other loans?

Mr Clyne—I have not seen the specific detail. The reality of this is that the devil will always be in the detail. But in principle the provision of more information to customers is fine, absolutely fine. But we have been down this path on financial products, where there was some provision of information and then we were quickly in a situation where product disclosures had to go to a hundred pages so the customer could inevitably see every permutation, which is not helpful to the customer—that in fact does not help search cost. We are trying now, as an industry, to wind that back to something that is more meaningful for the customer. So, with the proviso that it is consistent—so that people are comparing like with like—it is transparent in the way it is communicated and it is accurate, I think those sorts of initiatives are very positive.

Senator HURLEY—And what about the mortgage insurance factor? Do you think that that is something that can be prescribed by government so that it is more portable?

Mr Clyne—I think it will depend, because some of the industry use external insurers and some self-insure. There would be different thresholds. We use external mortgage insurers and generally, when a loan exceeds 80 per cent, loan devalues, so it will depend on what other people use. They may be switching from an externally provided insurer to a self-insurer. It would be a case-by-case example.

Senator HURLEY—I have a final question about covered bonds. Would you be interested in using that as a form of financing?

Mr Clyne—Yes, we will be. I think that is a positive development. They are used in many other markets. We have issued them ourselves out of our New Zealand bank. We have done two covered bond issues out of Bank of New Zealand. We are planning at some point in the future to do one out of our UK bank. We have seen other offshore banks issue into this market in recent times, at lower cost. It is not the be-all and end-all but it is another important step in diversifying funding and we would like to take advantage of it.

Senator HURLEY—Where does the cost of that funding fit in in terms of wholesale equity deposits? Will it be on the cheaper end?

Mr Joiner—It will be cheaper because our wholesale funding is AA rated and covered bonds are typically AAA rated. So we would be borrowing almost at the sovereign rate.

Senator HURLEY—So you would expect that that would lead to a lower—

Mr Joiner—Yes. The likelihood is that the capacity for covered bonds will be limited. Some jurisdictions allow five per cent of loans to be your capacity. I think New Zealand is thinking of maybe going to 10 per cent. So it would be quite a small portion of the book but it would be lower than average cost.

Senator HURLEY—But of course it would advantage the bigger banks who have more—

Mr Joiner—It should advantage everyone proportionally. If it is five percent, it is five per cent of however big you are.

Senator XENOPHON—Mr Clyne, on the issue of bank account mobility that Senator Hurley has alluded to, what is the attitude of NAB in terms of the technological capacity to facilitate that in years to come?

Mr Clyne—I do not have a time frame on it. We are dealing with very complex and ageing infrastructure in the banking environment, so we would have to look into the time taken. There may in fact be solutions that can achieve—

Senator XENOPHON—You are saying complex and ageing infrastructure in the context of IT?

Mr Clyne—Yes, absolutely.

Senator XENOPHON—You have got the funds to upgrade the IT, though.

Mr Clyne—We do. But, for example, we are replacing our core banking platform, which is a very stable system, but it can go down, as we saw in our case some weeks ago. It is very stable in the sense that no data is lost, but obviously there is time to recover. These systems are, in some cases, 40 years old. We are spending over $1 billion on replacing them. These are big investments we have to make. In terms of account portability, you would have to look at how you factor that in. There may in fact be other solutions that could be arrived at that achieve similar outcomes.

When people switch banks, what they generally struggle with administratively is changing all of their direct debits and various other things, and that is obviously a barrier to people taking advantage of portability. But people do move for good deals. We abolished account-keeping fees, which were highly complained about fees. We have seen six times as many customers move to NAB in the last 12 months on that basis. People will actually engage in it if you have a competitive offering out there, as we have had. So you can achieve it through just a competitive offering to say ‘we provide a better deal’.

There may be technological solutions that could achieve similar outcomes to total account portability. You might be in a situation where you could have a user interface that allowed you, if you had multiple bank accounts, for example, to redirect a direct debit from one banking institution to another. That would require you to have accounts in other banks, but if you had an account with bank A and you decided you preferred the deal with bank B then you could redirect direct debits from A to B. There are things that can be explored that may not be as complex or timely as total account portability.

Senator XENOPHON—So it is possible to at least significantly improve on the current system?

Mr Clyne—I do not know. I am just speculating that there could be options there. But I would not underestimate the complexity of the infrastructure environment that a lot of banks are dealing with; it has been built up over a substantial period of time.

Senator XENOPHON—Sure. Could we just move on to the issue of return on equity. I think Senator Hurley asked you a number of questions in relation to that—from 16 per cent to 13 per cent. I guess another way of looking at it is in relation to the spread between loan rates and cash rates. Can you indicate whether the domestic net interest margin has increased since St George, Bankwest, Aussie Home Loans, RAMS and Wizard were taken out as independent competitors? Is there a correlation between the two in terms of the net margins between them?

Mr Clyne—It is difficult to compare net interest margins by institution because net interest margins are really a function of the business mix you have. Amongst the big four, we have some that are perhaps 60 per cent retail and 40 per cent business; we are more like 40 per cent retail and 60 per cent business. You really have to look at individual net interest margins. Our net interest margin, as Mark said, is broadly flat over the period pre GFC to post GFC. So, certainly, in our business mix we have not seen a substantial increase in our net interest margin.

Senator XENOPHON—I know some commentators have complained—and it was not directed at your bank—about the difference in the spread for small business loans, which is significantly higher than the spread for home loans.

Interjector—Why don't you ask them about variable interest rates? You can't have variable interest rates in a contract. It's illegal. It's fraud. And taking money by fraud is stealing.

CHAIR—Order!

Interjector—You cannot have variable interest rates. It is the biggest fraud ever to be perpetrated on this country, and these people are thieves. Variable interest rates—it's illegal. You must have certainty of terms; otherwise there is no contract.

CHAIR—Senator Xenophon has the call.

Interjector—Ask them about their fee group. It's fraud, outright fraud. People are being destroyed by fraud. You cannot have variable interest rates and have a contract. It is fraud.

Senator XENOPHON—Sorry, Mr Clyne, for that interruption.

Mr Clyne—No, that is fine. I will respond to that interjection, in the sense that in fact—

Senator XENOPHON—It is normally politicians who respond to interjections!

Mr Clyne—Yes. One of the great benefits of 85 per cent of Australians having variable interest rates is that, when mortgages came down, over 90 per cent of our customers did not actually adjust their repayments. They took advantage of the reductions to get ahead in their repayments—or, if they were in financial difficulty, they did adjust their repayments and took out substantial equity.

Senator XENOPHON—Sure.

Mr Clyne—One of the big problems in overseas markets where you perhaps have 85 per cent fixed rates is that there was a lot of angst as interest rates were moving around and people felt locked in. There has been a lot of flexibility in the Australian market because we are one of the unique markets with a high degree of variable interest rates. To come back to your question, though—

Senator XENOPHON—About the spread with the small business loans.

Mr Clyne—Yes, this comes back to the earlier discussion around risk. The spread will always be higher on a small business generally, on a small business loan over a retail loan, because of the risk profile and the capital we have to hold against those loans. They influence the spread between whatever the benchmarks you are going to use; the spread will always be higher.

Senator XENOPHON—There is an unfairness that many perceive in that you get a small business loan secured on your home and you generally pay a higher rate than if it is just for a straight home loan. That is the case, isn't it, as a general proposition?

Mr Clyne—As a general proposition, yes, but you have still got to look at the security; you have still got to look at the ability of that business to perform to service the debt. So you are always making an assessment. On any residential mortgage you have got to look at serviceability and the income verification that will service that debt. The long-run loss profile on those loans is higher than normal residential secure mortgages, and that will drive the risk profile, that will drive the cost.

Senator XENOPHON—Unless someone loses their job on a straight home loan, and that raises the risk. Unemployment is a big risk factor.

Mr Clyne—Absolutely.

Senator XENOPHON—In relation to interest rates and the Reserve Bank increasing the cash rate, how far in advance does NAB plan in terms of interest rate rises? To what extent is the RBA's rate increase a tipping point or a key determinant? Is it less significant than it was, say, five or 10 years ago?

Mr Clyne—It is less significant because obviously we have all experienced very substantial balance-sheet growth and therefore the proportion of funds that we are particularly sourcing from offshore is higher. The other thing is that deposit competition has been far more intense in the last two years. This has got to be put in the light of the regulatory environment that we are heading into.

The regulatory environment is that we are having to move to a ratio that is going to determine 100 per cent net stable funding. That basically means that Australian banks between now and 2018 will have to source funds either from term debt—that is, with greater than 12 months to maturity—or customer deposits. Today the National Australia Bank sits at 83 per cent, so we have about 63 per cent of our funding sourced by customer deposits, 20 per cent through term debt and then the other 17 per cent through other means and short-term funding. We are going to have to move that to 100 over time and, of course, continue to support economic growth in lending to businesses. Because that trend is coming, the competition around deposits has been more intense: everyone wants to make sure they have got as much of the 100 per cent funded by customer deposits as possible. That has become a very big driver of funding over the last two years. Then, of course, we have had the very substantial widening in wholesale spreads off the GFC. So there has been a much more profound disconnect over the last couple of years.

Senator XENOPHON—This is a question I put to the Reserve Bank governor. A number of European countries will be looking at rolling over their sovereign debt. We know what has happened there, with Portugal, Greece, Italy and Ireland. To what extent is that an elephant in the room, that there will be a squeeze on funding in Europe? Is that something that the bank is taking into account in the next 12 months to two years?

Mr Clyne—We do take it into account. Last year we borrowed about $28 billion offshore. We are looking to borrow a similar amount this year. Obviously there was a period of time when access to funds was completely closed, and that is obviously why the benefit of the government guarantee allowed us to access using the sovereign wrap. It is not necessarily a question of access, but if you do start to see, for example, sovereign issues coming out of Europe and you have to fund at that point in time because you are trying to raise money, then you are actually going to have to pay whatever the market is offering at that point in time. So one of the things we have been very conscious of doing is trying to maintain our funding profile so we can step out of the market if there are short-term rises for a period. But if you have a long-term dislocation, such as the fact that you may have a sovereign debt crisis spreading over some time, then you will have to be back in the market, you will have to pay the increased funds and that will flow into costs.

Senator XENOPHON—Can I just change tack and go to a couple of other issues. In relation to ATM fees, I think you were a market leader in reducing ATM fees from $2 to $1.50. Firstly, did that make a difference in terms of people switching to NAB? Secondly, there is a complaint, which I think is a legitimate one, that people on low incomes who often use the ATM to check their bank balance—that is all they do; they are not looking to withdraw—are charged $2 or $1.50 or whatever it is. Is NAB looking at having a differential pricing structure for those who simply want to check their bank balances, particularly given the impact it has on low-income earners?

Mr Clyne—In terms of account switching, no. The more profound driver was in fact us abolishing the highly complained about exception fees and account fees. The issue really comes down to: you do not pay a fee if you use a NAB or a rediATM. Through the NAB and rediATM network, we have unique ATM locations in the country. The real issue on ATM fees is, I think, the independent providers who are charging well above the $1.50 fee in some of those locations. We have ATMS at over 3,000 locations that a NAB customer can use free of charge. I think the question on ATM fees is: should each bank make their ATMs available for free to customers and other banks? That, I guess, is at the heart of the issue. The irony is that what we try to do is invest more in ATMs so that our customers have more points of service to use it free of charge. If you say it is free then the temptation could be to say: ‘I won’t run any ATMs; I’ll just go and rely on bank AB and C to provide that as opposed to saying, ‘Actually, I want to give my customers more points of representation,’ which is one of the reasons we signed the deal with Ready last year to double our fleet. This was so that NAB customers could use them free of charge.

Senator XENOPHON—Finally, I attended, as did Senator Williams, for much of a day a mediation between the bank and three individuals—Ozzie Inak, Memhet Ali Kay and Memhet Canli. This was in relation to what I think you could say was quite an ugly dispute that ended up in the New South Wales Supreme Court before Justice Rothman, where certain findings were made against the bank. Fortunately, that matter was resolved as a result of the intervention of senior bank officers—and all credit to you for that. But it was a long, drawn out dispute; it was very ugly, it was very unfortunate in terms of the personal impact it had on a number of those individuals. What can be done so that these sorts of things do not get out of control? Again I emphasise that fortunately it has now been resolved. How do you prevent things from going haywire in the first place so that you do not have that enormous toll on the individuals and also the resources of the bank tied up in that sort of long-running dispute?

Mr Clyne—Obviously, it would be inappropriate for me to comment—

Senator XENOPHON—Just in terms of the systemic issues.

Mr Clyne—We have over three million customers in Australia and inevitably, given the millions of interactions we have with those customers, there are going to be situations where we do not do the right thing by them.

What we have been trying to drive is, I think, evidenced by our push on the fee front. We have been heavily criticised for that by a range of people who suggest that we are trying to drag the industry down. What we are trying to do—and what we are saying—is: ‘No. We want to provide a competitive offering. At the heart of that is our desire to have a better relationship with our customers. There will be situations—not wanting to comment on the specifics of that case—where we do not do the right thing by our customers. I think what we have to do as an industry, and certainly what NAB is committed to doing—is step up, acknowledge where we have made a mistake and try to rectify it. We deal in a regulated industry as well and, in many cases, you have to deal in black and white. You have to be very clear in the terms that you are providing and in the nature of the contract you have between the bank and the customer. Inevitably, when there is a dispute, there is grey. Unfortunately, those things often take time to resolve because you do not want your bankers dealing in grey. You need to do most of what you do in black and white in order to make it fair and transparent for the customer, and sometimes it does need to be escalated, unfortunately, where people make a pragmatic and common sense assessment on individual cases. We would like to see that resolved more quickly in most cases, but that is generally, unfortunately, what drives it. It gets to a situation where there is a dispute and an element of grey. Generally, it has to then go to more senior members in the bank to try and—

Senator XENOPHON—Although, in this case the Supreme Court said that it was black and white.

Mr Clyne—I cannot comment on the individual details of that case.

Senator XENOPHON—No. Thank you for your answer.

Senator WILLIAMS—I thank NAB representatives for being here. Could I commend you, first of all, on doing away with your exit fees. They have been one of my pet dislikes for many years and I think you have done a good job on that. Mr McInerney, could you give the committee your response to Treasurer Wayne Swan's announcement yesterday?

Mr Clyne—I will just intervene and say that it is not appropriate—

Senator WILLIAMS—Okay.

Mr Clyne—I am happy to respond but Mark and I are both directors of the bank and it is more appropriate that we comment.

Senator WILLIAMS—Okay. What is your response to yesterday's announcement, especially in relation to exit fees?

Mr Clyne—I am pleased that when things are announced we have already done them. The announcement on exit fees and the announcement on credit card reforms are both things we have already implemented, so I was pleased that it does not require us to respond.

Senator WILLIAMS—Are you disappointed that exit fees are going to be removed only on new home loans from 1 July next year?

Mr Clyne—I do not have the specifics of whether or not there is a case for them to be removed on existing loans but, as I said, we have dealt to them already; so our view is that we will just go out there and continue to market to other banks' customers that we have got the lowest interest rate in the market and we do not have exit fees, we do not have exception fees, we do not have account fees and we have reformed credit cards. So I think we respond in a proactive sense.

Senator WILLIAMS—That is fine for you to do away with your exit fees, but that does not help you when other banks still have exit fees, does it?

Mr Clyne—I think the reality is that a low interest rate does help.

