COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Competition within the Australian banking sector

FRIDAY, 21 JANUARY 2011

SYDNEY

BY AUTHORITY OF THE SENATE

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SENATE ECONOMICS

REFERENCES COMMITTEE

Friday, 21 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 Bushby, Hurley, McGauran, Pratt, Ryan, Williams and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

Competition within the Australian banking sector, including:

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

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

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

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

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

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

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

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

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

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

(k) comparisons with relevant international jurisdictions;

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

(m) any other related matter.

WITNESSES

BOND, Mr James, Economist, Financial Services Council 18

BOXALL, Dr Peter, AO, Commissioner, Australian Securities and Investments Commission 2

BROGDEN, Mr John, Chief Executive Officer, Financial Services Council 18

CANION, Mr Andrew, Manager, Western Australian Small Enterprise Network 110

CODINA, Mr Martin, Director of Policy, Financial Services Council 18

COFFEY, Mr Philip, Chief Financial Officer, Westpac 65

GREEN, Mr Micah, Economist, New South Wales Business Chamber 54

HAMILTON, Mr Christopher, Chief Executive Officer, Australian Payments Clearing Association Ltd 30

HANLON, Mr Peter, Group Executive, People and Transformation, Westpac 65

KELLY, Mrs Gail, Chief Executive Officer, Westpac 65

KING, Professor Stephen, Private capacity 99

KIRK, Mr Greg, Senior Executive Leader, Australian Securities and Investments Commission 2

LARBEY, Mr Miles, Senior Manager, Australian Securities and Investments Commission 2

ORTON, Mr Paul, Director, Policy and Advocacy, New South Wales Business Chamber 54

PRAGNELL, Dr Brad, Head of Industry Policy, Australian Payments Clearing Association Ltd 30

STOLLMANN, Mr Jost, Chief Executive Officer, Tyro Payments Ltd 30

Committee met at 8.48 am

CHAIR (Senator Bushby)—I declare open the fourth hearing of the Senate Economics References Committee's inquiry into competition in 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. Further public hearings are planned for next week in Melbourne. The hearing in Brisbane scheduled for next week has been postponed to allow the witnesses to concentrate on recovering from the floods.

These are public proceedings, although the committee may determine or agree to have a request to have evidence heard in camera. I ask photographers and cameramen to follow the instructions of the committee secretariat and ensure that senators' and witnesses' laptops and personal papers are not filmed. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as contempt. It is also 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.

[8.50 am]

BOXALL, Dr Peter, AO, Commissioner, Australian Securities and Investments Commission

KIRK, Mr Greg, Senior Executive Leader, Australian Securities and Investments Commission

LARBEY, Mr Miles, Senior Manager, Australian Securities and Investments Commission

CHAIR—I welcome officers from ASIC. Would you like to make an opening statement?

Dr Boxall—Yes, thank you, Senator. Thank you very much for inviting ASIC to appear before the committee today. In opening, I will briefly outline ASIC's regulatory responsibilities in relation to banking, including in particular our new jurisdiction over consumer credit. I will also briefly touch on one or two specific areas of ASIC's work which are relevant to the issues the committee is considering.

ASIC is Australia's corporate, markets, financial services and, now, consumer credit regulator. Together with Treasury, the RBA and APRA, ASIC is a member of the Council of Financial Regulators, which provides a high-level forum for cooperation amongst its members. In regulation of banking in Australia, ASIC is responsible for administering the licensing and disclosure regime for financial products and services established under the Corporations Act 2001, which includes bank deposits and many other services offered by banks, building societies, credit unions, collectively known as authorised deposit-taking institutions or ADIs, and other financial service providers. We also administer the consumer protection provisions in relation to financial services of the ASIC Act 2001, including the prohibitions against unconscionable conduct, misleading and deceptive conduct, undue harassment and coercion and, from 1 July 2010, provisions rendering void unfair contract terms in most consumer contracts, including contracts for banking and credit products and services.

Further, from 1 July 2010 we have administered the new National Consumer Credit Protection Act, which regulates consumer credit activities in Australia and covers all ADIs and non-bank lenders. I will say more about that later. We are not responsible for prudential regulation of ADIs—that is the responsibility of APRA—nor are we responsible for regulating competition issues, which is the responsibility of the ACCC.

In our approach to regulation, ASIC has a dedicated stakeholder team responsible for monitoring and dealing with large-scale compliance issues relating to deposit takers and credit providers. Also, we have a front-line complaints area responsible for receiving and assessing complaints and reports of breaches and we have deterrence teams which are responsible for pursuing formal enforcement action against an entity, where this is called for.

