COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Competition within the Australian banking sector

WEDNESDAY, 15 DECEMBER 2010

CANBERRA

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SENATE ECONOMICS

REFERENCES COMMITTEE

Wednesday, 15 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: Senator Bushby (Chair), Senator Hurley (Deputy Chair) and Senators Brandis, Cormann, Fielding, 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 8.01 am

CHAIR (Senator Bushby)—Welcome. I declare open the third 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. To date the committee has received over 100 submissions, which are available on its website. Further public hearings are planned next month in Brisbane and Melbourne. These are public proceedings although the committee may determine or agree to a request to have evidence heard in camera.

I 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 contempt. It is also 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 a request may of course also be made at any other time.

[8.03 am]

STRONG, Mr Peter James, Executive Director, Council of Small Business Organisations of Australia

CHAIR—Welcome, Mr Strong. Do you wish to make an opening statement?

Mr Strong—I would just like to say that I got here at eight o'clock in the morning because I own a shop in town: Smiths Alternative Bookshop—some of you may know it. It is Christmas. It is a busy time of year, so I need to back there. In some ways it would be good to be here when it is all busy and bustling, but I hope the shop is busy and bustling. My opening statement is that the Council of Small Business has recently reviewed what we have been doing for the last 30 or 40 years and has decided that we have not done a lot for small business. Nobody has done a lot for small business. In the last 20 years, red tape has gone through the roof: GST, superannuation, super choice—you could go on and on and on. Interest rates are higher than they have ever been for small business when compared to mortgages. Finance is hard to get compared to what it used to be. It is not good for small business.

More interestingly, we are being treated more and more as nonhumans. Our human rights have been taken from us in many ways when we are dealing with shopping centre owners and banks. Unfair clauses in contracts are fine when you are dealing with a small business and they are not fine when you are dealing with a person—quite interesting. We want to get our human rights back, and part of the process of our submission is to get those rights back.

A person from the Department of Health and Ageing came into my shop—by the way, the shop is the headquarters of the Council of Small Business; we make a statement that way that we are a small business—saying to us, 'We'd like to involve small business more in the healthy workplace scenario.' That is fine, and I will work with them on that. I then said, 'So your healthy workplace scenario picks up everybody, from the CEOs of Coles, Woolies and BHP down to the most casual of workers?' and the reply was: 'Yes, it does.' I then pointed out that it missed 2.4 million people, the self-employed, who are invisible when it comes to health—which is quite unbelievable. The woman I was talking to, to her credit, was also stunned and said, 'How or why did we miss so many people?' That is an issue, and that is what COSBOA is looking at now—driving the fact that, firstly, we are people and we want to be treated like people and, secondly, we are an integral part of the economy. Without us we would not have an economy. We need to stop and look at the business health and personal health of small business. That is what a lot of our submission is about.

CHAIR—I think you made some valid points in your introduction about where small business is at and the way that it is being viewed—or not viewed, depending on how you look at it—by a lot of bureaucratic organisations, but there was not a lot about banks, though, in your introductory remarks.

Mr Strong—Yes. When it comes to the banks and loans, the fact that we are people is what we are talking about. If a small business person goes into a bank and gets a loan for a house or whatever, they are treated as a consumer. Once we say we want a business loan, it is different issue—interest rates go up, charges go up and we are likely not to get the loan. Even though it is the same house as collateral, even though it is the same person, even though it is the same bank and even though it is the same bank manager, all of a sudden things change and they want more from us or they will not give us any.

Senator XENOPHON—The banks and others who have given evidence to this inquiry say that that is because the risk profile for small business loans is higher and therefore there is a weighting in terms of interest rates for that risk. The security may be the same, but the risk is higher. Do you think that is a fair comment?

Mr Strong—Our answer to that first of all is that we do not have any data from them. Another issue that we have is that the banks say lots and lots of things but they pull out no facts to support what they are saying. We have said to them quite often, 'That's fine; show us the risk profile. Show us how many loans you have given out and how many have failed.' In conversations with them one of the things they say is, 'We don't want to repossess someone's house; it will make us look bad. That is our fear. In theory, business is more risky and therefore we don't want to lend money to people who have a high risk.' Our answer to that, of course, is do not lend it to people who have a high risk. It is a really simple answer. If someone is at risk and you do not think the loan is going to work, do not give them the money. And the banks have a good history of not giving money to people who are going to fail. So we still believe they are using that as an excuse to charge extra interest. It actually fails the test of reality. As I said, we need information. We need them to give us the information to prove what they have said.

CHAIR—I hear what you say. We have had a lot of evidence from banks and others, including regulators, over the last couple of days, and small business finance has been raised in that context. Senator Xenophon, Senator Williams and I have all raised that issue. The point that you made is probably a valid concern—that they do not want to be seen to be foreclosing on people's houses and small businesses to get the money back that was not repaid because the business failed. Foreclosing on farms is a very high-profile example of where they may see that they are just going back to get money that they are owed but, ultimately, it does not go down very well in the public eye when they start foreclosing on farms and taking them away because they have had a few bad years of drought or whatever it might have been.

In terms of not loaning the money to those who they do not think will pay it back, I guess that is where the risk premium comes in. Banks do not always know, though, they have pretty good ways of weeding some out from others. There are probably some good businesses that do not get a fair chance to get off the ground, particularly with the bigger banks, where they have higher lending standards for small business, but ultimately banks are in the business of lending because they want to actually make a dollar out of the lending. So they do want to try to lend money but they have to draw the line somewhere. I think it is probably in the interest of the economy that they are more likely to give small business a go with some money than not. If they took the approach that you are suggesting—that is, just do not lend because of risk—I do not think we would see an awful lot of business loans out there, particularly for new businesses.

Mr Strong—I take your point. The interesting side of that that we hear a lot—and you always have to test anecdotal evidence, as we all know, but I hear this far too often to know that it is not true, and I have been through the same experience—is banks saying, when I am looking for a business loan: 'Don't do that, Peter. It's too hard and it costs you more. I'll just give you a line of credit against your house, and all will be good.' I know that is quite probably illegal from what I have been told, but a lot of bank managers out there get around it and say: 'Don't bother. You mightn't get it. It looks like a good loan to me. We'll just do a line of credit.' They get around it. When the banks come along with their information, they have lots of information that is useless. It is useful for them to present cases, but it is not useful for me if I want to know what is going on and why people get rejected. Our banks are very profitable. That is fantastic; let us not stop that. But when it comes to the economy—and I will talk about other things to do with that—we need the banks to treat us like people. As I have said to the bank several times, do not lend me the money if it is not a viable loan. I have no problems with that.

I need information about how many small loans have been rejected for small businesspeople and what the amounts of those loans were so that I can use to build policies and programs to get out there and help small businesspeople who are putting in small applications. We might find that the rejected loans are only small loans—$10,000, for example, for retailers going through changes that want to put in coffee machines or whatever. If they give us more information, we can come up with solutions to the problem. But if they just give us broad information and walk away, nobody can come up with a valid solution. If we find out that the applications are poor, great: we will put more training courses in, provide more support and mentor people in writing good applications. Or we will say to them: 'Don't bother. You're not going to get the loan.' That is a response to a person. Have you had the Financial Services Ombudsman in yet?

CHAIR—No.

Mr Strong—They came to a COSBOA meeting once and made a point of saying that they get more complaints to do with small business loans against banks which have their small business loan area based in their business area. The banks which base their small business loans in the mortgage get complained about less. If you treat someone like a person, they will probably understand and you will get fewer complaints. If you treat one person like a business, you will get more complaints. That really tells us how the financial sector should approach small business. Treat them like people, give them the information that you give to people, assess them like people and help them like you help people. The banks that do not are the ones that have more complaints. That is a really good example.

CHAIR—Do you have further comments to make in your opening statement? You mentioned that you were going to get onto some other things.

Mr Strong—One of the big issues that we have is the EFTPOS payments. I bank with Bendigo Bank. I did not know that other people had this problem until it was explained to me. When anybody comes into my shop and buys through EFTPOS it is then in my account by six o'clock the next morning. Every morning: Christmas Day, Boxing Day or Anzac Day. It does not matter—every day of the year, any sales from the day before go in. If you bank with any of the big four, any sales made on Friday, Saturday, Sunday and public holidays do not go into your bank until Tuesday.

Senator WILLIAMS—Or Wednesday.

Mr Strong—Or Wednesday—thank you. It is interesting. Some banks are worse than others. This year, Christmas Eve is on a Friday, which is a trading day. Then there is Saturday for those that trade. Then there is Sunday. Monday and Tuesday are public holidays. Any sales from those days, and Wednesday, will probably not go into your account until Friday and potentially the following week. There are many problems with that. First of all, it is not their money. If it was happening to me, it would be my money. If I have sold goods, that money would belong to me and I would not have it. The next problem is, if I have an overdraft, I am paying extra interest on that overdraft because the banks are not putting the money in? They say no. I say that you would need an actuary to work out if that is true or not. Based upon what they send you in the mail, who would know whether they are charging you extra interest? The next problem is: what do they do with my money? We say that they put it in the short-term money market. They say that they are not allowed to put it in the short-term money market and that they do not. They came to a council meeting a year ago and we asked them that question. We asked: 'Where does the money go? It is billions of dollars?' They said, 'It just goes.'

Senator WILLIAMS—It evaporates in the wind.

Mr Strong—That is right. They have an accounting package called, 'Mind your own business,' in the true sense of the phrase! It just goes. Giving that response, I might add, showed no respect at all to the council. We believe that they are using it to shore up their own liquidity and using it in the short-term money market. Whatever they are doing with it, it is billions of dollars of money that belongs to small businesses that they are using elsewhere.

Senator XENOPHON—With the bank that you bank with, Bendigo, there is no problem?

Mr Strong—The Bank of Queensland is not a problem; St George is not a problem.

Senator XENOPHON—Does it go in on the same day?

Mr Strong—The next day. With anybody buying stuff today, it goes in tomorrow.

CHAIR—Even on the weekend?

Mr Strong—Yes, even on Saturday. I have checked many times—Saturday, Sunday, Christmas Day.

CHAIR—They have paid on Saturday and it has shown up in your account on Sunday.

Mr Strong—Every time. It has never failed for me.

Senator WILLIAMS—Mr Strong, I find that very relative. I have spent all my life in farming and small business. On Saturday morning, I pulled my credit card out and put $5 into my shop account. I had my computer on internet banking. The $5 was gone in no time, off the credit card, and on the following Wednesday my business got the money. So it is a very valid question. One bank can do it—Bendigo Bank. I was with the Commonwealth Bank then for EFTPOS and I bank with St George, but it disappeared from Saturday morning until Wednesday. That is a certain cash flow loss for small business. Many businesses need that money now, not in two days time.

Mr Strong—I do my accounts on a Sunday morning. I do them then because I am doing my BAS on other days. Lots of people do their accounts on the weekend. If you do not have the money in there, how do you pay people? Our former chairman was on the phone yesterday talking to me about this very issue. He said that at that moment he had in front of him, on his computer, his bank statement and his sales sheet and was trying to work out his cash flow over the next few days—he owns a mini mart, which has high cash flow—to work out who he could pay. He said he could not trust what came from the bank. They finally gave us the reason why—it took a long time to find out why that happens for only the big four: their technology is too old. This is a real concern for us. We have looked at this and said, 'This is not just a concern—

Senator WILLIAMS—We will put that to Mr Norris later today.

Mr Strong—There are a few questions. What happens to the money? I would love to know what happens to the money.

Senator McGAURAN—On the same point, if I transfer money, via the computer, from one of my accounts to another account, it is instant. This opens a whole question.

Mr Strong—That is right. As you say, you walk into a shop on the weekend and buy something—

Senator McGAURAN—Of one of the big four.

Mr Strong—and it is gone. They blame technology. They told us what happens. In the middle of the night in every major capital of Australia, at 12 o'clock or 2 o'clock—he could not remember—the big four meet and swap tapes. That is how old their technology is. We could not believe that. Who would believe that in this day and age? What is really terrifying is that, two weeks ago, NAB had a technology melt down, and yesterday CBA had the same problem. To me it is indicative of the fact that they are probably right: they have old technology. That is a very dangerous thing for us all. It broke down two weeks ago. The banks normally follow each other, so I would imagine Westpac and ANZ will have a technology crash of some sort as well—

Senator McGAURAN—Everyone is boasting about their technology.

CHAIR—The CEO of National Australia Bank told us on Monday that they were spending $1 billion on their IT systems this year.

Mr Strong—NAB told our chairman the other day: 'There's some really good news. We're going to start transferring EFTPOS overnight, every night, and on weekends,' and we thought that was fantastic. He said, 'It'll only take three years.'

Senator WILLIAMS—To set up.

Mr Strong—My chairman is 74.

CHAIR—It takes a while to spend a billion dollars, I guess!

Mr Strong—That is right! We are asking: why haven't they upgraded their technology? We are saying they have not upgraded it on purpose. We are all going to suffer, as with the NAB meltdown. They have done it on purpose because they know that they can make money out of it. Have they not done it because they do not have the money? They have billions of dollars. Every year they get that money. That is not on. Have they not done it because they did not realise the importance of technology? I do not believe they did not realise that. So why did they not upgrade their technology from what I can gather is 1980s technology? The reason is that they cannot transfer EFTPOS and they make a lot more money from small business. I think someone should go back and have a look at all this and say, 'Okay, if you have been charging interest on overdrafts—and we want proper proof that you have not been—then you should pay the money back, and all the people who have lost interest on that money that should be in their accounts should also be reimbursed for that interest.' That is a lot of money over a long time. You cannot reimburse them for the time and effort they have wasted in chasing accounts, trying to work out things and doing cash flow management.

CHAIR—Do you have a couple more points to make?

Mr Strong—Yes—beyond EFTPOS. We think there is quite a crisis. Moody's have to do credit ratings based on a whole range of things. One has to be technology, the recency of that technology and the capacity of that technology. They will twig one day and our four banks will be rated ZZZ based on that. They have done it on purpose and we have to find out what they are doing with the money and get some compensation out of them. Another issue is unfair contracts. I will talk more about that. That is an issue right across small business when dealing with shopping centres et cetera. If I am negotiating a mortgage, I am treated as a consumer and I am given that protection; if I am negotiating with the same person, as I said before, I am not given that protection. We need to be given the protection that any other individual in society is given.

Senator XENOPHON—What is the threshold, though?

Mr Strong—On the amount of money?

Senator XENOPHON—At what level do you get the same or similar protections as a consumer? What do you say is a cut-off for a small business?

Mr Strong—My understanding is that there is a cut-off for consumers as well. Exactly the same. I would say, 'Treat us like consumers.'

CHAIR—The legislation as enacted I think is at phase 1. There are more phases to come which may include business, but there was a deliberate decision made to exclude business. It is actually excluded by the changes that were put through earlier this year, I think.

Mr Strong—At the last election Bruce Billson and the coalition put up a proposal to give business the same protection from unfair contracts as a consumer, and interestingly the banks came out and said: 'No, you can't do that. That's bad for business.' It might be bad for their business but I do not think it is bad for our business, and that is something we should take into account as well—protection from those sorts of things. EFTPOS is one issue, and the computer systems.

CHAIR—Switching banks? Your submission addresses—

Mr Strong—Thank you, yes, I will come to switching accounts. This is something a couple of academics put up to a Senate inquiry some years ago. It came from these fellas based in Melbourne, and we have had a look at it. The logic to it all is: at the moment in business if I need to change my account I have to go and tell all my customers my new account numbers. It happens to me, because I have suppliers. I will get an email, a letter, a phone call or whatever saying: ‘Here’s the new BSB and account number. Please change it.’

Senator WILLIAMS—Yes. They take months to do.

Mr Strong—And I forget. I am a person. Again, there is this expectation that I behave like a business. I am just a person. Quite often I do it because I am managing the cash flow, I am paying something at the time and it is there in front of me. But if I forget it will bounce back. I think, ‘What’s going on here?’ and I ring them up, and it adds time and effort. And then there are the poor old people at the other end.

I have never gone through this, and one of the reasons I would not go through it is that you have got to tell everybody. You have to change your credit card details, you have to do a whole range of things and it becomes very difficult. Most small businesses do not do it because it is difficult. It is not so much that they do not want to do it; it takes a lot of time and effort. You are walking out the door to do it and a customer walks in or something else gets in the way. It is a very difficult thing to do. The Commonwealth Bank, as far as I understand—this may have changed—actually makes you go in there physically to do it. Some banks will help you through the process. But it is quite a pain for business and it can affect your cash flow as people stop paying you for a while. It also gives the wrong impression: why are they changing their bank? What is going on?

With regard to the portable bank account number, let me say I understand that we do not rush into this. Some fellow came out on the radio this morning saying it could disadvantage smaller banks or businesses even more. And that is fine. Every change we make in the financial sector we think about—we think about it twice, we think about it 10 times—because the big banks in particular will be looking at what opportunity these changes present to them. So with the portable bank account number: yes, we have got to make sure that it is even for everybody, it is easy and it is something that can happen for everybody, not just for businesses.

One issue that has been brought up to me is that every time you open a new bank account you have got to bring your passport in and a whole range of things and prove who you are.

Senator WILLIAMS—A hundred points.

Mr Strong—The feeling is that if you have a portable account number you only do that the once. Another issue is that we would need to investigate to make sure that it does not give opportunity for fraud as people carry the same number through 40 or 50 years, but we do anyway. When we investigate this, we would like to be part of the whole investigation scenario. One of the issues we have looked at is the complete lack of transparency from the big four—or from all banks. You have no idea what they are doing. They turn up, they talk gobbledygook, they mention the word ‘bonds’, they carry on, and nobody knows what they are talking about really. I do not think they know what they are talking about. But it does protect them from questions or from people who might challenge them. So let’s be involved in this whole process. What the Treasurer brought out the other day we think is good. It is the first time ever someone has really shirt fronted the banks, and let’s stick with it but let’s make it as transparent as possible. COSBOA wants to be involved all the way—seeing what is happening, challenging, saying: ‘Will that work for all businesses? Will it work for retailers and for home based businesses?’ We want to challenge this all the way through so it works and it cannot be used by the banks to rort us.

CHAIR—I think you have raised some very good points there. We have heard a lot about the challenges of consumers in general switching banks, with a normal household account where you have a mortgage and you are trying to get a better mortgage rate by switching, yet you may have a few direct debits here and there paying this, that or the other. That is a hassle. But for a small business, I think you just made a very good point that it is even more complex because you have suppliers which pay you directly. There is another layer of complexity and challenge for a small business in switching banks, combined with the pressures that most small business people are already under with their paperwork. Another aspect that has not been raised in terms of switching banks is the actual challenge of the paperwork involved in applying for another loan with a different bank and going through all the requirements of proving your worth to them as a customer.

Mr Strong—I forgot to mention that there is also stationery, because you have your bank details on your stationery.

CHAIR—Yes. So there is another layer. In your opinion, that would be solved to a degree, provided the other issues can be worked through by portability of account numbers?

Mr Strong—That it is right. The other exciting thing is that we have a few brokers in the organisation. They say that they would become more motivated to develop new products if they could walk into my shop and say, ‘Mr Strong, this is what we have for you,’ and go through it. They would know that I could change quite quickly. Whereas now they would not bother, because they said, ‘We’d walk in there and you’d go, “Fantastic, but, no, sorry, we don’t have time”.’

Senator XENOPHON—Your existing bank may be keener to keep you in the first place?

Mr Strong—It creates competition. It adds this new process that does not exist at the moment. The small banks are the ones which are dynamic. Obviously, they have good technology and the old banks are lumbering old elephants. They have no idea and they would have to catch up. Making them do that would be fabulous. I bet you that their technology would come in very quickly, not in three years. I reckon it would come in in six months, if it worked its way through. As I said, we have to be careful. We looked at this package, and we said, ‘We have to be careful, because we’ve had changes in the past which have bitten us.’ I think Glenn Stevens said that the other day.

CHAIR—With any of these things, one of the purposes of the committee is to look at these things in a bit more detail. If you make changes to a system like this and the way things work there is certainly potential for unintended consequences. We try to shake those out before we do that. You also mentioned the reform package. I think you used the term: ‘It’s good to see, for the first time, the banks being shirt-fronted.’ Most feedback from the major banks on the reform package was to the effect that they are not upset by it, whereas the strongest objections, in the evidence we have had before us and from what I have read in the media, seem to be coming from a lot of the small players who we are supposed to help. In that sense, do you think that the government really has shirt-fronted the banks?

Mr Strong—It is a terrifying thing that you just said. We still support the fact they are doing something. The worst thing we could have had is nothing. The fact that the big banks have come out and said, ‘This is fine; the small fellows have said “We’re worried” is an indication that we need to do what you are doing—that is, tread carefully and have a look at the impact of every decision.

Senator CORMANN—Doing something is only better than doing nothing if the something you do makes it better, though, isn’t it?

Mr Strong—In the past—

Senator CORMANN—You should not just do something for the sake of doing something, should you?

Mr Strong—I agree with you; we need to do something that is planned, strategic, and tactical and we need to ensure that everything is assessed along the way. Looking at it over the last 20 years, every Treasurer, Prime Minister and minister has attacked the banks, verballed them, said awful things, threatened them, wept and cried. They did everything, but nothing has changed.

Senator CORMANN—The government, supposedly, wants to improve competition. We had John Symond from Aussie Home Loans in front of us yesterday, who made a credible claim that the non-bank lenders are the one sector of the banking sector that was able to impose some competition before the GFC. Yet they are very critical of the package and the big banks, which are supposed to be exposed to more competition, are very complimentary of the package. That would make one a bit suspicious as to how effective it will be to achieve its objective, wouldn’t it?

Mr Strong—We are always suspicious.

Senator CORMANN—Healthy scepticism is a very good position to start from

Mr Strong—We support that totally. As I say, it is still good to see something started, although there is not much mention of small business. To us, that was a glaring omission.

Senator CORMANN—There is nothing in there for small business, is there?

Mr Strong—Not specifically, no—nothing. We have said, ‘Okay, this is good in that we are addressing something. Now, let us step back and have a good, close look at it. What’s missing? Small business is missing. We need to take little steps at a time.’

Senator CORMANN—As long as they are little steps in the right direction. I just stress that. Often people are just happy to see something happening, but something can be counterproductive if they are small steps in the wrong direction. We have got to be quite assertive on that.

Mr Strong—I agree with you totally. Let’s take some steps in the right direction, but let’s take them. What I am worried about is that we will not do anything and we will end up in the same situation, with technology that is not working and that will crash soon. The four big banks are in trouble at the moment with technology; we have not seen the last of these crashes. So I totally support you, Senator. Let’s do something; let’s assess it. That is what you are doing as part of this committee. Let’s criticise what is missing, and there is plenty missing from the package—but there is a package.

CHAIR—Mr Strong, is there anything else you would like to offer before the senators ask you questions based on comments and the submission?

Mr Strong—The last thing I was going to talk about is the code of the conduct.

CHAIR—Could you briefly outline that?

Mr Strong—We have put out quite a large paper with our submission, pointing out that the code of conduct is a sham and that we need to step back. Part of what we are talking about is to step back and look and say, ‘Is this self-managed code of conduct working?’ It is not, so before we move on perhaps the first thing to do is to say, ‘Whatever we do, let’s forget about that for the moment. How are we going to assess it, how are we going to monitor it and how are we going to make sure we are doing the right thing?’ That is one of the things that I think has caused the problems we have got now. They have been able to get away with whatever they have wanted, to a degree, because they have run the code of conduct and the code of practice, and it has not been as efficient as it should be.

CHAIR—I think I might start with Senator Williams.

Senator WILLIAMS—Mr Strong, if I worked for your business and you were a small business and I earned $60,000 a year and my wife earned the same, I would have no problem going into the bank and getting a home loan, especially if I had 20 per cent deposit. They disregard the business you work for. But if you, who own the business, go in to get a loan, ‘Aha! You are a risk, you are a bad egg.’ What can be done here? You put up your house for security, it is 100 per cent secured, and your business is showing a healthy profit. I, as an employee of your business, have no problem getting a tick-off for a loan, with a cash flow and a deposit, yet you, with a healthier set of books and so on, could not. I see it as so unfair. I did watch the interest rates when they started to fall on 3 September 2008 through to April 2009. We had 4¼ per cent reduction in interest rates. Small business and farm loans went down one per cent, 1½ per cent at max in many cases—which is so unfair, in my opinion. What can you recommend to this committee as far as competition in banking? How can we fix this or make it fairer?

Mr Strong—Thank you for the question, because this is something that the council talks about constantly. How can we do this without intervening in the marketplace?

Senator WILLIAMS—Could I suggest to you: we used to have the Commonwealth Development Bank. We used to have the Primary Industry Bank. Do we need a bank that is focused on small business wholly and solely, or do we rely on the big four to keep doing what they are doing? In many respects a couple of the big four do not want to know small business. What is the answer?

Mr Strong—The answer is not to rely upon the big four, and the answer—I think you are right—is to set up a small business development fund.

Senator WILLIAMS—How would we set that up?

Mr Strong—We would set that up through a government agency. I know this is intervention and I know it is what a lot of people do not like, but we can see no other way of doing it. We have talked about this ourselves. If you trust the banks it will not happen. It just will not happen. They are not people who can do this sort of thing. So you set up a government agency and you set it up with a deadline, so you say it exists for three years. You say, 'This is its job; this is what it has to do and we will assess it as we go along and see if we need to continue,' and we talk and negotiate with the banks to see if they can take it over and give fair dealings with small business.

We go back to the code of conduct as well, and we have a look at that and see what we can do within that to monitor the banks and make sure that they are not rorting people just because they can. They should treat farmers and small business as people. That is the issue. They are not.

CHAIR—Just on that, Mr Strong, are you aware that the Australian Chamber of Commerce and Industry, in their submission, have recommended that the government explore the feasibility of a temporary small business loan guarantee scheme?

Mr Strong—I did not read that bit.

CHAIR—Apparently there are similar schemes operating in the US, UK, Canada and elsewhere. Is that something that COSBOA would support?

Mr Strong—We would absolutely, totally support it. I am surprised to see the chamber come out with it, because we have seen that as intervention for too long. I am very pleased to hear that.

CHAIR—They say they are very keen to support small business.

Senator WILLIAMS—The problem I have, Mr Strong, is that small business seems to be on a very uneven playing field. Big business, corporate business—borrowing millions—will probably get a rate of seven per cent. Small business, 10 per cent. My fear is that, as time goes on, in 40 or 50 years time with creeping acquisitions, big business is going to get bigger and bigger, and we are going to destroy our free enterprise system where people can have the choice to go into business but have no hope of surviving in business. Do you see us going this way, where the big will get stronger and the little ones either get taken over or squashed out?

Mr Strong—I absolutely see that. One of the things that have caused our problem in the banking sector now is our competition policy. We have almost a quadropoly with the banks; we have got the four big banks. We have got a duopoly in the grocery markets. We have got the three big players in retail tenancy. I think there are two players in petroleum. This competition policy has allowed, exactly as you said, the big fellas to come along and grab hold of everything. One of the ways around this is to start treating us like people. In the shopping centres, instead of negotiating on business to business, which is completely unfair, you say, 'No, they've got the same protection as anybody else.' If we start treating small business like people right across all those sectors then we are going to start protecting our economy.

Senator WILLIAMS—Here is an example. The corner store can buy their Coca-Cola cheaper from Coles and Woolworths that they can from Coca-Cola. Perhaps we need the Trade Practices Act amended to have truth in pricing so we can see what the big end of town is paying, or what kickbacks they get at the end of the year after their lump purchases, and see how small business can compete. My fear is that small business is going to do it harder and harder, to the stage where they simply will not exist—and down goes our free enterprise system.

Mr Strong—I have been moving away from the finance area, but it is all connected. When you put a big mall into a town, as you know, choice disappears for the consumer. It disappears totally. Again, the way we look at it is: treat us like people. The banks, the shopping centre council and the franchise council have all objected to getting rid of unfair clauses in contracts. They have said, 'No, don't do that', and the reason they do not want that to happen is that they know they will be brought to task on a lot of the unfair practices that they have had in the past. People will be able to sue them much more easily because they will be treated as consumers. That is the way to do it. I know that is a big picture view of it, but then we go down to the level of: why can I walk over to Big W and buy books cheaper than I can get them from my wholesaler? That is what I do.

Senator WILLIAMS—Exactly.

Senator XENOPHON—That, Mr Strong, raises issues of price [inaudible]. It is pertinent to this inquiry that we should raise issues of price discrimination and competition laws in this country. In relation to the issue of portability, of transfer or being able to switch from one bank to another, you know that Bernie Fraser, the former Reserve Bank governor, will be looking at the technological feasibility of that. But CHOICE, in their evidence yesterday in Sydney, indicated that in the Netherlands there is a legislative mandated requirement that if you want to switch from one bank to another you fill out a form with the new bank that you want to go with. They then send it to your existing bank, and that existing bank has a statutory responsibility within a certain period of time to switch things over. From your point of view, would that be a good interim step pending any technological solutions to a more rapid switching?

Mr Strong—That is perfect. It has got to apply to business.

Senator XENOPHON—Sure.

Mr Strong—Does it apply to business over there? Did they say?

Senator XENOPHON—Yes, I understand it is across the board.

Mr Strong—Good.

Senator XENOPHON—But I need to get that advice from CHOICE.

Mr Strong—I know plenty of people who would start to change and I know they would not change to the big four. They would change to some of the little banks. Bendigo, Bank of Queensland and those sorts of banks have a good reputation out there and people would change. I support that, yes.

Senator McGAURAN—Your concern about the EFTPOS payment delays for a small business is critical. It is not a minor thing at all. It sounds as old fashioned as the cheque. The cheque might beat it to the balance, which makes all the big banks' technology laughable. So we will have to ask them those questions. What is that all about?

By the way, I recommend you read the submissions by the Commonwealth Bank, and we had the NAB before us, because they wax lyrical about their small business sections. There would be a lot of questions I could ask on that—and for you to probably have the wry smile that you have got. My question is this: given that this is about competition, there is a second tier. You mentioned Bendigo. I do not want you to go into your personal relationship, but it sounds like, a la the EFTPOS situation, Bendigo has got it right and down pat.

Mr Strong—They have.

Senator McGAURAN—There is competition right there—significant competition. So are those second-tier banks, Adelaide, Bendigo—anyone else?

Mr Strong—Bank of Queensland.

Senator McGAURAN—What about ING? Do they do business?

Mr Strong—They have a different process. A lot of them have much better—

Senator McGAURAN—Shouldn't all those second tiers trigger competition at a rapid pace? And are they? Why are you and COSBOA just thinking in terms of the big four when these lower tiers have got it over the big banks? That in itself should create enormous competition—not just at the fringes; this is enormous.

Mr Strong—Again that is a good question. It is one of the questions we asked ourselves at the council meeting a couple of months ago when we met with some brokers who said that they have a capacity to help small business get loans beyond the big banks. We asked each other why we had not thought of that. I wondered why I had never thought of brokers and most at the council meeting said the same thing. For some reason or other—and you are quite correct—small businesses focus on the big banks and that is where we look.

Part of the package put up on Sunday I think was about promoting and doing a lot more work to get people to understand the small players and the second tier, which is a good thing. Last year we did a promotion to a lot of our members about changing to banks that offer better services and EFTPOS. The problem is that it is so hard to change banks. That is what came back to us all of the time. People would ask for the address of the local Bendigo Bank, the local Bank of Queensland or whatever and when you asked them if they changed banks they said they did not have time. There is still that issue.

Senator McGAURAN—But could you split your business? That is probably easier said than done on the shopfloor, but you could have your major loan or base loan with NAB and carry an EFTPOS account with another bank. Why don't you just do the split?

Mr Strong—That is a good idea. One of the issues is getting that information out to small businesses. Being people we often do not see what is in front of us because we are so busy. I think what you are saying is perfect. We have talked at the council about promoting particular banks; going out and saying to everybody, 'Think about these banks.'

Senator McGAURAN—It is probably very hard because COSBOA has limited resources. I have known COSBOA for 20 years. We do have the second-tier banks coming in. We ought to ask them about that. Here there is a marketing and competitive tool they should be able to use.

Mr Strong—That is right. Having somebody else's EFTPOS machine is a good idea, Senator.

Senator WILLIAMS—With your EFTPOS you said you went with Bendigo. You can have your EFTPOS machine with Bendigo and still bank at other banks, of course. And it is Bendigo that gets it through overnight even on Christmas Day?

Mr Strong—Yes.

Senator WILLIAMS—When you have EFTPOS with a bank they might charge 1.5 per cent commission on EFTPOS transfers and two per cent on credit card transfers. Are the commission rates at Bendigo competitive with the big banks? Do they charge more?

Mr Strong—I get good rates from Bendigo.

Senator WILLIAMS—It often goes on your turnover. A service station, for example, that turns over millions and makes the smallest of profit obviously gets a smaller discount. But you are finding Bendigo as competitive as the big four when it comes to commissions on EFTPOS transfers?

Mr Strong—They are competitive. I should state, by the way, that I am an ex-chair of the local Bendigo Bank. Bendigo are competitive. It comes down to the package they give you. The machine might cost you nothing whereas a big bank might charge you a fee every month to have the machine. That is the beauty of having someone walk in and say, 'Here is the package.'

Senator WILLIAMS—So they are competitive?

Mr Strong—They are competitive, yes. If they pay EFTPOS over the weekend, that makes them competitive straightaway.

CHAIR—Thank you, Mr Strong, and good luck.

[8.44 am]

DENNISS, Dr Richard, Executive Director, The Australia Institute

RICHARDSON, Mr David, Senior Research Fellow, The Australia Institute

CHAIR—Welcome. If you would care to make an opening statement, please feel free to do so.

Dr Denniss—Thank you very much. We are a think tank based here in Canberra. We have published a lot of research in the last couple of years on the need for reform in banking, the excessive profits in the Australian banking system and the need for regulation of the banking system, so we appreciate the opportunity to appear.

One of the first points to make is that I think we need to talk about what exactly is meant by competition in the Australian banking system and the oft heard assertion that the Australian banking system is highly competitive. I have taught introductory economics for nearly 20 years and I would fail any first-year student who described the Australian banking system as highly competitive. I am not sure—

Senator XENOPHON—You would fail the Reserve Bank governor, then.

Dr Denniss—I would.

Senator BRANDIS—It does not show a lot of hospitality to students who might have a different view from your own.

Dr Denniss—They would have to make a very strong and persuasive case and be very clear about what definition they were using. This is my point. This is my question to you and my question that I suggest you put to others. If they are describing it as highly competitive, what is the definition of 'competitive' that they are using? To suggest that an industry that has a degree of concentration amongst four big providers is highly competitive is entirely consistent with the commonly understood usage of the term.

Senator BRANDIS—That is complete rubbish, Dr Denniss. You can have a perfectly competitive market with four large players.

Dr Denniss—I reject that.

Senator BRANDIS—There is a large body of law that defines competition. You can have a perfectly competitive markets with four players.

Dr Denniss—I appear before you as an economist. I am sure that lawyers have an entirely different view.

CHAIR—Can we allow the witnesses to complete their opening statement, and then we will have some time for questions after that.

Dr Denniss—Thanks. There is a body of economic literature that says you can get to competitive outcomes even despite the existence of a highly competitive market through things such as the threat of entry, but, again, you could not describe the market structure as highly competitive, even if you wanted to describe the outcome as resembling that of a competitive market. To suggest that all the small players place enormous pressure on the big four is analogous to saying that all the small software companies in the world place pressure on Microsoft or all the small retailers place pressure on Coles and Woolworths. My suggestion to you is that you put pressure on those who do describe it as highly competitive to tell you exactly what they mean, because I really do not know.

The banks are an oligopoly. They act as an oligopoly, which does not mean they act as a collusive cartel, but it means that they behave in a way that, again, you would expect first-year economic students to describe as an oligopoly—that is, the higher degree of concentration gives them a higher degree of market power and higher degree of profit. It also gives them a lot of apparent—and this is very important—product differentiation, so it looks like there is lots of choice. Whilst choice is important—and I am not anti-choice—again, I think you need to prevail on those who suggest it is sufficient to explain how lots of choice is in and of itself a solution to anybody's problem. My colleague here has estimated that if you look at all the combinations of savings accounts, home loan accounts and credit cards that the consumer could go and choose from—so all of the different products offered by all of the different financial institutions—there are more than one billion options available.

CHAIR—In terms of permutations and combinations.

Dr Denniss—There are one billion permutations of: 'What savings account should I have? What credit card should I have and what home loan should I have?' To suggest that any consumer or any business finds access to one billion options a useful way to navigate the financial system I think is absurd. Again, straightforward economic theory suggests that these things that economists typically assume away, called transaction costs or search costs, are very high and that in turn the big banks profit from the confusion and from the difficulty in both identifying the options available and choosing between them.

People use—and there is plenty of empirical evidence about this—rules of thumb to guide them to make decisions when they are overwhelmed with choice. Fortunately—or purely coincidentally—for the big four banks, one of the main rules of thumb that people use is to go with what they have done in the past, what their friends are doing or what it seems like everyone else is doing.

The big four banks last year spent more than $1 billion on advertising. If you assumed the market was highly competitive, you would have to explain how four rational firms would choose to spend $1 billion between them on advertising if that advertising did not return a profit for them. To what end do they advertise? Does the advertising give them an advantage? If the answer is yes, how can the small firms possibly compete? If it is no, why are they wasting $1 billion? The purpose of the advertising is clearly not informative, clearly not to help me choose between products, because the fact is that the ads are designed to make me laugh. What information is conveyed in ads where banks mock their own poor customer relations? Though the advertising works as a very good barrier to entry, it helps to reinforce the view amongst people that, while there might be a billion choices out there, the easy, simple thing to do is to do what everyone else is doing.

We have done survey work asking people the simple question: do you think that the large profits earned by banks mean they are safer? One in four customers of the big banks think that that is the case. In banking, we are talking not about fish and chips, bottles of water or even petrol but about a product that people feel very emotional about: their life savings. Do you want to trust your life savings to a second-tier bank? Could there be anything less helpful to describe some of the smaller financial institutions than ‘second tier’? What that implies is ‘second rate’. Why don’t you go and put your life savings in the banks you have never heard of, the ones the regulator calls ‘second tier’?

One of the few bits of financial advice that most people understand it that there is always a trade-off between risk and return—there is no free lunch in Australia—and if you are offered high rates of return it means that you are taking an extra risk. So what am I telling you if I say that the second-tier banks are offering higher rates of interest? They are not as safe. Humans make decisions based on the information they have at hand. Economic theory talks about how the perfectly informed consumer makes the perfect decision. But, in reality, the banks profit from the confusion, the uncertainty and the perceived safety of banking with the big four.

