COMMONWEALTH OF AUSTRALIA

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SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Competition within the Australian banking sector

TUESDAY, 25 JANUARY 2011

MELBOURNE

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SENATE ECONOMICS

REFERENCES COMMITTEE

Tuesday, 25 January 2011

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

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

Senators in attendance: Senators Bushy, Hurley, Ryan 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.

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Committee met at 8.47 am

CHAIR (Senator Bushby)—I declare open the fifth hearing of the Senate Economics References Committee's inquiry into competition within the Australian banking sector. On 28 October 2010, the Senate referred this inquiry to the committee for report by 31 March 2011. To date the committee has received over 120 submissions, which are available on its website. These are public proceedings, although the committee may determine or agree to a request to have evidence heard in camera. I would ask photographers and cameramen to follow the instructions of the committee secretariat and ensure that senators' and witnesses' laptops and personal paper are not filmed.

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

[8.48 am]

BRODY, Mr Gerard Gavan, Senior Manager, Financial Inclusion, Brotherhood of St Laurence

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

Mr Brody—Thank you for the opportunity to appear at the public hearing. To give some background, the Brotherhood of St Laurence is an independent, non-government organisation based in Melbourne but with a national profile that has been working to reduce poverty since the 1930s. Our work includes direct service provision to people in need, the development of social enterprises to address inequality, research to better understand the causes and effects of poverty in Australia, and the development of policy solutions at both the national and the local level.

In the finance sector, we work to develop and demonstrate effective programs for disadvantaged people to address financial exclusion. Financial exclusion involves being denied access to affordable, appropriate and fair financial products and services, with the result that people's ability to participate fully in social and economic activities is reduced, financial hardship may be increased and poverty is exacerbated. The brotherhood supports measures to improve the effectiveness of competition but would say that competition alone is not enough to address the significant problem of financial exclusion for low-income and vulnerable Australians.

The focus of the debate in this inquiry and in the media has been on competition around mortgages. There are often obvious public benefits that flow from effective competition amongst mortgage lenders. Cheaper interest rates and the ability to switch providers without penalty will ultimately result in better outcomes for consumers. However, as many aspiring purchasers know, homeownership is increasingly unaffordable. Indeed, for many of the clients the brotherhood supports, homeownership is almost impossible. Yet such families and households do require access to safe and affordable financial products, and therefore the debate today should go beyond the mortgage market.

A particular example I would like to speak about is small-amount consumer credit, which is required by households to smooth expenditure, particularly related to things like education costs, whitegoods or vehicles. Over the past years, the banks have shied away from providing small-amount personal loans, instead pushing many onto credit cards or simply refusing to offer service. For many on low incomes, credit cards can be a debt trap designed to induce immediate spending without an affordable, planned repayment schedule. Some banks, such as ANZ and the National Australia Bank, are offering small-amount affordable loans in partnership with community agencies. This is very welcome. These programs have demonstrated that, when provided with opportunity and support, low-income earners can pay back debt. However, these are yet to become mainstream and more needs to be done to improve their scale.

Without easy access to safe and affordable financial products and services, many households turn to lower quality non-bank financial service providers such as fringe lenders, store credit providers and payday lenders. These fringe banking services generally provide fewer hurdles to

transact for lower income Australians, but their effect can be wealth stripping rather than asset building, and they can create a debilitating debt trap. If the development of this industry is the result of free market competition then we should question whether such a kind of competition in financial services is always a good thing.

In products beyond loans, low-income Australians also need access to fair and accessible transaction accounts. While there have been significant improvements in penalty fees charged by some banks on transaction accounts, ATM fees are still in excess of the cost to provide the service. While some banks offer free ATM transactions, if you are constrained or disabled then the cheapest ATM may not be convenient. The task force that has been set up to consider ATM fees, announced as part of the government's banking reform package, needs to ensure that the vulnerable are not burdened by unnecessary ATM fees.

In our submission we touch upon bank account switching, which is crucial to competition. Switching can be difficult, especially for vulnerable consumers who might not understand what the benefits are. For example, we have recently undertaken a survey of our clients' use of basic bank accounts, which, you would be aware, are a service innovation designed to provide low- or no-fee bank accounts to low-income Australians. Our research, which is yet to be published, has found that over 70 per cent of low-income clients surveyed were not aware of basic bank accounts and had not taken them up, leaving many paying bank fees unnecessarily. The analysis also shows that banks are not promoting these products and that information about them is difficult to find or unnecessarily complex.

The brotherhood acknowledges that competition is an essential element in providing banking services to the community. However, it sees effective competition as just one of the many necessary tools to ensure that provision of banking services is fair and affordable for all. In addition to effective competition, the brotherhood encourages things like monitoring and accountability. For example, in the United Kingdom and the United States, performance monitoring has become widespread in creating accountability among financial institutions to develop affordable, appropriate products to address financial exclusion. In the United Kingdom and elsewhere, competition regulators have powers to conduct market studies to determine whether competition is benefiting all consumers.

Secondly, there is reputation. Banks may be incentivised to service all citizens by way of reputational awards from government initiatives such as rating schemes in accordance with their contribution towards financial inclusion. One example from the United States is bank ratings under its Community Reinvestment Act, which give the public an indication of the bank's performance in meeting the needs of marginalised borrowers.

Tax incentives can be useful in rewarding firms that participate in and contribute towards building financial inclusion. This can involve increasing tax incentives for firms to invest in things like community development financial institutions. This would encourage financial investment from banks into CDFIs, which would help provide financial services to underserved markets, helping overcome social exclusion.

On community service obligations: further regulation can be used to ensure that financial institutions provide accessible basic services to all customers. This can be necessary in markets where policymakers recognise conflict between the profit motive of firms and the social policy

goals of the industry. For example, in privatised telecommunications, gas or electricity markets, companies are not able to deny access to less profitable rural or low income customers.

Finally, I turn to government funding. Governments can provide funding for the development of affordable, appropriate products. The federal government did provide funding to this end in response to the global financial crisis. For example, $44 million was provided to the no interest loans scheme, Saver Plus, and the matched saving scheme for low-income households, progress loans and StepUP program, while $7 million has been committed to support community development finance institutions. Government support can help establish business cases or identify where services will not be delivered without government subsidy.

That is my statement. I would welcome any questions that senators might have.

CHAIR—Thank you, Mr Brody.

Senator XENOPHON—Thank you for your submission. I was quite interested in this: in the United Kingdom, the UK treasury department has measurable objectives, including the goal of affordable credit—it is measured; there are benchmarks. Also, could you give further information on this: in the US, under the Community Reinvestment Act, how are financial institutions rated, and what difference has that made in terms of that rating for affordable credit? In other words, has it caused some competition in the marketplace with some accountability?

Mr Brody—In relation to the United Kingdom, they set up a number of years ago the Financial Inclusion Taskforce, an independent task force that reports to the United Kingdom treasury. The task force has been tasked with identifying measures to promote financial inclusion and improving access to things like basic bank accounts, small amount loans and insurance. It also regularly undertakes analysis of those areas to ensure that there has been progress and reports to the government in that regard.

In the United States, the Community Reinvestment Act is, again, administered by one of their central treasury agencies, which looks at the extent to which large banks invest in communities where there might be financial exclusion. Generally that is done through things like community development finance institutions. So rather than the bank going into that community itself, it will invest in local finance institutions which might have a mandate in that community to provide services to disadvantaged people. A public rating comes out of that to determine the extent of those sorts of investments and then the large banks generally use those sorts of rating schemes to advertise themselves around their reputation.

Senator XENOPHON—So it has made a difference in terms of some accountability or some transparency in the process?

Mr Brody—That is right.

Senator XENOPHON—This is my final follow-up question in relation to this. There is a bit of a conundrum here. On the fourth page of your submission, in the second paragraph, you talk about how the Australian banking sector comprises some of the world's safest and most prudently managed banks and say that improved competition is a good thing to drive down costs, which I think we all agree with. What do you do with the conundrum that if you lend too

aggressively—and we have seen it with credit card offers and solicitations—how do you get the balance right between what happened in the US, where there were no-doc loans or just a lack of prudential standards in giving loans, and the need of people who deserve a break, to try and get a foothold in life, to get access to credit? How do you balance those two from a policy perspective? I am really intrigued by it.

Mr Brody—Yes, it is a difficult balance; I agree with you. I think it takes a number of policies and tools to do that. On the one hand, to prevent exploitative lending, irresponsible lending, we need good standards around responsible lending. The recent changes to national consumer credit laws, which included for the first time responsible lending standards, should go some way to achieving that end. To ensure that works effectively, the regulator, through the Australian Securities and Investments Commission, needs to appropriately implement those laws and enforce the laws where there is lending that is contrary to those standards.

At the same time, we do need a framework to assist low income Australians and those who are excluded get access to loans that are going to help them get ahead and build assets. We see a real division between lending that helps someone to build an asset or get ahead and lending that is irresponsible and is only going to create a debt spiral. We should create a framework which encourages the former and not the latter.

CHAIR—You said that in past years banks have shied away from small loans to low-income individuals. Has that always been the case or is that a new trend?

Mr Brody—In our experience it has been a trend over recent years. Things like the lowest value personal loan have increased. Some years it was a smaller amount, maybe only $1,000 or $2,000. Generally the large banks lend $5,000 or $7,000 for the lowest-value personal loan.

CHAIR—So they have changed the value of the lowest value and, in part, presumably that is because of the changing value, in terms of the real value of the actual amount, but it might also be due to other factors. A broader way of asking that question is: in the absence of government action, do you think that providing banking services for lower-income people is something that banks should be willing to compete for, or is it something that they would rather not do? If they are not doing it what are the reasons for them not doing it? Are there sound financial reasons?

Mr Brody—That is a complicated question. Our organisation works with banks. We have a partnership with the ANZ to develop a small loan program called the progress loans program. The bank has obviously come to the table to work with us, because it recognises that financial exclusion is an issue for it.

CHAIR—Is it doing it because it sees that it is not meeting an obligation, or is it participating with you because it sees that there is a commercial return?

Mr Brody—It is a bit of both. I do not think it is simply one or the other. At the moment that program is not operating at a break-even point for the bank, but the goal for both the bank and our organisation is to have that program developed into a scale and a model that will return, perhaps, a modest profit to put back into the program or at break-even point. We understand that banks are commercial institutions and are not there just to provide services at a loss, but we are working with them to that end. I think they also recognise that it is a difficult prospect.

Something that they are not used to, I guess, is lending to this market, and that is why they are working with organisations such as ours to understand it better and to develop the business case for themselves.

CHAIR—So you are working with the ANZ, which is obviously one of the big four. I think ANZ probably call themselves one of the two stumps, rather than one of the pillars. Are the smaller banks taking the same approach to low-income people? Do they have a lower level in terms of loans? Are they lending more?

Mr Brody—I think it varies amongst the banks. Prior to our partnership with the ANZ, the Brotherhood of St Laurence did have a partnership with the Bendigo Bank at that time on a similar small-loan program. Because of difficulties in changes of management at that institution, that program did not continue and we developed the partnership with ANZ. But some banks are more likely to offer small-amount loans than others. Then again smaller banks and things like credit unions can often want to see a more substantial surplus in a consumer's budget in terms of having—

CHAIR—The ability to repay.

Mr Brody—That is right—before they will go ahead with the loan.

CHAIR—If it is the case with larger banks and smaller banks in general that there is an increasing reticence to make small loans, is it a risk issue or is it a scale issue? Are the banks looking at it and saying, 'On our long history of making small loans to people on a low income there is a certain risk which we are not prepared to wear,' or are they saying that the cost of managing these small loans does not make it worthwhile for them, or is it a combination of both?

Mr Brody—We believe it is more of a cost issue rather than a risk issue. With our progress loans program, for example, we have a default rate with that program of between one and two per cent, which is less than a mainstream personal loan product that a major bank would offer. We think that low incomes do have the capacity to pay back debt if it is provided responsibly and they are supported in that process. It does seem to us to be generally a cost issue. As you can imagine, there are fixed costs involved in delivering loans, and a return in terms of interest on a small loan is generally not as high as that on a larger loan, and that is the primary issue.

CHAIR—Which comes back to your comments about the program that you are jointly working on with ANZ. In that case, it is a scale issue that leads to their wanting to get to a position where they can make a profit—but not at the moment, because there is not enough throughput in terms of interest being paid to cover the administrative costs.

Mr Brody—That is correct.

CHAIR—It is not so much that default rates or anything like that are high?

Mr Brody—No.

CHAIR—Okay. So the repayment record, with the qualifications that you mentioned—provided they are lending responsibly and everything is checked out first in terms of ability to repay—is generally good, even though they are low-income borrowers?

Mr Brody—Yes, and that requires setting up a payment reschedule in accordance with people's needs. We work with low-income clients, and their payment reschedule is fortnightly so it is at the same time as their Centrelink income or other income on a fortnightly basis. It is generally done through a direct debit, so it is paid out on the day that the income comes in, so it is less likely they are going to default.

CHAIR—You also mentioned that there was a reasonable spread on offer of low-fee transaction accounts for people who would benefit from concessions but that not as many people who should be are actually making use of that. Why is that the case? Are they not looking? Do they just have a fatalistic attitude of 'I've got a bank account and I have to pay fees'? What is the answer?

Mr Brody—I think that is partly it. I think that people generally are not willing to switch transaction accounts. People get an account when they perhaps first get a job or leave home and they stick with that account for life. There does not seem to be a large amount of switching between transaction account providers in the general population. I guess that those with lower financial literacy might have greater reticence. Our clients, for example, often have other complexities going on in their lives which mean that the suitability or otherwise of a transaction account is not front and centre of mind and they have not gone out looking for transaction accounts.

CHAIR—Quite clearly, that is a problem, particularly for the people whom your organisation assists. Is that a problem of failure of the market—banks are offering the product but it is just not being taken up?

Mr Brody—We think that the banks could do more in promoting those products and identifying customers who would be eligible for such products—even make it a default option that they get put on those sorts of accounts. That would overcome the inertia of consumers and ensure that they are benefiting from what is out there on offer.

Generally, those accounts are available to those who have some form of Centrelink income or have access to a healthcare card or a pensioner concession card, for example. Banks generally know if that is the case with their clients, particularly around Centrelink income because it is deposited into their accounts. So we think that banks could do more about identifying the customers who would benefit from those other transaction accounts.

CHAIR—I can understand why you would say that, from the perspective of your organisation and what you are trying to achieve. However, I think the fact that the banks are offering that product means it is not so much a competition issue as a social obligation issue, in a sense, and no doubt that would be a good thing. But it is not really so much a failure of the market, as it would be if they were not offering the accounts. But they are offering the accounts. To some extent, it could be argued that it is up to organisations like yours to get out there and make sure that the people who should be benefiting from those accounts are benefiting from them.

Mr Brody—Yes, I agree, and we definitely do that. When we work with our clients, we explain the benefits of those sorts of accounts and help people access them. Our organisation is only going to reach a certain proportion of the population, and the banks have much greater access to customers who would benefit from those programs. So we think a more efficient way of dealing with the problem would be for banks to have a stronger obligation to offer those low-fee or no-fee transaction accounts to the people who are eligible for them.

CHAIR—I will move on. You were also talking about monitoring and accountability—basically a greater degree of transparency and a focus on banks and the degree to which they actually do meet social obligations to people on lower incomes. You also noted that there are specific regulatory obligations in other industries to provide access to people on low incomes. Senator Xenophon touched on this in terms of getting the balance right. But some commentators argue that part of the problem, at least in the US, that led to the GFC was a requirement for the bills that you were talking about, in part, to provide loans to people who on the whole really should not have got them and had an inability to pay, and that that then on a broad scale led to the development of the toxic assets, which then undermined the whole system.

Mr Brody—I guess that there is some analysis that has argued that. There is other analysis, which I am happy to provide to the committee, which would seem to suggest that the organisations that are regulated under the Community Reinvestment Act, and the subsequent organisations that they invested in, were not the ones that contributed to the subprime crisis, that it was other mortgage lenders, onsellers and brokers who were not regulated under that system that were the substantial causes of that crisis. I am happy to provide that research to the committee if it would be of assistance.

CHAIR—Okay. I have a question on the same subject, following up on what Senator Xenophon was asking. This is probably a strange question to ask, given that the evidence shows the banks are trying to give credit to just about everybody they can, subject to the interest rates through credit cards and things, as you have raised. What evidence is there to show that the reason that banks have not withdrawn from the market you were talking about, the small loans, is that they are being more responsible in their lending practices and basically more strict in ensuring that people who should not be getting it are not being loaned money?

Mr Brody—I do not think there is any good research or analysis around that question. I think that the increasing use of automatic systems to make credit assessments has contributed to the issue. When we engage in our lending processes we work with customers to really understand their position and to see whether that customer has the capacity and willingness to pay back a loan, and we make a decision based on that individual’s circumstances. When it is a mainstream banking system, there are often automatic processes in place which say that if you have an income below a certain level then you are just not eligible and which do not look at the whole circumstances around that household’s expenditure, needs and those sorts of things.

Senator HURLEY—I will continue along that line. I think often what happens when someone goes in wanting a small loan—you were talking about small loans—is that the banks say, ‘We’ll give you a credit card’ , and people end up paying a lot more interest on their loan than they would have under a personal loan.

Mr Brody—That is correct.

Senator HURLEY—In terms of that, what do you think of the idea of positive credit reporting to assist banks to identify those people who might be in a better position to pay?

Mr Brody—We have some misgivings about the proposals around positive credit reporting, mainly due to experiences in the past, where that is more likely to have led to people being excluded rather than included. For example, we work with the ANZ. They undertake a credit report check on our customers, and often that brings up under their standard policies a person who has had a bankruptcy or defaults sometime in the past and who therefore should not be eligible for a loan. We then have to provide evidence around why the customer might have dealt with that issue or might have moved forward, and then the loan might go ahead. So in our experience the credit reporting system has generally contributed to excluding rather than including people.

Senator HURLEY—But that is a negative credit reporting. A positive might show that there has been good repayment in the period after the bankruptcy. In previous inquiries we have been given quite a lot of evidence from people who are in favour of positive credit reporting, on the basis that that would assist.

Mr Brody—It may do that. I think it is yet to be shown to do that. We are more comfortable with the proposals around positive credit reporting now we have got a stronger and more responsible lending framework in place.

Senator HURLEY—That is an interesting thing because it seems to me that, if we are talking about increasing competition between banks, your proposal to report on how banks perform on those things would perhaps require some incentive for them as well to participate in it, and that might be one way that we could do it.

Going back to your survey question and the 70 per cent of people who were not aware of basic banking, did you at the same time ask them any questions about dissatisfaction or satisfaction with their banking services?

Mr Brody—Not specifically. We asked particularly around the use of basic bank accounts and then fees that they were charged. We are hoping to release the findings of that report very soon.

Senator HURLEY—Sometimes there is a bit of trade-off between banking fees and whether you do pay for an ATM transaction and so on, and so someone might stay with their account. Although, I think it is fairly clear—and the banks tell us this—that people do not switch accounts very often.

Mr Brody—That is correct.

Senator HURLEY—They do not look to do it. We have been investigating the difficulty of that and whether it might be related to automatic debits. Would it be your experience that people on lower incomes often have automatic debits to make sure that they keep up with their electricity accounts and so on?

Mr Brody—Very, very common. Many of our clients do use things like Centrepay to pay for essential services like electricity and gas accounts and water bills. Often we see other providers

making use of direct debit arrangements, which might not actually be in the consumer's interests. For example, we are seeing products which we would say are not providing good value, such as funeral plans and insurance and those sorts of things. Also, some whitegoods rental companies make use of this arrangement when there would be much cheaper ways of providing those services. Generally, they use direct debit systems to lock people in. The flow-on impact is that it makes it more difficult for people to change transaction accounts.

Senator HURLEY—Thank you.

Senator McGAURAN—I have a clarification question which refers to paragraph 3 on page 5 of your submission. You state:

... the ANZ and the NAB, do offer small amount loans to low income earners ...

Flicking back to page 3, you list four programs, and the Progress Loans program is one of them but it is available to only 800 borrowers. I just want clarification on that. I am sort of deflated by the fact that, as glamorous as the scheme seems, there are only 800 borrowers.

Mr Brody—That is correct. Our partnership with ANZ was established around that program in 2006. We have only worked with them in Melbourne. We have been conducting some further piloting of that program over this last year, particularly in taking more advantage of the ANZ branch distribution networks rather than clients coming to our offices, for example, to apply for a loan. We are hoping that through those sorts of pilots we will be able to understand better the prospects for improving scale of the program. At this stage, we are generally around that number of people.

Senator McGAURAN—So to get it right: is it the Brotherhood of St Laurence Victoria or Australia?

Mr Brody—We are based only in Melbourne.

Senator McGAURAN—So this pilot program is a Melbourne-specific program?

Mr Brody—That is correct. Under some circumstances, we do take applications from outside Melbourne. That might be over the phone, for example.

Senator McGAURAN—Have they a similar program in Sydney, for example?

Mr Brody—Not with the ANZ.

Senator McGAURAN—With another bank?

Mr Brody—The National Australia Bank, in partnership with Good Shepherd Youth and Family Service, has a similar program called the StepUP loan. The StepUP loan is available in around 20 communities nationally, I believe.

Senator McGAURAN—What I am trying to get a picture of here is that, while the programs sound good and the banks trumpet them, when you scratch the surface this program is only a

pilot and it is only for 800 people. When I say ‘pilot’, I think of something that would have been all set up and running for 10 years, but there is nothing there. The Brotherhood of St Laurence is one of the biggest charity organisations, along with St Vincent’s. But for all the trumpeting of the banks that they give out loans to lower income people, I can see little to nothing.

Mr Brody—I would agree that more needs to be done to improve those programs and take them to scale, and that is our objective in working with the ANZ.

Senator McGAURAN—Was there anything in place prior to the Progress Loans pilot program?

Mr Brody—With ANZ?

Senator McGAURAN—ANZ.

Mr Brody—Not that I am aware of.

Senator McGAURAN—Nothing, you see. Is there anything going on with Westpac?

Mr Brody—No.

Senator McGAURAN—This is 2011. I reckon that exposes them as pretty useless on that front.

Mr Brody—Yes.

CHAIR—You raised some issues with the ATMs, particularly in regional areas where people have little choice of which bank they can use to access funds. You pointed out evidence that we have had from other witnesses that some people on low incomes might be waiting for their benefit payment to come in and checking the ATM for a balance. If they are not using their own bank ATM, they incur a charge. This also raises the broader question of account portability and bank-switching generally. In those circumstances, why wouldn’t a person who is on a Centrelink benefit, who has only one ATM in town which is not with their bank and who is incurring a fee every time they look at their balance change to the bank that is providing the ATM?

Mr Brody—There are a number of reasons. I think we spoke earlier about consumer inertia. Especially with our clients, it takes some time to work with them to ensure that they are thinking about their finances and their money management issues and to build their financial literacy so that they are making the decisions that are in their own best interests. Often the case is that they have other complications in their lives, whether it is their family or they are looking for employment, which means that it is not something that they have dealt with and it is automatic, really, that they go to the local ATM because they need to get some money this week to pay for food or bills. I think more needs to be done to improve financial capability. We need to look at the issue of ATM fees to ensure that those people are not unfairly paying them.

CHAIR—But if you adequately address the bank-switching side of things then it might increase the likelihood of somebody in that circumstance actually switching from their bank to a bank that provides an ATM locally. It does not solve the problem of the ad hoc situation where

you are somewhere where there is a different bank. But particularly for people—and there seems to be evidence of this—who might live in a small town where there is one ATM, who bank with a different provider and who are consistently paying fees. If you dealt with the bank-switching side of things and got them to think about a switch then you would not necessarily have to put a cap on ATM fees, which other evidence shows might lead to a lower proliferation of the actual ATMs and a greater degree of removal of access.

Mr Brody—I would agree with you that some of the proposals being mooted around account switching should address some of those issues.

CHAIR—As there are no further questions, thank you very much, Mr Brody.

[9.28 am]

LOWE, Ms Catriona, Co-Chief Executive Officer, Consumer Action Law Centre

RICH, Ms Nicole, Director, Policy and Campaigns, Consumer Action Law Centre

CHAIR—Welcome. I invite you to make an opening statement.

Ms Lowe—We will make a brief opening statement. We assume that you have had the benefit of our submission. We would like to begin by simply noting the breadth and complexity of the issues that have been raised before you all in this inquiry—issues that go to both what we would describe as the supply side and the demand side of the market. We note that some submitters have indicated that the problem sits on the supply side of the market and that if you address that then the issues in the main will be dealt with. We certainly agree that there are issues that need to be dealt with on the supply side of the market. But we would also put to you that, unless you also look at issues on the demand side of the equation, on the ability of consumers to activate the competition that we all want, measures on the supply side alone will not be effective in addressing the problem.

We have addressed eight different areas in our submission. I would like to quickly touch on a number of them. We obviously come, avowedly, from the demand side perspective. That is where our expertise is in talking to you about how we believe consumers are better able to activate that competition.

So in terms of account switching we strongly support the inquiry that has been called and would simply make the point that we consider that it must come with a recommendation for change ultimately. Obviously the headline of that inquiry is to look at account number portability but there are a number of other options that could address switching issues if portability is found not to be an economic solution, and we would like to see those looked at very carefully. We support the ban on mortgage exit fees and would include within that the deferred establishment fees as an example effectively of an exit fee.

In terms of simplified disclosure, we would note that there had been some announcements already in relation to that. We would certainly support disclosure that occurs pre-contractually that enables consumers to visit a number of institutions, obtain a range of information and make a carefully considered decision rather than quickly being provided with disclosure at the point of contract. We would say it needs to be of standard form and key terminology. We would note that there is a significant body of existing work around these issues and what seems to work very well in informing consumers and we certainly support building on that work.

Finally, in relation to monitoring of the banking sector, we would very much like to see consideration of providing the regulators with appropriate powers to monitor the effectiveness of competition in the market in a general sense. We would note that other regulators such as the Office of Fair Trading in the United Kingdom have what we describe as general market study powers which enable them to look broadly at a market not necessarily based on a particular complaint but enable them to look generally at the effectiveness of competition in a market and

then make recommendations if indeed they find that that is not the case. We would strongly support powers of that nature for Australian regulators.

CHAIR—Thank you. In terms of the accounts which you mentioned in your opening statement, you say it must come with outcomes. What options do you think would actually be effective?

Ms Lowe—Obviously the headline that we are very interested in is the ability to move accounts holus-bolus really, and certainly a portable account number would be a way of achieving that. But we know that there are a number of other mechanisms significantly beyond what we currently have in Australia in other jurisdictions such as New Zealand, Europe and the Netherlands which stop short of actual account number portability but still enable a significantly more effective switching by consumers than we currently have in Australia. We would like to see all of those options considered. There has been much talk about the cost that may attach to account portability pure. We would like to be convinced of those costs and to see cost-benefit analysis of that. But even if the cost benefit is not there for that particular initiative, we say that there are a number of other effective pathways that that inquiry would look at.

CHAIR—In other countries, I think the Netherlands, there are requirements that if you turn up at a new bank and say you want to change then they contact the old bank and they do it all basically, and make sure that all of the direct debits and everything is switched over and all of those things are changed.

Ms Lowe—It also comes for a 12-month period with an automatic forwarding service, if you like, that is almost like a mail redirect or forwarding service. It automatically moves the debits and credits for the consumer and they then have that extended period to adjust the arrangements.

CHAIR—That might assist with customers who have an inclination to change banks but choose not to because it just seems too hard. We heard from the previous witness and we have had other evidence that there is also an inertia. The previous witness was talking about people who might open a bank account when they are a teenager and they stay with the same bank even though it may involve costs and fees. They might be using an ATM from a different bank in a small town where it is the only ATM and incurring fees where all they need to do is change accounts but there is just that inertia. They are not taking advantage of low fee accounts and things like that; they do not change even though they might qualify for low fee accounts. Making it easier to change does not really seem to be the problem with a lot of those people. How would you overcome the inertia? In those cases that does not seen to be the cause of why people are not changing.

Ms Rich—I agree that there is definitely customer inertia involved as well, so there is more than one barrier to switching. One of those is the psychological barrier—we know that. Another is the very real practical hassle of switching. I think they are intertwined, that they are not completely separate from each other. I accept that, if you were to make switching very easy, it would not necessarily and automatically deal with the psychological barrier issue but I think it would help. It would also enable everyone in the community to genuinely say, 'It's really easy to switch. Why don't you think about switching?' I should say that groups like Choice and ours have been very active in the last year in saying, 'It's not the easiest thing in the world but it's also not the hardest. So why don't you think about switching? There are actually different

options available for you in the market?' Despite the fact that there is historically a lot of customer inertia, we also know that certain banks which have introduced better accounts over the last year have been very successful in driving customers to take up their accounts. So there is some evidence that, as we get better—

CHAIR—Do you have examples of that?

Ms Rich—I do not want to name particular institutions, but it has been widely reported in the media that that is the case. You can see it in the annual reports of the major banks. You can see that there are customers changing their behaviour in response to better products being available. I think that over time we can see a bit of a cultural shift in that area too but we need to make it as easy as possible for customers so that instead of telling their friends about how they finally decided to switch saying, 'Gee, it was so hard, it wasn't worth it. I'm not going to do that again,' they say, 'Gee, it was really easy. You should try it as well.' That is the message we want people to be sharing.

CHAIR—I was not decrying, by asking that question, the advantages of making it easier to switch. I wonder whether it would go far enough. You say you support the ban on mortgage exit fees. The government has been working with ASIC over the last couple of years, using the new conduct type provisions, in terms of the provisions which are currently in existence. Late last year ASIC put out some guidelines saying the terms on which they would consider exit fees justified and basically saying whether they covered legitimate costs of setting up a loan and getting out of it. That has not had a chance to work through yet. It will be an ongoing process for existing loans because the government's intention is to ban only exit fees for new loans from 1 July. Do you think the approach ASIC had developed had the potential to makes exit fees fair and reasonable?

Ms Lowe—It certainly did seem that the initiatives ASIC were undertaking with the government were heading in the right direction. We certainly participated in the consultation process with ASIC in terms of their guidance to industry in setting those fees at an appropriate level. I suppose we would say a couple of things. We are of the view that they should be set at a level reflective of cost of early exit, as distinct from costs of exit in total, that those things would be mighty insignificant, particularly when compared to—

CHAIR—The cost of early exit is what ASIC was looking at?

Ms Lowe—Yes. I was simply making the point that if you section out exit costs that apply whenever the exit occurs and simply focus down on the costs attaching to early exit, we think that the numerical value of that cost would be very small. We noted in our submission, for example, that the essential services commission here in Victoria did a piece of work around termination fees in the energy industry and set them at a very low level indeed to take into account actual costs attaching to them. For those reasons, we consider that it is probably efficient to simply not allow the fees to occur in the first place, rather than go through an exercise of enforcing that behaviour. We would also note that the problem with those fees is that they are not part of the consumer's competitive assessment, if we can put it that way, in choosing a product in the first place. They tend to—

CHAIR—Assume they will not have to pay it because it is modelled over the longer term?

Ms Lowe—Precisely, and therefore they are not taken into account. Therefore that competitive discipline that would otherwise keep them at a cost-reflective level is simply not there.

CHAIR—In terms of your comments about the actual costs of early exit being small, would you concede that they vary depending on the size of the organisation? Some smaller organisations might find the cost of setting up new loans, as part of their overall cost, to be a more significant factor, as opposed to the larger ones, where it sort of gets lost in amongst the fees. Do they vary?

Ms Rich—They may, but I guess the question here is: if we are talking about recovering costs of setting up a new loan, why not just charge establishment costs? We do not have a problem with that. We do not have a problem with providers of any product or service charging to recover the costs of providing that product or service and a margin on top so that they can actually make a profit. The issue with exit fees is that they are poor practice for consumers for two main reasons, which Catriona has already outlined: (1) they act as a barrier to switching down the track and (2) because they back-end the fee and often express it as being contingent, consumers do not take it into account in making an assessment of the price, whereas with establishment fees it is very obvious what the cost is; consumers do take that into account when they are comparing between—

CHAIR—I cannot argue with that last point, but here is what I would like to raise: if it is paid up-front, everybody has to pay it. Similarly, if you are looking at switching then you know that you are going to have to pay an up-front cost when going to a new institution, which will be a barrier to switching as well, whereas if it is a true deferred establishment fee then only those people who actually choose to break within a certain period will actually pay it. If you actually do change and, in accordance with your expectation when you sign up, you do not break within that period then you can avoid that cost. So ultimately it shifts the cost onto everybody to pay for those few who actually choose to break early.