As I mentioned, ASIC is now the national regulator for consumer credit as a result of the transfer of responsibility from the states and territories to the Commonwealth. The new credit laws came into effect from 1 July 2010, which means that, amongst other things, home loans,

personal loans and credit cards provided or arranged by all kinds of credit providers or intermediaries are now regulated by ASIC. The new credit laws also introduced a comprehensive licensing regime for all participants in the consumer credit industry, including banks, building societies, credit unions, non-bank lenders, finance and mortgage brokers and other intermediaries.

Under the licensing regime, existing credit business firstly had to register with ASIC by 30 June 2010 and then had to apply for an Australian credit licence by 31 December 2010. ASIC has taken an active approach to the implementation of this new regime, and at the close of business on 31 December 2010 we had received almost 6,800 applications for a credit licence. To date we have issued over 3,000 licences and we are processing all the outstanding applications. We have consulted extensively during the implementation of the credit laws and have published detailed regulatory guidance and information sheets to assist industry to understand their obligations.

Another key feature of the new credit laws is the introduction of a statutory responsible lending regime, which came into force for banks, building societies and credit unions on 1 January this year. The key concept is that lenders and brokers must not enter into or suggest credit contracts to consumers if the credit is unsuitable for the consumer. Under the responsible lending provisions, a lender or finance broker must make reasonable inquiries about a consumer's financial situation, their needs and objectives and take reasonable steps to verify the consumer's financial situation. ASIC has published regulatory guidance about how it will administer the responsible lending provisions, which is illustrated by a number of examples.

Regarding mortgage exit fees, the new credit laws came into effect on 1 July 2010, including the new National Credit Code. Also in July 2010, the government's new unfair contract terms legislation came into effect as part of the reforms of the Australian Consumer Law. For financial services such as banking, the relevant provisions are found in the ASIC Act. Under this legislation borrowers can challenge the validity of early termination fees they think are unconscionable or unfair. Borrowers may also complain to ASIC or to an external dispute resolution scheme. The borrower or ASIC can seek review of fees by a court.

ASIC published guidance for lenders about how we propose to administer the National Credit Code and the unfair contracts legislation in relation to mortgage early termination fees, commonly known as exit fees, in November 2010. This followed a period of detailed consultation with industry and consumer groups. The guidance spells out ASIC's view on such matters as what types of costs and losses might be included in an exit fee, the types of losses that might not be recovered through exit fees and the limited circumstances under which a lender might vary exit fees during the life of a mortgage.

This is not the first work ASIC has done on mortgage exit fees. In 2008, at the request of the Treasurer, ASIC conducted an industry review of entry and exit fees applying to home mortgages, and our report was published in April 2008. Also, late last year ASIC released an online mortgage-switching calculator to assist borrowers.

There is some other work that the committee might be interested in. In 2009 ASIC conducted a review of the marketing and disclosure of term deposits by ADIs. ASIC has also been active in monitoring the role of ADIs in responding to consumers facing financial hardship who are

unable to meet repayments on their mortgage. ASIC has also recently released its report on the review of the Electronic Funds Transfer Code of Conduct. The EFT code is a voluntary code that provides protection for consumers who use electronic means for making payments, including ATMs, EFTPOS, credit cards, online payments, internet banking and eBay. The code provides key consumer protections in the case of fraud and on unauthorised transactions.

My colleagues and I stand ready to answer any questions you might have.

CHAIR—Thank you very much, Dr Boxall. You raised in your opening statement the issue of ASIC's new responsibilities in respect of exit fees and how that has come about. From ASIC's perspective, do you think that any lenders are still charging unacceptable exit fees?

Dr Boxall—I will pass the question to Mr Kirk.

Mr Kirk—Following on from the work a couple of years ago finding out what was happening in many market place, our broad approach in relation to that new jurisdiction has been, as a first step, to get guidance out to industry about what we think these new laws mean and how we will administer them. From getting the jurisdiction, that took until November to do. There was detailed consultation with industry. There was a consultation paper and lots of feedback. That guidance has gone out. Our next step will be a review of the marketplace.

In the interim we have been monitoring complaints. Individual consumers can now go to the external dispute resolution scheme. It is compulsory under the new credit laws that all intermediaries in credit and all credit providers are members of one of the two approved external dispute resolution schemes. So there are places for individual complaints to go, and we are working with the dispute schemes about their handling of those, but we thought we should leave a little bit of a gap between putting out the guidance in November and starting a full-scale review of the industry.

CHAIR—You said you had done some work over the last couple of the years. It was not a full-scale review of the industry?