I would like to make a couple of last points. The Australia Institute has suggested—and I think we circulated something to the committee last night or this morning—that the banks’ own annual reports show that their cost of funds is falling, not rising. This is entirely consistent with what APRA has suggested and of course entirely at odds with what the banks are suggesting. In a perfectly competitive market, when your costs go up, you put your price up to cover your costs. In a perfectly competitive market, when your costs go up and you put up your price, your profit does not change. Well, profits are rising in the Australian banking industry by around 15 per cent per annum. This is enormous growth in an economy that is growing, in nominal terms, by less than half of that. So there are only two ways to increase profit: either by increasing prices or by lowering costs. The banks report rising profits. The banks report to their shareholders falling costs; the banks report to their customers rising costs. One of those statements is untrue, and I suggest that you examine why all four big banks’ annual reports suggest that their cost of funds is declining and none of them—as far as we are aware—refer to their own annual reports in their submissions to the committee. It seems interesting that they would tell you shareholders one thing and the public something else.

Senator McGAURAN—I know you said that, but it is that declining or—

Dr Denniss—Not rising as fast as they think. No, it is actually declining. If you have got that piece of paper in front of you—

Senator McGAURAN—Not rising as fast as—

Dr Denniss—Yes. We previously said not rising as fast as they said, but according to their annual reports their interest expense as a percentage of their liabilities—for the Commonwealth their interest expense as a share of liabilities fell from 3.7 to 3.2 per cent and their interest expense as a share of their assets fell from 3.4 per cent to three per cent. I would ask them that question.

Very quickly to conclude, we believe that the announcements by the government, the calls by the opposition, the suggestions by the Greens will all help in some small way to improve choice and in some small way make the market slightly more competitive—more competitive, not highly competitive. But I do not believe for a minute that the government’s announcements or the calls by the opposition will actually go to the heart of why it is that the Australian banking system is so big and so profitable and, most importantly, rising so fast. If the motivation for this inquiry is the combination of record profits by the banks and the decision to increase interest rates by nearly double the RBA rate in November, then nothing announced by the government and nothing currently being suggested by the opposition will go to the heart of that problem. I will leave it there.

CHAIR—While we are still on the cost of funding, since that was one of the last things you raised apart from the fundamental need for change, which I will get in a minute, you have used some figures here that you say are publicly available. Certainly the National Australia Bank, from whom we have heard evidence in the last couple of days, put all information relevant to their costs, particularly their cost of funding, out in the public arena. The RBA has access to those from all of the banks. The RBA’s conclusion as contained in their submission to this inquiry was that the cost of the banks’ funding is increasing and has been doing so since the global financial crisis started but that since June 2009 the increase has continued, not decreased as your figures show, basically in line with the increase in the official cash rate. Given the RBA’s access to the banks’ funding cost details, why is their conclusion, which is also different to the banks’ conclusion incidentally, different to yours? Are you looking at the whole gamut of costs of the banks?

Dr Denniss—This is the information provided by the banks in their annual reports to their shareholders. This is not our information—

CHAIR—You are heading it ‘Interest expense as a share of liabilities’. That is what you are pointing to. Does that cover the whole gamut of their costs of obtaining funding to on-lend?

Mr Richardson—Everything described as interest expenses is included in that figure.

Senator WILLIAMS—What you are saying is that the money that the banks buy before they will sell it, their cost of buying that money is actually reduced.

Dr Denniss—According to their annual reports.

CHAIR—Does that include all costs that they would have to cover for their long-term wholesale funding, their short-term wholesale funding, their deposits—all the funds that they access? Basically there are three different views out there—there were two before you arrived and there are three now—as to the cost of funding of the banks. The RBA has one which says that it went up and is continuing to go up but it has destabilised and is basically now reflecting the official cash rate. The banks are saying it is continuing to rise and will continue to rise for another 18 months. You are saying on the basis of what you have seen in their reports to shareholders that it is actually now falling as a share of liabilities. Where is the difference? How do we reconcile those three different conclusions?

Dr Denniss—I will go first because I think the most important point to make is the simplest one—that is that the problem is that everybody is relying on the alleged incredible complexity of the problem to make it hard for everybody to get to the bottom of it. If I go back 12 months—

CHAIR—But the RBA has the expertise to—

Dr Denniss—If I go back 12 months it was common knowledge in Australia. Everybody knew that the banks' costs of funds and the official interest rate moved in sync. Everybody knew this 12 months ago. It was not discussed, it was not debated; it was common sense that when the RBA went up 0.25, the banks went up 0.25.

Senator WILLIAMS—It has been like that for about 15 years.

Dr Denniss—I think that is a very well-established, commonsense—

CHAIR—There has been a correlation but the argument is that it is not necessarily—

Dr Denniss—This is exactly my point: when it was good for the banks for everybody to suffer from this misunderstanding, I did not see anybody trying to correct the record. If you saw the evidence—

CHAIR—That may well be the case. They may well have done that for PR or other reasons. There is a definite correlation but their issue is causality.

Dr Denniss—That is right. Causality and how proportionate the relationship is, but the Commonwealth Bank's evidence to you on Monday included the statement that perhaps the banks had done themselves a disservice by allowing this very profitable misunderstanding to perpetuate itself for 15 years. When it was good for them, it was very simple. Now it is hard for them when we point out, what I think is to some extent the obvious, that not all of their costs are coming from the Australian official money market. All of a sudden there is a bombardment of complexity, so—

CHAIR—I do not disagree with what you are saying. The banks may well have seen an advantage in allowing for that 15-year-period—a commercial advantage, no doubt—the public to think that there was a stronger relationship than perhaps there really is. Now that that commercial advantage in allowing that perception to continue no longer exists, they want to argue otherwise. What we need to establish is: what is the real relationship and whether the banks have a real argument, regardless of the commercial reasons they might have allowed that to exist.

Dr Denniss—I will let Dave talk in a sec and I am not trying to avoid the question; I am trying to highlight the fact that the only reason the question is needing to be asked is that at the moment the banks' strategy is to confuse the hell out of everybody in the hope that this simple question goes away. The simple question is: if your costs are going up so fast, why are your profits going up so fast? I am simply urging the committee to keep coming back to the question that if their profits—

CHAIR—Have you done any analysis of what their costs of operations are? That is quite a different issue to their cost of funds. As I understand it from discussions that I have had in the past with various players, their costs of operations have actually been falling faster than that interest margin, which is part of the reason why their profits are maintained despite the fact that the net interest rate—

Dr Denniss—Absolutely, and in a highly competitive industry—let us go back to it—my first-year students again would tell you that what happens when your costs fall, you pass that onto your customers. You cannot argue in a highly competitive industry that if you are achieving big cost savings that you get to own that as profit. In a highly competitive industry if your costs are falling, your competitors are eating your lunch. That is why we like markets. I take your point: maybe it is their costs in another sphere of the business—

CHAIR—I do not think we have got to the bottom of the interest expenses question, but we are going to run out of time and I think other senators will have questions.

Mr Richardson—Quickly, since the banks have put in their submissions, I have gone through them on what they have said on this topic, looking at their costs of funding. It is very hard to follow. You do not see anywhere a clear graph or anything that says, 'This is interest expenses quarterly,' or annually, whatever in a time series that is clear and able to be followed. You get all sorts of discussion about 'This particular thing has gone up relative to the BBSW—sorry, we have to refresh ourselves: that is the bank bills swap rate—and such and such has fallen relative to so and so.' But there is no clear statement header about what the exact costs of raising funds are for any of those banks. So I thought I had better have a look at exactly what their annual reports say—and there it is. In absolute terms or as a share of liabilities or assets—

CHAIR—With respect, I suspect their annual report does not contain the same level of detail of their costs.

Mr Richardson—That is true.

CHAIR—You are looking at the publicly available information on their costs, and the annual report will be a summation of that rather than the detailed information that would have been provided to the Reserve Bank, under regulatory requirements, presumably. I have a lot of respect for where the Reserve Bank has arrived. The banks are telling us something different and today we will test out the views of another two of them. But the Reserve Bank does have access to a lot more information than what will be in the annual reports. Do you think that, if you had access to the same level information that the Reserve Bank has, your conclusions could be more accurate regardless of whether they may be the same or otherwise?

Mr Richardson—The way I would like to put it is that what I have presented is the aggregate outcome. It is true that from the published accounts you cannot go through and say, 'This expense happened to the Commonwealth Bank in relation to overseas funding.' We cannot get that level of detail, but what we can do is look at ABS balance of payments figures and get the equivalent figure for the banks as a whole. There we find once again that interest costs are actually falling. In the earlier submission I concentrated on APRA data. In response, the Chief Executive of the Australian Bankers Association said:

To be honest we can't work this out. Performing the same calculation we get the same result but I know it is not right because if it was we would have been being beaten to a pulp with this by the government and the opposition.

CHAIR—I would love to ask a lot more questions, particularly about some other aspects of your submission, but I am conscious of the time, so I will hand over to Senator Hurley.

Senator HURLEY—You are making your point that the banks have a large position and have consolidated that position through advertising and a community sentiment that they are safer. During the nineties there were a lot of other non-bank companies that started up—the mortgage companies and the brokers. What kind of market would you see as indicative of a competitive market? What would you see happening differently in all of those sectors if there were competition?

Dr Denniss—I hate to say it but it really comes down to definitions, and a competitive market is a market in which profits are low. One of the main definitions of a competitive market is that the people who own the businesses are only earning just enough profit to make it worthwhile to stay in business. That is what a competitive market is. What we have seen, and Mr Richardson has spelt this out on a number of occasions, is that in Australia in past decades the banks have competed against the building societies and credit unions and won. They have competed against the foreign banks and the won. They have competed against the home loan originators and won. They keep winning because they are bigger and more profitable, and, when they are under attack in one part of their business—say, home loans—they drop their home loan interest rate and increase their fees and charges somewhere else. Because they are big and diverse, when they come under competitive pressure in one sphere of their business they simply increase charges in another sphere of their business. And they have effectively said as much to the parliament. They have actually said that, if the parliament has the audacity to regulate down some of the excessive fees and charges, 'We'll just increase them somewhere else.'

Again, this is entirely unrelated to the notion of a competitive market. A competitive market has lots of providers and lots of choice, but just because there are lots of providers and lots of choice does not mean there is competition. So I would come back to the original point. I would look at the underlying profits—and, most importantly, the 15 per cent growth in profits—and put to you that any big market that is growing its profits at 15 per cent in a mature economy is not a competitive market.

In our submission we have suggested that you look into structural separation to break up the power of the banks and to give greater transparency between the different types of banking operations. At the moment, they have enormous cross-subsidies across the different parts of their organisation and, when they come under competitive pressure on one of their fronts, they just put their hand in somebody else's pocket.

Senator HURLEY—Is your objection to the size and profitability of the banks just in the banking sector; if so, why?

Dr Denniss—No. The Australian parliament has pursued national competition policy quite vigorously in many spheres for many decades and the arguments have always been that the wellbeing of consumers and the economy overall is enhanced when there are competitive outcomes. We have gone through enormous pain and dislocation to achieve competition in the electricity and utilities industries.

Senator HURLEY—But that was a break-up of government assets.

Dr Denniss—It was, but my point is that the theory that underpinned it was competition policy, that small providers fighting hard to keep costs and prices down was good for consumers. My point is simply that if we think that competition is good for the economy, if we think that competition is good for consumers, it seems weird that that conclusion would stop at the doors of the big banks. There are clearly consumer interests and economy-wide interests. You heard before from small business. Do you remember, David, what the total estimate of the cost to the economy for fee and charges was?

Mr Richardson—I think it was something in the order of $10 billion.

Dr Denniss—At $10 billion a year, it is effectively a private tax. If the parliament were to introduce a transaction tax, people would do you out of here. There is a private transaction tax. It is a profitable thing and it imposes enormous costs on small business that are in turn passed on to the consumers. The structure of the banks, the structure of the finance system and the structure of electronic funds transfer operate as a private tax on the Australian economy, and those who are concerned with competition and with low taxes should be very concerned at the operation of the banking system, for economy-wide reasons.

Senator HURLEY—That does not really answer my question. If any company gets too big or too profitable, should they fear that the government would come in and change the structure?

Dr Denniss—In a competitive market we would never fear a company becoming too big or too profitable. When the textbook works, this is not a problem. We are only here having this conversation because, when you have something like economies of scale—again, firstly it is economics. Market failures such as economies of scale allow the original participants—

Senator HURLEY—I think first-year economics also says that the market tends towards equilibrium. I have not done economics but I do not think it advocates the government interfering in markets.

Dr Denniss—It absolutely does. It says that when there are no economies of scale, when there is perfect information and when there are no transaction costs, we can leave things to the market and it will be okay. First-year economics says that when those market failures do not exist there is a case for government intervention, and if the benefits of intervention exceed the costs we should do it.

Mr Richardson—I should add that the four-course policy is the intervention at the moment that prevents further consolidation of the banking industry.

Senator HURLEY—You would approve of that, wouldn't you?

Dr Denniss—We do, but that is regulation. It is very important to understand that the inevitable consequence of the banking industry would be a duopoly or a monopoly. It is only regulation—

Senator BRANDIS—Why is that inevitable?

Dr Denniss—Why do they want to buy each other? Because it would be more profitable. There are huge economies of scale.

Senator BRANDIS—No. You said that it is inevitable. Why is it inevitable?

Dr Denniss—Because it is in the interests of the shareholders of all four banks to facilitate mergers.

Senator BRANDIS—But you said that it is inevitable.

Dr Denniss—Yes. I think it is, because economies of scale drive it that way.

Senator BRANDIS—Why is it inevitable?

Dr Denniss—I have just answered you. It is because—

Senator BRANDIS—That is not an answer.

Dr Denniss—If companies are run by people whose objective is to maximise the financial interest of their shareholders—

Senator BRANDIS—All companies, hopefully, are run by people with that objective.

Dr Denniss—Then that is the reason it is inevitable that it would tend towards monopoly, because of the enormous economies of scale and the enormous profits that come from a combination of economies of scale and market power.

Senator BRANDIS—On your economic theory, Dr Denniss, every sector of any economy will tend to monopoly; is that right?

Dr Denniss—No.

Senator BRANDIS—Well, it follows from what you have just said.

Dr Denniss—No, any sector with economies of scale—

Senator BRANDIS—will inevitably tend to monopoly.

Dr Denniss—will tend towards it, yes.

Senator BRANDIS—Inevitably?

Dr Denniss—Yes.

Senator BRANDIS—Okay, thank you.

CHAIR—You have the call now, Senator Brandis.

Senator BRANDIS—Thanks, Mr Chairman. Dr Denniss, I am looking at your attached document *Money and power: the case for better regulation in banking*. You say that the return on shareholders' equity of the four big banks is about three per cent of GDP and you think it should be about one per cent of GDP. Is that right?

Dr Denniss—Yes.

Senator BRANDIS—Where do you get that figure from?

Dr Denniss—The three per cent or the one per cent?

Senator BRANDIS—The three per cent is a calculation of two numbers. But you say one per cent would be an appropriate or reasonable return on equity. Where does that one per cent figure come from?

Mr Richardson—A figure of a couple of decades ago.

Senator BRANDIS—So does that mean that because that might have happened to be the case 20 years ago in a given year—assuming you are right—therefore that is the appropriate figure for today?

Mr Richardson—We can argue about the exact figure. But if we look at the national accounts a couple of decades ago for banking and finance as a whole the gross operating surplus there was about five per cent of GDP compared with about 11 per cent now. What we do know is that during that time the finance industry has become less competitive.

Senator BRANDIS—Do we know that? In the last 20 years there has been the comprehensive introduction of foreign banks, which for a period of time made it much more competitive.

Mr Richardson—You could argue that. Their share immediately went up to about 10 per cent of banking and has stayed roughly there ever since until the global financial crisis, when it fell.

Senator BRANDIS—Regardless of whether it is analytically rigorous to say that because a figure happened 20 years ago to be at a given level that is the right figure for today, nevertheless your position—the Australia Institute's position—is that the return on equity should be about one third of what it currently is.

Dr Denniss—The whole point of deregulating the banks, the explicit purpose of deregulating the banks, was to increase competition and to reduce profits. So it is interesting that in the period since we deregulated the banks their profits have gone up. I would like to quote Ian Macfarlane, a former RBA governor—

Senator BRANDIS—I have read your quote from Mr Macfarlane. By the way, the profits have gone up and down as the tables in your own research paper *Money and power* show. But let me stay with this point about the appropriate level of return on shareholders' equity. Table 3 of your submission—unhelpfully, it does not appear to be numbered but it is on the sixth page of your submission to this inquiry—reports, based apparently on the banks' annual reports, that the average of the four big banks' return on shareholders' equity is 15.5 per cent. So you think that the average return should be about five per cent across the big four. Is that right?

Mr Richardson—In the share market the return is about 7½ per cent at the moment. So that is what the owners of the banks are willing to pay for the earnings that the banks generate.

Senator BRANDIS—How would we enforce that, by the way? Would we indulge in some sort of price control?

Mr Richardson—We express that more as a target to be achieved through competition measures, regulatory measures and structural—

Senator BRANDIS—I will take you through what you say about each of those measures in a moment but, before we do that, can I draw your attention to some evidence that the committee received yesterday from Reuters. Taking the measure that you obviously regard as the relevant measure—that is, return on shareholders' equity—are you aware that, in the same year as your comparator year, the return on equity of firms in the consumer goods sector of the economy was 17.8 per cent, the return on equity of firms in the mining and energy sector of the economy was 22 per cent and the return on equity of firms in the telecommunications sector of the economy was 21.6 per cent? According to Reuters, the relevant figure for the banks—I think they included the smaller banks as well as the four big banks—was 14.8 per cent. But 14.8 and 15.5 are pretty close.

Mr Richardson—I am not going to quibble.

Senator BRANDIS—So taking the measure that you regard as the relevant measure, according to Reuters the banks in 2009 in fact had a lower return on equity than in the consumer goods sector, the mining and energy sector and the telecommunications sector. Do you say all of those markets are uncompetitive too?

Mr Richardson—Communications is definitely uncompetitive. Mining is definitely uncompetitive.

Senator BRANDIS—Mining is definitely uncompetitive?

Mr Richardson—Each mining company has a monopoly over the particular resources that it is licensed to exploit. In the consumer goods area, I am not sure which companies are covered there, but I have seen figures like Reuters' and I notice too that some of the banks like to compare themselves with the top 20 of the Australian Stock Exchange. That includes five miners. For BHP, I think their return on equity is something like 40 per cent at the moment. Telstra, of course, is huge and so on.

Senator BRANDIS—Sure. But the point I—

Dr Denniss—I think the answer is, yes, we would say those markets are uncompetitive.

Senator BRANDIS—Mr Richardson, basically you are saying that all of these various sectors of the Australian economy are uncompetitive. If you are right about that—and I am not acknowledging that you are—why is the banking sector any different from the other major sectors of the Australian economy?

Dr Denniss—I will take that. Because they provide an essential service.

Senator BRANDIS—Oh, do they?

Dr Denniss—Someone receiving Centrelink benefits has to have a bank account. The only way for them to receive their money is to receive it through the electronic funds transfer system. As an employee, once upon a time I could be paid my wages in cash. In the late eighties I got my first electronic funds transfer card. Banking now is an essential service because people cannot opt out of it. If I were to work here in parliament, I would not be able to ask for my money to be paid in cash.

Senator BRANDIS—I think your point is well made.

Dr Denniss—That is why it is different.

Senator BRANDIS—That is the whole reason for you to make that claim, is it, that banks' return on equity should ideally be about a third of what it is?

Dr Denniss—It is a very important part of it. One of the reasons they are so profitable is that we cannot opt out of consuming their product.

Senator BRANDIS—That is a fair point.

Mr Richardson—Can I add another point that I think is interesting. The value of equity in those accounts includes intangibles. If we exclude those intangibles, the rate of return rises to about 20 per cent. Those intangibles are things like goodwill. Goodwill does not exist in a perfectly competitive—

Senator BRANDIS—But goodwill is not comprehended by the figures that you have quoted.

Mr Richardson—Yes.

Dr Denniss—Yes. The return on equity includes goodwill as an asset. Given that the goodwill is valued by the capacity of your brand to generate profit, to include an asset such as goodwill—

Senator BRANDIS—If you had a five per cent return on equity in the banking sector, who would invest in the banking sector? You could get a greater return on your money by buying bonds.

Mr Richardson—There are many companies listed on the Stock Exchange that trade at a discount to their retained earnings, to their shareholders' equity.

Senator BRANDIS—My point remains, though, that you are recommending that the return on equity for banks should be lower than the bond rate. That is what it amounts to.

Dr Denniss—No. The 15.5 per cent is a point in time, and I think—

Senator BRANDIS—What is the point in time you have chosen?

Dr Denniss—It is a point in time when the return on equity is below the historical average. When we said one per cent is a better target than three per cent, that is based on the historical return. At 15.5, the banks are screaming at the moment, saying, 'It's got to go up, back to the 20 per cent we are used to,' and a third of 20 per cent is seven. For the purpose of this conversation I did not want to quibble over a third of 15, but that 15 is a point in time estimate that is far below the historical average.

Senator BRANDIS—Quickly, because time is against me, let me take you to the conclusions you state on the second last page of your submission. There are four recommendations for policy changes you make beyond generic, general words about regulatory and structural reform which are not particularised. One is 'legislating to ensure that interest rates charged by the banks move in line with changes to the RBA cash rate'. Right? Essentially you are recommending that there be a form of price control in relation to interest rates so that they cannot—

Dr Denniss—A form of, yes.

Senator BRANDIS—Okay. That is fine. Secondly, you recommend capping bank fees. That is yet another form of price control.

Dr Denniss—Yes.

Senator BRANDIS—Thirdly, you recommend 'mandating that all financial institutions offer a no-frills, low-cost everyday savings/transaction account to every customer as the default option'. So you are proposing that we require the banks to engage in a particular variety of service, whether they wish to or not?

Dr Denniss—Yes.

Senator BRANDIS—Lastly, you recommend 'restricting the interest rates that can be charged on unsecured credit'. Once again, that is a form of price control you are recommending.

Dr Denniss—Yes. Can I just add that we have price controls on electricity in Australia and they are very popular.

Senator CORMANN—They are not necessarily very effective.

Dr Denniss—Not very effective? Let's not pretend that we don't—

Senator CORMANN—Let's just go for popularity, right?

Dr Denniss—No. We do regulate—

Senator BRANDIS—I just want to locate ideologically where you are coming from, Dr Denniss. That’s all.

Mr Richardson—We have important precedents—for example, with the Reserve Bank regulating the interchange fees on credit card transactions. This is a recent regulatory change, as is the current ATM fee structure. So the government, through the Reserve Bank, has been keen on regulating some of the worst abuses that the banks have undertaken in the payment system.

Senator BRANDIS—You have got to stop these badly laden assertions, Mr Richardson, and just be a bit empirical—‘the worst abuses’. The point of your submission is to say the problem here is the banks are not competitive enough with each other, at least the big four. That is your big point. But the way in which you would make the market more competitive is to have more regulation and more price control. That is your approach, right?

Dr Denniss—Yes. Given that everything else has failed for 20 years, I think that is why we are there.

Senator XENOPHON—I will try and roll two or three questions into one because we have time constraints. You state in your submission at page 1:

> The ‘information asymmetry’ between banks and their customers allows banks to earn ‘rents’ by underpaying savers and overcharging borrowers …

Are you suggesting that the banks are making super profits, in the traditional definition of the term?

Bringing in another concept, yesterday we heard from Jonathan Mott, an analyst with UBS. His strong argument was that, if the banks do not make significant profits, that will affect their credit rating, and if they do not keep that AA credit rating it will put pressure on interest rates. So we do not win. We are in a lose-lose situation. Can you comment on those two clashing concepts together, please.

Dr Denniss—In a nutshell, yes, they are making supernormal profits. We have suggested that, if the parliament is unable or unwilling to regulate to drive either actual competitive outcomes or price restrictions, we should consider a super profits tax on banks. We have just surveyed the public about the upcoming tax summit next year, and 81 per cent of Australians support the tax summit considering the introduction of a super profits tax on banks. They do earn supernormal profits because of the combination of a number of market failures, including their economies of scale. As for the argument that they are doing us a favour by making so much money, that it is only because they earn so much profit margin that they can keep interest rate margins down—

Senator XENOPHON—In the sense that they have a AA credit rating, therefore it affects their capacity to raise money in international markets.

Dr Denniss—Yes. These rating agencies were shown to be entirely useless in the global financial crisis. The criteria by which AAA bonds were being issued in the US, which turned out to be completely worthless, are well understood. If the criteria of the ratings agencies are so simplistic that rather than looking at capital adequacy, rather than looking at our prudential regulation authority and what a good job it has done of preventing banks from going broke and rather than looking at the underlying structure and the quality of the loan book of the books, all they have to do is look at the end adding and say that it must be a well-run—just before the global financial crisis in the US, the American banks were very profitable—it concerns me that rating agencies have confused the profitability of a bank with the quality of its prudential standards.

Mr Richardson—We want profitable banks but not that profitable.

CHAIR—On the ratings agencies, I do not think it was suggested yesterday by Mr Mott that that is the only thing they look at. All the factors you refer to were part of the consideration and they make a conclusion on criteria which would include profitability of the banks. Regardless of whether or not they get it right, the fact is that it does impact on interest rates, on the cost of funding for the banks, which then flows on to the cost of funds they make available to Australian consumers.

Dr Denniss—If that is the case, the rating agencies should present evidence and tell you how profitable the bank needs to be before it loses its AAA rating.

CHAIR—Yes. It may well be a relevant point for us to look at.

Dr Denniss—So we can then say: what is the increase in the interest margin flowing from going from AAA plus to AAA to AA? Frankly, we might be a lot better off having AA banks paying slightly more—

CHAIR—There is only a handful of AA banks in the world. That is the highest rating of any bank.

Senator PRATT—Your submission talks about the cost of raising funds. I am interested in the emphasis you have placed on competition between banks and the need for more of it. I am interested in your views about the role of other institutions that would compete in this space. You seem to have put the emphasis on breaking up banks and forcing them to compete with each other rather than other players. I am interested in knowing why that is.

Dr Denniss—Again, it comes back to my opening statement about the definition of ‘competition’. I have a three-year-old son. He is free to compete in next year’s Sydney to Surf, but I tell you now I think he will lose. It is open to him to enter, although he has no chance against people who are far more able than him. The idea that we do not have to worry about the conduct of the big four banks and that we should focus solely on the ambitions of the small ones is a very profitable approach by the big four. We have to distinguish between competition the process—‘I am free to compete’—and competition the outcome—‘That looks fair.’ Look at what we do in the AFL. Look at what we do in the Melbourne Cup. We handicap. We put lead in the saddle of the fastest horses because we want a competition where we think every force has some chance of winning. In the Rugby League we have salary caps and in the AFL we have a draft which is specifically designed to give a leg up to those on the bottom. If the AFL, the Rugby League and the horseracing industry did not take competition seriously, frankly no-one would tune in.

Senator PRATT—I am interested in why the Australia Institute is in the business of critique in things and putting ideas out into Australia’s ideas market place, but if you are going to do serious reform you have to have different players lining up on the same song sheet at some point and saying, ‘This is how we tackle the problem.’

I have not heard any other players saying we should be looking at the structural separation of banks. I think it is a pretty big deal for you to just plop that idea out there and expect government to take it seriously unless there is a critique right across the nation that is actually making that idea viable. Clearly, you have put that idea out there, but it does not seem to be coming from anywhere else. But you seem to have dismissed ideas such as bank account portability. I would be interested in your sense of whether that could cause banks to more effectively compete with each other.

Dr Denniss—There are two different points that I will respond to quickly. I think bank account portability is so important that the banks are convinced it cannot happen and should not happen. I would encourage you to compare the statements of the banks to the statements of the telephone providers when we wanted phone portability. Bank account portability is very important. It will not in itself address the fundamental problems but it should be pursued vigorously. As to why other groups appearing before you are not as ambitious as us in the reform space, I can only say that, as an independently funded think tank, we have the privilege of conducting research and talking—through no filters—about our conclusions. Ten years ago we were well ahead of the curve on the need to tackle climate change. Two years ago, when we were talking about a super profits tax for banks, people were dismissing it, but 80 per cent of people now think it is a good idea.

Senator PRATT—I am not sure whether you had the opportunity to hear the evidence that came before us late last night from some banking analysts. It was along the lines of ‘disempowered consumers are what make our banks safe and support strong institutions’. What would you say to that?

Dr Denniss—I would say that, like the ratings agency that says the customer benefits from high profits, the idea that the banking system relies on the complexity and difficulty of changing accounts is an insult. We have done a lot survey work on why people do not shop around. I will give you one simple reason. Imagine that you bothered to spend four hours choosing the right bank account for you and another four hours doing all the work to transfer.

Senator PRATT—It would probably be worth my while to do that, but, no, I have not done it!

Dr Denniss—But it gets better: imagine that, a month after you did that, the bank wrote to you and said, ‘We’ve just changed all the terms and conditions and you’re free to start again if you want to.’ The reason people do not switch is that they have been trained to think that it is pointless. If you switch from a bad expensive product to a good cheap product there is nothing to prevent the bank from doing what they do all the time, which is rationalise, reform, modify and change—and then it is back in your court again. These people have actively been disempowered.

Senator PRATT—Yes. Hence the significance of bank account portability.

Dr Denniss—Absolutely.

CHAIR—Senator Pratt asked about structural separation. What you have proposed in your submission goes beyond the terms of reference of this inquiry but it is quite fundamental change to the banking industry. Given your view is that the industry is basically in a moribund state and needs some major change, would you support a major inquiry in which the terms of reference included the possibility of looking at the sorts of things you are talking about?

Dr Denniss—I would—as long as the major inquiry was not used as an excuse to do the things that everyone agrees we should already do.

CHAIR—One would hope that the inquiry, when set up, would have terms of reference that would encompass a number of things, including the possibility of addressing the issues you have raised, and then come up with a considered conclusion at the end.

Dr Denniss—Yes. Dave knows the history of this inquiries better than most. What would you say, Dave?

Mr Richardson—The important thing is getting the terms of reference right and getting these things properly aired. All the inquiries we have had, going back to the New South Wales upper house inquiry into monetary confusion in the 1840s, have talked about introducing new players and stimulating competition—and so did the Campbell and Wallis inquiries. Occasionally, the structural issue was addressed by things like setting up the state banks in the 1800s and the Commonwealth Bank in 1911—

CHAIR—Mr Richardson, we are running over time as it is. I am not critical of your evidence but—

Dr Denniss—I think what Dave was probably going to say is that, if the terms of reference just talk about competition—

CHAIR—This inquiry is focused on competition. But there have been calls for a broader inquiry into the financial system and the banking system as a whole which could quite easily encompass—and I think would need to encompass—the sorts of issues you have raised.

Dr Denniss—I would suggest as a term of reference: why haven’t any of those inquiries led to structural change, or why haven’t any of those inquiries—

CHAIR—But potentially, subject to the terms of reference, you think that such an inquiry could be useful?

Dr Denniss—Yes.

CHAIR—Thank you.

[9.41 am]

SATHYE, Professor Milind, Professor of Banking and Finance, University of Canberra

CHAIR—Welcome. Would you like to make an opening statement?

Prof. Sathye—Yes. Thank you for the opportunity to present before this committee. The main points of my submission are that, firstly, the banking market is highly concentrated, and it is especially so after the global financial crisis. In my opinion, this does not augur well for consumers nor from the perspective of financial stability. Secondly, I have done some calculations of the Herfindahl-Hirschman index, which is typically used for the purpose of assessing competition in the banking sector. I was amazed to find that, especially in the home loan market, the index has risen above 1,800—it could be said to have 'jumped the red light'—and that really worries me. With this high concentration in the home lending market it is no wonder that the banks are becoming a bit recalcitrant—and that is demonstrated by the banks' interest rate hikes.

Some measure were suggested recently by the Treasurer, and I have an opinion piece in today's Melbourne *Age* which examines those measures. It has been suggested that the scrapping of exit fees could be a way to increase competition in the market. I feel that it may have only a marginal impact rather than any substantial impact. Also, some of the other measures that have been suggested are, as I have written in my opinion piece, more cosmetic than substantial. I feel that the current situation of competition in the banking sector may not be much affected by what has been proposed. I have already addressed some of these measures in my submission.

Another point I have made relates to the view that the banks are 'too big to fail'. The pre-GFC thinking was that banks should consolidate and become big because there is an advantage in being big. But the GFC very well demonstrated that a larger size is no longer a desirable thing. As a matter of fact, larger sized banks can become a permanent headache for the taxpayer because we do not know when these guys are going to stuff it up and come back to the taxpayer. So I have some concerns about the size of Australian banks. I have said in my submission and through various other outlets that some radical measures are required in order to increase competitiveness in the banking sector.

You will notice from table 4 in my submission that the ratio of the banks' net interest income to total assets has remained constant through the years from 2004 to 2010. One of arguments the banks have been making is that they need to increase their interest rates because their funding costs have been rising. But the net interest margin has remained the same. Also, their profit margins have gone up significantly. These statistics, which are calculated from APRA's statistics, show that there is not enough competition in the market. The question that arises is: what is considered to be the right size for a bank and the right level of competition? Unfortunately, there is nothing in that can really tell us the right size for a bank or the right level of competition.

Senator XENOPHON—Is there a right level of profits as well?

Prof. Sathye—You could say that as well.

Senator XENOPHON—A reasonable level of profits?

Prof. Sathye—I would say there is a reasonable level of profits, but how do you find that point? If you look at the profit data of the banks, the average return to shareholders in Australia over the last five years has been something like 9.5 per cent, which is probably the highest in the OECD countries—and Canada is next, with 8.6 per cent. So some questions need to be asked as to whether it is really benefiting the community in the end, or who is it really benefiting? These are questions that need to be asked. I have said in my opinion pieces in various media outlets that the increased profits really benefit only two parties: the shareholders and, more important than them, the managers. We need to address this area in the sense of: what is the right size for banks and what is the right level of competition?

But I can answer that question in a different way. Given the data in table 4 of my submission, one can certainly say that the current state of the banks' profits has really crossed the level where we have the right level of competition. What that means is that there is a decidedly lower level of competition. If you compare the data of 2004, 2007 and 2010, you will find that in 2007 the ratios, the HIH, was looking much better in the different markets. In 2010 it has again gone haywire; it has gone back to the original levels of 2004 or even become much worse than that.

I have suggested towards the end of my submission what needs to be done to increase competition in the banking sector. I am of the view, as I have said in my opinion piece in the Melbourne *Age* today, that the measures that have recently been proposed are not really substantial in nature and may not be able to make a significant dent in the competition scenario in Australia. In my opinion, there are two measures that are required if we really want to make the market competitive. One measure—and I do not know how palatable this will be—is to have some kind of provision in our competition policy which allows for a demerger of banks. That will hang as a threat somewhere. At the moment, there is nothing except that you make appeals to them. Moral persuasion is being made to them: 'If you can bring down your interest rate, it would be great.' But, at the end of the day, there is nothing in there. It is the community that has given licence to the banks to carry on banking business and, at the end of the day, the businesses—as all business are—are directly responsible to the community as well. I find it a bit disturbing when bank CEOs say in the media, 'We're responsible to shareholders only.' With these initial comments, I leave it to the committee to ask questions.

CHAIR—Thank you very much and thank you for assisting us with the inquiry. You say that you have undertaken an assessment of the industry which suggests that it is not competitive and you used a criterion of some sort—I did not catch the name of it but it is mentioned in your submission. We have had evidence over the last couple of days from a number of witnesses, including regulators—RBA and APRA—that they think the state of the banking industry is competitive. There have been some discussions following whether that is possibly a legacy of a more competitive era prior to the GFC. In terms of 'competitive' they are talking about the number of institutions offering lending services, the number of products available and the diversity of the products available. All those indicators of competition in a market are present and so they say that, as you look at it currently, it is competitive. Some of that came about because there was an active competitive force driving competition in the late nineties-early 2000s, particularly from the non-bank sector, which was essentially wiped out during the global financial crisis. Where is the future driver of competition going to come from? Firstly, do you disagree with the conclusions of the regulators—and, from what you say, it appears you do—that the current state of the industry is competitive? Regardless, of that outcome, do you see any potential driver for competition within the industry or that could be formed within the industry?

Prof. Sathye—I am aware of where the regulators are coming from, having been a central banker in my previous incarnation. If you go by the statistics, there are plenty of institutions available. If you ask, ‘What are the various markets in which competition is taking place?’ there are players available in every market, so there are no worries. But, at the end of the day, I feel that, whether or not there is competition in the market, it should be judged on the basis of the outcomes that the players produce. If the outcomes that these players produce have suboptimal outcomes, then I would say that there is no competition in the market.

CHAIR—And that is what you concluded?

Prof. Sathye—That is what I have concluded.

CHAIR—That is not the criteria for assessing the degree of competition in the market that you believe APRA or the Reserve Bank would use?

Prof. Sathye—I would have thought that if they have examined it from the perspective, or from the lens, from which I am examining it then probably they would arrive at the same conclusion, because the conclusions I have arrived at are, again, based on the data published by them.

CHAIR—Okay. You mentioned that you have a piece in the *Age* today which examines the proposed Swan reforms.

Prof. Sathye—Yes.

CHAIR—I have not had the benefit of seeing that; I was not aware that it was in there. Would you mind outlining your overall view—you mentioned that you do not think it is going to make a substantial difference. In terms of particular reforms, is there anything in there that you think might help? Is there anything in there that you think might be counterproductive?

Prof. Sathye—There are two important things in the Treasurer’s recent announcement which would benefit all the players in the market. One is covered bonds, which is a good move. Of course, there are some issues there with respect to APRA. APRA have been giving their views about covered bonds and are not in favour of covered bonds.

CHAIR—We asked them about that yesterday.

Prof. Sathye—I believe that covered bonds are a good move. That will improve the funding position of all the players. But it is important to note that I am talking about all the players. In that, of course the major banks benefit and the smaller lenders will benefit. The small lenders benefit from the perspective that, during the crisis, the RMBS market completely dried up and they suffered.

CHAIR—Evidence we have had suggests that, for a covered bond issue to proceed, you are talking about a significant scale. I have heard anywhere between $100 and $500 million would be needed as part of the offer, and not all of the smaller players would be able to manage that.

Prof. Sathye—There will be some difficulties for the smaller players in that. When I was going through the reforms I felt that this was okay but that it will again benefit the major banks. The second thing was the listing of government securities in the stock market, which is good.