Senator WILLIAMS—But you have the lowest home loan rates, of the big four. You do not have exit fees. The point I make is that if other banks do have exit fees, such as Westpac and Commonwealth Bank, then those customers cannot get out of those other banks to actually go to your bank, because they have to pay an exit fee.

Mr Clyne—That is obviously a question you can put to them. I commented earlier about being seen to do the right thing by your customer. Even though we have the lowest rate, we do not want to be in a situation where a customer feels constrained if they want to go to another institution. And there are lower rates in the market; there is a whole range of providers. We say: our customers should not feel they are constrained from seeking another deal if they want one. That is doing the right thing by our customers. It is an important marketing proposition to the customer, because even when you are trying to win them across, you are saying to them, 'Look, this is the proposition we put to you. We have got the best interest rate in the market, we have no exception fees, account fees, et cetera, but if at a point in time you feel that that deal is not right for you, then we are not going to stop you getting out and seeking another deal. For us, whatever the others do is obviously a commercial decision for them. But from our point of view, it is a good proposition to our customers to say, ‘We don’t feel like we’re locking you in.’

Senator WILLIAMS—On your investment rates with the term deposits, a few months ago did you actually start to lower those rates, do you know?

Mr Clyne—They move around. The deposit competition has been quite intense. There will be certain points when significant rollover is occurring in the market. You do obviously respond to competitive pressures as well. The reality is that people come in and negotiate, having seen an internet deposit offer or a blackboard rate from a branch. It depends on how the competitive environment is going, and you try to retain existing customers and win new ones. It is almost a weekly proposition as to how that moves.

Senator WILLIAMS—Would the committee be able to get a graph of your last 12 months of, say, three-year investment rates? Would that not be a problem?

Mr Clyne—Yes, that is fine.

Senator WILLIAMS—That is about it from me, thank you.

Senator PRATT—Given that you have already abolished your own exit fees and that, according to your submission, you have lower interest rates compared with other banks, would you see the government’s move to remove exit fees as a good initiative that would place you in a position to attract business from customers who are currently at other banks?

Mr Clyne—It is obviously looking at new loans from July next year, so in the longer term it will mean that if customers—who take out loans beyond that period—are unhappy, they will be able to switch. It will depend on what our competitive positioning is at the time.

Senator PRATT—You would accept that it is a good thing for the government to do, given the position you have already taken, to abolish those exit fees for new loans?

Mr Clyne—Part of it is whether the community concerns are well-founded or not well-founded. What we have to do is move the relationship between the community and the banks into a better place. Initiatives that promote competition are on the whole going to be good.

Senator PRATT—I am not asking you for legal advice, but, if you accept the government’s position that to go further is unconstitutional then—notwithstanding the fact that you have removed it for existing loans—you must accept that the government has gone as far as it possibly can.

Mr Clyne—It is difficult for me to comment. I have not looked at the legalities of whether they can be removed and just focused on the fact that we have abolished them.

Senator PRATT—The opposition has come out and opposed the lifting of exit fees on the basis that they will not be lifted for old loans. But if it is not constitutional, there is not many ways of getting around that. Should Joe Hockey support the lifting of those exit fees?

Mr Clyne—I am not going to provide advice to the Treasurer or the shadow Treasurer.

Senator XENOPHON—He might be watching.

Mr Clyne—They are probably both watching, I imagine, or are at least going to get a transcript. What we have tried to do is be proactive in every sense. We have generally had a track record of doing what we think is the right thing. What others think and what is constitutional are broader questions.

Senator PRATT—If you think it is the right thing, perhaps Joe Hockey will get there eventually as well. People who are on existing contracts will eventually come out of their three- or five-year period during which they are locked into an exit fee. Would you expect competition to intensify as those exit fees are withdrawn?

Mr Clyne—It is a little early to say what might occur. I do not think that it can hurt competition. I should specify that we are talking about exit fees on variable mortgages. We think that exit fees are economically legitimate on fixed mortgages. You enter into a fixed mortgage contract and the bank incurs costs to set up and hedge against the profile of that fixed rate mortgage, so that is a different story. But it is different for variable rates. If switching is easier, it cannot hurt competition. As to whether it will play out with people taking advantage of it, that is difficult to determine.

Senator PRATT—Your submission cites the RBA governor's recent comments that beyond a certain point banking competition can have undesirable consequences. Do you think that we are currently near that point? How would we know when we were?

Mr Clyne—The dilemma is that on many metrics we have a competitive market. But there is a strong feeling from the community that the market is not competitive. We reference other markets that we operate in which have many more players and things like that that do not exhibit the competitive characteristics that exist in this market. There was reference earlier to the oligopolistic nature of the big four. In fact, at the moment, the differential on standard variable mortgage rates is the widest it has been in about 20 years. So you have quite intense competition among the big four.

CHAIR—That is quoting Treasury.

Mr Clyne—Yes. So you have that. But the reality that we have to face as an industry is that people do not feel that; they are not seeing that. We have to respond and engage to try and demonstrate that competition exists. In some cases, when you do things like abolish fees you are demonstrating that you are trying to meet people in a discussion about the nature of the industry.

CHAIR—While we are talking about that, in the document put out by the government yesterday with Swan's banking reforms, it notes under the banning of exit fees for new home loans section that several big banks have already responded directly to the government's existing measures by removing their mortgage exit fees. Would you say that that is the reason why the NAB removed its mortgage exit fees? Was it a direct response to the government's existing measures?

Mr Clyne—There has been talk around exit fees for most of the last 12 months. There have been a lot of people talking about reform in that space. The government has been talking about reform in that space for some time. ASIC has been looking at it. Obviously, consumer groups have been looking at it. Our view is that the likely trend is for pressure to be put on exit fees for some time to come. We are still having a discussion today about exit fees even though there has been some reform. Did it go far enough? Our view is that we need to get ahead of the curve, as we have on other fees. If something else happens with regards exist fees in six or 12 months time, so be it. We are already there. It is one of the factors in the equation, but it is also due to feedback from our customers.

CHAIR—Exactly: feedback from your customers. In all the discussions over the last 10 or 15 minutes about exit fees, you did not once mention government measures that have been implemented as the reason why you did it. It was more because you wanted to be ahead of the curve and because you were responding to customer feedback and so on. Is the government overstating it to claim credit for two of the banks removing their exit fees—or at least in your case?

Mr Clyne—No, I do not think so. It is one of the factors. The reality is that—

CHAIR—You have been very nice to them given what you have been saying.

Mr Clyne—No, I think it is one of the factors in equation. The point is that they were also getting customer concerns and there were queries to ASIC and other institutions about it as well. They were probably hearing very similar things. The issue of exit fees has been on the table for some time and we felt, 'Let's get ahead of the curve and deal with it, and we don't have to worry about future implementation.'

Senator FIELDING—Do you agree with the Treasurer's statement that the banks had not justification in lifting their interest rates above the official RBA cash rate in November?

Mr Clyne—I do not agree with that statement. We did have justification in the sense that our funding costs were rising. It would be fair to give nuance to the equation. What we have not done is create an understanding amongst the community that that was the case. Was there an economic justification? Absolutely. Was there a broader community justification? Perhaps not.

Senator FIELDING—Who are the Australian public to believe? The National Australia Bank or the Treasurer in regard to the banks putting interest rates above the Reserve Bank cash rate last month?

Mr Clyne—I think the dilemma is that we have, by and large, created a perception for many years that in fact interest rates only move in line—

Senator FIELDING—Sorry, time is short. You have said that the banks were justified. The Treasurer has said repeatedly again yesterday that the banks were not justified in lifting their interest rates. Who is right?

Mr Clyne—Based on the data I see that influence our costs of funding, our costs of funding had risen and there was an economic justification to raise them. But there is a broader equation.

Is there a community justification? There are competitive dynamics. There are many moving parts. Economically, absolutely, we were justified.

Senator FIELDING—Have you been asked by the Treasurer to justify why your interest rates needed to go up given that the Treasurer has clearly, categorically, stated that the banks were not justified? Has the Treasurer asked you to provide justification as to why you think the rates should have gone up last month above the Reserve Bank rate?

Mr Clyne—We do provide data to Treasury and a range of other stakeholders about funding.

Senator FIELDING—Did the Treasurer ask for you to justify that?

Mr Clyne—I have not had a conversation with the Treasurer around the November rate rises.

Senator FIELDING—You can see why the Australian public are thinking, 'The Treasurer says the banks are not justified.' The government is bringing in these reforms—and the Treasurer mentioned this again yesterday at his press conference—to address that issue as well as others. Can you see why the Australian public are thinking, 'What the hell is going on with interest rates?'

Mr Clyne—I do not want to get into semantics, but I think there is a case that says that we have not made our case to the public as to what drives our funding costs. So it is legitimate to say there is no justification if, in fact, you are saying: 'You've not made your case. You've not explained sufficiently what drives the funding.' I do not want go into the semantics, but there has been an acknowledgement around the importance of the rising costs of funds, but it is fair to say that the industry has not made the justification. We have not gone out there and really cracked an understanding in the community as to what drives our rates. So I am not trying to split hairs here, but it is a complex argument that we have perpetuated by actually moving in line with the RBA for a long time.

Senator CAMERON—Thanks, Mr Clyne. Every time I hear a banker in the public arena I think of this old blues band called the Animals, who had a great hit called *Don't Let Me Be Misunderstood*. The line was:

… I'm just a soul whose intentions are good,

Oh Lord, please don't let me be misunderstood.

It seems to me that is what the bankers are saying at the moment—there are all these good intentions and they are just misunderstood. It is more than that, though, isn't it?

Mr Clyne—I have not said that at all; in fact, I have been most forthright since I have been CEO. The reason we are here before the committee, as I said earlier, is that you are tapping into community concern. What we need to do as an industry is control what we can control. It would be nice if we used this opportunity for it to be the last banking inquiry, because, if we do not deal with these fundamental concerns around what a bank should do, what the role of the banks is, how profitable we should be, what the returns should be and what fees should be charged, this will go quiet for a period of time and then we will be back here in five years with another inquiry.

My comments have been: ‘As an industry let’s try to step forward and face the things we can do.’ Hence we were the first to abolish fees and kept the lowest interest rates—to show that we are trying as a bank to be more proactive. We are not going to meet you on everything because the reality is that in some cases we are misunderstood, but we cannot just say we are misunderstood; we have to show action as well. I am not just talking about action; I am showing the action we have taken. We have been first to do things and the most proactive. We are saying, ‘Because we have demonstrated some action, can we now talk about the things where we are misunderstood?’ I would not come here and say, ‘I’m just misunderstood,’ because I think that perpetuates the arrogance the industry has demonstrated. You have to demonstrate real concern where customers have been complaining about things for a long time.

Senator CAMERON—I think one of the biggest arrogances I have seen in the industry is executive salaries. I have raised the issue with both Treasury and the governor. The Productivity Commission had a look at executive salaries recently, and I am sure you have seen the report. The report indicates that for the bulk of the executive community in Australia executive salaries are based on European standards, but for the banking industry it is the US—Wall Street. Why is that and what is the justification for it?

Mr Clyne—I would dispute that. There are commercial banks and there are investment banks. We are a commercial bank. A commercial bank in the US of a smaller size does have remuneration significantly above what is paid to Australian executives. I am talking about commercial banking; investment banking is a different business model. Australian commercial bank executives are paid more in line with European executive banks.

I do not think we should be running away from the debate on executive remuneration; it does drive concern. I think the first thing we need to do is change the standards so we report actual income received, because, when the numbers are reported, in some cases a significant component of that income does not eventuate. In my case, at least 50 per cent of what I am paid I will never get. My bank has not delivered the return to shareholders people would expect. It has to be reported because that is potential income that could be received. In fact, you could argue that if our shareholders—

Senator CAMERON—You are not crying poor, are you?

Mr Clyne—No, I am not. I would not come here and suggest that, but I am just saying that it is important that, if we are going to have the debate—and I started by saying that we do not need to run away from it; it is a point of community concern—the first thing we need to do is get the real number and say, ‘This is actually the number people are dealing with.’ The potential number may never be realised or it may have all sorts of handcuffs and other things over it. Is the actual number something we feel concerned about? It is a genuine point of community concern and you cannot run away from it or not be prepared to debate it.

Senator CAMERON—One of the other issues I have heard is what has been described as conflicted remuneration models within the banks, where your staff who are face to face with the public have to keep trying to sell more and more debt to the public. Obviously again this is an area that causes real concern for politicians and the community in general. Where is that heading?

Mr Clyne—We have incentive models for all of our staff. Bear in mind, one of the big products that we sell is obviously the lending products—that is the business we are in. Also, we incentivise our staff for gathering deposits and customer service metrics and a range of other things. One of the metrics we have been incentivising our staff on in recent times has been deposit gathering, because it has been such an important thing to raise deposits. So we move all those things around. Broadly our staff give us strong feedback that they like an incentive model that is balanced around the provision of customer service, selling a range of debt and lending products, and raising of deposits.

Senator CAMERON—That seems to be in conflict with the latest analysis I have seen by the FSU, who had Essential Media do some work for them. They did some analysis with the bank workers and found that 90 per cent want sales targets and wages delinked. Are you saying your employees are different to that?

Mr Clyne—In many cases our employees like incentive programs. You also have to look at the percentage. I think there is a misconception that very significant components of their remuneration are linked. In many cases you can have as low as five per cent, maybe an incentive target. In fact, the majority of their income is based, obviously, on the important day-to-day things they do. We certainly do not have, at those levels, at the front line, very significant incentive programs, where perhaps 50-plus per cent is driven by that. That is why we get a lot of positive support from our staff to say they like that component to earn perhaps five per cent extra through a broad base of incentives, some of which involves selling debt, which is obviously what a bank does.

Senator CAMERON—Also in this survey, 79 per cent said that personal debt levels had reached the stage of requiring regulation to control it. They are not talking about their personal level but customers’. They are concerned that this spiral of increasing debt is an issue. Obviously you are selling debt, but the triple bottom line has to cut in somewhere and you have got to think about the community sooner or later.

Mr Clyne—We do. That is why we have been proactive on the fee reductions. Bear in mind, the heart of the GFC stems from a subprime lending crisis. The subprime industry in Australia is not the big four banks. In fact, one of the reasons I mentioned our microfinance program—and we have been campaigning strongly on this—is that what we need to do as an industry is get away from things like payday lenders and those where customers who do not have access to mainstream financial services are in fact exposed to very usurious interest rates. There is not substantial subprime lending that goes on in the big four banks; hence why the big four banks came through relatively strongly, because they were not experiencing the lowering of lending standards. I obviously do not have access to the study you are referring to. If you start to move back to an environment where you regulate the level of debt people can take on, that is a very complex issue to determine who can get a mortgage and at what rate and what income they need to service it.

Senator CAMERON—But it was getting to the stage where, every time you went to the bank, you were being offered more debt, on your credit card especially, and for me there are issues in relation to the general public on that one.

Mr Clyne—We do have to adhere to appropriate sales practices and product disclosures and a range of other things, and it is not of a subprime nature. It is always based around quite comprehensive credit scoring as to whether people are able to accommodate that.

Senator CAMERON—Would you have any fears about the establishment of a fifth pillar in banking in Australia?

Mr Clyne—It depends on the nature of the fifth pillar. We do not have any concerns around more competition, as long as the competition is based on an economic basis. I do not know whether the proposition is for a subsidised fifth pillar or a competitive fifth pillar; I am not sure. But we do not shy away from competition if competition is on a level playing field.