Mr Kirk—The work in 2008 was a review of both entry and exit fees in terms of what their levels were. At that time we were not the credit regulator in Australia—that was the role of the states—but the Treasurer asked us to look at these things, as obviously there was public concern about some of these fees. So that was really an information-gathering exercise, and we put out the results of that publicly. Following on from that, we did see some downward movement in the level of some of the fees charged by some lenders. Our next step is a detailed review of the market—a surveillance which we are preparing at the moment. We thought there should be a gap after November to give people a little bit of time to adjust and to put measures in place, and we have seen ongoing change subsequent to the guidance going out, including a couple of the major lenders stopping charging the fees on—

CHAIR—Would it be fair to say, then, that the investigations you have done and the development of the guidelines indicate that ASIC has developed an understanding of the entry and exit fees—particularly the exit fees—why the institutions do them and the varying reasons why they might put exit fees in place, and that you have developed the guidelines in order to

help financial institutions understand the circumstances in which exit fees and the size of those exit fees are okay and acceptable?

Mr Kirk—Yes.

CHAIR—And now the next stage will be to go on and make sure that the institutions are complying with the guidelines and that they are—

Mr Kirk—Indeed, and with our surveillance having a priority to target lenders who are charging the highest exit fees in the market to make sure that those fees are justified.

CHAIR—I have taken from the ASIC website 'Rules on exit fees are clear', an article by Tony D'Aloisio which was published in the *Herald-Sun* on 19 November 2010. It says in there that ASIC thinks:

Mortgage exit fees are acceptable provided they reflect—and are limited to—the lender's losses which can be directly connected to the borrower exiting the loan early.

Mr Kirk—That is correct. That is our view of the current law and how we would apply the current law.

Dr Boxall—And that is how our regulatory guidance is framed.

CHAIR—You have done a lot of work preparing to address the issue of exit fees. You have got to the point where you have guidelines, you have examined the issue and you have concluded that exit fees are okay provided they meet certain requirements or criteria.

Dr Boxall—We need to implement the law, so we have put out a regulatory guide about how we propose to implement the law. So, in the event that there is a case of a mortgage exit fee which we think is outside the law, we would move to take action.

CHAIR—Okay: you will move on that. But, given the steps that you have outlined and where you are currently at—including developing the guidelines, allowing a little bit of time for people to adjust to those guidelines and now moving towards the enforcement stage of the overall program—you have not really had a chance yet to see whether what you are doing is actually going to address the perceived problem that the public sees with exit fees.

Dr Boxall—We are just moving into the stage of surveillance and enforcement. That is what is being done.

CHAIR—So it is not yet evident whether what you are doing is going to work to the extent that it will address the problem.

Mr Kirk—Our primary task is to implement the law. We will be checking that the existing law is being complied with. Whether compliance with that existing law satisfies the public concern about exit fees is beyond our control. What we do really comes down to making sure there is compliance with the current laws.

CHAIR—But ASIC considers that the work it has done in terms of developing the program you have in place for exit fees would adequately ensure that, as you move down and actually start implementing it, you would be able to minimise the likelihood of financial institutions using exit fees to unreasonably add to profits and not just cover the costs of doing business that exit fees are supposedly charged for?

Dr Boxall—Yes, because we consider that the regulatory guidance that we have put out is quite clear about where we propose to go and that the financial institutions stay within that regulatory guidance and within the law then the law will achieve what it was aiming to achieve.

CHAIR—And essentially that is that the mortgage exit fees that would be in place after you have gone through that process and checked it would be limited to the losses of lenders which could be directly connected to the borrower exiting the loan early?

Mr Kirk—Yes, that is correct.

CHAIR—I guess it is probably a policy question whether it is reasonable for financial institutions to recover those costs which would be directly connected to the borrower exiting the loan.

Dr Boxall—That is a policy question, but that is how we interpret the law and how we propose to implement it.

CHAIR—Obviously the Treasurer has announced that he is going to ban exit fees from 1 July this year, but that is only on new loans. You will have an ongoing role with existing loans, presumably?

Mr Kirk—Yes, we would have an ongoing role with existing loans and an ongoing role with some aspects of payments on early termination, which would not be covered by the ban. As I understand it, some of the basic administrative costs of terminating a loan will not be covered by the ban, and I think there is also scope for the break fees on fixed-rate loans to still exist. Both of those would still be subject to the pre-existing laws, so we would have an ongoing role in administrating the laws in relation to those aspects of payments made on early termination.

CHAIR—But, presumably, the role that you will play in terms of exit fees post 1 July will wind down as more and more loans are written under the new laws where the exit fees are banned?

Dr Boxall—Yes, to the extent that industry has fewer exit fees because they have been banned, we will have—

CHAIR—As loans get rolled over—

Dr Boxall—We will have less of a role.

CHAIR—the vast majority will not have been written before 1 July this year.

Dr Boxall—Yes, we will have less of a role, but, as Mr Kirk said, we will still have a role with loans and with those fees which are not covered by the ban.

CHAIR—The prudential regulation of financial intermediaries such as banks and building societies—all ADIs—is covered by APRA; the prudential regulation of non-ADI financial institutions is covered by ASIC. In a nutshell, what is the difference between the prudential regulation aspects that you oversee in respect of non-ADIs compared with what APRA does with ADIs?