Barring these two measures, some of the other measures that have been proposed I found to be very futuristic in nature—task forces will be appointed and committees will be appointed and, whenever the task force gives the report, the committee will see what comes out of it.

CHAIR—Lots more consultation and lots more reviews.

Prof. Sathye—We are yet to see what comes out of it. At this stage, if I am asked whether this measure is going to increase competition, I do not have an answer to that because—

CHAIR—Because you do not know how it will turn out.

Prof. Sathye—So there is a question mark there. The only two measures which can help are the covered bonds issue and the government securities on the stock exchange. That will have a liquidity impact and a more funding impact. We hope that with that more funding, the banks will be in a position to pass on the benefit of that impact to the customers. The thing that I have a reservation with today is that there is question mark as to whether the banks would actually pass on the benefit to the customer. The Treasurer said that the cost of funding will be lower, but the question is whether or not it will be passed on to the consumers.

CHAIR—Particularly if the cost of funding is lower to a greater degree for the major banks than it is for the other players.

Prof. Sathye—Very right. Some of the other measures suggested include the exit fee, which I have already commented upon in the submission.

CHAIR—Could you just remind the committee as to your views on the exit fee?

Prof. Sathye—I do not think that the exit fee is going to make any substantial difference. There is only going to be a marginal difference. The switching behaviour of Australian consumers, even without scrapping the exit fee, is in line with international rates of switching. So this is not really going to make much difference. The important thing that happens is that the exit fee only ever addresses the financial cost of switching; it does not address the non-financial costs of switching. One of the big barriers there is the non-financial switching cost. What has been proposed is that there will be some kind of a fact sheet presented to the consumer in the new reforms but, again, that fact sheet is going to add to the cost to the banks. At the end of the fact sheet there will be in small print, ‘Please refer to the detailed product disclosure statement’. So, again, you are back to square one.

CHAIR—When you say ‘the non-financial switching cost’, are you talking about the challenges of actually doing the paperwork and—

Prof. Sathye—The challenge of doing the paperwork, doing the research and finding out which thing is better. At present you will find that there is at least a one per cent difference between the home lending rate of, say, a major bank and one of the credit unions, for example. In that one per cent rate, if that made a significant difference, people would immediately go to the credit union which is offering you a one per cent lower rate of interest. So why are they not going there? Either they are not aware of it or, even if they are aware of it, the hassle that is involved is preventing them. So even with a one per cent drop in the interest rate, it is preventing them from going to the credit unions.

CHAIR—I am aware of the time. We started this session late. So, on the exit fees, I will wrap up. We had high-profile evidence yesterday from John Symond from Aussie, and evidence from other, minor, players, that a lot of the competition that did exist pre the GFC came from non-bank lenders like Aussie, Wizard and RAMS. I would be interested in your view, firstly, as to whether that competition actually had an impact on the banking market during that period. Secondly, exit fees are an important part of their business model because they have upfront costs, which they defer on the basis that they can cover them if the customer stays with them for a while. His view is that the enforced removal of exit fees will impact significantly on the ability of non-bank lenders to regain their position as active competitors to the big banks and that it will therefore have a negative rather than a positive impact on competition. The evidence also suggests that the big banks are not particularly fussed about exit fees being removed.

Prof. Sathye—The big banks are not fussed about it at all. As a matter of fact, even before the announcement two of the major banks had already scrapped it. So it is an indication that it does not matter. From a competitive perspective, the major effect is that it does not matter because they had already scrapped it even before the measures were introduced.

On the second question, of whether the non-bank lenders will be affected by it, I do not think that they will be affected, for the reason that the advantages which non-bank lenders offer, in terms of fees and the services that they provide, may not be comparably offered by the major banks because if an exit fee was the only consideration then the consumer would have already gone, ab initio, with a major bank.

CHAIR—I think they were arguing that, if they cannot have that in there as an incentive for people to stay with them long enough for the costs of new loans being set up to be covered, then they will have to increase their interest rates and will not be able to be as aggressive in their competition with the major banks.

Prof. Sathye—It is true that they will have to cover those costs in some way.

CHAIR—Thank you.

Senator PRATT—Your submission makes some remarks about excessive competition and notes that there are dangers in it. Could I ask what you think the warning signs of excessive competition would be? And do you see any of those characteristics in our banking markets here in Australia?

Prof. Sathye—As I mentioned in my initial presentation, it is hard to determine what the right level of competition is. Hence, it becomes hard to say when the competition is excessive and when it is not. One of the criteria that one can use is the outcome that the present level of competition is producing. If the outcomes for the community that are being produced by the present level of competition are suboptimal, then I would say that the competition is not there—that there is excess concentration and less competition. As the data in table 4 of my submission demonstrates—and I have used those four or five parameters which demonstrate that—there is higher concentration and lower competition in the market because the outcomes that are being produced are suboptimal.

Senator PRATT—Do you have a view about what the impact on competition in this country of tighter lending standards might be?

Prof. Sathye—Tighter lending standards?

Senator PRATT—Yes. As you are aware, we have made some consumer reforms that mean lending standards have been tightened up and you cannot recommend inappropriate products to consumers. Is that going to affect competition in any way in your view?

Prof. Sathye—No, in my view that will not have any impact on competition as such, in the sense that, if we go by the level of borrowers now—the borrowers who satisfy those stricter criteria and the borrowers who do not satisfy those stricter criteria—then, so far as satisfying those stricter criteria is concerned, from the risk management perspective, the credit risk perspective, every institution will certainly desire that they operate within that sort of standard risk rather than in the subprime category, as one could say.

Senator PRATT—Given your remarks about competition, does good regulation and strong regulation by organisations like APRA et cetera mean we can afford more competition and we can encourage that competition?

Prof. Sathye—There is always a trade-off between regulation and competition in making the market competitive. The more you regulate the market, the more you stifle competition. But what I would suggest—and I think I mentioned it in my submission somewhere—is that there is a lot of data that needs to be made available by APRA and the RBA. I had some difficulty when I was trying to examine these issues of competition because the data was not available. When I contacted APRA and the RBA, their statistics departments said, ‘Well, this is what we produce.’ That is an area where probably more work can be done. The more data becomes available, the more transparent the system becomes—and, the more transparent the system, the more it is like a check on the system. So I would suggest going down that track. Otherwise, I think our prudential regulation is doing quite a good job.

I do feel that something needs to be done about our competition laws. When the merger of St George and Westpac took place, I went through the ACCC reasoning behind permitting that merger—and, when these merger decisions are made, they are made at a point in time. And that point in time was in 2007, pre the financial crisis—

Senator PRATT—Yes, pre crisis.

Prof. Sathye—so the ACCC felt, ‘Oh, well, everything is okay.’ But suddenly things changed, and we do not have any measure there, in case things change, as to whether or not a decision that we made at a certain point in time is now reversible. It is not reversible at the moment. There needs to be some provision in there, and the lawyers can apply their minds to how that can be done. But there has to be something in there, and that is what I feel.

Senator PRATT—Thank you.

CHAIR—Senator Xenophon.

Senator XENOPHON—Professor, because of time constraints—and my colleagues no doubt have questions for you too—I will try to roll three questions into one. In your submission, you talk about the concentration of the banks and you say:

> … in the … home loan market and investment home loan market it has crossed the safety HHI threshold of 1800. It implies severe concentration which can be detrimental to stability of the financial system—

if you could talk about that more. Also, there are two competing concepts in the evidence that has been given. The Australia Institute said that the banks are making 'superprofits' but, yesterday in Sydney, Jonathan Mott from UBS said that unless the banks earn healthy profits, good profits, they will not be able to maintain their credit ratings; if they do not maintain their credit ratings, it will cost them more to borrow; therefore, interest rates will go up. Where do you stand on those two competing concepts? Also, can you elaborate on your concern about the concentration in the market, and the threshold you refer to, being detrimental to stability.

Prof. Sathye—I will answer the last question first. I do not agree with that analysis that more profits mean a better rating or that the credit rating of the banks will be affected if their profits are lower. As a matter of fact, the Canadian banks have lower profits than the Australian banks, but their rating is not affected; their rating is similar to that of Australian banks.

Senator XENOPHON—How much lower? What return?

Prof. Sathye—It is a bit hard to say to what extent we can bring it down without affecting the credit rating, but the thing is that a credit rating does not depend exclusively on the profits that the banks make. A credit rating takes into account a number of factors, and those factors are basically the prudential standards in Australia and the asset qualities of banks. Those are some of the issues that are considered by the credit rating agencies, and on those counts Australian banks are in quite a good position. Profit is not the only indicator for determining the rating of the banks, so I do not agree with that proposition. Coming to the second question—

Senator XENOPHON—About concentration?

Prof. Sathye—Sorry?

Senator XENOPHON—The HHI index of concentration.

Prof. Sathye—Yes. I feel that too much concentration among the banks in the mortgage loan sector can be detrimental from a financial stability perspective in the sense that it has come out of several studies that Australian housing prices are already inflated. There was a study by the London based *Economist* which said that Australia ranks top so far as the housing prices are concerned. Housing prices are something like 63 per cent higher than what would reasonably be required.

Senator XENOPHON—Does that mean that the bubble could burst—

Prof. Sathye—That is my worry. There is a bubble there and if that bubble bursts then that is going to affect Australia because of the concentration with the major banks. That is going to affect the major banks.

Senator XENOPHON—What do you forecast as a time frame? If the bubble is going to burst, are you talking in the imminent future, next year, in 10 years?

Prof. Sathye—It is difficult for me to say. I would probably put two years on that. You will see a significant correction in the market in two years time. That is my feeling. We hope that we have a softer landing rather than a crash. That is my worry because there is a lot of concentration there.

Senator XENOPHON—Thank you.

Senator WILLIAMS—Just one thing of interest I noted in your submission it says:

Second, scrap the deposit guarantee for major banks but continue it for the mutuals along with a wholesale funding guarantee.

This wholesale funding guarantee seems very important to me because that allows those smaller financial institutions to actually borrow their money at a competitive rate. The government has removed the wholesale guarantee. Surely that is bad for those smaller competitors in the industry.

Prof. Sathye—Yes, that is correct. I agree with that. As a matter of fact the government needs to take actions that are decidedly in the favour of smaller financial institutions. The smaller financial institutions, the cooperatives, the mutuals, need to be given some kind of favourable financial institution status. If the deposit guarantee is restricted to the smaller players then that will create competition for the majors. What is proposed in the recent reforms is that the guarantee is going to be there for everyone. Again, you are back to—

Senator WILLIAMS—That is the retail investment guarantee is going to be there for everyone. The wholesale guarantee—

Prof. Sathye—The retail deposit guarantee.

Senator WILLIAMS—For all ADIs.

Prof. Sathye—Yes, it is for the ADIs, so it is planned for everyone. If it is planned for everyone then it is not giving any favourable treatment to the smaller lenders, so how can they compete with the majors? That is a worry. The second thing is the wholesale funding guarantee. That was scrapped on 31 March this year. I would suggest that that wholesale funding guarantee should be reinstated for the smaller financial institutions.

Senator WILLIAMS—So they can source their funds, especially overseas funds, at a competitive rate.

Prof. Sathye—So they have a good funding source available and with that funding source they are in a position to compete in the market.

Senator WILLIAMS—What about those non-ADIs that are secured investment companies? They do not get any guarantee. In fact, under the regulations, when they advertise they must state at the end of the advertisement that the investor may lose some or all of their money. That is surely making it difficult for those secured investment companies. I emphasise secured.

Prof. Sathye—I would probably restrict myself to the deposit taking institutions only.

Senator WILLIAMS—Yes. You talked about the break up of banks if they get too big and too powerful. Do you disagree with the amalgamation of Westpac and St George? Do you think the ACCC had it wrong in allowing that merger to go ahead?

Prof. Sathye—At the time when that merger was allowed with the criteria that was used for allowing that merger—and this is precrisis years—everything looked okay because things were moving in a different direction, but suddenly we had the crisis and it is a big revelation to us now that what we were doing there was really not okay. In the post-crisis scenario that is presented I personally would not have said yes for that kind of merger. That is why I am proposing there be some provision there which allows for the demerger of banks.

Senator WILLIAMS—My final question is on that point. Europe, the UK, the USA and even New Zealand have divestment powers but Australia does not have divestment legislation. Should that same power be given to the ACCC?

Prof. Sathye—I believe that should be given to the ACCC, yes.

Senator WILLIAMS—It would be a pretty radical move though if the ACCC split a bank up, wouldn’t it?

Prof. Sathye—It would be a radical move, but there is nothing in place at the moment which really can work as a sort of deterrent to the major banks acting against the interests of the community and producing suboptimal outcomes.

CHAIR—Thank you, Professor.

Proceedings suspended from 10.16 am to 10.30 am

CRAIG, Mr David Paul, Chief Financial Officer, Commonwealth Bank of Australia

McEWAN, Mr Ross Maxwell, Group Executive, Retail Banking Services, Commonwealth Bank of Australia

NAREV, Mr Ian Mark, Group Executive, Business and Private Banking, Commonwealth Bank of Australia

NORRIS, Mr Ralph James, Chief Executive Officer, Commonwealth Bank of Australia

CHAIR—I welcome Mr Norris and the other representatives of the Commonwealth Bank of Australia. I invite you to make an opening statement.

Mr Norris—I would like to introduce the team that is with me. Mr Ian Narev is executive general manager in charge of our business and private banking operations. Mr Ross McEwan is responsible as executive general manager for our retail banking operations. Mr David Craig is our chief financial officer.

I would like to make some opening remarks. The Commonwealth Bank is a major competitor within the Australian banking sector and as such brings to your committee a participant's view of competition within the market. The bank services over 11 million Australian customers, we employ more than 45,000 people, we manage over five million transactions accounts, we provide over one million mortgages and we handle almost five million personal savings accounts. I think it is fair to say that we can be found in just about every Australian city or town and where we are not present we usually have an agent available for our customers. We operate more branches than any other Australian bank and we have more ATMs than any other bank or network provider. In the financial year of 2010, the Commonwealth Bank provided its customers with over $100 billion in new lending. Of particular interest to this committee and the parliament as a whole is that we are one of the largest individual contributors to the Australian government. In financial year 2010 we paid $2.9 billion in taxes. Over half of our shareholders, indeed some 780,000 of them, are retail investors, many Australian mums and dads and small superannuation funds. We do take our heritage and our position in the Australian community seriously, and we value the longstanding reputation of the Commonwealth Bank. I believe we do operate in a very competitive market, a view that the RBA and Treasury have also expressed to this inquiry.

Today I wish to focus my remarks on three points: first, the increase in banking funding costs; second, bank profitability; and, thirdly, intensity of competition within this market. Firstly, one of the significant outcomes of the global financial crisis is that the cost of bank funding has become more expensive. We explain the sources of funding and the varying pressures on each element in our submission. Banks are now accessing more stable funding but from more expensive sources. These are likely to be structural changes, suggesting we will bear a high cost of funding for some time. One of those sources is deposits and competition in that market is fierce. Deposit customers of course benefit from higher interest rates. This is one element that is also influencing bank profitability.

The bank's ability to compete well and generate profit has sometimes been painted in a negative light. It is important to understand that the bank is a large organisation with a significant asset base and generates a profit commensurate with its size and its prudent risk appetite. I think it is far too simplistic to just highlight our profit figure without taking into account the numbers behind our business, with more than $600 billion in assets in our banking book. We also on top of that manage and administer over $200 billion in investor funds through our funds management operations. On key measures of profitability such as return on equity and return on assets, the bank's profit does not look unusually large compared with other major domestic companies.

You may be surprised to know that, although CBA is one of the largest companies by market capitalisation on the ASX, our return on assets ranks at 74 out of the ASX 100. Our return on equity ranks at 28 out of the top ASX 100. We are ranked first for dividends paid to Australian based shareholders, and CBA is one of the top four corporate taxpayers. Bank and corporate profitability in general is heavily influenced by the strength of the economy. Indeed, if banks do not make profits, economies go backwards. There is not a person in this room who would want that. The Republic of Ireland in the past few weeks is a graphic example of the problems of a weak banking system. Importantly, the strength of the domestic banking sector has precluded the need for any taxpayer bailout here in Australia. While banks have used the government's wholesale funding guarantee, they have paid for that privilege. In the case of the Commonwealth Bank, we expect to pay the government almost $1 billion for the use of this guarantee.

Let me move to competition. There has been a fair amount of discussion recently about competition in the banking industry. My experience is that competition is very strong for market share, for funding and for people. In segments such as mortgage lending, deposits and small business, competition is fierce. I am pleased to say that, since the start of the GFC, the Commonwealth Bank has been at the forefront of financial institutions supporting homebuyers and small-business owners, maintaining lending and supporting the economy. While the Commonwealth Bank is a major lender of funds for homebuyers, it must be recognised that there are over 100 providers offering a wide range of mortgages, with a wide spread of interest rates and fees. The rise of mortgage brokers, who currently initiate nearly 45 per cent of all new mortgages, has broadened that competition. The bank also made the decision early in the GFC to support the small-business sector. We were ahead of our competitors in lending to the sector that is so vital for the Australian economy and job markets. We did this through keen pricing to small business without altering our lending standards. Our depositors have clearly benefited from strong competition. Customers are reaping the benefits of a price war for deposits by getting higher returns on their savings.

The competitive banking sector has been a boon for Australians over the past couple of decades. Naturally, we welcome sensible government policies that assist fair competition. Australia's banking system passed its greatest financial stress test in seven decades, which highlights the benefits of having strong, well-managed banks and sound government finances in contrast to much of the developed world. Care needs to be taken that any stimulus to boost competition does not come at the expense of financial system stability or government credit worthiness. There is a trade-off between stability and competition. Getting the balance right is absolutely crucial. As the Governor of the RBA recently noted, there is a point beyond which excessive competition can lead to problems, as events in the US and Europe have demonstrated. At the end of the day, what really matters is whether the consumer is satisfied with the service we provide. That is why the bank’s key strategic focus in recent years has been to increase its levels of customer satisfaction. Businesses have to satisfy their customers and shareholders to be profitable, to grow and to be sustainable. We have improved our customer service by changing our culture and investing heavily in people and our technology.

I am proud to say that the Commonwealth Bank has worked hard to improve customer satisfaction levels over the past year—up from under 65 per cent, the lowest in the market, to over 75 per cent today, which is second amongst our major peers. That performance indicates just how well we are competing on customer service as well as on other measures. No-one forces any of our customers to come into one of our branches. We do not steal market share. We grow because we are well managed, secure and compete on the basis of providing excellent service to our customers. Going forward, the Commonwealth Bank Group will continue to strive to surpass our customers’ expectations in what is a highly competitive Australian financial sector. Senator Bushby, we are happy to answer your questions.

CHAIR—Thank you very much. A lot of what you have outlined is incorporated in your submission. After the submission was submitted to the inquiry, of course, the Treasurer, on Sunday, announced a reform package, including a number of measures that the government expects to improve and enhance competition in the banking industry. You have made no comments about that so far today. Would you care to make a general comment about whether you believe those reforms will actually improve the competitive situation in the industry and then any specific comments you may have about any of the particular measures?

Mr Norris—It is really too early to say what impact that package will have on competition. I think these sorts of initiatives are generally best judged through the lens of hindsight. Certainly at this stage it would be very much a prospective view. Some of the elements in the package obviously do assist in providing more competitive access to funding. The initiative around covered bonds is a good one. The additional funding that is provided through the AOFM is obviously a benefit for the smaller players. Therefore there are obvious elements of the package that I think will have a beneficial impact. But, as to the outcome and the quality or the depth of additional competition that creates, I think it is going to be, as I said, judged by hindsight. I also make the point that this is in many ways a very competitive market, particularly if you look at a market like the United States, for example. Net interest margins in the US run at around, on average, over 50 per cent of what they are in Australia. That is a market that has over 12,000 banks. It is also a market where, in the last 12 months, 400 regional banks have gone to the wall.

CHAIR—Almost every week, there is—

Mr Norris—Every week, or virtually every day, you will get a regional bank going to the wall. That is obviously an issue for the US system, but the margins there, as I say, are nowhere near as keen as they are in Australia. Certainly 12,000 competitors do not seem to have brought those margins down.

CHAIR—Despite the fact that, with those margins, there are still banks that are falling over. In the banking reform package, is there anything in particular that the Commonwealth Bank does not agree with?

Mr Norris—I do not think there is anything at this stage that we would get particularly exercised about.

CHAIR—Were you consulted by the Treasurer or the Treasurer’s office prior to its announcement?

Mr Norris—No, other than to say that the announcement would be made on Sunday.

CHAIR—But you had no prior knowledge of any of the—

Senator WILLIAMS—Don’t do a first!

CHAIR—Most of the witnesses that we have had before us have been asked that question and we have had a similar answer.

Senator BRANDIS—The Treasurer does not talk to many people.

CHAIR—No. The Reserve Bank governor told us on Monday that, without the independent increases in the interest rates by the banks over the official cash rate, the current cash rate would probably be about 100 basis points higher than it is. If you and other banks had not increased your rates at a greater level, and this 100 basis point increase in the official cash rate had actually occurred, to what extent would that have covered your increased funding costs?

Mr Norris—If we had not?

CHAIR—If you had not increased yours independently and if the Reserve Bank had increased its official rate by 100 basis points, to what extent would that have covered your increased funding costs?

Mr Norris—I will go back to a presentation that was given by the Deputy Governor of the Reserve Bank in December 2009—about a year ago today, actually—where he made the point that, if the banks had not increased their interest rates over and above the OCR, the banks would have gone into loss. There is a chart in that presentation and it is on the—

CHAIR—But that is assuming that the OCR was where it was.

Mr Norris—No. That is above the OCR—

CHAIR—Regardless of where it was.

Mr Norris—because of the fact that our funding costs are over and above the OCR.

CHAIR—That is what I wanted to get to. How are your funding costs independent of the OCR? If the OCR goes up, presumably to some extent that enables you to cover some of your costs?

Mr Norris—Some of the costs, but the point is that the OCR effectively acts as a base. There are three critical elements here as to the funding. One is obviously the issue around wholesale funding costs and what has happened over the period of crisis over and above the OCR. The second element is the fact that banks have moved from cheaper short-term funding in their balance sheets to more expensive long-term funding, so you have this rollover effect that funds that were borrowed prior to the crisis were borrowed at very low rates which, as they roll over, are more expensive. Thirdly, there is the issue about deposit rates. Mr Craig would be able to give you a more expansive explanation around that.

Mr Craig—The majority of our costs at the moment are not moving in line with the OCR. For example, consumer deposits in our consumer bank have increased around 137 basis points—1.37 per cent—more than the OCR since the beginning of the GFC. Wholesale funding, which is primarily from overseas, has also increased substantially; it has come up about 1.33 per cent more than the OCR. It is very easy to understand that international funding bears no resemblance to the Reserve Bank cash rate, but, similarly in Australia, because of the intense competition for consumer deposits, consumers have benefited significantly during this period as rates have gone up.

CHAIR—I understand completely that some of your costs have no direct relationship with the official cash rate, and I also understand it is more complicated than the way I am going to ask this question. If the official cash rate had gone up by another one per cent, that would have enabled you to raise your rates by another one per cent. What I really want to know is this. If, following the Reserve Bank, you raised your rate that other one per cent in accordance with the official cash rate, to what degree would that have covered your increases in funding costs?

Mr Craig—Very little, particularly in home lending. Because home lending is long-term lending you have to fund that out of long-term borrowing and the long-term borrowing rates are not greatly affected by the OCR. Shorter term lending that is done in other parts of the business is a little more related to the OCR.

CHAIR—It is not so much the OCR affecting those rates; it is what those rates are in an absolute sense.

Mr Norris—The point is that the OCR is effectively a floating rate. These other costs—

CHAIR—So there is a margin on top of the OCR with some of those?

Mr Norris—This margin floats on top of that, so there would have been a very—

CHAIR—You are saying the size of that margin has changed?

Mr Norris—There would have been a very slight diminution of that margin, so it may have been a few basis points, but not anything significant. These rates are pegged off the bank bill swap rate, which is then linked to the OCR. Therefore, as that moves up the other rates are still a premium over and above—

CHAIR—So, in effect, at least with some of your costs, if the official cash rate goes up it actually pushes your costs higher?

Mr Norris—Yes, correct.

Mr Craig—For the retail bank, about one per cent of our borrowing is based off short-term overnight rates, which is absolutely the OCR. That would have moved just in line with it and, to the extent that that had gone up, that would have helped—

CHAIR—So, in the absence of a change in the official cash rate, your evidence is that your funding costs have increased. If you overlay an increase in the official cash rate, your funding costs would increase even further.

Mr Craig—Correct.

CHAIR—The RBA evidence that we received on Monday was that the major-bank funding costs had risen largely in line with the official cash rate since about mid-June last year. Their argument was that, although there is still an ongoing increase over and above the official cash rate in your long-term wholesale funding, there has been some fall since the peak of the global financial crisis in the short-term wholesale funding and also in the price that you have to offer to attract deposits. That has largely offset the long-term wholesale funding since mid-June 2009. That is the conclusion drawn by the RBA on the basis of the information they have. Do you agree or disagree with that? If you disagree, why?

Mr Norris—I think the issue is that spot rates have largely stabilised—there is no doubt about that—but what we have is a situation where our funding book is not a book that can be repriced as spot, so what you have is a funding book that has a duration of terms built into it. Therefore, we have a significant amount of money that has had to be repriced as it has increased. The analysis about the spot is correct, but the fact of the matter is that there are three other factors that impact upon that—firstly, the rollover of existing funding that was in the book at a cheap price. For example, three-year money was 17 basis points over; it is around 90 basis points over now. So that cost increases as you roll that cheaper money from earlier investment—

CHAIR—Which is more the long-term funding—

Mr Norris—Yes, it is long-term funding; it is this three- to five-year funding. We have also reduced a significant amount of our short-term funding into longer term funding, which has meant that there is a higher cost there.

CHAIR—That is partly because of the Basel III requirements that basically provide a more conservative approach to your funding?

Mr Craig—That is right, and also because of our overall stance that we need to be more conservative, having learnt lessons from the GFC.

Mr Norris—Therefore, we have also taken on new funding durations that are seven years, 10 years, which we did not fund at before. Those durations are significantly more expensive than the three- and five-year durations that we were funding. So that also adds to the cost.

CHAIR—Presumably, though, the RBA is aware of all that and they are also aware of the changes in spot fees and the shorter term funding that you have looked at, and the deposits. They concluded—and made quite an explicit conclusion—that the major banks' increasing costs have run basically in line with increases in the cash rate since mid-June 2009.

Mr Norris—There is a chart in our submission that makes a lie of that.

CHAIR—Just to be clear, you disagree with that?

Mr Norris—I disagree with that interpretation. I do not disagree that the Reserve Bank is right in the fact that spot rates have largely stabilised.

CHAIR—The conclusion they draw at the end of that—

Mr Norris—I have not seen that conclusion. I have seen comments made by the Reserve Bank.

CHAIR—It is actually written in their submission.

Mr Craig—My understanding of their submission is that it is saying that the price at which you can raise funds has stabilised, and that is absolutely correct. But we have to continue to roll over funds. That is only the wholesale funds. Retail consumer deposits have grown very significantly in price over that period. I do not think they comment on that.

CHAIR—The evidence from the RBA is that they certainly did over that period, but in recent times they have started to drop. Is that the experience that the Commonwealth Bank—

Mr Craig—They move up and down.

CHAIR—I know they move up and down, but recently they have begun to fall.

Mr Craig—On average, in the last little while they have fallen a little bit. But of course they tend to be term deposits, so you do not get an immediate benefit from that.

CHAIR—But you are right that, in terms of the new business, you would be getting benefits from term deposits?

Mr Norris—We are getting some fractional benefits.

CHAIR—Moving beyond that, we will take your evidence as read that your costs continue to increase. When do you think that that will peak?

Mr Norris—I think we are talking somewhere around another 12 months before we will peak.

CHAIR—Beyond that point, you will start to seek new funding which will replace funding that you took at the peak when things were quiet and which is now a bit lower?

Mr Craig—That is on the wholesale side. That is absolutely correct, yes. On the retail side, of course we do not know. It depends.

CHAIR—You do not know exactly where things will go.

Mr Norris—The issue here is that I think interest rates are going to be significantly impacted by RBA decisions which will revolve around how the economy is performing.

CHAIR—What is the Commonwealth Bank's current prediction for the official cash rate over the next 12 months?

Mr Norris—Our view is that it will increase.

CHAIR—Do you have a figure that you have published?

Mr Craig—Yes, our economist thinks that by the end of next year it will be 100 basis points higher.

CHAIR—In terms of your decision to put up interest rates over and above the official cash rate—and the most high-profile example of that was in November, on Melbourne Cup Day—your argument is that it is because of the increase in funding costs, which we have just examined to a reasonable degree. Have you been asked by the Treasurer to justify why your interest rates needed to go up, given that the Treasurer has clearly stated that he thinks it is not justified?

Mr Norris—He has not asked me specifically.

CHAIR—Has anybody from the Treasurer's office contacted the Commonwealth Bank to ask that?

Mr Norris—Not that I am aware of.

CHAIR—And there has been no request to provide any explanation in writing?

Mr Norris—No.

CHAIR—Treasurer Swan was sitting in the meeting yesterday saying that the major banks are upset about the reforms that he proposes. I have already asked you about your assessment of the overall reform package, but I take it from the comments that you made with regard to that package that you would not classify your response to that reform package as being upset.

Mr Norris—I think that we have to be very careful that we do not end up tilting the playing field and having a situation where the government ends up with an unacceptable degree of risk. We also have to be careful that we do not end up in a situation where poor behaviour is encouraged in lending markets. I think it is fair to say that we have just come through what has been one of the most disruptive periods in world financial markets, which has been caused by poor lending decisions, poor regulation and poor oversight.

CHAIR—But not in Australia.

Mr Norris—Not in Australia. We have a banking system that has performed very well. I think we have to be very careful that we do not end up creating an environment that would lead to some of the unfortunate outcomes that have happened in other markets—in Ireland, the UK and the US—through poor lending standards and a situation where you end up with competition which is a race to the bottom.

CHAIR—But, presumably, you do not see anything in the reform package that you think is likely to upset you in that way.

Mr Norris—Not at this point. It seems to be a well-considered set of initiatives.

CHAIR—You mentioned in your opening statement that you believe there is a trade-off between stability and competition and that we need to get that balance right. I do not think anybody would argue with that. The evidence that we have had before this committee over the last couple of days suggests that there was an additional level of competition in the banking industry in the late 1990s and early 2000s, particularly driven, I guess, by the non-bank lenders like Aussie Home Loans, Wizard and RAMS and so forth. Do you think that the level of competition that existed then was excessive or pushed that balance in any way?

Mr Norris—I think if you looked at what the outcome has been over the balance of the decade then you would come to the conclusion that it has not been excessive. We have not seen any bank failures, but I think it is fair to say that a lot of the non-bank lenders were able to take advantage of what could be regarded as very low funding costs—

CHAIR—With the securitisation market.

Mr Norris—which did not take into account, potentially, the true cost of risk. So I think that what we are seeing internationally now is a realisation that a lot of the problems that were created internationally were based on the mispricing of credit. That is why at the moment the international securitisation market is a market that is not particularly active because of the fact that lenders into those sorts of vehicles expect a higher level of return because the risks are greater than what they had previously appreciated.

CHAIR—Given what you just said, do you think that it is likely that the securitisation market will in the near term approach the levels of activity that it did at an international level, with particular reference to interest in Australian securitisation products, or do you think that the business models that they were based on were unsustainable and it is unlikely to get back to that point.

Mr Norris—I think for some of those providers it was an unsustainable business model going forward. I think that securitisation will come back but it will come back at a higher cost. Also, the provider or the lender will be expected to hold a higher level of risk, whereas previously on those securitisation vehicles they were able to effectively pass all of the risk on.

CHAIR—Skin in the game, so to speak.

Mr Norris—Yes, they will have skin in the game, which will mean that they will have to price in the additional cost of that risk that they are holding as well.

CHAIR—Pricing in the additional cost of that risk I guess increases the cost of funding for those institutions that will be looking to fund banking products through securitisation, which will make it harder for competition.

Mr Norris—I think the point is that if you go back to where we were, we may have been in a situation where that market was a market that, as I said, was mispriced. Therefore, there is a well-understood situation that is now prevailing in most developed markets that the cost of credit has to take into account the risk premium, which, to a large extent, was competed away. We withdrew from a number of transactions that were in the business and institutional banking market in 2006-07 because our view was that the pricing just did not reflect the underlying risk in those transactions. I think that our view was borne out by what happened a few short months later.

CHAIR—One of the reasons why I am asking this is because you stated that you believed that the banking industry is competitive as it stands today. The Reserve Bank and Treasury have both said that, as you noted. One of the questions that I have been asking some of the witnesses is the degree to which that current state of competition—whatever it may be—is a legacy of the period of high competition that was driven by those non-bank lenders in the late 1990s and the early 2000s. Without a similar sector of the industry continuing to drive competition, will the current state of competition remain or begin to dry up?

Mr Norris—It is quite interesting to look at the underlying figures. If we go back over the last decade, we have seen a situation in which the net interest margin for banks has fallen by 100 basis points. If we look at our own mortgage portfolio and look at the net interest margin return on that, since prior to the crisis—so going back to early 2007—to where we are today that margin has dropped 15 per cent. I would suggest that if there had been a situation in which there was not sufficient competition in the market then it would be hard to understand why we would see that.

CHAIR—That answers the first part of it, with you saying that we are competitive now. Do you think part of the driver that brought that net interest margin down was the impact of the non-bank lenders?

Mr Norris—The bulk of what we have seen in the last three years has been since the non-bank leaders exited the market. Our margin on mortgages has fallen 15 per cent in that period.

CHAIR—But that was a very unusual period.

Mr Norris—The funding costs are part of that. We have had a situation in which we have not passed on all of the additional costs. There are still over 100 mortgage providers in the market. Go on the net and look at rates.com and people like that and you will see a great variety of product and a great variety of providers.

CHAIR—There is no doubt that there are a great number of providers. We only have limited today and there are a number of senators who want to ask questions. We could go into some considerable detail in terms of the quality of competition. Treasury, in their red book advice to the incoming government this year, advised that the banking industry is oligopolistic in nature, despite of the fact that there are over 100 lenders. That is primarily because of the market share held by the four majors.

Mr Norris—I would like to address the oligopoly issue. Since I have been Chief Executive Officer of the Commonwealth Bank, we have been very focused on customer satisfaction. We have spent billions of dollars on upgrading our branches and our products. We had a situation back in the early 2006 period where only a handful of our products were five-star rated by CANSTAR CANNEX. Today, all of our retail products are rated at five stars. At the same time, we increased training and spent a lot of money on systems and processes. That has cost billions of dollars. If this was an oligopoly, why would we as an organisation spend billions of dollars on customer satisfaction just for the sake of doing it? Why we have spent those billions of dollars is to make us a much stronger competitor. As a result of that, we have seen our customer satisfaction levels improve, we have seen the number of products per customer improve on the back of the fact that our customers have a stronger linkage with us as an organisation, we have seen our complaints to the banking ombudsman go from a 33 per cent share of all complaints to them in March 2006 to 11 per cent in March 2010. If as a chief executive and a hardnosed businessperson I was to take the view that I could get a return through operating an oligopoly why would I and my board spend that sort of money to get those sorts of results?

CHAIR—It is a fair comment. One of the witnesses from earlier today suggested—and I do not necessarily agree—that the reason why you do that is because there is competition on certain levels to maintain market share. Effectively, by doing that you are creating a barrier to entry for other potential competitors—that is what they are saying. As I said, I qualify that by saying that I do not necessarily agree. But there are arguments as to why you would do that in terms of trying to deliver a commercial return that does not necessarily prove that there is true competition in the market.

Mr Norris—I would suggest that there has never been a time when there has been more intense competition between the four majors than there is today. You also see that in the different strategies that being led by the different banks. We have seen one of the banks taking very much a price led approach to competition. We as an organisation are taking a very strong view around quality, customer satisfaction and investing in our business to make sure that we are achieving that. We are investing hundreds of millions of dollars in a new banking platform, which will be the most modern in this part of the world and the biggest migration of any information system in the history of Australia's banking industry. All of that is about making us a more formidable competitor going forward. It is not to ensure that we remain part of some oligopoly.

CHAIR—I would love to ask you more questions, but we have a number of senators waiting. I have a final one. There has been a lot of talk in the media and suggestions by particular politicians about the benefits of a potential broad based inquiry into the banking industry and how that might proceed. I asked the Banking Association about it yesterday and I also asked the National Australia Bank about it on Monday. What is the view of the Commonwealth Bank of the potential benefits that could be delivered from a broad based inquiry that examines where we currently stand, given that we have not had one for 14 years and we have just been through a period of major change?

Mr Norris—My view is that if an inquiry takes place we will be very happy to cooperate and take part in it.

Senator HURLEY—There is nothing simple in the financial industry. On the one hand, we had the situation that it was very useful during the global financial crisis that we had large, stable and profitable banks in a banking system that could see us through the world instability. However, we are starting to come out the other side now and people have been looking at the profits of the banks. You and other banks have made points about return on equity, which we have heard are around 13 to 16 per cent. You have talked about comparisons to other top 100 companies in Australia. However, the difficulty for the banking industry is that so much hangs off what happens within the banking industry. Small to medium businesses and individuals are paying interest rates are starting to cause them some difficulty now. The view from many of those people is that the banks should not be looking to come out of that global financial crisis early and return to pre-crisis levels of profitability.

Mr Norris—If we look at profitability, our profitability on a return on equity basis is below what it was prior to the crisis. It is certainly still running below on a return on assets basis. If you look at what has been the international benchmark—and this is looked at very closely by rating agencies—it is obviously the profitability of a bank. Its ability to absorb shocks comes from its ability to generate profit. If we look at where our return on average assets is in our banking business, it is about 75 basis points after tax. If we look at that in comparison with other industries, in the retail grocery industry the best of the supermarkets have a return on equity that is more than double the average of the banks. We also see resource companies with returns significantly above those of the banks. It is fair to say that the reason why banks have been successful during this whole crisis is because the Australian banks were profitable and had strong capital bases and this meant that we were attractive to offshore investors to provide funding. For virtually all of its history, Australia has run a current account deficit. That current account deficit has been funded through offshore debt providers. If we have a banking industry that is seen as potentially weak or as having problems then the banking industry will be downgraded by the rating agencies, and in fact the cost to borrowers will increase because our funding costs will be increased by virtue of the fact that we will be seen to be lower rated.