Senator McGAURAN—Next year, 2011, what is the bank's forecast for interest rates—up?

Mr Clyne—As far as the Reserve Bank cash rate is concerned, I think our current forecast is that it will rise by 75—

Mr Joiner—Fifty.

Mr Clyne—We have moved it down to 50; it was at 75. So we think there are probably another 50 basis points of interest rates to come.

Senator McGAURAN—Now that the two key reforms—covered bonds and no exit fees; you are a little different, but I am bundling the top four in together—have become a key policy, as it takes effect, what is the effect on interest rates—down?

Mr Clyne—There are a lot of variables that would drive that equation. If you took both of those purely in isolation they would possibly have a positive impact, because covered bonds would be issued at a lower cost. Exit fees—we do not have exit fees; we are talking about a proposition for the future—may have a competitive driver but that could be offset by substantial increases in wholesale borrowing off a year of sovereign debt crisis, deposit costing, competitive pressures and a range of other things. It is a little difficult to answer. If you try to isolate it and say, 'If nothing else happened and everything else stayed even—

Senator McGAURAN—You would adjust your predictions on interest rates?

Mr Clyne—No, we would not adjust our predictions on interest rates. Those interest rates are going to be driven by what the Reserve Bank is trying to set in terms of getting their inflation target under control.

Senator McGAURAN—It sounds as if this will not have a big effect at all, if any effect.

Mr Clyne—It is difficult to determine at this point in time because—

Senator McGAURAN—The Treasurer has determined it.

Mr Clyne—It is a fact. What I was indicating is that I do not see either of those moves as being worse for competition.

Senator McGAURAN—I have one other question in relation to costs of funds. Covered bonds are there to reduce the cost of funds. We are told that you think—it is ironic; we should all know by now—that it is going to be capped at five per cent. You are just assuming that, on the New Zealand model, aren't you? That is very strange; you would think that would be part of the announcement. We will go with the five per cent, which is absolutely minimal—ineffectual—I would say. What would you say? Is it really going to reduce the overall cost of funds for the bank in 2011? If it is then again you have to adjust your look at interest rates.

Mr Clyne—Just look at the competitive rate—separate that from the RBA the rates—that we put into the market based on our cost of funds.

Senator McGAURAN—Yes.

Mr Clyne—The answer is that I do not know. We will raise about $28 billion next year. We do not know yet the level of covered bonds we will be allowed to raise or the appetite in the market, but if we are able to replace some of that $28 billion with covered bond issuance that will reduce our funding costs next year.

Senator McGAURAN—But you do know the appetite in the market; it is absolutely minimal. Is that correct?

Mr Clyne—Not based on our New Zealand issuance, no. We have done two covered bond issues—

Senator McGAURAN—What of the Australians?

Mr Clyne—You are issuing to AAA debt investors. They can be from anywhere. In fact, most of our New Zealand issue went into Europe, from memory. The demand is global. We would have to look at the demand for that and the amount that we are allowed to do. They are going to be cheaper. By definition they will be cheaper than what we are going to issue wholesale debt funding at.

CHAIR—I have a couple of questions to finish off. While we are still on the cost of your funds, the RBA says in its submission that since mid-2009 the increase in costs has moved broadly in line with the cash rate. Do you agree with their conclusion?

Mr Clyne—No; we think there are move moving parts, particularly in the costs of deposits. There are a number of data points that they do not necessarily have full access to. We think that there is a—

CHAIR—You think that they do not have complete information.

Mr Clyne—They are basing their assessment on what they can see. From what we can see we think there is a 10 to 20 basis point differential. The cost is higher.

CHAIR—They say that the increase in the long-term debt is offset by a decline in relative cost of short-term wholesale and fixed-rate funding. But you do not agree with that.

Mr Clyne—We see that our cost of funds has risen beyond what their assessment is.

CHAIR—Te other question on costs is: when would the cost of your funds have peaked?

Mr Joiner—We still have some pre-crisis wholesale to roll off and roll back on.

CHAIR—Presumably it is a bit like a bell curve—

Mr Joiner—Yes.

CHAIR—but at what point in time would you have reached the highest cost in terms of accessing funding?

Mr Joiner—It moves around, but probably another 18 months or so.

CHAIR—Sorry, I meant in the past, in terms of the individual cost that you would have had to pay during the crisis.

Mr Joiner—Deep in the crisis, when everyone thought the capitalist system was going out the window—

CHAIR—Yes, when during that would you have hit the peak in terms of the spread that you would have had to pay?

Mr Clyne—I cannot remember when it was. It would have been about 18 months ago: in March-April 2009.

CHAIR—You have answered the question I was heading to. In 18 months time you will reach the peak. You are saying that the long-term cost of your funding will keep on increasing for another 18 months, as you come off the—

Mr Joiner—Yes, but at a more gradual rate.

CHAIR—But that is the long-term. Obviously the short-term has different factors at play.

Mr Joiner—Yes, the short term has gone down. It remains to be seen what intensity there is in deposits, given we have all got this Basel III change.

CHAIR—That impact of increase will continue for about another 18 months. After that presumably you will be renegotiating your long-term debt on the basis of coming off very high borrower costs on to what will be presumably lower in 18 months time.

Mr Clyne—That is correct, and it may be 18 months but when customers see the Reserve Bank rate go down and the banks go down beyond that—

CHAIR—That is what I was going to ask. Will that be happening?

Mr Clyne—If we are publishing our funding data as we have then it will be quite transparent that in fact that is how our funding data is moving. We have put our funding data out there since April last year to justify what we think is increasing cost. If we continue that, which we are committed to do, then you see the point where it comes out.

CHAIR—Obviously it is not in full detail, because the RBA cannot analyse it accurately. The data you put out there, you remove commercial-in-confidence or remove detail—

Mr Clyne—No, we have been putting quite transparent data out there for 18 months.

CHAIR—Then why can't the RBA properly assess your costs?

Mr Clyne—We look at—they will make their own assessments. We have been putting that data out there to show—

CHAIR—You think they should be able to draw the conclusion that you have drawn, on the basis of the information they have?

Mr Clyne—I cannot comment on what drivers they are using, but we are just putting our data out there as we have been and we will continue to do that. There will be a point in time when in fact, much as we are rolling from less to more expensive, we will be rolling from more expensive to less expensive.

Mr Joiner—We have about $46 billion of short-term wholesale that will need to be replaced with long-run wholesale under Basel III over the next several years. That is going to cost more.

Senator XENOPHON—Perhaps you can take this on notice. In terms of the Basel III changes, do you think that those changes are unfair in relative terms given the state of the Australian banking industry and the state of regulation? You may want to take it on notice. I do not know whether you can answer it now.

Mr Clyne—I think it is more appropriate for APRA to comment about how they see it. But it is fair to say that the reforms are going to add cost to the system; higher liquidity, more term funding will cost, and capital.

Senator XENOPHON—Are we paying for the sins of other banking systems, in a sense, through Basel III?

Mr Clyne—I think it is really not appropriate for me to comment on it. But you cannot stand aside—we are issuing lots of debt into in offshore markets and you do need to be able to stand up there credibly and say you are adhering to some global standards, but they are going to add cost.

Senator XENOPHON—Sure.

CHAIR—One final question, and in view of your comments about a banking inquiry to end all banking inquiries this is sort of relevant. Looking at the achievements of previous reviews such as the Campbell inquiry and the Wallis inquiry, do you think there is any value in having a new independent financial system inquiry that looks as at all aspects as opposed to this one, which is just looking at competition, and done on the independent basis, given the changes that have occurred in recent years?

Mr Clyne—I certainly think we need to move to an environment where we are trying to end what is clearly at the moment a disconnect between the bank industry and the wider community. If that type of inquiry is a positive step forward to improve the communication process, we certainly would not be opposing it.

CHAIR—Thank you, Mr Clyne, and officers of the National Australia Bank for attending today.

[2.39 pm]

DEGOTARDI, Mr Mark, Head of Public Affairs, Abacus

PETSCHLER, Ms Louise, Chief Executive Officer, Abacus

CHAIR—Welcome. Thank you for attending today. Do you have an opening statement?

Ms Petschler—We do, thank you. We have a short opening statement and then we would be happy to take questions. As you would know, Abacus represents Australia's mutual banking sector, about 115 credit unions and mutual building societies who together serve 4½ million customers, or members, as we say, around the country. Our industry is very proud of its credentials, with a long history of safe and prudent management of our members' money and products and services in banking that put customers first, also our history and our track record of sensible and well-funded growth.

This approach that our credit unions and building societies have shown allows us to sit here today representing the banking sector with the highest credit quality in the market, the lowest amount of arrears and bad debts, the highest levels of liquidity and capital and the highest customer satisfaction ratings in the market. Abacus members—our credit unions and mutual building societies—are mutuals. They are owned by their customers and they are built traditionally around the ethos of self-help, with mutuality the cornerstone of the industry's values and practice. This is a very different model from those that our listed banking competitors have. Our industry absolutely and unambiguously puts customers first. Our shareholders are our customers, so we are fortunate not to have to struggle with some of the tension and divide between shareholder and customer returns.

We believe credit unions and building societies have earned their reputation for service, value and security, and that, on the basis of that and our broad representation across Australia, we are natural, prudent and credible place for policymakers to turn to for advice and input on increasing competition in the Australian banking market. Credit unions and building societies are going to be delivering a competitive alternative in banking long after the current media debate is over, and well into the next one, but our industry feels this is a great opportunity for us to make some sensible and well-thought-out reforms that well increase the vibrancy of our banking market and deliver to consumers the competition they are after.

We welcome the government's announcement yesterday as a constructive step towards those long-term reforms and we welcome this committee inquiry as well, which we hope will give us a bipartisan space to go through some of the initiatives and some of the further opportunities that we see. Obviously with the government's announcement yesterday there has been a bit of a focus on whether mutual banking institutions will become the fifth pillar, a stronger competitive alternative to the big banks. There has been a lot of commentary both in the committee today and through the media over the past 24 hours. Some of it has been very sensible commentary about what more needs to be done in wholesale markets and some of it has probably been a little bit silly.

But I want to reflect briefly on what credit unions and building societies think in terms of the package that was announced yesterday and the opportunities ahead. We do think there are some very important positive steps in the Deputy Prime Minister's announcement on banking competition and, unlike some of the banks, we feel that they will make a real difference in terms of consumer choice and competition. No doubt you have heard today claims that there is plenty of competition in the banking market. But competition has to be more than just rebadged offerings from the same factories and it needs to be about more than immediate price points. It has to be about access, price, products, service standards and choice. We have argued that awareness and understanding of our prudential system—of which we can all be rightly proud—and the cost of wholesale funding have been obstacles to credit unions and mutual building societies increasing their market share and being able to afford a higher degree of competitive pressure on big banks. So we were especially pleased to see, in the awareness piece in the government's package, a focus on a better explanation of the prudential system and a better explanation of the fact that your deposits with any banking institution—whether it be a big bank, a regional bank, a building society or a credit union—are covered by the same protections and administered under the same rules.

Linking that with the proposed campaign will, we think, make a difference. We base that not on a feeling we have but on 18 months worth of market research on the barriers that people have to switching to credit unions and building societies. We constantly find the view that the big banks are covered by a separate and better regulatory system, and that is a barrier to change. So we see the idea of the protected deposits seal and that link back to government regulation as a very pro-competitive reform. It is, I guess, a variation of the recommendation that we put forward to clean up some of the regulatory language in the Banking Act and call banking institutions 'banking institutions', but we believe it will achieve the same result.

Importantly, if it is coupled with measures that make it simpler for Australians to move between banking institutions—and my colleague Mark and I have some ideas that we are happy to share about ways that that could be done—that will see a greater degree of contestability in terms of the retail banking market. I should emphasise that it is very much the retail banking market that credit unions and mutual building societies are engaged in. We think that is more than window dressing and will certainly be putting our weight behind it in terms of using it as a tool to remind more Australians of the choice they have and of the options they have outside of the big banks if they would like to look at a customer owned model.

In terms of the cost of wholesale funds, we have seen some constructive steps made and we are going to continue to see opportunities for reform and for further engagement by the government. For us, the retail deposit guarantee is part of that funding picture. Credit unions and building societies have always been, and will always be, majority deposit funded by their retail depositors. It is our view—while we welcome its continuation and that announcement yesterday—that the retail deposit guarantee at a level of $1 million helps us compensate for some of the lack of community understanding of the fact that we operate under the same regulatory system.

In terms of the broader wholesale market, the Treasury has been committed to actively facilitate credit unions and building societies working together in aggregated vehicles to raise wholesale funding. We have two quite advanced initiatives underway in the industry at the moment as well as our industry centrals, like Cuscal, an AA-minus bank that the credit unions own. We have a range of ways in which we can build on the collective balance-sheet strength of the industry. There are some tweaks that we need and some approaches that we are looking for that we hope will come from the active engagement of Treasury.

We also welcome the government's announcement of a further tranche of AOFM's RMBS investments because the recovery of the securitisation market and better pricing for smaller banking institutions will help regional banks, us and non-bank lenders to deliver tighter pricing and put more competitive pressure on the banks. We see the announcement yesterday as a constructive start to the long-term project of bringing more competition to the big banks. We are going to use the consultations that the government has announced as a way of generating further ideas around initiatives to help bring vibrancy to the banking market and a true sense of contestability to consumers going forward.

In terms of the focus on credit unions and building societies, we have not and are not seeking any radical or ad-hoc special deals for our industry. We have been around for a long time and, as I say, we will be around for a lot longer. But we would like to see increased recognition of the value of the mutual structure in financial services and in our laws and the role that we play—and that we intend to increase—in terms of competition and prudent banking practices. Australia is one of the few jurisdictions with a big credit union system that does not have any recognition of the mutual structure within its banking laws or financial services regulations. We think there is a case to say that a fair regulatory system should work for us as well as the big guys and the smaller banks. That is why the work that we are hoping to progress on options for mutuals to release franking credits, for example, is an important initiative from our perspective. It would help us deal with what we see as a barrier to competition.

We are very keen to bring more competitive pressure to the banks. We do not claim that we will always be the cheapest, but we do believe that over any reasonable period of time consumers will get a great deal if they look at a credit union or a mutual building society. We see this committee's work and the government's announcements yesterday, the ongoing debate with the opposition, as an opportune point in time for us to address some sensible, well thought out, pro-competitive reforms that will make a difference for Australian consumers. Thank you.

CHAIR—Thank you. In respect of the government's proposed reform, to what extent, and when, were you consulted on the detail of that?

Ms Petschler—We were not consulted on the actual package, but it is fair to say—and I am sure this is true of all banking institutions—that we have regular engagement with Treasury. Over the past two years we have had many conversations with government about our ideas about ways to bring more competition to the banking market. Certainly over the last three months, Mark has made a number of submissions about the ideas on that that we think are worth while. We received the package when it was released at 11 am yesterday, but, based on the discussions that we had had as part of that policy process, we were hopeful that there would be some recognition of the issues that we had flagged.

CHAIR—That is interesting. The government told us during the last sittings of parliament that they could not release the proposed package because they were consulting and they needed to work through it and make sure that all the issues were dealt with.

Ms Petschler—It may well be the definition of consulting.

CHAIR—It may well be.

Ms Petschler—If you look at covered bonds, I think the discussion with the major banks and Treasury about covered bonds has been going on for over 18 months, potentially. Some of those issues are subject to a long policy development process.

CHAIR—We will leave it at that. I could go into it more if you want to, Senator Cameron.