Mr Kirk—This is limited to lenders. A lot of APRA's role in relation to ADIs and a lot of the prudential concern arises not because they are lending money but because they are taking money on deposit. Prudential concerns about pure lenders and all of the lenders who are outside the APRA regulation are just lending money—they are not taking money on deposit. Prudential concerns are much less in the sense that consumers are less at risk because, with a loan, rather than the financial institution having their money, the consumer has the financial institution's money. It is a very different circumstance.

CHAIR—And the money that they are lending out is sourced more on a business relationship rather than a consumer relationship as most deposits would be. They still have to get the money from somewhere.

Mr Kirk—Yes, there is another aspect in terms of how they collect the money they lend out.

Senator XENOPHON—Mr Kirk, there still is a risk, though, because if they make bad lending decisions that could affect their whole lending portfolio, couldn't it?

Mr Kirk—If a lender makes bad lending decisions and is going to go broke, is potentially insolvent, the position of the borrowers from that lender does not change. Their position is that they owe money to an institution and they may pay it to the institution or they may end up having to pay it to a liquidator, but their own funds are not put at risk by that institution's problems.

Senator XENOPHON—I am surprised you say that. Wouldn't that have implications more broadly if a lending institution fails because of poor lending practices in terms of confidence in the market place?

Mr Kirk—What I am saying is that, in terms of the comparative level of prudential concern, it is much lower in relation to a pure lender than it is for a deposit-taking institution where the institution has the consumers—

Senator XENOPHON—I will not hold this up, Chair. I might follow this through later. Thank you.

CHAIR—You note yourself that the difference between ADIs and those financial institutions that you oversee is primarily that the ADIs are deposit-taking institutions whereas yours are mainly involved in lending. But most of the criticism in terms of the lack of competition in the banking industry comes about from the lending side rather than from the deposit-taking side. In fact, I think most evidence clearly identifies that there is a lot of competition on the deposit side

at the moment. But the lending side is where the issue is and the primary problem appears to be the reduction in competition that has come from the non-ADI lenders over the last two years. So I am interested in the level of oversight that you have as to the non-ADIs and in those factors that have actually led to the significant withdrawal from the lending market of those financial institutions that you oversee. One of the terms of reference is how the GFC has impacted on them and also how government decisions have impacted on them. The obvious one is the failure of the government to extend guarantees in a way that would have assisted mortgage trusts and other similar organisations which I believe you oversee. Would you care to comment on that, please.

Dr Boxall—It is actually outside our bailiwick. On the one hand it is a competition issue, which is the ACCC, and the issue about deposit guarantees was handled by the Reserve Bank and Treasury. As I mentioned in the statement, we look at licensing and disclosure. So as to whether a lender has disclosed information when they have been making a loan and things like that, we might have views on the level of competition but in a sense they are personal views; they are not an institutional point of view.

CHAIR—If a fund becomes frozen, then is that something that you take an interest in?

Dr Boxall—Yes.

CHAIR—Most of the funds were frozen during the GFC and there are varying arguments about the extent to which that was directly and solely because of the GFC and then, further, whether decisions of government exacerbated that. Is that something that you have looked at at all: the causes of why those funds needed to be frozen?

Dr Boxall—We have looked at issues. Not in our bailiwick but elsewhere in ASIC we have looked at issues—for example, frozen mortgage funds and property trusts and things like that—and a lot of it goes to the issue about the managed investment schemes. ASIC has put out some material on those issues. But in terms of delineating the cause of it, so to what extent it was the cause of the GFC and to what extent it was caused by the failure of the government to provide deposit insurance, we do not have a view on that.

CHAIR—I might at this point hand over to Senator Hurley.

Senator HURLEY—Thank you, Chair. Dr Boxall, in your introduction you mentioned that you are having a look at areas of hardship in mortgages. Is that right?

Dr Boxall—Yes.

Senator HURLEY—This is not strictly in the competition area but I am thinking about what is happening in Queensland with people whose houses might be flooded and would be having trouble. Would that come under it? Are you looking at how banks might handle something like that?

Dr Boxall—Yes. I will hand over to Mr Kirk.

Mr Kirk—The work that we are doing on hardship came out of the global financial crisis in the sense that we were concerned that there would be people struggling with their home loan, so it was to make sure that there were procedures in place for dealing with that. We had in relation to lending the support of the law in the sense that there are provisions in the new national credit laws and in the previous state credit laws that provide a right for a consumer who is in temporary hardship to go to their lender and seek a variation of the terms of their loan, whether it is a moratorium on payments or a reduction in payments or an overall extension of time to pay.