Ms Lowe—I suppose we would say a couple of things about that. Firstly, institutions can—and do all the time—use their discretion to waive up-front costs or give discounts in order to attract business that they consider to be appealing.

CHAIR—But that is not usually offered, though, to lower income earners. It is usually attractive potential customers that are more likely to receive those sorts of offers, and it does not help people on lower incomes, generally.

Ms Lowe—We will certainly accept that. The other point, though, is that, as a result of the work that ASIC did looking at these issues, it certainly appeared that in general these fees were being set to apply at a period which was greater than the average length of a home loan. So the fees might be payable at five years, and the evidence seems to suggest that the average length of a relationship in relation to a home loan is in the three- to five-year mark, depending on who you listen to. So it is not the case that this small minority of consumers were paying this fee. In fact, on average a significant proportion of consumers were paying the fee. I suppose the final thing to say is that, if we accept that the deferred establishment fee is recouping cost over a period of time, we would expect at the expiration of that period of time, whether it be three or five years,

to see a reduction in the costs applying to that loan, and we do not see that occurring in the marketplace.

CHAIR—I cannot argue with that point. The other thing about exit fees is the impact on smaller lenders. Quite clearly an important part of competition in the banking industry is active participation of smaller lenders. The evidence that we have had put to us suggests—and it comes back to my question earlier—that the costs to smaller lenders in setting up new loans, as a proportion of their overall costs, are a greater thing for them; they are a larger hurdle for them to overcome. The evidence also shows that, on the whole, the larger exit fees are charged by smaller lenders; in fact, two of the larger ones, as you would be fully aware, have waived exit fees already. Some evidence that we have received suggests that banning exit fees will actually make it harder for small lenders to compete and undermine the competitive landscape in the industry. What are your comments on that?

Ms Lowe—We absolutely support the presence of responsible, competitive small lenders in the market—we agree that that is an important feature of a competitive market. But we also want a genuinely competitive market, not one that looks like it is competitive, and the reality is that, if consumers are making choices based on what appears to be a more attractive offer but in fact—because of fees and charges that they are not taking into account—is not, then we need to question the reality of the competition that appears to be taking place. We want genuine competition by smaller players, not the appearance of it.

CHAIR—But, in any normal competitive market, any player would be competing on the basis of a number of factors—price, fees, the product itself—and those aspects will vary. The evidence I am referring to suggests that these smaller players are able to attract business by offering lower interest rates. If you as a customer sign up to that, you have the certainty of lower interest rates than you might have been able to get from somebody that does not charge as much in exit fees. If you stick with that institution for three, four or five years—whatever it might be—at the end of that period you are going to be better off if you have not switched, presuming that that lender has not done something abhorrent in the meantime with its variable rates. It is a competitive product, I think. It is legitimate to say, 'We will charge lower interest rates now, but you will pay a higher fee if you go early.' It is an offer to the market which in a competitive environment should be able to proceed, shouldn't it?

Ms Rich—We agree that there should be competition on price and the product itself. But what is the price of the product—the mortgage—here? Is it the interest rate or is it the total overall cost of the product? I would argue that it is the overall cost of the product.

CHAIR—But if they stick with it for the period they get the benefit of the lower interest rates and no exit fee.

Ms Rich—The cost of the product is the interest rates plus the fees you pay. You must take into account the exit fee if it is going to be paid by the average consumer, and the evidence says that that is the case in Australia. In any case, as Catriona said, if the fee were genuinely about recouping the establishment costs of the mortgage, the interest rate would come down once you had reached that time and they had recovered the cost of entering you into the mortgage through the charging of the interest rate. But that does not occur, and what that suggests is that Australians as a whole are paying interest rates on those mortgages that are set above the level

that would efficiently be set in a genuinely competitive environment. So, basically, a lot of Australians are paying a much higher interest rate than they should be or than we would like to see them pay in a competitive market.

I think the bottom line, again, comes back to the basic point that we want to see genuine competitive discipline put on their costs—the price that consumers pay for the mortgage—and it is very hard to have competitive discipline applied to contingent back ended fees. We just know that that does not work, but if you make them establishment fees and lenders have to genuinely compete on the basis of factors such as upfront fees and the interest rate, on both of which competitive discipline is placed, consumers understand them, they know that they are going to have to pay them and they take them into account. Everything suggests that the competitive discipline would keep those interest rates and fees down to a level where they would be more appropriate.

CHAIR—Do you think that, if your one-page disclosure document had in bold and underlined words such as ‘Please be aware that, if you seek to exit this contract early, you may pay an exit fee of up to $12,000 if you do that within three years’, that might have the benefit of customers thinking about that and taking that into account as part of their consideration of the offer?

Ms Rich—It is possible, but we know about the cognitive bias that humans have: they tend to be a bit overoptimistic about these things and to assume that contingent events will not apply to them and that they will not have to refinance within the first three years of the loan.

We are big fans of simplified disclosure in a one-pager, and I would love to see that. If early termination fees were to remain then, yes, we would want that clearly disclosed in such a form. But the reality is that many consumers would still say, ‘I’m not going to worry about that, because that’s not going to apply to me,’ not knowing what the lender knows, which is that the average person will actually have to pay that fee.

CHAIR—We will work through a lot of that. We have evidence for and against a lot of those points. We have received evidence that small lenders are able to establish themselves to get a degree of market share because they can compete on price on interest rates. But the only way they can do that is by ensuring that they sign up people for a certain period. If they cannot do that, what impact will it have on the ability of smaller players to actually compete on a particular price on interest rates? If they are not in the market doing that, what does that enable larger players to do with their prices?

Senator HURLEY—I would like to explore the ATM system and the recommendations you have made. You were talking about a cap on the amount of ATM direct charges and so on resulting from that. We have had quite strong evidence from financial institutions that that would be a problem because you would not get the number of ATMs, the accessibility or the players in there. How do you respond to that?

Ms Lowe—I suppose there are a few things to say about that. Firstly, we note that there have been a number of players who have entered the market simply by putting ATMs in place. They are shareholding businesses that are expected to provide a rate of return to their investors. Our concern is that the pressure from those businesses will be to keep increasing the fees under the current system that we have. Also, that there will be a pressure for increasing returns from those

businesses in circumstances where they do not have a retail front of house, such as banks and credit unions and other institutions have, that may provide some customer interface that would put downward pressure on those fees. We are particularly concerned about those impacts in precisely those areas where it may not otherwise be economic to put ATMs in place. We have seen some very serious problems emerging in remote areas where there may be a single ATM provider in place that is not the provider of the majority of the account holders in that area. Consumers, through very understandable behaviour, are incurring enormous levels of fees, particularly relative to their low incomes. So initiatives need to be put in place to help address the, frankly, blatant unfairness that is occurring to some consumers in remote communities, particularly remote Indigenous communities. It is not a simple one-size-fits-all economic argument here; we are seeing some very pointy examples of the impact of that one-size-fits-all approach to these issues that are emerging. We take very seriously the need to provide a solution to those consumers.

Senator HURLEY—If you have an account with the major banks you do not pay the fees. There are an aggregate number of smaller banks, of which I am a member, where you also do not pay the fees. That produces, I suspect, some downward pressure on other machines, because the evidence is that people have gone back to using machines in their own bank that do not incur fees. So people are very aware of this pressure. It seems to me that, certainly in the urban areas, if the fee is stuck around the $2 mark, your point is that then the rural areas, particularly the very remote areas, including Indigenous settlements, would follow suit. Would it not be better to deal with that issue specifically rather than putting what financial institutions call a draconian restriction on their services?

Ms Rich—We were one of the few groups that made a submission to the Reserve Bank at the time that they were introducing these reforms from the community sector side of the equation, and we are supportive of the reforms. We were very supportive of moving to the direct charging regime and, frankly, we are not worried about what is going on a couple of blocks from here in terms of ATMs. We are quite happy to not have a cap on ATM fees if all of Australia acted the way the ATMs here in the Melbourne CBD work. It would not be an issue. Our concern was alway about situations where competition is not going to provide discipline or pressure to make sure that those fees are set at a fair and efficient level for consumers. We do not object to ATM operators actually making some kind of return on their machines; of course they need to. We do not want to see a situation where there are no ATMs available in certain communities because there is regulation that prevents operators from making a sufficient return on the machines to actually run them. Everybody agrees about that.

The concern we have always had is that it was obvious that there were going to be situations where competition was not going to work and it was not going to keep fees down. That has proven to be the case. The most obvious situation within remote communities, where there are not many options, and in particularly remote communities, where there is a lot of disadvantage, is that the financial habits of people are such that they make balance inquiries before they take money out, which is actually responsible in that situation. They are trying not to overdraw their account. We think it is highly unfair that we have a situation where there is no regulation of that and they can be charged $10 a pop for essentially making one transaction in trying to check firstly that money is in their account. To suggest that there is nothing that we can do about it is not true. But that is not the only situation. We pointed out in our submission to the Reserve Bank that we thought there would be other situations where that would occur and we proposed a

potential solution of a maximum cap set at a level that they would compete under anyway. If you set it at $3, for example, it is not going to affect the business of any of the banks in any of the major cities in Australia but it would ensure that you would not get to excessive $5 or $10 fees somewhere just because they can. We also need to do something about the fact that there are certain situations where people will go and check their balance once, twice or three times over before making a transaction and we might need to think about whether the regulation targets balance inquiry transactions separately from cash withdrawal transactions. That is another potential solution to this particular problem. In some ways if you think about it in a different ways it really should be a right to have information about your financial account and to know what is going on in your account. If you think about it in those terms, then it seems very unfair that you get charged $2, a dollar or whatever it is just to check the information about your account.

Senator HURLEY—For a lot of rural and very remote communities it would be quite expensive to send a person out to service an ATM. It might cost a lot more than for a metropolitan area one. So a cap on fees might be quite difficult. Of course it is not the bank that is providing that service, so if you are also talking about balance inquiries then you might be in a situation where the bank might have to cover that cost if you put a cap on.

Ms Lowe—We would suggest that there are other potential solutions to this. As you mentioned, we have seen partnerships develop between smaller providers. Indeed, some large and small providers have formed partnerships to provide a wider access to ATM networks. One option might be to have a partnership in relation to the approach to ATM fees in these communities so that a range of institutions effectively share those costs and therefore provide a much wider catchment of consumers with access to fee-free ATM transactions. There are plenty of options that could be used to address these problems.

We would note that this is not an entirely new problem; there has been awareness of this problem for some few years now. So there has been a period of time during which the industry has had the option to come up with its own solution, and we would note that that has not occurred. In the meantime, very vulnerable consumers are losing very significant proportions of their income—their low income—to this behaviour. So we say it is time to provide a solution for those consumers.

Senator RYAN—With respect to the ATM fees, which I am interested in, a lot of these are third party ATM providers, which have been rolled out quite significantly, probably over the last five or six years. With the ones that are charging above that $2 level—the ones you mentioned in certain regional areas, including the $10 example you mentioned—I am assuming they are not banks; they are third party providers. Is that a correct assumption?

Ms Lowe—Yes, that is a correct assumption.

Senator RYAN—So these are places where the banks have historically not put machines? Are they newer machines or are they machines that have been there for years and on which the fees have gone up since the Reserve Bank changes?

Ms Rich—They are not necessarily areas where the banks have not once had a presence. One of the trends, of course, has been that banks have been removing their presence in some of those

areas. What you might see is a better maintained, cheaper ATM replaced by a third party operated ATM that is more expensive and not serviced as well and so on. So there are a range of problems in terms of ATMs in those areas.

Senator RYAN—Presumably that is partly because of what Senator Hurley mentioned: it would not be cheap to maintain these machines and continually supply them with cash. Had the banks withdrawn for economic reasons? Did they withdraw before the Reserve Bank changes came in, or since? I just think there is an interesting point here: did they withdraw before they were allowed to charge fees, or did they withdraw afterwards and have someone move in straightaway that charged higher fees? That can teach you something about the costs of providing service.

Ms Rich—Ultimately it is the banks that can answer that better than us. Certainly the trend was there before the ATM reforms coming in, although I do not know the extent to which they changed their behaviour once they were able to recover fees. We would not disagree with the fact that it costs more to operate and maintain an ATM in that sort of community—not at all. We accept that, and that is why we did not disagree with the fact that you do not want to set regulation at a level that would prevent anybody from being able to operate an ATM in that area. So we do not disagree with that. Where we have concerns is on whether what is going on is just what is necessary to maintain that ATM or not. I am not convinced that, just because it is more expensive to maintain an ATM in a remote area, it is acceptable to have the situation that is going on now. I do not necessarily accept that that is correct.

Senator RYAN—Finally, with those examples of $10 fees, is that truly exceptional or is it commonplace—the $5 or $10 fees? Are we looking at the one or two extreme examples with that, or is that something that we need to be cognisant is not uncommon?

Ms Rich—It is very difficult to know at the moment. We rely on anecdotal evidence, essentially, of consumers. We do not have the resources to go out and do that kind of survey.

Senator RYAN—Fair enough.

Ms Rich—But the Reserve Bank was supposed to provide us with more information about the progress and implementation of the ATM fees reforms. We did not see a lot of that information after the first month or two, when they published their first report, and my understanding is that they are now meant to be collating that information and publishing a second report. One of the things that we are eagerly awaiting is some more information about existing—

Senator RYAN—And that report does capture non-bank-provided ATMs?

Ms Rich—Yes, that is right.

Senator HURLEY—I have a follow-up question on one more area, and that is your recommendation that the government should introduce market studies and investigations powers in the banking area. The ACCC currently does market-wide studies in a range of areas. Why do you think they do not have sufficient powers?

Ms Lowe—There is an argument that, under section 28 of the Trade Practices Act, the ACCC do have the power to conduct own-motion investigations. Equally, there is an argument that they only have the power to do so currently by ministerial request—whereas regulators, being regulators, are concerned, properly, that they are acting within the scope of their powers. So we would certainly like it to be absolutely clear that the ACCC do have the power to conduct these sorts of studies.

Part of the mechanism that occurs in other jurisdictions is that there are a range of reasons why the regulator may choose to exercise those powers. It may be at the request of the government but it may also be based on other information that they receive in the course of their information gathering. It may be on the basis of complaints or, in other jurisdictions, supercomplaints, which is where consumer bodies are able to approach a regulator with a series of examples and a substantial body of evidence and say, ‘We believe that there are competition problems in this market,’ whether they be supply- or demand-side problems, and the regulator is then empowered to investigate those matters and to make recommendations or indeed take action as a consequence.

The Office of Fair Trading in the United Kingdom have done just that. They have examined in a very broad sense the way a whole range of markets are working—and they are the same sorts of markets in which we see particular instances of problems occurring here in Australia. So they have had a chance to look at doorstep selling, at debt collection and at certain issues that arise in the real estate industry. The power, if you like, in these sorts of initiatives is that they are flexible in their application. The regulator might decide, ‘Well, there’s a little bit of a problem but we’re comfortable that it’s working all right.’ They might decide, ‘We need to take some enforcement action.’ They might decide to make a recommendation to what is, in the UK, a separate competition regulator. So it is an informative tool that we think would greatly benefit Australian regulators.

Senator HURLEY—Okay. Thank you.

CHAIR—Senator Xenophon.

Senator XENOPHON—Thank you for your submission and for making a number of concrete recommendations. Going back to the issue of ATM fees, I was up in Cape York recently, a couple of weeks ago, at Aurukun, Coen and Lockhart River. It is $500 return at least, I think, or around that to go from Cairns. If you were servicing ATMs, it would be very expensive in those communities. That is the mischief or the problem that you want to deal with. Do you have some form of subsidy? Do you have a requirement of anyone’s ATM licence or anyone who is an ATM operator to say, ‘You must provide a requisite number of services per 100 ATMs you have in a particular area,’ or do you have some form of subsidy so that Australians in remote communities are not disadvantaged? How do you remedy this, without using a sledgehammer to crack a walnut?

Ms Rich—I would think about it in two ways. Firstly, you want to get the economic regulation right. You want to make sure that the regulation is such that you have the best, most efficient system—that you provide access to services that people want in those communities but at a price that is sufficient to enable those services to be provided but not more than what would be sufficiently competitive. That is the economic regulation aspect, and we have probably

already spoken a lot about that here and we think we can probably do a bit better on that. That said, we accept that that does not necessarily mean that the price of a transaction is going to be the same there as in the Melbourne CBD.

Senator XENOPHON—But to what extent? In the same way that a postage stamp has the same value everywhere? Do you apply that principle?

Ms Rich—That was my second point. Once you get that first area right—and that may involve a maximum cap, which is a proxy where competition is not going to work any further or something like that—you have the question of social regulation, and that is really a question of social policy: what do we think is fair practice in those communities? If we think, despite the fact that it costs a lot of money to run those ATMs, that we should be allowing people access to them and we do not think they should pay $20 a pop or whatever the cost might be, then the question becomes: how do we deal with that? And you are right; that is a question of social policy. If we decide we do not like that situation then we have to decide how we deal with it, and essentially what you are talking about is some form of subsidy. How you do that is also a question of social policy. Do you impose that as an obligation on the financial institutions that run those services, and therefore it gets smeared across the base? We do that all the time in different areas; that is one option. Do you do that as a universal service obligation type of government-funded subsidy, essentially to provide those services where they might not otherwise be provided at that level?

Senator XENOPHON—Or a bit of both, a hybrid of both.

Ms Rich—Exactly. Our view is that those are not necessarily bad options, but they are not economic questions as such; they are questions for the government and the community to decide on.

Senator XENOPHON—In your submission you made a number of practical recommendations on exit fees. Recently, a well-known mortgage broker in Adelaide, Ray Hampson, contacted me and said: 'What has been ignored in this debate is in relation to mortgage insurance. If you switch from one lending institution to another, you have paid your mortgage insurance for 30 years—it has been put at the top end of the loan. It is a significant cost of thousands of dollars, and no credit is given when you switch to another.' Is that something that your organisation has looked at, and do you agree that there is scope for reform in portability of mortgage insurance, given that you have effectively the same product; you have just switched banks?

Ms Lowe—We have not looked at the issue in detail but we are certainly aware that there are issues around consumers paying premiums for a short period of time for effectively a long-term benefit that they do not get.

Senator XENOPHON—And they have to do it all over again.

Ms Lowe—or, more properly, protection for their financial institution that they do not get. So there is certainly scope to look at, as you say, portability of those products, pro rata refunds of premiums or things of that nature. At the moment it certainly appears, from the information that

we have, that there is an extra benefit accruing there that consumers are paying for, perhaps unfairly.

Senator XENOPHON—In relation to exit fees in general, some commentators have said, 'If you abolish exit fees, consumers will cop it in the neck some other way; the banks will find a way to charge it up, to make consumers pay.' Is the bigger picture one of increasing the level of wholesale competition in the level of funding so that we have more access to funds? Is it that competition that can make a difference because there is a tightness in money supply?

Ms Lowe—We will say a couple of things in response to that. Firstly, as we have mentioned, where those costs are genuinely occurring, we are quite comfortable for them to be recouped by businesses. In some respects, it is where the fees are placed in the transaction that has such a significant impact on consumer behaviour and consumer cognisance of those fees. It is for that reason that we are more comfortable if it appears in an upfront fee context or indeed an interest rate context because the evidence tells us that consumers do take those things into account when they are making a choice but they do not take into account deferred fees, which they think they will not pay, whether or not they are aware, frankly, they may apply. In terms of greater access to wholesale funding, we simply note that we are supporters of a broad suite of responsible players in these markets and we are supportive of initiatives that are being carefully looked at.

Senator XENOPHON—Do you have a view on the Canadian securitisation scheme, which is a government-backed fund for the home market? If you do not, that is fine; you might want to take the question on notice.

Ms Rich—We have some broad views about various supply-side measures, but the basic point we are making is that we are not suggesting they are not important but I would disagree if you were suggesting that we should place all our efforts on them.

Senator XENOPHON—No, I am just talking about it as part of an overall package.

Ms Rich—We certainly support looking at all of those kinds of measures. We do not disagree that there is no point in consumers being able to switch easily if there is no-one to switch to or if the products to switch to are too expensive. Again, we do not disagree with that; we just think you need both. Similarly, we do not agree that you could have all these great players out there in the market and then suddenly have competition. We do not agree that that is the case. You do need to do things with the barriers to switching to ensure that consumers can take advantage of it. Otherwise, you do not actually have competition; you just have lots of competitors.

Senator XENOPHON—Thank you.

Senator McGAURAN—You mention under a recommendation on page 67 the code of conduct for banking practice. I recall when that code was introduced all the controversy around it and all the toing and froing around producing it. As you know, it was basically introduced to balance to some minor degree the consumer power against the banking power—very few players. In short, you being a leader consumer advocate, is it worth the paper it is written on?

Ms Lowe—We certainly are still supporters of the banking code of practice. It occurred in an historic context, I suppose, and certainly lots of things have happened since then. It is obviously

a self-regulatory mechanism, albeit one around which the disciplines on that self-regulation are significant, in the sense that it is subject to independent monitoring and it is enforceable via the banking and consumer contracts. So it does set a benchmark, I suppose.

Senator McGAURAN—Who independently monitors it?

Ms Lowe—It is called the Code Compliance Monitoring Committee. It is a funny sort of entity.

Senator McGAURAN—Who are they? Are they federal, state, attached to the ACCC or what?

Ms Lowe—That is a very difficult question to answer, actually. It comprises an independent chair, a consumer representative and a banking representative, and they monitor compliance with the code. It grew out of the Australian Bankers Association but is separately located from it and in fact is located with the Financial Ombudsman Service.

Senator McGAURAN—This is a question we should answer through our secretary more than anything else: do they report to the parliament? As I say, the code of conduct in some way is to make up for the lack of consumer power against the very powerful and few players in the banking sector. So that is something this committee ought to add to its investigation.

In your recommendation you are saying that the code needs to be toughened. Is that because there is a culture within the banking sector of bypassing it, not living up to the spirit of it or pushing the very limits of it?

Ms Lowe—We would note that the code is actually coming to the end of a review period and it is intended to be regularly reviewed. We would say that that recognises that it is intended to be an evolutionary document. It is intended to represent good practice in the industry, and as time passes and practices change we think what is good practice also changes. We would also say that there is real scope in that code to address some of the issues that we have been talking about.

Senator McGAURAN—I have one last question. When you meet the banks on behalf of your customers and clients, do you actually put the code down and say, 'Now, look, we think there's a breach here' and do the banks take that seriously? Or was the code just for the moment when it was first introduced? Do you rely on it?

Ms Lowe—It is a tool—one of a range of tools, I would add, including some very important regulation that we have recently secured. But, yes, it is a tool that we use in our practice. The danger with the code is that it becomes less relevant if it is static. If it does not evolve to note current issues and practices then it will in time become less relevant because it will be overtaken by other initiatives. We would certainly encourage the financial institutions that sign up to it—and they do not all—to keep it ahead of current issues that are emerging, because otherwise it will become an irrelevant document, when it has in the past been pointed to as a benchmark.

CHAIR—Thank you to the Consumer Action Law Centre for assisting us today. We will now break until 10.30 am.

Proceedings suspended from 10.19 am to 10.29 am

BEZZI, Mr Marcus, Executive General Manager, Enforcement and Compliance Division, Australian Competition and Consumer Commission

CASSIDY, Mr Brian, Chief Executive Officer, Australian Competition and Consumer Commission

GREISS, Mr Rami, General Manager, Investigations Branch, Mergers and Acquisitions Group, Australian Competition and Consumer Commission

SAMUEL, Mr Graeme, Chairman, Australian Competition and Consumer Commission

WALKER, Dr Jill, Commissioner, Australian Competition and Consumer Commission

CHAIR—I welcome officers representing the ACCC. Before we start I take the opportunity to remind photographers and cameramen to follow the instructions of the committee secretariat and ensure that senators' and witnesses' laptops and personal papers are not filmed.

Would you like to make an opening statement?

Mr Samuel—I know that a couple of commentators in this morning's newspapers are suggesting that I will be making a 'protracted' and 'impassioned' plea for price signalling reforms. No doubt to your great relief, I will not. We have, over the past four years, presented our case on this issue, hopefully in a dispassionate and concise manner, having analysed the economic and legal issues and focussing on our primary remit, which is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.

We come here today to answer your questions and to engage in a constructive discussion with the committee. If, towards the end of our allotted time, we consider there are further matters that might be usefully addressed, I will so indicate to the committee and, if time permits, seek to address those matters with some short concluding comments.

CHAIR—You raised, in your short opening statement, the issue of price signalling. What is your current view on the ACCC's powers to address price signalling and do you consider that price signalling is an issue that needs to be addressed by regulation?

Mr Samuel—I do not want to make this protracted nor impassioned but this goes to a relatively long discussion on the history of this matter which goes back, I guess, to the decision of the full Federal Court in the Ballarat petrol case of Apco and our application to the High Court to seek special leave to appeal, which was rejected by the High Court.

A summary of the matter is perhaps best contained in a one-paragraph submission that was made by Julian Burnside QC to the High Court when he said, in his opening statement of the leave to appeal:

If the court pleases, this application raises a short but very important point concerning the meaning of the word ‘understanding’ in section 45 of the Trade Practices Act. Various full court decisions, including the decision below—

which was the Apco decision—

interpreted the word ‘understanding’ as requiring a commitment—at least a commitment by one, of not both parties—to the alleged understanding.

After some discussion involving the parties, Justice Hayne and Chief Justice Gleeson, Chief Justice Gleeson concluded by saying:

Thank you, Mr Burnside. The decision of the full court of the Federal Court turned not upon any controversial view of the meaning of the relevant provisions of the Trade Practices Act but upon the full court’s view of the facts in the light of the case as pleaded and argued by the commission. In light of the facts so found the case does not raise any issue of law suitable for a grant of special leave to appeal. The application is dismissed with costs.

That goes to the heart of the concern we have, which is that in the absence of an ability to demonstrate a commitment by at least one, if not both parties, to an understanding or to some form of coordinated behaviour, then we do not have a contract arrangement or understanding within the meaning of the cartel provisions of the Trade Practices Act. We have debated this in various hearings of Senate estimates and the like and elsewhere.

We have gone through various iterations of this process, including a Treasury discussion paper that focused on a possible expansion or change to the definition of understanding, which followed along the lines of a recommendation that was made in the petrol inquiry report, which included, as appendices, advice from Mr Burnside QC with some recommendations as to how the definition of ‘understanding’ might be modified for the purposes of section 45.

Following on some submissions made in respect of a Treasury discussion paper on that issue we had another look at it and considered that perhaps an alternative approach was that which was primarily recommended by Caron Beaton-Wells and Brent Fisse in a paper that they prepared, which related to the experience in the United States and in the European Union—that of facilitating practices or concerted practices. That is where we are at at the current time. We have pursued that course of action. In the absence of dealing with this matter we have a position in the current time in some of our investigations where, in relation to alleged cartel conduct, parties will acknowledge they have met, will acknowledge that they have exchanged information concerning prices and other factors that are of competition between them, but they will deny the commitment. And on the denial of the commitment under the law as it currently stands—as now affirmed by the full Federal Court and the High Court—we cannot take the matter any further.

Mr Cassidy—Can I just add to that. You might say, ‘Why don’t you concentrate on clarifying the meaning of “understanding” in the formulation “contract, arrangement or understanding”?’ That would certainly help, but I think our position goes beyond that in the sense that there is behaviour, which is recognised certainly in other jurisdictions, that does not involve any contract, arrangement or understanding. It purely involves signalling on the part of a significant player in an industry or sector of intentions about pricing, about quantities, about other strategic behaviour, with the intention of that signalling being to condition the behaviour of their competitors. That sort of behaviour is likely to become increasingly apparent, given the

tightening and the increasing of penalties which parliament has enacted for what you might call more traditional cartel behaviour involving contracts, arrangements or understandings. Particularly in industries where there are relatively few players—and of course we have a lot of those in Australia—signalling behaviour can be just as effective in achieving collusive outcomes as the more traditional forms of cartel behaviour. So even if the term 'understanding' could be clarified we would still argue that you need to go beyond that to get at behaviour which does not involve any contract, arrangement or understanding but nonetheless can have exactly the same outcome as the more traditional cartel type behaviour that does involve some form of contract, arrangement or understanding.

CHAIR—Thank you for that. The first point I take out of all of that is that the ACCC does consider that there is a mischief that needs to be addressed in terms of price signalling and that that has potential anticompetitive outcomes for consumers in Australia. For the purposes of *Hansard*, I see you are nodding, Mr Cassidy. Secondly, you do not believe that the current legislative powers granted to the ACCC in view of the Federal and the High Court decisions gives you sufficient power to adequately address that mischief.

Mr Samuel—That is correct.

CHAIR—That is not a universally held position, is it? We have had evidence, and I think we are hearing from economists and competition experts later today, that would disagree on either or both of those points: firstly, that there is a problem that needs to be addressed and, secondly, that you do not have the powers to address it. Would you agree that there are legal commentators who consider that you do have the power to address those issues?

Mr Samuel—I am not sure that there are legal commentators to suggest we have got the power to address the issue, but I think that there are legal commentators who suggest we do not need the power—in other words, that there is not a problem that needs to be addressed. I think that goes to the fundamental philosophy of competition and competition policy and competition law. It probably can be summarised in one sentence in relation to the European competition law. A fundamental principle of European competition law is that every trader act independently when deciding its business strategy. The sorts of issues that we have discussed and that Mr Cassidy has just put to you cut across that fundamental principle of European competition law.

Mr Cassidy—There are some who suggest, Senator, that we might be able to get at some of the target behaviour, if I can call it that, if there is an underlying agreement to be exchanging information. That is a possibility. But I come back to my point that with this sort of behaviour there will quite often been no underlying agreement involved. It will be initiated by one significant player in the market, and the intention of that player will be to condition the behaviour, the response, of his competitors. So we would say that there is a class of conduct—a not insignificant class of conduct—that we simply cannot get to with the law as it currently stands but which is unlawful in other jurisdictions.

CHAIR—In terms of the solution that the ACCC sees in terms of how government can assist in delivering you the powers that you need, all the evidence that I have read about this suggests it is a highly complex area and there is a myriad of questions that need to be asked and considered before developing that solution. Do you believe that it is possible to put together an

answer that will adequately protect consumers whilst managing to step around a lot of those queries that have been raised about how this can be done?

Mr Cassidy—We do. We particularly look at the EC and the UK, where there is a solution, we believe, and the solution has been in existence ever since the EC was formed. It is in the original article 81 of the treaty which formed the EC. The sky has not fallen in in the EC or the UK because of this particular piece of law. Nonetheless, it is operative. We have very recent cases that we can go to which, to be quite frank about it, are unlawful in the UK and unlawful in the EC but would not be unlawful here. We believe there is a way of, if you like, getting at this sort of behaviour, this sort of conduct, without affecting legitimate market conduct. It is an area where you need to be careful, admittedly, because there are some fine lines between what you might call questionable conduct and quite legitimate conduct, but nonetheless we believe it can be done.

CHAIR—Certainly some commentators argue that there can be benefits for consumers—I do not mean to misquote you, but I am trying to recall the words you used in the EU context—when individual enterprises take into consideration what other businesses are doing and knowledge of that when making their own decisions. Those benefits may well be lost if you are clumsy in the way you approach this issue.

Mr Cassidy—To pick up the word 'clumsy', I certainly agree with that. In the EC and indeed in the government's draft bill, and for that matter the opposition's draft bill, I think there is a recognition of that in the way each of those separate laws or bills are drafted and there are exclusions. There is a possibility of authorisation for conduct. So I think there is a recognition, both in the drafting and in the various exclusions, of the fact that some of the types of behaviour we are talking about—

CHAIR—So when you are talking about authorisations you are talking about allowing an enterprise to go to the ACCC and say, 'We want to be able to do this' and be authorised to do that, thereby removing themselves from liability for their actions that might otherwise be captured.

Mr Cassidy—That is right, in terms of the government's bill there is an exception for joint ventures, for argument's sake. There is an obvious need in joint ventures for information to be exchanged between the parties involved. Again, just focusing on the government's bill, it is only the exchange of price information that is a per se offence. With the exchanging of any other information we would have to prove that the exchange had the purpose of substantially lessening competition. So there are safeguards built in, both in the way the bill and the opposition's bill are drafted and in the various exemptions and exclusions which are permissible. Without going into the detail, I think it is an area where you do need to be careful because there is legitimate behaviour that you do not wish to capture; nonetheless, there is behaviour that you do need to capture.