So, as you said, these things are not simple. We have a number of elements that mesh together to create a situation where, given that our returns over the last 15 to 20 years are pretty much consistent with where they are today, unfortunately the issue that is going to have the greatest impact on borrowers, going forward, will be the performance in the Australian economy, and the decision as to whether interest rates rise or interest rates fall will be in the hands of the RBA. I think that that will be the most significant impact, going forward, on borrowers.

Senator HURLEY—Okay, well let's talk about those interest rate levels again and this discussion about whether the interest rate rises by the banks are justified in terms of their funding costs. You were talking about net interest margins before and about a decrease of 15 basis points—

Mr Norris—No, 15 per cent.

Senator HURLEY—Fifteen per cent, sorry—since 2007. Let's go back a bit further. The year 2007 was the onset of the global financial crisis. What about something like 2004? I understand from other sources that your net interest margin, the overall net interest margin, is the same as it was in 2004.

Mr Norris—I will pass on to our chief financial officer to answer that.

Mr Craig—There is a figure in a Reserve Bank diagram in our presentation, on page 8, which shows that there has been a steady decline in net interest margin really for the last 20 years.

Senator HURLEY—Twenty years?

Mr Craig—Yes.

Senator HURLEY—But at what level do you want to maintain it? If you are getting a net decline, at what level do you stop and say, ‘Okay, we won’t decline below that’?

Mr Craig—We are trying to run a bank that is profitable in a very competitive market and, as Mr Norris said earlier, we have not in fact recovered all of the increases in costs that we have had in our retail bank. We have still left some on the table for our customers; we have tried to share the pain. And we think that at the moment that is a fair position to be in.

Mr Norris—I make the point that since 2000 there has been a drop of around 100 basis points in net interest margin in our business. We have worked very much on the view that we would see a diminution in the margin of about 10 basis points per annum, and that was our view right through until the global financial crisis.

There is one element that has actually come into play as a result of the global financial crisis, which is this whole issue of risk and the fact that risk based pricing has come back into vogue. The reason for that is that we saw the world awash with liquidity during the early part of the 2000s and through to 2006-07, which saw credit being woefully mispriced in a lot of markets. As a result of that we saw a situation where lending criteria were loosened substantially, which had resulted in a situation where subprime loans would be written, CDO instruments were being created and all the rest of it, on the back of what was a very poor assessment of underlying risk.

What we have seen since the crisis began is the fact that every market, every debt provider, has now taken a significantly closer look at what they are prepared to lend money at. And, as a result of that, there has been an increase in what is called the risk premium. In our business bank, our institutional bank and markets operations those margins have gone up and they have gone up because there has been, through our risk management practices, a much tougher view of what should be the risk premium applying to any loan in those particular areas.

Senator HURLEY—I am sorry; I am not quite following you. Are you saying that because other institutions are looking at the risk premium they are requiring you to have a better net interest margin?

Mr Norris—They are lending money to us at a higher rate and that is where our funding costs have gone up.

Senator HURLEY—How does that relate to the net interest margin?

Mr Norris—The net interest margin is all part and parcel of that. On one side, we have the money that we borrow; on the other side, we have the money that we lend at. The difference between them is the net interest margin. If interest rates go up on the funding side and we do not put the rates up on the lending side, the net interest margin reduces. What we endeavour to do is to keep the net interest margin in line by—

Senator HURLEY—Your chart shows that at around 2004 your net interest margins are about the same compared with now. It did decline but it is now trending back up.

Mr Norris—I think you have to look at the net interest margin on a trend basis. From 2004 it fell as well. I think the situation is that you cannot take a one-year view. If you go back through any series, you will see troughs and peaks and you have to look at the overall trend. The overall trend has been down. When I joined this business back in 2005 we had a net interest margin which would have been around two—

Mr Craig—Yes. What you are seeing in this chart is the net interest margin for the Australian group. So it takes the two elements that Ralph has been talking about. On the one hand, our margins in our retail bank—which is obviously charging rates to consumers for home loans—have dropped by 15 per cent; on the other hand, our margins in our business bank have increased somewhat to take account of risk. That is what Ralph was describing. When you are looking at that 2004 number, you are seeing risk incorrectly priced for business lending. So those margins have gone up a bit. Offsetting that, margins have declined in the retail side.

Mr Narev—We should note, again going back further, that since 2009 business margins have also reduced 23 per cent in the long term.

Mr McEwan—On that chart on page 8, you will see there have been a number of peaks and troughs. I think you are seeing cycles of business. But the long-term trend on that chart is downward, and we suspect it will continue to go down with competition. That is what we have seen. We have certainly seen that from the retail banking point of view where there has been considerable competition for retail deposits. Our retail deposit business makes up about 60 per cent of our funding for home mortgages—the big pressure on that side of the balance sheet and we suspect that that will continue while there is demand for funding.

Senator HURLEY—It is going up now but you expect it to come back down again.

Mr Narev—It has come down in the retail bank, but it has gone up slightly across the group for other reasons like business banking.

Senator HURLEY—Let’s accept that and talk about the second part of your costs and something that the RBA talks about—that is, bad debts. Your bad debt ratio has gone down, so that reduces your costs.

Mr Norris—Our bad debts are still not down to where they were prior to the crisis. They are still running at higher levels, but our view is that that situation will obviously improve.

Senator HURLEY—So it should continue to improve and that will reduce your costs?

Mr Norris—Hopefully, if economic circumstances continue and we do not get obviously exogenous shocks like we have seen over the last two or three years. We seem to get one every few months. One month it is Ireland and it is Greece another month, or whatever. Hopefully with a stable environment and a world recovery then one would expect to see a much better bad debt outlook.

Senator HURLEY—You would agree that that would reduce your costs?

Mr Norris—That would reduce the bad debt costs, yes.

Mr Craig—Our returns were well below the long-term average obviously during the GFC. This is a cyclical business and we take a real hit and our shareholders take a real hit during bad financial times. Our dividends were frozen and indeed reduced, as was the case with many bank dividends at that time but now they are returning to more normal levels.

Senator HURLEY—You mentioned that as competition increases your margins will come down. I know it is very difficult to predict, particularly in these times, but where would you see increased competition coming from given that a number of your competitors have reduced in size, or even dropped out or been taken over.

Mr Norris—I think, as I said earlier on, our greatest competition at the moment comes from the other majors, who are well resourced and certainly are providing a lot of very strong competition. I think that because we have four large banks—we have two large supermarkets, we have, I think, three or four major oil companies—it is fair to say that if you looked at the pricing strategies of all of the banks I do not think you would find a time when there has actually been a greater level of difference in the approach, which I think is a good sign of competition and effect. It is also interesting to note that, if you do a lot of comparisons with other financial institutions, a lot of the smaller banks in particular have not had the lowest prices. They have generally had interest rates that have been above the rates of the major banks throughout the crisis.

Senator HURLEY—They can put pressure on you through service and other things.

Mr Norris—That is one of the reasons why we are putting a lot of effort into our own business around customer service and satisfaction.

Senator XENOPHON—Mr Norris, the RBA has announced nine increases since February 2009. Is it correct that, of the big four banks, your bank has been the first to increase rates on five of those nine occasions?

Mr Norris—I do not know specifically but I would not argue with that.

Senator XENOPHON—I think Westpac did once and NAB three times, making up nine. Can you explain why is it that the CBA has been first cab off the rank when it comes to increasing and passing on interest rate increases to consumers?

Mr Norris—We make decisions based on commercial reality and we have made a decision at those times to, obviously, increase our rates because our funding costs had reached a point where we felt that we needed to. I think it is fair to say that we have made that decision probably more quickly than our competitors in those five instances that you outlined.

Senator XENOPHON—Because you had more pressure and funding costs?

Mr Norris—I think it is fair to say that when the Reserve Bank increases the OCR all banks end up moving. It comes down to the timing of those moves.

Senator XENOPHON—And the extent of the movement as well; is that a function of your funding costs?

Mr Norris—It is absolutely a function of our funding costs.

Senator XENOPHON—The Australia Institute, in evidence earlier today, extrapolating from your 2009-10 annual report says that interest expenses fell as a percentage of both assets and liabilities. So you spent less money on interest in 2010 rather than 2009. How do you correlate that with the issue of increased funding costs?

Mr Norris—I will ask my CFO to comment on that.

Mr Craig—Interest expense and interest income dropped because the interest rates that the Reserve Bank set were lower. All they are reflecting are that the rates in the market during the GFC were lower because the Reserve Bank dropped rates and then they went up again. I think that is merely a reflection of the interest rate not the margins.

Mr Norris—The OCR fell through that period to three per cent and now has gone back up.

Senator XENOPHON—You are saying that overall it is still costing you more despite your spending less as a percentage of interest.

Mr Norris—The number is distorted. The main reason for that number is the fact that the Reserve Bank was decreasing the OCR.

Senator XENOPHON—We look at interest rates overseas in the UK, the US and Japan which are significantly lower than our interest rates. Can you understand that the public feels aggrieved when it comes to our level of interest rate rises compared to other countries?

Mr Norris—The decision on interest rate settings is a decision taken by the RBA. In the US, the net interest margins for banks have a three in front of them, rather than a two in front of them as they do in Australia. So the fact is, while the interest rates in the US may be down at less than one per cent on an OCR basis, the banks add on top of that a margin of over three per cent. Here in Australia, the banks add a margin that has a two in front of it, so our margins are more efficient than they are in the US but our rates are higher because of the OCR setting.

Mr Craig—Which is because the economy is stronger. High interest rates in Australia are a function of the fact that the Australian economy is strong. There are low interest rates in the US because they are still recovering.

Senator XENOPHON—You do not believe that, if we had a more competitive market, that would—

Mr Craig—It is not a question of competition; it is a question of the relative strength of the economy and the settings of the Reserve Bank and central banks in those economies.

Senator XENOPHON—So you do not think competition has any role to play in terms of the fees banks—

Mr Craig—The absolute level of interest rates in this country compared to the interest rates in other countries is a function of the health of the economy and the actions of the central banks.

Senator XENOPHON—But the margins?

Mr Craig—No, the margins are higher in the US than they are here.

Senator XENOPHON—Sure.

Mr McEwan—The other issue, Senator, is that Australia is having to borrow considerable amounts of money from those very countries that have the cash. We are having to import that money to support our home lending book, for example, and we are having to pay for that money. We do not get it at the rate of 0.25 per cent or one per cent.

Mr Norris—Because the money has to actually be swapped into Australian dollars and the interest risk has to be taken into account. So it is the hedging cost that actually gets the rates here up to where they are.

Senator XENOPHON—The Commonwealth Bank has a 33 per cent share in Aussie Home Loans. We heard some quite feisty evidence from John Symond yesterday in relation to that. Can you indicate to what level the Commonwealth Bank, with its 33 per cent shareholding, have a say in either the day-to-day running or the long-term strategic decisions made by Aussie Home Loans?

Mr Norris—We do not have any influence over the day-to-day operations of Aussie Home Loans. As you found with Mr Symond yesterday, he is very much his own man, and we have a representation on his board of two people out of six. John has 67 per cent of the vote; we have 33 per cent of the vote.

Senator XENOPHON—What about long-term issues—do you have a say in the long-term strategy of Aussie Home Loans?

Mr Norris—Mr McEwan here is one of our nominee directors on the board of Aussie Home Loans so maybe Ross would like to talk about that.

Mr McEwan—Very clearly, the day-to-day management of the business is done by John and his executive team. We have no involvement in that at all. All of our third-party relationships are at arm’s length with him. For example, the head of our third-party broker team does not sit on his board and has an arm’s length relationship. John is involved—

Senator XENOPHON—So you do not regard Aussie Home Loans as a subsidiary of the Commonwealth Bank?

Mr Norris—No, it is an investment.

Senator XENOPHON—You are aware that the government has, in terms of the AOFM's involvement—

Mr McEwan—Correct.

Mr Norris—John certainly made me aware of that.

Senator XENOPHON—So your view is that they are not a subsidiary in any reasonable sense of the word.

Mr Norris—No.

Senator XENOPHON—Therefore, the decision made not to allow Aussie Home Loans to participate by virtue of your investment you regard as an unfair decision.

Mr Norris—I can see why John is aggrieved.

Senator XENOPHON—Do you regard it as an unfair decision?

Mr Norris—I think the decision should be reviewed.

Senator XENOPHON—Finally, going back to the issue of the percentage of bank funding costs, you are saying that in 2009 interest expense as a share of liabilities was 3.6 per cent and as a share of assets was 3.4 per cent. It has now gone down to 3.3 per cent and 3.1 per cent respectively. You are saying that is not relevant in terms of your costs of funding.

Mr Norris—It is the margin above. I think the issue here is that it fell on both sides, on the earning side and also on the deposit side, because of the impact of the OCR.

Senator WILLIAMS—Mr Norris, I think it was on 21 August that it was written up in the media that you said you were likely to raise rates above any Reserve Bank cash rate movements. Is that correct?

Mr Norris—I do not know where that was printed. There have been comments attributed to me which were attributed in error and have been—in the *AFR*, for example—retracted. So I do not know—

Senator WILLIAMS—Did you make statements to the media or publicly around August that the Commonwealth Bank may have to raise their rates above the Reserve Bank cash rate?

Mr Norris—I have certainly made comments about the fact that our cost of funding was continuing to increase and, obviously at some point, something would have to give—yes.

Senator WILLIAMS—Did you make those public statements to soften up your customers or to signal to your competitors that you would be moving above cash rates or to prepare the public for an injection of pain?

Mr Norris—There is a combination of factors. One is obviously our investors, and also our customers, but it was not intended to be what has become known as some price signalling device—no.

Senator WILLIAMS—It was not intended for that. The other banks would have said, ‘Hey, it’s pretty obvious that the Commonwealth Bank is going to move above Reserve Bank cash rates,’ and it certainly sends a clear message to your competitors, doesn’t it?

Mr Norris—I think it is fair to say that all of the bank chief executives have said at some point—including those of some of the smaller banks—that funding costs were an issue and have made similar statements. We see a situation where this is an industry-wide issue. It is not something that is specific to the Commonwealth Bank.

Senator WILLIAMS—We are talking about competition and banks. That is the reason for this committee inquiry. If you can raise your net interest rate margins, doesn’t that clearly show that it is not very competitive? If I have a retail shop in a street in a country town and raise my prices, that is certainly saying that there is not a lot of competition—if you are in an industry where you can do that.

Mr Norris—Senator Williams, I think we have already made it quite clear that, during this period of the crisis, our retail margins have actually dropped 15 per cent, so we have not had the ability to claw back that compression in our net interest margin in our retail bank. As we said earlier, where the overall margin has been impacted and either maintained generally or has come down somewhat, is through the higher risk premium than is being afforded to business. It is important to realise that we look back to the past and we will have another Basel III and all the rest of it. I do not think anybody should be of the view that we do not risk, in the future, another crisis in banking or finance. We have seen them previously. In the future you will see them, particularly if we end up in a situation where there is a propensity for people to lend money inappropriately and mispriced. Certainly, from my perspective, I make no excuse for being prudent. We are looking after our depositors’ money. Our depositors want to be able to come to the bank, get their money and have security of receiving that money back. It is up to us to make sure that we lend that money prudently and appropriately. Certainly, from the point of view of business banking—and this is where we have seen a significant amount of loss over the last three or four years—it comes back to having inappropriately priced for risk. Some of those transactions would not have been done if those organisations had to pay a price which was more equivalent to the underlying risk of what they were going to use that money for. I think it is particularly prudent for a banker in this day and age, particularly having seen what has happened over the last three years, to price appropriately for risk in business and institutional banking.

Senator WILLIAMS—If a small business wants to borrow, even if they put up their house for security, they pay a higher rate than, say, an employee of that business. Here is the situation: if I worked in a small business and earned $60,000 a year and my wife was earning the same, and I had a deposit, I could get finance far cheaper than the business owner could, but if the business goes broke I lose my income as an employee of that business. How is it that the business pays such a price and yet employees of the same business get a far cheaper rate when they borrow money? Are they both at risk?

Mr Norris—It comes down to probability of default and what the loss would be given that default. I will pass that question on to Mr Narev, who is the head of our business and private banking operation.

Mr Narev—Senator Williams, it is a fair observation and a discussion that we also had at the committee inquiry into the access of small business to finance in April.

Senator WILLIAMS—Exactly.

Mr Narev—We do have a differential of 50 basis points between a residentially secured business loan and a personal home loan. Through the crisis, that has been by some considerable distance the lowest of all the major banks, showing there is quite a bit of price competition in the market. The reason we have that difference, notwithstanding that there is residential security, is that over the long term—which is how we look at the probability of default for business lending—the difference in the likelihood of a default on a business loan, because it is taken out for business purposes, is roughly 50 basis points above what it is for a home loan. So, consistent with Mr Norris's comments about the importance of pricing for risk, we add those 50 basis points to the standard variable home loan rate, and that gives us our residentially secured business rate.

Senator WILLIAMS—Okay. You were a witness at the Senate Economics References Committee inquiry into access to finance for small business, and one of the recommendations of that inquiry was that banks abolish exit fees. Now, we have already seen the National Australia Bank and ANZ abolish their exit fees. They may well have establishment fees. You would probably say, 'If we abolish our exit fees before the four years are up then we will have to put on establishment fees.' I know it stifles competition, because I went to change banks two weeks ago and it was the exit fee that prevented me from getting an interest rate that was ¼ per cent cheaper. So why have the two biggest bank lenders, the Commonwealth and Westpac, who have the greatest share of home loans in Australia, retained your exit fees?

Mr Narev—I will ask Mr McEwan to comment in a minute on residential loans. What I would add is that we do not have, and we have not had, exit fees for people with business loans. It suits some of our competitors to draw the committee's attention to residential loans, not business loans, but our practice has certainly not been to have exit fees for business loans.

Mr McEwan—On the exit fees, Senator, I think it just shows the competitive nature of the business, to be quite honest. Different parties respond in different ways. We will be reviewing, as we do, all of our fees, because we have remained very competitive fee-wise and our aim is to stay that way. It is interesting to look at the statistics on people who make a different decision depending on whether or not there is an exit fee. Our stats show that about 10 to 11 per cent of people pull out of a loan in the first year, second year, third year and fourth year, even though there is an exit fee, and it is exactly the same number in the fifth year and beyond. So I appreciate your position, but the stats actually show that it is not a determining figure, particularly when that fee is one of the lowest in the market or has been traditionally. There have certainly been fees from the smaller nonbanks that have been very high, and that has been their competitive position—a lower interest rate but a very high back-end fee. We have chosen to stay with lower fee structures in our portfolios, and that has been our traditional position.

Senator WILLIAMS—Okay. My last question is on small business. I was in small business. It was a Saturday morning. I pulled out my savings account card and put it through an EFTPOS machine. I had my computer open. The EFTPOS was with the Commonwealth Bank, but I bank with St George. I took $5 out of my account and put it into my business. It was gone from my savings account within a matter of seconds. That was Saturday morning. It appeared in my business account the following Wednesday. This morning we heard Mr Strong from the Council of Small Business Organisations say he is with Bendigo Bank and he gets transfers every night—weekends, Christmas Day and everything. Why can’t you do the same; and why does it take three or four days when a weekend is included? Secondly, what happens to that money? It goes out of my account in one second but it does not appear in my business account until four days later. Where does it go?

Mr Narev—In terms of your question about why we cannot do it, we appreciate and have heard from businesses that they do want that—

Senator WILLIAMS—They certainly do.

Mr Narev—As part of the investment of over $700 million in our new core banking system, that will occur, and in fact—

Senator WILLIAMS—Overnight?

Mr Narev—Immediately.

Senator WILLIAMS—Seven days a week?

Mr Narev—Seven days a week. In fact, from the time that comes on board at the end of 2011, all of our merchants will get real-time recognition of their takings, even on a Saturday or a Sunday.

Mr Norris—I am pleased to say that we have now converted all of our retail accounts—all of our deposit, transaction, term deposit and savings accounts and high-rate internet accounts—to this new platform. We converted the last of those accounts last weekend and we now have all of our retail accounts operating in real time, so any transaction that takes place anywhere within our banking network will register instantly. We are the first to do that.

Senator WILLIAMS—Small business will be very pleased to hear that. Thank you.

CHAIR—Senator Pratt.

Senator PRATT—You would have to say that two out of six people on the board at Aussie would allow you to exercise a fair degree of influence, wouldn’t you?

Mr Norris—As I said, I do not think John is somebody who takes kindly to—

Senator PRATT—I am pleased that you have brought senior people along today, and indeed Mr McEwan is a member of the Aussie Home Loans—

Mr McEwan—I am a director of Aussie Home Loans.

Senator PRATT—Aussie has been a significant player in competition and it is clearly trying to beef that up. Surely you would want to be at the heart of watching what is going on there.

Mr Norris—We do not have any influence over pricing. That is something that is done by management and is outside of our control.

Senator PRATT—So what decisions are you actually participating in?

Mr McEwan—We have an agreement with John that any of the long-term strategic issues that involve capital—we do have involvement as John said yesterday but we do not have day-to-day involvement. Our board meetings, which are held every two months or six to eight weeks, revolve around the financials of the position, as we are a shareholder, and long-term positions for that business, not short-term daily.

Senator PRATT—The Treasurer has made it clear that RMBS funds should not go to big banks, in the interests of competition. Clearly, you are trying to put yourself at the heart of what your competitors might be doing.

Mr Norris—I think it is fair to say that we have no oversight on John's business day to day. He has his own customer base. He has his own pricing. He operates independently in that regard.

Senator PRATT—And you will take a share of those profits.

Mr McEwan—Yes, we do as a 33 per cent shareholder.

Mr Narev—That is why we made the investment in Aussie Home Loans. When we made the investment, we saw a business succeeding on the force of its independence and John Symond's personality. We would be cutting off our nose to spite our face to try and stop that.

Mr McEwan—John gets his funding from other parties as well, so he does not just look to the Commonwealth Bank. We are one that he will ask for commercial arrangements with just as he deals with other parties.

Senator PRATT—Nevertheless, you have placed yourself at the heart of what you are still arguing is one of your competitors.

Mr Norris—I do not know whether I agree with that.

Senator PRATT—When is the CBA going to lift exit fees?

Mr Norris—The whole point is we will review our fees as we do on a regular basis. When we have made a decision, we will make an announcement.

Senator PRATT—Is there a reason why unlike other banks, like the ANZ and NAB, you haven’t already done this?

Mr Norris—I would have thought that you would have liked the concept of a competitive market where people do not actually move in lockstep. I think just underscores the fact that the market is competitive.

Senator PRATT—Surely if you are offering a competitive interest rate then you could remove your exit fees to allow customers to stay with you because you are competitive.

Mr McEwan—I think you are picking on one piece of a very big jigsaw when it comes to selecting a home lender and why people go with an organisation. There are areas like service, establishment fees, ongoing fees and people take all of those into consideration when taking a home loan. You cannot just pick on one piece. When we do our reviews, we review it across the whole proposition and make sure it is very, very competitive as we have been.

Mr Norris—I would like to make the point also that we had the lowest exit fee in the market. Where there are many other lenders that have many thousands of dollars in exit fees, ours was the lowest, even of the major banks, and certainly lower than banks that have recently removed them. The point is: it is a competitive market and people will make their decisions based around their competitive position and what they are focusing on.

Senator PRATT—But part of that positioning is that you will lock customers in because of that exit fee so they are prevented from choosing a lower interest rate.

Mr McEwan—We have actually got the stats to show that that is just not a reality, unfortunately. There are some individuals that take that but, when you have got a low fee as we have had, I do not think that is the situation. I will give you an example: we purchased part of the Wizard Home Loans book about two years ago. That had very high exit fees on it and as part of that deal we negotiated to have those either withdrawn or reduced to a reasonable level. At the same time, we took that book and we reduced the price people were paying by one to 1.5 per cent to bring them down to the levels that our customers were getting at that time. We understand other players in the marketplace and their positioning, so our view is to make sure that we have got competitive rates right across but it is a package; it is not just one fee. I am very reluctant to be sitting at a Senate inquiry giving my fee structure and fee packaging and how we do it because we will make sure we are very competitive.

Senator PRATT—Why would you be reluctant to explain your fee structure—

Mr Norris—There are obviously issues for us with regard to ASX announcements about impact on profitability or things of that nature that have to be taken into account. If we are going to do anything, we would want to make sure that we carry out our obligations in that regard and also appropriately. At the same time, we are obviously looking at our competitive position across a whole range of products and services. It is interesting to note that we actually provide three million customers with fee-free banking. So we have a significant range of initiatives across a wide range of products and services which do make us very competitive.

Mr Narev—And 130,000 business customers who, as I said to Senator Williams, do not pay exit fees.

Senator PRATT—It is very difficult for consumers to make their own choices about fee structures when companies such as yours keep that information as tactically private as possible—

Mr Norris—That is not true, actually.

Mr McEwan—I am reluctant to tell you what we are going to be doing in the future, because that is something we need to work through and make sure it stays very competitive. All of our pricing is very open and disclosable. So our customers do get all of that information.

Senator PRATT—Could I ask what share of the Australian home loan market the CBA has?

Mr Norris—We have around 24 or 25 per cent.

Senator PRATT—The ACCC has said that there is strong evidence of major banks price signalling to each other that they are intending to raise mortgage rates. Could I ask what your response to the government's proposed price signalling legislation is? Can you understand public cynicism at the crabwalk of interest rate movements when you are publicly commenting on your intention to raise rates and then other banks do the same?

Mr Norris—I think it is fair to say that we as banking organisations give a significant level of economic commentary. We have very significant economics departments in our organisations that provide economic commentary to businesses and a lot of commentators generally in the economy overall. Part of that is always going to have an interest rate dimension to it. It is like talking about where the price of oil is going to go, talking about where the price of precious metals is going to go—things like that. These are instruments that are critical to the forming of an economy, and I think the issue here is that if price signalling—as it is being described—is going to be part of the ACCC's mandate to oversight the industry, then obviously if there is a new definition we will abide by that definition. But I think it is important to realise that the future direction of interest rates is something that is critical for a lot of parts of the market from an economic perspective to look at their own strategies and what that means. Retailers, for example, will look closely at what interest rate forecasts and projections are with regard to their future strategy in the short to medium term.

Mr Craig—Just to be very clear: we do not price-signal, and we absolutely have not had private discussions between banks about pricing.

Senator PRATT—I am not talking about private discussions. Mr Norris, you earn in a year what it takes 30 average Australians almost their entire working life to pay back to the CBA so they can own an average Australian home. Can I ask how the CBA justifies this? Can you understand how Australians feel anxious about the overall debate that we are having about competition between banks?

Mr Norris—Senator, firstly I will talk about my package—less than one-third of which I have actually received. Even so, that is still a significant number, but it is certainly not $16 million.

That is a number that, if I were to hit all of my performance hurdles between now and 2014, I might well be fortunate enough to receive. But I would have to say that the chances of that are probably less than 50 per cent because of the fact that these are tough performance hurdles that are put in place appropriately by my board.

In regard to my remuneration, the remuneration is not set by me—it is set by the board, taking into account that we are an organisation that has 45,000 employees, operates in 12 countries around the world and has a very complex business model. That remuneration is then tested against the market by the board, by the board remuneration committee, which then takes, also, external advice on that particular level of remuneration—takes advice from them, so that they have professional advice. Then it is up to the shareholders of the organisation, the owners of the organisation, to make their decision as to whether or not they approve the remuneration package that is paid to me. It is interesting to note that 95.5 per cent of shareholders voted in favour of our remuneration report at our last AGM only a few weeks ago.

Senator PRATT—That did not get to the entirety of my question which was, I suppose, to compare that to the situation of your average Australian.

Mr Norris—I am just explaining what I can explain, all right?

Senator CORMANN—Mr Norris, do you at the Commonwealth Bank place an actual value on your Australian banking licence?

Mr Norris—Absolutely.

Senator CORMANN—Sorry?

Mr Norris—Yes. I mean, we would not operate without a banking licence.

Senator CORMANN—No, I mean: do you actually quantify the value of your Australian banking licence?

Mr Norris—Our business would have very little value if we did not have a licence. It is not valued in our books, though.

Senator CORMANN—Okay—so it is not an asset value. So what impact does your Australian banking licence—which comes, of course, with a regulatory framework, access to the RBA, prudential oversight and so on—have on your level of funding costs, compared to countries where, I guess, there is not the same stringent regulatory framework and prudential oversight?

Mr Norris—The first thing is that our costs of borrowing are determined, obviously, by our credit rating. The fact that we reached the point during the financial crisis where there were fewer than 10 banks in the world that had AA credit ratings, after there had been more than 70 banks in the world with AA credit ratings, was the significant determinant as to what we borrow funds at. So if we were rated lower than AA then there would be an increase in funding costs.

Senator CORMANN—So, essentially, in a comprehensive sense, your Australian banking licence contributes to a lowering of, to a downward pressure on, your cost of funds?

Mr Norris—No, it is that the business is assessed by the rating agencies as to the strength of the business, and they have a number of criteria that they will look at. The fact that we operate in Australia is one part of that, from looking at the economic situation, but certainly the major issues around rating are the resilience of the organisation, its sustainability and its ability to continue to generate reasonable returns and profits; those are the factors that are most relevant.

Mr Craig—I think evidence of that is: many of the smaller banks, of course, have banking licences, but they are having more difficulty accessing cheap funds. So it is a function of our credit rating.

Senator CORMANN—You have said before, and told us again today, that the banks' funding costs justify the increase over and above the cash rate. The Treasurer, Wayne Swan—presumably based on high-level, senior, expert advice—has said that there is no justification for the increase in interest rates over and above the increase in the cash rate. Is the Treasurer wrong?

Mr Norris—I do not know where the Treasurer gets his information from, but I have to say that our information is contrary to that view.

Senator CORMANN—So you are saying that the Treasurer is wrong?

Mr Norris—I am saying that our information is contrary to the information that he has.

Senator CORMANN—So he is wrong?

Mr Norris—Well, he does not have our information. I go back to the fact that, at each time there has been an OCR increase, the banks have had a message that there is no justification for increasing rates. I will go back to the comment I made a little earlier in this discussion: Deputy Governor Battellino made, in his address back in December of last year, a comment that said that if the banks had not increased their rates over and above the level of the OCR the banks would have gone into loss. Do you know what would have happened if the banks had gone into loss? We would have had our credit ratings downgraded. We would have ended up in a situation where interest rates would have gone up significantly. We would have ended up, I think, in a situation that would not be dissimilar to some of the deleterious effects that we have seen in other economies internationally. So I just rest my case on that.

Senator CORMANN—Whenever the Treasurer has made these comments which you say are not consistent with your information, have you ever sought to correct him? Have you ever sought to swap notes with whoever is giving him his advice and whoever is giving you your advice?

Mr Norris—We have given briefings at various times to Treasury officials with regard to our funding costs and what is going on there, yes.

Senator CORMANN—Do you agree with the proposition that your bank is in effect too big to fail?

Mr Norris—I think this whole issue around ‘too big to fail’ is the fact that we are a bank that does not take that view. We are a bank that is run on the basis that we will not fail and the ‘too big to fail’ part does not come into it.

Senator CORMANN—Of course, there have been some very big banks overseas that have failed. If you look at what happened during the economic downturn, governments have rescued and subsidised banks directly and indirectly around the world.

Mr Norris—Poorly managed and poorly supervised banks.

Senator CORMANN—As we see in hindsight, yes.

Mr Norris—But, even so, I think it is fair to also make the point that what led to the unravelling in the UK banking market was not initially a large bank. It was Northern Rock, which was a relatively small bank but had a significant systemic impact on the UK economy. I think in this country we would have had difficulties even if we had had a smaller bank fail—and I think there was a real risk of that back at the time the government decided to put in the deposit guarantee. The issue does not really come down to the size of the bank. I think any banking situation where a bank fails has the potential to have flow-on impacts.

Senator CORMANN—So are you saying that all banks are in effect too big to fail?

Mr Norris—No, I am not saying that they are too big to fail; I think that there are ways and means that you make sure that you have a resolution process. I think that the Reserve Bank, APRA and regulators are well alive to that. My job as a chief executive is to make sure that the risk management systems and the way that we operate our business is such that failure is not an option.

Senator CORMANN—I totally accept that, but do you accept that the perceived likelihood that a government will bail out an important financial institution like yours if it were to get into trouble has actually increased dramatically—

Mr Craig—Lehman Brothers—a small bank in the US—was allowed to fail, and I do not think there is any doubt that, with the benefit of hindsight, the US regulators and US government would have bailed out Lehman Brothers had they realised what a psychological impact it would have on the market for a relatively small bank to collapse. I think there have been very big lessons learned around the world about the importance of having financial stability, and it is very difficult to predict what size is going to cause the problem.

Senator CORMANN—I have a few questions about your financial claims scheme. The wording in the legislation gives the government the right but not the obligation—it says ‘they may’—to ask other ADIs to help out in the event of a failure. How likely do you think it is that this right would be exercised?

Mr Norris—I think that it is a right that may well be exercised.

Senator CORMANN—I ask the question in the context of Steven Munchenberg, the head of the banking association, who made the assertion that the banking industry underwrites itself. Do you agree with that proposition?

Mr Norris—I think in this situation you would have a situation where the banking system would underwrite itself because the participants in the industry would be expected to help, solve and resolve the problem.

Senator CORMANN—Have you made provision for that contingent liability in your budget, in your balance sheet?

Mr Norris—If you look at the assets and liability profiles of banks here in Australia, you certainly see a situation where the assets and deposits are such that you would end up with a work out. It is similar to the situation that we found ourselves in when we bought BankWest. BankWest was, to a large extent, a failing bank. It would have been a failing bank if we had not bought it, because it was owned by an organisation that had carried out lending practices that were highly, I believe, inappropriate.

Senator CORMANN—Which bank was that?

Mr Norris—BankWest. So we took that bank on and we have restructured it.

Senator McGAURAN—Were the lending practices carried out by the parent—

Mr Norris—Under them.

Senator McGAURAN—or by BankWest itself?

Mr Norris—By BankWest, but both. I think if you have a look at the other subsidiaries that were owned by HBOS, the quality of lending in all of those entities was of a poor quality.

Mr Narev—And specifically, Senator, if we look at the way in which they did their business lending in Australia compared to the way we did it, there were significant policy differences which led in part to the difficulties.

Senator CORMANN—I am going to run out of time in terms of my line of questioning and I have some points I want to get to here. What I hear you say is that there is no quantification of the potential exposure for a call to be made on ADIs to help out others in the event of a failure.

Mr Norris—Typically, banks fail mainly because of issues around liquidity. Normally, you are still able to collect on loans which the deposits are supporting. So I think the issue here is that these workouts take time. We have seen in the past that that happened with the State Bank of Victoria when Commonwealth Bank acquired that, which was a failing bank, back in the early part of the 1990s. So these sorts of problems and issues have been resolved before. At a point where a larger bank which has the ability to raise liquidity to support the liquidity needs of the failing institution it can be done.

Senator CORMANN—But does that in effect mean that the Commonwealth Bank would have to guarantee all the net deposit liabilities of any other ADI in the event of a default?

Mr Norris—No, that is not the case with this.

Senator CORMANN—But that is the effect of the legislation, isn’t it?

Mr Norris—The legislation gives an outline of a process, and I think that that process is one that—

Senator CORMANN—If banks don’t underwrite each other’s net deposit liabilities then the banks do not really underwrite each other in the final analysis, do they?

Mr Norris—The banks have a means by which they can come to assistance, but I do not think you can take the view that the banks are providing an open cheque.

Senator CORMANN—But if you look at what governments have done when HIH collapsed, and there have been other significant collapses we have discussed, do you believe it is more likely that future governments will use taxpayers’ money to bail out collapses in the future or do you think they are just going to make an unlimited call on banks like yours?

Mr Norris—I think you have seen with the bank failures that have taken place in this country over the years that there have not been too many situations where government money has been used to bail them out. We have had a number of entities that have largely failed: State Bank of Victoria, Bank of SA—

Senator CORMANN—Who bailed them out?

Mr Norris—They were taken over by other institutions.

Senator CORMANN—Who then essentially covered the whole cost?

Mr Norris—Exactly.

Senator FIELDING—On Sunday, with the Treasurer’s big announcement of the banking reform package, unprompted and on his own he made a clear statement, which I raised on Monday and was raised before, that the banks were not justified in lifting their interest rates above the official Reserve Bank’s movement. You have made it clear today that you disagree with that statement. But can you see why the Australian public are left guessing who is right on this issue?

Mr Norris—Certainly I can understand the angst and certainly I got caught up in the maelstrom of this, because it became very personalised rather than actually debating the issue. I think the point is that we have provided, repeatedly, proof that our funding costs have increased. Our funding costs and our depiction of those funding costs are audited independently by an external auditor and we are prepared at any point to stand up under public scrutiny on that. I have a chart here, which my chief financial officer has, which clearly and graphically explains that.

Senator FIELDING—Is that the one that actually shoots up a bit towards the end? They have come down but they have gone back up. Is that the chart that says ‘Major banks net interest margin’?

Mr Craig—No, that is the margin one.

Mr Norris—The issue is you have to remember that through the crisis the Reserve Bank—

Mr Craig—Have we got that one?

Mr Norris—Yes, that is the one that I am referring to.

Mr Craig—Which we included with our media release when we put the rates up.

Senator FIELDING—Clearly what has happened is that the Treasurer made this statement as recently as last Sunday. You are saying that you have been justified in your position since November.

Mr Norris—Throughout the whole crisis I have made the point that our funding costs have increased. And I made the point when we made our announcement on 2 November that it was due to the fact that our funding costs had increased and in fact our retail net interest margin had actually reduced 15 per cent over the period of the GFC.

Senator FIELDING—So, rather than us debating it here, what if the Treasurer and his department wanted to sit down with you for you to convince the Treasurer—

Mr Norris—Absolutely.

Senator FIELDING—and for him to come out and say: ‘I’ve sat down with the four CEOs of the banks. I’m now convinced that they’re right’? Because the Australian public are left guessing. They are thinking: ‘These greedy banks!’ The Treasurer again on Sunday said you were not justified and in essence we are left feeling that we are being ripped off. So you can see how urgent this is, because the Australian public believe the banking reform package is going to help in that regard with fixing some of the home loan interest rates.

Mr Norris—As far as interest rates are concerned—and I am very conscious of potential price signalling et cetera—there is no doubt that if you talk to any economist in Australia the view of the economist will be that interest rates will increase by somewhere between 75 and 100 basis points over the passage of the next year, and that will be driven by the central bank, not by us.