In light of the global financial crisis and the concern that there might be a rising number of consumers in this position, we did a review of the lenders and put out a public report which raised some issues, and then we did subsequent work making sure that lenders addressed those issues. We think that over the last two years there has been much improvement from major lenders in terms of meeting the requirements in the law.

Senator HURLEY—Is there any difference between the lenders? Are they all doing their bit to put in those hardship provisions?

Mr Kirk—Historically and when we started this work there were some differences, in the sense that they all had some sorts of procedures around hardship but some had specialist teams who were really focused on it and they advertised the availability of it much better on their websites and in their other communications with consumers. Generally speaking, I think we have brought the average standard up to the standard of the better ones. There are probably still differences, but it is much more even and generally a higher standard than it was. This is amongst lenders. The other thing that happened during that period was that, perceiving a potential problem, the Treasurer came up with some principles for lenders in terms of handling hardship. So our review focused not only on the strict legal provisions but also on the Treasurer's principles that lenders had signed up to.

Senator HURLEY—This is where it is applicable to the competition hearing, I think. Are the major lenders, the banks, any different from the credit unions and the other non-bank lenders? Did you see any difference between them in the way they addressed hardship provisions?

Mr Kirk—Just from a resources point of view, we cannot do a review of every lender in the country in that regard, but we focused on a selection from each of those three groups. Again, at the beginning there was unevenness in each of them. Probably the non-bank lenders were a little bit less sophisticated in their approach. Some of the banks' approach comes out of the broader customer relationship that they are wanting to sustain, whereas for lenders often it is just an individual transaction. But, again, over the period in which we did the work we think the standard came up.

Senator HURLEY—Did it come up universally or did others need to jump up a bit more, and did they do that?

Mr Kirk—I think we brought the slowest ones up to the field. I would not say that it is completely even. There are always going to be differences in approach, and the law leaves some scope for differences in approach, but I think that the laggards have been brought up to the field and generally the standard overall is higher than it was a couple of years ago.

Senator HURLEY—So you would not say, in terms of the outcome and people looking at those hardship provisions now, with the flooding and other disasters around the country, that they would not be better off with the big banks or larger credit unions?

Mr Kirk—I think it would be dangerous to generalise in that way.

Senator HURLEY—I want to move to switching of accounts. ASIC and APRA developed an account-switching package that gives customers a list of direct credits and debits going back 13 months. Can you tell us how many customers have used this service?

Mr Kirk—I do not have figures. We did some work with institutions. When the package was announced, we did some initial work about their implementation of it. We thought there were some shortfalls in the initial implementation. We gave them some recommendations and made sure that those changes were made. We did a subsequent review which was not public, but subsequently, I think, it has been released under FOI, so there has been some publicity given to it. It found that, overall, institutions had put these procedures in place. So implementation had happened consistent with the requirements. But there was a relatively low level of usage at that point—this is probably going back two years—though consumers who had used the new procedures generally reported a better experience switching than those who had not. We identified that one of the problems in the situation is making sure consumers are aware of this possibility of the service. It is very difficult to compel an institution to advertise to its customers that it will give them help to leave, and that is probably too much to expect from institutions.

Senator HURLEY—Choice have provided us with some examples from the Netherlands and the UK, where they have gone a step further to make it easier to switch. If you are talking about real competition it does seem to me that people should be able to switch accounts more easily. We all know how difficult it is where people have direct debits and standing payments, even if they have a list of them to send off to those people and to organise the switch. Institutions naturally try to keep their customers by linking accounts and by providing that debit service, but if there is a possibility to get a quarter of a percent better service somewhere else, clearly it is better if it is easier for the customer to switch rather than going in and being told by the bank, ‘We’ve got this long list of direct debits for you and you will have to organise that,’ and so on. Do you think it would be difficult for the banks? Do you see that there are policies that might make it easier for that switching to occur?

Mr Kirk—First of all, I would agree with you that relationships that customers have with their bank and the arrangements that they have in place for payments to third parties mean it is necessarily complex to switch—a lot of things have to be changed. The government has announced a proposal to explore, through an inquiry done by Mr Fraser, whether real transaction account portability similar to mobile phone number portability can be achieved in terms of the cost implications of doing it and the technical issues that might lie in the way. We would wait to hear the outcome of that review before we formed any opinion on the feasibility, because we have not done an independent study of our own. If it can be done, intuitively it is hard to see why switching would not be a lot easier if you could switch your whole account and the number moved across and everything that was attached to that number moved across automatically. It sounds like a very good idea and a very good thing to promote switching and to promote competition, but we wait for the outcome of that review in terms of how feasibility it is and what the costs and other barriers might be.

Senator HURLEY—Thank you.