CHAIR—The mischief that we have already referred to does not apply just in banking, does it? It potentially applies in other industries as well?

Mr Cassidy—That is right.

CHAIR—Do you think that the powers that you need should apply to wherever such mischief occurs?

Mr Samuel—The general principle of the Trade Practices Act, which is now of course the Competition and Consumer Act, is that it should apply with very rare exceptions, such as telecommunications, across all sectors of industry and commerce. We consider that this is an issue that will affect a variety of sectors in industry and commerce in Australia and ought to apply across the board. As a matter of government policy at this point of time, we have legislation which reflects a focus on the banking industry, but there is provision made for that to be expanded across other sectors by means of regulation.

CHAIR—By means of regulation—do you think that is the best way of dealing with that? Should the legislation apply to this behaviour regardless? Traditionally, regulation has a lower degree of parliamentary scrutiny than legislation does. Would it be better to allow that? What other aspects of the Trade Practices Act would deal specifically with an industry like this in terms of the broad scope change that we are looking at there under that proposed bill?

Mr Cassidy—I think there are two issues raised in the question. As the chairman said in terms of application, it should apply across the economy because this conduct is not limited to the banking sector. That having been said, if there is going to be a mechanism whereby the coverage of legislation can be extended we do have some attraction to the regulation option because it is clear when the law's coverage changes and it is clear at what point that does apply beyond the banking sector. So we would think it should apply more broadly, but equally if there is going to be some sort of phased mechanism for coverage we think a process of regulation going through both houses of parliament is a preferable approach because it does give us clarity as to exactly what the law is and who it applies to at a particular point in time.

CHAIR—So you are attracted to the regulation approach rather than legislation because it allows you to progressively cover various sectors as the ACCC has the ability to look at it. Is that right?

Mr Cassidy—If you are comparing either doing it by regulation or extending the coverage by separate legislation, the point I was making I do not think would differentiate between those two. But if you were looking at using, or were perhaps using, some other form of disallowable instrument, we would probably favour the regulation approach. It is clearer in terms of timing.

CHAIR—I am curious as, off the top of my head—and I am not a competition law expert—I am not aware of any other aspect of competition law that extends its coverage in this way. Generally, most provisions in the act would cover all industries if the behaviour of the parties triggered it. In this case it is a quite specific provision and it is only dealing with banking and allowing it to extend by regulation. That seems a strange way of approaching it and I am curious as to the ACCC's thoughts on that.

Mr Samuel—I do not think any of our comments in the past have suggested this ought to be industry specific. That is a matter of government policy. I think what Mr Cassidy has indicated is that if government policy is such that it should initially be confined to the banking sector then we think that the most efficient means of expanding it beyond that on an industry-by-industry basis is by regulation. But we have never, I think, indicated in any of the comments that we have

made on this over the past four years that we consider that this needs to be industry specific. We think there are a number of industries, ones that would immediately come to mind, that could be subject to this form of regulation. But in any event it does not matter. It is not so much an industry issue as it is a collective approach that can be adopted and is adopted by participants in a range of industry sectors. It is the nature of the cooperation between them that we are concerned about, rather than whether it is a particular industry.

CHAIR—That was my understanding. So essentially it is a policy decision by government to confine it to banking at this point—

Mr Samuel—That is correct.

CHAIR—and the construction is a government decision based on your views of how things should proceed.

Mr Samuel—That is correct.

CHAIR—In terms of the views of others that you already have the powers, I will test that a little bit further. I am looking at a submission from Malleson Stephen Jaques, who will be appearing before us later today. They say:

> In our view, the Trade Practices Act (as currently drafted) would allow the Commission to successfully prosecute one or more competitors for exchanging information about a future price by proving that:

and then they go through four things including:

- one or more competitors was attempting to arrive at an understanding that had the purpose or likely effect of fixing, controlling or maintaining a price or a component of a price; or
- one or more of the competitors was attempting to arrive at an understanding to exchange information about future prices and the understanding had the purpose, or would be likely to have the effect of substantially lessening competition in a market; or
- two or more competitors had arrived at an understanding to exchange pricing information, and the understanding to exchange the pricing information had the purpose or would have likely effect of substantially lessening competition in a market; or
- two or more competitors had arrived at an understanding that had the purpose or likely effect of fixing, controlling or maintaining a price or a component of a price.

As for those four scenarios in which they believe you have the power currently, is that an example of where it does not go far enough in terms of addressing what you think the mischief is? That is given that they say the mischief does not need to be addressed and you do not need to change your powers because that already covers it.

Mr Cassidy—It might be if we could establish either that there is an attempt to arrive at an understanding or that they have arrived at an understanding, keeping in mind what the Full Bench of the Federal Court has said the law means in relation to understanding, where there does need to be a commitment on the part of at least one of the parties to act. But what we are saying is if you have a situation where a firm unilaterally decides it will signal to its competitors what it is going to be doing in relation to its pricing or its marketing or other strategic behaviour there is no attempt there to arrive at an understanding since—

CHAIR—So none of those four scenarios?

Mr Cassidy—Yes, none of those four scenarios. So that is the sort of conduct which we say the law simply does not apply to at the present time. But equally that sort of conduct can be just as deleterious to consumers as the more conventional cartel behaviour involving arrangements and understandings.

CHAIR—So for my and the committee's understanding, they say they believe you have the powers needed but you would prefer to see price-signalling powers go further than the extent to which they think that you currently have the powers.

Mr Cassidy—Yes. What I am saying is that there is conduct which we think goes beyond those sorts of scenarios that they have drawn and which should be capable of being subject to the law, which it currently is not.

Mr Samuel—The problem is the requirement of a commitment as summarised in Apco and as affirmed by the High Court. Let me take the example of a group of competitors sitting around a table when one of them says, 'You know it would be really useful if we were to let each other know what we're doing in our prices,' and the others say, 'Yes, that would be a useful exercise,' but that is as far as they go. That does not amount to a commitment. Indeed it may be that in those circumstances they go away and they do exchange prices as a matter of process but on the few occasions they just do not cooperate; they do not do it. That, if you like, creates the perception that there was in effect no commitment but there is a wink and a nod. That is not a commitment that is sufficient to be covered by the current law. So I think the submissions you have got from Mallesons and a couple of others suggest the problem is that the ACCC does not plead an arrangement or an understanding to exchange information but, rather, they are looking at whether or not there was an understanding—that is, a commitment—to move prices following the exchange of information. But our concern is that you can just as easily set up a process of cooperation and coordination between competitors without a commitment—

CHAIR—So without even any meeting or discussion. So there is an inherent understanding that—

Mr Samuel—In fact, Mr Cassidy has indicated that one leader might take the initiative and start to send prices out and others might respond and there may have been no discussion at all.

CHAIR—It has been suggested by some witnesses, in terms of the banks, that they seem to take turns in being price leaders.

Mr Samuel—I would have to say, Chair, that we have done a bit of an analysis of that and I do not think that that stands up to any scrutiny at all.

Mr Cassidy—If you look at the Geelong petrol case, which we lost—and I do not want to look bitter and twisted in any sense because we lost that—and if you look at the behaviour there which is all on record, you see a group of petrol companies and petrol retailers in the Geelong region were passing on to one another their pricing intentions. They were not innocent discussions talking about the footy and the weather and saying, 'Oh, by the way, I'm increasing my price to $1.45 a litre this afternoon,' because they were using code in these discussions. Admittedly the discussions then looked a bit odd but nonetheless they were using code in the discussions—

CHAIR—Which suggests a very deliberate action.

Mr Cassidy—That is right. And yet the court ruled. We took legal advice on whether we had grounds to appeal, and the legal advice we had was that we had no grounds to appeal following the Apco decision; the court ruled that that behaviour was not unlawful.

CHAIR—I will move on from there. Others may have questions about price signalling. On a different topic, what existing competition laws prevent a merger between two of the four major banks?

Mr Samuel—In competition law it is section 50 of the Trade Practices Act. Then you have the specific provisions of the financial services shareholdings act, which are a matter that is outside the remit of the ACCC. In terms of pure competition law, it is section 50, which prohibits any acquisition of shares or assets which is likely to have the effect of substantially lessening competition in the market.

CHAIR—Obviously any actual proposal would require you to go through the proper processes that you would look at to assess it; but, given that we have four major banks now, do you think that such an analysis would be likely to prohibit such a merger?

Mr Samuel—You can imagine the headline if I said yes or no to that, can't you! Let me go back and be a bit more cautious.

CHAIR—What are the broad issues that you would look at in terms of assessing such a proposal?

Mr Samuel—I think it is best illustrated by reference to some of the more recent transactions that we have had a look at. In particular, you would be able to get an analysis through looking at the public competition assessments that we issued in relation to St George-Westpac and CBA-BankWest. Fundamentally we would examine both the product and the geographic markets in terms of the product market without wanting to limit it. It would focus on a range of areas including retail banking, corporate banking and institutional banking. It may also include issues of wealth management. You could run through the raft of different product or service areas that the organisations were engaged in. In geographic terms we would potentially look at a national market but would also consider implications on a state or regional basis and would then consider the prospect of a substantial lessening of competition in each of those markets. It would be a very rigorous examination.

Senator McGAURAN—But it is still an assessment. You would make an assessment on an application for four to become three. To clarify the question in my mind, given that it is government policy for both sides that the four pillar policy remain, what enforces that policy? Is there anything in law to say no other than your own objective and subjective assessment?

Mr Samuel—The two laws that apply are the Trade Practices Act section 50, which is confined to a competition assessment—

Senator McGAURAN—But you may see it differently. I am not saying you will or you will not.

Mr Samuel—That is right. Then, if we get to the four pillars, that becomes a matter of policy which is capable of being administered by the Treasurer under the financial services shareholdings act, which requires the Treasurer's consent for any acquisition of shares in a banking or financial institution beyond the order of 15 per cent. That is where the four pillars policy is invoked. But that is a policy matter.

CHAIR—Still on the merger, just prior to the GFC becoming as bad as it did Westpac and St George merged. You approved that. You went through the process, conducted an assessment and approved that merger. Do you think the circumstances today, with the increased concentration of most aspects of the banking industry in the market some 2½ years after, would alter your assessment at all if you were conducting that assessment today?

Mr Samuel—It would be very difficult to give you an answer on that without having considered the matter and really examined the relevant markets. I think what is important to recall is this: in the St George-Westpac merger we did a very thorough analysis but then, as will happen in complex merger decisions, before making a final decision we issued a statement of issues. A statement of issues is designed deliberately to evoke and provoke responses, submissions and comments. So in the statement of issues that we issued in respect of St George-Westpac we made comments about whether St George was a vigorous and effective competitor. We expressed a preliminary view that in terms of retail banking we did not consider that there would be likely to arise any competition concerns in the retail banking area. We did that to provoke submissions in response.

It is interesting to note that in response to that particular issue—I am focusing on retail banking because I do not think there was a debate about corporate or institutional banking and there was an issue that we raised in relation to wealth management—we received three submissions. One was from Choice, another was from Mortgage Choice and the final one was from the Finance Sector Union. I would have to say to you that none of those submissions provided any substantive material to change the position that we derived from analysing very carefully market data and a very rigorous market analysis to come to the conclusion that St George was not an effective competitor in the retail banking area such that a merger with Westpac would be likely to lead to a substantial lessening of competition in the market, as is required under section 50. I also note that we issued on 13 August 2008, which was just prior to the collapse of Lehman Brothers, a public competition assessment and devoted some three or four pages to discussing this particular issue. That is on the public record.

CHAIR—As I understand from that—forgive me if I am misquoting you—the essential reason it was allowed was because St George and Westpac were not great competitors between each other. They had different market segments or—

Mr Samuel—No, it was because, on our analysis, St George, except on some infrequent occasions, was not a price leader in terms of interest rates. There were many other competitors in the marketplace that were more effective competitors, particularly in terms of interest rates at the retail level. We need to remember this was prior to the impact of the GFC, but they were primarily the non-bank financial institutions. The Reserve Bank statistics indicated that those institutions were invariably at a lower interest rate than the major trading banks in terms of their standard variable rates, and they were the real source of competition. St George, both in terms of its market share in the retail area and in terms of its interest rates, was never seen as a true,

effective competitor in the retail banking arena, and for that reason it was not appropriate—and, indeed, at law—to prevent the merger of those two bodies. It could not have been prevented on the basis that there would likely be a substantial lessening of competition.

CHAIR—Okay. To come back to my original question, given that things have changed significantly since late 2008—I particularly note in your comments that the non-bank financial institutions which were providing real competition prior to that time are essentially out of the market now and not providing that competition—and given that the concentration of most sectors of the banking industry such as mortgage lending has greatly increased and the four majors now have over 80 per cent of home mortgage lending, up from 60-something per cent, do you think that those changes in circumstances, if you were analysing it today, would have any impact on your decision? Are they relevant to the decision that you have made?

Mr Samuel—They would certainly be relevant to any decision we would make, but I am not sure that they would change the ultimate decision, because the question we would have to ask is: is St George Bank today, assuming it was operating as a separate entity, a vigorous, effective competitor that imposes a competitive tension on the major trading banks. We have not done that analysis in terms of the regional banks, so it is difficult to come up with an answer. I can only give you the anecdotal evidence on that issue, which would tend to suggest that the regional banks today, despite the concentration that has occurred in the industry, are still not effective price competitors relative to the major trading banks. That is why we have consistently said that it was the NBFIs that were the effective competitors and that it is their reintroduction to the market that will—

CHAIR—We have had a lot of evidence before this inquiry that one of the reasons why the smaller ADIs are not able to compete as strongly on price is primarily because of funding issues and a whole host of reasons. That may or may not change in coming years. When you conduct your assessments do you only look at the status, the current view? Or do you take into account the potential for a smaller non-ADI to become an effective price competitor if the securitisation market recovers and they can get money again at a competitive price? Do you look forward or is it just—

Mr Samuel—You have raised a very important issue. The wording is that we have to look at the 'likely' impact on competition, amongst other things. 'Likely' means to look forward to the foreseeable future, as we put it, and to look not at mere speculation but at whether there is a real chance. 'Real chance' are the words that were used by Justice French in the AGL-Loy Yang case to identify the definition of the word 'likely'. What I have indicated in public comments since the GFC is that looking forward in the banking and finance sector has not been made easy. That understates it. It is extremely complex. It is complex because there are a whole range of both national and international factors that have the potential to impact upon the banking and finance sector in this country and therefore it is very difficult for us to take a longer term prognosis or view as to the likely impact of mergers or the like. A result of that, as I have indicated, I think that after a very rigorous analysis of what we can foresee into the future we would adopt a very cautious and conservative view about future finance sector mergers.

CHAIR—But when you say a 'cautious and conservative view', does that mean that you will be less inclined to block a proposed merger or more inclined?

Mr Samuel—I do not want to categorise this one way or another. It is rather more to say—

CHAIR—What is the default position? If the things are not established then the default position would be to allow a merger to go through, wouldn't it?

Mr Samuel—In terms of the law, yes, because in the event that we were to take a position where we wanted to oppose a merger it would be incumbent upon us then to proceed to the Federal Court for an injunction and therefore we would have the burden of proof.

CHAIR—So if you are taking a more conservative approach then essentially it is—

Mr Samuel—No. I have to say to you that a more conservative approach would be to say that we are concerned about the competition implications of the merger because we cannot with any degree of probability determine what the likely competitive tensions in the market will be in the foreseeable future, 'foreseeable' being beyond a few months or a year or two. Therefore, we would to take a more cautious, conservative approach which would tend towards opposition to a merger. However, as you properly point out, we then have the burden of having to take that to the Federal Court for an injunction, which puts the burden of proof on us. That is where it can be quite complex.

CHAIR—In that context—and you have mentioned also the forecasting in the financial services sector at this stage is particularly difficult—if you approved a merger and then discovered on the basis of information you did not have available to you at the time that it has substantially lessened competition, what powers would you have to address that merger subsequently?

Mr Samuel—In the absence of having been misled by the parties in the information we had been given—being misled may well include the failure to give us relevant information—I would think it would be unprecedented for us to then move to unwind the merger.

CHAIR—Do you have the powers to do that though?

Mr Samuel—We do, yes. Within two years—

Mr Cassidy—Three years.

Mr Samuel—Three years, sorry. But we would have to demonstrate to the court that we had been misled either by deliberately misleading information being provided to us or by the deliberate omission of information.

CHAIR—So that is the only circumstances in which you can actually divest; you cannot do it on the basis of information that nobody deliberately misled you about but which subsequently became apparent, highlighting the fact that a merger has substantially lessened competition?

Mr Samuel—It is at the discretion of the court. Over the 30-odd year history of the act, I do not think trying to reverse a merger has ever been contemplated on the basis of—to put your terms into a single word—a mistake.

CHAIR—Not so much a mistake, just information that was not apparent. Circumstances change. The last two years are a classic example. Things have changed dramatically since you made your last decision. Whether those circumstances would justify what I am saying or not is obviously a complex matter, but I am just wondering whether the powers exist, if the ACCC considered that it did justify an attempt, for you to be able to do that.

Mr Cassidy—I think you have got two scenarios there. You mentioned that circumstances have changed.

CHAIR—That is right, because you cannot forecast, as the chairman said—

Mr Cassidy—Yes, but we could not go to the court and say, 'We didn't oppose this merger but now things have changed and we now want to oppose it.'

CHAIR—That establishes an answer to my question.

Mr Cassidy—It has got to be, in a sense, the situation at the time of the merger. If, at the time of the merger, there was information that we were not aware of—and we had not been misled; we simply were not aware of it—then, firstly, as the chairman said, we would think long and hard about going to a court. I suspect we would also struggle to convince the court that, given there was information there that we had not uncovered somehow, the court should now overturn the merger. It really is a fairly narrow set of circumstances that would see us go to court to try and overturn a merger which we had previously approved.

CHAIR—I am aware of the time, so I will ask just one final question before I hand over to other senators. If there were a proposed merger between one of the majors and another, smaller ADI, for that not to be approved, for you to be able to legally block it, you would have to be able to show that that smaller ADI was an active price competitor in the market. Given that the reality at the moment is it is very difficult for them to be an active price competitor in the market, it is probably open to us to conclude that that would be a hard thing for you to prove at this point in time.

Mr Samuel—Subject to alternative scenarios being available. For example, if you have got a proposed merger between a major trading bank and a smaller ADI and an alternative scenario that contemplates a merger between two smaller ADIs, albeit on less satisfactory commercial terms for the shareholders of the two smaller ADIs, if we were to form a view that that would be substantially more competitive than the merger between the major trading bank and the small ADI then we would prevent or oppose the merger between the major trading bank and the ADI.

Dr Walker—It all depends on the factual versus the—

CHAIR—I understand that. They are hugely complex assessments that you need to undertake but, on the basis of what the chairman was saying earlier about St George needing to prove—even if it was looking at it now—that they were active competitors on price and the fact that they could not do that two years ago and probably would not be able to now because it would be even harder for them to be if they were independent, then it certainly opens a door that it would be difficult for the ACCC to block a proposed merger between a major bank and a smaller ADI.

Senator HURLEY—I would like to go back to the price-signalling issue. You were talking about legitimate market conduct as opposed to questionable market conduct. I just want to make it clear in an example. If there were discussion between a range of commentators—like journalists, academics and politicians—about where interest rates were going to go and a question was asked at a forum of a banking group about where they saw interest rates heading, if the government proposal were enacted, would it be price signalling if any executive of a bank gave a view as to where interest rates were headed in the forthcoming year?

Mr Samuel—It depends on the way it is done. If there is a general discussion about interest rates, and banking executives say, 'We can see interest rates potentially going up over the next while; we think the Reserve Bank is likely to lift interest rates,' that is a general economic discussion that would not, in our view, give rise to a difficulty under the provisions as proposed.

A much more critical example of something that happened more recently in the United States might give you an idea. If a banker says something along the lines of, 'We're going to wait to see what the Reserve Bank does next week, but I think it is fair to say that, if the Reserve Bank lifts its rates by 25 basis points, because of rising costs we would be likely to lift our rates by a greater margin—we won't define the margin but it is likely that it will be lifted,' we think that starts to get into the area of price signalling. If a banker says, 'I'd be reluctant to move my rates beyond that of the Reserve Bank cash rate if it lifts it next week, but if the others do I won't be left behind,' in our view that is clear price signalling. In fact, it is almost saying, 'I don't have any cost reasons for increasing my interest rates beyond the Reserve Bank cash rate, but in terms of the competition I am simply signalling to my colleagues that it doesn't matter what my cost pressures are, I won't be left behind; I will join them if they lift above the cash rate.'

We are not alone in taking this view, I have to say. It has most recently been considered in some preliminary skirmishes in the federal District Court of Atlanta in the United States. Let me give you that as an example to point out the correlation between the attitude of the courts there and the difference here in Australia. In August last year in the federal District Court of Atlanta a matter was heard that involved the following: an airline company, AirTran, had in a public briefing with analysts, journalists and the like said, 'We'd like to introduce the first baggage check-in fee. We have all the systems and technology in place, but our main competitor is Delta Air Lines and we wouldn't be likely to do it unless they did it.' Delta did it a week later and AirTran followed very soon after that. As a consequence a class action was brought against Delta and AirTran for having entered into an agreement contrary to the Sherman act. The defendants sought to have this action dismissed, effectively on a summary basis. The District Court judge said, and I am not quoting him, 'No, I think there is a serious issue to consider here as to whether or not this is, in effect, a facilitating practice.' A coordination of conduct—a transmission of information between competitors—was occurring that, if I can move to the EU, has taken away from that independent action that is expected in a truly competitive market. The judge also noted, by the way, that the Department of Justice was investigating this matter.

To conclude this answer, one or two boardroom discussions that I have had around these issues have been interesting. I have had two or three directors of companies that operate both here and in the United States say that, if they made comments in the United States such as the AirTran CEO made, or such as those that I have given you in hypothetical form that might be made by bankers, the Department of Justice would be on their front doorstep in a matter of minutes.

Senator HURLEY—There was an article in the *Australian* in 2009 which reported comments by the ANZ CEO, Mike Smith. He said that, while reluctant to increase home loan rates over and above the Reserve Bank's rates, if other banks moved their rates outside moves by the RBA he would not be 'stuck on his own'. That is precisely the kind of comment you are talking about.

Mr Samuel—Yes, and we could not deal with that sort of comment under the law as it currently stands.

Mr Cassidy—The problem with that sort of comment—the evil of it, if you like—is that it says to the competitors, 'If you increase your interest rates I will follow,' which means you are signalling to the competitor that if they increased their interest rates they would not need to worry about being stuck out there on their own and losing market share.

Senator McGAURAN—Are you saying that price signalling is the same as price colluding?

Mr Cassidy—Yes, it can be.

Senator McGAURAN—Which there is a law against.

Mr Cassidy—Yes. Let me give you two simple examples. A group of competitors get together and agree that next Tuesday they will increase their price by X. That is conventional cartel behaviour, commensurate with collusion.

Senator McGAURAN—That is collusion; there is a law against it.

Mr Cassidy—If the same competitors do not get together but one of them gives a public speech—

Senator McGAURAN—Boy, are you stretching a definition. You are putting signalling in with colluding.

Mr Samuel—No, he is not.

Mr Cassidy—They can have exactly the same consequence in competition terms. You can get people together and they can agree on a price.

Senator McGAURAN—That is right. So they are one of the same in your eyes.

Mr Cassidy—That is right, because they end up with the same outcome.

Senator McGAURAN—Colluding is signalling; signalling is colluding.

Mr Cassidy—They can end up with exactly the same outcome.

Dr Walker—They are different types of coordination. It is all in the coordination spectrum. Explicit coordination and tacit coordination definitions vary but the outcome can be the same.

Mr Samuel—Let me give you a summary of the way this is expressed in terms of the European Commission. A concerted practice enables rivals to:

determine a coordinated course of action ... and to ensure its success by prior elimination of all uncertainties to each other's conduct regarding the essential elements of that action ...

That is in the well-known EU case of ICI against the Commission of the European Communities. It goes back to 1972, I might say, which predates the Trade Practices Act.

Senator McGAURAN—You would not want to go on any financial show—

Senator HURLEY—Just the final point—

Mr Samuel—That is an important an important point. Could you repeat that, because I think that is important.

Senator McGAURAN—You will not see any bankers go on any financial show anymore—Bloomberg, or whatever the 24/7 shows are now—ever again.

Mr Samuel—With respect, Senator, if I might say so, that is part of the—

Senator McGAURAN—That is called 'market information'. You are putting a cap on market information.

Mr Samuel—No. Let me give a response to that, because that is part of the response that has come from some sectors of the business community to these sorts of reforms. I want to go back to the initial answer I gave to Senator Hurley. This does not prevent a broad discussion of economic conditions and where one thinks interest rates might move generally into the future. You raise your eyebrows but I can tell you that our economic and legal analysis of this is that this does not prevent those sorts of discussions. It is very interesting but the Reserve Bank never heralds its proposed moves in interest rates, but it gives a very full and very thorough explanation about what it has done after 2.30 on the day of its board meeting as to why it has moved interest rates and how it has moved them and what the various factors are that they have taken into consideration. What we have is two or three different scenarios. One is an after-the-event commentary and discussion as to why it is that bank (a) has moved its interest rates. We have done so because there are prospectuses et cetera and therefore we have had to move our interest rates in accordance with what has just been announced. That is perfectly legitimate.

The second is to discuss beforehand where, generally, economic conditions may be, how bank economists and even bank CEOs say, 'Look, we think that economic conditions are such that we think that the cash rate might move in certain directions.' That again would appear to be perfectly legitimate. Where we get into some difficulties is when a bank CEO or others within the bank say, 'We are not sure what the Reserve Bank will do next week, but we are saying now, ahead of time, "If the Reserve Bank moves by 25 basis points, it is almost certain we are going to move beyond that."'

Senator McGAURAN—Isn't that called 'market information'?

Mr Samuel—No, it is not. I call it 'market softening up', actually. It is not actually informing the market about anything other than what the bank intends to do, whereas the market is far more concerned—certainly the borrowers are far more concerned—about what the bank has just done when it does it today and then the market wants an explanation as to why it has done that and why interest rates have moved in accordance. To actually say 'I intend to do the following with my prices' is not so much market information as it is to do two things—in the broad use of the words 'political terms': to soften up the market but in the more specific form to signal to one's competitors what one intends to do. If you get all the competitors or the vast majority of them saying, 'Don't worry; we're going to do the same thing,' you remove the uncertainty associated with the true competitive tension.

Senator HURLEY—So, in the event that there is this change that you are anticipating, do you think that that might change the behaviour of banks in the way they go about things? How do you anticipate they will deal with that?

Mr Samuel—Some of the more outrageous comments that have been made in response to this and the opposition's proposed legislation would suggest that they won't ever talk. I see some comments by CEOs who say, 'We can't comment on that because the legislation isn't law yet.' It seems to me it is taking it to the extreme. Despite all that, I think that what we will see is one thing cut out of market and that will be the forecasting by individual banks of what they intend to do with their interest rates as distinct from a broader discussion about interest rates generally and economic conditions generally, both of which have been the subject of and could continue to be the subject of discussion.

Senator HURLEY—Isn't this perhaps a problem for people who may be anticipating taking out some sort of loan, particularly a mortgage, where they want to know if their bank might be looking at increasing mortgage rates beyond the RBA?

Mr Samuel—I suspect that those who take out residential mortgage loans for periods of 20 or 30 years will be less concerned about what the bank might be intending to do next Tuesday than they will about what the bank intends to do in one, two, three, five or 10 or 15 years time. That gets into the whole issue of flexibility to be able to move from one banker to another in the event that a particular banker's policy on interest rates happens to go substantially against the borrower.

Senator HURLEY—In short, you do not think that the market will necessarily be less informed, including consumers?

Mr Samuel—Certainly I do not think the consumers will be less informed. Consumers will potentially not be softened as much, but then that may be a good thing because it may increase the tension on the banks in terms of interest-rate movements. And this gets into a whole range of factors that relate to interest-rate movements generally. But the important thing is this: information on prices in advance of time can in one sense be seen to be useful, but in most cases the vast value of its usefulness is in allowing competitors to know what you intend to do.

Senator HURLEY—So just to make it crystal clear: if banks know that they cannot signal that publicly, if they meet each other at a function and signal it privately then that would be against the existing law?

Mr Samuel—It is very difficult to see any redeeming factor in having private discussions on these things.

Mr Cassidy—To be clear: unless there is some kind of underlying agreement, arrangement or understanding then even doing it in private at the moment is not against the current law.

Dr Walker—It needs that commitment element.

Senator HURLEY—Right.

Mr Samuel—For example if banker A sees banker B at a function and says, 'If the Reserve Bank lifts its rates by 25 basis points next week, I'm letting you know I intend to lift mine by 45 basis points,' that on its own is not a breach of the law, although banker B can go away with a lot more comfort to his board and say: 'I've heard from banker A they're going to lift by 45 basis point. We ought to take that into account to determine what we'll do next week in response to the Reserve Bank's rate.'

Senator HURLEY—'We won't be uncompetitive if we do the same.'

Senator McGAURAN—When do the colluding laws kick in, if not then?

Mr Samuel—No, they do not kick in then. Which colluding laws? The current colluding laws?

Senator McGAURAN—The existing laws.

Mr Samuel—When banker A and banker B agree that they will not only exchange information but that they will also say to each other, 'I'm lifting mine by 45 basis points next week, will you do the same?' and the other says, 'Yes, I'll do the same.'

Senator McGAURAN—So at this mythical function A and B meet, but if only one of them signals then that is not colluding?

Mr Samuel—That is not colluding.

Senator McGAURAN—And why would you, unless you had a great desire to visit Her Majesty's prison, signal back: 'Oh, yes, I'll do the same. Thank you for that information.'?

Mr Cassidy—Senators, you may be interested in this. In the UK there was a recent decision involving two banks—the Royal Bank of Scotland and Barclays—where the Royal Bank of Scotland was accused of passing on specific pricing information to Barclays. According to the Office of Fair Trading press release this occurred through a number of contacts on the fringes of social, client and industry events. There was no underlying contract agreement or whatever. The Royal Bank of Scotland simply passed on this information to its competitor Barclays. That was found to be a breach of the law in the UK. The Royal Bank of Scotland agreed to pay £328.5 million in penalty for that, but that would not be a breach of the law here.

Senator HURLEY—I would like to move to another topic, ATM fees. A consistent criticism throughout our inquiry has been that, although the RBA decisions have freed things up a little, there still is not adequate competition with ATM fees among the people who provide the ATMs. I am just wondering if the ACCC has any view on that.

Mr Cassidy—It is hard for us to provide a view on that. We did some work with the Reserve Bank a few years ago on interchange fees, including in relation to ATMs, where the view we and the RBA took was that they were too high, but we have not had occasion to do any recent work in relation to ATM fees. By that I mean we have not had any reason to investigate the setting of ATM fees.

Senator HURLEY—Is that because the RBA is doing that work or because you do not see any problem?

Mr Cassidy—As you know, we are basically a regulator and law enforcer, so that tends to be where our focus is, unless we are directed by the government to, under part VIIA of the act, undertake a pricing review, like the ones we did on petroleum and on the grocery industry. That more general surveillance-cum-information provision, particularly in relation to the financial sector, tends to be undertaken by the Reserve Bank.

Mr Samuel—We have had involvement a little more at the margin but it does have potentially some impact on competition in a positive sense. In June 2009, January 2010 and September 2010 we received successive applications from Cashcard, from the Bank of China, from Cuscal Ltd and from Suncorp and Bendigo Bank to remove the transaction fees in respect of ATMs amongst those banks. That has potentially provided some competitive tension because it has enabled collective groups to provide for transaction fee ATM usage.

Senator HURLEY—Talking about having a look at what is happening in the market, the Consumer Action Law Centre proposed that there be increased ability for monitoring of the banking sector and in particular:

…market studies and investigations powers, based on the model in the UK *Enterprise Act*, into Australia's competition law framework.

I am wondering what your views are on that.