Senator CAMERON—Fine. Go for it.

CHAIR—Do the reforms as proposed, in your view, deliver a level playing field between the banks, particularly the big ones, and mutuals?

Ms Petschler—I think they are definitely a step forward. As I mentioned, there are some areas—and franking credits is one example—where we find we are a bit of a square peg in a round hole in terms of the Corporations Act and the Banking Act. We don't want to not be covered by those bits of legislation and the rules that we have, but we see in jurisdictions like Canada and in the European Union's implementation of Basel that there is recognition of a customer owned structure. That is an area that we really have not had a lot of traction on, and we are keen to look at funding costs—the real killer issue in terms of greater competitive pressure on the big banks. While it is not as significant for us, it is certainly quite significant for mutuals and definitely so for the regional banks and non-bank players. I think that is where we still have a bit of work to do to get to a level playing field.

CHAIR—In terms of funding costs, securitisation is obviously an important aspect to the mutuals as well as others. But mutuals, certainly prior to the GFC, were making full use of that. The RBA told us this morning that the securitisation market in Australia is now effectively near its natural level, primarily because a lot of the investors in that were in existence based on business models that were unsustainable. They told us that the level of activity that exists now, in their view, is pretty close to where it will naturally be. Is the level of activity in securitisation markets sufficient for your members to get the funds that they need to be able to compete?

Mr Degotardi—The quick answer is no. We would certainly argue that the securitisation market needs re-invigorating, and if we are to provide more competition then access to more wholesale funding sources, including securitisation, needs to be improved. If the securitisation market were to remain the way it has been over the last 12 months permanently into the future, clearly that is a challenge for us in terms of diversifying our funding.

CHAIR—I do not want to misquote the Reserve Bank governor, but it was a surprise to me. He was indicating that the intervention by the government—the $16 billion so far and the $4 billion proposed—is welcome and is needed to help keep things going along, but in terms of the actual size of the securitisation market the indication, as I understood him, was that it is not likely to get a lot bigger.

Mr Degotardi—I think all the people that we have dealt with, our industry partners and others would suggest to you that the securitisation market will never get back to the level that it was before the GFC. I think that is accepted. Are we at the natural level? I am loath to contradict the RBA governor too, but it is certainly not the expectation of the people that we are talking to, and certainly that is not our hope.

CHAIR—We might ask the Australian Securitisation Forum that tomorrow as well.

Ms Petschler—Our members say it is not access to funding that is the issue.

CHAIR—It is the cost.

Ms Petschler—It is still the cost, and the cost differentials still do not translate well to the quality of the underlying assets for smaller institutions.

CHAIR—I note in your submission that the lower level but still very secure RMBS needs a bit of a push along as well. I will turn to another thing that interests me, and it is relevant to the reform package announced yesterday as well. In your submission I think you say that 27 of your members would qualify to take on the label of banks if they approached APRA and asked for the right to do so. Why do your members not take up that opportunity?

Mr Degotardi—At least some of them would consider ‘bank’ not to be a great brand right now, and that is certainly part of the driver. But one thing that credit unions and building societies have always represented is a model of customer owned banking. Up until this point, most of our members have considered that that is the brand they want to pursue. Certainly in our submission, and we did not get it in the package yesterday, we asked for a tool from government that would help us with the consumer awareness piece, which was the issue around the approved or authorised banking institution. We did not get that but we did get a substitute yesterday in the government protected deposit seal, and that certainly will go some way to improving the awareness of consumers around regulated institutions. I think now that some of our institutions will consider asking APRA to consider their application for a bank licence.

CHAIR—Particularly given that there was a change in recent years—I cannot recall how long ago it was but it is certainly in the last decade—that allowed your members to become a bank whilst still being a mutual. Your members do not need to demutualise as they once did to become a bank.

Mr Degotardi—To be clear: none of our institutions is considering demutualising to become a bank.

CHAIR—But you can do it now, despite going to APRA and saying, ‘We’ve got the $50 million and all the boxes are ticked; appoint me a bank.’

Mr Degotardi—Our largest mutual has more than $500 million in its capital, so they easily qualify in that regard. For us, it is a question of what they do with that. Perhaps they will become a bank and then tell people that they choose to be a credit union.

CHAIR—It does confuse me reading in your submission where you are pushing for the right to be called an Australian banking institution yet, where your members have the opportunity to call themselves a bank, they do not. Even though they could now be the Gundagai credit union, they could become the Gundagai credit union bank.

Mr Degotardi—The point we make, though, is that we think it is the terminology and the reasoning around the approval that need to be completely revisited. Our point is that those old benchmarks set down for ‘bank’ and the use of banking by APRA and under the Banking Act should be reviewed, because we think they are based on old terminology and do not reflect that we all meet the cost of being an ADI currently. Everyone from the smallest credit union to the largest bank meets those standards. Our point, which we have made to government and reiterate to the committee here, is that the best barrier, the best test we have is APRA and its regulatory system. It is not easy to become an ADI so, for us, it is a little anomalous that we are not allowed to use generally accepted terms like ‘banking’. We do not want to be banks. We want to be mutual loan institutions, credit unions and building societies. We just do not want to be restricted in terminology that is easily understood in the marketplace. Currently, we are.

Ms Petschler—I would like to add to that. Credit unions see themselves as part of a global credit union system and there is a very strong attachment, for better or for worse, to that name. But I suspect the consequence of not changing the regulatory terms will be that we will start seeing ‘mutual bank’ and ‘credit union bank’ used.

CHAIR—I can understand where you are coming from and where your members are coming from. I respect their position and I can see exactly why they do that but, sitting on this side of the table where we are looking at ways to try to increase the level of competition in the banking industry as a whole, I suspect that, from the perspective of the broader public, some of your larger members calling themselves banks would be viewed by the public in a way that would probably enhance competition. I think there would be some degree of support by the public for people like St George Bank when it went from being a building society to being a bank. They liked seeing that there was another big bank out there, even though it probably was not that much different in how it operated—I think it had to demutualise. If some of your bigger members did that, I think it would increase in the public mind the reality that there is more competition out there.

Ms Petschler—That is no doubt true. But we do turn back to the fact that all the institutions, all the ADIs, meet the same standards and have the same protections. We were hopeful that, from the smallest to the largest, we would have the opportunity to at least talk about calling them banking institutions. But I think that your view is right and we will see that happen.

CHAIR—I can understand your argument on that as well. I am not arguing against it. I am trying to get my head around the space that you are in in terms of what we trying to deliver in enhanced competition.

Mr Degotardi—I think there is little question that, in the light of yesterday’s announcement, some of our members will consider their position and make that clear fairly soon.

CHAIR—Another point you made in your opening statement was in terms of your welcoming making the deposit guarantee permanent. You mentioned the figure of $1 million. I asked Treasury this morning whether the $1 million would continue and the indication was that there is no guarantee of that. All that has been undertaken at this point is that there will be a scheme which covers deposits for all ADIs and beyond that the structure of that scheme may be quite different from what we currently have as the temporary measure. I am not sure whether you were aware of that but you mentioned $1 million, which made it sound like you were under the impression that it would continue as $1 million.

Ms Petschler—I think the structure is reasonably well advanced in terms of how the scheme will operate.

CHAIR—Have you been consulted on that?

Ms Petschler—Absolutely.

CHAIR—Well, you know more than I do then.

Ms Petschler—But the $1 million amount is our preference. We argue that you should not move from the $1 million, that people understand it, that it is simple, that it gives the vast majority of retail depositors comfort in dealing with a smaller bank or a credit union or a building society. Now that is obviously a position that we are going to be arguing with the government over the next few months, and that is our absolute preferred position and I would encourage you to speak to the regional banks as well.

CHAIR—In view of the time, I will ask just one more question on that. I note that you argue in your submission that it should be $1 million and you say:

Investors with more than $1 million to deposit are more likely to be able to contribute to the market discipline necessary …

I can understand you are saying that people with more than $1 million would have discipline, though surely most people with half a million dollars would also have that sort of discipline.

Mr Degotardi—Not necessarily. You could sell your house and have half a million dollars in the bank and—

CHAIR—Well, you sell your house these days and you have a million dollars in the bank.

Mr Degotardi—Yes, depending on where you live. So for that period of time you might not fall into the sophisticated investor test basket, but certainly we think the real issue around the guarantee level is that that is where it is set, that is where consumer expectations have been set, and certainly we would be disappointed if consumers were led to accept something else and therefore formed a view of our institutions as being somehow less safe and secure as a result of that change.

Ms Petschler—We may have expressed ourselves poorly there. One of the issues we trying to get at is that you can expect players in the market at a larger level to understand the prudential system, but I would not want to wish understanding that prudential system and reading the Banking Act on normal human beings. I think we should do our best to shelter them from that terrible cost factor as much as we can.

CHAIR—Fair enough.

Senator XENOPHON—Ms Petschler, is it fair to say that, in terms of the services that you provide and certainly the home lending market and those sorts of consumer services, you are up there with the banks in terms of the range of services? To what extent though do you provide the level of business banking services for small and medium enterprises? Is that something that is not an area of specialty for your members?

Ms Petschler—It is not an area of focus—absolutely—and if you look at our total loan book it is a relatively modest proportion and we are definitely—

Senator XENOPHON—How modest?

Ms Petschler—Mark has got the figures in front of him.

Mr Degotardi—Our sector does roughly $2 billion in small business finance.

Senator XENOPHON—What is that as a proportion?

Mr Degotardi—On quick maths, that is about three or four per cent of our lending.

Senator XENOPHON—Thanks.

Ms Petschler—It is at the small end of the SMEs. It tends to be secured lending, secured with mortgages. However, I would say that varies. Like everything in our sector, we are talking about some regional areas where we have got really big brands, like Newcastle Permanent Building Society and Greater Newcastle. They do quite a large amount of commercial lending. Smaller institutions that have a much more pure retail focus would do much less. So it is definitely an area that we see as a growth opportunity in regional areas where we have over 70 per cent of the market. So in those places we are able to really kick that off.

Senator XENOPHON—Thank you for that. I will move to the area of switching, and Bernie Fraser will be looking at that whole issue. I think some banks are saying it is going to be too difficult or it will take forever to achieve it. What is your view? Do you think there are ways to make it happen—and I think Cameron Clyne from the NAB said that there was scope to try to make it easier for people to switch from one institution to another. What is your view? What is your take on the IT and the IT capabilities of this?

Ms Petschler—I will let Mark speak about the actual portability of the account number and the IT aspect. From everything our member institutions tell us, it would make a massive difference if we had a standardised process with an obligation on the bank that you wanted to leave for a way to verify your identity. That would take a lot of the angst out of transferring for consumers.

I am not sure that we need an expensive, high-tech solution. We see in some other countries that there is a process where you tell the new bank that you want to leave the old banking institution and they have a positive obligation to provide standard information in a set time frame and a way of verifying that it is the right person.

Senator XENOPHON—So that might be another way—if you sign an authority that triggers a whole chain of events?

Ms Petschler—But an obligation on the banking institution that the consumer wants to leave to do things in a timely fashion. In the UK they talk about six days. Those things would make quite a big difference, on both the mortgage and transaction account side, because our member institutions tell us that it is delays on discharges and problems for their potential members in trying to get information in a timely fashion that can hold things up.

Senator XENOPHON—Can you take on notice to tell us if you are aware of other jurisdictions where that is occurring? Could you provide us with further details on that? That might be at least an interim solution or it might be an alternative solution to the whole issue of transferability and the ease of access for consumers.

Ms Petschler—Absolutely. In terms of the portability of numbers, credit unions and building societies are one of the problems. Our numbers are shorter. Because we connect through central agencies, the banks see a different version of the account number than the actual account number and we allow our members to attach all sorts of different accounts with different numbers.

Senator XENOPHON—You do not think in big numbers, do you?

Mr Degotardi—Our members might see the banks as a problem because their numbers are too big! If it is to be only a technological solution that presents challenges for small institutions, we need to be a bit careful about that. But should we invest in a process of getting a better account portability? Absolutely.

Senator PRATT—Can I ask how progress is going in relation to aggregated funding? I understand that the government is doing work on that with the sector. I would like to ask how the government is progressing with that and, in turn, how your sector is progressing with that.

Mr Degotardi—One of the ways that credit unions and building societies, as small institutions, access these markets is through aggregated power. They have been doing this for quite some time, through institutions like CUSCAL and others, where aggregated service providers provide their ATMs et cetera. Groups of them are getting together and looking at ways that they can crack this nut. Obviously, for a $100 million credit union or a $200 million credit union accessing the wholesale market on its own is very, very difficult. But together their balance sheet power is a really useful way of doing that. We have been engaging with the government and with Treasury on how to do that. They are very complex transactions, but we are very pleased with the progress to date. We are hopeful that those funding groups will be able to access those markets in the near future.

Ms Petschler—It is our perspective that it is more the industry than the government that is doing the work at the moment. We are keen to see that 'actively facilitate' element of Treasury taking hold of those opportunities.

Senator PRATT—The recent government statement says 'continue helping mutuals to develop a structure to raise aggregated funding'. I suppose we will see what they continue to do in that context. How is it that mutual banking institutions set about to compete with bigger banks, given the argument that your costs are higher? How do you characterise your position on in the marketplace?

Ms Petschler—That is quite a common question. The reason we get that a lot is that we are a lot of small institutions. There are two factors to it. We operate a national system, so the individual institutions do not stand alone; they connect through central bodies that hook them up with VISA and payment systems. You heard Mr Clyne talking about the rediATM network. That is actually a network owned by the credit unions, so that is an example of how they work together. They do pool their liquidity to be able to drive better outcomes on wholesale funding as well. The other driver, really, is the advantage we have in that our shareholders are our customers. That does give us a pricing advantage because we tell our members that our dividend is going to be in service and pricing and they certainly hold us to account if we do not meet that promise.

Mr Degotardi—The interesting thing is that we crack that nut through aggregated ways, but one of the advantages we have is that we get community engagement on a very individual and local level. That is one of the benefits that the diversified institutions bring.

Senator PRATT—I note that your submission talks about the need to combat consumer misconceptions and that the package recently put before us seeks to address some of that. Will the package make a real difference, particularly in the context of the definition of ‘bank’? We have already had some discussion about the 20 credit unions that might already be eligible to meet APRA’s authorisation guidelines. I would like to ask that about the marketing for your institutions in the context of all those issues, for those 20 credit unions, but also in the context of the review of current guidelines that might, I suppose, see more of your institutions eligible to use the term ‘banking services’.

Mr Degotardi—Again, our institutions certainly would like to be able to have better consumer awareness. There is no question in our mind that the government protected deposit seal that we are able to use as part of the package yesterday will be very helpful to our sector and to other small lenders to clarify exactly who we are and where we stand, as Louise mentioned in her opening statement. There is absolutely no question that our research shows that consumers need to be given more information so that they can make better decisions around the institution they choose. Certainly we think the awareness campaign, with the logo, will be a really instructive way of doing that. Individually, our institutions are doing their own work to help themselves, and that has always been a feature of our industry. Certainly, when we engage with APRA around the review of what should be the appropriate level of the banking licence requirements, we will certainly put our views quite forthrightly. As I expressed to the chair a little earlier, we think simple terminology, understood by consumers, is not a big ask. It is not going to fundamentally rock the banking system. We think it is just a word that consumers will understand.

Senator PRATT—If it is just a word for consumers, why do you think there has been such resistance? Have the banks in some way sought to preclude you from using the word?