Senator XENOPHON—Following on from Senator Hurley's line of questioning, is it fair to say that there was a distinct lack of knowledge amongst consumers in relation to their ability to switch and the bank switching package announced by the Treasurer some 18 months ago? Does that point to a lack of resources in publicising the ability to switch? Also, Mr Kirk, you said that there is a problem that banks are not going to advertise that you can switch. If there was a mandated requirement to say, 'This is the number you call and these are your rights,' in terms of being able to switch and to facilitate switching, would that give some effect to portability?

Mr Kirk—In that work we did it did seem to be apparent that there was a relatively low level of understanding or knowledge of this facility by consumers.

Senator XENOPHON—Not much was done to publicise it, was it?

Mr Kirk—I guess the difficulty—and it is always a problem that we face with these sorts of issues in financial services with abstract publicity, advertising on buses or on TV when people are not thinking about switching and it is not an issue for them—is that it is very hard to get people to pick up on that. The advertising is much better if it is targeted at a time you are thinking about it.

Senator XENOPHON—How do you do that?

Mr Kirk—I do not think that it is easy in this situation. It would be very hard to expect the institution that has them as a customer to actively promote their assistance in getting them to move—

Senator XENOPHON—Mr Kirk, do you acknowledge that there was a distinct lack of publicity and a distinct lack of resources in letting people know of the bank switching package?

Mr Kirk—I would acknowledge that there was not large scale advertising—

Senator XENOPHON—How much was spent, do you know?

Mr Kirk—No, I do not know at all. I think that it got a fair bit of coverage because of the announcement and the subsequent promotion of it by the Treasurer. We did everything we could within our resources to promote it and it is still promoted on our website and in communications with consumers. But that said, I would accept—again, going back a little in time—that there was a relatively low level of knowledge of it.

Senator XENOPHON—In the Netherlands they have a system in place, as I understand according to evidence given by Choice, that if you want to switch there are mandated requirements. So if you go to your lending institution and say that you want to switch, there time constraints: you need to do it within a certain time and you need to do it expeditiously. Would something like that, do you think, make it easier for consumers in the absence of an electronic bank portability number?

Mr Kirk—I really cannot comment on the situation in the Netherlands because I do not know what the provisions are.

Senator XENOPHON—You have not looked into that?

Mr Kirk—Not the Netherlands in particular.

Senator XENOPHON—Any other jurisdictions in terms of portability?

Mr Kirk—Not in terms of the detail. We did make some inquiries—and this information was slightly indirect because it came from the UK. The UK had been looking at portability themselves and the one jurisdiction where there was more portability—and it was one of the Scandinavian countries—still reported a relatively low level of switching. It may be that even providing a lot easier way to move may not always get people to move.

Senator XENOPHON—Given ASIC's role in the formulation of policy in relation to the whole issue of switching, and the bank switching package comes under your jurisdiction, if you like, would it be fair to say that ASIC has not done that much research on the issue of switching in other jurisdictions at all?

Mr Kirk—We have made some inquiries in the UK. We have looked at some published reports. But our role in terms of switching is to administer the laws that we have and the processes that we have. It is not to develop new policy in terms of new ideas and that is why the government has appointed Mr Fraser particularly to run that inquiry.

Senator XENOPHON—So wouldn't it be reasonable to see what other jurisdictions were doing to see if this works, given that you have been given this regulatory role in terms of switching?

Mr Kirk—Our regulatory role in terms of switching was to administer the scheme that had been put in place. It was not to develop a different scheme of our own or to come up with other policy ideas. We are not the policy adviser to the government on this issue.

Senator XENOPHON—Sure, I understand. On another issue, you have been charged under the new consumer legislation to look at unreasonable exit fees, and I think that you indicated to Senator Bushby how you will be doing that, and you will be targeting the higher exit fees first. An issue was raised with me just yesterday by a well-known Adelaide finance broker Ray Hampson. He told me that one of the issues that he has faced when trying to get more customers or potential customers to switch mortgages is the issue of mortgage insurance. There is not portability of mortgage insurance. If you have paid your mortgage insurance for a 30-year loan, it is something that is sort of stuck and if you get another loan you have to start from scratch again. He regards that as quite onerous and unfair on his customers. Is that something that ASIC will look at? Is it on ASIC's radar in terms of unfairness? It could be very onerous in the context of having to get brand new mortgage insurance.

Mr Kirk—I would agree that that is a problem for consumers in terms of the initial insurance premium being a sunk cost and if they switch they have to pay another one. The government has

announced in its banking package that it will look at that issue and whether that insurance can be made portable, and that is a task with the Treasury at the moment.

Senator XENOPHON—As part of Bernie Fraser's—

Mr Kirk—I imagine we will be consulted in the process of them looking at the feasibility, and clearly there has already been some public comment on it by insurers and some interest expressed. That seems to be potentially fertile ground.