Mr Cassidy—That would obviously be a matter, in a sense, for the government. There is a power at the moment, as I referred to, under part VIIA, for the government to direct us to undertake reviews of particular industries or sectors. It has to be based on pricing issues, but, as you recall, we undertook fairly wide-ranging reviews of the petroleum industry and the grocery sector, hinging on the issue of pricing. Once you get into the factors behind pricing, of course, you can go a fair way in looking at an industry. So I think it would really be a matter for the government as whether they thought the existing provisions were adequate, as far as we are concerned, or whether there needed to be some more broad-ranging ability for the government to request us to undertake inquiries in particular sectors.

Senator HURLEY—We had some evidence last week about the payments system and EFTPOS and credit transactions, in particular from a company that was a new entrant to that

area, Tyro. I do not know if you have had a chance to have a look at their evidence, but they said that, although they had assistance from the Reserve Bank and good advice from the ACCC about entering this market, they still encountered quite a lot of competitive difficulties. They had been setting up for eight years and operating for four years, and they had only about five per cent of the market, for a significant investment in software, IT and so on. They were saying there are a couple of areas where they were encountering particular difficulties. One area was the IT system and the software under which the current system transfers the payment and the other was bundling of services. I wonder if you are aware of those problems.

Mr Samuel—I will pass over to my colleagues, but I do not think it has come across our radar screen.

Mr Bezzi—It is a bit difficult to know how to respond. We are looking at some issues that may well be what you are talking about, but without further details it is a difficult to be certain. It is not something I can comment on. It is a fairly confidential investigation at the moment.

Senator HURLEY—In particular, I want to talk about bundling of services. You mentioned that banks are getting into wealth management. There is clearly some advantage if you bring an organisation in on a general banking service because you can then get them into other areas and provide other things. There is a cross-subsidisation, in effect. You tell them you will lower their fees for credit transactions, providing that they have a bundle of services with the bank. I wonder what your general policy view is on cross-subsidisation of services, the bundling of services. Can it lead to anticompetitive behaviour?

Mr Cassidy—We have just thrown a complication into it. I was going to say that ,of course, we look at it from a competition point of view. There is nothing necessarily wrong with bundling. But we get concerned if the bundling involves anticompetitive behaviour. I can give you a quick non-banking example—

Senator HURLEY—It is inherently competitive in the cost of providing a service. If someone is trying is trying to break into that one sector of the market, it generally increases competition. If someone is providing it at cost or below cost and providing the customer uses the other services, there will be better margins.

Mr Cassidy—That is where you have to be careful. Bundling can be beneficial to the consumer. We would only go after a bundling arrangement if we thought we could establish that the bundling arrangement actually had either the purpose or the effect of keeping out a competitor. If it provides consumers with some competitively priced, say, financial products but a by-product is that new entrants with a single product or not as many products have difficulty entering, we would probably, apart from anything else, struggle before a court to establish that that was anticompetitive behaviour, even though as a consequence there can be a barrier to entry. But it does really turn on the competitive impact and why the bundling arrangements are put in place.

Mr Bezzi—In a completely different industry, we did take action for anticompetitive conduct that arose out of bundling in a tender for health products. The case involved Baxter Healthcare. That was a breach of the misuse of market power provisions.

Senator XENOPHON—Mr Samuel, I have many questions to ask you. My terseness is a function of time not temperament.

Mr Samuel—I never query temperament.

Senator XENOPHON—I want to start with the comments you made to the *Australian Financial Review* in April 2009. You expressed concern over the state of competition in the banking and said that the risk is with four big banks, because of the diminished role of non-bank financial institutions, we end up with less than intensive workable competition. You expressed concerns that the ACCC was increasingly concerned that the lack of competition would ultimately reflect in costs to consumers. You are on the record as saying that. Do you disagree with that?

Mr Samuel—I am probably repeating the sorts of comments I made in some earlier answers I gave to Senator Bushby.

Senator XENOPHON—Sure, but I will just go to your specific comments. On 6 December 2009 you told ABC1's *Inside Business* program that the banking and finance sector in Australia has changed significantly in the past year, presumably because of the GFC, and that any proposed mergers would be examined very critically based on the existing and likely future competition. You went on to say:

I think you would have to say that it would be a difficult ask to see any more of the regional banks moving into the fold of the major trading banks in light of the global financial crisis.

Mr Samuel—Again, that goes back to some of the questions Senator Bushby asked me and I attempted to answer those in that context. I think it is a similar set of circumstances.

Senator XENOPHON—You went on to say:

There's even a question that you might ask, that if Westpac were to seek to acquire St George today rather than prior to the global financial crisis, whether we'd have the same view as what we had back then.

Mr Samuel—Having put that as a hypothetical question—which is exactly the very question Senator Bushby asked—I did not provide an answer. But, of course, that was immediately interpreted by some in the media as suggesting that we would have a different view today. I tried to give some expansive answers on that when Senator Bushby put these questions to me at the beginning of this hearing.

Senator XENOPHON—But doesn't your comment back in 6 December 2009 reflect the fact that you look at prospective matters and not just retrospectively when you are considering an issue of a bank merger?

Mr Samuel—We look very significantly at prospective issues because the act includes the wording 'likely to have the effect'. 'Likely' means, 'Is there a real chance in the foreseeable future of it having an effect of substantially lessening competition?' We always look prospectively.

Senator XENOPHON—Thank you for that, but are you saying that prospectively you could not foresee that there would be a shake-up in the global financial markets as a result of the GFC?

Mr Samuel—No. You are taking me back to August 2008, the time of that decision?

Senator XENOPHON—Yes.

Mr Samuel—I would say two things. This goes back to the answer I gave to Senator Bushby. The first is that I do not think anyone could have forecast even in August—in fact it was earlier than August because I think our decision was made a bit earlier, maybe in June or July—the collapse of Lehman Brothers and the cataclysmic shake-up in the financial system that occurred as a result of that and other factors that played on from that through the global financial crisis. If there were, there would be a lot of wealthy people today who might have shorted some stock in a whole range of financial institutions. I think that looking prospectively forward no-one would have expected what happened with the global financial crisis. But you then have to ask yourself, 'Would it have made a difference to our decision in respect of St George and Westpac?' I went through a fairly elaborate answer on that to Senator Bushby which I am happy to repeat.

Senator XENOPHON—No, I heard your answer to that. But is it fair to say that the St George-Westpac merger was allowed on the reasoning that you have set out and that if anyone could have foreseen what occurred in the GFC you would not have allowed the merger but it was just one of those things that was such an outlying possibility that it was not considered?

Mr Samuel—I do not think either our statement of issues or indeed even the public competition assessment predicted that there would be a cataclysmic upheaval in the world's financial system. It might have shaken a few people if we had forecast that. But I do not think that anyone could have reasonably expected that to have been part of our considerations, and it certainly was not.

Senator XENOPHON—Let us go to your statement of issues. At paragraph 27 the ACCC's statement of issues stated:

Some participants claimed that St George is a strong competitor on price for certain retail banking products. However, the ACCC has not seen evidence to suggest that St George is a price leader in any of the relevant markets.

Mr Samuel—Correct.

Senator XENOPHON—Is whether you are a price leader or not necessarily a determining factor, because in the absence of being a price leader you may still have a significant role in providing competition in the marketplace?

Mr Samuel—Yes, but I think you have taken one part of a total consideration—

Senator XENOPHON—But I have not taken it out of context.

Mr Samuel—No, you have not taken out of context, and you are absolutely right because if you go on to paragraph 28 we also then went on to say:

Many participants also noted the strong customer service ethos of St George. This is also borne out by market research data …

Then we go on and we cover various estimates.

Senator XENOPHON—And I was going to get to that.

Mr Samuel—But we then went on to say that, in our view, as to the lack of price leadership—notwithstanding the service factors that are referred to in paragraph 28—we did not consider the competition concerns were likely to arise in any of the retail banking markets. And then, as I responded, the submissions we received on that did not provide any substantive evidence to negate that particular proposition. That is the purpose of an SOI: to see whether—

Senator XENOPHON—Sure. Can I just go to paragraph 28, to which you have just referred. Gail Kelly, when she gave evidence before this committee last Friday, waxed lyrical about the customer ethos of St George and how warm and friendly it was and how terrific it was—I am not sure if that was a contrast with Westpac or not!

Mr Samuel—I thought she would not make any contradictory comments about either Westpac or St George, but that is fine.

Senator XENOPHON—I think the record should show that Mr Cassidy is laughing, and he is not alone. But in terms of customer ethos, wouldn't that—the fact that St George was so out there in terms of having such a good reputation for customer service—be a factor militating against it being the subject of a takeover by one of the big four?

Mr Samuel—Absolutely, but that is the reference in paragraph 28 of the SOI which moves away from price and talks about the customer service ethos.

Senator XENOPHON—Yes, but I am saying: the ACCC has correctly picked up on that point, about St George's customer service and its reputation. Wouldn't that be a factor to go against approving a merger—because you have correctly highlighted that issue?

Mr Samuel—Yes, I am sorry. I have not made myself clear. Paragraphs 27 and 28 focus on price and service factors which impact on competition. Those are the factors that we would take into account and, as you have indicated, would militate against approving a merger in that area. However, we went on, in paragraph 29, to say:

The ACCC considers that competition concerns are unlikely to arise in any of the retail banking markets. There are a number of alternative competitors in each of the markets and St George, while competitive in terms of price and customer service, does not appear to be unique or a market leader in either attribute.

We then went on, in 30, to say:

The ACCC will accept additional comments or evidence from market participants regarding St George's role in driving competition in these markets. The ACCC will further consider these product markets if it decides that such an assessment is warranted.

Senator XENOPHON—That is my very point, though: you do not need to be a price leader; you do not need to be unique in the market to actually make a difference in the marketplace in providing that additional level of competition.

Mr Samuel—But you have got to make a substantial competitive difference or, to put it more accurately, the merger has got to lead to a substantial lessening of competition in the market for section 50 of the act to be able to apply and for us to be able to proceed to the court for an injunction. Our conclusion was that the merger would not be likely to lead to a substantial lessening of competition in that market, and that is further outlined in the public competition assessment over a period—

Senator XENOPHON—Do you think that section 50 in its current form, with that test, is a test that has served consumers well over the years?

Mr Samuel—It has been through various iterations over the 30-odd year history of the Trade Practices Act and now the Competition and Consumer Act with movements from concepts of dominance in the market to substantial lessening of competition. I might ask Dr Walker to comment on this, but it would be a rare circumstance indeed where we would wring our hands in frustration and despair and say, 'If only the law was different we would stop this merger because we do not think it is good in terms of preserving the competitive tension in our market.' But you might want to comment, Dr Walker.

Dr Walker—If you were to lower the test, then you would risk chilling mergers which would promote efficiency—promote an efficient market for corporate control. So there is a balancing exercise. You cannot just ban all mergers.

Senator XENOPHON—Sure. But Gail Kelly would not concede—and I understand why she did not—that there was any less robust competition in the marketplace as a result of the merger of St George and Westpac. Do you consider that the logical extension of that merger being approved is that there is somewhat less robust competition in the marketplace? It could be workable competition, as the ACCC describes it, but, in terms of the level of robustness of competition, we have lost something there. You are not going to get St George putting out ads saying, 'Leave Westpac and come to us,' are you?

Mr Samuel—But that is the case in any merger, Senator. If you take a competitor out of the market and merge it into another competitor, there will always be an impact on competition. The problem is this—and let me just take the words 'likely to have the effect of substantially lessening competition in a market'. Delete the word 'substantially', so it becomes 'likely to have the effect of lessening competition in a market': you would not just have a chilling impact, you would almost make the economy, in the context of rationalisation and consolidation, unworkable. And I might say that these have been considered many, many times by many experts in the area. Would you change 'substantially'—

Senator XENOPHON—Sorry, that was not quite my question. Would you agree that the level of competition in the marketplace is less robust than it was, as a result of the merger of St George and Westpac?

Mr Cassidy—Substantially less robust, Senator? No.

Senator XENOPHON—I am not asking that.

Mr Samuel—But that is important.

Mr Cassidy—That is the test we apply. You are asking us to assess something which we have never looked at. What we looked at was whether there would be a substantial lessening of competition, and the conclusion we reached at the time, which is what is important, is that there would not be. If you want to grade that down and say, 'Well, not substantial, but has there been some lessening of competition?' you start to get into an area where we did not make that assessment, because that is not the assessment we are required to make. If you bring it right down, any merger would probably reduce competition to a certain extent.

Mr Samuel—In some area or geographical product area of the market.

Mr Cassidy—Yes. It is almost inevitable.

Mr Samuel—So what is in between, Senator? Some have suggested that 'substantial' ought to be changed with the word 'material'. There is some legal opinion that says there is very little difference between the two. Maybe 'significant'. Is there a legal difference between significant and substantial and material? Not insignificant? Insignificant? We are getting into a whole range of different expressions. I have to say to you that over recent years in a different context we have examined these issues. I go back to the comment I made before: I do not think that I can recall a case where the commission has considered a merger and has wrung its hands in despair or frustration and said, 'If only the act were drafted differently we'd have stopped this merger because we don't think it's good.'

Senator XENOPHON—But look at the Herfindahl-Hirschman concentration index, as Professor Sathye did in his evidence to this committee. He says that we are at a very high level of concentration, particularly in terms of the home loan market, compared to other countries. You are familiar with the HH Index, obviously.

Mr Samuel—Yes, of course. I am not sure if we have got the HHI impact on St George-Westpac.

Senator XENOPHON—I just want to move on—

Mr Samuel—But I think that is important. You have raised the HHI. Have we got it here?

Mr Greiss—It is 1,500 for most of the retail banking market at the time.

Mr Samuel—That is important.

Senator XENOPHON—Perhaps you can take that on notice.

Mr Samuel—But I think it is worth just commenting because you have raised it.

Mr Cassidy—We will take it on notice because we need to do perhaps the international comparison. The HHIs in different product markets after the merger were all below 1,500. The

guidance figure we use, which is the same guidance figure that is used in North America, is 2,000. So the HHIs were relatively low in each of the product markets even after the merger. But let us take it on notice and we will give you a full answer on that.

Senator XENOPHON—That is fine. In the limited time available, can I just move on to an article by Richard Gluyas in the *Australian* on 18 October, 2010. I think you are familiar with Richard Gluyas. We are all familiar with Mr Gluyas and his articles on banking and other issues. On the merger question, the article led with the line ‘Never say never’. Mr Gluyas suggested that the door was ‘left ajar’ to any further mergers. He referred to you addressing commentary that the NAB-Axa ruling meant that there would not be any more bank mergers and that you protested in the third person saying, ‘Samuel did not actually say that.’ Are you saying there is a door open for further takeover of regional banks in this country, given the current parameters of section 50?

Mr Samuel—I remember the article and the discussion I had with Mr Gluyas. It is an accurate report. The difficulty is this: that in this area there is a tendency for commentators—I am not talking about Mr Gluyas in this case—to take what are carefully considered and carefully prepared comments and take them to the extreme. For example—

Senator XENOPHON—Welcome to our world!

Mr Samuel—Yes, I know, and that is why I am being careful about putting this in the correct form, which I think I did when I was commenting in relation to Senator Bushby’s question before. If I comment that we will subject any future mergers to a rigorous analysis and that we would be cautious or conservative, I have seen that taken to the extreme of saying, ‘Samuel says there will be no more mergers.’ That is not what I have said. What I have said very carefully is that they would be subjected to a rigorous analysis and, in the context of the difficulty of forecasting into the foreseeable future the likely impact, there would be a cautious and conservative approach. So, just to round this off, Mr Gluyas is absolutely accurate in what he has written, which is that what I have said is that I cannot say—certainly I cannot say as an individual; it is the whole commission that deals with this—that there will never be another merger. What I can say to you is they will be subject to a rigorous analysis with a very cautious and conservative approach being adopted.

Senator XENOPHON—And my question to you is given your comments and a number of comments to the *Financial Review* in April 2009 and to the ABC’s *Inside Business* program on 6 December 2009 that the bar will be higher given the context of the GFC and the shake-up in world financial markets.

Mr Samuel—Actually the bar will be lower, I think.

Senator XENOPHON—In the sense there will be more—

Mr Samuel—It depends whether you are trying to stop—

Senator XENOPHON—That is right. It will be more difficult to have a merger given what has occurred as a result. Given the statements you have made, given what has occurred in terms

of global financial markets, does that mean that section 50 will be interpreted more strictly in a sense in the context of any mergers?

Mr Samuel—No, you cannot interpret it more strictly because we do not interpret it. It is the Federal Court that does the interpretation. What we can do is say that we—I want to go back to use the words I have used, carefully chosen—will be adopting a more cautious and conservative approach. But, as Senator Bushby pointed out in the questions he put to me, we ultimately have to apply those tests and the tests of section 50 in the Federal Court. That means that we would have to seek an injunction and have to be able to demonstrate that there was a real chance—I use 'real chance' in terms of Justice French and AGL—that a merger would lead to a substantial lessening of competition in the market. But I have to say to you that it is rare indeed that we are challenged in the view that we take. Therefore I think that we would be taking a cautious and conservative view. There are, as Dr Walker pointed out before, elements of looking at the factual—that is, the proposed merger before you—and then looking at the counterfactuals or the alternative scenarios that may be in existence.

Senator XENOPHON—But in the context in which section 50 would need to be considered by the ACCC and indeed by the Federal Court if it came to that, you would need to consider what has occurred in the last two years in world financial markets.

Mr Samuel—Absolutely.

Senator XENOPHON—Can I go on to another matter. It would be remiss of me not to raise this. Mr Gluyas has also written a number of other articles in relation to your involvement with DFO.

Mr Samuel—Yes, I am aware of that.

Senator XENOPHON—I have raised this with you and I raise it respectfully. There is an ongoing dispute, as I understand it, in terms of indemnities. Do you understand that there is a perception in some quarters that because there is an ongoing dispute that involves significant amounts of money, that involves the banking sector, that it could complicate your role, and how do you deal with those perceptions?

Mr Samuel—I am not sure whether it means that I would be tougher in seeking retribution for harsh treatment by the banks or adopting a softer approach with a hope and a prayer. I have to say to you that I do not think that either applies. The very transparency of the way that we operate and of my fundamental ethos of putting the public interest to the forefront is well recognised. I might equally say that, while it is interesting that my own financial affairs are a matter of apparent interest—certainly to Mr Gluyas and the parties that provide him with information—I have not taken the steps of making inquiries of Dr Walker or any of my fellow commissioners as to whether they are having difficulties getting loans for their houses or whether they are having difficulties with their current mortgages, with mortgage interest rates rising. I am not sure what Mr Cassidy's position is or that of Mr Greiss or Mr Bezzi or others, but I am very happy to ask them all to see whether they are having any difficulties at all and whether that would tend to have them becoming either more difficult or easy or—

Senator XENOPHON—So you are saying that because there is transparency you do not have a concern. Finally, Professor Zumbo has suggested that the ACCC be required to monitor formally the four big banks. Do you see merit in that proposal?

Mr Cassidy—As I was saying earlier, that is something the government could ask us to do. It is really a matter for the government.

Mr Samuel—But I think it is worth making an observation that monitoring is a process of examining relevant facts, putting them into a report and then publishing the report. I am not sure what Associate Professor Zumbo was contemplating, but there is a real question as to whether monitoring has any significant impact other than on a once a year basis or whatever the case might be. Having the publication of a report produces certain facts and information that might be relevant to some people but in the end it is not as valuable as having the transparency of the banking market as we currently have it.

Senator RYAN—I want to return briefly to a couple of issues that have not been covered with respect to price signalling. The example you mentioned, and correct me if I am misquoting you, was if a bank says, ‘If the RBA raises its rate by 25 basis points next week, we are going to go up 40.’ That is the upward side. If, for example, a bank came out and said, ‘Well, if the RBA goes up by 25, we are going to try and hold it down, we are trying to go for 15.’ Do you have a view about that sort of scenario with respect to price signalling?

Mr Cassidy—That can be just as deleterious to consumers. It may be in a context where several of the banks are worrying about market shares and contemplating not increasing their interest rates by as much as the Reserve Bank. Again that could be an attempt by that particular bank to, if you like, limit the extent to which their competitors hold their rates down. So it can work on the down that way just as much as on the up.

Senator RYAN—I appreciate that. That takes me to the point I was going to raise, which is a test for impact upon the consumer. You mentioned earlier that with price signalling the market is interested in the explanation after the fact. The RBA does not put out its minutes on the day it puts out the decision, they come quite a bit of time later. There are examples in other parts of the economy like the catalogues we get in our mailboxes from Harvey Norman and Coles where I would argue you can put up the case they have some consumer benefit because they bring awareness to the consumer. I delivered those as a kid at various points. It does create a bit of competition. You notice there are more of them around Christmas, for example. What I am saying is that it is not always when the announcement is made that is the issue. Isn’t the issue here a potential test upon the impact on competition, one of which is whether consumers end up paying more than they otherwise would?

Mr Samuel—Yes, and of course legislation that is being proposed by the government in the context of the public information that you are talking about has a purpose competition test.

Senator RYAN—As the opposition wanted before it. I have a couple of minutes left. The forecasting issue you mentioned might mean that the banks’ forecasts of their own interest rates might not be as robust. Bank forecasting under a law like this might not have forecasts of their own interest rates.

Mr Samuel—You have to ask what the value is to consumers of a bank forecasting what its interest rates might be next week, as distinct from explaining after they have shifted their interest rates why they have shifted them.

Senator RYAN—Or next month or next year, I suppose. But the point is that other people will still be forecasting, and doesn't that produce potentially an enforcement issue when somebody I know who works at a bank speaks to someone he goes to uni with who is a reporter and that person is inadvertently releasing some information. Isn't there a risk here about trying to chase too many rabbits down too many holes? You would have to go after whether banks used third parties to leak information or to get a message out to the marketplace: the word on the street is that the CBA—not the verbal CBA, but that CBA is going to raise its interest rates by more than the RBA. Isn't that a risk?

Mr Samuel—I would say two or three things. The first is that there is a limit to the number of rabbit chasers that we have got, so it is unlikely we are going to be chasing too many rabbits down too many holes. The second thing is that you would expect that laws of this nature will make participants in industry, in this case the banking industry, just a bit more cautious about what they do. They would be reflecting upon why they are saying what they are saying and whether it is there to assist consumers, and I mean assist rather than soften up consumers, or whether it is there to assist competitors. Then what we will be dealing with if these laws were passed is some of the more serious cases where you have circumstances as Mr Cassidy described them before in response to Senator Hurley's question and the comments of one banking CEO. He described it as the evil of that particular comment. They are the more egregious type circumstances that we would be pursuing. But I have to say to you, as I think we pointed out, that these laws have been in place in one form or another in the UK and in the European Union and are developing in the United States through court interpretations, the Sherman act, for the many, many years, and the sun still rises.

Mr Cassidy—In terms of the government's bill, that casual sort of disclosure simply would not be covered. If an intermediary is involved, we would have to be able to show that the competitor was deliberately using an intermediary in order to communicate information to another competitor.

Senator RYAN—I appreciate that, but one of the benefits of the Australian approach has been there is much greater certainty about the law, unlike in the United States, where they do have interpretations. The broad drafting of the Sherman act can mean that you can inadvertently fall foul of a law that was very broadly drafted, by this court interpretation that Mr Samuel mentioned, whereas we do it legislatively, which tends to give a high degree of certainty of not breaking the law, if uncertainty about what you can enforce.

Mr Cassidy—That is true. Without wanting to delay, I think one of the issues with US antitrust law generally is that it goes back a long way, it is very brief and a lot of it revolves around court interpretation. One of the advantages, if I can put it this way, of Australian antitrust law generally is that it is articulated law and it is a lot clearer. I think that is relevant to this discussion because there are some who suggest that all this can be just done easily just by saying something like 'concerted practices are unlawful' and having a law definition of 'concerted practices'. The problem with that is that you could end up in a worse situation—

Senator RYAN—Lawyers will make a lot of money going to courts.

Mr Cassidy—where a lot is then left to judicial interpretation as to what the law actually means.

Senator RYAN—Thank you.

Senator McGAURAN—I turn to you, ladies and gentlemen at the table, as the watchdogs of competition, to help this committee define and understand competition, one of the core issues of the committee, I suspect. The four bank chiefs have come before us with their own interpretation of what competition is. In fact, they have got a mantra going, each one of them, that there is a trade-off between competition and stability. They believe that too much competition leads to instability. We can point to the *Hansard* where each one has said that. But I really think you should read what the CEO of the Bankers Association, Mr Steven Munchenberg, has written. Five times he riddles an article in the *Australian* with that very point, that there is an inverse relationship and too much competition means instability. He just riddles it through his article. I will just read some of it:

… one conclusion from the crisis—

that is the GFC, the global financial crisis—

is that too much competition can undermine stability …

He also says:

The US and Europe have paid a high price for instability in their financial systems and, in part, that instability is the result of excess competition.

He even says that Europe now is addressing that and that Australia is taking stability for granted—too much competition. That is the banks' mantra and understanding of competition and what they are trying to get across to this committee. My question to you is, quite simply, was the GFC a product of too much competition or, more so, mismanagement and lack of regulation? Secondly, isn't competition a driver of efficiencies in the economy? Too much is not necessarily a bad thing.

Mr Samuel—Yes and yes. The answer of yes to the first question is inaccurate, because you had two alternatives in that first question, or proposition. I have heard this mantra being put before, that we need less competition and more stability and stability is good et cetera. The inevitable corollary of that is that a monopoly is the most stable.

Senator McGAURAN—Yes, orderly marketing.

Mr Samuel—That is right. I had a public debate with the former Governor of the Reserve Bank Ian Macfarlane, who now is a banker with the ANZ Bank, on this very issue. He argued that it was lack of competition for corporate control flowing from the four pillars policy that led to less competition in the banking market, which led to our not suffering the impact of the GFC.

With the greatest of respect to Mr Macfarlane—for whom I have the highest respect—and to the bank CEOs, I do not think that it is up to us to be regulating levels of competition, saying, ‘We ought to have competition to this level; that will be stable. If we adjust the volume knob just slightly to get more competition, that could be less stable. But if we turn down the volume knob a little bit in competition, we will have a more stable environment.’ You deal with stability by appropriate regulation. That is the role of the Reserve Bank and APRA. It is a great credit to them, and to ASIC, in terms of the three peaks that were involved, that we avoided the GFC because they applied tough prudential regulations, particularly following the restructuring of APRA as a consequence of the HIH collapse. I attended the Competition Committee of the OECD in February last year and Ross Jones, Deputy Chairman of APRA, made a presentation to the Competition Committee of the OECD, which was discussing the whole issue of competition in the banking and finance sector. Ross Jones’s presentation was applauded by members of the Competition Committee of the OECD who were present there as demonstrating what a very effective, thorough and rigorous prudential regulatory environment can do to preserve stability. But I doubt that APRA, the Reserve Bank or ASIC would say that what they tried to do was adjust the volume knob in terms of competition. They focused on the prudential requirements. It is the prudential requirements that bring about stability, not the adjusting up or down of the competition level.

Senator McGAURAN—So the bank mantra is rubbish?

Mr Samuel—I will leave you to have that discussion. I have given my answer.

Mr Cassidy—The debate about making domestic shipping more competitive is a mantra that has been around for a number of years. The argument there was: we have more competition, we are going to have more rust buckets going around the coast and we will have more prudential safety type issues.

Senator McGAURAN—Bring back the Wheat Board full floor price!

Mr Cassidy—Yes. The bank argument is just a version of that, dressed up appropriately for the financial sector.

Senator McGAURAN—One last question: if you are seeking the full gambit of the law between price colluding, a tough ‘catch you’ law, and, way over here, price signalling, which is, ‘Be careful what you say,’ why are you not seeking the full gambit with regard to antitrust laws and why are you not asking the parliament for tougher antitrust laws along American lines?

Mr Cassidy—We have and we got it.

Senator McGAURAN—You have already got it?

Senator XENOPHON—Not divestiture.

Mr Cassidy—Not divestiture in the form as it exists in the US; that is true. Divestiture is not a remedy in relation to cartel conduct in the US. It is a remedy for monopolisation. But you are right: we do not have that sort of divestiture power.

CHAIR—Thank you to Mr Samuel and the other officers from the ACCC.

Proceedings suspended from 12.13 pm to 13.04 pm

DAVIDSON, Professor Sinclair, Private capacity

DAVIS, Professor Kevin Thomas, Private capacity

VALENTINE, Professor Thomas, Private capacity

CHAIR—Welcome this afternoon to Professor Davis, Professor Davidson and Professor Valentine. Thank you for assisting us with the inquiry.

Prof. Davis—Thank you very much, Chair. I decided, given the breadth of the enquiry, to focus solely on one topic in the submission, and that was the issue of mortgages. In the submission I made six recommendations. One of them is actually a general recommendation—that there is a need for much more public data. When one tries to look at bank competition, it is very hard to find adequate data. Even though banks submit a lot of information to APRA, not very much of it is released into the public domain.

Turning to mortgages specifically, my first major point was that our common mortgage is very unusual by world standards. Australian mortgages are traditionally and typically set at an interest rate which is variable at the lender's discretion. That is very unusual internationally, and I believe it is also undesirable from a risk-sharing perspective in terms of who is better able to bear the risk of changes in banks' funding costs and in terms of the availability of information. So, one of my recommendations is that we should move away from that particular structure for mortgages.

My third recommendation is that we should replace those sorts of mortgages with a structure where the interest rate that is charged is set in the contract as linked to some particular observable indicator rate—or it could be fixed for a particular period. Essentially, we would have mortgages that were variable or adjustable, but they adjust automatically, every month or quarter, in line with some market indicator rate. That indicator rate would not be the cash rate, which a lot of the political debate is about at the moment, but something like a bank-bill swap rate which the banks can utilise for their risk management purposes. You might also have a situation where the loan interest rate could be adjusted in response to pre-designated, observable changes in the borrower's characteristics, much as you have with business loans, where certain covenants apply.

A consequence of that change would be, firstly, that the margin on new loans over the indicator rate could be different to that on old loans. Secondly, if a bank's funding costs change—for example, if it got downgraded from a AAA or AA to a BBB rating and its funding costs went up—then it would not be able to change the interest rate on its existing loans but it would certainly change the interest rate it was charging on new loans. I think that would change the nature of competition in the market for new loans.

It would also have implications for bank risk management. The current structure of our loan setting for interest rates effectively gives the banks an easy ride in terms of risk management. If interest rates change, they pass on the interest rate change to existing borrowers. I think that those changes would be advantageous. They would also take the setting of interest rates outside of the political domain in the sense that, once a borrower had taken out a contract for a loan,

their loan rate would adjust automatically and all of the changes in the bank's funding costs, over and above changes in that basic indicator rate, would be reflected in the competition for new loans.

The fourth recommendation I make in the submission is to allow zero-cost mortgage transfers at the reset dates of mortgages. A loan that is entered into might be a 25-year loan but it might have a reset date after five years, when the costing could be revisited. My argument is that we should allow a zero-cost transfer of mortgages. In other words, borrowers would not have to pay out their mortgage and take out a new one with a different lender; they can simply transfer it automatically to another lender—and I believe that was one of the changes recommended by the government at the end of last year.

My fifth recommendation was that we should prohibit exit fees after the reset date. You obviously need to have exit fees where there are fixed-rate loans for a particular period and someone wants to pay out the loan prior to the end of that period.

My final recommendation was that, rather than having deferred establishment fees built into the loan arrangements and maybe charged when an individual pays out their loan, deferred establishment fees should be made explicit by being added to the loan principal. In other words, if a bank has particular establishment fees but does not want to charge the borrower upfront, then they should be added to the loan principal. At the moment what happens is that fees are implicitly added in, in the sense that if you leave early you are charged an amount, so the bank is making an implicit loan to the borrower where that loan gets paid out conditionally if the borrower leaves early. My view is: why not simply make those deferred establishment fees explicit? In other words, if the bank has a $1,000 upfront fee and does not want to charge the borrower that amount of cash upfront, they should simply add the $1,000 to the loan principal and it will be paid off over the life of the loan or it will be paid off automatically as part of the paying out of the loan prior to that.

All of these recommendations for changes have implications for securitisation and interest rate volatility and they also have some macroeconomic effects. They also have implications for prudential regulations. I think those are all matters that can be fairly easily taken into account. They were the recommendations I had in the submission. I am happy to talk about other issues regarding bank competition, but that was the basis of my submission.

CHAIR—Thank you, Professor Davis.