Mr Degotardi—I suspect there is no Machiavellian plot by the large four. I certainly think it is a basis of history, in part, and points in time come when history needs to be revisited. This is the appropriate time for—

Senator PRATT—So you would say that the preclusion on using the word does put the mutual banking sector at a competitive disadvantage because of the common perception about what 'banking services' means?

Mr Degotardi—It is certainly not helpful.

Senator WILLIAMS—You said Abacus strongly rejects the notion that covered bonds are pro-competitive. So you are saying the decision yesterday is not going to do a lot to add competition?

Mr Degotardi—There was a lot of discussion in the lead-up to the announcement of the package yesterday by other industry associations who are obviously pursuing other interests, suggesting that covered bonds was the competitive solution to the money market. To be clear, Abacus does not have a problem with the concept of covered bonds. It certainly makes sense in terms of broadening the funding diversity of large institutions, but is it going to be a single source or a huge source of funding for smaller lenders? No, we do not think so. Will that lessen the pressure on other sources of funding that we access and that those larger players access? The jury is out a little. We suspect it will help somewhat less than other institutions, but some our institutions equally, including one of these aggregated funding groups, is looking very actively at issuing covered bonds. We are hopeful that we will be able to access that market, but we certainly wanted to make clear in the lead-up to the announcement yesterday that it should not be the only component of the competitive package.

Senator WILLIAMS—If the government were to reintroduce a wholesale guarantee for Abacus members—the smaller players in the game, if I can put it that way—with a fee that does not rip you off, that would surely assist you to access funds at a more competitive rate, just like the big four with their credit ratings. Is that correct?

Mr Degotardi—Yes, it is.

Senator WILLIAMS—Have you requested the government to do that?

Mr Degotardi—We certainly put in a submission before this inquiry and we have certainly made that clear as one of the options that the government should consider. We are not, however, immune to some of the arguments against such a market intervention; it is a significant market intervention. I guess the point we would make, however, is that during the GFC the largest banks accessed a wholesale government guarantee that we were not able to access because of the differential pricing on that guarantee. The cost for us therefore was too expensive. And that did put us at a disadvantage. A guarantee to even-up that playing field now would have been a simple solution, from our perspective; perhaps not a simple solution from an international market and government perspective.

Senator WILLIAMS—You mentioned superannuation funds. I think one of your members basically asked, 'Why aren't superannuation funds investing with us?' That is a question I have asked for many years. We borrow a lot of money overseas. We have $1.3 trillion of Australian savings in our super funds. Why don't they invest more of that money with people like you? You are a guaranteed ADIs; you are not going to fall over. You would think you were a safe investment. Why don't the super funds invest more with you?

Mr Degotardi—It is an excellent question. We certainly are not in the position of saying to government or anyone else that they should mandate the way that super funds invest their funds. My money is in a superannuation fund, so I want to make sure they are doing the right thing with them. But certainly we think that if we can divert some of that investment in a sensible and prudent way into ADIs, generally speaking, then that is a good thing. Our advice is that the suggestion around bullet bonds and bullet bond securities that was talked about yesterday may in fact be one of those ways, and we are very hopeful that that will be a way in which we can access some of that funding.

CHAIR—I have a final question—I could ask you a few more but, given the time, I will not. You acknowledge the important role that public debate over the past month has played in raising banking competition as an important issue for government and consumers. Has the raised level of awareness of the issues surrounding banking actually led to an increase in inquiries, particularly from the major banks but also from customers, to your members?

Ms Petschler—It absolutely has. The difference between this debate now and where we have seen this come up before is the level of interest and the number of inquiries and, in fact, applications that our member institutions are receiving. A number have reported 300 per cent increases in actual loan applications. We saw in the October ABS stats that our market share of home loans grew well in excess of the banks' and we are holding our highest level of market share for 12 years—that is pre the last month's worth of debate. We have heard some terrific stories from some of our members who are opening new branches where their builders have had to put up barricades because of the number of people coming in and saying, 'When are you going to get this branch open so I can quit my bank?' There is definitely a real appetite for change, and the easier we can make it for people to change and have options, the more we are going to see the result. But without the ability to really access wholesale funding at an affordable rate our degree of growth will be constrained because of that present level.

CHAIR—Because you just do not have the money to onlend, basically?

Ms Petschler—As I said, we are running levels of liquidity of about 18 per cent, so we are very liquid. But we will not hit the accelerator on growth unless we are confident that if those funds all disappeared we would still have other options in the medium term.

CHAIR—There is a limit to which you can actually meet the demand if it grows too quickly, given your current funding?

Ms Petschler—That is true, although, Mark, you looked at some statistics about what a doubling of our market share would need and it is actually, we believe, well within our means for that kind of growth.

Mr Degotardi—That is absolutely right. We are certainly not going to hit those boundaries any time soon and we are more than capable of dealing with demand.

CHAIR—So where would the extra funding come from if that did happen?

Mr Degotardi—We are continuing to grow our deposit base now. Some of our institutions have accessed the AOFM money as well and we will hopefully do some of that new money as well. Perhaps as we work through the bullet bond securities and other things we will access that money over time. Certainly if we were to have the same conversation in 18 months or two years time that would be an issue for us.

CHAIR—What we have heard today is that there is competition for the funds to onlend. What if that is the case and it is harder to get hold of the funds? You say you are maintaining a degree of liquidity. That means that you have some room to move at the moment in terms of lending, but you are not at the point yet where you think you need to start discounting to onlend and not fight as hard to get funds in to then lend out. But there is obviously a balance that you need to maintain within certain parameters, in terms of how much you raise, how much you lend out and how hard you try at each end.

Ms Petschler—Absolutely. APRA focuses very much on the funding plans of our institution, and we regularly go through testing processes that assume terrible catastrophes that hopefully never happen—and I touch wood while I say that. It covers everything—from natural disasters through to a big bank collapsing et cetera.

CHAIR—And all the stress tests.

Ms Petschler—Absolutely. We need to really hit the accelerator on growth. We need access to those funds but at a cost that lets us be competitive to meet that demand. In terms of doubling our market share at the moment, we estimated that our really big credit unions and building societies would only need to write another 25 home loans a week and our smaller credit unions and building societies would only need to write one extra home loan a week. That is definitely well within our current funding arrangements.

CHAIR—And that could double your share?

Ms Petschler—Absolutely.

Senator McGAURAN—What is your share?

Ms Petschler—We are writing about 9½ per cent of new home loans at the moment. We are about 11.2 per cent by value of the household deposit market—not all deposits; household deposits—which actually makes us the fifth largest holder of household deposits in Australia after the big four.

Senator PRATT—In terms of the debate about what is being characterised as a fifth pillar, for you to go from 10 to 20 per cent, if there is such a plan to double your market share, that is what it would like shortly.

Mr Degotardi—That is right. What I would be very keen to emphasise, though, is that we do not have aspirations to be the CBA, but I can certainly tell you that, if we get ourselves into a position where we begin to take market share away from the major banks and other institutions, that is competition at work. That is when you have the competitive market happening. So whether we end up at 10 per cent or 12 per cent or 15 per cent, it is really in some ways a moot point if we are putting that competitive pressure into play.

Senator PRATT—In a sense, if you were the Commonwealth Bank that would almost defeat the purpose of competition because you actually need the smaller players to provide a diversity of competition. If we just had another big bank and no small players in the market, we would probably be in exactly the same boat, I would suspect.

Ms Petschler—I think that the last 20 years of retail banking in Australia shows you that you will find the sharper price competition from smaller non-ADIs, non-banking institutions. We absolutely agree that there is a very legitimate role for community based ADIs. We are part of sharing the risk of the banking system as well.

CHAIR—Thank you for your evidence today.

Proceedings suspended from 3.22 pm to 3.34 pm

BOURIS, Mr Mark Leigh, Executive Chairman, Yellow Brick Road Wealth Management

NICHOLSON, Mr Bryn Conway, Chief Operating Officer, Yellow Brick Road Wealth Management

WILLIAMS, Mr Owen Francis, Non-Executive Director, Yellow Brick Road Wealth Management

CHAIR—Welcome. Would you care to make an opening statement?

Mr Bouris—There is a distortion today in how banking is conducted and is perceived to be conducted in this country. The complaint emanates not only through the media but, most importantly, through consumers. It appears to be unfair that there is a lack of choice. What I mean by unfair is the perception that banking is unfair in this country through lack of choice. Mind you, I am not here to opine on whether that complaint is true or not; that will stand on its own two feet. If it appears to be unfair, it needs to be addressed as the perception obviously can aggravate the distortion.

This unfairness really emanates from the control of both the liability and the asset sides of the balance sheets by the four major banks in this country. We need to change the perception. To do so, we need to build a structure to encourage new entrants into the banking environment and to enhance the current competitors to the big four. It does not really matter who the new competitors are, but we would expect that they should include not only nonbanks but also foreign banks, mutuals and regional banks and be all-inclusive.

We take the view in our submission that a fifth pillar can be created not as any one entity but rather as a market segment or a collective of medium sized Australian lending institutions. That would not be dissimilar to how the non-bank financial institutions formed a segment in the 1990s and early 2000s, taking about 20 per cent market share from the banks in lending. I hasten to add that we are not trying to recreate the non-bank financial institution, or NBFI, market.

Today the solution to creating a fifth pillar, being a collective of medium sized Australian lending institutions, needs a change in liquidity. Our submission deals with liquidity in two ways. We take the view that liquidity will not come from any one particular source but needs to come from a combination of sources. First and foremost is the mutual segment, whom you heard from prior to us. Credit unions and building societies have in the past been a valuable alternative to banks. We submit that the government create further assistance in making the mutual segment a more attractive place to deposit your moneys, by guaranteeing Australian depositors exclusively in relation to mutuals. That would allow them to build the deposit side of their balance sheet, which in turn requires them to acquire more assets.

We commend the Treasurer’s statement today about the franking credit available to members of mutuals. That is another way of enhancing the way that mutuals can attract more deposits and greater membership. Of course, one of the most important things—and the previous speaker spoke of this—is that anything that allows there to be further understanding of the mutuals’ work and their safety et cetera will, by definition, immediately create a greater volume going both into the deposit part of the balance sheet and into the asset part of the balance sheet. So an education awareness program funded by government around the safety of mutuals is very welcome.

At Yellow Brick Road we have introduced a very unusual initiative—and it is unique to us—in relation to the mutual segment. We have an exclusive distribution agreement, white labelling a particular credit union's balance sheet to lend our own mortgage product. They build their liabilities; we originate the assets. The reason for this is that this particular credit union is very good at building the liability part of their balance sheet—in other words, attracting depositors. They have very good interest rates for depositors, they are a very safe organisation, they are APRA regulated and they have good access to members, who generally speaking put their money in deposit. What they are not that good at is originating assets. Of course, as their liabilities grow, they have a requirement to increase their asset position. We at Yellow Brick Road are very good at originating assets. We have done that through a branch based system throughout the east coast of Australia in the last 12 months. We now have 42 branches up and down the east coast of New South Wales. We originate mortgages through those branches and we put them onto the balance sheet of this particular credit union. I hasten to add that our interest rate—the interest rate of the combination of us and this particular credit union, known as Gateway Credit Union—is the lowest interest rate in the market in all categories. As I said earlier, they build the liabilities; we originate the assets. It is an unusual business model.

But of course the mutuals will potentially, if successful in this particular challenge, reach a saturation point—that is, they will get to a point where they need to refresh their balance sheet and need to access the RMBS market. The second form of liquidity that we are proposing in our submission is reigniting the RMBS market. Our assessment of the reason that there is not sufficient liquidity today in the RMBS market is more about market perception of asset qualities and liquidity. Therefore we propose a simple rebuild from the ground up of a new structure for RMBS in Australia for Australian assets. In my previous business, I was the chairman of a company called Australian Mortgage Securities, which was owned by Wizard Home Loans. We were the largest issuer of Australian backed mortgages in the world. I have had a lot of experience in this particular area. We created mortgage pools for about 12 years. Australian mortgages were well sought-after. There was a high demand for them. What has happened over the years is that there has now become a problematic perception of the value of Australian assets and Australian residential mortgage backed securities. That is something that is not hard to change.

In our submission, we propose that the new structure for RMBS relies on transparency, consistency and minimum standards, all with the objective of maintaining the perception and proving the reality that residential mortgage-backed securities in Australia are low risk. We are prescribing the creation of a pool of RMBS in Australia that are very prescribed in terms of geography, demography, LVRs, performance, seasoning et cetera. Just to name a few, we are requiring issuers to put equity into the particular issues—which is somewhat similar to the Canadian model, which shows that they are not just buying their assets or originating assets and then loading the risk off to somebody else—that they maintain equity in there; that there are minimum standards of quality in relation to not only the performance of the pool but how the pool is created; there is credit scoring and transparency; and that they have capped LVRs. The rest of them are contained in our submission. It is not an exclusive set—in other words, it is not designed just for people like us or credit unions; the banks can use the same process as well.

The model in the nineties for issues created supply—in other words, we would create the supply, go to the market and we would sell the supply, because there was massive demand for our product. In our view, what we have to do today is create a product class that meets the demand. Meeting the demand today means going out to find those investors and find out what the investors actually expect to see in a RMBS issue and in the portfolio in terms of the structure and quality of the assets.

In this country there is still a view that, when it comes to creating a RMBS issue, we go back to the old structures that we always created in the nineties and the 2000s. There has been a lot of talk about covered bonds and bullets. We understand how those all work, but they are structural issues with respect to cash flows and security. We are talking about going right to the heart of the asset, how it originated, what it looks like, who it is lent to, what its performance standards are and doing it time and time again. Once we create a set of these—obviously, with the assistance of the AOFM—we would then like to build secondary liquidity in the marketplace. What I mean by ‘secondary liquidity’ is having the opportunity for those investors who invest in these particular classes of assets to then be able to trade them on an exchange. We are proposing an exchange whereby these bonds can be traded both at a retail level and wholesale level.

Finally, as part of the standardisation process we submit that a recognised category of lender be established, known as an Australian Financial Institution. The AFI would replace the more difficult NBFI terminology that exists today. The NBFI terminology has its origins, which are actually positive origins, in the nineties. But today they tend to have negative connotations in the RMBS profile of originated mortgages, particularly with overseas investors. Overseas investors will eventually be required to give us enough liquidity to continue to build enough cash flow to lend. So we need to be able to do something to attract overseas investors, and overseas investors have a view on nonbanks. That is not to say that nonbanks have had a problem in this country, but they certainly have internationally.

Our submission in relation to AFI calls for tight regulation of these entities by APRA and, as I said earlier, the AFI will form a very important part of the rebuild of the RMBS structure. Our submission concludes with some remarks about the government’s position on funding such initiatives. We do not expect the government to fund this sort of initiative. We do submit that if it cannot be funded through consolidated revenue that a social licence fee on major banks, subject to conditions including capacity and other things, be used as a levy to fund the initiative in the early stages. So here we are talking about something that may last between two and three years. Just to ensure that this is a funded initiative, if for some reason there is enough consolidated revenue there to fund this sort of transaction then we do not propose that. But we do think there are ways around funding these things and we would not like to see funding used as an issue to say that this initiative is not possible. As I said earlier, this social licence fee is only one solution; others may certainly exist. I commend our submission to you.