Senator XENOPHON—That would make quite a significant difference in terms of the actual costs people face, wouldn't it?

Mr Kirk—Yes, the premium for a lender's mortgage insurance policy is in the thousands of dollars, so it would make a difference.

Senator XENOPHON—So it is a huge disincentive to switch in itself?

Mr Kirk—It is certainly a cost consumers face if they are going to switch, which means either that you have to switch to a much better loan or that it takes much longer to get to the break-even point where you start getting the benefits of switching and you have paid off the costs of actually doing that.

Senator XENOPHON—Finally—I do not know whether Senator Williams will be following this up, and I am conscious of time—in response to Senator Bushby's questions about the whole issue of loans, I was concerned by your comments that if the institution goes bust then that is not really going to hurt the lenders, those that have borrowed the money. I suppose that is technically correct, but what about the implications to the broader confidence of the financial system if an institution goes broke? In other words, do we need to be vigilant of poor lending practices, because that seems to have been a key factor in the meltdown in the US with the residential property market?

Dr Boxall—The issue about which institutions are subject to prudential regulation is a government decision, and the government has decided that the deposit-taking institutions should be prudentially regulated by APRA. All institutions, both the ones that are regulated by APRA and the ones that are not regulated by APRA, have to have a licence, and that is where we come in. One of the conditions of having a licence is certain issues which go to the financial management of the institution, so to that extent there is some form of monitoring of the financial situation of these institutions. The government has made a decision that there is greater prudential risk for institutions which accept deposits and lend money than there is with institutions which just borrow money on the wholesale market and lend the money.

Senator XENOPHON—Do you agree with that, Dr Boxall?

Dr Boxall—It is not really a question of whether I agree with it or not, Senator Xenophon, because it is a government decision and the government has made that decision. The logic of the decision is that if an institution that takes deposits and lends money gets into financial difficulty there is a danger that people's deposits will be put at risk, because the institution has the people's money. With institutions that just lend to consumers, that borrow money on the wholesale market

from other businesses and lend to consumers, consumers are not directly at risk in the first instance because they actually have the institution's money as opposed to the institution having their money. The broader issue that you and Senator Williams have raised that this could pose a threat to the financial system, even though they do not have a deposit-taking responsibility, is an issue that prudential regulators have wrestled with. At the end of the day, the government has made a decision that APRA will just regulate deposit-taking institutions and that deposit-taking institutions and non-deposit-taking institutions will have to be licensed and as part of the licence they will have to have some financial requirements.

Senator XENOPHON—Thank you.

Senator WILLIAMS—Dr Boxall, in your opening address you talked about the front-line complaints section. During our inquiry into liquidators many submissions were very critical of ASIC when they lodged complaints about liquidators—for example, the infamous Stuart Ariff. Is your complaints section going to be more efficient with this consumer credit control than what you have been with your complaints about liquidators?

Dr Boxall—As I understand it the liquidators are not part of the terms of reference of this committee, but the handling of the—

Senator WILLIAMS—I made an analogy that you have now established a front-line complaints section as far as consumer credit goes.

Dr Boxall—That is right.

Senator WILLIAMS—You also have a complaints section as far as the insolvency practitioners industry goes. We heard in our inquiry how hopeless that complaints section was. What I am asking you is, with this consumer credit section, is your front-line complaints section going to be more efficient and more responsive to the public's complaints?

Dr Boxall—We have one consumer complaints centre, which handles all complaints—and I do not accept for one minute that they or anyone else were hopeless in handling complaints on insolvency regulations—

Senator WILLIAMS—I would like to debate you on that, but we will move on. We will not go there; time restricts us. I want to take you to section 420A of the Corporations Act. Are you familiar with that section, which deals with the situation whereby a bank sells someone up on the value of their assets? Am I correct? Is anyone familiar with section 420A?

Mr Kirk—Not off the top of my head.

Dr Boxall—We do not have a copy of the Corporations Act with us.

Senator WILLIAMS—When someone is in financial trouble—for example, a business or a farm falls over—when the bank sell that asset they must sell it at a price at or around market value. They cannot just go and fire sell it. That is the way I see section 420A. Does ASIC, as corporate watchdog of financial institutions, actually monitor those parts, as far as the sale of

assets are concerned, or do you just wait until you get complaints if assets are undersold of value?

Dr Boxall—I do not think any of us here are familiar with that section. We are not expecting a question along those lines, so we will not be able to answer it.

Senator WILLIAMS—Could you take that on notice?

Dr Boxall—Sure.

Mr Kirk—Generally speaking, in terms of issues like that we monitor what is going on in the marketplace principally through complaints. If we were getting complaints that there was a broader problem in terms of practices of institutions—for example, selling up people's properties when a loan is having to be paid—we would then likely do a broader review of practices in the marketplace. Complaints are the initial indicator that there may be a problem. If there are complaints that indicate by either their number or their nature that the problem is not just individual, it is not just a one-off problem with a particular consumer, but there is a broader problem in terms of the approach in the marketplace either by one institution or in the market generally, that is when we start doing those broader surveillances, often producing a public report and recommending changes.