Senator FIELDING—I have one question on price signalling, but that was a ‘yes’ that if the Treasurer did call and ask the bank to front up and go through the detail then you would open up your books to show why you were justified?

Mr Norris—Yes.

Senator FIELDING—Okay. Hopefully the Treasurer will pick up the phone and actually call.

Senator WILLIAMS—Don’t hold your breath.

CHAIR—He said he already has.

Senator FIELDING—With regard to price signalling, back on 4 November in the *Australian* it was reported—not your bank—that the ANZ CEO had made some statements clarifying some earlier statements about the bank being reluctant to increase home loan rates over and above the Reserve Bank rates. The CEO of ANZ, Mr Smith, subsequently clarified his remarks by saying: I don’t want to be ‘stuck on my own’. That is a huge concern to me and the general public when we hear statements like that—when we say we have great competition and then we have a CEO of one of the big four banks saying things like ‘I don’t want to be stuck on my own’ when it comes to interest rate movements. You can see the concern that the Australian public have in this regard. Do you think that this move outlawing price signalling in the banks is a good move by the government, or not?

Mr Norris—As far as Mr Smith’s comments are concerned I did not see them; I have not seen that particular article. But obviously Mr Smith will be here this afternoon, so I am sure you will address that issue with him. Certainly I think, as far as price signalling is concerned, there are, as I said, legitimate reasons why anybody should be, from an economic commentary perspective, looking at interest rate outlooks.

Senator FIELDING—But what sort of competition is there when everybody basically follows each other with interest rate movements? People are left feeling ‘Why change’—and, by the way, I should declare I do bank with CBA—‘to another bank when basically they are all the same?’ That is how people are left feeling.

Mr Craig—We are all competing for funds in the same market and the costs are going up. Everybody has got different funding structures, and you will note that the different banks put up their rates by different amounts presumably because their funding costs are a little different, but at the end of the day all that we have tried to explain—and interestingly I think you have done a very good job of pointing this out as well—is that our costs are going up. There is a risk clearly with this legislation that we will not be able to explain that as clearly in the future because it will be seen to be price signalling. But from our investor point of view and our continuous disclosure point of view we think it is important that we are able to explain what is happening with our business, and obviously you believe that as well from the point of view of the Australian public understanding these costs.

CHAIR—I know we are over time, but we will just take a little bit more time and hopefully we can wrap it up.

Senator BRANDIS—I just wanted to tidy up two things very quickly, please, Mr Norris. Let me start where Senator Fielding left off on price signalling. It seems to me price signalling is one of those phrases that people throw around without necessarily there being a common view about what it means. You do not understand price signalling to mean, do you, merely making predictive statements about possible future movements in rates?

Mr Norris—I do not see that as being price signalling.

Senator BRANDIS—No. I do not know if you have had an opportunity or your senior officers have had an opportunity to look at Mr Hockey’s bill which deals with this issue, but you would be aware, if you had had the opportunity to have a look at it, Mr Norris, that in any event the prohibition that it would institute is subject to not only a competition test but a double competition test so that the breach operates upon there being both a purpose of substantially lessening competition in a market and the affect of substantially lessening competition in a market. You would not be concerned, would you, about a prohibition on anticompetitive price signalling that was subject to a strict competition test like that?

Mr Norris—I would not have any problem with that.

Mr Narev—Senator, can I just add one comment on that.

Senator BRANDIS—Yes.

Mr Narev—Mr McEwan and I both sit in pricing committees in the retail bank and the business bank where we make recommendations and ultimately discuss them with the chief executive. In making these decisions we do not trawl through these newspaper articles and see what the chief executives have said. If we work in an environment where under any form of legislation for any reason these comments cannot be made anymore, it will not affect in any way the pricing decisions that we make. We simply do not refer to them.

Senator BRANDIS—I would not want it to be thought that there might be a chill effect on you making appropriate predictive statements to the market either. You do not apprehend that, if it is subject to a strong competition test, it would have such a chill effect?

Mr Norris—With the appropriate test. I do not see that we have been indulging in price signalling and that has never been the intention. I can see how some people would interpret it that way. As Mr Narev has just said and in Mr McEwan’s case, when both of them make decisions with their pricing committees, they will make them based on the economic fundamentals of the business not based on some comments that have been made by people in the marketplace.

Senator BRANDIS—Indeed. Secondly, can I go back to the issue of exit fees. I do not know if you had the opportunity, Mr Norris, to listen to or have a look at the evidence from Jonathan Mott from UBS to this committee yesterday afternoon in Sydney. He made a point, which I must say as a noneconomist struck me as a fairly important one, of the importance of the stickiness of deposits to the stability of the system. If I understood him correctly the point that this particular economist was making was that, if capital flows can be too mobile and deposits can go from one institution to another too easily, then, particularly at a time of panic, it could create a risk of destabilising institutions from which those deposits might be very swiftly withdrawn. He put this in the context of the trade-off that you rightly identified in your opening remarks between pure competition on the one hand and stability on the other hand. I wonder if you would care to address that, Mr Norris?

Mr Norris—I think that that is a valid point. Generally when you find banks failing it is the liquidity issue that occurs because they do not have sufficient liquidity to meet the depositors’ demands for their deposits to be returned. As we know banks borrow and then intermediate and provide loans on the other side of the balance sheet. You cannot liquefy you loans fast enough to be able to satisfy all of your depositors turning up on the same day wanting their money back. Therefore, if you do have a situation where competition is driven to the point where you get this flow of deposits through the system with such a velocity that it does start to threaten the liquidity availability of any given bank, then, yes, that is a very bad outcome.

Senator BRANDIS—So if I put it in layman’s terms: the stability of the system depends, among other things, upon there being up to a point some brakes upon the capital flows.

Mr Norris—I think there is the need for some brakes but the real critical issue that leads to that sort of outcome is always through a crisis of confidence. Generally, it is a situation where the market has concerns about the institution that then becomes widely known in the community or rumours get spread around which leads to a panic that these two people were not wishing to withdraw the funds. That is why we have a range of different types of deposits and funding durations in order to make sure that our funding profile is diversified not just by type but by duration in order to protect against that situation of having the potential for withdrawals to happen instantly across all of your business. Every bank endeavours to make sure that its funding profile is a diversified one.

Senator McGAURAN—I have a couple of quick questions. I cannot help but decipher that the only time you hear from our Treasurer is down the barrel of a camera. You speak to his officials but not to the Treasurer himself. Given that you have led the charge on five occasions, we hear, on lifting the rates higher than the cash rate movement, has the Treasurer met you or picked up the phone to you on any of those five occasions?

Mr Norris—I would not like anybody to have the view that I do not have any discussions with the Treasurer at all. I talk to the Treasurer from time to time and certainly I have made sure that he is aware of our interest rate positioning. The fact of the matter is, as has been stated, he generally does not agree with that.

Senator McGAURAN—Are these times when you bump into him at a cocktail party or are you sitting at a desk discussing the matter?

Mr Norris—I have had meetings with him in his office. I have had discussions with him on the telephone.

Senator McGAURAN—In your introduction—I feel I have to jump in here and defend competition.

Mr Norris—I am a great believer in competition.

Senator McGAURAN—I am not sure you are because between you, the Reserve Bank and the other majors—or not enough; I should not say you are not—there is a catchcry that there is a trade-off between competition and stability, and too much of that trade-off and you get the GFC. But the GFC had nothing to do with competition. Competition at its base is many players in the market. The GFC had everything to do with—and you went on to say—poor lending criteria led to subprime lending, mispricing of credit. Isn’t there a trade-off between less regulation and stability? Competition has nothing to do with it. If you had double the players in Australia during the GFC, you would have got the same result.

Mr Norris—There is an interesting series of analysis on this—I think it is Bain that has done this analysis in the UK—which points to the problems in the UK banking system were largely due to unbridled competition that led to the failure of Northern Rock.

Senator McGAURAN—That is lack of regulation.

Mr McEwan—No, competition. Maybe we can forward a copy of that particular review to you.

Senator McGAURAN—Please do so. So competition is fewer players in your eyes.

Mr McEwan—No. Competition is a situation where you get competitors that tend to misprice, and when they misprice you end up in situation where the stability of the system is put at risk. If you look at what has happened through the GFC, a significant part of the reason for that has been due to mispricing and—

Senator McGAURAN—Bad management.

Mr McEwan—A combination of factors, but mispricing is generally due to bad management.

Senator McGAURAN—Not competition.

Mr Norris—But competition, to take a short-term competitive view—

Senator McGAURAN—Competition is not mismanagement.

Mr McEwan—over competition.

Senator McGAURAN—We beg to differ. I say competition is not mismanagement. I read in the *Financial Review*—creditable, I suppose. It says that companies such as—we move from the small end to the big end of town now—Woolworths, Tabcorp, Westfield, BHP are now accessing funding offshore. I do not know whether that is a developing market, a returning market or it has always been there. If the big end of town has this access, that is competition and real competition against you.

Mr Norris—Sure. What has happened is that obviously during the crisis we saw a situation where Australia had a heavy reliance on offshore funding. So we have a small number of borrowers who, roughly speaking, borrowed a fairly significant amount of money and therefore there are funders out there, providers of funds, who look to diversifying their funding profile.

Senator McGAURAN—Is that a developing market or has it always been there?

Mr Craig—It is a returning market.

Senator McGAURAN—The Treasurer tells us that the two key points of his reform—covered bonds and exit fees—will bring down interest rates. I heard you say before that you have factored in an increase in interest rates. Will you be looking at your predictions or estimates or expectations in the light of these reforms and, therefore, in bringing down your expectations, interest rates will rise?

Mr Norris—I think it is fair to say, as I said initially Senator McGauran, that my view is interest rates will continue to increase and they will increase primarily because the Reserve Bank will move the rates up.

Senator McGAURAN—Regardless of these reforms?

Mr Norris—Because of the fact that the Reserve Bank is responsible for monetary policy. If the Reserve Bank has concerns about inflation and the speed of growth within the Australian economy, they will make movements. I think it is fair to say that all economic commentators and major economists in Australia are predicting an increase in interest rates over the next 12 months.

Senator McGAURAN—So the Treasurer is wrong. You were speaking about Aussie Home Loans and in the backdrop of my belief that competition is many players, what is your control over BankWest interest-rate policies et cetera? Is it an independent entity?

Mr Norris—BankWest is a 100 per cent owned subsidiary of the bank. As a result, we have oversight of its risk policies, its general financial reporting and the like. We do allow BankWest to price their products as they see fit, given that there are certain return hurdles we are looking for as a shareholder. How they achieve that and pricing is up to them. You will see that BankWest pricing is not consistent with Commonwealth Bank pricing. What we have done is provide equality across the group and the fact that our transfer pricing between our retail bank at Commonwealth Bank and what is done at BankWest is consistent. So the provision of funds that come from the core of our organisation and are provided to BankWest are done on exactly the same basis but they do have a different pricing strategy from that of the Commonwealth.

Senator McGAURAN—And you indicated today that basically it was a merciful takeover not a good investment at the time.

Mr Norris—It was always going to be a good investment at the right price.

Senator McGAURAN—Of course it was. From mythology it was a merciful takeover.

Mr Norris—To be fair, we have to provide $17 billion in funding which no other organisation could have provided at that time in taking that organisation over.

Senator McGAURAN—Or it would have collapsed.

Mr Norris—Yes. Potentially it would have collapsed.

CHAIR—Thank you for the Commonwealth Bank in assisting us today. Thank you also for your forbearance in terms of time.

Proceedings suspended from 12.24 pm to 1.07 pm

HIRST, Mr Michael John, Managing Director, Bendigo and Adelaide Bank

CHAIR—Welcome. Would you like to make an opening statement?

Mr Hirst—Yes, I would, thank you. Thank you for allowing me the time to appear today. You have a copy of our submission, and I am happy to answer any questions on that afterwards and certainly questions on anything else that you might have. However, I would like to make some opening remarks. There is no doubt that the impact of the global financial crisis and the actions taken to mitigate it have had an impact upon competition in the financial services sector in Australia. The major driver of that impact has been the availability and price of funding for the economy and that has in turn directly impacted the supply in terms of credit for end borrowers. At the height of the crisis, all financial institutions faced difficulties in funding their balance sheets and it was right that the government responded by guaranteeing the wholesale debt and deposits of authorised deposit-taking institutions. However, I personally believe that the execution of that initiative could have been handled differently. Given what eventuated, a better outcome would have been achieved by pricing the guarantee exactly the same for all ADIs whilst limiting the amount each ADI could raise under the guarantee. This would have preserved the existing market dynamic and avoided the outcome of the major banks using the artificial pricing advantage that emerged to make significant grabs for market share. However, what is done is done and I will leave that matter there and move on to the matters at hand.

As I observe the current debate on competition, I am becoming increasingly concerned that the discussion is being narrowed to the point that it is really a debate about price—the price of loans, ATM fees, exit fees and such. In any industry, a strategy that focuses on price alone is simply a race to the bottom. A great example of this is the emergence of non-bank mortgage providers in the 1990s. Those organisations entered the market because they identified that banks were subsidising their other activities by charging relatively higher rates on home loans. By competing on price in the home mortgage market alone, they were able to quickly gain material market share. The banks responded by competing with them on price. As a result—and the NAB highlighted this on Monday—banks were forced to cut costs as revenue shrank. This resulted in bank job losses, branch closures and banking utility being withdrawn from individual communities—many of them based in rural Australia.

Once a bank left town, people were forced to go to other places to do their banking and, pretty soon, they were doing their shopping in other towns as well. Before too long, most businesses in the towns that lost their banks closed. Some of the communities that found themselves in this position worked hard to return banking services by raising capital and joining with us to establish a community bank branch of Bendigo. Some do not have banking services anymore and some do not have a meaningful business presence at all.

But it is not only the communities and bank staff described previously that suffered at the hands of the price-driven strategy. Fast forward to the GFC, and those organisations that competed solely on price were the ones that were ultimately fatally damaged. As a result, there are next to no non-bank originators of real size remaining in the market. Their business model, which focused on best price, could not survive the external shock to the economy and their customers were left without funding for their loans. So while price is one important part of the competition debate, it is just that: one part.

As can be illustrated by the examples I have given, focusing on price alone can actually have the effect of lessening competition and, in the case of major bank branch closures in the 1990s, eliminating services altogether. Therefore, it is vital that we broaden the discussion. Competition should be defined by its many facets. Bendigo and Adelaide Bank competes on a value-for-money offering. We compete by partnering with communities to provide banking services where no-one else is prepared to. We compete by providing customer service at a level that is recognised as superior to any other bank in Australia. We compete by investing in infrastructure. For instance, the newest payment switch in Australia was built by a company in which we own a 47 per cent share. We compete by innovating to provide new solutions—community banking being one of the best examples of this.

Our ability to compete on factors other than price enables us to provide valuable and sustainable banking services in 90 communities across Australia where no other bank is present. Community sector banking, Rural Bank and our equity release product for the aged, Homesafe, further underline this point. None of this would be possible if we move to a position where the nation believed that competition equals best price. We must elevate the debate to where competition reflects choice and value. Importantly, we must agree a commitment between consumers, business, banks, regulators and government to develop a banking system and the infrastructure that will ensure our economy is as efficient and as fair as can be.

In closing my remarks, I note that for competition to be provided at this broader level, it is imperative that there be no impediments to, firstly, accessing sufficient funding to accommodate the number of customers who wish to exercise choice in their banking relationships, and, secondly, establishing a level regulatory playing field in respect of capital application. Our more detailed thoughts on these two points are outlined in our submission. As I stated earlier, I am happy to take any questions you have on the submission or on any other matters you would like to raise. Thank you.

CHAIR—You indicated in your opening statement that the GFC and actions—by which I presume you mean action taken by the government in response—contributed to a lessening of competition in the banking industry in Australia. In terms of the actions taken by government, you mentioned the guarantee—and I will ask about that in a minute—but were there any other actions that you think contributed to the lowering of competition?

Mr Hirst—No, I do not believe so, and I think it is important to put that in context. When the GFC emerged, it was a real shock to the economy and, as things deteriorated significantly overseas, the Australian economy ran the risk of being dragged into the malaise, even though the economy was performing well. So I think the government moved very quickly and appropriately, as I said in my submission, to put the guarantee in place. Their major concern at that time was the stability of the financial system. I think that was right. Perhaps if we had the opportunity again, I think we would need to have an eye on competition as well.

CHAIR—Okay. I do not think there is any argument about the need for the wholesale funding guarantee. I might be wrong on this, but I am fairly sure that it was first suggested by Malcolm Turnbull and so it has bipartisan support. I guess the issue—and we have had an inquiry into this in the past—is how it was delivered. You yourself just stated that its primary purpose was to help foster stability. In discussions I have had with other people and, I think, even with Treasury during the inquiry that we held on this, it was indicated that a rational investor looking to provide such a guarantee would price for risk, and therefore the differential price on that guarantee that was available to differently rated banks was an appropriate thing to have. However, if the primary purpose of the government intervening in the market in that way was to provide stability, should they have been looking at it as if they were a rational investor, given the outputs that they were trying to deliver?

Mr Hirst—I would probably question whether or not a rating is an appropriate way to look at the riskiness of individual institutions. I can very easily mount a case that a $50 million credit union is not as risky as the Commonwealth Bank: they do not invest in CDOs, they do not have international operations, they do not have business banking. But they will never be able to get a AA rating because they are simply not big enough—and, from our point of view, our size holds us back in terms of our rating as well.

CHAIR—What is your rating?

Mr Hirst—It is BBB+ from S&P and A2 from Moody’s, so we have got a bit of a split rating. I think, when we look at our financial institutions in terms of the risk associated with each of them, we need to understand that they are extremely well regulated by APRA, and one of APRA’s mandates is to ensure the stability of those individual institutions. Given that that is the base platform for being regulated in this economy, I think that there is a very strong argument to run that we were all equally risky and therefore should have received similar pricing.

CHAIR—That answers the second half of the question, in a way. So, regardless of what the market might have done, if you had been an external rational investor looking to provide a similar mechanism, you are saying that because of the outcomes the government was seeking to deliver and because the risk from APRA’s perspective was pretty well mutual, relatively, they should have priced accordingly and given you the same price, whether you were a AA bank or a BBB+ bank.

Mr Hirst—Yes, that is my view, although my understanding is that it was not the government that set that price; it was the Council of Financial Regulators.

CHAIR—Okay. So you had to pay a higher rate at that point to access wholesale funds with the government’s guarantee, which went straight to the government. When you then went to the market to try and obtain funds using the guarantee, like others did you find that you had to pay a higher price anyway?

Mr Hirst—Actually, we and our subsidiary Rural Bank were the only two banks in Australia that did not use the government guarantee.

CHAIR—You did not use it at all?

Mr Hirst—No.

CHAIR—Was that because you found it too expensive?

Mr Hirst—Yes. It was uneconomical for us.

CHAIR—There were other options that were more—

Mr Hirst—We made a decision very early on that we could not rely on anybody else to get us through and that we needed to operate within our own financial resources. As a result of that, we did not take on the guarantee.

CHAIR—So, even if it had been priced the same, do you think you would have made the same decision?

Mr Hirst—I think if it had been priced economically then we would have made a different decision.

CHAIR—Okay. Thank you.

Senator XENOPHON—Chair, just a quick question. Mr Hirst, if it had been priced at the same level for Bendigo Bank as for the four big banks, would you have taken it on?

Mr Hirst—I think we probably would have.

Senator XENOPHON—Thanks.

CHAIR—You quite correctly, in my view, note that competition is not all about price; there are a whole suite of factors that any business can compete on when trying to attract custom. Quite clearly, Bendigo Bank, together now with Adelaide Bank, have identified a market niche which you are filling and competing for in your own way, which is quite different, certainly, from what the major banks do, and probably any other financial institution in the country. But, in that context, you indicated that the non-bank institutions collapsed because they were competing solely on price—because that was their sole focus.

All the evidence we have had so far suggests that they collapsed because they could no longer get access to wholesale funding at all, at any price. Are you saying that their reliance on cheap securitisation enabling them to compete on price was the reason? I guess what I am saying is that the evidence we have had is that they fell over because they could not get the funds, not because they were solely competing on price.

Mr Hirst—Well, that would be their view, obviously. My view is that they had a very single focused business model, it was based purely on price, and many of them funded themselves very short for long-term funding so that they could push that price down further. Because of that model that they ran, when there was no funding available they collapsed. I would question whether or not they could return in the same way, given the experience they had.

CHAIR—I do not think that conclusion is any different to what we have heard. The securitisation market, from the evidence we have received this week, particularly from the Reserve Bank, is getting close to around half what it was pre GFC, and most of that is domestic, with very little interest from the international market. Short of some innovative product being offered, given the brand damage particularly of RMBS, there does not seem to be a lot of potential appetite for that in the coming years either. Would you disagree with that?

Mr Hirst—Probably not. I think the experience for securitisation overseas was very different to the experience for securitisation in Australia. In Australia nobody has ever lost a dollar investing in RMBS. The reason that the securitisation market disappeared in Australia for new funding was because there were so many organisations overseas who held Australian securitised paper that when they got into trouble they were distressed sellers of that paper. So they were returning all of that market to domestic investors and because they were distressed sellers they were selling it at 200 over, 300 over, and nobody could issue new RMBS at an economic level. So as soon as that secondary market overhang is cleared, that is when we have seen, with the assistance of the AOFM, some demand come back in.

CHAIR—In terms of the international appetite? The Reserve Bank indicated that they thought a lot of the investor interest was coming from institutions that had unsustainable business models and that they are unlikely to be returning to the market any time in the future.

Mr Hirst—I think some of it will have to do with whether or not that is true and those institutions are around; some of it will have to do with how RMBS gets treated in liquidity under Basel III, because if it is part of liquidity there will be a demand for it and therefore—

CHAIR—Quite clearly, that would change the baseline.

Mr Hirst—That is right. Domestically, we did a billion-dollar issue last week. It had some fixed tranches in it to try and open up the style of investor that we could get in, and we did get some, albeit muted, demand from overseas.

CHAIR—While we are on that, you also made the comment that there must be no impediments to access to finance or to funds for the banks. What impediments do you think currently exist and how can we remove them?

Mr Hirst—One of the issues we have is that as an economy we fund a fair bit of our activity from overseas. Most of that gets raised through the banks, and that is clearly one of the banks' roles in the economy. But at some stage issues are going to arise around appetite for individual names. I am heartened to see that there are now corporates going to offshore markets in their own name. That will alleviate some of that situation. But we do need a big increase in domestic appetite for fixed interest.

Our fixed interest market relative to our equity market is quite small on international standards. That is the case even though we have got a terrific savings pool in superannuation. Unless we can get a domestic fixed interest market of substance up and running, we are going to remain hostage to offshore investors, we are going to be reasonably inefficient as an economy because there will be more going into equity and we will not be leveraging to the appropriate amount we should, and there will be some restriction on funding for lower rated institutions—and they are not lower rated because they are more risky; they are lower rated because they are small.

CHAIR—I will move on to the Treasurer's reform package that was announced on Sunday. You have been quoted as making some statements on that in public. What are your thoughts, for the benefit of the committee, regarding that reform package and its ability to improve competition, in the way that you define it, and deliver benefits to Australian consumers?

Mr Hirst—I think on balance it is positive. First of all, it raises the issue of competition and choice and puts on the horizon for people that there are—

CHAIR—That has been firmly raised in the last couple of months anyway, I would have thought.

Mr Hirst—That is true. We think the package probably has something for everybody. Not everybody is going to like everything that is in it. From our point of view, there are five things in it that we think are helpful. The first is the boost in the flexibility of transferring deposits and mortgages. Clearly when you have the highest customer satisfaction in the market you would expect to be a net beneficiary of that, and in fact we know that 20 per cent of people who are looking to change banks are looking to change to us. So that would be a big plus for us.

The continuation of the Financial Claims Scheme I think is good for all small institutions. There is no doubt that in the GFC some people experienced a flight to quality. The additional money for the RMBS is helpful. As we move through new raisings with the AOFM, the AOFM are taking less and less of the total deal, so something like $4 billion can probably be leveraged up to $12 billion in total issuance. In terms of the bullet bond structures, we have already achieved that.

I think it is reasonable for us to have covered bonds. Initially we were against it. We felt that it played into the hands of the majors and would again give them preferred access to funding and allow them to grab that market share, but I have come to the view now that, the more funding we can make available for the whole system, the more likely it is that those institutions who are high rated will use those wholesale markets, and that will free up some of the irrational pricing that is currently being seen in term deposit markets. Then, of course, the commitment for the fixed interest market is obviously something that—

CHAIR—Is there anything you do not like?

Mr Hirst—If we were to end up mandating account number portability, that would be very difficult but I think it can be achieved in other ways. I think the anticompetitive price signalling is going to be difficult. Most of the time when I talk about funding costs it is in answering a question for investment analysts. Without knowing what the legislation is going to look like, I would be concerned that it would reduce transparency for the investor market.

CHAIR—You raised the issue of investment analysts. I have a copy of an analysis conducted on Monday by Credit Suisse of the government's competition reforms, and they conclude, if anything, major banks are perhaps long-term relative winners from the reforms. They say that they see regional banks are 'not unequivocal winners' from the reforms because you are relatively more exposed to reforms to increase mortgage competition and also to the fixed IT costs associated with potential deposit account portability reforms. Do you agree with their conclusion?

Mr Hirst—I do not agree with their conclusion. I agree that we would be relatively more disadvantaged if account number portability were forced on us and we did not see some other way. I think increasing choice in mortgages and transaction accounts will play into our hands. You could go either way on the covered bonds issue.

CHAIR—I also note that they recommended Bendigo Bank over one of your competitors. In the context of this, they thought it would probably benefit you more than one of your competitors.

Senator HURLEY—Thank you, Mr Hirst. We have had the non-banking sector, particularly Mr Symond, being very—well, not very critical but saying that the smaller banks did not do anything to reduce interest rates and were not very significant in the equation, and the major banks also implying something similar. So I guess you are caught between those ends of the spectrum. You have partially answered where you fit in by saying it is not about price and it should not be solely about price but that you add choice and value. That is very certainly true in the regional areas. I am from South Australia and we have Bendigo and Adelaide branches in South Australia which are well supported I think because they local and are giving good service. I suppose any government support for your bank in particular shores up competition; it does not necessarily increase competition. So I am wondering how you see the recent government moves—whether they do not only shore up essential parts of the banking spectrum like your bank but also help to at least create the possibility of entry for other people. I am thinking particularly of areas like the securitisation market and the initiatives in things like 'bullet' RMBS. What is your attitude to instruments like that? Would you use them? Have you used them?

Mr Hirst—If I could work backwards on the question: as I said earlier, we did an issue last week that included two bullet tranches of RMBS. The reason we are doing that is that we feel that it will open up those people who are prepared to invest in RMBS because they do not have the prepayment risk or the tail risk associated with traditional structures. So, from that point of view, we think that is a plus, and we think that it will help us access more funding. We think the whole AOFM program for RMBS will certainly help restore that market. We would want to see that continue until that market was restored.

Senator HURLEY—Mr Symond also said that it was not enough—that you would need $30 billion to $40 billion a year in that market. Do you?

Mr Hirst—I noticed that either Mr Laker or Mr Stevens felt that one of the issues that we had is that we had had too much access to credit at times. I think the market will find its own level and should be allowed to find its own level on that.

In respect of the issue of price, even though we do not compete on price, we are always competitive on price. If I have a look at our home loan rate at the moment, we are higher than NAB, the same as ANZ and cheaper than CBA and Westpac. So, from that point of view, whilst we will not always be the cheapest we will certainly always be competitive.

Senator HURLEY—Being competitive is always dependent on whether you can be, and you mentioned that in terms of the costs of your funds. Apart from deposits, of course, you get funds in those markets like the securitisation markets, and you mentioned the RMBS. I was not quite sure how the corporate bonds fitted in there for you. Could you just run through that and perhaps talk about the recent government initiatives in that?

Mr Hirst—It is really more an issue of increasing the size of fixed interest investment. That obviously is a two-way street: there need to be instruments for people to invest in and there need to be investors who are prepared to do that. The broader the participants that you have in that market, from an issuing sense, the more likely you are to get people prepared to invest in that market, because it will be a more liquid market.

I think fixed interest is important for another reason domestically, and that is: as our workforce moves from the contribution part of superannuation into the draw-down part of superannuation, it is very important that they have access to capital preserved products as opposed to capital growth products. We have seen, just in the last few years, the number of people who retired and then had to re-enter the workforce because they did not have an appropriate mix of defensive and aggressive assets within their superannuation.

Senator HURLEY—That is clearly very critical as we are most certainly moving into that stage. Your involvement in that is as part of the broader financial market but also in providing advice and assistance to those clients who might be in that position. In other words, are you entering into that wealth management area as well?

Mr Hirst—We are seeking to enter into it. We do have a branch based planner of business. We have about 50 or 60 planners. We think that the mood of change around the Cooper report on superannuation will be positive for the environment or for the economy and that a branch network such as ours would be ideally suited to distributing the low advice, no advice type product that probably 80 per cent of people need.

Senator HURLEY—I asked NAB what percentage of their total income was comprised of wealth management. Can you tell me what it is for you?

Mr Hirst—It depends how you define it. If we include in our wealth management our funds management business, our planning business, our relationships with planners and platforms through term deposits and margin lending, on that basis—I do not know this for certain—it would be around 20 to 25 per cent.

Senator HURLEY—And that is clearly going to assist banks like yours, particularly in regional areas, where people will come in and get that advice.

Mr Hirst—I think it will assist in terms of providing low advice in places that are reasonably remote and do not have a lot of financial planners and other professionals to advise them. As we work through it, I think it will require some wind-back of FSR. But I think that would make sense given where that report is headed.

Senator HURLEY—Thank you, Mr Hirst.

Senator XENOPHON—Mr Hirst, on Monday—the day after the Treasurer’s announcement—the stock market seemed to react; its initial reaction was to give a tick to the big four and to give a reduction in the share price both for your bank and the Bank of Queensland in particular. Does that indicate the sentiment that there was not much in this package for the regional banks and the foreign owned banks—the so-called second-tier banks?

Mr Hirst—What it indicates is that there was not as much in the package as what had been mooted in the paper in the two weeks leading up to it when our share price had run up by 60c and 70c. I actually spoke to a group of investors in Sydney in the middle of last week and said, ‘If our share price is rising as quickly as it is because of expectations of what is going to be in the package, then I think the market has got it wrong.’ The reversal you saw on Monday was the market admitting they got it wrong.

Senator XENOPHON—And it is your view that there is not a level regulatory playing field. I do not want to use ‘second-tier banks’ as a pejorative term, but do you consider that banks such as yours—the regional banks, not the big four—are being discriminated against or are at a disadvantage in a regulatory sense?

Mr Hirst—I think there are a number of things that could happen on the regulatory front that would help the second-tier banks. One of the issues that we face is that we have to hold twice as much capital to support a mortgage as what the major banks do because of the different approaches we have to measuring our capital adequacy.

Senator XENOPHON—You do not think that is fair from a risk or a safety point of view?

Mr Hirst—No. I think a mortgage is a mortgage, and we have got a $15 billion mortgage book, so it is hard to imagine that the risk in our book is not pretty much the same as the risk in the majors’ book. It is statistically valid.

Senator XENOPHON—What is the reason for that?

Mr Hirst—The reason for it is that the majors are on what is called the advanced model. They have to take additional capital charges elsewhere in their business for operational risk, and they do that because of the model they take. I guess what we would say is that, if we moved to the advanced model, we would also have to take an additional capital charge for operational risk, but that charge would be nowhere near what it is for the major banks because of the simplicity of our business.

Senator XENOPHON—And when you and other non-big-four banks raise this, what sort of response do you get, either at a government level or at a regulatory level?

Mr Hirst—The regulator quite rightly says that if we wish to move on to the advanced model, we can. We have started down that path, but it is a two- or three-year path.

Senator XENOPHON—Two further quick questions because of the time constraints. Bendigo & Adelaide Bank is quite keen to explore the Canadian mortgage model as a way forward. Is that correct?

Mr Hirst—That is correct. We think that model has proven to be very resilient during the global financial crisis. You would think if anyone was going to be impacted by issues around securitisation it would have been Canada because they are right next door to where the major securitisation issues were. Yet it got through that period very well and continues to do well.

Senator XENOPHON—Finally, in general terms how much has your bank's cost of funds increased since June 2007? That is the reason given by other banks for increasing above the RBA's cash rate. To what extent are your funding pressures on the cost of funding greater, equal to or less than those of the big four?

Mr Hirst—It is somewhere between 130 and 140 basis points.

Senator XENOPHON—More than the big four?

Mr Hirst—No, not more than the big four; more than where we were before the global financial crisis. As we sit here today, we probably fund ourselves, as long as the AOFM continues with the RMBS market, at about the same level as the major banks. We all compete on the same price more or less in the term deposits and the retail market. Our weighted average cost of funds on the AOFM deal that we did last week was about 115 basis points, which is about where the majors raise three- to five-year money. The problem is not so much price at the moment, it is the volume and the access that is the issue. Until that securitisation market comes back, that is going to be a problem.

Senator XENOPHON—So do you agree, to paraphrase John Symond from Aussie Home Loans yesterday, that all of these other reforms are tinkering around the edges in a sense compared to sorting out the issue of securitisation?

Mr Hirst—No, not necessarily, because, as I said in my opening remarks, I look at competition across a whole lot of different factors and so all of those need to be looked through. But I guess the major problem right now is the volume of funding that is available to non-major banks. You asked me earlier about the regulatory issues. Another issue that would help the RMBS market and is a regulatory issue would be allowing RMBS to be part of banks' liquidity holdings. If that were able to be done then that creates a natural demand for RMBS and gets that market up and running.

Senator XENOPHON—Would Basel III allow that?

Mr Hirst—Basel III has outlawed securitisation in terms of being available for liquidity but you can understand why that would be the case, because the performance of securitisation in offshore markets has been abysmal. That has not been the case in Australia, and I think one of the things that we should be considering in localising those rules is allowing RMBS to be part of liquidity, allowing the term debt of all ADIs to be eligible for repurchase at the Reserve Bank.

CHAIR—We should know by Christmas.

Mr Hirst—Sure.

Senator XENOPHON—In essence, then, are Australian banks, and through the banks consumers, going to cop it in the neck through Basel III rules because the securitisation markets in other markets have not worked that well, they have been lax overseas? Are we going to cop it as part of the collateral damage of being part of Basel III?

Mr Hirst—We are certainly disadvantaged to some degree.

Senator McGAURAN—Given that you say there are many factors to competition and one definitely is many players, and that is what I would like to see in the market, can you give me a sense of the mood of the market? Given that your bank is a prime target for a takeover, if not the last of the great takeovers, what is the sense of the market: are the sharks always circling, or is it the end of the takeover period?

Mr Hirst—I think mergers and acquisitions generally occur as a result of a shock to the economy and when funding becomes available to enable those to happen on the other side of that shock, so we are probably moving into that M&A period now. Having said that, I do not have a sense of sharks circling. We have a very valued proposition by our shareholders and our customers in the communities in which we operate. I think that, as long as we are able to continue to do that and perform at a level that is profitable for our shareholders, we have a place in the economy.

Senator McGAURAN—Have you met with the ACCC to discuss these matters? I do not know if that is wholly appropriate; I should imagine it is. Have the ACCC in any way signalled that this is really the end of the takeovers, given that I seem to take their signals as being that is what they are saying, that they did not like the last one they did, St George? So is there almost protection at least for the moment—the moment being five years perhaps—around your bank so it is safe from takeover? Have the ACCC sent you that message?

Mr Hirst—No, they haven’t and I haven’t met with the ACCC.

Senator PRATT—Mr Hirst, you have already made some comments about the banking competition package but I am interested to know which elements within it you think will actually contribute to competition.

Mr Hirst—I think on a broad basis, rather than just for ourselves, the ability to transfer deposits and mortgages is a very good one. I think there is the community awareness campaign, and the financial claim scheme certainly is a good one, then the RMBS, the bullet bond structures and the emphasis on a fixed interest market.

Senator PRATT—So they are all things that you think will enhance competition and therefore, notwithstanding the cost of funds and the underlying other internal costs of each institution, they are the things that will keep the services that banks and other financial institutions are offering competitive with each other.

Mr Hirst—I certainly think that they will help.

Senator PRATT—I would like to ask you this. Do you think the Treasurer ever said that this banking reform package would actually reduce interest rates? I think he has been verballed on that.

Mr Hirst—There clearly needs to be a distinction between the rates that are charged on loans and paid on deposits and the official cash rate. They are related in some way but they are not directly related. The official cash rate has no spread on it for risk and it is really the risk element that has pushed up the pricing of loans, rather than the absolute level of interest rates.

Senator PRATT—So what is your opinion of what you think the Treasurer is trying to achieve with this package?

Mr Hirst—I think he is trying to make sure that there is competition in the market so that communities and individuals in communities have access to banking services. Banks play a very important role in the economy and it is such an important role that, on a bipartisan basis, we were prepared to guarantee it. So, from that point of view, we are trying to make sure that in a fair economy everyone has access to banking facilities.

Senator PRATT—So you would or would not agree—and I suspect I know the answer to this—with John Symond's assessment of the Treasurer's banking competition package yesterday in evidence.

Mr Hirst—I have not had a lot of time to read what Mr Symond had to say. I think that to some degree it is hard to know where he comes from given that he is 33 per cent owned by major bank.

Senator PRATT—Can I ask you about the significance of the RMBS market and the government's support for that. As I understand it, it came in in block phases—$8 billion, $8 billion. What is the significance of that commitment thus far and what values will the further $4 billion add?

Mr Hirst—It has certainly been significant in making funding available for those who could not access wholesale funding in their own name or use the government guarantee. It is a very important market for the economy and, to the extent that it provides liquidity and deals in that market, it is extremely worthwhile. The initial deals that were done were almost solely funded by AOFM, but as we have moved through time they are taking less and less of the share of a deal. I think they took about 50 per cent of our last one. On that basis, the $4 billion that was provided in this package on Sunday should equate to at least $8 billion in funding.

Senator PRATT—That is access to funding. What impact does that have on the price of that funding?

Mr Hirst—Again, if you have a strong cornerstone bid for a deal then that will drive price down to the extent that it increases liquidity and increases demand, and that drives price down as well. But the price has got a hell of a long way to go before it gets back to where it was.

Senator PRATT—So you would agree on that basis that it allows institutions like yours to be more competitive with the big four banks?

Mr Hirst—It allows us to take advantage of the opportunity that we have created. To the extent that we do not have access to that market, then it limits our opportunity.