Prof. Davidson—Good afternoon. Thank you very much for inviting me to speak and allowing me to make a submission. Overall, my view on the Australian banking system is that the Australian system is robust, stable and profitable. This is a good situation to be in and is certainly much better than the alternatives, which we have observed around the world in recent times.

My paper basically gives a broad overview of some regulatory issues, some banking issues and some things which government can or could not do. But I want to jump to my overall recommendations and make five points. The Australian banking system does not, generally speaking, have monopoly power. The banks are not monopolies and should not be treated as such. To the extent that we have consumer protection legislation, the same legislation should

apply to banks as applies to all other organisations. There is nothing special that we should add there.

The banking system itself and the business of banking are remarkably complex and extraordinarily risky. I am not convinced that it is wise that government officials, regulators and politicians should be consistently and persistently second-guessing decisions that are made in the banking system. Profitability in and off itself is not a measure of a monopoly. An unprofitable banking system would be very deleterious to the Australian economy. The government should concentrate on establishing conditions under which the private sector can seek out and earn profits through meeting the needs of the Australian community—something which the banking system does quite well.

Policy makers and regulators should adopt an evidence based system to regulation and not the kind of knee-jerk, ad hoc approach that we have seen recently. Banking systems, generally speaking, are not subject to pure panic attacks, which is the common perception. We should not regulate as if that were the common perception. Insolvent banks should be allowed to fail, and illiquid banks should be subject to the Bagehot rule, which is to lend at a steep rate to good collateral.

Finally, I do not believe that the Australian government should seek to own a bank either outright or through the post office, nor should it seek to set prices in any of the banks, and that includes the Reserve Bank. Those are basically my recommendations. Thank you.

CHAIR—Thank you, Professor Davidson.

Prof. Valentine—I will take a little longer than my colleagues. In my submission, I argue that the most recent outbreak of bank bashing had little justification. It is not unusual that somebody as old as I am can remember quite a few similar periods; but in this situation the media and politicians, from both parties I might say, have adopted the approach of the Queen of Hearts in *Alice*—first the verdict, then the trial. In other words, there is no proof to justify the abuse which has been heaped on the heads of bankers. I have said on a number of occasions in a light-hearted way that there seems to be an argument for antivilification laws to protect bankers. Now I say that is 'light-hearted' because in fact I do not support antivilification laws in any context; but, as a group, they have taken a hell of a battering compared to some other groups that we feel we should protect.

We need to recognise that the financial services industry is the backbone of the economy. It allows transactions to be carried out and funds to be allocated efficiently. If it is undermined by unwarranted criticism—that is, criticism not backed by evidence—or hampered by unnecessary and niggling regulation, economic growth and employment will be reduced. Mr Chairman, in the 1980s we dismantled a system of regulation of banking and finance in general because it did not have the desired effects and because it had effects that were not intended. It would be very foolish of us now—now that there is a new generation that forgets the regulation of the seventies and early eighties—to introduce a completely new system of regulation to hamper the efficiency of the banks. But my main point is that nobody has proved that the banks have misbehaved in any way that requires punishment or revenge—words I have heard trotted out over the past three or four months.

Let us look briefly the allegations that have been made against banks. The first is that bank interest rates are not tied to the RBA cash rate. I do not need to say that much more about that to this committee, because I think that by now you have had sufficient evidence to show that it need not be. There is no reason the banks should follow the Reserve Bank cash rate, and in fact on this particular claim the Reserve Bank has cleared the banks. I think we should pay attention to the Reserve Bank in that respect.

Second, it is suggested that there is a lack of competition in banking because there are only four banks. But an industry with four participants—or, for that matter, 10 or two participants—can be either a tightly organised cartel gouging customers or highly competitive; the number of participants in the industry is not the important thing. We have known since the discussion of the early 1980s with respect to competition in the US that the level of competitiveness depends partly on the ease of entry to the industry, which is known in economics jargon as 'contestability'. Therefore, saying, 'There are four banks—it can't be competitive,' is not very sensible at all. The best test of competitiveness, as Sinclair has indicated, it is to look at the outcomes—that is, are the banks making an excessive profit? If they are not making an excessive profit, it is very hard to argue that they are uncompetitive.

The fact that banks make large profits is another charge made against them, but the question is, 'Are these what are called "super profits"?' This term was introduced in the discussion of the resources rental tax. Super profits are profits above those necessary to keep the shareholders happy. Economists also call super profits 'rent'. Unfortunately, too many commentators assume that any profits at all are super profits and should be taxed away, taken away or regulated away. We can look at this proposition by using the capital asset pricing mode, a well-developed methodology to consider the rate of return earned by banks. The capital asset pricing model is a standard methodology for testing whether excess profits have been made or not. If you apply that approach to banks, there is little evidence that they have made excess returns. This is indeed the conclusion that normally comes out of such studies. For example, the Martin committee, chaired by Steve Martin, the Labor member of parliament, came to the same conclusion some time ago.

Senator McGAURAN—Twenty years.

Prof. Valentine—Yes, but one of the things about this sort of analysis is that one can go back and do it for any period one likes, and nobody I have seen has presented evidence of excess returns over any reasonable period of time. If it appears that banks are earning a competitive return, there is no reason to load them with additional regulations which will simply reduce their flexibility and efficiency. In general, any such regulations will be borne by the consumers in one way or another, though we have no way of determining in what way. That is one of the things about unintended consequences—they are normally unintended—but, if the banks are earning a competitive return, it has to come out on the consumers somewhere. In the paper I will give you I had two examples of this, but a third has appeared in the *Australian Financial Review* this morning.

Removing exit fees will have unintended consequences depending on how the banks try to recoup the lost fees, but let us suppose that they impose an upfront fee instead of an exit fee or, alternatively, spread the costs over the life of the loan, which I think most consumers would prefer. That would actually make switching more difficult, because every time somebody switched their mortgage they would have to pay a new upfront fee. I think it is important in

terms of switching to distinguish between switching a deposit account, which is not that difficult, and switching a mortgage, which has all sorts of problems attached to it.

I have commented in my paper on restrictions on signalling. I think the whole discussion is ridiculous. The banks know what each other's costs of funds are. They know what they are going to charge, roughly, and I do not see why we should stop consumers getting important information which might be useful to them in deciding, for example, what size mortgage they should be applying for. Let's face it: the Reserve Bank was able to predict what was going to happen to the banks' cost of funds and therefore to the charges. It expected that they would put up their rates by more than the increase the bank made in the cash rate. Consequently, we would not be surprised if the other banks had that sort of information.

In the *Australian Financial Review* today—I do not know if you saw the article—was a suggestion that we should try to tap into superannuation funds in order to obtain more and cheaper funding for banking. I feel that would be undesirable unless it happens as part of the private system, because, if you look at the figures released by APRA, superannuation funds through the last 10 years have made a deplorable return, and to compel them to hold low-yielding assets so people can have low-yielding mortgages would mean that they would make an even lower return. That is not a particularly desirable result. However, if, for example, it was decided to allow banks to issue covered bonds, it may be that superannuation funds of their own volition would judge them to be a good investment and funding would be obtained in that way.

Having said what I do not think should happen, let me tell you what I think should happen. First of all, I think there should be a regular review of bank returns by one of the RBA, APRA or the ACCC. If it is found that those bank returns are in excess of a competitive level, that question should then be taken up by the ACCC—rather than producing bank bashing—to discover why that situation has arisen. In that situation I think the ACCC would look to barriers to entry to banking, because if the banks are making an excessive profit it is to be expected that other banks would enter the system—maybe overseas banks, in those situations. I say this review should be regular. That does not mean every quarter. As you suggested, something may have happened back in the year 2005. But such a review could cover the whole period since the previous review—and it is desirable that it should because there are short-term year-to-year variations which may not really prove anything at all. So you would probably want to do it over a reasonable period.

I also recommend, and have done ever since I worked with the Campbell committee in the early eighties, that there be regular and independent inquiries into the financial services industry. We had an understanding then, which was continued into the Wallis committee, that there would be a review every 10 years. It is now 14 years since the Wallis committee. Consequently, I think it is probably time for another such review. You could suggest what sorts of issues such a review should take up; Kevin has already given some suggestions with respect to mortgages. I think it could look at the credit card issue. It appears to me that there are still restrictions on entry to that part of the payment system—that is, it is not entirely contestable, interest rates seem to be very high and there is an additional problem of credit card debt that many of the social services organisations are worried about. That is one issue that I think could be put up for discussion.

Another issue, which I think we need to resolve very quickly, is this question of the guarantee of deposits and the idea of a bank being too big to fail. The reality of the situation is that most of

us have regarded deposits as being guaranteed since the year dot. There was an implicit guarantee which caused a great deal of concern. During the GFC the government—I think wisely—guaranteed deposits explicitly and charged a fee for doing so. That may be a model that one can follow, but I think we do need to resolve this particular question. It is related to the question of covered bonds, because the regulator's concern with covered bonds is that they remove some of the money available to help depositors and they are not happy with that situation. But, once the question of a guarantee is resolved, that might resolve that question as well. So I think that particular question—on which there does not seem to be a lot of agreement—would certainly be worth a new committee thoroughly investigating it.

CHAIR—Thank you, Professor Valentine. Since you are the last to be speaking, I might start with some questions for you. Please feel free to interrupt and also add your views on what I am talking about and asking about.

Prof. Valentine—You should not be encouraging me!

CHAIR—In general, Treasury said in their red book—the advice to the then incoming government in August of last year—that the banking industry is oligopolistic in nature. Is that something that you would agree with?

Prof. Valentine—That simply means there are relatively few competitors.

CHAIR—Yes. Does that in itself present a problem or potential for a problem?

Prof. Valentine—No. I come back to the point I made earlier that if, in fact, those four main banks—there are quite a lot of other competitors in that industry as well—are not making a profit in excess of a normal level then we have to assume the industry is basically competitive. The current theory in economics—current since the early 1980s—would suggest that that is because there is potential competition out there and if the banks did decide to get together over lunch, fix rates and all that type of thing then that potential competition would enter the system. That potential competition would possibly be a very large international bank, for example. In fact, several of them are here. They would simply need to expand their activities in that case.

CHAIR—What barriers would exist to such an institution stepping up to become a major competitor to the four trading banks?

Prof. Valentine—I know of none, which is why I would argue that so far there is no evidence that the banks have behaved in an anticompetitive fashion.

Prof. Davis—I think there was one in the case of retail deposit markets. Basically, foreign banks that come into Australia as branches are not allowed to compete for retail deposits of an initial balance below $250,000.

Prof. Valentine—There are several foreign banks that—

Prof. Davis—Their subsidiaries are able to, but there is a preference by banks to operate internationally as branches, although I think the regulatory changes that are going on currently

worldwide will mean they will generally have to end up having to operate as subsidiaries so that they have a separate capital base.

Prof. Valentine—I think that is reasonable, but the very fact that they have a preference for the branch suggests that they do not think they will make a lot of money out of taking on the Australian banks across the board. They are trying to cherry-pick, which is highly desirable. It is the way competition drives down margins, as with the independent mortgage providers back in the nineties: once they entered the mortgage market—cherry-picking, in effect—they drove down the margin on housing loans. It may be worthwhile for branches to do that sort of thing, but I cannot see any impediment at the moment to a large bank entering Australia. Indeed, my understanding is that the four pillars policy does not—or at least under the previous government, the coalition government, did not—restrict the possibility of an overseas bank taking over one of the big four, or for that matter an insurance company. It simply restricted two of the four from getting together.

CHAIR—So you do not see any major impediment.

Prof. Davis—There is one other issue that I think has been raised, which is the withholding tax—

CHAIR—I was going to raise that.

Prof. Davis—on banks borrowing from overseas parents and so on. There is a potential—

CHAIR—Differential tax treatments and other regulatory treatments that might need to be addressed in that case.

Prof. Valentine—Yes. Anything like that, I think, is a valid argument, but that involves removing regulations rather than producing additional regulations.

CHAIR—This goes to behavioural analysis in some sense but, given that during the global financial crisis there were some overseas banks that owned subsidiaries in Australia—BankWest is an example—which were having problems making profits in their home markets when as it turned out, and it may well have been foreseeable at the time, there was an opportunity to make profits in Australia, as our four majors and even smaller banks have continued to do, why wouldn't they stay here and try to make profits here if that is possible in Australia when most other banking markets around the world are very tough?

Prof. Valentine—I think when you get into trouble in any business you have to sell off assets and unfortunately the assets that are saleable are the best ones, not the worst ones.

CHAIR—That was a specific example. Why then aren't other foreign banks at the moment looking at Australia? Is it because the profits are not large enough to justify the expense of coming in even though good profits—maybe not superprofits, under your definition—are being made whereas things are still pretty tough in most of their home markets? Why aren't they looking to Australia now as a place to go to try to supplement their income so that they can improve their bottom line overall?

Prof. Valentine—There are some banks in the rest of the world that are still in a sound position. We should not get too diverted by the US's view of the situation.

CHAIR—We have four of the top 10 now.

Prof. Valentine—There are some banks in the world that are in a fairly good position. I meant to mention in my original discussion that we have to recognise that our banking system performed extremely well during the GFC, to the credit of the management of those banks—who quite possibly learned a lesson from what happened in the early 1990s—and the regulators, who have done a good job as well. Certainly they may have learned the lesson from what happened.

Prof. Davidson—To answer your question directly, the signal for entry into a market is earning supernormal profits. So if banks in Australia are not turning supernormal profits there is no incentive for foreign banks to enter. If foreign banks are not entering into Australia that is because they are not perceiving there to be unusually high profits in Australia. So our banking system is profitable, sure, but it is not what economists might call a supernormal profit.

CHAIR—That worries me to some extent. If, as we have seen over the last two years—it might be slightly changing now, I do not know; we will have to wait and see—there is an increasing concentration in most sectors of the banking industry, particularly amongst the big four, do we have to wait until such time as we end up with a market that is genuinely oligopolistic in nature and character and those banks start earning superprofits

Prof. Valentine—If they do, there should be new entrants.

CHAIR—There would be at that point. I concede that. But there is a period where consumers suffer in between before you get to the point where you have new banks coming in.

Prof. Davis—I think it is also important to recognise the fact that banks are not just banks. Banks cover the whole gamut of the financial sector. So it is not obvious to me that there is not some entry into areas such as investment banking. Certainly in the areas of funds management and so on which our banks are major players in there are certainly lots of overseas institutions wanting to move into Australia for those things. It may well be that there may be no interest in entry into retail banking. Historically it was always thought that overseas banks had no comparative advantage in going into retail banking in foreign countries. I think that has probably changed now with technology and so on. It may very well be that what you are seeing is entry of specialised players into particular parts of the financial sector that the banks operate across.

Prof. Valentine—That is what is called cherry picking. Basically what this means is that if there is an area where the banks are making an excess profit, not overall but in just one area, it is in the interests of people to come in and cherry pick or, as we sometimes call it, hit and run and take advantage of those profits. That is what happened with the independent mortgage providers. I am a little surprised it is not happening with credit cards, which is why I think there may be some impediments to entry to that particular—

CHAIR—We heard some evidence on Friday from Tyro, which is a private payments clearance company. They threw some light on some of those problems, some of which I think the ACCC should take an interest in and we raised that this morning with them.

Prof. Valentine—I was involved with the ACCC in the early part of the century looking at the credit card situation. But, as I understand it, the payments system has now been taken over by the Reserve Bank as part of its responsibility. I am not sure the ACCC is that involved in it.

CHAIR—They are not. The ACCC were not aware, at all, of the issues. I asked the CEO of Tyro Payments on Friday whether he had raised it with the ACCC and he said, 'No, we've been working through the RBA.' They may well be competition issues. I do not know but they might start talking to see—

Prof. Valentine—I would not like to say definitely that there is no freedom of entry but I think the signs are that it would be a question for a new inquiry. I mentioned an independent inquiry. I have this hobby horse that an inquiry run by the federal Treasury is not independent. The Treasury reports to the Treasurer, which is proper, but that means that it is not an independent inquiry.

CHAIR—While we are on that, were the Campbell and Wallis inquiries genuinely independent?

Prof. Valentine—The Campbell inquiry was completely independent. In fact, I can tell you now, many years after the event, there were some rather furious confrontations with the then secretary of the Treasury, John Stone. You might remember that gentleman! He, for example, did not want the committee to recommend a floating exchange rate. The Wallis committee was half and half. It had an independent committee but the secretariat was—

CHAIR—Bureaucrats.

Prof. Valentine—basically a Treasury secretariat. The Martin committee—John will be able to clarify this, I think—was an independent committee.

CHAIR—It was a parliamentary committee.

Senator XENOPHON—Professor Valentine, what would your view be of the Productivity Commission looking at these issues?

Prof. Valentine—I believe the Productivity Commission is one reasonable basis for doing that.

Senator XENOPHON—You would regard them as—

Prof. Valentine—If you are concerned about getting a secretariat—it is not that easy to get together a secretariat because, after all, it is a part-time job for, say, two years—basing it in the Productivity Commission, I think, would be a reasonable—

CHAIR—But with an independent committee.

Senator XENOPHON—Would the commission take the work or would the commission provide the secretariat support for a—

Prof. Valentine—To provide the support rather than the Treasury.

Senator XENOPHON—No, I mean—

Prof. Valentine—Let’s be honest. In any of these studies it is the secretariat that largely writes the report and gives the input to the committee, which leads to the decisions they make. So it is very important to consider how such a committee is to be staffed.

CHAIR—I am conscious of the time. We do not have a lot of time for this and I imagine the other senators are going to ask questions. There are a few things I want to get through. On the competition you talk about super-profits as being the characteristic which suggests that there are competition failures. How many industries, in difficult circumstances like we have faced in the last couple of years, would have the ability to increase their prices to maintain profits at a similar level, or maintain their return on equity, in a truly competitive situation? Would that be another indicator that maybe there is not a truly competitive market?

Prof. Valentine—That they increase—

CHAIR—The banks say that the reason they need to put up their interest rates to the extent they do is that changes in circumstances over the last couple of years have led to increased funding costs and they need to increase their costs to cover those and maintain their profits. They have used all sorts of arguments such as stability and ratings and all sorts of things as to why they need to maintain their profits but the key to my question is the fact that they can choose to maintain their profit levels when other industries do not have the same luxury. In difficult times they have to cut the cloth to suit.

Prof. Davis—In a perfectly competitive industry if input prices go up you expect to see output prices go up by the same amount. Profits would stay at the normal level in a perfectly competitive industry. In banking we have seen a situation where, as we all know, the banks’ funding costs have gone up because of higher borrowing costs in international markets. I think the fact that interest rates have gone up is not an indicator that there is a lack of competition. One might question whether interest rates have gone up by the appropriate amount—whether they have gone up too much—but I do not think one can just point and say—

CHAIR—If they can maintain their return on equity—and use their own figure that they point at—and if they can unilaterally decide to change their prices to maintain their return on equity when other large companies that get assessed on their return on equity have had to wear a loss because of the tough times, does that—

Prof. Valentine—No, let’s be reasonable. The banks’ margin—and the Reserve Bank has published a paper on this—was cut back by the GFC. They have now returned, as the Reserve Bank has said, to the margin they had prior to the GFC. I think that is the history of the majority of Australian companies. Yes, in that period where economic activity slowed down, they did not do that well. But most of them are back to doing quite well.

Senator XENOPHON—Was that largely because the provision for bad debts during the GFC—

Prof. Valentine—No, only partly. It was mainly because of the increase in the cost of raising funding overseas. Overseas banks were very unwilling to lend to any other bank at that stage of the game. Even though our banks were sound, they were a bank and that was that.

Senator XENOPHON—I think the ANZ in their evidence, and I do not want to misquote them, said that the reason their profits jumped was their provision for bad debts has reduced significantly since the previous financial year.

Prof. Valentine—It certainly would have contributed to it. But a whole lot of industries went through a bad time for a while, even the mining industry in 2009. But they have returned to profitability and I do not think this indicates any special competitive power that the banks have and other organisations do not. As Kevin says, it is a natural thing that if your costs go up, you have to raise your price in order to maintain a normal level of profit.

CHAIR—Yes, that is right. I was asking in relation to the normal profits.

Prof. Davis—We have to be very careful about trying to interpret bank accounting profits because bank accounting is a real nightmare to try and work out exactly what is there. You see it when banks make their presentations. Sometimes they will refer to underlying profits or cash profits and all sorts of things. It is a difficult area. Associated with that is that when you look at the banks in Australia, you will see they are conglomerates that operate internationally. So you do not necessarily get any idea about what is happening in terms of the Australian deposit or loan markets in terms of competition by looking at the banks' aggregate because they span all sectors in the financial sector in Australia plus they operate overseas.

In some respects the point I was making about bank interest rates setting on loans is relevant here. When the banks found that their cost of funding went up because of greater credit spreads on wholesale lending, they were able to increase interest rates on existing loans rather than simply those customers not being affected by that because they would be locked into contracts with different margins.

CHAIR—Which means a smaller increase because it is spread across more.

Prof. Davis—Yes, and it would have a greater impact on new housing loans, for example, because the banks would have to price those according to their marginal cost of funding rather than their average cost of funding which they currently do. The way in which our interest rate setting on loans is structured is relevant in terms of who bears the cost of those adjustments at particular points in time. Part of my view is that our current rate setting structure on loans passes too much of the risk of those changes in funding onto existing loan customers.

CHAIR—While we are on that point, are you suggesting that we should regulate to make that a reality or should we educate to point out to people the more attractive aspects of that to people? How would you recommend we approach that?

Prof. Davis—Ideally as an academic, I should say educate, but having taught very bright students for many years my faith in our ability to educate the average on finance is very low. One has to look at history and ask why we have this particular structure for our housing loans. My view is that it goes back to the dim, dark ages of history when interest rates were controlled

by government, and therefore to borrow you never had to bother about what interest rates were. You knew it would be at the ceiling set by the government. We removed that ceiling on housing loan interest rates but we did not ask whether the current institutional structure of loan contracts appropriate for the new environment. Most of the time up until now it has been because all interest rates have tended to move in line. But in the GFC there was a dramatic shift in banks' funding costs.

CHAIR—From what banks have said, I do not think we will see them moving their interest rates anywhere near the cash rate movements from now on. They will be doing it independently. What cost would regulation have on society? Regulating interest rates leads to a rationing of credit. If you start to regulate how banks put their loans together, what impact will that have on the market?

Prof. Valentine—This is what I meant when I said we had this experience up to the early 1980s. They were regulated and if the Reserve Bank, which was the regulator in that situation, got it wrong then that caused difficulties. In fact it did get it wrong from time to time and that is what promoted the growth of the non-bank financial institution group, which was fragmented and to some extent inefficient and was only there because the Reserve Bank had got the interest rate decision wrong. It was even worse in New Zealand where in fact a whole lot of financing went out into the solicitor market—if anything horrifies you then it should be lawyers running the financial sector—

Senator XENOPHON—That is a bit unfair!

Prof. Valentine—light-hearted, Senator—simply because bank interest rates were set at inappropriate levels. So, yes, you can do that, but you would have greater faith in the ability of regulators to get it right than I do. And I just want to comment on what Kevin said. I am a little older than Kevin and I remember a time when every mortgage was a fixed-rate mortgage. The big shift was from the fixed rate to the variable rate. Talking to young people now—I agree with Kevin to some extent that they do not understand a lot about finance—the big decision they have to make is between a variable rate mortgage and a fixed-rate mortgage, and unfortunately they often get it wrong. They go for the fixed-rate mortgage simply because that seems to give them certainty, and as we saw in recent times that left many of them paying a much higher rate than they really needed to pay if they had gone for the variable.

CHAIR—When banks work out fixed rates, the house always wins.

Prof. Davidson—The variable rate mortgage suits Australia very well. It fits in very well with our institutions. It also makes our monetary policy work quite well. What makes me more comfortable about it is that, even though banks can unilaterally increase their prices, as Kevin suggests, the consumer has a choice of variable or fixed and, within that, how much variable and how much fixed they want to have. So it does give people a great deal of flexibility in structuring their lives. Yes, our students are not very good at finance, but nonetheless if we have a look at the history of the past 20 years or so people have more or less gotten things right. I am very comforted by that. I do not think that it is a huge problem.

Prof. Davis—Can I make it quite clear that I am not advocating any regulation of interest rates. What I am advocating is the—

CHAIR—No, I was using that as an example of how government interference can have consequences. I was wondering what consequences would flow by telling banks the structure of the loans that they—

Prof. Davis—The contractual arrangement should be that the bank will change the interest rate on your loan in accordance with movement in some indicator rate, some observable rate. That is what I am advocating in effect, and it is the more common thing that you see overseas.

CHAIR—And would actually allow banks, to some extent I guess, if they are clever with the way they are doing it, to match up their funding costs.

Prof. Davis—Yes.

Prof. Valentine—You would, for example, use the 90-day bank bill rate. The trouble with that is that does not necessarily represent a good indicator of the bank's cost of funds, and in recent times it apparently has not. But another alternative is simply for the Reserve Bank to put out an index of the banks' costs of funds.

Prof. Davis—There are various ways you could do it.

CHAIR—And as I understand it, according to evidence we have received from the big banks, some of their funds are based on the cash rate plus a margin. So it is the other way around in a sense. There are a lot of other questions I could ask, but we really need to move on.

Senator HURLEY—Professor Valentine, I would like to go back to your submission where you talk about the deposit guarantee. You said:

> The only policy question is – what is the appropriate fee? The temptation for politicians to obtain some kind of implicit and ill-defined fee (such as lower lending rates) must be resisted.

I think that is a good point. We had evidence somewhere along the line that only 30 per cent of Australians have mortgages. Whereas clearly it is an important factor and one we must take into account, we should not let it skew discussion totally. Can you elaborate a bit on that? How do you see a fee working and do we need that kind of explicit fee?

Prof. Valentine—My concern is that in my view we have always had a guarantee of bank deposits. All my life I have assumed that a deposit with one of the big banks was essentially governed and guaranteed and if one of those banks got into trouble no Treasurer of any party was going to go on television and say it could go to hell and the depositors could wear it as they should have had better judgment. I think they would bail the depositors out. This was indicated by the fact that the big banks could borrow in the market at a lower rate than other organisations. So now that it has come to the point—that is, we have introduced an explicit guarantee under difficult circumstances—maybe we do need an explicit guarantee but with a fee charged to make up for the fact that bank deposits are guaranteed. Now that fee would come over to the deposits in a competitive banking system. It is not going to be borne by the banks. It would be passed on to the depositors presumably in the form of a lower interest rate on bank deposits. So as a depositor you would have the choice of a bank deposit, one which is guaranteed and has a lower interest rate, or some alternative investment which pays a higher interest rate. I think it might be

better to make all of that explicit. On the other questions related to this—and I think there is a whole lot of work that needs to be done in this area—my view is that if a bank gets into trouble, even if it is one of the big ones, it should be allowed to fail but the depositors should be protected. That is, the management and the staff and the shareholders do not need to be protected, only the depositors. So what we are talking about is not a bank guarantee—and that is not what we had, as I understand it from recent experience—but a deposit guarantee.

Senator HURLEY—So that clarifies it. In effect, you would apply it just to those big four banks and not any of the other banks and they would have the advantage of lower interest.

Prof. Valentine—I think again it is ill developed but I think it would be extended to any organisation that has been designated a bank by APRA.

CHAIR—Bank or ADI?

Prof. Valentine—ADI probably.

Prof. Davis—I think Tom is correct in the sense that the either implicit or explicit guarantee of bank deposits gives banks an advantage over non-bank institutions. That is an issue that I think perhaps does raise concerns about the structure of the financial system, that the extension of such guarantees in a sense across bank activities squeezes the non-prudentially regulated sector of the financial sector. If I can also make two comments on the deposit guarantees, there is a lot of discussion about the financial claim scheme and the fact that there needs to be a fee for it and that banks could be levied if one bank fails and APRA has to pay out depositors. I think it is worth noting that the financial claim scheme that is legislated is a closed resolution scheme, so it only comes into operation if the government or APRA has decided to actually close down the bank. Tom said he would like to see some banks close down if they got into trouble, but I think that is never going to happen.

Prof. Valentine—I would like to see it never happen.

Prof. Davis—Okay. So the question of whether it would actually ever be implemented is another matter because typically APRA will find ways to resolve a bank situation while it is still open by getting business transferred. The second point that I think is worth noting as to that financial claim scheme is that when APRA comes in, if it does implement the scheme, and pays out depositors it then stands first in the queue as a claimant on remaining assets ahead of all other uninsured depositors and other creditors. What that means is that, given the structure of banks' balance sheets, as long as only a small proportion of deposits is guaranteed it is basically the other claimants on the bank who are going to lose money and there will never be a situation where APRA would not recover the entire amount paid out to pay insured depositors and therefore the need for a levy on other banks is pretty small and pretty unlikely.

Prof. Valentine—If I could make another comment, of course there was an unintended consequence in the bank guarantee when it was introduced. It caused problems for funds, rather than ADIs, which also offered a similar sort of asset. In fact, a lot of them were forced to freeze their units in order to protect them from a rushing out of money. That would be a problem. If you introduced any scheme that would be a problem which would have to be managed and thought about beforehand so you did not get a repeat of that. Now that is not a criticism of what the

government did. It had a weekend to do it. It had no choice but, in my view, to introduce that guarantee but it did have unintended consequences. This is one reason why I feel it might be advantageous to think of introducing an explicit guarantee and organising it properly so that we do not have to do it again at the last minute.

Senator HURLEY—Thank you for that. That touches on something I was going to ask about, and there are other ramifications. We have heard a lot about the differential fees being charged on the wholesale guarantee between the big banks and the smaller regional banks and so on and the difficulties that the regional banks feel that has been causing. But you did say you wanted it to be part of an inquiry.

Prof. Valentine—I agree with Kevin. I think it has to be uniform across all the relevant institutions so that it does not create a new competitive advantage for somebody or other.

Senator HURLEY—Professor Davis, you talked about having a fixed rate or an adjustable rate. Did I get it right that you were talking about this having the effect of spreading the costs across—

Prof. Davis—It is the other way around. Under the current structure, for example, when the Australian banks found that their cost of funding in wholesale markets went up then they were able to recoup the extra cost of funding by spreading it across all of their existing loans plus new loans, whereas under the situation where the interest rates on their existing loans were tied to some indicator rate if that had gone up then, yes, the interest rate on existing loans would go up. But to the extent that their borrowing costs went up over and above whatever happened to indicator rates, that extra cost would either have to be borne by shareholders, who are receiving returns for taking risks of that sort, or recouped by increasing interest rates on new loans. So my main concern is this one of risk sharing. Retail borrowers have got no idea what might happen to bank funding costs in the future. Take, for example, the situation where a bank's credit rating went from AA to BBB overnight for some reason. Its cost of funding would go up. Under the current scenario existing borrowers would find their interest rates pushed up even though they have had nothing to do with it. The question is: who should be bearing that? Eventually with that high cost of funding the bank will lose business, because it has got to increase its interest rates on all loans, but some part of it is borne by existing borrowers. I am not sure that is appropriate.

Prof. Valentine—If the system is competitive, Kevin, surely the bank would have to bear it.

Prof. Davis—Sorry?

Prof. Valentine—If it is reclassified as BBB the bank would have to bear that cost because it could not charge a different rate from others.

Prof. Davis—But not initially. Under the situation I am advocating it could not. Under the current situation it increases its interest rate on all of its existing housing loans, because they are at its discretion. Therefore in the short term the shareholders do not take as big a hit. Ultimately in the long term the bank goes out of business or finds it cannot make new loans to new borrowers because its rates are higher. As I said, it has never been a problem before because there have not been those differences—

Prof. Valentine—But I think that is when it is the bank that is bearing the risk, but anyway—

Senator HURLEY—I was a bit concerned that during a good period you might get borrowers on that fixed or adjustable rate and if things turned bad then you would get a situation where new borrowers would not be able to get into the market. I was around in investment banking in the early eighties and I remember how the changes freed up things quite considerably for borrowers and caused quite a bit of innovation. I share a bit of concern about any going back to any kind of regulation restricting the banks.

Prof. Davis—I stress I am not saying regulate interest rates. It is to regulate what types of contracts are allowed to be written and therefore the risk sharing that is involved in those. I agree that one of the consequences of this change would be that, if a bank suddenly found its borrowing costs rose dramatically relative to the market average, then under the type of loan structure I am advocating it would have to increase its rate on new housing loans quite substantially. That is effectively what happened with securitisation.