CHAIR—Thank you very much. Yellow Brick Road seems to be quite innovative in its approach to the market that it deals in and, similarly, Mr Bouris, your experience with Wizard was quite innovative back when it was operating as a separate entity. What you have outlined today is fairly innovative and certainly different from what many of the other submissions have suggested. A lot of the suggestions in the submissions go to securitisation and how to restart the RMBS market or to grow it. But I think you have been a bit more specific and come up with some quite different proposals here. In terms of your current business, how much of this is built into that? You say that your expertise is in originating assets, not in attracting money in the first place.

Mr Bouris—To answer that question, in the Wizard environment we had a two-part business. The first part of the business was a branch based business which originated the assets; in other words, it did the lending, subject to the credit criteria that we set. We also owned a wholesale entity, which we bought from ABN Amro, which was the funder, which was the issuer of the bonds. So we did both sides of the project. We just were not—

CHAIR—That is primarily securitisation?

Mr Bouris—It is 100 per cent securitisation. As I said earlier, that particular entity started its early days being owned by AMP—AMP established it. BZW bought it and then ABN Amro took over BZW, and then we bought it from ABN Amro. We have sold that entity since then, but it was the largest issuer of mortgage backed securities in this country, bigger than any of the banks. The expertise that I have lies in the fact that I was a chairman of that entity and I went on every single roadshow, both Australian and international, for every single issuance we ever did. Why we are digging deep into how these asset classes look is that I have been talking to investors of late—the big super funds and all the investors that I used to talk to both here and overseas—and they are looking to come back into this market, but what they really want is a low-risk asset to start off and they are looking for something that is very prescriptive, maybe salary and wage earners, Sydney, Melbourne and Brisbane—I am not saying this is the answer—or mortgage insured, less than 85 per cent LVR et cetera. Nobody has sat down and actually put together a package like that, and if you could get government assistance—

CHAIR—Why do you need government assistance?

Mr Bouris—AOFM, for a start—you would like to see some bidding done by the Reserve Bank subsidiary.

CHAIR—Okay.

Mr Bouris—And, in addition, the establishment of an exchange. When these investors acquire the mortgage pool and give us the money and we pay down the warehouse, what happens is that they have to mark the market, the asset in their books, and they like to know that there is a secondary market whereby they can trade them if they need to. Now, some people have been calling for a government guarantee on these assets or pledges et cetera. We are saying that, if you make the assets so prescriptive and you have some place where people can actually exchange them—not like an ASX but like an exchange for bond trading, for mortgage backed securities—it gives them more visibility, it is pretty obvious what the asset that is being traded is and there is scoring in terms of what the credit score of a particular pool is. So there is a whole stack of high-quality information that allows buyers to have some interest. It may be a retail buyer. It may be someone who has a small super fund with half a million dollars in there who says, ‘I wouldn’t mind owning $150,000 worth of Australian backed mortgages which have this credit score and have been rated by their agency, and lend money to everyone in Sydney who is earning over $70,000,’ or something like that. I am just making this up as I go along. But it is not hard to do these prescriptive classes. Now, no-one has tried this, and government—

CHAIR—Has it been tried elsewhere in the world?

Mr Bouris—I am not sure about elsewhere in the world. By the way, Australia is a leader in mortgage backed security issuance anyway, so to some extent the world might be looking to this country to start establishing these sorts of things.

CHAIR—We probably have the healthiest securitisation market.

Mr Bouris—We have the healthiest securitisation market and the best-performing mortgages still, and we are known globally as a very robust environment for sophisticated instruments in this particular area. Most countries do not even have variable rates. They do not have redraw available on their mortgages. We have a number of things that every other country marvels at. We have this reputation which it would be great for us to take advantage of today. We are not trying to do something like be a world leader, but I am suggesting that we have an advantage here that we are not making use of.

CHAIR—And we have a problem that this would help fix as well.

Mr Bouris—Correct. That is why I am saying, 'Let's have a deep dive into this.' There are so many big organisations like Deutsche Bank, these big, lead, international organisations, that only three or four years ago were very active globally. They had clients globally who would tell them straightaway: 'This is what we would like to see in a pool. We don't want to see non-conforming, we don't want to see stuff coming from this particular geographical zone, we don't want to have this particular demography. Yes, we will invest, and let's start investing in these categories.' Then you can price that and say, 'Okay, now we've got another category; how would you price the next category, of people maybe in the demography you didn't like,' and start to build confidence back into the marketplace.

That is exactly how securitisation started in this country in the nineties—to allow people like me, Aussie and Rams to do what we did. We used to do 100 million securitisations in Australia domestically. It was a big deal. Then we started doing 200 million and 300 million. Then we found our demand could not be met by the supply, so we started going overseas. We just did it in small, piecemeal ways. We are still trying to do these big deals here. Nobody has actually come and said, 'Okay, let's try and do something comfortable,' and we do need government assistance in that in forming the exchange and making sure that we get AOFM to tell us the sorts of things they would like to see in a mortgage bill, how they would price it and how we would go along with them to see the investors and say, 'We have the support of the AOFM for this particular pool. What sorts of things would you like to see in the pool?' We can do this, because there is very little securitisation going on at the moment and we have this luxury of being able to cherry-pick and start to rebuild.

CHAIR—The RBA said this morning that they thought the securitisation market, with the assistance of the AOFM, is basically getting closer to its natural level and that a lot of the activity that occurred prior to the GFC was dependent on investors who had unsustainable business models. They are no longer in the market and therefore the appetite for RMBS of the investors out there who are likely to invest in Australian securitisation is a lot lower. I do not think that is entirely inconsistent with what you are saying, because what you are saying is that you create an appetite by offering something that is quite specific and that will appeal to investors.

Mr Bouris—Correct. You defined that exactly. Instead of us saying that we are going to create the supply, let us go and create the demand based on what they want. I do not think anyone has addressed it from the demand side. We would like to address the demand side by getting a survey of what they would expect to see.

CHAIR—Where would you start? Would you start locally?

Mr Bouris—Here, locally.

CHAIR—Yes, but if you set something up, who would you need to actually—

Mr Bouris—Go and see some of those State Street advisers who look after—

CHAIR—Would the government go and see them?

Mr Bouris—I would say that you could form a group. There are plenty of people within ASIC and people like Greg Medcraft. There is a whole series of people who could pull this together and go and address the various big investors around the country and ask them how they would see themselves investing. You could talk to 10 at $10 million each and just do one that $100 million one, see how that performs, watch it and then start to build from there. I think that is the way forward. I wish someone did it years ago.

CHAIR—To do a number of small ones like that, would you need that exchange before you could start it?

Mr Bouris—I do not know the answer to that, but I—

CHAIR—There is a scale issue there, I would imagine.

Mr Bouris—There is a scale issue there. That is probably the reason why we suggested that there be government assistance and some form of funding from somewhere to build this exchange. My sense is that one of the big issues around issuance is: what do I do if I am a buyer of these assets, what happens if I want to get out quickly, how can I get liquidity, and who is my buyer? You need a place to do that. I think Owen has had a lot more experience in this particular aspect than me because we never had an exchange-traded bond before. This is why we are suggesting we have this and it will probably be a little inefficient in the beginning.

Mr Williams—There were some comments made before us appearing about liquidity and the ability to lend from their liquid position. It is about duration; it is about the ability to have confidence of maintaining a certain level of long-term, secure funding that you can lend against. At least if there is a market then there is a price that can be made in the market and you can create that longer term trade. The other aspect of it is that for investors, particularly superannuation funds and funds managers in this country, there are essentially three things they look for: security, liquidity and net return. Security we can address through having transparent product. That is one of the big issues globally and, no matter how good our mortgages are, we still have the rub-off of the lack of transparency in vehicles overseas, in the US and elsewhere that led to a lockup of the market. It led to a position where investors would not invest because they did not know what they were investing in. They did not fully understand the underlying assets and the complications in those underlying assets. That is still hanging around in the background, and I think we can overcome that with improvements in transparency, as Mark said, and improvements in understanding. When people are investing they know what the demographics are, they know what the LVRs are, they know what the duration is and they know that it is a yield to maturity lending market.

Australian superannuation funds and other funds like to have liquidity, even though for the most part their long-tail maturity is in their own portfolios, superannuation funds in particular. They still like to have a degree of liquidity in the portfolio. How do you create that liquidity? You can create all the bond markets you like, but, unless there is liquidity in those markets, the funds will say, ‘How do I trade this? How do I liquidate part of my position if I decided that I want to have five per cent of my portfolio in these assets instead of 10 per cent?’ If there is no secondary market, then marking to market in difficult markets or trading those assets becomes a bilateral arrangement where they have to try to sell them through an investment bank or into a process rather than into a market.

CHAIR—Is that how RMBS is traded at the moment?

Mr Williams—They are traded in the bilateral way—that is correct.

Mr Bouris—They have to make a market with somebody else.

CHAIR—Was that not an issue with securitisation prior to the GFC?

Mr Bouris—No.

CHAIR—The liquidity issue?

Mr Williams—No, it wasn’t. There were a lot more funds sloshing around in the system, there were a lot more people who were not as concerned about the maturity profiles as they now are and Australian super funds were not such big lenders into those funds anyway. The international lenders were the bigger lenders. They have now—I will not say evaporated—gone into hibernation for their own reasons, although some of them are coming back with an appetite, as Mark said, in small ways. But if we want to access the Australian funds we have to meet what the Australian super funds and investment funds want. If you are a super fund you want some degree of liquidity even though you may not need it. If you are a fund that has just investment funds from mums and dads, then they might want their money back tomorrow. How do they get their money back unless there is liquidity in the instruments that you are buying in the fund?

CHAIR—As has already been mentioned today, there is $1.3 trillion or $1.4 trillion of Australian superannuants’ money invested, a lot of it overseas. If we could somehow, in a commercial, market based way, attract a lot more of that to be invested into Australian finance institutions, I would have thought that would go a long way to assisting competition with some of the non-bank financial institutions and even some of the smaller ADIs.

Mr Bouris—As a case in point, with the particular credit union we deal with, Gateway, if we do at great job of originating assets for them, at some stage they are going to want to loosen up their balance sheet and sell off some assets. They have great assets. They have very good credit criteria and well-seasoned books. They could actually do a very good bond issue. In order to keep them being as active as they are—and they are a bit of an example to all the other credit unions because their initiative often gets talked about by other credit unions—you want to keep them alive. They are precisely the sort of organisation you want to get sponsored into these new RMBS structures and show how they can continue keeping their own liquidity alive, allowing us to gather some more assets. That actually builds a market segment, and it is a market segment that took on the banks in the nineties and the early 2000s—there was no one individual organisation. Wizard had five per cent of all new mortgages, Aussie probably had the same and RAMS probably had something similar, so between us it was 15 per cent. There is your competition. There is your fifth pillar, if you want to call it that—a pillar of a whole lot of other people. That is what we are talking about.

Senator XENOPHON—You need an environment for that to flourish, though, don't you?

Mr Bouris—We are at a time now where institutions are starting to become more aware of asset classes other than cash that are equal to cash, but for an asset class to be equal to cash you have to be able to trade it to get cash. That asset is mortgaged backed securities—that environment is coming back. We have some luck here in terms of timing. What we do not have, though, is a structure to take advantage of the timing. It is not exactly here yet, but it is getting there, and now is the right time to operate.

Senator HURLEY—That is precisely the point, isn't it? We have been having a discussion all day about stability and competition. You need stability in the banking sector primarily, but we also need competition. What you are proposing skews a little bit towards the competition side of things, and that is precisely what this inquiry has been talking about. The Reserve Bank also said this morning—and it is an important high-level point—that in some instances at least it would appear the taxpayer is being asked to shoulder more risk one way or another in order to facilitate the provision of private finance. I think a number of people would argue that we are too early in the cycle of recovery to start talking about the kinds of instruments that you are talking about and putting at risk taxpayers' funds like that.

Mr Bouris—The market is already doing our own RMBS issuance now. We are not suggesting anything new. We are suggesting a new form of RMBS issuance which is much more prescriptive. In other words, instead of having a broad pool of a whole lot of mortgages that have been originated with four or five attributes and nothing else being shown and then rated by an agency, with the agency giving it the tick and saying it is AAA, and no-one else getting to see what is going on inside—we are saying, 'Have all those things, plus make it very prescriptive and completely transparent and disclosed to the investor market.' We are submitting that we should have a greater level of disclosure in relation to what the attributes of the pool are and to repeat that time and time again to show that we can originate and fund Australian backed mortgages which have these particular attributes. Probably 70 per cent of all mortgages in Australia fit into that category.

Senator HURLEY—Why would you need to create a whole new market for that? Why wouldn't you have a branch of RMBS to do that? That is what I am driving at. Why would you need to create that separate market and why are you talking about one level of risk and then another level of risk? Isn't that what happened with the GFC—risk piled up on risk until we got very risky instruments?

Mr Williams—Could I make a point of clarification. We are not advocating government guarantees for—

Senator HURLEY—But you are asking the government to help set up the market.

Mr Williams—Only help to establish the market. For the participants to establish a market, whether it is the ASX or a bond market or any other market, without the support and imprimatur of the government would be a big ask.

CHAIR—It is really regulatory assistance—

Mr Williams—It is regulatory assistance. It will require a body to issue a licence to a party to run the market. The government is already investing quite heavily in B pieces in securitisation. You talk about stratification of mortgages. The AAA pieces, the AA pieces, the A pieces, the B pieces—those RMBS securities are already stratified based on the percentage loan to valuation ratio and the particular risk characteristics in which RMBS products are already stratified. So this is not a new adventure. We are not advocating anything new in that respect. What we are advocating is creating transparency, liquidity and an ability to trade that will encourage Australian institutions, particularly superannuation funds and fund managers, to participate in a market, to invest Australian dollars back in Australian RMBS product, not take the money off and invest it in share markets or foreign debt markets or products overseas. We want to encourage them to invest back in this market. What do they need to do that? They need liquidity and they need security. In security they need transparency and an understanding of what is in the pools, and that is what we are about. It is not about a government guarantee.

Senator HURLEY—In order to back that up, as you say, you need the government imprimatur on that. That is a big step, isn't it, otherwise you could start to set up this kind of market. There are all kinds of instruments out there that have developed when there is demand for it. Why do you need a government imprimatur for this one?

Mr Williams—'Imprimatur' is perhaps not the right word. Let's say we need somebody to establish the market, to issue a licence to run a market, to establish the parameters on which—the ASX is not a good example because that is a share market as opposed to a—

Senator HURLEY—If you are issuing a licence that is an imprimatur. If the government issues a licence that is an indication the government thinks it is a stable—

Mr Williams—In some fashion the government regulates issuance anyway in debt markets and equity markets. APRA and ASIC control those issuances.

Senator HURLEY—So why do you need something different for this one then?

Mr Williams—Because we want a traded market. We want people to be able to buy and sell just like they buy and sell Commonwealth bonds, semigovernment securities or local government bonds. We would like people to be able to trade that, preferably on a screen, so they can know that what is behind that is coming from a regulated position.

Senator HURLEY—I am not saying the idea is bad. I am just saying that it is probably a bit early in the cycle of recovery to start doing that kind of thing.

CHAIR—It may well be the best time to do it, though.

Mr Nicholson—I suppose our view is that now is exactly the right time to have this kind of support from the government because it is this kind of support that will allow us to rebuild the marketplace on a better foundation. If we do it in the right way with support from all the parties, including the government, we can actually make a low risk marketplace rather than the old marketplaces that were bilateral and where we could not see inside the pools or understand what the risks really were.

Mr Williams—So you are looking for a more blue chip and a—'totally' is a big word when it comes to security—far more secure and appealing investment for the public and the super funds or whatever.