Senator PRATT—And you do not have a problem with institutions that have, I suppose, a fair proportion of that market? If the big four have a large ownership share in such institutions, do you think that they should be excluded from participating in the RMBS?

Mr Hirst—My problem with some of those institutions is, as I have outlined before, that they play simply on price; they do not have sustainable business models. I think to the extent that one is significantly owned by a major bank then the major bank should look after it.

Senator PRATT—You can see that with the business models in terms of the kinds of products that they offer as brokers et cetera, can't you?

Mr Hirst—Yes.

Senator PRATT—I think we have had a little bit of commentary on the capacity of customers to switch. How do you think you will be placed in terms of the promotion of competition there?

Mr Hirst—Given our customer satisfaction rating, we would expect to be a net recipient of that. We think that we do not need account number portability to do it. We think there are other ways to do it. and we are working on a couple of prototypes which we are prepared to share with the industry. From a mortgage point of view, there is currently a project about electronic or e-conveyancing. If the industry could get together and for the 80 per cent of people who just need a standard, everyday mortgage agree to the terms of what an industry mortgage might look like, we can put that into an e-conveyancing project. So if you wanted to swap from Westpac to us it would simply be a matter of it happening in a central electronic register. This reduces an enormous amount of the cost in the industry, and I think it would pretty much fall straight to the price.

Senator PRATT—Terrific. It sounds like a good thing to me.

CHAIR—One final question: you mentioned in response to my earlier question that on balance you think the reforms are positive. Do you think that they are likely to make a significant difference or just a positive difference to competition?

Mr Hirst—I think we will only know with time.

CHAIR—Thank you. And thank you, Mr Hirst, for your time in assisting us.

[1.54 pm]

BATH, Mr Michael Paul, Acting Chief Executive Officer, Australian Office of Financial Management

CHAIR—Welcome. Thank you for attending to assist us today. Would you care to make an opening statement?

Mr Bath—No, thank you, Chair.

CHAIR—We do not have a submission either, but I guess we are all relatively familiar with what you do.

Mr Bath—I had some input into the Treasury submission on RMBS matters, Senator.

CHAIR—I understand that as well. Can you provide the committee with an update on where the investment of the current $16 billion is at?

Mr Bath—Yes. As of right now we have invested $12.537 billion and $14.922 billion of private money has invested alongside of us giving a total of $27.459 billion which is a ratio of about 46 per cent public money to private money. That ratio has improved substantially over recent times.

CHAIR—In terms of private involvement?

Mr Bath—That is correct. If I can illustrate, for the 2008 calendar year the AOFM invested $1.996 billion against $637.2 million of private money, which is about 76 per cent of the total of $2.6332 billion. In 2009 the AOFM invested $5.75746 billion and there was private sector investment of $2.97414 billion, a total of $8.7316 billion and a ratio of 66 per cent public money to private money. That is excluding the $5.3-odd billion of RMBS deals that were brought to the market without AOFM support. If you include that number in the denominator, you are looking at about 41 per cent of the investment coming from the public sector. In 2010 the AOFM, including today's transaction with Wide Bay Australia, has invested $4.78357 billion. There has been $11.31068 billion and a total of $16.094 billion of supported deals. Public money is running at 30 per cent of the total and there was $2.9 billion in a couple of non-supported transactions. If you include that number in the denominator then the proportion of transactions that were supported by the government was 25 per cent.

CHAIR—The need for government involvement is decreasing in order for the deals to be put through but there is still a need to some extent.

Mr Bath—That is correct.

CHAIR—It is becoming less important for you to take the lion's share—

Mr Bath—I would not say less important for us to be involved—

CHAIR—No, but the level of involvement is less important.

Mr Bath—I would not describe it as less important because the portion that we are taking now is largely the slowest to repay portion of most transactions. We changed our strategy in about April or May so that we were now cornerstoning a single tranche typically of the transaction that would have a weighted average life of about five to six years. Prior to that time we had essentially bought shoulder-to-shoulder with other investors. Typically the AAA super senior tranches of these things have a weighted average life of three years. By taking out the longest or slowest to repay—

CHAIR—Are they lower rated?

Mr Bath—No, they are all AAA rated. By taking out the slowest to repay third of the transaction what we have essentially done is to break that top rated AAA piece that would normally have a weighted average life of three years into two pieces, one that we are taking that is a third of the transaction at about five to six years and that has facilitated the creation of two-thirds of the transaction with a weighted average life of 1½ years.

CHAIR—Your involvement with that approximately a third is vital for those deals to go ahead?

Mr Bath—Without it and without the pricing that we have been prepared to buy it at I think that it is fair to say that the market would have struggled to bring a one to two year weighted average life investment. The reason that that piece was significant was that we thought and we have been proven correct that bank balance sheets would be prepared to hold 1½ year weighted average life mortgage backed securities prior to clarification of the application of the Basel III liquidity rules in Australia and that has been the case.

So there has been a tightening of margins in the overall structure: one, because we have been able to create a relatively short-dated piece that a new set of investors—namely, the bank balance sheets have been prepared to buy—have been prepared to buy at around 100 to 105 basis points over the bank bill rate; and, two, we have been prepared to buy the longer piece that I described at a pretty aggressive rate as well; so between 110 and 130 basis points.

CHAIR—So you have got about $3.5 billion of the current allocation yet to allocate. How long ago was that $8 billion allocated to the AOFM or to be made available for this purpose?

Mr Bath—The second lot?

CHAIR—Yes.

Mr Bath—The Treasurer issued his third direction to us on 30 November 2009 in which he allocated not only the second tranche of $8 billion but also the remaining $246 million left over from the first stage.

CHAIR—In seeking to allocate that $8 billion, or the second tranche, have you had an active strategy to go out there and try to find investors with whom you would join to try to get the securitisation market moving and to spend that $8 billion or is it something that is available and you look to people to come to you? Are you actively trying to get that out there as quickly as possible, or are you trying to feed it out to keep the market moving? Is there a strategy over the timing or is it just as quickly as you can?

Mr Bath—It is not as quickly as we can—and we are not what I would call the rate-determining step of the process. The rating agencies tend to be pretty busy. There is a capacity that the market can operate at, and I have certainly tried to make it my objective not to be that rate determining step. I will leave it to market participants to advise you as to whether they think that we are the slow link in the chain.

CHAIR—It has now been about 13 months since that $8 billion was made available and you are now $4½ billion into it. I am just wondering whether you are having any challenges in actually finding opportunities to invest it. What is the constraint that has led to 13 months and you are only a little bit over halfway through investing that?

Mr Bath—It has varied from time to time. There tends to be a hiatus over December, January and February. I would expect that the detail that we priced today will probably be the last one for the calendar year. In the corresponding period last year we did not do any deals. There was one deal done in January, two in February, three in March and two in May. These are deals that we sponsored. It then picked up in July. So it moves in fits and starts. I think it is fair to say that, for the first part of this calendar year, there was, if you like, a left-over bid tone to the market as a result of improvements that had happened around September to November-December 2009. There was an improvement in margins, deals were getting done and we were getting scaled back to a much smaller proportion than average of each transaction.

A few things happened around the first quarter of this year. One was that, because there had been a flurry of activity late in 2009—some deals not needing our support—a lot of the pressure had come off the issuers. They were, I think, expecting that margins would contract further and I do not think any of them wanted to be the last one to print at a level of 130 or 140 over the bank bill rate. So that was one aspect. The pressure had come off them and they had a bit of capacity—they had freed up capacity on their balance sheets and on their warehouse providers' balance sheets—and there was a little less pressure to get mortgage backed securities out the door.

CHAIR—Has that pressure returned?

Mr Bath—There were also a few other things going on. At the same time there were some rumblings coming out of Europe—and, as we know, the 'sovereign debt crisis' is now a household name. At the beginning of the year, Greece was just starting to look a bit shaky, and the investment community was saying, 'We're not sure that we want to be invested in credit; full stop'—of which mortgage backed securities is a subset. So they were starting to back away.

Through much of April, May and June not many transactions were occurring. In about May we changed our strategy and that had the impact of, first of all, bringing a new set of investors to each transaction, because essentially what I would call the traditional real-money fixed income investors had decided that they could find better deals in a secondary market or they had other forms of credit that they saw as better value at the time. So by changing our strategy we were, if you like, pitching deals that were open to the market to a new investor clientele, namely the bank balance sheets, and they have been prepared to buy those. It picked up again through the second half, particularly the third quarter. The third quarter of this year had $6.9 billion of supported deals, of which we invested $2.2 billion.

That brings me to my next point, which is that the share that we are investing in each transaction is falling. While we had a quieter quarter in Q3 of this year—with only $2.2 billion versus, say, the second quarter of 2009, where we invested $2.97 billion—there was roughly double the number of deals done in the third quarter of this year versus the second quarter of last year. So a mixture of things have caused the slowdown in the rate of our own investment.

CHAIR—I understand. We only have limited time and—

Mr Bath—I am just trying to answer your question as best I can.

CHAIR—It is as frustrating for us as it is for you, but we do have try to keep our questions short and, where we can, the answers short but still complete. Looking forward, with what you know about the investor market at the moment, how long do you think it will be before the remaining $3.5-odd billion you have will be fully invested?

Mr Bath—It is difficult to say. Six months ago my advice would have been that probably by Christmas time we could have expected to have expended it, but as that ratio has improved—in other words, we are being called on to invest less and less—that has dragged out. My best estimate now would be Q1 or Q2 of next calendar year, but it could take longer. It is very difficult to say.

CHAIR—Then you have the new $4 billion on top of that.

Mr Bath—That is correct. We do not actually target a rate of investment. It is not something that we get particularly concerned about. What we would be concerned about is if deals were trying to come to market reliant upon our support and, because we did not have sufficient resources, we were unable to support the market. As far as I know, that has not been a criticism that has been levelled at us by anyone. I have been looking for that criticism because it is a genuine concern that we might be perceived to be impacting negatively on the market, and I would want to make sure that I resource the function correctly, but I have not heard that criticism to date. I think the rating agencies could probably do with a few more resources—that might help the deal flow improve—but I do not think we are the deadweight on the market at this stage.

CHAIR—When the investments you have already made mature, do they come back to you for reinvestment or do they go back to the government?

Mr Bath—They essentially go back to the government.

CHAIR—It is provided for a once-off opportunity and, once it matures, it goes back?

Mr Bath—Yes. Essentially, we are being tasked with buying $16 billion—or, now, $20 billion—worth of mortgage backed securities, not holding a portfolio of $16 billion or $20 billion of mortgage backed securities.

CHAIR—On Monday the Reserve Bank governor indicated—and I do not want to misquote him—that he thought the securitisation market was getting back essentially to a level that is closer to a normal level in Australia domestically, excluding those investments that were coming internationally based on, as he put it, unsustainable business models. I do not think he was saying it has fully reached that point, but he was saying it was close and roughly half the securitisation investment that was occurring prior to the GSF was international and roughly half was domestic and we are getting close to that half that was domestic in terms of size for what is expected this year, with the AOFM's assistance. Do you agree or disagree with that? Do you think there is room for the securitisation market to grow significantly in Australia, whether domestically or through investor interest from overseas?

Mr Bath—If you are asking whether I agree, I must admit that I did not hear all of the governor's testimony.

CHAIR—It was a surprise to me when he said it.

Mr Bath—If we are talking about price, I think there is a long way to go before—

CHAIR—No, he was not talking about price.

Mr Bath—Was he talking about volume only?

CHAIR—Yes.

Mr Bath—Dr Debelle, who was in Sydney with Governor Stevens, gave an excellent presentation at the Australian Securitisation Forum conference a couple of weeks ago. He showed the share of total housing finance that was essentially coming from mortgage backed securities, or securitisation more broadly. That share had fallen and had not stabilised. I do not have the chart but I have a speech that Dr Debelle gave today—I do not know whether these are the same charts but I could have a quick look. My sense is that you would probably need $30 billion worth of securitisation issuance per annum.

CHAIR—According to the evidence we got on Monday, we are looking at $28 billion this year.

Mr Bath—I think it is more like low 20s at the moment.

CHAIR—That was the figure that was given to us. It was an estimate of what it would end up being at the end of the year.

Mr Bath—I think you are looking at low 20s for the calendar year—that is, $20 billion. If you were to support the same share of housing finance with securitisation as you did five years ago, I think you would probably need a larger number than that. But that is a big if.

CHAIR—I am not saying that we are getting back to the level of support that it had before but to the level that properly priced for risk RMBS would be likely to achieve in Australia, given the vastly reduced appetite and capability of international investors.

Mr Bath—I am not sure I understand your question, then.

CHAIR—I think it got back to the $30 billion-odd level that you yourself just raised. The suggestion was that, at the moment, that is roughly around where we would end up, given that there is likely to be a vastly reduced appetite coming from international investors, which really provided the rest of it that was occurring prior to the GFC.

Mr Bath—Okay. I think it is fair to say that there was a significant demand pre the GFC for domestic RMBS which was coming from foreign bank special purpose vehicles, SPVs or SIVs, and they are clearly not coming back. So there is a need to find a broader investor community. I think the foreign investors will come back. They see the Aussie dollar as a good product, or Aussie dollar interest rate products more broadly as good products. Once we get clarity on the application of Basel III liquidity rules in Australia, however that plays out, I think you will get domestic fixed income investors returning to mortgage backed securities.

Senator HURLEY—Can you give your view on some submitters who have called on Australia to establish its own version of the Canada Mortgage and Housing Corporation?

Mr Bath—It is a policy choice for government. In the package released on the weekend, the Treasurer noted that the AOFM and Treasury had said that mortgage backed security investment was more appropriate than providing a government guarantee for mortgage backed securities, and that is one aspect of the Canadian model. In my mind, the Canadian model has two components to it. One is a government intervention in what I would call the lenders mortgage insurance market, so it guarantees credit performance, if you will, on the underlying mortgages and it essentially takes the role of what we would call a lenders mortgage insurer. In Australia in the 1960s or 1970s, the Australian government had a mortgage insurer. However, as the market was opened up to the private sector and competition, the government of the day stood back and now there are private sector providers of lenders mortgage insurance. That is one aspect of it.

The other aspect of it is that you have a facility that essentially guarantees the creation of a bullet structure. You have two aspects: you have a government guarantee of the credit and you have a facility that guarantees performance, if you will, on a bullet structure. By ‘bullet structure’, what I mean is that they have the look and feel of something more like a government bond. There are coupon or interest payments over the life of the transaction and then at what we call maturity you get back all of your principle and the final coupon. Mortgage backed securities that we have been investing in by and large until recently—until the deal we did last week with Bendigo and Adelaide—have been amortising pass through structures. These are less attractive to investors because not only do they get their principle back in dribs and drabs over time but they also do not know exactly when they will get it back. There are two types of risk—or features that investors are not particularly attracted to—that the bullet structure removes. One is the long-term dribs and drabs return of their capital and one is the unknown rate at which the capital will come back. So the bullet structure is attractive to investors. The recent transactions—there have been two, one by the Commonwealth Bank through its subsidiary Bank West and one through a Bendigo and Adelaide bank that we supported last week—have been demonstrated to be cost effective for the issuers. We have through our participation in the Bendigo transaction enabled about 50 per cent of the debt to come out of that structure to be structured in bullet form. The Bank West deal had, without our support, around 20 or 21 per cent in bullet form.

Senator HURLEY—Without any support whatsoever?

Mr Bath—Without any support from the Commonwealth. We were prepared to buy a tranche of that transaction that was, if you like, hypersensitive to changes in the rate at which mums and dads pay their mortgages off. Because we were prepared to take that cornerstone interest, it is fair to say that the structure was able to generate a higher proportion of bullet securities. The Canadian model takes that one step further and says, ‘The government will intervene if it needs to to support all of these notes that are coming out to be structured in the form of bullets.’ That is essentially the policy choice. Do you set up a permanent institution to guarantee credit performance? Arguably, credit has not ever been an issue on mortgage backed securities that have been issued in Australia. There has never been a credit loss on a rated mortgage backed security in Australia, so why do you need the government to guarantee something that does not need a guarantee? It is a bit like prescribing an antibiotic to someone with a virus. That is one aspect of it. The other aspect of it is: do you want to set up a permanent institution that will enable the ratio of bullet securities to the total amount of mortgages being financed to be increased further? That is a separate question to whether a government should be guaranteeing mortgage backed securities.

Senator HURLEY—Thank you, Mr Bath. You have not only finally explained clearly what the Canadian mortgage system is but answered about three other questions I had. In terms of these RMBS, Aussie said yesterday—and I may not have this quite right—that they received a letter from AOFM saying that they would not participate. It is addressed from you to Ernest Biasi. It says: ‘Ernest, I tried to call you a couple of times today. I am afraid that, contrary to previous advice, the AOFM is not going to be in a position to support the transaction based on CBA’s ownership of AHL.’

Mr Bath—That is correct.

Senator HURLEY—So they had been advised previously that AOFM would support that particular—

Mr Bath—They had approached us several months ago. I should clarify: this email was from me to the Commonwealth Bank. Ernest Biasi is an employee of the Commonwealth Bank. The Commonwealth Bank was looking to arrange the transaction.

Senator HURLEY—On behalf of Aussie Home Loans.

Mr Bath—Yes.

Senator HURLEY—Okay. So we have the connection there already.

Mr Bath—That is not unusual. The big four, as well as other investment banks such as Deutsche Bank and Macquarie Bank, have been acting as arrangers, structurers and lead managers for the transactions that we have been involved in.

Senator HURLEY—Of course. Yes, I understand that.

Mr Bath—So one of the big four being involved in that is nothing new. In the course of our discussions with arrangers, they will come to us and say: 'We're thinking of bringing a transaction for x. How does that grab you?' We will say, 'We'll wait and see the proposal.' I also want to make very clearly that we have not received a proposal formally from Aussie Home Loans or from any arranger on behalf of Aussie Home Loans. An arranger, CBA, had expressed an interest on behalf of Aussie Home Loans and had asked whether they would be eligible, given their ownership status. We advised some months ago that we thought that they would be. We heard nothing for several months and then in the last week of November I was at a function in Sydney and a Commonwealth Bank employee said that they were nearly ready to go on this transaction and they would be sending us a proposal that week. That was the week ending 3 December, which was when I sent this email.

During the course of that work, I became privy to the language that had been incorporated into the government's package on banking reform and I noticed a stiffening of language, if you will. I raised this with the office and said, 'You need to be aware that we don't have a proscription on buying mortgage backed securities from anyone issuer and that we have supported transactions from a range of issuers, none of whom had been wholly owned by or a subsidiary of a big four bank.' Our objective is to support competition. Therefore, we did not feel that buying a transaction that was sponsored by one of the big four banks was in keeping with the government's objectives. Clearly, for a 100 per cent owned issuer like Bank West, for example, it was pretty obvious to us that there was no opportunity for us to support that transaction. We had not been of that view for Aussie Home Loans.

However, in the course of seeking clarification from the Treasurer's office it became clear very quickly that the expectation of the Treasurer and Deputy Prime Minister was that the government would not be supporting transactions from an issuer that was 33 per cent owned by one of the big four banks. That is what I expressed to CBA. Essentially, my view was that, provided the clarification did not cause me to breach the FMA Act—because the Treasurer is not in a position to direct me to invest in a specific investment and, alternatively, he is not able to direct me away from a specific investment—this did not have that effect. Therefore, I was prepared to make clear to the CBA that, following clarification from the Treasurer and Deputy Prime Minister, I was no longer able to support this transaction—which, I might add, still had not reached the formal proposal stage.

Senator HURLEY—Thank you, Mr Bath. I understood from what Mr Symond said that it was a policy decision of the Treasurer that resulted in this. But I was a little concerned that it seemed like he had only that day got an email that caused him to abandon an issuance that he had every expectation of being—

Mr Bath—As I said, we had not received a proposal, so there was a lot of water to go under the bridge before we could have supported it. We had due diligence to undertake. The way that I was preparing to deal with this issue of ownership and whether it was competition supporting or not was to investigate whether the funding model of Aussie Home Loans relied significantly on the Commonwealth Bank.

For example, the reason we reached our own conclusion that we should not support the BankWest deal was, as I understand it, that BankWest has a shared funding arrangement with the Commonwealth Bank. It is a bit like saying, ‘No-one is buying jet fuel for Jetstar; someone is buying jet fuel for all of Qantas’s businesses.’ So, whether it is Qantas or Jetstar that actually uses that petrol, there is no point in saying, ‘I’ll give you a petrol subsidy only for Jetstar because’—

Senator Xenophon interjecting—

Mr Bath—I could not comment on that. So essentially that is how we looked at it. There was a lot of water to go under the bridge before we actually committed taxpayer money to the transaction. I think it is a bit disingenuous to say that he was ready to go with a $2 billion dollar transaction and that we pulled the rug out from under it. We have not heard from—

Senator HURLEY—I am very happy to hear that.

Senator BRANDIS—Mr Symond did not say that.

Mr Bath—I beg your pardon.

Senator BRANDIS—Senator Hurley has said that he said that, but Senator Hurley’s statement is erroneous.

Mr Bath—I think there was paraphrasing.

Senator HURLEY—I would like to defend myself. I did not state that. I was asking what the situation was; I did not say that.

Mr Bath—If I could also clarify, I think I was paraphrasing.

Senator XENOPHON—I will follow a similar line of questioning to that of Senator Hurley. Your email of 3 December, which was tabled by Mr Symond, certainly livened up proceedings yesterday.

Mr Bath—So I heard.

Senator XENOPHON—In terms of your email to the Commonwealth Bank, you said that the Treasurer has clarified his expectation that the RMBS program not support the major banks or their subsidiaries—whether fully or partially owned. It went on to say that in light of that clarification the AOFM will not be in a position to support the AHL transaction at this time. What is AOFM’s definition of ‘subsidiary’, and how has the definition of subsidiary changed? I will give you a context. If you look, for instance, at section 50AA of the Corporations Act, which looks at the whole issue of control in the context of subsidiary, it defines ‘control’ as the capacity of an entity to determine decision-making directly or indirectly in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity. How is ‘subsidiary’ defined in the context of the decision that was made with respect to Aussie Home Loans?

Mr Bath—At this stage, I am planning to seek further clarification in the formation of the Treasurer's next direction to deal with the final $4 billion. I will be looking to clarify this with both Treasury and the Treasurer's office. But, for the purposes of this, I have said that, at this stage, it is pretty clear that 30 per cent is too high a proportion. What that proportion needs to be before we will support a transaction remains to be seen. It clearly has to be more than zero, because I think the National Australia Bank owns a chunk of Suncorp Metway, for example. So zero is not the right answer, because essentially I would not be able to fulfil my mandate. But the number is somewhere between zero and 30 per cent, it would seem, in the Treasurer's mind, and I will be looking to seek clarification on what proportion or what methodology should be used in order to reach such a conclusion.

Senator XENOPHON—So you reached that conclusion on the basis of an expectation from the Treasurer or the Treasurer's office that Aussie Home Loans was, in effect, a subsidiary of the Commonwealth Bank.

Mr Bath—That is correct.

Senator XENOPHON—But the legal definition of 'subsidiary', I would have thought—and I am that Senator Brandis, with his expertise in this field, can pick me up on this—has a clear definition in the legislation.

Mr Bath—Perhaps I should not have used the word 'subsidiary'. It might be that, more correctly, I should have said that the Treasurer has clarified his expectation regarding the proportion of ownership of beneficiaries of the AOFM program.

Senator XENOPHON—So therefore it has gone from a subsidiary to an investor—is that what you are saying? There is a clear difference between being a subsidiary and the levels of control and simply being an investor.

Mr Bath—Again, Senator, I am not a lawyer—

Senator BRANDIS—But there is a difference between being an owner and being an investor. You do not have to be a lawyer to know that.

Mr Bath—I beg your pardon?

Senator BRANDIS—You do not have to be a lawyer to understand Senator Xenophon's question.

Mr Bath—I do not, but I do not know exactly what the proportion is and where the Treasurer's expectations are not being met. But before I do another single transaction I intend to find out.

Senator XENOPHON—I appreciate that, and I appreciate the work that you and the AOFM are doing. Mr Symond, yesterday before the committee, clearly felt aggrieved at the decision that he saw had been made. Obviously there must be a basis for that decision. Are you saying that the basis of the decision is not so much about being a subsidiary? I am just trying to understand. Did the Treasurer or his office say, 'This is because of the beneficial ownership,' or, 'This is because we take Aussie Home Loans to be a subsidiary'? You have used the word 'subsidiary', but did the word 'subsidiary' come from the Treasurer's office in the context of your email to the Commonwealth Bank?

Mr Bath—Yes, it did. In fact, it said 'subsidiary, whether fully or partially owned'.

Senator XENOPHON—Okay. This is a very important issue and I am sure Senator Brandis has more questions on it. Just to clarify: the word 'subsidiary' came from the government in relation to this.

Mr Bath—'Subsidiary, whether fully or partially owned' were the words.

Senator XENOPHON—So when you tried to clarify earlier that it might have been beneficial ownership, that was your construct.

Mr Bath—That is right.

Senator XENOPHON—But to be absolutely sure about what happened, 'subsidiary' actually came from the government in relation to the decision that you made.

Mr Bath—'Subsidiary, whether fully or partially owned' were the words of the government. That is correct.

Senator XENOPHON—And has AOFM looked at what the common legal definition of 'subsidiary' is and the definition as set out in common law or the court interpretation of it?

Mr Bath—Not since that time, no. In fact, no.

Senator XENOPHON—Thank you.

Senator BRANDIS—Mr Bath, let us just stay right there, where Senator Xenophon left you, with the phrase 'subsidiary, whether fully or partially owned'. Was it an adviser in Mr Swan's office who gave you those words?

Mr Bath—Yes.

Senator BRANDIS—It was not Mr Swan himself?

Mr Bath—No, but I asked him to check with the Deputy Prime Minister that he was comfortable with this position and he did so.

Senator BRANDIS—So these words, you are telling us, had the specific sanction of Mr Swan?

Mr Bath—That is correct.

Senator BRANDIS—You understand, Mr Bath, don't you, that you could have a subsidiary which is partially owned but that not every partially owned entity is a subsidiary of another entity?

Mr Bath—I did not know that, no.

Senator BRANDIS—To use the example of these two particular institutions, if CBA owned, let us say, two-thirds of the shares in Aussie Home Loans, then Aussie Home Loans would be regarded as a subsidiary of CBA but a partially owned subsidiary because the CBA would not own all of the shares. If CBA owned 100 per cent of the shares of Aussie , the latter would be a fully owned subsidiary. But to own a minority shareholding in another entity, according to ordinary legal concepts in the Corporations Law itself, as Senator Xenophon has referred us to, does not make the smaller entity a partially owned subsidiary. It makes it partially owned but it does not make it a partially owned subsidiary. You understand that, don't you?

Mr Bath—I do now.

Senator BRANDIS—You did not understand that at the time?

Mr Bath—No, I did not. As a lawyer I make a very good bond trader!

Senator BRANDIS—And obviously Mr Swan did not understand.

Mr Bath—I am not prepared to comment on what Mr Swan understood.

Senator BRANDIS—Was the adviser in Mr Swan's office with whom you spoke aware that CBA owned one-third of Aussie Home Loans?

Mr Bath—Yes.

Senator BRANDIS—He was?

Mr Bath—Yes. Actually, I think I might have advised that it was 30 per cent. I am not sure if it is a third or 30 per cent.

Senator BRANDIS—Whatever. So whoever was the genius who gave this advice was of the view that, where a company owned a minority interest in another company, the smaller company was nevertheless a partially owned subsidiary of the larger company?

Mr Bath—I think it is fair to reach that conclusion from the information available, yes.

Senator BRANDIS—That is very alarming. Let us go back to the start of the email, and you are obviously a little embarrassed at this: 'I am afraid that contrary to previous advice …' I want to draw you out a bit more about the 'previous advice'. Was the previous advice oral or written?

Mr Bath—I believe it was oral. I was not present for it. I think a couple of my colleagues had met with either Commonwealth Bank or Commonwealth Bank and representatives from Aussie Home Loans some months ago.

Senator BRANDIS—Again for the benefit of the committee we will get this onto the *Hansard*. What is your understanding of the substance and effect of that previous advice?

Mr Bath—The AOFM having been asked whether the ownership structure of Aussie Home Loans, given that it was partially owned by Commonwealth Bank, would render it ineligible for participation in the AOFM program, we advised that it did not, in our opinion.

Senator BRANDIS—And that was never reduced to writing?

Mr Bath—No, that is right.

Senator BRANDIS—Was a minute made by the officer who gave this advice?

Mr Bath—I might have received an email to that effect, but I am not 100 per cent sure.

Senator BRANDIS—This is a fairly important matter. It involves potentially a very substantial amount of public money. I am just a little alarmed that it was being dealt with in such an offhand manner. Mr Bath, would you please have a search of your files and find out if there is any documentary record at all, whether a file note, an email, a letter or anything, which documents the advice which was given on this previous occasion?

Mr Bath—I will do that. I am prepared to say that I was of the view until the last Monday in November, in fact until the first Friday of December, that we were in a position to support the transaction. So that is not an issue from my perspective.

Senator BRANDIS—I understand that. I just want to try and define with a little more particularity what was said to the CBA on behalf of the Australian government.

Mr Bath—Could I explain how we go about doing the transactions, which might shed a bit more light on it. Until such time as we receive a formal proposal, we receive soundings. An investor might approach us and say: ‘Would you buy this thing if it was structured in this way? Would you buy something from this issuer? Could you clarify whether someone is eligible if they have entered into a self-securitisation transaction before but they have not done a public deal before?’ So—

Senator BRANDIS—I completely understand there can be all manner of exploratory discussions, but this is a narrower point, as it seems to me. The question that was asked of your office was whether or not a particular player in the market, Aussie Home Loans, met or did not meet an eligibility criterion by reason of the fact that a third of its shares were owned by one of the four big banks. The answer was no, that it did not fail to meet an eligibility criterion for that reason. That position has been completely vacated in this email. That is what it amounts to, isn’t it?

Mr Bath—I think that is a fair comment.

Senator BRANDIS—On the decision you made to contact the Treasurer’s office, you said before, ‘I’d noticed a stiffening of the language.’ Was that on the basis of your reading of this rather flimsy document *Competitive and sustainable banking system*?

Mr Bath—I am not sure that I would describe it as a flimsy document.

Senator BRANDIS—That was my description. I am referring to this document.

Mr Bath—The package that was released on Sunday. I had seen drafts of it, yes.

Senator BRANDIS—Were you involved in the drafting of it?

Mr Bath—I had made drafting suggestions where statements of fact needed correction or what have you, but I would not say I was heavily involved in the drafting.

Senator BRANDIS—Okay, that is fine. In the section beginning on page 19, 'Introduce a third tranche of support for the RMBS market', if we go over to the second page of this section of the document, page 20, the second full paragraph reads:

Every dollar of this $16 billion investment will go to helping our regional banks, credit unions, building societies and wholesale lenders—not one dollar will go to the big banks.

Is that in particular the passage you had in mind when you talked about noticing a stiffening of the language?

Mr Bath—Yes, Senator.

Senator BRANDIS—If you took a strict view of that, you might think that if not one dollar was going to go to the wicked big banks then if there was even a nominal shareholding by a big bank in an RMBS participant then they would be rendered ineligible.

Mr Bath—That was my concern, yes.

Senator BRANDIS—I know you are a public servant and you cannot be too free in what you say here, so I am not going to embarrass you, but I must say that it does seem inevitably to follow from your earlier observations about how zero would be the wrong standard that that is somewhat inconsistent with the essentially rhetorical language used in this document, that not one dollar would go to the big banks.

Mr Bath—I think that is a fair comment.

Senator BRANDIS—All right. There seems to be policy confusion all over the place here, and that is not your fault. Did you consider asking the Australian Government Solicitor for their advice about whether potentially the Australian government was exposed to a legal liability at the suit of either Aussie Home Loans or the CBA on the basis that the representations that had been made to them on behalf of your office earlier in the year had been vacated?

Mr Bath—I took the view that, as we had not made any commitment to invest, we had only said that at this early stage, without seeing any form of proposal—and we have still not seen a proposal from Aussie or CBA on behalf of Aussie—that I did not see that as a significant risk.

Senator BRANDIS—But it cannot be denied, can it, that by the representation that had been made to CBA you had encouraged a proposal by telling them that the mind of the Australian government through its relevant agency at the time was that they would meet the eligibility criteria.

Mr Bath—I think it is fair to say that we had advised them that we did not see that they were ineligible on the basis of this one criterion, but we had not seen a proposal in which we assess a raft of other criteria.

Senator BRANDIS—I understand that. That is why I am focusing on this one criterion. I think you have, if I may say so, very fairly been very responsive and narrowed your answers to the specific questions I am asking. But it does amount to this, though, doesn't it, that whatever might have happened in relation to eligibility on other grounds, in relation to this particular criterion of eligibility which was the subject of the earlier advice CBA and AHL went about preparing a proposal which was about to be put to your office in the belief, encouraged by you, based no doubt on your good faith understanding of the policy of the Australian government at the time, that a one-third shareholding was not a disqualifying factor according to the way in which the eligibility criteria were then understood.

Mr Bath—I think we can assume that they did go about creating this proposal but I am yet to see any evidence that it actually exists.

Senator BRANDIS—You are not going to see it now because they have been told, with the authority of the federal Treasurer and Deputy Prime Minister himself, that they are out. You would not be expecting to see a proposal after they received that email, would you?

Mr Bath—What I said was that in light of this clarification the AOFM will not be in a position to support the AHL transaction at this time. As I have said, I am planning to seek clarification on precisely what level of ownership meets or does not meet the Treasurer's expectation in the next direction.

Senator BRANDIS—So we are now in a position, aren't we, that on the basis of this policy change by Mr Swan and these rather extreme and rhetorical words on page 20 of the government's policy announcement, no RMBS provider which is owned to any degree by one of the big four banks, or in which one of the big four banks has any level of investment interest whatsoever, is going to be in a position to be supported by the AOFM. That is what this says.

Senator PRATT—Chair, can I ask about the program?

Mr Bath—I am not convinced that that is the case.

Senator BRANDIS—That will be my last question. Mr Bath, what did you say?

Mr Bath—I said: I am not convinced that that is the case.

Senator BRANDIS—Does anybody know?

Mr Bath—I am planning to seek clarification on this matter as part of the process of getting the direction for the final $4 billion investment.

Senator PRATT—Chair, I am prepared to put questions on notice, but not if I am simply ceding time to other senators.

Senator BRANDIS—Mr Bath, since this email was sent on 3 December and it is now 15 December, don't you think that is a very long time to leave the market in such a state of uncertainty?

Mr Bath—No, I do not. We have completed two transactions since that time and I am satisfied that they were competition enhancing, which is the government's objective.

Senator BRANDIS—You would acknowledge that, after the policy change on 3 December decided by Mr Swan, there is a state of uncertainty now about how these criteria are going to be applied?

Mr Bath—That is why I am going to be seeking further clarification on the next direction before I invest any further taxpayers' money.

Senator BRANDIS—Thank you very much, Mr Bath.

Senator PRATT—I want to ask from the perspective of our financial system as a whole rather than from the point of view of individual issuers what the advantage is of having financial intermediators securitising mortgages rather than issuing bonds to fund mortgage lending which remains on balance sheets?

Mr Bath—It tends to be more cost-effective. Because mortgages are such a safe investment, by issuing debt that is backed by those mortgages the overall cost of funds for a financial intermediary can be reduced significantly.

Senator PRATT—So the advantages are in the organisation doing the credit assessment on housing loans continuing to bear the risk?

Mr Bath—They manage to transfer some of the risk in the process of securitisation, but they still charge a fee to the trust that is issuing the mortgage backed securities. It is a benefit to the issuers of such paper.

Senator PRATT—Do you think there should be any recourse to the originating bank when the loans are securitised in order to maintain incentives for good credit assessment by lenders?

Mr Bath—I think there is a need for some degree of skin in the game and that has been worked through by the regulatory authorities.

CHAIR—Thank you, Mr Bath, for assisting.

[2.48 pm]

ANDERSON, Mr Peter, Chief Executive, Australian Chamber of Commerce and Industry

EVANS, Mr Greg, Director, Economics and Industry Policy, Australian Chamber of Commerce and Industry

HOLYMAN, Mr Richard, Deputy President, Australian Chamber of Commerce and Industry

SCOBIE, Mr Andrew, Board Director, Australian Chamber of Commerce and Industry

CHAIR—I welcome representatives from the Australian Chamber of Commerce and Industry. Thank you for attending today. Accept our apologies for holding you up slightly. We hope to make up some time as we go. Would you like to make an opening statement?

Mr Anderson—I thank the Senate for the opportunity. The Senate has received our submission in this inquiry. The submission goes to a range of issues dealing with access to finance, the cost of finance and how a lessening of competition in the post-global financial crisis environment is affecting the small and medium business consumer.

I have with me Mr Holyman, our deputy president; Mr Scobie, a board member and co-chair of our Business Finance Taskforce—both office-bearers of the organisation who are in a position to be able to supplement our submission and our discussion today—and Mr Evans, our Director of Economics and Industry Policy. In view of the time, I will keep my comments very brief. I will hand to Mr Holyman in a moment to advise the Senate of a couple of key features of some additional research that we have provided and undertaken.

There are three things that I would like to impress on you in my opening remarks. Firstly, this is a very real and immediate issue for the small and medium business consumer. It is one which is affecting investment and our capacity as a nation to secure the full benefits of the economic recovery. Secondly, the impact of a lessening of competition in the market is by no means just a consumer issue. It is an issue that is playing out in terms of business finance, and in that respect it is very important that we do not allow costs to simply be transferred from the consumer side of the industry to the business finance side of the industry, because that ends up playing out by affecting investment jobs and ultimately damages consumer and economic activity. Thirdly, there are some significant gaps in the competitive nature of this market which have had direct impacts on the small and medium business sector, and they warrant a policy response by the government and by the parliament.

This is not a case where the government or the parliament is being asked to respond according to some wish list of industry. There are some failures in the proper operation of this market, they are having a practical impact, and a policy response is appropriate. In that respect, a number of the measures which the government has already announced on the business finance side with a view to increasing liquidity and competitiveness in the market are supported by the ACCI. There are a number of additional matters which, as proposed in our submission, we believe ought to be actioned by the government and/or the parliament. With those few remarks, I will ask Mr Holyman to conclude our opening statement by referring to a number of additional matters.