Prof. Valentine—But there is a problem now with variable-rate loans, because quite a few young people get involved in loans that they cannot sustain at higher rates. I think the governor of the Reserve Bank, at a time when we had very low interest rates, went out of his way—though he could not do it explicitly—to warn people that rates were going up. He did not say this, but essentially what he was implying was: if you are going to take out a mortgage, you have to realise the variable rate will be a lot higher in a couple of years. Again, I think you come back to education and you come back to the regulator ensuring that banks and other lenders have in place systems that take that into account when they decide on the creditworthiness of a borrower, and that they actually refuse a loan if they think the borrower cannot sustain it in an era of higher rates. And I believe that they do have such a system—that APRA do look into those sorts of things.

Senator HURLEY—Just one more question. You were talking about the early eighties, and one thing I noticed was that new entrants, rather than jumping into providing a whole banking system, chose to pick niche markets. Some of them were the more profitable areas but not necessarily. Others were ones that they could just get into without a great deal of investment.

Prof. Valentine—There is a classic case—I will not name the company, but it consists of two letters. It had a banking branch, which was the only branch it actually had. To become a bank you had to have at least one branch. It had only one branch, at the bottom of Martin Place. It was very obscure; it had large pot plants in the front so that nobody would go in. I said to the economist of that bank at the time, ‘What would happen if I sent my grandmother in to open a bank account?’ and he said, ‘She would be sent to the 20th floor of Australia Square and asked to fill in a 30-page application form.’ They just did not want that business.

Senator HURLEY—No, that is right.

Prof. Valentine—They were there to do investment banking.

Senator McGAURAN—What was its name again?

Prof. Valentine—Two letters!

Senator HURLEY—And that relates to what was alluded to before, the Tyro situation, where they are getting into that payment system but there are barriers to entry. It is of great concern to me in terms of competition that people cannot choose a niche because of the way that banking has become so interrelated, particularly in terms of software and IT structures. Do you have any comment on that? No? Agree, disagree?

Prof. Valentine—One comment I would make is that I think there is good competition amongst the major banks and the banking sector. One of the things that do concern me is the structure of the sector. If you think about the financial sector, it is a bit like a triangle, with the Reserve Bank at the top, then the banks and then everybody else—and everybody else in the financial sector is dependent upon the banks for access to ultimate liquidity, which does put the banks in a very powerful position in that area. Now, I think it is possible to conceive of a situation where there is competition between the banks, who are in that second layer, but part of that competition makes it hard for other institutions to get in and compete with them. I think it is possible to imagine a structure where there is competition between the banks that keeps their profits at reasonable levels but which also makes it easier for other institutions, who ultimately rely on banks for access to liquidity, to get into the business of competing with the banks in various areas, because they do not have the access to the ultimate liquidity provided by the Reserve Bank.

I do know that, during the GFC, some of the securitisers complained about the fact that they struggled to get access to warehouse funding or lines of credit so they could issue commercial paper to fund the warehouses of mortgages they were trying to build up to then securitise. Whether they were valid concerns or it was just the fact that the cost of funding had gone up for everybody and they recognised it, I do not know. But there is a potential issue there.

CHAIR—Senator Xenophon.

Senator XENOPHON—Just following Senator Hurley's line of questioning in her exchange with you, Professor Valentine, about how the Reserve Bank governor warned about variable rates—

Prof. Valentine—That is my interpretation. I cannot speak on behalf of the governor, obviously.

Senator XENOPHON—No, I know. Only the governor can, I guess! Leaving aside whatever the governor may or may not have said about that, there is the issue of mortgage stress and how finely balanced it is. Doesn't that point to the market having if not failed then having been inadequate in terms of the regulatory framework? Because there have been quite aggressive lending practices, any loan should be stress-tested against someone's capacity to pay, allowing for reasonable changes in interest rates. Does that point to a need for—

Prof. Valentine—I do not think we have had the problem they had in the US which reached ridiculous levels where, as I keep pointing out to my students, there is apparently a housing loan in existence in the name of one 'M Mouse'. Whether that is Mickey or Minnie I am not sure. Nevertheless, they certainly did not look at the situation properly. So far as I can tell, our banks have been reasonably prudent. The loan losses are not anything like the loan losses elsewhere. APRA has encouraged such prudence and we would not want to change that situation. One of

the dangers you have is that people feel that young people should have a right to a mortgage. I do not think that is true. I think if they cannot repay it we are not doing them a favour getting them into a mortgage. The first step I think would be for the regulator, APRA—and I think it is largely doing this—to ensure banks have controls in place so they do not lend to people who are going to get into mortgage stress.

The current situation became so bad that perhaps people you would predict would never get into mortgage stress have slipped into it. Nevertheless, we need some moderation in lending. I would agree that in general that is a prudential control which probably has to come from APRA rather than from hoping the banks will always do the right thing or, worse still, as we saw in the US, you will not see a whole lot of people setting up outside the APRA net. There are still people in Australia who are bad credit lenders—in other words, they advertise, 'I'll lend to you if no-one else will.' They have the low-doc type loans that caused all the problems in the US. I have recommended that APRA's powers should be extended to such lenders to impose prudent lending procedures on them as well.

Senator XENOPHON—On the issue of prudent lending, the difference between a mortgage rate or an overdraft rate and the rate you pay on credit cards is exponentially quite significant.

Prof. Valentine—About what, 12 per cent?

Senator XENOPHON—I think 18 or 19 per cent.

Prof. Valentine—No—I mean the difference.

Senator XENOPHON—The difference is 12 per cent, that is right. And the banks say, 'That's because we have a greater level of risk.'

Prof. Valentine—In the credit card, do you mean?

Senator XENOPHON—In the credit card, but does that point to a failure to have reasonable lending practices or more prudential lending practices with respect to credit cards, because that is an area of significant growth or significant profitability for the banks?

Prof. Valentine—All I can say is I think there is a real possibility of that, which is why I suggest it is a topic which would merit some consideration.

Prof. Davidson—I think there is a great deal of unintended consequence of putting limits on credit card interest rates as well.

Senator XENOPHON—I am not suggesting that; I am suggesting prudential requirements in terms of lending. Are you saying that that is unwise as well?

Prof. Davidson—No. I would imagine the banks already have prudential requirements when making credit card offers. Bear in mind, of course, that when you own a credit card the bank observes your cash flow stream. So when you receive offers to increase your limits, they are making a business decision based upon what they know you are spending and paying in and

what have you. So it is not clear to me that what appears to be predatory lending actually occurs in Australia. I would be a bit loath to rush in to that particular area.

Senator XENOPHON—I did not suggest predatory lending but, as Professor Valentine indicated, there is a differential between—

Prof. Valentine—I would call it careless lending. Predatory lending is a strange concept because it suggests that the lender is making loans which are not going to be repaid, which is a very strange concept.

Prof. Davidson—We do not have any of it in Australia.

Prof. Valentine—I think it is careless lending we are talking about it.

Senator XENOPHON—Sure.

Prof. Davidson—There is a differential but I think there is also a huge difference between a home loan and a credit card. Credit cards are more risky than home loans. Whether or not that justifies a 12 per cent differential I am not sure.

Senator XENOPHON—But that is the nub of the question.

Prof. Davidson—Yes, sure. That is a very specific empirical question.

Senator XENOPHON—I will ask just one more question, given the time constraints. I am not sure if this has been put to you in similar terms. One of the arguments that have been put by a number of consumer credit groups and welfare groups is that the banking sector in this country is highly regulated. It should be treated more as a utility. So when banks say, 'Our return to equity isn't that great,' aren't the risks for a bank in this country relatively low, and is it total risk or non-diversifiable risk that is relevant? Is there something to be said for a bank, because of the nature of the regulation of our banking sector, being treated more like a utility than any other company on the stock market?

Prof. Davis—I think one of the dangers is that we know that, when you talk about efficiency in the banking sector or any sector, it is actually not the standard, static efficiency that economists talk about—and this goes back to the Campbell inquiry that Tom was involved in—it is actually the dynamic efficiency and inventiveness and responsiveness to new developments. I think if you start to treat it like a utility, you run the risk that you close out a lot of innovation and adjustment to behaviour.

When we talk about utilities, we are talking about—although I guess NBN and telecoms are a bit different—gas pipelines or electricity transmission lines, and there is not much in the way of substantive innovation going on there that creates a lot of dynamic efficiency. We are talking about a fairly standard sort of product that is homogeneous. I think in the case of finance it is a very different world.

Having said that, there are some parts of the finance sector that are fairly stock standard. We have the distinction people talk about between casino banking and utility banking. I do not think

that it makes sense to regulate them as if they are utilities. But, having said that, there may be some scope in a proposal that I have seen from the OECD that says you should get banks to change to a non-operating holding company structure where one part of it is sort of the standard banking—taking deposits; making simple loans—and the other subsidiary part of the non-operating holding company is the investment bank.

Senator XENOPHON—On notice, could you refer us to that OECD paper?

Prof. Davis—Sure. Macquarie Bank already has that structure. Suncorp has just gone to it as well.

Prof. Davidson—In the bad old days we could have said that banks were like utilities and they worked on the 3:6:3 model—they borrowed at three per cent, lent at six per cent and were at the golf course by three! I do not think we actually want to go back to the bad old days of banks being utility-type organisations. Dynamic banking has served us very, very well.

Prof. Valentine—I do not see why you would want to replace an oligopoly with a monopoly. I cannot see any good coming of such a substitution. And we have had bad experiences with public utilities which were monopolies. Just on Kevin's point: I perhaps should mention, as a matter of history, that at the Campbell committee we looked closely at the holding company concept and, at that stage—and that was 30 years ago—it seemed to us that there was a lot in it. So perhaps it is something that is worth—

Senator XENOPHON—Maybe its time has come.

Prof. Valentine—Maybe.

Senator RYAN—I just want to turn back to the issue of fixed-rate mortgages and explore and expand on the point you made, Professor Valentine, in your submission. In particular, what are the consequences for other bank lending departments, divisions, programs, if we move to compulsory, fixed-rate mortgages?

Prof. Valentine—No, I do not think that was Kevin's proposal. His proposal was that it be indexed to a particular—

Senator RYAN—No, I was referring to this. You have a small section in your submission, I think, Professor Valentine, saying that it is impossible to pass on the interest-rate risk to the lender—unless I am misreading the submission. In your submission you say:

> In an article in the Australian Financial Review of 8 November 2010, Jeremy Cooper suggests that we should go over to long-term fixed rate mortgages. He asks "why can't Australians choose to pass all the interest rate risk over to the lender at the onset?"

And your response is that it can't be done.

Prof. Valentine—Yes. The borrower is left with some risk if they make the wrong decision.

Senator RYAN—Yes, and, as a general rule, the banks are probably better at picking future interest rate rises than most consumers.

Prof. Valentine—Perhaps.

Senator RYAN—Well, costs. There is a specialisation element there. The point I want to know about talks about mortgages. What would be the potential impacts on bank lending to small businesses and to businesses generally if we moved to a more regulated mortgage market? I remember the time before deregulation when my parents were lucky because they had one of the mortgages that were capped at 13 per cent. The parents of a lot of my friends at school had mortgages that hit 17 and 18 per cent in 1989 and 1990. It was put to me by one of my university lecturers that, when you had a huge proportion of mortgages that were capped, because money is fungible other people were effectively paying—I think Professor Davis mentioned this earlier—a higher cost to compensate for the fact that some mortgages were capped. How would the move to a regulated banking system flow through to lending to small, medium or large businesses?

Prof. Valentine—A bank that has a large number of capped mortgages should have funded itself in a way which balanced that. Again, I would expect APRA in this day and age to look into that. If a bank were giving a whole lot of fixed rate mortgages but funding them out at variable rate funding, APRA would not be very happy with the prudential aspects of that behaviour.

Senator RYAN—If we could move to a more American model where most—

Prof. Valentine—They can do this. They do not have to directly fund it out of an equivalent fixed rate; they can simply use interest rate swaps to swap into a fixed rate so that they are in effect paying a fixed rate as well as receiving one from the mortgage.

Senator RYAN—Sure. If we moved to an environment where a fixed rate was the standard model of a mortgage—the standard model in Australia seems to be a variable rate, with people fixing a part of it; this is really a consumer driven issue—would it be possible for the banks to cover all those costs, given where the banks and the consumer market are at the moment?

Prof. Valentine—Yes, but that is creating a big risk for consumers that they will get stuck in a fixed rate and the market rates will go down.

Senator RYAN—I agree with you there. I am not trying to challenge that or anything. Given the preponderance of Australian banks, the strong growth in the Australian housing market and some of the challenges around business access and finance during the last few years, if we moved to a fixed rate mortgage model in our mortgage market would that have any impact on the business lending market? The banks do both. Is there a potential negative or positive impact upon the other activities of our banks? It is still pretty critical to the economy.

Prof. Davidson—It really depends on what their existing book looks like and where they want to be in terms of positioning themselves in the market. So it would really vary from bank to bank. There is an argument that some banks are already in the position where they do not really want to have more home loans. They actually want to move elsewhere. That might explain some of the differentials we have seen in interest rate rises over the last while. But it really depends on where they are at.

I think the real issue is that we want to avoid a situation where we have credit rationing for any reason other than the prudential requirements of the loan itself. We do not want to be in a position of turning away good loans simply because the banking system cannot finance that particular loan at that time. The more regulation that we heap onto the system, the more likely that becomes. So we want to have a flexible system where banks can make good risk assessments of loans, then make those loans and then wear the cost if those loans go bad.

Prof. Valentine—To expand on that: if you have credit rationing, it will go somewhere else—probably somewhere less desirable than the banking system.

Prof. Davidson—We want to avoid a black market in financing. That is very much the case.

Prof. Davis—Fixed rate lending is different from government regulation of interest rates. Fixed rate lending, as notionally talked about, is purely the bank saying: 'The rate on a housing loan for the first four years is fixed at X per cent.' As long as the term that it is fixed for is in the order of three, four or five years, I do not think it has any problems for Australian banks. The problem with the US situation was that they had fixed rates for 30 years, and that is impossible to fund without substantive risk.

Senator RYAN—That was what I was trying to get at before.

Prof. Valentine—It was a huge risk. It was what caused saving and loan problems.

Senator RYAN—That was what I was trying to get at before. My point was not clear. If you are funding fixed long-term mortgages—25-year mortgages at fixed rates—that does bring risk into the system.

Prof. Davis—What you want is a 25-year mortgage, the interest rate fixed at four years and renegotiated at the end of those four years. As long as the customer is able to exit the bank and take their loan somewhere else at that point in time if they do not like the terms of the renegotiation at zero cost, it is a perfectly acceptable situation. The bank can hedge the interest rate risk associated with that. If it is a four-year period, they can recoup any of the costs—the establishment costs and so on—over that four-year period.

Prof. Valentine—Why do you choose five years? Because it is difficult for the banks to get fixed rate money outside of five years.

Prof. Davis—I picked four to five as the—

Prof. Valentine—It would be difficult to get a swap. You certainly would not get a 30-year swap.

Senator RYAN—One final question: will that have any likely impact on the ability or otherwise—I know there are varying views on this—of the Reserve Bank to use monetary policy to meet its inflation target? One of the things I have read comparing the American economy to the Australian economy is that, even though most people own their homes, our consumers are more sensitive to interest rate rises both in terms of the money that goes in and out of their pockets and also in terms of expectations, which do drive behaviour, whereas in America I am

on a fixed three per cent interest rate now and am probably not too happy, but 10 years ago I might have been.

Prof. Davis—I think it is fair to say you have different distribution effects. If existing borrowers have got fixed rate loans and the Reserve Bank changes interest rates but those rates do not change for those borrowers, then it has no immediate impact on them and there is much more impact on new borrowers. So I have no idea whether a change to the distributional effects of monetary policy would be a good change or a bad change.

Prof. Valentine—It is difficult because, as was mentioned earlier, only about 30 per cent of people have mortgages. So in a way we are asking 30 per cent of our people to bear the burden of monetary policy.

Senator RYAN—I feel it.

CHAIR—Thank you, gentlemen, for assisting us with the inquiry today. It is much appreciated.

[2.21 pm]

PRICE, Mr Rob, Head of Strategy, Credit Union Australia

WHITEHEAD, Mr Chris, Chief Executive Officer, Credit Union Australia

CHAIR—I welcome Mr Chris Whitehead from Credit Union Australia. Would you like to make an opening statement?

Mr Whitehead—Yes, if I may. Thank you for the opportunity to address the committee today and to make a short statement on behalf of CUA. I am conscious that our industry organisation, Abacus, has already given detailed testimony and therefore I am going to restrict my comments to items of particular interest to CUA.

CUA is Australia's largest customer owned financial institution. It welcomed the announcement of the Senate inquiry and has been following it with a great deal of interest, and it welcomes the opportunity the inquiry gives to the credit union sector to publicly voice its concerns around issues of competition. CUA has utilised this opportunity through a submission and of course by participating today. The government's subsequent announcement of the competitive and sustainable banking system package, designed to strengthen the mutual sector, empower consumers and increase the safety and security of the banking system, addressed several but not all of CUA's concerns, so I will comment on these briefly.

We believe that by supporting and strengthening the mutual sector the government's reforms will, potentially, have an important impact in increasing competition and ensuring Australian consumers are offered more competitive banking products and services. The advantage of the customer owned model is that any improvement in competition will directly benefit our customers, as all of our profits are reinvested into our business. As a first step, we would like to see recognition of the value of the mutual sector in both the Australian regulatory environment and our banking laws. In the statement to the Senate inquiry, Abacus noted that Australia was one of the few jurisdictions with a major credit union sector that does not have any special recognition of or special provisions for the mutual structure in its banking laws or financial services regulations. A fair regulatory system should work in our favour as well as in that of the major listed banks.

International jurisdictions such as Canada, Europe and the UK have up to 40 per cent of consumers banking with a mutual. The relative strength and contribution of mutual institutions in these markets are in large part due to a number of carve-outs in the legal and regulatory systems that we have not been able to benefit from in Australia. For example, the mutual sector will continue to evolve, and further aggregation and consolidation is inevitable. In the long term we believe it would be greatly to the advantage of consumers for there to be larger mutuals that are able to compete with both scale and strength. CUA has within its heritage 150 credit unions that have merged to form an organisation that now comprises around 400,000 customers and 78 branches, with assets around $8.5 billion. We recognise however that further growth is vital to more effectively access economies of scale.

This ongoing consolidation will be hampered under the current legal and regulatory systems and current tax structures. CUA supports a consistent national approach to reducing stamp duty, which varies from state to state, easing further effective consolidation of the sector and simplifying the complexity of aggregation. Reassessment of franking credits and how they might be utilised by customer owned financial institutions is a further example of how the current regulatory system disadvantages the mutual model.

On the specifics of the government's package, we would offer the following comments. The $4 billion increase in support for the residential mortgage backed securities market is important and will underpin further growth. However, it is unlikely to be sufficient to support anticipated demand from the credit unions and building societies movement if competition in banking is indeed to increase to meaningful levels. We would encourage access to the wholesale market to be assessed on the quality of the underlying assets and purpose of that funding rather than purely on the credit rating of the institution.

CUA conducts extremely prudent and responsible lending practices, with arrears levels of only 0.14 per cent of our gross total loans as at 30 June. Our performance as a responsible lender has been proven over multiple business cycles and should be taken into account in determining the price we pay for wholesale funds. The continued underlying guarantee of deposits through the financial claims scheme is vital given continuing economic uncertainty internationally and a possible reoccurrence of the perception that only the banks offer adequate security.

As the government has flagged, the FCS will be confirmed as a permanent part of Australia's financial system. The issue for CUA is the level at which the Commonwealth guarantee is set as from October 2011 and any cost for access to the guarantee. Any reduction in the level at which the guarantee operates at, or if there is a renewed push for it to be substantially altered, needs to be managed carefully or else competition could be further damaged by the perception that smaller institutions are vulnerable. Indeed, CUA would prefer for the level to remain at $1 million or alternatively for the guarantee to exclusively apply to those members of the mutual sector in perpetuity. In line with this, as CUA is regulated in the same way as the banks, we do support the introduction of a public awareness campaign and the government protected deposit symbol so that Australians are aware their money is safe with us. The government has the opportunity to make a meaningful contribution here by depositing some of its own funds with the mutual sector.

The government's willingness also through the Australian Prudential Regulation Authority to provide greater flexibility in the use by the credit unions and building societies of the terms 'bank' and 'banking' is potentially vital to conveying the breadth and depth of financial services offered. CUA's submission was very strong on this issue. We favour changing the classification of authorised deposit taking intuitions to authorised banking institutions to enable CUA to reassure consumers that we are regulated in the same way as banks and to reinforce our core function, which is banking. However, as CUA's submission also makes clear, we have no intention in current circumstances of branding CUA as a bank. Rather, we will aggressively market CUA as being in the business of providing a comprehensive suite of competitive banking services. The mandate given to Bernie Fraser to investigate options for improving account- and mortgage-switching options is also important and CUA will be seeking to meet with Mr Fraser in order to present our thoughts.

CUA's submission to this inquiry canvassed a range of additional measures which were not addressed directly by the government but which we consider would materially assist in strengthening customer and financial institutions and thereby sharpening competition. To summarise, these are the reassessment of how franking credits may be utilised, an amendment to the Australian Office of Financial Management's mandate to invest in notes below A-rated level, greater market transparency in terms of multibank branding to ensure consumers are aware of ultimately the institution that they are banking with, and proactive enforcement of the Trade Practices Act to prevent dominant players and financial services from misusing their market power.

CUA has demonstrated over the last 12 months that it is able to beat the major banks on mortgage rates and service, and I have a document I can hand out which illustrates this in some detail. As we look ahead, we will do everything possible to publicise our competitiveness in banking services and our commitment to Australian communities and to the advantages of the customer owned model. We consider the government's changes will assist us in this mission, but there are other steps which are warranted and which can add to the credit union sector's competitiveness. We urge the committee to ensure we get this opportunity.

In closing I would like to highlight one last matter, which is that the CUA has its headquarters in Brisbane on the banks of the Brisbane River, so the last two weeks have been challenging for us as we have had to manage an evacuated headquarters as well as floods hitting many of our Queensland branches. The professionalism and service commitment demonstrated by CUA and its people during this unique time, including the prompt restoration of services and the reopening of the majority of our branches within 48 hours of that flooding and the reopening of branches in areas such as Emerald and Toowoomba promptly is testament to the safety, security and commitment to service of CUA as an institution. Our business has played a significant role in supporting the flood-hit local communities in which it operates. This community based support is the proud heritage of CUA and the mutual movement. At times such as these, its value to our customers and their communities was never more apparent. I therefore urge this inquiry to make every effort to ensure this type of business continues to flourish into the future. Thank you, and I would be pleased to answer any questions you have.

CHAIR—Thank you very much, Mr Whitehead. You talked about Mr Swan's package and noted that you welcomed some of the things in it, some of which reflected what you and Abacus have been asking for, and others of which do not go as far. One of the things in there that you did mention was the willingness of APRA to allow the mutuals to use the term 'bank' and to respond with quick applications if any of the mutuals who met the criteria actually asked for that. Is that any different to the current situation?

Mr Whitehead—It is, although I would say that our desire is not to call ourselves a bank.

CHAIR—I understand what you are saying. But being a mutual or an ADI of your size, currently or prior to the announcement by the Treasurer, you could have, if that is what you chose, rung up APRA and said, 'We would like to call ourselves a bank,' and you would have a right to do that?

Mr Whitehead—As I understand, yes, we would be able to apply for a banking licence. I understand that would mean we would no longer be a credit union, which is also protected term. We would then be a bank instead of being a credit union.

CHAIR—I will get onto that in a second. But if you decided to do that today, the announcement by the Treasurer in December makes no difference to your ability to do that now as it did then. We had evidence from APRA which indicated that if you meet the requirements you have a right to call yourselves a bank.

Mr Whitehead—Yes, that is my understanding. CUA currently has reserves in excess of $650 million, so given the entry level is $50 million then clearly it comfortably sits a long way above that.

CHAIR—Okay. Coming to the issue of why you choose not to, are you saying that if you chose to use the term 'bank' you would not be able to call yourself the 'Credit Union Bank of Australia'?

Mr Whitehead—That is our understanding. Certainly guidance to date has been not absolutely clear, but using the term 'banking' without being a bank was also considered not acceptable, particularly to the extent—

CHAIR—I understand that. But if you applied to APRA and you were granted—as you would be—the right to call yourself a bank, are you saying you could not use the label 'credit union' even if it was part of your branding?

Mr Whitehead—That is my understanding, yes—that credit union is a protected term in the same way as bank is a protected term; it is a defined term.

CHAIR—If that were possible, could that be attractive to your institution?

Mr Whitehead—I still believe we would not call ourselves a bank, but it would obviously make it much clearer that we could be in the business of banking if we had a bank licence, so it would assist in terms of the way we position ourselves. The key point here is that we very much want to position ourselves as an alternative, so calling ourselves a bank we believe detracts from that as well as diminishes from our heritage as a credit union. Our desire is nonetheless to be able to very clearly represent that we are in the business of banking, and that is really what we are seeking. Our concern right now is that with the ADI designation there tends to be talk of banks and nonbanks and we get lost in a kind of no-man's-land, where we are regulated by APRA as if we are a bank but we do not get the recognition for that through the term 'an ADI'.

CHAIR—I understand where you are coming from and I can see exactly what you are trying to achieve, but it does seem like you are trying to have the cake and eat it as well, in the sense that you want to stay a credit union because there are marketing advantages and because of the history and all sorts of things that flow from being a credit union, and you do not want to be a bank because banks are big, nasty and all those sorts of things, and yet you do want to be a bank because people inherently feel that banks are more secure and that there is government backing. Yet you do not want to call yourself one. It is a difficult tightrope to walk. From the policymakers' perspective, it is a difficult one to answer. Sitting where I am, I do not know that,

for the average man and woman in the street, a change from ADI to ABI would really resonate that much. I would have that thought that to achieve what you are after, the inclusion of the word 'bank', not just 'approved banking institution', somewhere in your title would be needed to really have that effect that you are talking about.

Mr Whitehead—I think we would very much agree if that were the term 'banking' as opposed to 'bank'. 'CUA Banking' or 'CUA Customer Banking' might well be where we meet on that, I think.

CHAIR—The word 'banking' is more attractive than 'bank'?

Mr Whitehead—That is correct, because that describes—

CHAIR—I understand where you are coming from with that. Franking credits is another one of the changes that you requested that was not delivered, or has not been delivered so far. What currently happens with the equivalent of franking credits with mutuals? Do you actually record a figure that is an equivalent that just builds up? Is it something that you actually know from your books?

Mr Whitehead—It does. Yes, we accumulate franking credits on our balance sheet. We have got well in excess of $100 million of franking credits currently as CUA, and they essentially sit there unused and unusable. The interesting thing is that, when two mutual institutions merge, the franking credits of the mergee, if you like, disappear, so the value of those is lost in the merger process, which seems patently unfair. But obviously the fact that they sit on our balance sheet unusable—

CHAIR—What would happen to a credit union with franking credits if it demutualised?

Mr Whitehead—Then those franking credits could be used against the dividends, as I understand it.

CHAIR—So they could, at that point. A lot of credit unions have demutualised but still retain the name 'credit union' and operate as such. Obviously Credit Union Australia has not made that decision at this point, but others have. There is obviously value in it for them. That is one way of getting the benefit of franking credits, presumably.

Mr Whitehead—Yes. It comes with a significant change in the whole philosophy and raison d'etre for the organisation, in that, clearly in the process of demutualising and the change of ownership, that moves towards a shareholder owned model and away from the customer owned model which we believe is fundamental to our philosophy and indeed our longer term ability to provide competition in the marketplace. Looking at international comparisons, we would argue that the presence of a strong mutual sector that has not demutualised is in fact a significant benefit to competition, by comparison with other markets. The process of demutualising exposes a small or medium institution to the vagaries of the stock market, to a different set of drivers for its management and its board, and diminishes the community values that we feel are important to our foundation.

Mr Price—I think it is worth adding there that it also changes the pricing proposition.

CHAIR—That was my next question. I note that you have stated that your ability to invest 100 per cent of your profits back into the products and services you provide is one of the key advantages of mutuals. Does that fully or at least in part offset the cost disadvantage that you have in terms of accessing funds for you to loan out? Looking at these graphs which you have supplied today suggests that it possibly more than compensates for it or there may well be other factors. How do you manage to price below others? Is the fact that you are mutual and you do not have to pay dividends to shareholders a key part of that? If it is not the only part, what other advantages do you have that enable you to do that—without breaching any commercial-in-confidence matters, of course?

Mr Whitehead—It is a significant part of that. Firstly, we do not have to generate profit at the same levels. We need to generate sufficient profits to maintain strong reserves and to fund the growth and development of the organisation, but that is the limit of our profit requirements. Anything in excess of that is returned through better pricing. The fact that a shareholder based institution would be paying out something like 60 per cent of its profits in dividends does give us a significant pricing advantage—or, looked at another way, we return dividends to our shareholders, who are our customers, through lower prices rather than in the form of a separate dividend. It does support that model. We are aided by the fact that we have a relatively simple business. It is a pure consumer business. It does not have the volatility of business and corporate banking, which obviously varies enormously with the economic cycle. Our intention is to keep it a simple and low-cost business as well.

CHAIR—What has happened to your funding costs over the last two years? Where do you source most of your funding from? If securitisation was a major part of it, how much has that fallen off now and how do you source funding that enables you, according to your graph, to price competitively, particularly over the last 12 months?

Mr Whitehead—At the moment, about 70 per cent of our funding is retail funded and around 30 per cent is through wholesale, and the cost of both has gone up. Retail funding is primarily through term deposits, and the driver behind the cost increases there has been a greater competition for term deposits, particularly coming from a more aggressive participation in that market from the major banks than was perhaps the case three or four years ago. So that has driven up our retail funding, which is the primary source of funding for us. Most of our wholesale funding is in the form of warehouses, which now are provided by the major banks. I note the earlier comment from one of the economists about the reliance by other players on the major banks for liquidity, and that is absolutely our position. So we currently have warehouse facilities through one of the majors and potentially through another of the major banks. What has changed there is that the costs have gone up and competition for those warehouse facilities has diminished. Previously CUA had a warehouse facility with an overseas European bank, and what we have seen has been the exit of those overseas players from the Australian market. That has driven up costs additionally. Prior to that, securitisation was a very important part of our mix. It remains so, and we have done a number of securitisations, including one approximately 12 months ago. There were two issues with the support of the AOFM. So that still remains an important source of funding for us, albeit a more marginal and difficult one than it has been in the past.

CHAIR—You are now in keener competition with the major banks for deposits. You ultimately get a large part of the remainder of your funding from the majors, who presumably are

giving it to you because they get a better return from you than they might be able to get passing it on elsewhere. Do you have a smaller net interest margin than the majors? I am looking at your graph once again and seeing that you are competitively priced. Obviously part of it is that you do not have to pay profits to shareholders, but you are still quite keenly priced. Are you squeezed to do that or is it quite sustainable?

Mr Whitehead—We are certainly priced for sustainability. Squeezed? Absolutely. We have made a choice, as we have done previously in rising rate cycles, not necessarily to pass on all of those increased funding costs. But, not having the requirement to maintain a steady level of dividends, we can choose to take a different return at different points in the cycle. For instance, if I go back prior to the GFC, three years ago CUA did not pass on all of the rate rises or did not do so as quickly. It made a deliberate choice to lower its profitability for a period in recognition of what it felt was a drain on its borrowing customers. So we do have greater flexibility to do that and to bear some of the pain for a period, but obviously that can only be within the boundaries of prudent management of our reserves.

CHAIR—A final question before I hand over to some others. Is the cost of your funds continuing to rise? Ultimately most of yours is deposits, but do you anticipate that your costs are going to continue to rise? If so, will they peak in accordance with your current planning on assumptions that you work with, and, if so, when?

Mr Whitehead—We do not have the same kind of forward agreements as some of the major banks—

CHAIR—You do not have large wholesale—

Mr Whitehead—Yes, so we are seeing a funding costs at the moment largely flat over the last eight to 12 months or that kind of period. So perhaps we have been at the peak. Of course, that is hard to call in terms of what further pressures do come on funding costs, but right now we are not expecting further increases, we have seen a levelling off.

CHAIR—Could that be part of the reason why you are able to maintain keen pricing, given that your funding costs have levelled off, and yet all the evidence we have had from the big banks before this committee suggests that theirs are still rising?