Mr Nicholson—That is right. They require a certain level of understanding of the quality of the component. This is why we are suggesting that standardised credit scores for all of the mortgages in the pools are critical. It is so that we know that, even if we are buying a pool from this credit union, that lender or Yellow Back Road over here, the same principles have been used, the same scoring matrix has been used—

Senator HURLEY—You are requiring the regulator to look at every issue to ensure that those standards are adhered to.

Mr Nicholson—No. What we are requiring is just an industry standard which is agreed by the industry and which is then endorsed by government to say that this is the minimum standard of disclosure and this is the minimum standard of quality of a mortgage pool to be considered at this particular level. We are not staying that outside that standard there could not be transactions. We are not saying that you would ban transactions that were not of that standard, because there may be things that could happen outside of that.

Senator HURLEY—But isn't this precisely the problem that we have encountered? We have auditors but they were not reporting correctly on the underlying assets. You are proposing that the government license and give the stamp of approval to something on which it is not getting confirmation regarding the underlying assets.

Mr Williams—There are two different things here. One is the market and the establishment of the market and the other one is the underlying issuances, or issues. The issues themselves would be rated but they would be rated against a standard set of parameters agreed by the industry and confirmed by the ratings agencies, auditors or Uncle Tom, as long as they were agreeing that this set of standards had been adhered to. We are not asking the government to review the individual mortgage pool issues; we are asking the government to be, just as they are with the ASX, the regulator of that body.

Mr Bouris—The government does it through ASIC. I will give you a good example. Five or 10 years ago, if you did a bond issue you would have to report on your delinquencies and arrears but there were three different ways or three different methodologies to report arrears, and everyone used to argue which was the best methodology. When I saw investors in Europe, I would follow St George. RAMS would go in first; they would have one methodology. St George would have another methodology and we would have yet another methodology. All three of us would come out with the same price and we would get the issue away. That methodology for arrears and delinquencies has become a problem over the years. Investors would say to us, 'We never really understood that methodology and, by the way, there were three and we didn't know which one was the right one.' Each one of us would argue that the algorithm was correct mathematically. The sort of thing we are talking about here is having one algorithm on how arrears and delinquencies are reported and that it become an industry standard. People still argue about the methodology on how arrears and delinquencies are reported. What we are suggesting here is shrinking all the possibilities into a dozen possibilities and working on just those. It does not mean that someone else cannot issue another pool with other characteristics. Let them do it, and they will get a price as they should. But this is a way of getting something priced at its absolute minimum.

At the moment, the pricing of residential backed securities is quite expensive. You do not go to the markets because it does not make sense as you cannot go and lend with enough margin to make money. What we are asking is: how do we find the lowest possible common denominator of the attributes to give us the cheapest possible price for a pool of mortgages? How do we do that? You can build from there. We are not asking for it to go to the point where it went in the US, where it got out control. ASIC can take a view on these things as well. ASIC can say, 'We don't like that particular pool, because we don't like the attributes.' What we asking for right now, in this early stage, is to get the lowest possible common denominator of attributes and what the price is and whether it is a sustainable price going forward.

Senator WILLIAMS—And you were saying that, as a result of that, you end up with cheaper finance available for our financial institutions because of the security of them?

Mr Bouris—Correct. 'Bluechip' is not a word that we like to use.

Senator WILLIAMS—I just plucked that out of the air.

Mr Bouris—We are not necessarily looking to lend to people in expensive houses and expensive areas. There is a sweet spot here, and it is probably the sorts of customers that credit unions, regionals, building societies and the smaller banks, generally speaking, lend to. Our average loan was $250,000 when we ran our mortgage pool. So the average pool was about $235,000 to $250,000 over a 10-year period. That is the spot we are looking at going to.

Senator XENOPHON—Is there not an assumption, though, that that is based on current housing stocks being adequately valued? There were predictions—I think somebody was going to walk to Kosciusko and back and I think he may have—that there was going to be a housing burst.

Mr Bouris—That is right.

Senator XENOPHON—It is none of you, I take it. Is there not an issue there about whether the current housing stock in some markets may be overvalued or be at the peak of its value? Is that one of the risk factors that you take into account?

Mr Bouris—Yes, you are 100 per cent correct. I recall in 2001 I was sitting in an office in Washington doing a bond issue and I got asked exactly the same question. The *Economist* was writing articles then about the overvaluation of Australian residential property. That discussion has been going on for a long, long time. It comes down to things like unemployment levels in this country and the number of interest rate rises. The more you stress a mortgage with interest rate rises—and the less competition there is there is more ability to stress interest rate rises and you can have out-of-cycle rate rises because the market is contained—the more likely you will end up in that territory.

The fortunate thing about this proposal is that today we are starting off at a much lower price. I am talking about new mortgages going forward. If you were talking about mortgages that were done two or three years ago, you would be concerned about the prices and valuations in some parts of Australia. But today we are talking about mortgages that originate from today on—some point hereon—and you would hope that today's pricing represents fair value. That is the first point.

The second point is that we have always had this issue in Australia as to our real estate prices being overvalued. That comes down to talking to the individual investors about how the Australian mortgages originated and asking them once again: do you believe Australian mortgages across all of Australia is overpriced or do you think it is just in certain areas? You can get into the Australian Bureau of Statistics and see the statistics and see where some areas have grown 25 per cent. They may be the areas that have got a problem. Other areas have remained pretty static.

Senator XENOPHON—And some areas have dropped, haven't they?

Mr Bouris—Yes, some areas have dropped. That may be a problem, because they may drop further. Once again, you need to talk to the investors and say: what are the demographics and geographics that you would like to see in this pool?

Senator XENOPHON—So you cannot see that we would ever get to a situation as there was in the US where you saw a massive collapse in housing prices? We are in pretty good shape compared to the US.

Mr Bouris—We are in pretty good shape. The only rider I would put on that is: if interest rates when up three or four more times and if unemployment started to go in the other direction, we would have stress on our house prices because that would increase supply.

Senator XENOPHON—So we still need to be mindful of international factors, such as the rolling over of European sovereign debt, and if there is a slowdown in the world economy that could affect the housing market here?

Mr Bouris—If that resulted in a higher cost of funds to the banks and if the banks then felt the need to pass that on outside of the Reserve Bank and if the Reserve Bank took the view that it did not need to reduce interest rates to watch this asset class, that would potentially be a problem.

Senator XENOPHON—Sure. Just finally, Westpac CEO Gail Kelly has cautioned that any move to increase funding availability to financial service providers such as yourself is risky given that these providers do not have the same underwriting standards, capitalisation or profitability benchmarks. I am not saying I agree with Ms Kelly, I am just saying that is one of the criticisms she has made. How do you respond to that sort of criticism?

Mr Bouris—Ms Kelly is one of our greatest bankers in this country. My response to that is once again we would go to the investors and ask them what are the credit criteria for the mortgages they are seeking to buy from us. It would be them along with mortgage insurers that would set the environment within which we created credit policy. We are not just going to sit there and create some credit policy which is lending 95 per cent LBR or 105 per cent or something; this is going to be market driven. This is not like it was in the 1990s and 2000s where we set the supply. This is where we are trying to meet the demand. I am quite sure that the demand of investors today is for absolutely 100 per cent safe and good quality credit mortgages. We will not be able to create something that is risky.

Mr Williams—I might add to that that, whichever bank we might be talking about, the people whose mortgages they are referring to are the same in our shop as they are in the bank shop. People are moving from banks to nonbanks or to AFIs or to others for different reasons. They are not moving because they are poor credits. Part of our submission is to improve the transparency of credit across the market. That is the main driver of our submission in that respect.

CHAIR—Which should lower risk, which is why you are talking about the price being lower.

Mr Williams—Exactly.

CHAIR—Because if they existed they would be willing to buy into them because by being so transparent you have actually reduced risk.

Mr Bouris—They know the risk, they can make an assessment of the risk and they can actually participate in the formulation of how the pool is built, in other words, what is the credit they want.

Senator CAMERON—I suppose we could have an inquiry into your submission alone, given the issues that it raises. But it seems to me that one of the outcomes would be that ratings agencies would be sidelined in this approach. If the government says, 'We are guaranteeing the standard for the different levels of securitisation,' ratings agencies become redundant. Is that correct?

Mr Bouris—I think the investors would still want to see the rating agencies all over it.

Senator CAMERON—That is a shame.

Mr Bouris—They are very expensive, I can assure you. One of the things that the rating agencies could do is, once the criteria and the prescription are set down, they could be the ones that go back and report on it as another layer of reporting back to the investors, as well as knowing that the government have participated in the prescription. But I do not think we will get away on an international basis without a rating agency, I am afraid.

Senator CAMERON—So the rating agencies are more important than government guarantees.

Mr Bouris—In some respects that is—it would be nice to be able to create something whereby we did not need rating agencies, but unfortunately I think we are stuck with them.

Mr Williams—Could I add to that the we are not advocating that the government prescribe the proposition that are the standards. We are saying that there are a set of criteria that investors will see as adequate, there are a set of minimum standards that are quite obvious, like standardising defaults and arrears, like having X amount of information in respect of a pool of mortgages that is being sold into a market. So it is more market regulation that we are talking about as the government's role rather than the government prescribing. Just as APRA would not want to prescribe the contents of a product disclosure statement made that investment a good investment. We are not advocating that at all. What we are advocating is that the government simply supervise the creation of market. That means that there is still a role for auditors, for ratings agencies or other parties to review the contents of those packages of mortgages. It need not necessarily be a ratings agency, it could be an auditing firm that says, 'Yes, we have reviewed this portfolio of mortgages and what is in that portfolio complies with the market standards as set out.'

Senator CAMERON—It sounds like a political party's election promises, but I will not go there.

CHAIR—I wouldn't.

Senator CAMERON—You hope I don't.

CHAIR—I wouldn't if I were you.

Senator CAMERON—Treasury have put their submission in. They have a chart. I am sure you cannot see the chart here but you would know what it means, that the share of outstanding housing credit by the major banks has boomed since January 2008, that non-bank lenders have come down and other non-major banks have declined as well. If we went down this track, what you would see would be that chart coming together again, because this would provide more funding in a different area. So bank profits would come down. There are two hits on the banks here. One is that, by the very nature of what you are proposing, their market share would decline and the second is that if profitability stays up they have to pay what you describe as a social licence fee—and I wish we had thought of that name. It is really a superprofits tax, isn't it? The point I want to make is this. How do you deal with the vested interest of the big banks in this? It is going to be huge.

Mr Williams—I do not propose to discuss the vested interest of the banks. I think that would be a long discussion. But in terms of reducing the profitability of the banks through reductions in their market share, that is really just a return to the equilibrium that occurred, as your chart shows, prior to the GFC. We are not trying to cut the banks' profits, we are not trying to impose a superprofits tax and we certainly do not advocate a tax. What we are trying to put forward is a proposal that is not unfunded. We do not believe in putting forward unfunded proposals. There is a number of propositions or a number of alternatives for funding a market establishment. It is not a particularly expensive exercise to establish a market but it does require a commitment of funds. We recognised that the government has a funding challenge and we did not want to go putting forward something that was unfunded. That is the simple proposition from—

Senator CAMERON—So this social licence fee would come in but if the banks' market share comes down and their profitability falls then the social licence fee would finish?

Mr Williams—We are only advocating it as a short-term measure to fund the establishment of the market.

Senator CAMERON—The timing of this is really critical because if you do not get your market share up in time—although I suppose one comes with the other, doesn't it? If you get the market share up the profits come down. It is very interesting. That is all I can say.

Mr Bouris—It is also subject to a series of constraints. We are suggesting that the fee that comes from this exercise only come out from banks who are getting a certain return on equity. We are not trying to put any of the banks on Struggle Street. It will return not only equity but also capacity to pay.

Senator CAMERON—I do not think you need to have any sleepless nights over that.

Mr Bouris—We certainly would not want the smaller banks or any medium sized banks to feel this way. We are just saying that there is somebody making a lot of money because they have market control. What we are saying is this: somehow we can fund this whole proposal in the short term by getting some of that money to establish an exchange, which by the way all banks can access as well. This exchange is not just available to mutuals and credit unions and people like us. They would also get a benefit out of that; actually they would be the biggest beneficiaries because ultimately the big banks would be the biggest user of these exchange traded bonds.

Senator CAMERON—On what will be my very last point, one area that you have not dealt with here is superannuation funds. Could they have a role in this? You might want to take that on notice because I have run out of time. Please do.

CHAIR—Senator Pratt has a question.

Senator PRATT—I am sure your response to this will canvass some of the issues that we have already discussed but I want to know what in your view a fifth pillar of banking actually looks like in a sense. Are we really best served by something that looks like another big bank or is it the diversity of institutions that we are talking about here, so the kinds of partnerships that you have got and the programs that you have got with credit unions et cetera. I suppose the diversity of the institutions under that are more important.

Mr Bouris—It was going to be very difficult to build a fifth pillar today. You might have the opportunity to bring a big foreign bank in to do something like that but I would say big foreign banks would not want to come here to take on Australian banks today in this environment.

Senator PRATT—It would not necessarily enhance competition to the same extent as a diversity of other institutions.

Mr Bouris—Correct because a big bank like that might just become part of the oligopoly and play the same game. What we are suggesting is that the fifth pillar would be a collective of smaller to medium players. I do not mean 120; we are talking about 20 or 25 medium-sized players who could all, in an ideal world, have one per cent each of the market share. An 80-20 split would be about the right percentage between the big banks and the smaller collective because that is enough to make the banks consider market share instead of profitability. When they think of market share,. they start to reduce their margins and try to attract more borrowers. That reduction in margin ultimately is where we want to be because that flows on to the consumer as the better interest-rate price.

CHAIR—Thank you, Mr Bouris, and other officers from Yellow Brick Road for your assistance today and for your very interesting proposals.

Mr Bouris—Thank you for the invitation.

[4.26 pm]

CORNISH, Associate Professor Selwyn, Research School of Economics, Australian National University

CHAIR—Welcome. Do you have an opening statement you would like to make?

Prof. Cornish—Yes. Thank you for this opportunity to appear before the Senate Economics References Committee this afternoon. The submission I made to the committee concentrates on the penultimate reference which is the one about past inquiries and their impact. In essence, my submission says that there have been a number of major inquiries into the Australian financial system over the past 75 years. The first of these inquiries, the royal commission into the Australian monetary and banking systems in the 1930s, was commissioned exactly 75 years ago. Inquiries were initiated following major crises in the Australian economy—the Great Depression, the stagflation experience of the mid-1970s and early 1980s and the recession of the early 1990s. It is perhaps not surprising that no inquiry took place in the 1950s and 1960s or since the mid-1990s, for these were periods of economic stability, at least in the case of Australia. I am not here to advocate another major inquiry into the Australian financial system at this time, nor am I saying that there should not be another inquiry. If one were to be held now, its major focus would, I think, be quite different from that of earlier inquiries. Whereas the earlier inquiries focused on why economic problems had occurred and what should be done to ensure that they did not arise again, a new inquiry would surely concentrate on why the Australian financial system has successfully avoided the international recession commonly associated with the global financial crisis.

There can be no doubt that each of the major inquiries into the Australian financial system were followed by important changes. Having said that, one should not conclude that the inquiries initiated the changes in the Australian financial system. The changes that took place—for example, greater regulation after the royal commission of the 1930s, deregulation after the Campbell and Vic Martin inquiries and the greater focus on financial stability and the payments system after the Stephen Martin and Wallis inquiries—were occurring to some degree before the inquiries took place and were the result of previous systems breaking down under pressure.