Mr Holyman—The recent VECCI-Victoria University survey on SME access to finance surveyed 284 businesses in Victoria during June and July, and found that 34 per cent of respondents indicated that inadequate access to finance was an obstacle to growth and:

- 30 per cent of respondents indicated that they had passed up attractive business opportunities in the previous two years …

Basically, this was because (1) attempts to access external finance were unsuccessful, (2) credit was not available in sufficient quantities, (3) finance was too expensive or (4) lending conditions were too strict. We have now organised for this survey to be commissioned across the country, not just Victoria.

It is very clear that the exit of non-bank lenders and foreign banks has meant that small business owners have had to adjust their business strategies. This has involved delaying plans for expansion, downsizing or, in some cases, closing an otherwise viable business. Many niche finance products, such as fit-out finance, which is relied on extensively in the retail sector, simply no longer exist. In my life as a private employer I also chair a retail group with some 80 retail stores, and it is very clear to us that over the last three years the availability of finance to refit those stores has totally vanished from the marketplace. It is a very small example of how the opportunity to invest has diminished; you have to do it out of your own capital resources, which has consequences for both employment and other aspects of the business throughout.

So we think it is vital that this inquiry take steps to provide solutions for business borrowers and does not just focus on mortgage borrowers. Let us remember that lost investment opportunities never show up in economic data, yet they are real—they cost the economy and they cost us jobs. Thank you.

CHAIR—Thank you for those opening remarks. I can assure you that this inquiry is not just focusing on consumers; it is also focusing on the effects of competition, or lack thereof, in the banking industry on business and small business in particular. A number of the questions and comments that have been put over the last few days have addressed that issue to some extent. We are very pleased to have you here to assist us in that regard. Would you classify the banking industry as it stands today as competitive?

Mr Anderson—There is some competition in the industry. This is not a market that is completely absent of competition, but, as our submission shows, the level of competition has waned in the post-global financial crisis environment, as we have seen a number of foreign players exit the market, as we have seen the major institutions take a greater share on the mortgage side of the market and, as Mr Holyman just said, areas such as fit-out finance and export finance have seen significant areas of market failure due to a less competitive environment.

CHAIR—Those last points are more as a consequence of lowering competition rather than—

Mr Anderson—That is right. There are competitive forces, but those competitive forces have waned and they have had a practical deleterious impact on the business market in the private sector.

CHAIR—So you would still classify it as a competitive sector but not as competitive as it was two or three years ago, for a whole host of reasons through the GFC. Some of the evidence we have heard is directly related to the GFC and other evidence is related—and in your submission you probably touch on some of this—to decisions made to address some of the issues during the GFC, like the pricing differential on the wholesale funding guarantee.

Mr Anderson—Yes, that is right, Senator.

Mr Holyman—I would like to add one thing. There is a very large degree of cherry-picking going on within the banking sector. Yes, they are extremely competitive when they have a strong client and they want to pitch for that business. But in the SME market there are a lot of businesses that do not fall into that attractive group. That does not mean they are failures and it does not mean they are failing—they are solid businesses—but they may not have all the levels of security that some of the higher businesses have. In those cases, swapping banks is not an option. Leaving an existing banking institution is not an option and no banks are chasing them. At that level, competition is very sparse.

CHAIR—Most of the regulators have provided evidence to us that, prior to the GFC, competition was for business customers. They would compete to attract the customers. Because of structural changes that have occurred throughout the GFC, competition is now for the funds, with depositors trying to get long-term and short-term funding so that they can lend it out. I guess that plays out in what you are talking about: if they are not competing as hard for the customers, they can be a little bit choosier about whom they provide funds to and the terms upon which they provide those funds.

Mr Scobie—There are regional and rural implications in that bankers are choosing to lend differentially in different marketplaces. In your home state of Tasmania, for example, there has been a 33 per cent downturn in investment in productive plant and equipment. That is shown in the last ABS statistics. That is, in large measure, due to constricting availability of credit.

CHAIR—I am not disagreeing with you, but are you able to provide a reference for the degree to which that is being driven by restricted finance rather than restricted demand?

Mr Scobie—We could provide you with supporting evidence of the causal factors.

CHAIR—Thank you. We have had evidence that, prior to the GFC, a significant driver of competition was coming from the non-bank financial institutions—probably not so much for business, but, to some extent, Aussie, Wizard and RAMS were driving a high degree of competition that led to them gaining a significant market share of the home loan market in the mid-2000s. I presume that had a flow-on effect to other forms of business, particularly in the context where banks and financial institutions were competing for customers rather than the other way around. They have basically completely gone out of the market. Most of the evidence that we have received suggests that it is because they can no longer get funds to lend out, certainly not at a competitive rate. Your submission focuses on securitisation, which is where they got most of their funds from. Do you think that, in the absence of a force like that driving competition—even in the state of competition that we have, which you have indicated is lower than it was—it is likely to be maintained?

Mr Anderson—The level of competition is not going to significantly improve just by relying on the market trying to heal itself. There is an issue about accessing funds but also, on the business side, being able to apply funds to business lending, as distinct from the consumer side. What we have seen is that, by a consequence of foreign players exiting the market, the major institutions have just been more comfortable operating on the consumer side of the market and using available funds at that level. So, even as a consequence of the impact on those mutuals on the mortgage side, there has been the spillover effect on the business consumer side, and that is that the major institutions do not see a particular competitive need to come to the table on some areas of business finance.

On export finance: this is an area where the banks have been able to make their own judgment that they do not need to actually play in that game, (a) because it is safer to play in the game on the mortgage side and (b) because there are not competitive pressures which are bringing them to that table. I might ask Mr Evans to just add to those remarks.

Mr Evans—I support those comments. With respect to business lending, it has been particularly the exiting of foreign banks—not because they were having credit difficulties in Australia but because their parents were having difficulties elsewhere—and the non-bank lenders but also, importantly, as the deputy president mentioned, in niche areas, and particularly in lease financing, it has become a lot less competitive. That has an impact on the extent to which you can invest in plant and equipment. In fact, one of our survey questions at the time the government introduced the accelerated investment allowance was: ‘To what extent have you been impeded investing in plant and equipment as a result of not being able to obtain finance?’ It was quite high, the number of respondents who had difficulty taking advantage of that government initiative due to difficulties in obtaining finance.

CHAIR—I am aware that we have limited time, and I do have a few questions I want to ask. You have a number of recommendations as to how we can move forward from that. As you mentioned in your opening statement, they include covered bonds, which I think have bipartisan support, and even the involvement of the AOFM, which also has bipartisan support. Indeed, that was originally proposed by the coalition. One of your recommendations that I find quite interesting is the temporary small business loan guarantee scheme. Would you care to outline what you mean by that, how that could work and what the risks might be to government, which from a legislator’s perspective is obviously an important issue?

Mr Anderson—There are schemes of this nature in a number of other industrialised nations—Canada, the United States, the United Kingdom—that are worthy of some serious assessment at the very least. What governments in those jurisdictions have done is to provide some mechanisms for government to provide some guarantees on small business loans where there is some clearly demonstrated market failure that is not being met by the market. They are all subject to some significant caveats and conditions, and we do not walk away from those caveats and conditions, because it is critical that the government, on behalf of the taxpayer, does not put itself at risk in this area. We would not want that either. So all decisions that are made in respect of this policy initiative would have to be prudentially made. But, where there is a market gap, then there is at the very least, I think, a reasonable case for the government to assess what is happening in this respect in those other nations and identify its applicability to the Australian circumstance, because this is not a case, as we said, where the market is just going to heal itself.

To give you an illustration of what is evidence of a market gap: in Australia—and our submission references this—63 per cent of small and medium business owners are now using their credit card facility as a form of business finance. That is extremely high by international standards.

Senator XENOPHON—At 21 per cent or whatever?

Mr Anderson—At extremely high rates, that is correct, with all of the costs associated with that. If we have a situation where small and medium businesses are having to resort to credit cards to secure credit, then that is prima facie an indication that there is some market failure that warrants a proposal like this being looked at. That is what we are asking government to do as the first step. We do not want the government to undertake non-prudential practices at all but we do want the government to ensure that every stone is turned to see whether or not we can do something to improve competitive pressures in this market.

CHAIR—Your recommendations once again reflect to some extent the reform announced by Swan, the Treasurer, on Sunday but they do not, as you noted, incorporate all of them. Some of them have been welcomed by both sides of politics, others less so. In one of your recommendations, recommendation 8, you note that 'lenders should only be allowed to charge loan exit fees on a cost recovery basis'. The Treasurer has gone further than that and is going to ban exit fees altogether. Is that something you support, or do you think a cost recovery basis is the right way to deal with it?

Mr Anderson—I will ask Mr Evans to comment on that, but we have a clear view.

Mr Evans—Senator, as you indicated, our view is that it should be on a cost recovery basis. Our concern is the unintended implications if you do otherwise. In fact, you may adversely impact those borrowers who are still with an institution and pass those costs on to existing borrowers. We believe this is not an opportunity for fee gouging from the banks but it should simply reflect the costs associated with discharging a mortgage and the like.

CHAIR—I do not want to labour it, but some of the evidence we have received suggests that most of the costs are upfront. In the past a lot of financial institutions would hit the borrower upfront with a fee, and as a way of avoiding having to charge that fee and making it easier for consumers they defer it. A lot of these exit fees are actually deferred application fees—that is how they sell them—which are not payable if you stay with them for a certain period of time. Do your comments hold if that is the case as well? Are they recovering the reasonable costs? Is it a cost recovery basis?

Mr Evans—If you operate on the basis of having transparent pricing at all points in the transaction, that would generally deliver the best result.

CHAIR—My final question, given the time, is this. In recommendation 10 you recommend that there be a Productivity Commission inquiry into the degree of competition. There have been calls, particularly from certain politicians, for a broadscale inquiry looking at the whole of the financial industry and banking industry in the terms of a Campbell or Wallis type of inquiry. Do you think that the sort of inquiry that you are talking about there could be incorporated into a broader such inquiry? As a separate issue, do you think such a broader inquiry would be valuable?

Mr Anderson—The difficulty with a broader Wallis style inquiry is simply that they tend to take an enormous amount of time because the scope of those inquiries covers so much ground. What we are trying to do here is to identify the fact that there are certain specific matters that do warrant some further consideration. We have just discussed, for example, the small business loan guarantee—

CHAIR—And the Productivity Commission is well placed to do that.

Mr Anderson—and a Productivity Commission inquiry with a specific remit has the potential to bring about a result and some recommendations earlier in the piece. We are not opposed to incorporating that issue into a broader inquiry, but this is a pressing issue. This is not something which just requires assessment from an intellectual point of view or a system design point of view. There are structural problems that are playing out now in the market.

CHAIR—That answers the question of whether it could be incorporated, to some extent. There might be some timing issues, but in terms of the broader inquiry itself as a separate issue?

Mr Anderson—There could well be a broader inquiry. We are not opposed to that and we would fully participate in it. These are matters that bear directly on our economic capacity and our future economic structure. But the priority is to take steps which will help bring about greater liquidity and competition in this market now because, as the research and the survey results that Mr Holyman has referred to show, this is an immediate issue that is playing out in the market and it is not healing itself sufficiently to allow this to continue unattended to by the parliament or the government.

Senator HURLEY—We have done the small business inquiry on this committee; we know that there are a number of difficulties in the small business community. We keep hearing from the banks that things are getting better and they tell us that they are lending quite well to the small business sector at this stage. But we are also hearing other evidence from the banks. The ANZ noted in its submission:

> ... the number of small business customers who are 90 or more days past due on their credit facility has increased as a result of the financial crisis

and ANZ claims that in its small business banking segment the delinquency rate has more than doubled since 2007. The information that you have about small business using their credit cards does indicate that there are at least cash flow problems and maybe some more serious problems within some businesses.

I do think that small businesses have suffered from banks closing down and not lending to more risky customers, even if they are only slightly more risky. But, rather than direct money to areas such as assisting, with government moneys, small businesses to get loans and putting pressure on the banks, would it not be better to provide that money directly to businesses to look at how their businesses operate?

Mr Anderson—They are not mutually exclusive goals. There is no question that there are risks associated with business lending; there always have been. The question before this committee is whether or not a reduction in competition is creating a greater problem in that respect than there has previously been and whether people who have credible cases for access to business finance are being denied because of risk rating by the institutions.

Our concerns, which we express in our submission, are that businesses with a long history of relationships with their institutions are being denied applications for credit even in profitable circumstances. So it is not a case of saying: ‘Let’s put all of our focus on trying to improve the capacity of businesses to understand what they need to bring to the table when they have a discussion with their banks.’ It is also a case of asking: ‘Have banks acted responsibly in re-rating those risk factors and putting some of the costs on the business side of the equation from the consumer side of lending?’ The overwhelming evidence is that banks have gone beyond what is reasonable in both of those regards.

Mr Holyman—Again, one tends to relate as much as possible to the feedback we are getting and our own experiences in the real world. I think if the banks were asked about their frequency of auditing SMEs and putting them under pressure, you would find that that number would have tripled from what it was three years ago. They are sending in auditors. If you put in an application to extend your financial arrangements to do some investment or acquire acquisition in the business, the credit processes that you go through these days are to some degree untenable. There is simply no inducement anywhere that we see in the system for banks to think otherwise; it is not that they do not need to take any further opportunistic chances. They are putting a lot of barriers up for any expansion of facilities. That is definitely happening out there today.

Senator HURLEY—I take your point on that. Indeed, that is anecdotal evidence from people I know who have had a long history of dealing with banks and found that conditions have tightened considerably.

Mr Holyman—It is not about the businesses being successful or not. It is process driven.

Senator HURLEY—That is right. In your recommendations I think you have rightly focused on developing that other funding level to enable competitors to come back into the market—or at least for those financiers that are there to reduce their costs so that they can start to lend at lower rates or reduce their conditions.

Mr Scobie—In that context, you have had the withdrawal of the international banks, in large measure, which has reduced direct competition in that space, and it is a known phenomenon. To assume that local, second-tier institutions are going to be able to move from being principally mortgagee lenders and into the business banking space in a timely manner is not an adequate solution to the problem. Those regional banks, and other mutuals et cetera, that have been alluded to—and which may or may not be helped by the securitisation or the covered bond solution to the problem—do not have, in and of themselves, the capacity to move into the provisioning of those services easily. There is certainly considerably more that needs to be done to allow them to have the capability to meet the demands of the marketplace. Without doing so and with fiscal and monetary policy being determined, at the moment, in the light of the resources sector's super cycle that we are now on, we run the real risk, systemically, over time—and that is why we have called for a Productivity Commission inquiry—of actually reducing the breadth and depth of the Australian economy and really negatively impacting on regional and rural Australia, in particular, and our capacity to prosper beyond the end of the super cycle. As Glenn Stevens said publicly, recently, Australia has a fantastic capacity to manage adversity. We do not manage our prosperity anywhere near so well. And right now we appear to be running the risk of doing precisely that.

Senator HURLEY—You identified where I was getting to with my question. It is hard to see those second-tier banks—in particular, the credit unions and mutuals—stepping into this breach. I was wondering if you were hoping that the majors would come back, or if you were looking to foreign banks to come back.

Mr Scobie—Without directly addressing things, at the moment you have, with the covered bond initiative, a fairly limited and not deep enough initiative to that degree, insofar as it is going to AAA rating. Most of the regional banks are not in that position. Consequently, this is in fact further reinforcing the position of the big four banks and not increasing the capacity of the regional banks and other mutuals to meet the needs of the business community and step into the breach—the structural failure that is occurring at the moment.

Senator HURLEY—I am just wondering if your best position is not to give the majors more profitability, to strengthen them.

Mr Anderson—There are two objectives here that we should be working towards. One is to add liquidity to the market, whether it is a pool of funds which can be accessed by majors or second-tier banks. If you add liquidity to the market then you provide greater capacity for the flow of finance and the necessary capital to grow the economy. The second is to add competitive pressures, forces within the market, and the second-tier institutions are part of that equation. For example, if you equalise the cost arrangements in respect of the wholesale funding guarantee, that is going to be a direct advantage to those second-tier institutions, and they would have the capacity to flow that through. That might not increase the pool, but it certainly would allow them to compete more actively on price.

Senator PRATT—I want to ask what your overall impression of the banking package is, in terms of the elements of it that you think will be of assistance.

Mr Anderson—We have indicated that the package that has been announced has a number of desirable features, particularly on the business side. It does not, however, meet all of the needs of the small and medium business sector. There are a number of additional matters, as Senator Bushby has alluded to, that are in our submission that have not been included in the package, and which we commend to this committee and which we believe ought to be recommended to the government and the parliament.

Senator PRATT—There are elements that you do believe are pro-competitive. Specifically, what do you think benefits small and medium businesses? What benefits will be extended to them?

Mr Anderson—I will ask Mr Evans just to comment on a couple of those details.

Mr Evans—I think principally they were the issues that added liquidity in the market, and that related principally to the initiative with regard to the residential mortgage backed securities—the additional funding there—but also the introduction of innovation in the marketplace for the issuance of covered bonds. So I think it was those issues, with respect to business; adding liquidity in the marketplace was the most welcomed aspect.

Senator PRATT—So, in that sense, you would agree with what the lender RESIMAC has said: that the RMBS market has been vital to permitting the continued flow of finance to the small-business community?

Mr Evans—Principally, the RMBS market is mostly about providing mortgage lending for households, but to a great extent it is also used by the small-business sector. So any benefit there is welcome.

Senator PRATT—Resimac asserted that there would be thousands of businesses without access to finance without the support of the RMBS. Would you agree with that statement?

Mr Scobie—The reality is that of course it is the case that there are many hundreds of thousands of businesses in Australia and many of them borrow secured by mortgage-backed borrowing.

Senator PRATT—That is right.

Mr Scobie—It is the only way for many small businesses that they can borrow. So it is self-evident to that degree. However, that would have been the case under any circumstance.

Senator PRATT—Yes. We have had a lot of debate about competition in banking and people seem to be conflating, in some instances, competition with bringing interest rates down. I want to ask where you think small-business sits currently in terms of things in the economy which are putting upward pressure on interest rates. I come from Western Australia where there is a significant skill shortage emerging. It seems to me that there is some trouble distinguishing in the debate about competition between banks and some of the other precious small businesses are likely to face where some parts of the economy booming but you still have small business struggling to access finance in some instances.

Mr Anderson—There is an issue of access but there is also the issue of cost. It is very clear for us to say to this committee today that the lessening in competition has had a deleterious effect on the cost of finance to small and medium businesses. It is not just a question of access. With the lessening of competition, major institutions are in a much better position to state their price. Having said that, there are a number of other factors in the economy which are putting pressure on interest rates. You have mentioned the pressure on capacity and skill shortages, the level of government expenditure and our willingness as a nation to bring our budget back into surplus in good time all bear on the question of setting of interest rates. We have, as a result of the lessening of competition, seen a significant impact on the cost side for small and medium business lending and it has been a disproportionate effect compared to what has happened on the consumer side. The small and medium business sectors have borne the brunt of tighter credit conditions in Australia.

Senator PRATT—I think it is worth having your organisation distinguish and separate out the elements of that debate and put them on the record for the purpose of this inquiry. Thank you.

CHAIR—Thank you to the Australian Chamber of Commerce and Industry for your assistance today.

[3.30 pm]

HODGES, Mr Graham, Deputy Chief Executive Officer, ANZ Banking Group Ltd

NASH, Ms Jane, Head of Government and Regulatory Affairs, ANZ Banking Group Ltd

SMITH, Mr Michael, Chief Executive Officer, ANZ Banking Group Ltd

CHAIR—Welcome. Would you care to make an opening statement?

Mr Smith—Yes, I will make a short opening statement. Firstly, Australia's banking system is regarded as a standout globally, having weathered the GFC remarkably well. Australia's banks maintained the flow of credit to the economy both through the height of the instability which was triggered by the collapse of Lehman Brothers in September 2008 and subsequently. Our strong banking system underpinned the economy and, indeed, employment. This is in stark contrast to the position in many developed countries, and I think it was aided by the swift action on the part of the Australian government and the regulators to deal effectively with systemic risk that threatened the banking sector and the health of the Australian economy and jobs within the economy.

The introduction of the deposit guarantee instilled confidence in depositors, and the wholesale funding guarantee ensured banks continued to access international funding on reasonable terms in the time of crisis. The government's action was necessary at the time and the wholesale funding guarantee has subsequently been withdrawn in an orderly and, I think, appropriate way. Australia is one of the few OECD countries where the government has been a net beneficiary of revenue from its banking system as a result of the GFC. Around $5.5 billion will be paid by banks to the government for credit enhancement by the time the last of the guaranteed wholesale funding expires.

The second issue is that the nature of competition has changed. Competition in the deposit market has never been so intense. Deposit rates have been bid up as financial institutions compete for stable sources of funds. Our Asian operations have been an advantage to us. They enable us to access the savings pools of customers in Asia and thereby supplement the deposits we raise in Australia. Depositors in Australia are presently benefiting from interest rates of up to seven per cent and there are almost four times as many deposit customers as there are mortgage customers. The higher cost of this funding is, of course, flowing through to lending. This means lending rates are increasingly less related to the RBA's official cash rate. The GFC also exposed the business model of some of the non-bank lenders to be unsustainable in that they did not properly price for liquidity or credit. Those lenders have exited the market. Other small lenders reliant on securitisation for funding have been affected by the sharp drop in demand for RMBS. This created a gap in the market that was filled by the major banks.

Thirdly, government policy measures appropriate to smooth adjustment to the shock of the GFC are those that facilitate competition without imposing unnecessary costs on our customers.

The government's banking package includes some measures which fit this description. Further support for the securitisation market through the AOFM will assist funding of smaller lenders. Australian RMBS are of high quality and this approach can be easily switched off when it is no longer needed. Diversifying funding sources is also appropriate. Developing a significant Australian corporate bond market attractive to retail investors and allowing the issuance of covered bonds are directionally right.

Turning to customer empowerment: active, well informed customers help lift competition. In the short to medium term, more transparent fees and shorter, more effective disclosure requirements would allow customers to more readily compare products and assist informed decision-making. The idea of the proposed mortgage fact sheet is to provide a simple statement which will help consumers compare the costs and features of mortgages. Financial institutions can also assist here by providing simple, transparent products. In the longer term, more financially literate and informed customers will grow competition in the market. ANZ has made a significant investment in understanding the issues related to low levels of financial literacy, and which groups in the community are most affected, and in developing programs aimed at building the skills of the more vulnerable in the community. Our programs are delivered in partnership with the government and community organisations such as the Brotherhood of St Lawrence. Some of those organisations have made submissions to this committee. That concludes my opening statement. I am now very happy to answer questions from the committee.

CHAIR—Thank you, Mr Smith. I note that in your opening statement you have not addressed the issue of your funding costs, yet you do so in your submission. Would you care to outline what is happening with your costs of funding at present?

Mr Smith—There are three aspects to the adjustment of cost of funding that has happened post GFC. The first is that the cost for wholesale funding, on which the Australian banking system is reliant, has adjusted as part of the global market's adjustment in credit pricing—pricing for risk. So banks are now thought to be of higher risk than they were before.

The second issue is that the competition for domestic deposit gathering has got very, very intense and, therefore, the cost of deposits has been bid up. There is a difference of some 160 basis points for the average deposit rate vis-a-vis the official cash rate before the crisis and after the crisis. For mortgages, the difference would be 100 basis points. So that is the squeeze.

The third thing is that the mix of our liability book has changed so that we have put in place far more longer-term funding. This has been done to protect the AA rating, which is so important for the banks, and also at the behest of APRA, in that they would rather see that stability of long-term funding.

CHAIR—And Basel III changes may well require you to head in that direction?

Mr Smith—Basel III will create further issues, particularly around liquidity. But, in terms of the actual deposit ratio, it is going to be far stricter than it was in the past.

Mr Hodges—I will just add another thought to that if I may. When we look at the proportion of our domestic customer base that we use, our domestic customer funding—which we have tried to grow through the crisis because it is a stable form of funding—we have lifted that. As

Mike said, the overall pressure on domestic deposit markets reflects that. But we have also seen a mix shift within the domestic deposit market because, as interest rates for deposits have risen, the opportunity cost of sitting on a low-interest deposit versus taking a high-interest deposit increases. So what we have seen is a switch in our book as well. People have moved from low-rate deposit products to higher-rate deposit products. Term deposits have clearly become much more attractive, and we have seen more of our funding shift into those higher-rate deposit products as well.

CHAIR—What percentage of your funding comes from across-the-board deposits?

Ms Nash—58 per cent.

Mr Hodges—Chart 6 of our submission shows that.

CHAIR—It is a fairly substantial proportion of where your funds come from. Presumably, looking at those different sources of funding and the pressures that are upon them in terms of prices, the ANZ's evidence is that they are increasing and continuing to increase. The overall funding in those three areas of funding that you referred to your evidence is that they quite clearly have increased throughout the GFC. Are they continuing to increase? What is happening to the average cost across that funding?

Mr Smith—Yes, they are. The funds both in the domestic market and in the offshore market are continuing to increase. It has stabilised a little bit in that the actual credit markets internationally have stabilised but what is happening is that deals that were put on pre-crisis at 16 basis points are being renegotiated at something like 120 or 130 basis points. There is actually a graph on page 7 of our submission which shows how that repricing will move forward. So we will continue to have upward pressure on our margin until 2012. Then you will see it will stabilise but at that higher base.

CHAIR—Okay. Mid-2012, did you say?

Mr Smith—It probably will be. I would say from the look of this graph it is about the first half of 2012. Until then we are going to see a steady increase in pressure.

CHAIR—In your overall cost of funding.

Mr Hodges—We have about 20 per cent of our wholesale term funding which is pre-crisis. So that is still to flow through.

CHAIR—That still has to flow through. Presumably at some point there will be funding that you took out during the peak of the crisis at a high level.

Mr Hodges—Yes.

CHAIR—Which is going to start coming off and that is when your cost—

Mr Smith—That will compensate. That will actually bring it down to—

CHAIR—And that is more in your long-term wholesale funding. What will happen to your overall average cost of funding will depend to some degree on what is happening with deposits at the time and probably to a lesser degree short-term wholesale funding.

Mr Smith—That is correct.

CHAIR—This question is not designed to trap you. I have asked the same of another two major banks as well. The Reserve Bank on Monday indicated that on their assessment of the major banks their cost of funding since mid-2009 has basically risen in parallel with the increase in the cash rate. It has not risen above that since then. Their argument was that while the long-term wholesale funding continues to increase at a greater level that is being offset by a stabilisation in short-term wholesale funding costs and stabilisation in deposit costs. That is their assessment. Neither of the other banks agreed with that and I doubt that you will either but I am interested in your views.

Mr Smith—You are right! I understand where they are coming from because they are talking about this window during which time the credit markets internationally have actually smoothed out. In fact they started to peak up again as a result of problems in Europe and I suspect we will continue to get these ups and downs. Because we are only assuming that this is going to continue to be quite smooth so long as credit markets globally remain less volatile than they were of course during the height of the crisis. What they have not taken into account is the lag effect of that repricing that we have on the longer dated stuff. Also I think that with the domestic deposits they have not really factored in some of the very aggressive pricing that has gone on there.

CHAIR—Do they not have access to the information they need.

Mr Hodges—I think they can see absolutely what particular product rates are but we obviously get mix effects going on in that all the time. I think in a broad sense they watch where these rates go but they cannot see the same detail we can of how our book is structured.

CHAIR—So it is a detail issue you think that leads them to draw that conclusion. Quite clearly, their conclusion is something that you do not agree with.

Mr Smith—No, I do not. But I can understand how they could think it. If you were looking purely at the way the international markets were moving, it would be easy to draw that comparison. But you would have to look at the whole maturity of our book—which is quite a complex issue—and also the different structures in the different countries. One of the issues is that we operate in 32 countries and we have a very different liquidity management for each place. This is a group issue for us. It is quite complicated.

CHAIR—I am sure it is complicated, and it is probably beyond most of us to understand the detail—certainly beyond me. So you are saying that you can understand why they would draw that conclusion on the basis of the information before them. Do you not make the information available that they would need to draw the proper conclusion?

Mr Smith—Yes, we do. I think there was a speech by the RBA yesterday—

Mr Hodges—Even today, where they have been talking about funding costs and recognition of funding pressures. It is clear that we are perhaps privy to slightly more detail in terms of how our individual bank books are working. As Mike said, it is a complex issue.

Senator CORMANN—Trust us; we are from the bank!

CHAIR—It depends on what you are talking about.

Mr Smith—If there is a lesson to be learned here it is that when the RBA comes out with some comment like that we should actually go straight back and say, ‘Hang on a minute; this is the information that we have got, which doesn’t agree with that.’ I do not think we have perhaps had a quick enough dialogue.

CHAIR—That statement is actually contained in their submission to this inquiry. I will try to find it.

Mr Smith—I remember the statement.

CHAIR—Treasury also have made statements. They made statements before the Senate Economics Legislation Committee at estimates recently that they keep a close eye on the banks and they do not think that their funding costs are sufficient to justify increases over the official cash rate. They made statements to that effect on Monday in Sydney—that they do not believe that that is the case. I suspect to some extent the advice that is coming from Treasury and the RBA is informing the Treasurer when he goes out and makes similar statements. I believe the Treasurer has made statements saying that he does not accept that your funding costs are such that they justify increases above the official cash rate. Do you agree with the Treasurer?

Mr Smith—I think that they have been operating with information perhaps similar to what the RBA has and they have come to a different conclusion from the banks. It is very difficult to know exactly how they have calculated this. I would go back to the fact that we would not want to increase rates unless we really had to. This is not a decision that is taken lightly. It is not something that is easy to take and can only be done for very, very sound commercial reasons. The last thing we want to do is to put our customers at risk. The last thing we need is customers with problems. That is a real problem for us.

One of the things that I have been a little bit concerned about is that there seems to be a perception that customers do not matter to banks. Customers do matter. We cannot survive as a business without customers. It is everything. It is front and centre. And we care what is going on with the customers.

CHAIR—I understand that. To some extent, I am interested in the view that the Treasurer and the regulators have formed and how that is different to the view that you have formed. Has Treasurer or anyone from his office ever rung you to ask you personally why you have increased the rates above the official cash rates?

Mr Smith—I have had regular meetings with the Treasurer and contact with him and his office over many months. When the issue of funding has come up, they have had their view on this and we have had ours, and we have tried to explain where we come from and they have tried to explain to us where they are coming from.

CHAIR—Quite clearly, as of Monday at least, you have not convinced Treasury of your perspective.

Mr Smith—I think the comment is that we agree to differ on this.

CHAIR—After the November cash rate rise you increased your rate at a greater degree than the cash rate. Did the Treasurer call you after you announced your intention to do that?

Mr Smith—After we announced it?

CHAIR—Yes.

Mr Smith—No, but I rang him just before we did it.

CHAIR—Prior to the public announcement you rang him to let him know that was happening?

Mr Smith—Yes, which is normal.

Senator CORMANN—What did he say when you advised him? What was the reaction?

Senator HURLEY—Come on. It was a private conversation.

Mr Smith—I think the fact that we maintain a dialogue over these issues is important, particularly with his office and with the Treasury.

Senator CORMANN—But he did not try to dissuade you in any way?

Ms Nash—I do not necessarily think it is appropriate to go into the content of the conversation.

Senator BRANDIS—It is a matter of considerable public interest.

Senator CORMANN—I think Mr Smith was quite happy to answer, but I can see that he was protected from the side.

CHAIR—Can I ask a slightly different question: did the Treasurer ask you to justify why your interest rates needed to increase more than the official cash rate?

Mr Smith—No. I think it was very clear that he felt there was not a need to and we felt there was, and that need was based on our facts, not on—

CHAIR—On the basis of that phone call or otherwise in respect of that great rise, did he ask you or the bank to provide in writing an explanation of why it needed to raise its rates more than the official cash rate?

Mr Smith—No, and I do not see why he would do that.

Senator CORMANN—You said at the beginning of the discussion on this that you would not increase rates by more than you had to. Why wouldn't you do that? A view has been expressed by various witnesses that not just your bank but banks in general would increase rates by as much as they think the market can bear in any given circumstance—I think one witness said, 'As much as they can get away with.' In terms of the way the system operates, what is preventing you increasing rates by more than you have to? Is it just because you have a good heart?

Mr Smith—No, it is a competitive environment. You cannot be out of market; you have to be able to compete.

Senator CORMANN—But you have a fair idea what your competitors are doing and that, in a broad sense, they are going along similar lines.

Mr Smith—I know what the other banks' balance sheets are doing. There is so much information in the public space about banks.

Senator CORMANN—When you say you have to compete, that really suggests that you do go as far as the market can bear rather than as much as you have to.

Mr Hodges—I disagree. I think what Mr Smith is saying is that it is a competitive market. If we see an opportunity to grow our business in that market in a segment that we are really interested in chasing, it gives us that opportunity. We have been growing our business across most of the markets in the last 12 months and, we think, we are very competitive.

The other thing it is worth reflecting on is that pricing is only one aspect of the competition in the marketplace. People compete on the features of the products and on service. In fact, over a long time now our bank has had a convenience and simplicity strategy around retail banking and that is what our customers tell us really works well for them. You always have to be in the market around pricing, but non-price issues are just as important for many of the customers. That is why we are No. 1 in customer satisfaction and have been for at least five years. We really work very hard on our customer proposition—on what customers are asking for. As I said, you have to be in the market; you have to be on someone's shopping list. Price is one of the important factors, but it is not the only one. We think it is a very competitive market, frankly. If there is an opportunity for us to expand our business, we will look at that, and we are obviously doing that at the moment. We are growing above our system.

CHAIR—I will move on from funding and interest costs; other senators may ask questions in that area. The Treasurer's reform package was announced on Sunday and to some extent it fits in with what you were talking about regarding the market already being competitive. This is quite clearly intended to enhance competition. To what extent do you think the measures outlined in the reform package are likely to enhance competition in the banking market?

Mr Smith—I think there are some things there I agree with and some things that I don't. As I mentioned in my opening remarks, there are a couple of things with regard to access to funding for the smaller players which are positive. I think the securitisation take-up by the government—an extra tranche of that—is not going to make a massive difference in terms of the actual quantum that is put in, but it is to stimulate demand for that product from other investors.

CHAIR—It will take things forward even though not at a dramatic level and be of assistance.

Mr Smith—Yes, but I think the thing to do is to kick-start the market again. It is to get that RMBS market moving again. I think that has the possibility of doing that. Anything that we can do to develop the corporate bond market would be positive. I think that would be a good idea, particularly for our customers. On the institutional and corporate side I think it—

CHAIR—And you think the proposal in that respect is likely to have legs?

Mr Smith—I think it is going to be a difficult thing to do. It is not an easy one to change. There are a number of things that I am not as happy about. I think direct legislation on things like exit fees is a mistake. We have already taken away exit fees.

CHAIR—On business and consumer?

Mr Smith—No, just on variable rate mortgages.

CHAIR—Fixed rates are another?

Mr Smith—Not on fixed rates because, obviously, with fixed rates you have to lock in your own funding.

CHAIR—That is right.

Mr Smith—So there is a massive cost if they were to break that. Indeed if this legislation were to apply to fixed rates, which is not clear, it would kill the fixed rates market, I suspect. I think that you should not legislate that. You should let the market deal with that. The prosperity of this country is based on fundamental economic reform which has happened over 30 years, really since the floating of the Aussie dollar, and all governments—from the Hawke to the Keating, Howard, Rudd and Gillard governments—have been moving that way and I would like to hope that they continue.

CHAIR—I concede Hawke, Keating and Howard but not beyond that. So essentially you think overall there are some good things in it and there are some things that you think are not so good. Would you describe your attitude to the package as that it would upset you or upset the ANZ?

Mr Smith—There are bits that are a bit irritating, I have got to say, and there are bits that I think are quite sensible for the industry.

CHAIR—You used exit fees as an example. It sounds, given that you do not have exit fees on variable home loans—

Mr Smith—But I think the issue there is that once you start creating legislation it is the thin edge of the wedge and—

CHAIR—Rather than a practical thing impacting you at the moment, that is more a—

Mr Smith—It is a philosophical issue.

CHAIR—Yes, a philosophical issue.

Mr Smith—It is the principle.

CHAIR—Yes, it is an issue of principle. So it is irritating but it is not something that would make you greatly upset with the government at this point in terms of impacting on your operations.

Mr Smith—That is a fair comment. The covered bonds issue is positive. I think the problem with covered bonds is this. It is a bit like securitisation. It is a drug we should really get off. One should be looking at actually increasing deposits as being the key funding for the bank. Whilst I will put in place a program to test covered bonds, it is not something I would want to rely on for the big banks. But it will probably be a bit more important for the smaller banks, and I can understand that.

CHAIR—Although the evidence that we have received suggests that there is probably a minimum issue amount for covered bonds that may well be beyond—as it is going to be hundreds of millions of dollars probably—

Mr Smith—But they could probably package that and there will be ways—

CHAIR—That is what they would need—exactly. There are some challenges in terms of delivering that.

Mr Hodges—I think that if there are willing issuers and there are buyers out there the market will find a way to package or structure that so that the smaller banks can benefit from that market. I have no doubt that will happen.

CHAIR—I think the other two big banks that we have heard from so far have been probably a bit more enthusiastic about covered bonds than you sound to be.

Mr Smith—They have a slightly different philosophy on their funding. I am a bit more conservative in that respect in that I like deposits.

CHAIR—So what would you recommend in terms of increasing deposits?

Mr Smith—It is a hard one. I think there probably needs to be some sort of adjustment to something like the superannuation funds or something fundamental like that.

CHAIR—Taxation treatment?

Mr Smith—Yes. You change your tax to basically give people an incentive to save. At the moment the only incentive to save is through super. A bank deposit attracts the highest rate of tax you can pay.

CHAIR—It is actually double taxation.

Mr Hodges—It has been that way for a long time and I guess superannuation is a strategic focus for government and has been for a long time, and quite importantly for retirement savings. But it has been at the cost to some extent of the bank deposit, which, as you say, get taxed when you earn it and then gets taxed at the marginal rate. So whether you saw some tax reduction in bank deposits, at the moment the way the system is that is part of the reason why the system is short deposits in Australia. So people tend to save in superannuation or maybe paying down their mortgage as a tax-effective way. It is interesting that people do work that out pretty quickly.

Mr Smith—They get a house.

CHAIR—Thank you. In view of the time I will hand over to Senator Hurley.

Senator HURLEY—Senator Bushby asked you what you thought of the Treasurer's plan. I presume you are aware of shadow Treasurer Joe Hockey's nine-point plan. What do you think of that?

CHAIR—Tell us what you think, please!

Mr Smith—I have probably already said enough about that.

Senator HURLEY—So you prefer not to comment. I do not blame you at all. You do not believe that that would be any significantly greater spur to competition than the Treasurer's plan?