Mr Whitehead—If that was the case then clearly our pricing advantage will continue to grow, because we have no purpose other than to pass any benefit on to our members. We did see in the last cycle of interest-rate increases that CUA's pricing difference to the major banks increased, or the gap between our price and the average of the major banks increased, and that presumably would continue to occur because we drive our pricing off our costs.

Senator XENOPHON—Do you see stamp duties and/or mortgage insurance as an important barrier to customers switching mortgages between banks? Mortgage insurance is something that has been left to the side but I know that one mortgage broker in Adelaide, Ray Hampson, contacted me about that recently and said that that is a real factor given that you cannot transfer the mortgage insurance and that could be a cost of several thousand dollars, because you pay for 30 years or whatever and if you switch after a few years you are still left with the balance of the cost of that. Is that something that is on your radar?

Mr Whitehead—We certainly believe that there are things that could be done to aid portability. Greater portability of lenders' mortgage insurance would be one of those factors and we would encourage that. We think that could assist. A further one I would highlight is that there has been some coverage about the standardised switching process, for instance for bank accounts in the UK and the clear requirement for the bank that is, if you like, losing the business to respond within fixed timeframes. We see that as an issue as well. But it takes a long time to settle on a mortgage when it is coming over from another institution. CUA has been very successful in the last 12 months in growing its business, which is not surprising given the pricing advantage we have. But it is a frustration that it can take many weeks for a mortgage to be transferred over and to go through the process. So there are a couple of things there that would help.

Senator XENOPHON—Sure. And this whole issue of bank account portability has been an area of discussion. Short of the full seamless portability in the way you can transfer a mobile phone number, which is a point of comparison but not a reasonable comparison, in the Netherlands they have a mandated requirement so that the lending institution you want to leave has to provide certain information in a timely manner. That is not full portability but it is fairly seamless and it is structured and mandated. Do you think that is something that would work here?

Mr Whitehead—Absolutely. It is something we would like to see.

Senator XENOPHON—It is not a criticism of credit unions but the point has been made that when it comes to small businesses and small to medium enterprises in this country they do not really have much choice, that your sector—again not a criticism of your sector and the tremendous services that your offer but in terms of providing that level of service for smaller to medium businesses, loans of five, 10, 15 or 20 million, that is not the sort of thing you are geared up for, that entrepreneurial sector. Is that something that could change or would that go against the ethos and the parameters of what credit unions should be about?

Mr Whitehead—It is certainly not against the ethos or the parameters. Credit unions do make a big contribution—I would suggest that the S end of the SME. CUA has in excess of 20,000 small business customers. We do not provide the full range of small business services but in terms of sole trader businesses, small franchises and so on we do support that business. It is something we would like to expand on in due course. It is something I am conscious needs to be done in a prudent fashion. The kinds of credit levels you are talking about—$5 million, $10 million or $15 million—on a balance sheet of our size obviously starts to get very lumpy, very concerning. Below that kind of level, then I think we absolutely have a role to play and are playing a role already in supporting small business.

Senator McGAURAN—I think in the nineties a flurry of credit unions were given the opportunity to become banks. Is that right? If I remember, several of them—and St George was one and, what do you know; it has been taken over. Is my recollection of history correct, that credit unions have done the swap and they have been given the smooth path to do it already? Quite a significant number did it and since then they have all been taken up, they have merged.

Mr Whitehead—Yes, I think that is true. Whether you look in the Australian market or the UK market, the vast majority of demutualising mutual organisations have now disappeared

within the major banks. Indeed, I would describe a CUA demutualising as selling to an unknown buyer.

Senator McGAURAN—Sorry, what was that?

Mr Whitehead—I would describe it as selling to an unknown buyer, that ultimately your assumption would be that in demutualising in all likelihood you are going to be bought.

Senator McGAURAN—Yes, that is right. I would agree with that. Would you also agree that there is no serious barrier on the path to becoming a bank at the moment? Maybe it could be made a little bit easier but it is really there.

Mr Whitehead—That is correct, yes. We could apply for a banking licence. As I say, that is more around how we describe our business.

Senator McGAURAN—If I walked off the street into a credit union, what is the difference? I find it puzzling; I am sure others do. Can I just deposit or take out a house loan or a car loan and organise an overdraft and all that?

Mr Whitehead—Yes. In terms of consumer banking, you will find all of the same services available. So pretty much any common requirement of retail banking we provide, through to personal loans credit, mortgages, transactions accounts, savings accounts, insurances, foreign currency, foreign money transfers—

Senator McGAURAN—Do you have to join the credit union first?

Mr Whitehead—Yes, but many credit unions now have no restrictions around who can join. So when you open your first account, you automatically become a member, which means you buy a share in the credit union, which costs you $10, which is refundable should you cease doing business with us, and that is the only barrier if you like.

Senator McGAURAN—Are you telling me that the only reason—having seen these graphs and that your interest rates sit below all the major four and have done for a decade or more, I suspect—you are not flooded with customers is because of some psychological barrier to the name?

Mr Whitehead—I think that would be not to accept that there was a lot more the movement could do itself in terms of raising awareness of the services that credit unions provide and in terms of providing greater accessibility. I think it is incumbent on us to do better job of informing the public about what we do, and your questions highlight that—that we have not done a good enough job of making people aware that credit unions such as CUA offer a full range of services. So I think it would be somewhat remiss of me to say that was all some accident. I think we have a large part to play in that.

Some of that does come down also to the benefits of scale. As I mentioned, CUA has over 150 credit unions within its heritage. Clearly, as we get larger, we can invest more in terms of larger branch networks. We now have 78 branches. But we can also raise awareness through advertising. We are now on television, advertising, which we have not been in the past. And

services have developed over time as well. So I think there are still a lot of people who are not aware that you do not have to qualify for membership, that anyone can be a member, and how easy it is to be a member of a credit union. That is where I think that a public education campaign tied in with our own efforts can make a huge difference in raising awareness of competition.

I would say that the other thing you would experience walking into one of our branches is the fantastic service. Credit unions typically have delivered customer satisfaction at levels about 10 per cent ahead of the major banks.

Senator McGAURAN—So the utopian solution that is right under our noses to this idea of banking competition is the credit unions. All we need to do is lift the profile of the credit unions and we have suddenly got access to a dozen or two dozen new institutions to compete with the banks.

Mr Whitehead—I think it is an important component. I would not say that it is necessarily the only component. But if you look at other markets where there are large mutuals—and I do not think it is just about large numbers of mutuals but about mutuals with genuine competitive scale—then they do provide a very important element of competition within those markets.

Senator McGAURAN—Then someone is not trying hard enough. Maybe this is something our committee could look at. If the government could lift your profile, aside from your own efforts to lift it, then there it is: there is the competition to the banks.

Mr Whitehead—I believe that is certainly an opportunity, yes.

Senator McGAURAN—Thank you.

CHAIR—As there are no more questions, thank you very much, Mr Whitehead, for assisting us with the inquiry. We will break for afternoon tea.

Proceedings suspended from 2.57 pm to 3.07 pm

FISSE, Mr Warren Brent, Private capacity

HENRICK, Ms Sharon Louise, Partner and Convenor of the Competition Law Group, Mallesons Stephen Jaques

CHAIR—I welcome Mr Brent Fisse and Ms Sharon Henrick. I propose to give you both an opportunity to make an opening statement and then we will move on to questions. Ms Henrick, would you like to make an opening statement?

Ms Henrick—I have a very brief statement to make. Thank you very much for providing the opportunity to give evidence today on the proposed amendments to the Competition and Consumer Act to outlaw price signalling. We think that the amendments proposed by the government and the coalition concern very important questions.

In our view, they concern in particular three important questions. The first of those questions is whether it should be against the law for competitors to exchange information about future prices, capacity or strategy. The second question is: if it should be against the law for competitors to exchange that information, in which types of circumstances should any new law apply? The third and, in our view, perhaps the most important question is whether the current law is sufficient for the Australian Competition and Consumer Commission to successfully prosecute a person or a corporation making information about their future prices, capacity or strategy available to one of their competitors. Importantly, as happened in the Apco service station case—a case that some people refer to as the Geelong petrol retailers case or the Leahy case—the competitor who received the information did not commit to act on it but they nevertheless used the information. So they willingly received the information, they did not commit to act on it, but they used it.

In our view, the current model is sufficient to allow the Australian Competition and Consumer Commission to successfully prosecute both the person who gives that information and the person who receives that information. Without wishing to criticise the commission for the way it pleaded the Apco case, we considered that if the commission had pleaded that case differently it would have been able to succeed against Apco and Apco's managing director who received the information about future prices. In particular, we believe that if the commission had pleaded an understanding to exchange information or to give and receive information with an anticompetitive purpose or with an anticompetitive effect—so either of those things—it should have won the case against Apco and Apco's managing director.

Senator XENOPHON—Sorry to interrupt, but this is important. You are basically saying that the ACCC were sloppy in the way that they prosecuted their case in that matter. Maybe you do not want to use the word 'sloppy'—

Ms Henrick—I do not, funnily enough!

Senator XENOPHON—They could have done a better job?

Ms Henrick—I think they could have done a different job. If they had done a different job, they could have pleaded it more widely. What the commission pleaded was a narrow understanding to fix prices. If they had pleaded that and, in the alternative, an understanding to exchange pricing information with an anticompetitive purpose or an anticompetitive effect, we think that should have succeeded.

Senator XENOPHON—So the inevitable corollary of what you are saying is that, if the ACCC had competently prosecuted that matter, there could have been a different outcome?

Ms Henrick—I think the commission is entitled to lose cases. One of the key roles for the ACCC is to push the boundaries of the envelope and to go to the court and ascertain where they are. Inevitably, in my view, that means they are going to lose cases. I do not wish to criticise them for that.

Senator XENOPHON—But in this case you are saying that, because of issues with the pleadings, it seems that the envelope that they decided to push was a very small one; they could have had a much bigger envelope to push?

Ms Henrick—I do think that, yes.

CHAIR—Please continue.

Ms Henrick—Further, under the current law, we believe that a person or a corporation who signals their future prices or gives information about their capacity or their strategy to another competitor and they give that information with an intention that the competitor might act on the information—so they signal the information with an intention that the competitor might, not will, act on the information—that would breach the current law of intent. That would be so even if the competitor who received that information did not act on it. So all that is necessary is an intention to signal a price or information about capacity or strategy and an implied suggestion that the recipient might act on the signal. Therefore, in our view, the current law is sufficient to catch the type of conduct we understand you are concerned with. We consider that the government's proposed legislation would have a number of important unintended and adverse consequences. The proposed legislation would, for example, pose significant and unnecessary risks for vertically integrated businesses who supply goods or services to their competitors, and the goods and services are not resupplied but used up or transformed in the process of production or manufacture. In that situation, the competitors would need to discuss prices but they would not come within any of the proposed exemptions under the government's proposed legislation, and that situation would result in a breach of that proposed legislation.

The proposed legislation would also pose significant and unnecessary risks for the way that many legitimate business structures such as alliances and consortiums carry on their day-to-day businesses. Those legitimate business structures may not satisfy the existing complete defences for joint ventures, even though they would meet—and they do—exchange information about prices for entirely legitimate business purposes. We think the proposed legislation would pose unnecessary risks for many information vendors who provide useful information about the process of competition, including estimates of market shares which private businesses and government agencies use on a day-to-day basis.

So we respectfully ask the committee to carefully and forensically consider whether these proposed changes to the law are really necessary to capture the conduct we understand you are concerned about. In our view, those proposed changes are not necessary because the existing laws give the commission and others ample power to prosecute successfully price signalling conduct. Thank you.

CHAIR—Thank you, Ms Henrick. Mr Fisse, would you like to make an opening statement?

Mr Fisse—Thank you for the opportunity to make a submission and also to be able to be here today to speak to it. I propose in these initial comments to focus on the additional submission that was provided to the committee last week. The additional submission is based on a submission by Dr Beaton-Wells from Melbourne Law School and me to Treasury about the exposure draft, the Competition and Consumer Amendment Bill (No.1) 2011. That submission cuts to the chase and deals with, as we said, most of the key issues that arise from the exposure draft.

The additional submission has three main sections: first of all, a summary of the main criticisms, beginning at page 3. The next main section sets out examples of what we call unjustified overreach, or as some people have put it, unintended consequences of the exposure draft if the prohibitions therein were to be enacted. The third section of the additional submission focuses constructively on recommendations as to what should or could be done going forward.

I will focus mainly on the recommendations in a constructive spirit for the remainder of this brief opening statement. But, before doing so, I would like to stress what we see as the main criticism of the exposure draft, in particular the prohibitions against private disclosure under section 44ZZW and against private or public disclosure under section 44ZZX. Both of these prohibitions, as you are well aware, focus on information disclosure by one competitor. There is no requirement of proof of an agreement or an understanding—there is no requirement of proof of collusion, in other words—and that is the fundamental tack that has been taken in the exposure draft provisions. That approach, in our view, is fundamentally mistaken because, once one moves away from a requirement of collusion, deliberate coordination or, under the current law, contract arrangement or understanding and focuses merely on information disclosure, it is inevitable that the prohibitions are going to suffer from extreme reach—in our view, unjustified overreach.

A key point here, we submit, is that the provisions in the exposure draft are very different, fundamentally different, from the prohibitions that exist in the United States, under section 1 of the Sherman Act; under the EU competition laws; and under the United Kingdom competition laws. Contrary to the statements or suggestions made by representatives of the ACCC this morning, the exposure draft provisions do not simply reflect the law in those other jurisdictions—they are fundamentally different. And that is because they focus on unilateral information disclosure and move radically away from a key requirement of collusion or, as under the present law, a requirement of a contract arrangement or understanding. In our submission, that is the fundamental error of the exposure draft prohibitions.

To move in a constructive spirit to our recommendations, the first recommendation is that the exposure draft requires extensive reconsideration. It suffers from many problems, including the fundamental problem I have just outlined.

The second recommendation is that any new prohibitions in this area should apply to all goods and services and should not be capable of extension by regulation. The prohibition should not be limited to just division 1A goods or services or to just one sector, such as the banking sector.

Our third recommendation is that neither section 44ZZW nor 44ZZX should be enacted, because they focus—wrongly, in our view—upon unilateral disclosure of information instead of strategic coordination between competitors—or, to put that another way, collusion of some kind.

A fourth recommendation is that proper consideration needs to be given to whether or not the conduct of the kind that the ACCC understandably has expressed concern about can and should be addressed by new prohibitions, and to whether or not they are adequately covered by the existing prohibitions under the Competition and Consumer Act. This goes to the consideration that was raised by Sharon Henrick a few moments ago of course. In other words, whether in cases such as the Apco case, the Leahy case, the petrol service station cases, it would be possible to rely on, for example, the law of attempt, attempting to enter into an understanding to fix prices, or whether or not there is an understanding arrived at between competitors to exchange information, for example, in a way that is likely to control prices or in a way that is likely to substantially lessen competition in a market. In our view, not enough work has been done to examine the reasons why the ACCC enforcement actions in cases such as Apco and Leahy did not succeed—whether there was, for example, not the best theory of the case and whether or not the evidence that was put forward corresponded adequately to the relevant theory of the case.

The next recommendation is that, to the extent that the current provisions are considered inadequate, possible ways of amending the concept of an understanding under the cartel prohibitions in the existing law should be examined further. One possibility is to replace the current element of commitment as required for the concept of an understanding with a different concept—a concept, say, of mutual expectation. That would be similar to the approach that it is already adopted in New Zealand under the Commerce Act there and it is similar to the approach that is adopted in the United States. This is an important question. It is glossed over in the regulation impact statement prepared by the Department of Finance and Deregulation about the exposure draft.

A further recommendation is that if section 44ZZW or section 44ZZX are to be enacted they need to be formulated quite differently from the current drafting. We make a suggestion that any new prohibition should be limited essentially to cases of strategic coordination between competitors—or, to put that another way, collusion in a redefined or extended sense. But the focus should still be on collusion, as it is under the existing law.

There are a number of other amendments that in our view would need to be made if 44ZZW or 44ZZX were to be enacted. I will focus on the more important points here. The exceptions that are provided under the exposure draft are inadequate. They are too narrow; they are not broad enough in scope. To mention just one of the problems, the joint venture exception that is provided is far too narrow in a number of ways. For example, it does not apply to proposed joint ventures. It does not apply to collaborations between competitors that are pro-competitive but

happen not to be in the legal form of a joint venture. Those are two of the severe limitations of the joint-venture limitation under the exposure draft.

There are also problems with the exemption that applies in the case of resupply. Where one competitor supplies another competitor with goods or services for resupply, the limitation of that exception to resupply is ludicrously narrow, and that in itself is a significant failing. There are other issues relating to exceptions and exemptions, including the need for a collective acquisition exemption, as is in place for the cartel prohibitions under section 44ZZRV.

Finally, if you can bear with me, senators, I would like to make a comment about a potential loophole in the exposure draft that is not addressed in the regulation impact statement or in the explanatory note, nor was it addressed this morning by the representatives of the ACCC. The loophole concerns the potential use of continuous disclosure by publicly listed companies as a mechanism for price or other signalling. That approach, if used skilfully enough by publicly listed corporations, could be used in a way that would attract the exemption for conduct that is authorised by or under a law of the Commonwealth or a state or territory. I think it is tricky to deal adequately with that potential loophole, but it is an obvious loophole and it needs to be tackled if indeed we are going to see the introduction of these prohibitions based on information disclosure. To wrap up, my own preference is not to, as I have tried to make clear, have any such prohibitions limited to information disclosure but to adhere to the more traditional approach of requiring some form of collusion before we impose liability upon competitors for their dealings with other competitors.

CHAIR—Quite clearly both of you are of the view that there is no great need for further regulatory intervention to address the perceived problem around price signalling. But do you generally see that there is a mischief that can have detrimental competitive effects through the concept of price signalling?

Ms Henrick—Previously the ACCC's predecessor, the Trade Practices Commission, has succeeded in prosecutions. There is one very famous case that occurred in Senator Xenophon's home town of Adelaide, a case that involves a group of Adelaide publicans. To briefly summarise that case, they were selling 13 bottles of beer for the price of 12. They used to have a regular Friday lunch and at one of their regular Friday lunches one of the publicans stood up and said words to the effect of: as from the next day he was only going to sell the 12 bottles of beer for the price of 12 bottles of beer, so people would not get one additional bottle of beer for free. He then left the room, and nobody said, 'Yes, we're going to follow' or 'What a fantastic idea!' There was no further discussion on the topic, but all of their conduct then harmonised around supplying the 12 bottles of beer for the price of 12 bottles of beer. The Trade Practices Commission succeeded in a prosecution of that. That was an announcement of an intention about a future price that others followed, and they succeeded in that prosecution under the provisions on price fixing. So price signalling is not a new concept and there are, even in Australia, cases where there have been successful prosecutions around it.

Mr Fisse—To answer your question 'Is there a mischief that is not adequately covered by the present law?'—

CHAIR—I am not asking whether it is not adequately covered yet; I just want to establish whether there is a mischief that policymakers should take an interest in with the aim of limiting potential for anticompetitive conduct.

Ms Henrick—In my view, policymakers have already taken an interest in that and that is why we have these existing laws.

Mr Fisse—In my view, there is a mischief that should be addressed if it can be addressed without producing unjustified overreach—as in the kind of example set out in section 3 of the additional submission. If I could focus on a particular situation that was raised this morning by the chairman of the ACCC—cases where competitors studiously agree not to show any commitment to fix prices. In that situation, there is some gap in the present law. That gap however could be closed, if need be, by amending the concept of understanding to cover cases of mutual expectation short of a mutual commitment.

CHAIR—From memory, Mr Cassidy was not particularly keen on that remedy this morning. Were you here then?

Mr Fisse—Yes. With respect, I disagree with him. If we pass to the position under European competition law, which was said to be a desirable model by Mr Cassidy and also by the Chairman of the ACCC, under the concept of a concerted practice there is no requirement of a commitment or a mutual commitment between competitors. But at the same time it needs to be realised that they do not go to the extreme of imposing liability for unilateral disclosures of information, contrary to the suggestion of Mr Cassidy and the chairman of the ACCC this morning.

CHAIR—I take it from what you are both saying that you think that the current laws are sufficient to address the mischief to the degree that it is commonly accepted as existing.

Ms Henrick—I do, yes.

Mr Fisse—I would have to say that I think there is a problem with the requirement of mutual commitment. I think that is an unduly narrow limitation. But the difficulty is reformulating the law in a way that does not result in unjustified overreach—these cases of unintended or extreme consequences where quite silly outcomes are produced because one is moving too far away from the concept of some kind of agreement or understanding between the parties.

Senator RYAN—If the definition and the meaning of the term ‘understanding’ was changed to try and capture the price signalling behaviour—because it is important term in the act—would that potentially have some unintended consequences? Is that word used commonly enough as a threshold test that it might actually have unintended consequences for other offences or something like?

Mr Fisse—That is an issue that needs to be addressed. But it would be possible to come up with a special definition of the concept of understanding in some context if need be. The alternative possibility is that a broader concept of understanding, subject to testing that in the various situations where the law is likely to be applied, could well be workable. It is unwise to try and fix and thereby push everything into the same pigeon hole with these concepts under the

Trade Practices Act. If we need to have different definitions for different purposes so that we guard against undue overreach or avoid other problems that would be the sensible way to go.

Ms Henrick—I have a slightly different view to Brent there. I think it is instructive to look at how this debate came about. Really it came about after the commission lost the Apco case. In that case there were a series of telephone calls between competitors—different service station owners—giving and receiving information about future prices for petrol. Apco, which is a company, and its managing director attended those calls and they received the information about their competitors' future prices and they said in their direct evidence that they found that information to be commercially useful so they used it, but they gave no commitment to the giver of that information that they were going to do so. So they just said: 'Thanks very much. I have got that information.' He said he went away and made his own decision about what he would do with it.

We say that that is fine; that is not going to get you there on an understanding to fix prices but it will get you there on an understanding to exchange information. There was definitely an understanding to give and receive the information because they participated in the calls. If the commission had said that there was an understanding to give and receive information with an anticompetitive purpose or with an anticompetitive effect, we say even under the existing laws of understandings they would have and should have succeeded.

Senator RYAN—Purpose and effect are different though, aren't they?

Ms Henrick—They are.

Senator RYAN—Purpose is a lot harder to prove, isn't it, than effect?

Ms Henrick—It is very interesting that you should say that because some years ago we did a study and looked at every case since 1974—

Senator RYAN—That must have been fun!

Ms Henrick—It took a lot of us. We wanted to see if there was a difference in outcome between cases where someone has alleged an anticompetitive purpose to an anticompetitive effect. We found that more cases succeeded where they alleged an anticompetitive purpose than an effect. I think personally that the reason for that is that if you want to show an anticompetitive effect you need expert economists and they often oppose each other whereas for purpose the court can just assess the direct evidence of the purpose and form a view.

Senator XENOPHON—You made reference to the European approach. Ms Henrick, I think you were quite clear in both your evidence and your submission about the challenge of the inadequate pleadings in that case. How would the outcome potentially have been different under the European approach?

Mr Fisse—I think there is no doubt that in a case such as Apco or Leahy under the European approach, the concerted practice approach, liability would be imposed. There have been similar cases in Europe where liability has been imposed under that approach.

Senator XENOPHON—So, in other words, any defect in the pleadings would have been overcome by having the different test?

Mr Fisse—I would not go that far. If there were defects in the pleadings—

Senator XENOPHON—I am saying that, if the pleadings were as narrow as they were as the ACCC presented them, there would have been a greater likelihood of a remedy using the European approach?

Mr Fisse—That is my understanding.

Senator XENOPHON—You would agree with that, Ms Henrick?

Ms Henrick—The prohibition is under article 101 of the Treaty on the Functioning of the European Union. In my view, based on the latest case, which is the T-Mobile case, it has four requirements. The first requirement is that there must be an exchange of information, so the giving and receiving of information. Where the court finds that the exchange of that information is capable of removing an uncertainty it finds that it satisfies what the Europeans call the object test, so it has an anticompetitive purpose—that is how we look at it.

The third element is a presumption that if there is an exchange of information and it has the purpose of removing an uncertainty then it will have an appreciable effect on competition. The person who is being prosecuted can try and rebut that presumption, which is what is happening in that T-Mobile case. So under the European law there is both a purpose and an effect requirement, and that is entirely different to what is in the government's exposure legislation, because it requires neither.

CHAIR—I was going to ask something about the EU situation. The ACCC seems to have a strong desire, from the evidence that they gave this morning, to be able to operate in this area with an EU like approach. Is that what they are getting with the draft legislation?,

Mr Fisse—In my view, no. I think there are fundamental differences between the prohibitions in the exposure draft on the one hand and the prohibition against entering into a concerted practice under article 101 of the European treaty. Sharon Henrick has gone through the elements of a concerted practice. They are very different from what is proposed in the exposure draft. One fundamental difference is that at least article 101 is seeking to require strategic coordination between competitors, whereas there is no definition requiring strategic coordination under the exposure draft prohibitions.

CHAIR—Is there any similarity? Is it heading us more towards a European approach?

Ms Henrick—I think it is taking us away from the European approach.

Mr Fisse—And I, for one, do not understand why more effort has not been put into trying to capture the essence of the concept of a concerted practice under European law if we must have, if we need to have, amendments to the Competition and Consumer Act in this area.

CHAIR—How easily would the EU approach to price signalling translate into the Australian competition law scenario? Could you pick it up and introduce it or would it require other changes?

Mr Fisse—There are a number of difficulties in simply translating it. I do not believe that would be possible. There would need to be quite considerable drafting changes. Another fundamental difference that is worth noting is this: there is essentially a defence of legitimate business justification under article 101 of the European treaty; there is no equivalent exemption of a legitimate business justification under these exposure draft prohibitions. It is true one can apply for an authorisation by the ACCC under the exposure draft provisions, but, as is well recognised, that is a very costly, cumbersome and largely commercially impractical solution.

CHAIR—There are lots of questions I would like to ask but we do have limited time. I would note that I suspect you may well come before the majority of this committee in a proper examination of the bill itself when it becomes a bill and comes before the Senate, so we might have another opportunity to delve more deeply into the issues of the provisions.

In terms of the exemptions and authorisations, I raised this morning with the ACCC some of the issues about unintended consequences and how difficult it might be to step through all the questions that need to be asked—and I think are asked in some of the submissions you put before us—and answered before you end up with a workable solution. They say that the exemptions and authorisations provide them with the answer to be able to authorise activity that might be positive in nature in terms of competition, normal business practice or whatever it might be; that using those does actually provide the solution, so any problems that you might have can be fixed with that, everything will be fine, and we are just left with the restrictions on those activities which are deemed to be anticompetitive. What do you say to the ACCC's evidence in that regard? I know you have already partly answered that.

Ms Henrick—Yes, so we are going to have a very similar answer. The authorisation procedure can be very time consuming and very expensive. Where you have got an ongoing arrangement such as a joint venture or some kind of consortium, they are long-term relationships where you need an ongoing exchange of information. The commission only authorises those arrangements for up to five years at a time, as a maximum, so every five years the parties have to go back before the commission and go through a public process. I think authorisation is not an efficient way of dealing with something that obviously has a legitimate business rationale.

CHAIR—It sounds like putting in place clumsy legislation and then saying, 'We'll fix it by letting you off the hook with all these sorts of things if you can justify it and go to the expense.'

Senator HURLEY—I have a general question on this idea of strategic coordination. An article in the *Australian* in 2009 reported the comments of ANZ CEO Mike Smith. 'While reluctant to increase home loan rates over and above the Reserve Bank rates, if other banks move their rates outside moves by the RBA he would not be stuck on his own.' Do you believe that that kind of comment should be prohibited?

Ms Henrick—If under the current law and if when Mr Smith made that comment—

Senator HURLEY—I am not asking about current law.

Ms Henrick—It may be prohibited.

Senator HURLEY—Okay. You believe that he could be prosecuted under the current law.

Ms Henrick—If Mr Smith's intention was to signal an intention about what ANZ would be doing in the future and he had that intention together with a suggestion that the recipients of his signal might follow then the current law would prohibit that conduct.

Senator HURLEY—Clearly, there is a difference of opinion here again. The ACCC said that not only would that not be prohibited under the law but also if he said it privately it would not be prohibited.

Ms Henrick—It depends on Mr Smith's purpose and his intention. We do not have evidence of that currently.

Senator HURLEY—There is clearly a difference again between your interpretation of the court tactic with the Apco case and that of the ACCC. Rather than trying different things in court, would it not be better to make the intention of the legislation clear?

Ms Henrick—I believe it is clear, to be honest. When you plead a case to court you have to make sure you plead it properly, taking into account the risk that you might lose some of your arguments. So you need a backup. We were not involved in the Apco case, but in that case it seemed to us that the commission did not plead the backup. We believe that if it had pleaded the backup, it should have won that case; that it pleaded it too narrowly.

Senator HURLEY—Mr Fisse, can I get your response to the ANZ CEO's comments? Do you believe they should be prohibited?

Mr Fisse—I think that is a very marginal case. I raise the question whether in any event it should be a matter of priority for the ACCC to be taking enforcement action in that kind of case, particularly given that the same outcome could be achieved in other ways—for example, by making a continuous disclosure statement in a rather more skilful way than was made by the CEO on that particular occasion, as reported by the *Australian* in 2009. It is a marginal case. The ACCC should focus much more obviously on start cases of price fixing, of which there are still many recorded instances in the Australian economy.

Senator HURLEY—Presumably they are interested in all cases of price fixing, but we are talking about banking in particular.

Mr Fisse—The ACCC has a litigation budget, as I understand it, of about $18 million a year. It seems, with respect, rather fanciful to ask them to chase rabbits down these particular burrows, in the kind of scenario that you have raised, when there are many other cases of more obviously anticompetitive conduct that the ACCC is struggling to deal with adequately in part because of its limited litigation budget.

Senator HURLEY—You make crass populism that the politicians and the ACCC, presumably, are responding to the concerns of people with mortgage and other interest rate requirements who feel quite nervous about that sort of thing.

Mr Fisse—To follow on from that situation, if the CEO of a bank makes a statement of that kind, alerting either existing mortgage holders or potential mortgage holders to an increase in rates, I would agree with the view expressed this afternoon by Professor Valentine that that kind of information is what consumers need if they are going to manage their mortgage commitments in the future.

Senator HURLEY—What consumers do not need is a bank signalling another bank so that they can raise interest rates without fear of not being competitive. That is what concerns policy makers at the moment.

Ms Henrick—But surely, Senator Hurley, you can see that Mr Smith's intention could have been entirely legitimate.

Senator HURLEY—Oh, really? I do not necessarily see that. I am not a competition lawyer, I must admit.

Mr Fisse—I would put the point rather differently, namely that if this legislation were to be enacted it would be extremely easy for CEOs just to adjust what they say and to achieve exactly the same effect of communicating intended price increases to competitors in a way that would have a legitimate justification. In terms of the purpose test under section 44ZZX, the argument would be that there was no substantial purpose of substantially lessening competition in a market. That would be an obvious denial of liability by a person in the position of the ANZ Bank in that particular scenario and also, in terms of individual liability, the position of the CEO.

Senator HURLEY—That will provide some comfort to those who criticise the legislation in terms of not being able to provide that information.

Senator McGAURAN—How could you possibly let student Xenophon pass his law classes? Was he a good student?

Mr Fisse—He was a brilliant student.

Senator McGAURAN—Brilliant? Come on; he is not here. He is pretty good in the Senate but he had to learn more about law than he probably ever dreamt of in any of your lectures. Bank representative Mr Steven Munchenberg of the Australian Bankers Association wrote an article in the *Australian* on 17 January. He has riddled through it the mantra of the banks and bank chiefs that there is an inverse relationship between competition and stability—that you have to play one off against the other; you have to find a balance—and that if there is too much competition, you have instability; so much so that the executive of the Australian Bankers Association makes quotes that the global financial crisis was related to exactly that—that too much competition led to all that instability. He says:

> ... one conclusion from the crisis is that too much competition can undermine stability, and that a stable banking system is crucial to economic growth.

That is known. He says that instability 'is the result of excess competition', and goes on to say:

With US banks still failing, and EU countries struggling with their government debt, investors are not taking bank stability for granted, even if Australians are.

He goes on further:

The challenge for this year will be to strike the right balance between stability and competition …

You can see that it is to their advantage—and I asked you the same question—to define competition to their liking.