I think the view taken by Sir Harold Knight, the Governor of the Reserve Bank of Australia from 1975 to 1982, is the correct one. Knight spoke about the Campbell committee providing a catalyst—and that was his word—for change. That is to say it was an agent of change rather than being the agent of change. It hastened the process of change and it did so by refocusing a hitherto inchoate or rather amorphous debate much more sharply on the key issues. It provided coherence and authority. An impressive report was produced, which set out the issues systematically. It argued judiciously and it concluded succinctly.

All the inquiries followed this form and each of them was an impressive piece of work and was well received by the interested public. All of the reports are now significant historical documents. I think the Campbell committee’s report is probably the most impressive of the reports of these various inquiries. It was not a radical document. It did not initiate the process of deregulation; in fact the process was well underway before the Campbell committee reported. It did not seek to promote a particular ideology; rather it was a pragmatic exercise. It sought to explain how the regulatory system had broken down. The world had changed. If the monetary authorities were to succeed in combating current problems of which inflation was the major one then new systems of operation had to be implemented.

The report's principal recommendation included the deregulation of bank interest rates; the introduction of tender systems for the marketing of government debt; and a managed float of the Australian dollar, not a free float. Some of these reforms were underway before the Campbell committee reported. Indeed some of them were introduced while the committee was still sitting. What the report of the Campbell committee did was to accelerate the process of change to 'speed it up' in the words of Sir Harold Knight.

These reforms by the way allowed the Reserve Bank to formulate the cash rate system, which is now the major operational instrument for conducting monetary policy in this country. Without these changes, the bank was unable and would be unable to control monetary growth and hence control the rate of inflation. Their implementation lies at the heart of the last 20 years of prosperity in this country, a remarkable period of sustained economic stability without parallel in the economic history of Australia.

Let me conclude by referring briefly to the Vic Martin committee and its report. It was a follow-up to the Campbell committee. The ALP in opposition when the Campbell committee reported towards the end of 1981 opposed virtually everything in the Campbell committee's report—root and branch. Within three years of the advent of the Hawke government in March 1983, all these recommendations had been implemented: foreign bank entry, bank interest rate deregulation, floating of the dollar.

Prime Minister Hawke and Treasurer Keating commissioned a small group chaired by Vic Martin, the former general manager of the Commercial Banking Company of Sydney, which had been absorbed recently by the National Bank to form what is now the NAB, to investigate the Campbell committee's recommendation in the light of the new government's social and political priorities. The Martin group gave the major Campbell committee recommendations a big tick, and of course the rest is history. In other words, the significance of these reports in the final analysis is that they explained lucidly and cogently the necessity for change. By doing so, they served to expedite change. That is it.

CHAIR—Thank you, Professor Cornish. You mentioned in your opening statement that the past major inquiries into the banking industry have focused on economic issues that the nation had been through at that point but, despite having gone through a significant global disruption to many economies, our banking system has held up pretty well. You think that if there was a new major banking inquiry, it would look at why we came through that pretty well. Surely it could also look at lessons of what occurred elsewhere in the world. There has been a lot of disruption to banking systems worldwide in the last two-odd years and also, as a result of that the situation that we face looking forward, it is very different to where we were 2½ years ago. Such an inquiry could look at not just why we got through it but where we go from here to ensure that the system that we move forward with is appropriate to the new climate that we currently face.

Prof. Cornish—Sure, and I think care has to be taken. We have been more successful than almost any other country in getting through the last two or three years without experiencing major economic and financial difficulties. But we should not be complacent about that. But you are right that if a new major inquiry were to take place, and it focused on why we came out of the crisis as well as we have, then of course comparisons would have to be made as to why we did well when other countries did not do so well. Sure, there would have to be some comparisons with other places, but presumably the main focus would be on the Australian situation.

CHAIR—The whole point of holding a major inquiry is to re-evaluate where we currently stand, and part of that would be how we came through the crisis, what problems did occur and where we did well. We would then ask if what we currently have is the right overall structure looking forward for the next 10 to 15 years. To what extent have past inquiries focused on the promotion of competition? Was that an important factor in any of them?

Prof. Cornish—The Campbell committee and the Vic Martin inquiry, in recommending the entry of foreign banks into Australia for example, argued that one of the benefits of foreign banks would be to increase the degree of competition within the Australian financial system. Generally speaking, the inquiries have not focused on what might be considered micro-economic issues; they were focused more on macro issues.

CHAIR—This inquiry is charged with looking at competition, which, as you have correctly identified, is a micro issue. But such an inquiry would look far more broadly than what we are currently charged with today, which is the way that the structure of the system is set up at a macro level and what impact that has on the ability to manage the economy in a sustainable and ongoing way and ensure that there is money there for economic activity and so on.

Prof. Cornish—Yes. The five inquiries that I mentioned in my submission were comprehensive inquiries, not single issue inquiries. They looked at the financial system. They might have focused on some particular issues but their aim was to look at the system as a whole.

CHAIR—In looking at the system as a whole, each of those would presumably have had some impact on competition within the industry. With the way you set up the inquiry, competition would have been considered to some degree?

Prof. Cornish—Certainly the Campbell committee and the Vic Martin committee did touch on competition. As I said, they talked about increasing the amount of competition through permitting the entry of foreign banks, for example. That was a fairly big issue. Campbell was looking at the whole of the financial system and focusing on the problems that had arisen with the old regulatory system.

CHAIR—And there was the Wallis inquiry, which resulted in APRA being set up as a separate agency within prudential regulation. As part of its charter, APRA is required to balance competition, amongst other factors, even though its primary responsibility is stability. Presumably that would have come out of the considerations of the Wallis inquiry.

Prof. Cornish—Yes, but the Wallis inquiry was set up in the wake of the problems of the early 1990s, the recession at that time, which saw the largest collapse of institutions since the 1890s. The idea of having a separate prudential supervisor and regulator of banks really stemmed from some of the problems associated with the institutional collapses of the early 1990s.

CHAIR—But it has served us well over the past two years, I would have thought.

Prof. Cornish—Yes, although the Reserve Bank, which had the responsibility for prudential supervision and regulation, was moving in that direction anyway. But, sure, I think APRA did an excellent job, and of course if there were to be a new, comprehensive inquiry then certainly it would focus on the work that APRA did.

Senator HURLEY—I am just wondering how you see what the government is doing with international organisations, particularly in the Basel round of talks, in any discussion about having another Australian inquiry. Could it work alongside or would it have to wait until the conclusion of those discussions?

Prof. Cornish—It could wait. One does not know how long the Basel III negotiations are going to go on for. As soon as it seems that they are going to wrap up, ‘in a month’s time’ or something, some major power starts to question some of the proposals. The important point is that, if there were to be another major inquiry, then the proposals that are being discussed in Basel would form part of that exercise, I would have thought.

Senator HURLEY—Because Australia has committed to that process and would presumably implement whatever was agreed at Basel, regardless of what an inquiry in Australia found.

Prof. Cornish—Yes. My understanding is that APRA has been moving beyond the proposals—

Senator HURLEY—In some respects, yes.

Prof. Cornish—In some areas, yes.

Senator HURLEY—In a couple of cases, Australia has successfully argued to be exempted from the proposals.

Prof. Cornish—Yes.

Senator HURLEY—Okay. Thanks.

Senator PRATT—Just briefly, I note that in your submission you have referenced a wide range of inquiries, including the House of Representatives Standing Committee on Finance and Public Administration inquiry into banking and deregulation. You have not mentioned the Senate economics committee, probably because we have not done really big, bookend inquiries—

Prof. Cornish—Yes, I was focusing on the big, comprehensive inquiries.

Senator PRATT—Yes. But I was wondering whether you had any comments on the nature and conduct of the inquiries that this committee has done, on the way it is undertaking the work on this occasion and on the committee’s work looking into the future.

Prof. Cornish—I must say I am not altogether familiar with recent Senate inquiries. I have been taking notice of this one, obviously, and I was here this morning to listen to the Governor of the Reserve Bank's statement, questions and so on. Coming back, Chair, to your opening questions, although this country has successfully negotiated the global financial crisis, there are some changes that have come about through this, and you are focusing on those. Those sorts of things would, I imagine, also be of interest to a major inquiry, particularly the competitive issues and the increase in the big banks' share of lending. So no doubt the hearings of this inquiry and the outcomes of this inquiry would be of interest among the terms of reference of a larger inquiry.

Senator PRATT—Thank you.

Senator McGAURAN—I will see if I cannot get you to the nub of this inquiry, which is about competition. What is your view in regard to banking competition? Do you agree with the Treasury submission that we have an oligopolistic state in the sector?

Prof. Cornish—To be frank, I have not read Treasury's submission, but I would say that I would want to listen very carefully to what the Reserve Bank has to say on the topic. I think over the last 20 years the Reserve Bank has done an excellent job in conducting monetary policy in this country and helping to maintain the financial stability of this country, so I would be inclined to listen very carefully to what the Reserve Bank has to say. I think the Reserve Bank has come out of this crisis pretty close to the top of central banks in the world. I attended the Reserve Bank 50th anniversary symposium and I was struck by the number of top central bankers that gave praise to the Reserve Bank of Australia for the work they did. Of course it was appropriate in the circumstances to say nice things about the bank, but they were said quite genuinely, I think.

Senator McGAURAN—So I take it you believe there is adequate competition in the market.

Prof. Cornish—I think there is a lot of competition in the market. One of the things that happens after a crisis, a jolt to the financial system, is that there is a flight to quality. We saw it with exchange rates, with gold and initially, surprisingly, to the American dollar and so on. And I think it is the same with institutions. Depositors, for example, are nervous, are uncertain and want to be assured that their deposits are in safe institutions. It was complicated a little bit by the government's deposit guarantee. But what is happening in the short term is not necessarily indicating that we have a permanent trend developing.

Senator CAMERON—I suppose your submission says, 'Let's have an inquiry.' Is that it?

Prof. Cornish—No, not really. I must say I was surprised with reference (i), which did not to me seem to fit in with what I consider to be the aim of the committee. It was suggested that, since I have written on the economic history of the Australian financial system, banking, monetary policy and so on, and looked at some of these inquiries in some detail, it might be appropriate for me to make a submission. It was in those circumstances that I made a submission.

Senator CAMERON—Professor Cornish, one of the other banking systems that were held up as a role model for proper regulation—and I am not sure whether you are an expert on international banking systems or you have looked at this banking system—was the Canadian banking system. I am sure you have not looked at the Treasury submission, because it only just came in, but one of the charts in their submission shows that the concentration of the major banks in Canada is 55 per cent. In Australia, it is 75 per cent. So it seems to me that you can still have a good outcome with less of a concentration in terms of the number of banks. Is that your assessment as well?

Prof. Cornish—Are the dates the same? Are the comparisons there for the same dates?

Senator CAMERON—It is the Treasury and World Bank. There is no date on it. It just shows you the percentage and concentration. Sorry—yes, there is. It is for 2000 to 2008, the same period.

Prof. Cornish—My understanding of the Australian situation is that, before the financial crisis, the majors had a smaller proportion of business than they have now. There has been an important change that has occurred over the last three years or so. What I am getting at is that, if you compare the proportion of our banks' business before the crisis to after the crisis, it is different. If you are then comparing the situations of Australia and Canada, you have to get the same dates—

Senator CAMERON—Yes, but the dates are up until the financial crisis.

Prof. Cornish—I see. It is an average.

Senator CAMERON—Yes, up to the global financial crisis.

Prof. Cornish—Yes.

Senator CAMERON—So Canadian banks are a bit less concentrated than Australian banks.

Prof. Cornish—Yes. Both countries did well through the crisis. One had a larger concentration, obviously, than the other, but I do not think that concentration has much to do with whether or not a country did well through the crisis. It might have something to do with competition, but I cannot comment on the Canadian competitive situation. I do not know whether or not expert opinion would say that there is more competition in the Canadian financial sector.

Senator CAMERON—Yes, but competition is only one aspect of banking, isn't it?

Prof. Cornish—Yes.

Senator CAMERON—I am not sure if you are an economist—are you?

Prof. Cornish—I am an economic historian. I am a macroeconomist, not a microeconomist.

Senator CAMERON—You would know JK Galbraith, wouldn't you?

Prof. Cornish—Yes.

Senator CAMERON—Because Senator McGauran and I have become Galbraithians, haven't we?

Senator McGAURAN—I have. What was the term?

Senator CAMERON—Galbraithian.

Senator McGAURAN—No, the other one.

Senator CAMERON—Countervailing powers.

Senator McGAURAN—Yes, countervailing powers.

Senator CAMERON—Do you have a view on countervailing powers in the banking system?

Prof. Cornish—Galbraith used that term to suggest that, what, there should be a government countervailing power?

Senator CAMERON—No, a countervailing power from unions, a countervailing power from buyers, a countervailing power from consumers—a whole range of countervailing powers. It seems to me that some of those are not there in the banking industry.

Prof. Cornish—That is why the Commonwealth Bank was established in 1911. It was not established as a central bank; it was established to counter private banks. It was a publicly owned bank to compete against the private banks. It was not so much that, at that time, it was necessarily felt that there was a lack of competition; rather, it was that so many private banks went to the wall in the depression of the 1890s and a lot of depositors lost their money. There was no APRA; there was no protection or guarantee at that time for depositors. So the Labor Party in particular wanted a publicly owned, commercial bank to compete against the private banks. But the idea of government owned financial institutions disappeared a couple of decades ago.

Senator CAMERON—Is that a good thing or a bad thing?

Prof. Cornish—I do not know. That is for others to say. It seems to me that we have done pretty well over the last couple of decades.

Senator CAMERON—In Australia?

Prof. Cornish—Yes. The Campbell report argued against publicly owned institutions and for the deregulation of the financial system but, at the same time—and this is something that people often forget—it recommended that there should be a stronger prudential regulatory system. At the same time that it was recommending the deregulation of bank interest rates, floating the dollar and so on, it was pushing very hard for stronger prudential regulation. This really got the Reserve Bank going. It did a lot more work after Campbell. It set up a supervision unit. The Banking Act was altered in the 1980s to provide a stronger prudential system in Australia. So the thing is that you can control the system through means other than government owned institutions.

Senator WILLIAMS—I have just one question, Professor Cornish. So you agree with Joe Hockey that it is time for a 'Sons of Wallis?

Senator CAMERON—Nobody agrees with Joe Hockey.

Prof. Cornish—Not necessarily, no. I said in my statement that I am not advocating—

CHAIR—You are ambivalent.

Prof. Cornish—a new comprehensive inquiry, but nor am I opposing it. The purpose of my submission was to point out that there had been a number of major inquiries in the past and that—

Senator WILLIAMS—And the benefits out of those inquiries, no doubt.

Prof. Cornish—fundamental changes occurred after those inquiries. Some of those changes would have occurred anyway.

Senator WILLIAMS—The Martin inquiry was in 1993 or 1994?

Prof. Cornish—There are two Martins. Stephen Martin was involved in the House of Representatives inquiry in the very early nineties. The other Martin, Vic Martin, was involved in the 1983 inquiry. In Canada, for example, it is well established now that they have a comprehensive review of the financial system every 10 years. It has been suggested that we should do likewise. Of course, a lot of people are now saying that it is more than 10 years since Wallis reported so it is about time we had another one. As I said, I am not a strong advocate one way or the other.

CHAIR—Thank you, Professor Cornish.

Committee adjourned at 4.59 pm