Mr Smith—In any of these issues we have got proposals from both sides of the house. I know that you will not necessarily agree with each other but there is some good stuff in all of it and some things which perhaps are a little difficult to understand how they would take place. I think consultation is the important thing in this. I think that the idea of this account portability and the fact that this is going to go out for further consultation is quite an important thing. The actual logistics and difficulties of doing this and the cost of it would be so huge. I think we forget what the issue is. The main issue of moving account is direct debits. That is the thing that most irritates people. So let us just find a way of doing that, and then we do not need all this other stuff.

Senator HURLEY—I would agree with you completely. Let us talk about some of the nitty-gritty of proposals. A couple of submissions have mentioned the Canadian authority that now deals, I understand, with both mortgage insurance and a kind of a government guarantee of the quality of assets. Do you know anything about that system and you think it might be applicable in Australia?

Mr Smith—I have a fundamental problem with the taxpayer supporting private industry for that sort of scheme. I can understand why it was done in Canada, because you have a slightly unusual situation particularly vis-a-vis what was going on in the US. That system was a sort of pragmatic solution. I do not think it would be great for us. I think it leads to a sort of moral hazard. Having said that, I think it would be useful if the government, as it has suggested, can kick-start the securitisation market in some way. That does not mean it has to own it.

Senator HURLEY—The mortgage insurance question has been raised quite separately from whether the government should manage that but it has certainly been raised with me in terms of being a significant cost for the consumer.

Mr Hodges—When you take out a loan and you have above 80 per cent loan to valuation, you need to take out mortgage insurance. I think I did hear that that is maybe a barrier to people switching because they have to then retake out mortgage insurance. Is that the question?

Senator HURLEY—That is right. It is a cost if you switch.

Mr Hodges—I must admit that I am not familiar with just exactly how that works. It is quite a technical issue.

Mr Smith—You would have to have portability of the insurance product as well as the account.

Mr Hodges—Typically, when we would do a house loan and we would look at the person who is borrowing, we would look at how much they were borrowing. The insurance does provide, effectively, credit enhancement for the bank, because they are borrowing a relatively high amount. Historically, it is always shown that we would have losses on the higher loan to value ratio, which is why you take out mortgage insurance. Conceptually, if you could see that that is the same individual in this bank as in that bank, maybe the insurance policy could transfer. I guess that is something which we need to take up with the insurers.

Senator HURLEY—It would be part of the consultation, hopefully, with account portability.

Mr Smith—The problem is that a number of banks self-insure. So then you would have a problem.

Senator HURLEY—Exactly. I might finish there, Chair, and let others ask some questions.

CHAIR—Thank you. Senator McGauran.

Senator McGAURAN—The three key points of the reform announcement by the Treasurer were the exit fees, the covered bonds and at least an investigation of enhancements to the ACCC's powers with price signalling. They are the three least headlined—

Mr Smith—That is the other one I did not agree with.

Senator McGAURAN—You do not agree with—

Mr Smith—The price signalling.

Senator McGAURAN—And exit fees. You are very cool on that. Given that announcement, would you describe the points in it this way: bank bashing; pure populism; political football; vendetta against the banks; dangerous and massive economic impact—and, dare say, negative; shame; out-there proposals; push up prices; frighten investment; 25,000 AN Z workers all vote—presumably under your instructions; and base level response? Would you use any of those terminologies?

Mr Smith—No.

Senator McGAURAN—Well, you have.

Mr Smith—No, I have not; not in relation to this situation.

Senator McGAURAN—You have used those terminologies in regard to Mr Hockey's very points that align with that announcement—all bar the exit fees, which you are very cool about, I should add. They are the exact same points that Mr Hockey made.

Mr Smith—We have already abolished the exit fees; so that does not actually affect us.

Senator McGAURAN—I am focusing more on your reaction.

Mr Smith—My reaction to what?

Senator McGAURAN—You are pulling your punches with the Treasurer's announcement, which aligns directly with Mr Hockey's nine-point plan—bar the exit fees.

Mr Smith—No. I said a number of the issues that I did not like were the number that you just read out—the price signalling, the account portability and the exit fees, which in principle I do not think is good.

Senator McGAURAN—Your response goes a long way to the backlash that you received. It was quite hysterical, and you received a backlash accordingly. You also said that this committee would be a vendetta.

Mr Smith—With respect, I did not think that sort of commentary was really proper for me to use in front of you. I am trying to be rational and fact based here.

Senator McGAURAN—Here today; were you then?

Mr Smith—I do not know in what context those remarks were made. I think that is quite difficult for me to—

Senator McGAURAN—Mr Smith, please, you are on—as it has been reported—$10.86 million and you are telling me you do not know in what context your comments were made. If I were the board I would be worried by that. You know very well the contents. I have got the article—

Mr Smith—I said the context.

Senator McGAURAN—Contents or context?

Mr Smith—Context.

Senator McGAURAN—Either. It is in relation to Mr Hockey's early lead and public charge on these matters.

Mr Smith—Senator, I think I have said enough about that. It was an issue at the time which was difficult to understand. I had just been in a meeting with the leader of the party. These comments came just straight after that. It was a surprise and I reacted. I run a business—

Senator McGAURAN—They are unprecedented.

Mr Hodges—I might say, Senator, I am not sure they are. I have been around long enough to remember a number of fairly strong reactions between banks and parliamentarians going back many, many years. Besides, we are here to try to assist the inquiry in working through what these issues are. I think it is very difficult for Mike to pick out particular comments there—

Senator McGAURAN—We don't listen to Mr Smith, we are here in this inquiry, but don't think you are getting off all that lightly. On Mr Hockey's nine-point plan, as you have put it—which are the key points of the Treasurer's own announcement—Mr Hockey has 'taken economic lessons from Hugo Chavez'. I did some investigating on the President of Venezuela. This is a man who wants to socialise, and has socialised, private enterprise. No doubt he has got the banks in sight, but he has certainly nationalised the oil industry there. He is a man who has stripped his own people of their human rights. He despises capitalism. Is that a fair, genuine comparison? Would you like to say something about that? Can you even tell us you regret that comment?

Mr Smith—I do regret it. It was a one-liner which I do not think has been very helpful, to be perfectly honest. I do regret it and I certainly did not mean it personally. But, again, I have said very little about it since.

Senator McGAURAN—But you did cross over to the personal. You used comparisons to be personally hurtful. You made comparisons not only to President Chavez. You were comparing him to Mr Costello and Mr Turnbull. That is a personal attack.

Senator HURLEY—Chair, on a point of order: yesterday you picked me up, in a discussion with Aussie Home Loans, on the relevance of an issue which I thought was directly relevant. I think Senator McGauran is discussing an issue which is a media comment about something that is not directly related to this inquiry. I understand a number of other senators want to ask questions. He is taking up a lot of time on an issue which is peripheral.

CHAIR—Thank you, Senator Hurley. I do not think there is a point of order, but I would remind Senator McGauran that we are here for a purpose, and that is around the terms of reference, so could you please direct your questions to that end.

Senator McGAURAN—Chair, can I just yield, on a similar topic, to Senator Brandis.

CHAIR—Yes. Senator Brandis.

Senator BRANDIS—I will not be long; I just want to deal with the issue of comments by Mr Smith about price signalling. By the way, Mr Smith, I spoke to Mr Hockey a couple of days after you made that remark and I think it was received in the spirit in which it was intended, but it is very gracious of you to express your regrets. Mr Smith, do I understand you are opposed to the proposal for there to be an amendment to the Trade Practices Act in relation to price signalling?

Mr Smith—No, I do not oppose it. I just do not understand the way it has been enunciated at the moment.

Senator BRANDIS—It has been enunciated by the government in reasonably brief and largely rhetorical language in this document, *Competitive and sustainable banking system*.

Mr Smith—Yes, which I think is the issue. We have got to be very careful that we do not stop banks talking together, because they have to do that in terms of a workout, with a problem customer, or something like that.

Senator BRANDIS—I accept that, and I think that is very sensible, if I may say so. Have you or your officers at the table had the opportunity to consider Mr Hockey's bill in relation to price signalling which was introduced in the last sitting week of the parliament?

Mr Smith—No, I have not.

Senator BRANDIS—One of the elements of the Hockey bill in relation to price signalling is to make the offence subject to a very strong competition test so that conduct which might otherwise be price signalling will not fall foul of its prohibition unless it is for the purpose and is likely to have the effect of substantially lessening competition. The two elements in the existing Trade Practices Act of purpose and effect are both built into the excusal provisions of the Hockey bill, so it is a stronger competition test than sections 45 or 46 of the existing Trade Practices Act. Would you have any misgivings about a price-signalling prohibition being introduced into the TPA provided that conduct were not actionable unless it were anticompetitive in both of those senses?

Ms Nash—I think that when you put things in that way it does sound sensible, but we have not had a chance to look carefully at the bill. On the surface of it I do not think anybody would necessarily disagree with what you have just said there, but for us—

Senator BRANDIS—I am just telling you what is in the bill.

Ms Nash—Yes, that is okay, but before we can say, 'Yes, we agree,' or 'No, we don't agree,' we really need time to take advice.

Senator BRANDIS—Sure; I understand that, though I must confess I would have thought that you might have read it, given the notoriety of the issue and its importance to the bank. But, be that as it may, let me reassure you that ordinary predictive statements that are made in the ordinary course of banking business would not be comprehended by the term 'price signalling' as Mr Hockey's bill is drawn, and unless such conduct were shown to have an anticompetitive purpose and effect it would not be caught by the bill that Mr Hockey has introduced. So it is a very narrow prohibition. In those circumstances, Mr Smith, that wouldn't frighten you too much, would it?

Mr Smith—Again, I think it depends very much on: 'Am I allowed to talk about interest rates as part of my normal business?' And I think we have to—

Senator BRANDIS—I would expect the answer to that question is yes.

Mr Smith—Yes, but I think we have to understand that it is difficult to price signal commodities because by their nature they are just traded, and money is a commodity. It would be rather unusual if I were asked my views on interest rates, or the likely movement of interest rates, or the interest rate environment or foreign exchange—what is the Aussie dollar doing?—unless I could actually see exactly what I could and could not say. But I understand where you are coming from and, as Jane says, it sounds very reasonable.

Senator BRANDIS—Thank you for that. I am just concerned that there are a lot of red herrings being raised by the loose use of this term 'price signalling', which in the government's policy has been essentially expressed in rhetorical language without any protections. If I could encourage you or those who advise you on these matters to study the Hockey bill, which is now a public document, I think you would have a very high level of reassurance that the ordinary course of business sort of statements that you have just described would not be caught by it.

Mr Smith—Okay, Senator, I will do that.

Senator XENOPHON—Mr Smith, I should disclose that I am a customer of the ANZ Bank and my first question is in relation to bank switching, which should not necessarily be seen in the context of my disclosure. You talked about account portability being quite problematic in terms of costs, and I think the Australian Bankers Association said it could cost several hundred million dollars to facilitate it. In the Netherlands they have, as I understand it through Choice's evidence yesterday, a legally mandated requirement that if you want to switch banks you give an authority to the new institution and they provide the details to that institution. So there is a mandated requirement with some time lines to expedite that happening. Would you look at that differently to having a technological solution to it?

Mr Smith—I think it makes a bit more sense because it is a sort of practical solution. I think that runs for about a year and a day, from memory. That is what they do in the Netherlands so that you could catch all of the standing orders or direct debits that went through your account in a year—you would ensure that you had got them all. I think that that is probably a sensible way of looking at it.

Senator XENOPHON—Jonathan Mott, an analyst with UBS, gave evidence last night in Sydney and he had the view that if a system is too portable it would lead to instability. Do you agree with that as a general proposition?

Mr Hodges—Can I just say that when we looked at what happened in the UK when Northern Rock collapsed a lot of people were watching the queues in the branches but actually a lot of money was taken out through the internet bank. So my sense is: if a customer had issues with a particular institution then they might just withdraw their money and then put it in somewhere else much more quickly rather than try to switch accounts like that. I understand the consequence of what you are saying, but I would have thought that that would be a long way of trying to move your money, frankly.

Senator XENOPHON—Also, yesterday Mr Mott from UBS gave evidence that banks need to have healthy profits or big profits because if they do not then their ratings will go down and if their ratings go down that will push up interest rates. You have a contrasting view from others such as *Choice* and also Professor Milind Sathye from the University of Canberra, a former deputy governor of the Reserve Bank of India, who takes the view that we have a very highly concentrated banking market here in Australia, based on a number of indexes. Do you accept that view of Mr Mott's that if your profits go down that could affect your credit rating? And how do you contrast that with Canadian banks, which seem to have equivalent credit ratings to Australian banks but whose profit levels may be a little bit lower?

Mr Smith—Canadian banks are actually as profitable as—

Senator XENOPHON—So I am wrong about that?

Mr Smith—Yes, in terms of return on equity—if we are looking at it on that basis. But I think the issue there is that profitability is one aspect of what the rating agencies look at, and sustainable profitability is an important pull-up point because the issue is not so much the amount of profit as the amount of capital that you are generating, because unless you can generate additional capital through profits you cannot grow your business and so you cannot issue more loans. So it is very important for a bank to be able to grow, and the best way it can grow is through generating its own capital. The piece that you do not retain, of course, is distributed as dividend.

Senator XENOPHON—Earlier today the Australia Institute gave evidence that their analysis of the 2009-10 annual reports of the four major banks indicated that interest expenses fell as a percentage of both assets and liabilities. Their contention was that banks are spending less money on interest in 2010 than in 2009 and that that is inconsistent with evidence that costs are rising. That was their proposition. I think they gave figures that indicated a drop between 2009 and 2010. For instance, for the ANZ, interest expenses as a share of assets dropped from 3.4 per cent to three per cent and interest expenses as a share of liabilities dropped from 3.7 to 3.2 per cent.

Mr Smith—Yes, but that does not reflect the mix—

Senator XENOPHON—Yes, but I just wanted to get you to respond to that.

Mr Smith—If you look at the actual numbers, they have significantly increased, year-on-year.

Mr Hodges—Might that also reflect the fact that interest rate levels overall are different, and so you are not comparing apples and apples? In a sense, those numbers are reflective of the absolute level of interest rates, not margins in the market.

Senator XENOPHON—So you are saying that it is not reflective of margins, even though the overall costs seem to be somewhat less?

Mr Hodges—Well, if interest rates were another 10 per cent higher, then your overall numbers would be grossed up and if they were much lower they would be grossed down, I presume. I have not seen their report but it does seem that that may be a factor.

Senator XENOPHON—You may want to take the question on notice in the context of the assertion made by the Australia Institute.

Mr Smith, you talked about the issue of customer empowerment in your opening statement—having more transparent fees, better disclosure requirements and simple, transparent products. I am not singling out ANZ, but is that an acknowledgement that things could be done better in terms of consumers?

Mr Smith—Absolutely—yes.

Senator XENOPHON—And you understand the level of community disquiet or concern in relation to banks? I think your colleague, or your fellow CEO, Mr Clyne on Monday told the inquiry that, essentially, the nation’s banks had themselves to blame for their low community regard and had confused the public with their previous policy of linking interest rates to the Reserve Bank’s official cash rate instead of funding costs. Is that a fair comment of Mr Clyne’s?

Mr Smith—I think it is. The fact that the banks have moved their interest rates in line with the RBA adjustments has led to the understanding of the public that there must be a connection, and that is quite understandable. So I think we have created that problem for ourselves and I would agree with him.

Senator XENOPHON—I want to make sure I get the context right for this; context is very important. On 29 October in the *Financial Review* an article by Marcus Priest and Matthew Drummond refers to you saying that you flatly rejected the need for another bank inquiry. Was that in the context of this inquiry or a Wallis type inquiry? Given what has transpired in the last few weeks and what has been announced, do you think there is scope for a more comprehensive inquiry into the financial system in the context of what has occurred?

Mr Smith—I hope that this inquiry actually presents the facts and indeed can make some views and judgments based on fact, which will hopefully clear up a lot of the misunderstanding around the whole issue. Whether or not we require a further inquiry I think depends very much on the findings of this committee, but if such an inquiry was called for then of course we would partake in it.

Senator XENOPHON—I want to touch on the issue of Mr John Symond from Aussie Home Loans. You may be aware of his evidence, which was reported widely today, and his criticism of the package and the whole issue of securitisation. I think you have said that securitisation is a drug we should get off.

Mr Smith—I am talking about banks more than—

Senator XENOPHON—Mr Symond's evidence was that the advent of Aussie Home Loans and other non-bank lenders increased the competitive pressure in the 1990s in the context of the home loan interest rate market. Do you see a role for a Canadian type setup? You commented earlier, but do you concede that the advent of Aussie Home Loans and other operators made a difference and was a factor that increased competition in terms of that alternative access to funds?

Mr Smith—Yes, but I think what we have to look at is where does competition come from. The trouble with banks is that they are very conservative things, they are very traditional, they do not normally look at differences. What John Symond did was bring some innovation to the market, and perhaps the model now needs to be adjusted a little bit. But I actually think that where we should be looking is at what technology will bring us: what is going to be the change that technology will bring which will allow new entrants into the market without the infrastructure that the banks have and all the baggage in terms of the massive amounts of infrastructure we have?

Senator XENOPHON—Does that mean in the same way that Qantas has Jetstar as a low-cost carrier, the ANZ would be looking at a different product in the marketplace?

Mr Smith—Let us look at a good example, ING Direct. You have got a bank which is basically internet-based, it does not have any branches and therefore is providing a service with a tiny amount of the cost that we have and therefore can be much more competitive. I think other such situations will occur. You have got Virgin airline issuing a credit card. These are the sort of things that may well happen.

Mr Hodges—On the technology side, clearly all the banks are trying to invest in technology but the bigger you are in fact the more disadvantage you have in some of these areas because you are less nimble and you have a lot of legacy platforms that you have to connect everything with. So to some extent the technology is supporting competition coming from the smaller players, the more nimble players, and we have seen that across parts of the market. I think the switch into online banking has been quite dramatic. We have introduced mobile banking tools and technologies; others will follow. So the way we do banking in another 10 years could be quite dramatically different from what we do now, just as we would not have anticipated 10 years ago the way things happen in this market. I think that will leave an avenue open for other competitors who we currently do not know about to enter the market.

Senator XENOPHON—Hence the question whether, in the same way you have legacy airlines having offshoots, that was something on the agenda.

Mr Smith—Absolutely.

Senator XENOPHON—My final question relates to Basel III. Of course you will not know what the final rules will be and what has been negotiated internationally by APRA but there is concern. Senator Bushby has been asking questions on this at Senate estimates for many months. Is there a concern that with the tightened liquidity requirements and with the other requirements of Basel III—whatever they will be it seems there will be tighter requirements in part to respond to what has occurred overseas—will there be an element of Australian consumers having to pay for the sins of other banking systems when ours has been very strong and robust? In other words, and to put it colloquially, will we be copping it in the neck to basically make up for the sins of others?

Mr Smith—I do not know whether we will cop it in the neck but we will certainly feel an effect.

Senator XENOPHON—It might be a whack on the back of the head.

Mr Smith—Yes, a whack on the back of the head. I think we have all become used to the fact that there will be a bigger capital requirement and I think the banks will get better at managing the products which are capital light rather than some of the more traditional products. They may need to change the product mix which they sell. Liquidity is much more difficult because there are still ideas floating around and it is unclear where that will go but if banks are required to hold massive amounts of additional liquidity in low-yielding bonds for repo purposes in times of trouble that would be a major cost. So far, APRA and the RBA have done a great job in pushing back some of the international ideas which are done for international reasons but are actually there to protect London as a financial centre, or New York or wherever. There is a lot of national interest in this.

Senator XENOPHON—Sure, but there will be a flow-on effect, presumably. Is the bank considering that Basel III has the potential to increase the cost of finance in Australia?

Mr Smith—There is potentially a flow-on effect but until we know exactly what has been agreed it is going to be hard to—

Senator XENOPHON—Can you give a range? Would it be between 50 basis points and 100?

Mr Smith—I have no idea. We thought we had got the capital issue resolved last month and then every regulator in the world went back to redefine what a risk asset was. So suddenly what was known became unknown.

Senator XENOPHON—So it is a known unknown!

Mr Smith—Indeed. I think we have some way to go in this debate. All I would say is that the understanding of these issues by APRA, the Reserve Bank and Treasury means that we are across it. It is a question of making sure that we push back against the vested interests of other countries.

Senator XENOPHON—So we will not know how big a hurdle Basel III will be until next year?

Mr Smith—No, we will not, but it is going to be progressive. It is not going to happen overnight; it will take many years. Basel II took 20 years to implement. The Americans started it and at the end of the day said that they did not want to do it anyway, so the rest of the world confirmed apart from the US and therein lies a story. So Basel III still has quite a long way to go.

Mr Hodges—Your point was whether we would be affected here because of what happened offshore. We are already seeing that through wholesale funding costs and all those sorts of things which reflect the repricing of risk that has gone on globally. There is no way the Australian system, as it currently stands, can be isolated from what is happening in global markets.

Senator XENOPHON—Including the rollover of European sovereign debt next year.

Mr Hodges—Yes, and I think there are real reasons to have some concerns about how that will play out through the course of next year.

Senator PRATT—Mr Smith, you have acknowledged that the ANZ and other banks necessarily stepped in to fill the gap during the global financial crisis. In turn, would you acknowledge that there is now, therefore, less competition in the market and that it is a legitimate objective to restore some further competitive pressure?

Mr Smith—I think you could take it two ways. First, you could look at it and say there is less competition. That is assuming that the major banks do not compete with each other—and I can assure you they do. It is quite brutal competition, frankly. The second is that the important part of that was that, even though these second-tier players left the field, customers, both consumer and corporate, were still able to access funding and that maintained the economic growth in the country. Had that not happened, had the banks not been able to step in, we would have had a real problem.

Senator PRATT—How important are sticky consumers? I imagine they are important. We have had some discussion of that.

Mr Smith—Sticky consumers? Literally?

Senator PRATT—People who will stay with your bank instead of taking their money elsewhere and constantly flitting around looking for the best deal. I imagine that is important, and that should not mean that a bank should not earn that stickiness or take it for granted.

Mr Smith—I think that is absolutely right. It is like respect. You have to learn respect; you cannot just expect it to come with the title or whatever. The issue around customers is about the experience they have with the bank, and it is that customer experience that we work so hard at. I admit we do not get it always right and we often do not get it a lot right, but we do try because without our customers we are nothing.

Senator PRATT—You are unsticking consumers by removing exit fees—in a good way, I would say, and I would hope you are creating sticky consumers—

Mr Smith—We hope they stay with us because they want to.

Senator PRATT—Yes, that is right. Do you think that other banks should also remove their exit fees?

Mr Smith—I think that the market dictates this stuff, so eventually there will be pressure for them to align themselves in the same way that we react to different competitive pressures. I think that it will happen but, as I say, we would have to work very hard at trying to maintain our customers. They have to want to stay with us.

Mr Hodges—I offer an example going back a number of years as often you can see how it plays out over a number of years. Our bank was the first to introduce the $5 account where you just paid $5 a month and you got your account. We had that in the market for about 18 months and we were winning good business in the market and then—this is back in the early 2000s—suddenly all banks were in there with some similar variant, something which was a low-cost, low-fee account where people came in. I think the way the market does work is that if someone gets a good product and it wins business or they take a fee off, as in this case, consumers notice this and if it is important to them they will react to it. If it is not important to them then they will be focusing on other things and they will use other products. So I think the market will sort that out pretty quickly.

Senator PRATT—Will the ANZ be charging other fees to make up for the removal of exit fees in any way?

Mr Smith—No.

Senator PRATT—Good; I was hoping that would be the answer. Has the ANZ spoken to the Treasurer or his office over the last 18 months about any of the elements that are included in the recent banking package?

Mr Smith—I think a number of these issues have been raised in conversations.

Mr Hodges—Covered bonds would have been one.

Mr Smith—Certainly covered bonds, yes; certainly exit fees.

Senator PRATT—I asked Mr Norris this morning to comment on the fact that his yearly package was equal to what 30 Australians would have to pay the CBA over a lifetime in order to own their own home and I think he missed the point completely. So can I ask you this, Mr Smith. Do you get to talk to ordinary mortgage holders very often? Do you appreciate the significance to them of the contract between the ANZ and them, to the wellbeing of themselves and their families?

Mr Smith—Yes, I do. I am very sensitive to it. I meet a huge number of our customers over a year. As I said earlier, these decisions to raise rates are taken with incredible seriousness. It is not something you would just do. Our customers are front and centre of everything we do and, of course, I have to be in touch.

Senator PRATT—We have had some discussion about Mr Hockey's bill and you have said that it sounds very reasonable and would not present any issues for any major banks. Is your impression of Mr Hockey's bill that it sounds very reasonable and would not present any issues for any major?

Ms Nash—That is not quite—that is in part, I think, what Mike said. The other thing that he said was that he would need to understand much more about what he might or might not be able to say. And the same view would apply to the government's bill, and we have not had time to go through it in any fine detail.

Senator PRATT—Everyone is talking about the costs for wholesale funding as the big competition issue, and we have had lots of discussion about that—Mr Symond and Mr Naylor yesterday and banking groups. I think I read that the ANZ had a bond issue earlier this week. I wonder if you could give us a sense of what the pricing differentials are, in real terms. What pricing does a bank like the ANZ pay compared to Bendigo or similar?

Mr Smith—The pricing purely reflects the rating that the bank has. In fact what is slightly strange is that, even though the Australian banks—the major banks—are rated AA, we actually do not raise money at AA price; we raise it at a slight premium to AA. The reason for that is there is so much Australian paper in the market in relation to the size of the economy, and it is all Australian bank paper. So, in terms of the basis point difference at the moment—between AA and A minus—it would be, I think, at the moment, about 50 basis points. And that is a rough estimation.

Senator PRATT—How did the government guarantee on wholesale funds work for ANZ during the GFC? How much did you use and to what effect?

Mr Smith—We used the window when we had to.

Mr Hodges—It was from the end of 2008, so I think they came in on around the 12th or so for the domestic guarantees—12 October—and maybe the international one came in just slightly thereafter or around then. We used that up until about June 2009, and then beyond that we found that our investors were telling us that they would prefer to take normal paper from us with the higher yield that we would give them on unguaranteed paper rather than a guaranteed paper. Because we had borrowed the government's guarantee or paid for the government's guarantee it reduced the yield that they were getting. They became comfortable enough through 2009 that they would prefer to have our nonguaranteed paper rather than guaranteed paper because it gave them a yield pickup, and yet they felt comfortable with the risks. So it was probably only for about that seven or eight months that we used that. We have not used it since.

Senator PRATT—Does that mean you have a lot left?

Mr Smith—We do not have a lot. We probably have about $15 billion. It would not have been a lot. But that was, again, something we had to come straight off as soon as we could in terms of building the yield curve back in our own name. So far that has gone pretty well.

Mr Hodges—I see you are smiling at us saying we do not have a lot: $15 billion does not sound much, but $100 billion or so is our wholesale funding.

CHAIR—I am sorry. I smiled when you said $15 billion was not a lot but I understand that in the context of your overall funding it is—not in terms of average.

Senator PRATT—Given, I suppose, the level of taxpayer support and the role that that support has played over recent years, where do you think banks sit currently as good corporate citizens?

Mr Smith—To answer your second point first, I think that, as corporate citizens, we are extremely good. Our corporate responsibility model is one of the best. We have won the Dow

Jones sustainability index for the fourth year running as the best bank in the world for this. I think that is high praise for an Australian bank. In terms of the taxpayers' money, not one cent of Australian taxpayers' money went into the banking system—not one cent. The government has received or will receive over $5 billion as a result of the guarantee scheme. None of those schemes have been called.

Mr Hodges—I think it is a question about taxpayer support. That could be interpreted as saying that the taxpayers provided support in a sense of financial support, which it has not. In fact the banks have paid for it. It is true that the sovereign, the Commonwealth, provided its use of its guarantee at a fee, which was very appropriate for the time, given the systemic risk that was in the marketplace. It was quite a scary time and I think they did the right thing exactly at the time.

Mr Smith—I think the way they structured that was clever because it was the right thing to do. It was not a giveaway; it was renting.

Mr Hodges—It put a deadline on it. If you looked at it from an issuer point of view, if I were the government issuing it, it also risk-adjusted it and said that those with the higher risk should pay a higher amount because it is a contingent liability for the Commonwealth and that is the way it was structured.

Senator PRATT—These are very interdependent relationships—Australians, their mortgages, the whole economy, the shareholders, the bank. In a sense, when we are here debating bank profits and the pressures on mortgage holders, we want to see as much pressure on banks as possible to be those good corporate citizens.

Mr Smith—Yes but, as I said earlier, we have four times as many deposit customers as we do mortgage customers who are benefiting by that increased rate. There is a lot of the community who are actually benefiting from this. As I said before, we are completely understanding of the importance of these decisions. We do not take it lightly. It is a very difficult decision to make to raise rates and it is one that is taken with all the facts in front of us.

Senator CORMANN—Mr Smith, I was interested in your quite categorical response to Senator Pratt's question about exit fees and whether there would any replacement fees or any increase fees in other parts. You were quite adamant and said no. Does that mean that exit fees did not cover, in the past, an expense that you as the ANZ Bank incurred?

Mr Smith—Our retention of mortgages has been extremely good. We have been growing our mortgage levels above system for the last year despite being a little more expensive than a number of other offerers. That is often because of the quick decision-making process and the settlement process which is very well perceived in the market. Price, as Graham said earlier, is just one element in this, it is not everything.

Senator CORMANN—I understand that, but essentially you are saying that you can absorb the loss in revenue from the exit fees.

Mr Smith—We can because, as I say, we have to work hard to make sure that we do not lose.

Senator CORMANN—Sure—which means that, essentially, you were previously charging more than you could have. I guess that raises the question of whether there are other fees and charges across the banks that are the same.

Mr Smith—No, it does not, because there is always a cost of actually creating a loan or of repaying a loan. There is inevitably a cost.

Senator CORMANN—But you are still going to incur that cost and you are not going to impose a fee.

Mr Hodges—We only recoup that if the person left within the four years.

Senator CORMANN—Do you expect that nobody is going to leave?

Mr Hodges—We are going to back ourselves to hang onto our customers.

Mr Smith—This is the management challenge and you need a few aspirational challenges.

Senator CORMANN—Is that a change from what you would have done before, Mr Hodges? You would have always tried to hang onto your customers, I would have thought. That is just business as usual.

Mr Hodges—We had one of the lowest exit fees in the market, so, in a sense, it was easier for us to give that up than it would be for some of the other institutions. It is still something which we recognise from a philosophical point of view. It was something that we could do and say that we stand to not handcuff our customers to us through this sort of fee, but we will win the customers' business and keep them.

Senator CORMANN—Sure. I will not dwell on it much longer, because we are short of time. In your opening statement, Mr Smith, you mentioned that you have four times as many deposit customers as ANZ mortgage customers. What is the overall value of your deposit account versus the overall value of your mortgage account?

Mr Smith—In terms of?

Senator CORMANN—In terms of dollar value. You are talking in terms of the number of customers. I would be interested to know the value of the mortgage business versus the deposit business.

Mr Smith—It is obviously going to be very different because your average deposit is much less, about $30,000, whereas your average mortgage is about $260,000.

Senator CORMANN—That is why I am asking you the question. I got the impression that you were trying to suggest that, really, it is all swings and roundabouts and—

Mr Smith—No. What I was saying is—

Senator CORMANN—there are many more deposit holders, so why do you worry about mortgage?

Mr Smith—Say you are a pensioner and you rely on dividend income and some bank deposits and you do not have a mortgage. Only 30 per cent of Australians have a mortgage, so there is a whole part of the community that also benefits. That was the point I was making.

Senator CORMANN—That is subject to all the limitations that we have in the tax treatment of deposits and what an attractive investment that may or may not be in that context. I am just indiscriminately rushing through a series of issues in the interests of time. The chairman of the ACCC, Graeme Samuel, has expressed—and I am quoting from some background that is in front of you—that the banks are publicly commenting on how they are planning on increasing their rates, which is effectively providing comfort to the big four that they can increase without facing any competitive pressure. That of course goes to the issue of pricing. I see you shaking your head. Do you want to make a quick comment on Mr Samuel's claim?

Mr Smith—I understand what he is saying, but I go back to the point earlier about money being a commodity. It is very difficult not to comment on where rates are going. I have my view, and the bank has its view, but is it right or wrong? We do not know. If you could advise me what the Aussie dollar is going to be next month, I will listen to you and maybe I will agree with you or will not—

Senator CORMANN—I would not listen to me, if I were you, to be honest! I am sure you have got much better people to listen to than me.

Mr Smith—It is right to be able to have an opinion on these things. Any of these comments, certainly from my perspective, were not meant to be priced signalling. I do not care what the other banks do as long as we can remain competitive.

Senator CORMANN—But when you make your announcements in relation to rate changes, is there a first-mover advantage or a first-mover disadvantage from your point of view? Are you essentially providing the meat for the market and providing cover for others?

Mr Smith—If we are talking about variable mortgage rates, to be candid, to move first takes a bit of bravery because you really 'cop it', to use your expression.

Mr Hodges—In the back of the head!

Mr Smith—Well, everywhere. I would say that that is a very politically sensitive one.

Senator CORMANN—Politically sensitive for the banks, you mean.

Mr Smith—In terms of the variable mortgage rate. And the reason that the variable mortgage rate is politically sensitive, I believe—again, going back to comments where the banks, frankly, have not helped themselves—is that there is no real and transparent reference rate which is a market rate. The rates that we create for the mortgages are what the bank thinks appropriate. That has worked very well for 20 years, but—

Senator CORMANN—For a long time you all increased at the same rate, and for a very long time it was in line with movements in the official cash rate.

Mr Smith—But there is quite a bit of difference now. I think you will find that there is also quite a bit of difference in the strategy of each bank and I think that that is also a healthy sign of competition.

Senator CORMANN—Just going to the government's so-called competition reform package, I have got here an equity research paper from Credit Suisse, which you will be pleased to know continues to recommend ANZ among others. It makes the point:

If anything, major banks are perhaps long-term relative winners from the reforms …

Whereas, it states:

… regional banks were "not unequivocal winners from the reforms".

That is, they are relatively more exposed to reforms to increased mortgage competition and also to the fixed IT costs associated with potential deposit account portability reforms et cetera. Is it your overall perspective that the major banks are better off as a result of the reforms announced by the government compared to the smaller banks?

Mr Smith—I think if you are trying to make the system more competitive then everybody in the system should be better off, shouldn't they?

Senator CORMANN—The question is of relativities though. You have the four big banks and everybody else. I guess the question from a public interest perspective is whether there is going to be more competitive tension overall or whether we are just making the bigger banks bigger.

Mr Smith—Competitive tension comes anyway. That is what a market economy does. I think the danger is if you impose regulation that stops the free market working. When John Symond came into the market all those years ago there was a big gap in the market. He saw it and he went for it. Because of that he drove down the costs of mortgages.

Senator CORMANN—We have this analysis here from an organisation that makes it its business to assess the impacts of policy announcements like the competition announcements and it is making the point that, if anything, major banks are going to be better off over the long term compared to some of your other competitors.

Mr Smith—If they were, it would be marginal. I do not think there would be much in it. As I said, I would like to watch the market actually create that competitive tension because I think that is the proper place for it.

Senator CORMANN—We have had a lot of discussion around the tension between competition and stability, between competition and financial safety. The regulator says that their first focus is on financial safety while taking competition issues into account whereas organisations like Choice tell us that the balance has swung too much the financial safety way and we are not taking competitive issues into account enough. Do you think that our regulatory framework, including our system of prudential oversight, has contributed to a concentration of banking among the four large banks, making it too difficult for smaller players?

Mr Smith—No, I would not say that they have gone out of their way to restrict competition. In fact, I do not think they see that as their brief. That is not their brief; their brief is to maintain the stability and strength of the financial system.

Senator CORMANN—Understood. There is a balance and a tension, which everybody agrees, and if you take the regulatory requirements to the nth degree then larger businesses are going to find that easier to handle than smaller businesses and it will create barriers to entry. Do you think the balance is right or have we contributed to a concentration?

Mr Smith—I think you can always reduce the amount of unnecessary regulation. I think regulation should be good regulation and should not be onerous on the customer. I think in opening an account and transferring an account the amount of documentation that we are required by law to make sure that the customer complies with is onerous. There is all this additional regulation that comes in. The key to regulation is good supervision of the regulation. I think that is where Australia has done well. I think the more regulation you put in, the worse the competitive environment gets, particularly if you pass legislation that makes people do things which are not necessarily thought through.

Mr Hodges—Just on your continuum of entire competition versus entire safety, I think we sit somewhere in the middle there. We are not at either end of that I believe. You just have to look back a few years to when there were a number of bank operator players in the market here who were in some difficulty to see that it was not overregulated. We saw a number of products operating in this market that had built up in the boom, some of which we did ourselves—low doc lending and things like that—which actually proved to be not particularly great banking. So there were opportunities for us to push very much down the competition line. I think the market overall has said that some of that stuff that was done in the early mid-2000s really was not particularly good banking. You have seen a move back from that. I do not think that in that continuum we are in a difficult space at the moment from a regulatory point of view. There is access to the market.

Senator XENOPHON—This morning Dr Richard Denniss from the Australia Institute in his evidence noted that in a robust competitive environment it would not be possible for costs to increase and profits to increase at the same time. That was his assertion. The question he posed, which I guess I am posing to you now, is how do you explain higher wholesale funding costs with record profits? That is the nub of the debate I think. How would you characterise that tension between the two?

Mr Smith—I think he is looking at the wrong things. I think you should look at your revenue and then decide how much you can spend. You can spend as much as you can afford effectively. That is what it comes down to.

Senator XENOPHON—But in terms of general economic theory: if costs increase and there is a strong competitive market you would not expect profits to increase as well.

Mr Hodges—No. In the banking system in the last couple of years one of the big important swing variables had been provisioning for bad debt. What we saw in 2000 to 2008 or even 2009 was a very big lift in the cost of provisions or the cost of bad debts, which the banking system wore. What we have seen in the last 12 months is that that level of provisions has come down and as a result of that the banking profits have flipped back up a bit from what were lower levels. In fact, they can coexist. Provisioning was a very big factor.

Mr Smith—Also was revenue. Revenue increased as well.

CHAIR—I thank the officers from the ANZ Bank and also Hansard and the secretariat for assisting us today in Canberra and in Sydney over the last two days. The inquiry is adjourned until 24 January.

Committee adjourned at 5.02 pm