I ask these questions: was the global financial question related to too much competition or was it more related to bad management and lack of regulation? The second question is: what is competition? I thought the touchstones of competition were many players, which led to the efficiency of the market. Or am I wrong and they are right?

Mr Fisse—Firstly, I am hesitant to speak about a particular causal connection that I have not really looked at closely—that is, between competition on the one hand and so-called stability on the other. But I must say I am profoundly sceptical. It seems to me to be a very simplistic view of economic causes and effects. To answer the second part of your question, it would seem to me that the problem in the global financial crisis, at least at the beginning with Lehman, really stems from a number of factors, again. I think it is too simplistic to say that there was too much competition. Personally, I would be inclined to say that there was not enough regulation, but that is my own view of that situation.

Senator McGAURAN—And bad management?

Mr Fisse—And bad management. It is not an argument about some kind of close or symbiotic relationship between stability on the one hand and competition.

Senator McGAURAN—Ms Henrick, do you have a point of view on that?

Ms Henrick—I would be very reluctant to distil down a single cause of the GFC, to be honest. But it was my personal impression at the time that there was a lot of cash in the global economy and that some types of financial instruments were not sufficiently regulated. But that is easy to say with hindsight, especially in instruments that related to certain types of debt market. As to the relationship between competition and stability, certainly when I was a student of economics what you were aiming for was some kind of equilibrium. I am not sure if that is what Mr Munchenberg is saying when he talks about stability, but certainly in economic theory I suppose you do have those equilibrium points that are, in a homeostatic way, relatively stable.

Senator McGAURAN—Do I take it that you both disagree? So there is an inverse relationship between stability and competition?

Ms Henrick—I am just not quite sure what Mr Munchenberg means when he speaks about stability. If he means a point of equilibrium then I can see there is a relationship, because competition drives that, certainly in theory.

Senator McGAURAN—I can tell you what they are meaning. The reason I am pushing this point is that four CEOs have come before us, all on $10 million plus each, and he is trying to direct the very definition that this committee should be looking at. This committee is all about competition, so it is not to be sneezed at—let alone their representative writing feature pieces in a major newspaper. They are quite serious about this connection, and you are right: they have not gone into the depths of defining stability. The common understanding of that is basically bank failure or not or bank lack of profits or lesser profits or not. That is the only way you can take it—the common understanding of stability. So I would ask you to take the common understanding.

I take it quite seriously. They must all think we are all mugs, and that must be how they are going to treat the economy in their little oligopolistic way, if they think we are going to buy their definition of stability—and they keep it going like a mantra. It is a serious point. They have no right, I think, to come before us and tell us that competition has an inverse relationship to stability. If there is a deeper meaning to what they have said they have not attempted to tell us. On face value it is just that. I think they have been trying to treat this committee as mugs, and I think that must reflect in other ways they manage their banks and their clients.

I would ask you again. Competition and many players drive efficiency of the market. Gail Kelly told us that it does not drive efficiencies in the market: too much competition actually drives inefficiencies in the market. Read her in *Hansard*. That is the definition of competition and the definition of instability is, as I said, quite simply lesser profits and even bank failures. Is there an inverse relationship?

Ms Henrick—I read a paper by Ken Henry that was written almost a year ago now, about competition in the retail banking sector in Australia. Even though I am a lawyer it did seem to me that what he was saying was very cogent because he was saying that there was competition in the retail banking sector. In that paper he set out the reasons but he spoke about the importance of innovation going forward in that sector.

I think there is evidence of competition in the banking sector in Australia. Whether it is the right amount or whether it needs changing is another question but I think that to say that there is no competition, for example, or to portray it in kinds of extreme, does not seem to be helpful.

Senator McGAURAN—I am going to try and pin you down on this. This will be my last attempt so if you want to duck it you can. To this point I fear you have; correct me if I am wrong. Is there an inverse relationship, as we are being told by the big four, between competition and stability?

Ms Henrick—It depends on the type.

Mr Fisse—My own view is—

Senator McGAURAN—I know where you are coming from. I thought maybe in the cloisters of this room and with the protection of the table you might give us the upfront answer, which the professor has.

Mr Fisse—I think what I said before was that it seems to be a dubious proposition because there are so many complex factors that one would need to consider. It is an empirical question, ultimately. This theoretical speculation about relationships between a select number of things that are happening in a market seems to me to be too simplistic or at least, to use the economic jargon, 'contestable'.

Senator McGAURAN—Good on you. I will leave it at that.

CHAIR—I might finish off with a few more questions. When I was asking questions of the ACCC this morning I think I quoted one of your submissions. I am not sure which one; I was flicking through and I found it there. I think it may have been yours, Ms Henrick. It talked about how the ACCC did have the power to proceed with prosecutions, and there were four dot points that followed, indicating certain scenarios. If it made out each of those individually then it would be able to proceed with prosecutions. I asked the ACCC, 'Where is the problem here? Some commentators think that you do; you say you don't.' Their response was essentially, 'The difference is in what they think we should have the power to do.' That was how they put it. I do not want to paraphrase them or misquote them but my understanding was that they were saying, 'Where commentators think we have the power to take action it is because that action does not go as far as we would like to go.' That was their interpretation of the differences of opinion between people like you, who say that they do have the power to take action, and their position that they need further powers to be able to address it. I think the issue, as they say it, is that they want to go further. Is that a position that you would agree with?

Ms Henrick—No, I do not agree with that. It is not a question of whether they should; we would say they could have gone further if, in that Apco case, they had pleaded it differently. It is as if I were drafting the terms of reference for a Senate economics reference committee and I only drafted two criteria. One of the possible consequences of that is that when you start doing your inquiry you find that your criteria is too limited because you cannot possibly predict everything that is going to happen. So whoever drafts your criteria has a final criteria, 'other relevant matters' and drafts some other, very general, criteria in your terms of reference. What we are saying is that when the commission pleads a case it needs to have a similar attitude. It cannot plead fanciful causes of action but it could have pleaded an alternative and we think that if it had pleaded an alternative it would have succeeded.

It is like if I were drafting the terms of reference for a Senate Economics References Committee and I only drafted two criteria. One of the possible consequences of that would be that, when you started doing your inquiry, you would find that your criteria were too limited—because you cannot possibly predict everything that is going to happen. So whoever has drafted your criteria have final criteria—other relevant matters—and there are some other very general criteria in your terms of reference. What we are saying is that, when we commission and plead a case, it needs to have a similar attitude; it cannot plead fanciful courses of action, but it could have pleaded. And we think, had it pleaded an alternative, it would have succeeded.

Mr Fisse—I have a slightly different view, which is that there is a difference, and a significant one, in the definition of collusion in Australia and in other jurisdictions such as the EU, the UK and to some extent in the US. There is a difference in definition and the scope of liability is broader in those other jurisdictions. Just to focus on that: there is no requirement of commitment, in the same sense, in the EU, in the UK or in the US. In my view that difference should be

recognised and conceded. The question is: if there is a gap, is it possible to plug that gap by adopting prohibitions that do not go overboard, that do not throw the baby out with the bathwater—as in my view the exposure draft prohibitions do? In short, I think the gap between Australian law on the one hand and the law in other jurisdictions should be recognised.

CHAIR—So your evidence is that the ACCC may well be right in saying that they want to go further—there may be some aspects of the law that could address a gap that exists between their legislative powers and those of similar regulators elsewhere—but you are suggesting that, to the degree that the mischief needs to be addressed, they currently do have those powers; they are just not using them in the right way at this point.

Ms Henrick—I think there is recognition of a mischief. I have tried to explain that by talking about the Adelaide publicans case, which I think was a very early case of price setting, albeit not in the banking industry. While I am more familiar with European law than US law, it is true, as Brent said, that you do not require a commitment to act; all you need is an exchange of information. But, actually, under Australian law, you can have just an intention, an attempt, to exchange—the exchange could even be unsuccessful. So, in many respects, I think the Australian law, even though it is different, our law of attempts would actually allow the commission to cover greater ground.

CHAIR—And if there was put in a pleaded case, you could achieve similar outcomes?

Ms Henrick—Yes, I believe that.

CHAIR—I have a final question on a specific matter you raised, Ms Henrick. Your submission argues for a broad IWT exemption for interest paid to non-residents by financial institutions. Can you elaborate on the distortions that this would remove, and do you know how much this would cost?

Ms Henrick—Could I take that on notice? I am a competition lawyer. Although I am here on behalf of all of Mallesons Stephen Jaques, that was part of our submission that was written by one of my colleagues in the banking and finance group. So I am sorry, I do not feel qualified to answer that question.

CHAIR—No problem; thank you. There being no other questions, thank you very much for your assistance.

[4.09 pm]

McPHEE, Mr James Lachlan, Chief Executive Officer, Members Equity Bank

CHAIR—I call Mr McPhee from Members Equity Bank. Thank you, Mr McPhee. Would you like to make an opening statement?

Mr McPhee—Thank you. Good afternoon, and thank you for providing ME with the opportunity to appear today and provide our views on competition in the Australian banking sector. I welcome the opportunity to make a few opening remarks and look forward to responding to any questions the committee may have. I thought I would begin with a couple of opening comments about ME Bank. ME Bank was established in 1999 and obtained a banking licence in 2001. It is owned by 33 industry super funds. Since inception, ME Bank has been formed to provide simple, fair and transparent banking products and services, targeted mainly at members of the industry super funds. ME Bank has assets of approximately $20 billion, in excess of 230,000 customers and more than 700 employees across Australia.

As a relatively new participant in the banking landscape, operating with a small, 13-branch network, ME Bank has relied heavily on wholesale markets via securitisation to fund its growth. ME Bank issued its first residential mortgage backed security in 1995 and has undertaken over 45 transactions, with a total issuance of around $40 billion. Over time, this has allowed ME Bank to continue to grow its mortgage portfolio, which now consists of around 123,000 home loans, whilst maintaining responsible lending policy, evidenced by the fact that no losses have resulted from any of the RMBSs issued.

ME Bank is proud of the fact that it has always acted as a responsible lender and did not follow the market in reducing underwriting standards when there was an abundance of liquidity and capital available. The philosophy has always been to develop products that are in the consumer's best interests, not the shareholder's, and to ensure that credit is only extended where there is clearly the capacity to repay.

The success of the RMBS market was a key driver in the significant reduction experienced in home loan margins during the late 1990s and early 2000s. This has enabled a number of newer, smaller entrants to compete against the larger, more established institutions. The underlying beneficiaries this competition created were the consumers, reinforcing the view that access to competitive funding plays a critical role in competition.

The global financial crisis disrupted wholesale markets, affecting both availability and pricing of funding. As we are all aware, governments around the world acted to ensure stability of the banking system, which was an entirely appropriate response when, at the height of the crisis, all banks faced funding challenges. Whether or not the pricing structure of the government guarantee on wholesale funding was optimal, I believe, is open for debate, but the government response as a whole was timely and well executed.

However, due to poor underwriting standards for home loans in many countries, the securitisation markets around the globe stopped functioning as investors became nervous about

the quality of the assets they were investing in. The market did not discriminate between countries in the respective quality of the securitisation issues but simply threw the baby out with the bathwater. In Australia, the closing of the securitisation markets made it difficult for many of the smaller players to remain competitive. If this market failure had been due to poor lending practices within the Australian banking system then I believe there should be no cause for complaint, as the industry would have brought it upon itself and should have to deal with the consequences. This was not the case but simply a failure of the overall system. Consequently, I strongly believe that government intervention in working towards ensuring the RMBS market was able to operate somewhat effectively again was entirely appropriate.

In our submission and comments on the reform package announced by the government, we focus heavily on supporting any initiative that assists the operation of an efficient and effective securitisation market. With around two-thirds of the Australian banks' balance sheets in mortgages, the RMBS market is a significant funding source and thus critical to ensuring competition.

Finally, ME Bank endeavours to compete on other factors in addition to price and to invest in providing an enhanced customer experience. The bank was recently acknowledged as being the financial institution whose customers were most likely to promote their financial institution to family and friends. We are proud of this accomplishment during a period in which financial services providers and customers endured challenging economic conditions and many customers had a negative sentiment towards their bank. Critical to the functioning of competitive markets is the ability for customers to exercise choice. Our submission is supportive of further examination and measures to develop an efficient mechanism to allow customers to easily and efficiently select and change financial institutions. ME Bank is determined to continue to provide a competitive banking alternative and supports any reforms aimed at promoting competition. Once again, I thank the committee for inviting me to comment.

CHAIR—Thank you for that, Mr McPhee. Your submission refers to—and you have referred to it today—problems caused by the weakened state of the securitisation market. How much did that hamper your actual ability to lend? Did it actually cause you problems or were you able to continue to meet demand for lending?

Mr McPhee—No. During the period of the GFC there is no doubt that demand outstripped supply. The organisation managed that through a number of standard procedures: through tightening credit, so restricting access to funding through that mechanism, and through price. There is no doubt that during that period the bank could have lent more than it was able to lend had the markets been operating normally.

CHAIR—You said you tightened your lending. How did you differentiate between the customers you were going to lend to? Was it by applying higher lending standards?

Mr McPhee—That is right. There are a couple of mechanisms to do that: through the loan to evaluation ratio, in terms of ensuring greater quality of credit, and through capacity to repay, building a greater buffer of capacity to repay.

CHAIR—So as a consequence—and I am sure this was not something you were intending—there were some people who may have qualified for loans through you prior to the GFC who did

not qualify afterwards and missed out despite the fact that in normal circumstances you would have thought they were a reasonable risk to lend to?

Mr McPhee—Yes. I think that is a very fair statement. I think you would see that applied right across the banking industry. You only had to look at the mortgage loss insurers who tightened the loan criteria at which they were insured. As a securitiser obviously you need to insure the loans that you securitise. So to some degree the competitiveness in the mortgage loss insurance industry does have an influence on what loans you can underwrite if the intent is to securitise those. The tightening of credit criteria that occurred across the banking industry was quite well reported during that period of time.

CHAIR—Has that normalised now? Are you able to meet demand now?

Mr McPhee—Yes, we are. That is why we continue to say that the support under the AOFM program has been very important. As part of that we have issued a number of securitisation deals since 2007 which enabled us to meet demand, as you put it.

CHAIR—You have mentioned in your submission that is very important that the AOFM has stepped in to facilitate and restart the securitisation market. To what extent has ME Bank involved itself in the AOFM issuances?

Mr McPhee—Since the onslaught of the GFC, ME Bank has done eight securitisation issues for a total of $6.1 billion. In five of those issues there was AOFM involvement and the amount that they took up was $1.79 billion and those five issues totalled around $4.2 billion. That is creating capacity for us to on-lend. So you can see it is quite significant.

CHAIR—So involvement of the AOFM in those five issuances essentially gave the market confidence to also join in to buy your securities?

Mr McPhee—That is exactly right. It provides that cornerstone investment and confidence around that issuance. It also enabled price to be driven down to create a more competitive environment. The bank did conduct a couple of early issues without AOFM support at much greater margins. Once the AOFM support came in the margins reduced to about 130 basis points over the bill rate down to currently 110 basis points. The latest cash rate adjustment by the RBA on Melbourne Cup Day enabled ME Bank to increase our mortgage rate only by the 25 basis points in line with the RBA, again it is basically because of the competitiveness of the securitisation market.

CHAIR—How do your mortgage rates compare with the four majors?

Mr McPhee—Our standard rate is 7.24 per cent, which is anywhere between 45 to about 62 basis points below the standard rate of the major banks.

CHAIR—You are not a mutual though, are you? You are owned by—

Mr McPhee—We are owned by 33 industry super funds. However, those funds operate at a profit for members, so all the profit the bank makes ultimately is around a profit from the member business model.

CHAIR—Do profits from the ME Bank go to the super fund?

Mr McPhee—Correct.

CHAIR—So it is not contained and reinvested in lower prices. It goes around, in a way—

Mr McPhee—Exactly.

CHAIR—but not everybody who is a member of a super fund is necessarily a customer of ME Bank.

Mr McPhee—That is correct. There are 5½ million members of industry super funds. As I said, we have about 230,000 customers. Any profit that ME Bank makes goes back to the industry super funds and their profits obviously go into returns to their members.

CHAIR—In essence, from the industry funds' perspective, this is an investment which is intended to earn an income and help supplement the retirement savings of those industry funds' members.

Mr McPhee—Correct. They are making an investment on behalf of their members in ME Bank.

CHAIR—Like in Westpac or NAB or any other vehicle they may choose to invest in.

Mr McPhee—Correct.

CHAIR—In terms of what is going on with the AOFM's securitisation, the government will be putting in up to $20 billion.

Mr McPhee—Yes.

CHAIR—To what degree do you think the government will need to act further through the AOFM to stimulate the securitisation market? Or do you think that the market will recover? We had evidence from the RBA on the first day of these hearings in which they indicated that probably half of the securitisation market as it existed prior to 2008 in Australia was coming from unsustainable special investment vehicles from overseas which are unlikely to return. If you look at the quantum of securitisation that is going through the Australian market now, we are getting close to about half of where we were prior to the GFC, which would suggest that if special interest vehicles are not coming back we are probably getting back to around where we were. If that is the case, do we need further involvement by the AOFM and, if so, why?

Mr McPhee—I think that is the critical question that you have just asked. I think that the further investment by the AOFM of another $4 billion to take it up a total of $20 billion is a good step forward. When that funding has been used up, I think the question then will be, 'What is the state of play of the securitisation markets at this point in time?' I think you have asked the crystal ball question there. The markets certainly are focusing now better than they were. We have, as I said, conducted a couple of issues without AOFM support. So everyone is out there testing the resilience of the markets. I completely agree with your comments that SIV structures are

unlikely to come back for all the reasons that we have just been through from over the last three years. I am comfortable with where the AOFM currently sits. It is providing us with the support that we need to stay competitive and to meet our customer demands. But it will be interesting to see if the floods in Queensland have an impact. I think it would be difficult to conduct a securitisation issue with a lot of asset exposure in Queensland at this point in time. Again, I think it is just a wait-and-see exercise.

CHAIR—I have some more questions, but I want to give others an opportunity. I know that Senator Hurley has to leave a little bit early.

Senator HURLEY—You were saying that you were formed in 1999; is that right?

Mr McPhee—That is right, yes.

Senator HURLEY—We had some evidence previously from non-bank mortgage providers—in particular, John Symond from Aussie Home Loans—who said that during the nineties it was they who drove down the interest rates at that stage and created the competition. I think there is a fair argument for saying that. Do you think that organisations like yours are now performing that kind of function?

Mr McPhee—ME Bank resulted out of another entity, called Super Member Home Loans, which was formed in 1994. That was around the same time as Aussie Home Loans. In a previous life it was Adelaide Bank, which was quite a heavy user of securitisations, with the first issue in 1996. As I said in my opening address, I genuinely believe it was the advent of the securitisation market and those players that reduced margins on home loans quite considerably. I do think it is now organisations like ME Bank that are providing the innovation and competition to make sure that margins do not blow out. Obviously, the more concentrated the market becomes, the greater the ability to widen margins. I think it is organisations like ours that are providing the extra competition to make sure that does not happen.

Senator HURLEY—Would you say there might also be some argument for saying that the kind of banking structure you have does provide more safety and security in terms of what the market does if we return to the stage where finance is easier and cheaper to obtain again?

Mr McPhee—Sorry, the question being?

Senator HURLEY—Is your banking structure a better structure to drive competition than the non-bank mortgage providers that were around in the nineties?

Mr McPhee—Since the GFC, the approach that ME Bank has taken is that we are growing our balance sheet and therefore we want a mixture between retail deposits and securitisation. Nowadays, unless you are almost 100 per cent retail funded, people are saying that there is risk. I do not subscribe to that view because I think each market has its risks from time to time. One thing about the securitisation market is that what it actually does is perfectly match funds to the assets that you are funding, because in effect you are selling that income stream into the marketplace, so that there is no maturity risk that comes with securitisation. I would like to think that the structure that ME operates under now does provide a greater level of stability in the system, depending on whatever shocks the market might throw at us.

Senator HURLEY—Good. There has also been a fair bit of discussion during the hearing about the interplay of super funds and the banking sector. Indeed, there is an article in today's *Financial Review* on that very issue. Given that you have got a foot in both camps, so to speak, can you provide your view on the interaction there?

Mr McPhee—If you look at the whole structure of the financial system at the moment, people are saving through super and it is the banks that are providing credit. Providing credit is so important to an economy. You want to get credit out into the productive economy—I do not think there is any dispute about that. If you go back to my parents' generation, their assets and liabilities or their savings and their borrowings were probably with the one entity. You cannot keep saving in one vehicle and borrowing through another vehicle unless you somehow transfer those savings and put them to productive use, to where people want to borrow. So, clearly, that is the structural issue that has to be resolved. Obviously the way that is happening today is that those funds are being borrowed from offshore. That is the balancing item that we are seeing. A lot of super funds are investing offshore, so to some degree it is a circular flow of funds.

I know there have been some views about mandating a certain percentage of super funds' investments into a specific asset class and that sort of thing. I do not subscribe to that. I believe that the super funds' sole purpose test is a very reasonable test: to act in their members' best interests at all times. But what I think we can do, and what we are trying to emphasise in our submission, is to make the securitisation market active and provide good investment vehicles with good income streams flowing from them. There are a whole bunch of ways you can encourage people to invest. It is no different to, say, investment housing, where there is a tax benefit for having an investment in housing. So it can be done through a number of ways, rather than mandating industry super funds to put a certain percentage of their investments into that asset class. I think there are better ways to achieve that outcome. But there is no doubt that you cannot have all your savings in one vehicle, called the industry super funds, and all your borrowings coming out of the banks.

Senator HURLEY—Do you think that covered bonds might form part of that mix?

Mr McPhee—Yes, we are supportive of that. I know not every participant in the industry is supportive of that, saying it actually assists the major banks. I suppose we take a slightly different view—that anything that assists having liquid markets out there and funding available to banks to lend out into the productive economy is a benefit to the system, because, if you can access different funding pools, that should take the pressure off other funding pools. So I think, as a broad industry comment, it is an initiative that we are supportive of. I do not think there is any sort of magic bullet out there, by the way. I do not think it is the solution itself but I think it is part of the solution.

Senator HURLEY—Do you think it would benefit the major banks more than banks like yours? That has been one of the criticisms.

Mr McPhee—Yes, it does, through the rating. We are a BBB rated entity and, therefore, we need a greater level of subordination, and that influences the cost of the funding. That being said, if there is a securitisation market that is operating and a covered bond market that is operating, I still think that what that does is take the pressure off other funding pools, and that is only going to be in our best interests—in the smaller placed best interests, anyway. So I understand that

argument. I still think that, if it is acting in the industry's best interests, we are possibly a beneficiary of that anyway.

Senator HURLEY—Right. Your submission talks about a government-provided lenders mortgage insurance. You discuss that issue and you say:

Explicit Government insurance against catastrophic risk would commoditise mortgages to a greater extent, reducing margins (and interest rates) measurably.

That is pretty topical, considering the flooding situation. Could you expand on that a bit more, on how that might work.

Mr McPhee—Sure. All we are saying is that a fundamental component of the securitisation market is that you have mortgage loss insurance. It is no different to the competition argument in the banking industry. The more consolidated that gets, the less competitive that insurance becomes and the harder it is to develop economic securitisation vehicles.

If you go back in history, there was a government mortgage loss insurer and there were four or five at one stage. We are down to two. As I mentioned in my opening statement, we saw credit conditions tighten through the GFC and a lot of that was actually driven by the mortgage loss insurance. That is a completely rational and reasonable response.

All we are saying there is that we think it is important that we keep competition in that market, the mortgage loss insurance market, as well, because that is an input into making sure that the securitisation market operates effectively and efficiently, which means players like us can provide that competition to make sure that mortgage spreads do not increase. That is, if you like, the flow-on effect that we are trying to get to there.

Senator HURLEY—So, if the government themselves were to get involved in that market in order to increase the number of players in it, would you see them doing that on the basis that they recovered costs? Because, if not, then the cost would have to be borne somehow or another.

Mr McPhee—I think it could be a commercial enterprise that is profitable; it could make money. It is not a cost exercise, if you like. I suppose it is our response to the commentators talking about Fannie Mae and Freddie Mac in the States and whether we should set up those types of vehicles. I do not think that is the right response. There was talk about just a government guarantee for mortgage-backed securities, to make sure that market continues to function. Here there is even a lesser onus on the government to make sure that it is really a product solution, providing insurance on a purely commercial basis, and I think it could get an appropriate economic return. It is really just making sure, again, that that market is competitive.

Senator HURLEY—It is quite possible that the government might in fact provide a form of default insurance, in the end, by having to contribute a fair bit of money to the rebuilding in Queensland and possibly Victoria and elsewhere. So, much like the bank guarantee, the government kind of end up—in a major catastrophe—being an insurer in some respects in any case.

Mr McPhee—Exactly right. That is a very good point. So what this is trying to do is put in place a solution before that, if you like, which is done on an economic and sustainable basis—and it is trying to resolve that very issue you are talking about. It is just an idea that we thought was worth exploring.

Senator HURLEY—One final question on a different subject: ATM access and fees. Does your organisation have ready access to a network? Does it have an ATM network of its own?

Mr McPhee—Yes, we use Westpac. We do not have our own proprietary ATM network. We leverage off Westpac's.

Senator HURLEY—Do your customers pay ATM fees?

Mr McPhee—Yes, they do at the moment, but, again, that is something that we are looking at. To be honest, with competition, that fee is something we need to absorb as a cost of using Westpac's ATM network.

Senator HURLEY—Do you think there is a need to try and increase competition between those ATM providers? This inquiry has considered at length that perhaps fees have not been driven down as much as the RBA might have hoped. Would you agree with that?

Mr McPhee—I think it is reasonably competitive. If it could be more competitive, I would be in favour of that. We have to be careful about the economics of providing ATMs. We do not want to drive them out of the industry because players would stop investing in that infrastructure, and that is not in anyone's best interests. There is a balance between making investment in ATM networks rational and logical and giving the customer a fair proposition.

Senator HURLEY—Is the fee that Westpac charge uniform across Australia between metro and rural areas, or does it vary?

Mr McPhee—It is for us. I am not privy to what they charge elsewhere. I am only aware of our arrangement.

Senator HURLEY—Thanks.

CHAIR—I note your submission raises the issue of the AOFM extending the scope and the type of security that it purchases and moving on from just the AAA. Is there a greater risk to taxpayers in doing that? Currently, the money that the government has invested through the AOFM has been a good and safe investment, and it is earning good money too, I believe. If they extend beyond the AAA, what risks are there to the taxpayer and are they something the taxpayer should be concerned about?

Mr McPhee—I will answer that question in two ways. Yes, the risks by definition will be greater as you work down the tranche of securitisation. The highest rate of tranche gets paid off first, but by definition the risk must be greater. Do I think it is an acceptable risk at the price? Yes, I do. There has not been a dollar lost in the RMBS market in Australia. In the 45 issues that we have done, over $40 billion, we have never lost a dollar. Our underwriting standards are very disciplined. Then there is mortgage loss insurance and, if you like, there is the structuring of the

bonds, and the different rating of the different tranches. Do I think it is an acceptable investment? Absolutely, and I think history shows that. This reliance we have on the rating agencies is a little interesting, if I can put it that way. That was one of the core components of the GFC: the very poor underwriting standards globally, specifically in the US. These bonds were rated AAA, and we all know how that panned out. Therefore, it is curious that, on the one hand, we say that the rating agencies did not coat themselves in glory and, on the other hand, we base a whole system around validating the rating agencies' methodology.

CHAIR—If we do not trust the rating agencies, how does the AOFM assess what are good investments and what are not?

Mr McPhee—I was not saying do not trust, as a blanket comment; I say it should not all be around rating. You have asked a very reasonable question of me: do I think it is a fair investment? Yes, I do and I have given you some reasons for that. The rating agencies are not saying it is a reasonable investment; they are saying, 'This is where we are rating it.' It is just a decision as to—

CHAIR—You are not asking him to go down to junk bonds or anything like that.

Mr McPhee—No. That is right. We can point to a long history in this country. If you look at the basic underwriting standards that banks require, the critical question is whether these asset classes or securities are worth investing in or not.

CHAIR—Given that—and your evidence is not inconsistent with what other non-major banks have told us—I presume you think the government is being overly cautious.

Mr McPhee—Yes.

CHAIR—If so, why do you think they are being overly cautious in this respect, given the potential benefits that you and others outline for the market if they were to invest in these lower rated securities?

Mr McPhee—Great question. I do confirm your assumption of my answer to your first question. I do think the government is being overly cautious. Why? Well, I completely accept that the government's balance sheet is not there to bail out or assist commercial enterprises. That being said, I think it should be used in times of fundamental market dislocation if that means ensuring competition which acts in the best interests of the general population or the consumer out there. That is the way I would answer that question. So, through my lens, I do think they are being overly cautious. I can understand why that might be the position. I would just say: let us hope that that does not lead to a reduction in competition, which has its own costs.

CHAIR—You talked there about the government using its balance sheet. Are you saying there should be more than the current $20 billion that is promised with the additional funds used in lower rated securities, or do you think that the $20 billion or what is left of it should be spread across a number of different rated securities?

Mr McPhee—The government has committed $20 billion. I think at this stage that is fair enough. Spread that across the different tranches of the securitisation. When that $20 billion looks like it is getting close to being fully utilised, let us reassess.

Senator XENOPHON—Following on from Senator Bushby’s line of questioning about the quality of rating agencies, I could talk about whether some should have gone to jail in the sense that they went from AAA to ZZZ in the course of a couple of weeks. Does that mean there ought to be a more robust way of assessing rating agencies? Should there be some benchmarks and standards for not just the institutions that are rated but also the investment vehicles; they need to be rated as well. Is that a better way of doing things?

Mr McPhee—I think that is great question in terms of this: anyone who makes an investment and outsources all their assessment of credit to the rating agencies is, in effect, outsourcing that component of their business. They are reliant on investors to make some determination about the right asset class to invest in and the riskiness of those asset classes. So I would turn around and say: the rating agencies provide their assessment; it behoves investors to then make their own assessment. If there is a difference between those two assessments, why? If there is no difference between those two, that is fine. One confirms the other.

Senator XENOPHON—We need a more rigorous approach to rating. We need to do better than we have in the past—

Mr McPhee—You could say that.

Senator XENOPHON—To put it mildly. Do you think rating agencies discriminate against smaller ADIs such as Members Equity Bank? Also, what is your view on the wholesale funding guarantee, which is up for review in October? There is a criticism that the big four have been really favoured by that. How can we redress that imbalance?

Mr McPhee—Quickly, in response to your first question: I do not think the rating agencies’ methodology has covered itself in glory. There is a good argument that turns around and says: some of the simpler organisations that borrow funds from their local community, invest in their local community, know their local community and invest in solid assets called housing are very, very safe institutions because they are not buying CDOs and they are not trading foreign exchange. There is no way that the risk team at Lehmans or the risk team at UBS could know the real risk when they said, ‘I think our risk tolerance is about $50 billion. Yep, we wrote that off. We’re good to go.’ They had very, very, very intelligent and significantly sized risk teams, but they got it wrong. So not all these models always work. If you ask me: ‘Do I think there is a bias against smaller organisations?’ yes, I do, because the answer keeps coming back to your capital base. You need a larger capital base to deal with factor X. I disagree with that. I think what you need to do is understand the underlying risks of the business and make sure your capital supports the underlying risks of the business. I would say that some credit unions are very, very safe organisations.

Your second question was about the price of the wholesale funding. As I said in my opening address, I think that the government guarantee should have been applied evenly across all the ADIs—assuming that we believe that we have, as I think we do, an excellent regulatory regime here—and not relied on the rating agents. Again, I think it validated their business model, which

I think is open to criticism, and then allowed the market to further differentiate on that, which it did. So we had two issues of $500 million each and in effect paid 150 basis points for the government guarantee, and our issues went about an extra 25 basis points over those of the major banks. So those issues cost an extra one per cent. Having two $500 million issues means we are paying an extra $10 million of interest per year. We do not make that much profit. That has a huge impact on our profitability, which again creates capital for us to go and lend.

Senator XENOPHON—And we have heard that loud and clear from institutions other than the big four banks. Thank you; that was very useful.

CHAIR—Thank you very much, Mr McPhee, for assisting us today.

Mr McPhee—I appreciate the opportunity.

Committee adjourned at 4.46 pm