Senator WILLIAMS—So that if the High Court ruled, for example, that a bank institution had breached the Corporations Act, would you have to take action on that?

Mr Kirk—That is a very abstract question.

Senator WILLIAMS—I mentioned where the High Court ruled that a bank breached the Corporations Act under section 420 but, when I reported that to ASIC, nothing was ever done about it, anyway.

Mr Kirk—Our approach would differ and, again, we are dealing in very abstract territory because I do not know the circumstances.

Dr Boxall—Can I suggest that if you provide us with that information, we will get back to you.

Senator WILLIAMS—I will gladly do that.

Senator PRATT—We have had some discussions already about mortgage exit fees. I want to ask if you have a sense, given the fact that they will be banned from the middle of next year, of the time period over which most consumers will be free from an exit fee contract. As I understand it, they are over three or five years. At which point in time would we expect consumers to no longer be confronting an exit fee and perhaps therefore competition in the sector to increase because those exit fees are no longer there at all?

Mr Kirk—Broadly speaking, with respect to people who are already in loans, the standard provision is the exit fee applies to either the first three or the first five years. Of course, those people may have been in those loans for a couple of years already so that it will tail off over the

next five years. It will not be even throughout, so probably for the first three years there will be a steep decline in the number of people who face exit fees for leaving. There will be a long tail but that tail will be no longer than five years.

Senator PRATT—Whilst there will be a long tail, in terms of the marketplace—and I appreciate that ASIC, APRA and ACCC are all responsible for different components of this, but they all interrelate—the competition effects of that will intensify quite quickly as that ban is implemented over the next 12 months and two years and as people come out of those kinds of contracts.

Mr Kirk—I guess it would be speculating to say what the impact in the marketplace will be but, in terms of the number of people with loans who have exit fees, they will go down reasonably quickly over that three years, with a smaller number lasting a couple more—

Senator PRATT—Can you highlight to the committee what your prospective involvement will be and what kinds of plans have been put in place for ASIC's involvement in the proposed community awareness and education campaign? Will that be facilitated through the ACCC?

Mr Larbey—The community awareness campaign comprises a number of components. One of the key areas where ASIC will be involved, in conjunction with the government, is in launching our new interactive consumer website. The site content is close to completion, as I understand it, and it will be a fully interactive site designed to encourage behavioural change amongst consumers and to promote and support financial literacy. In terms of launch dates, that is still being discussed with ministers.

Senator PRATT—What kind of promotion will that website receive in a broader marketing campaign?

Mr Larbey—My understanding is that it will receive a significant amount of public marketing and promotion and obviously also through PR activities, speeches, media releases and so on from ASIC and other stakeholders. We work closely with a range of stakeholders in developing the website and I think there is a lot of collaborative support from stakeholders.

Senator PRATT—I am unclear whether there will be a broader marketing campaign attached to that.

Mr Larbey—That is my understanding. We can confirm that for you. The website is not the responsibility of the people here, but we can certainly confirm that for you.

Senator PRATT—That would be terrific.

Mr Kirk—Beyond the website, the government may have plans for marketing around the particular banning of exit fees, but we are not part of that at the moment.

Senator PRATT—As I understand it, the Bank on a Better Deal campaign has been proposed. I am just trying to work out which institutions will be responsible for which bits of that campaign as it rolls out in the future.

Mr Kirk—Our primary responsibility is the website.

Senator PRATT—That is terrific. With respect to credit cards and interest rates, what will ASIC's involvement be in monitoring whether consumers are paying more interest than is necessary?

Mr Kirk—Credit cards are subject to the new national consumer credit laws. So we are responsible for disclosure and conduct issues. As part of its banking reform package the government has also announced particular measures for credit cards not only in relation to its marketing and unsolicited limit increases and those types of things but also putting more effort into standardising the way that interest is calculated. Again, as I understand it, the detail and the implementation is being developed, in consultation with stakeholders, at the moment. I would expect that we will then be responsible for ensuring there is compliance with those requirements to have the standardised rates.

Senator PRATT—As I understand it, that legislation is currently being worked on in order to be fast-tracked and, once it is implemented, it would then be your responsibility to enforce that legislation?

Mr Kirk—Yes, that is our expectation.

Senator McGAURAN—I am following up on Senator Williams' questions, who spoke about your front-line complaints department. In relation to the Queensland and Victoria flood situations, tensions are sure to rise now between the financial institutions and consumers. It is only natural. In relation to that complaints department, what extra resources or what unit have you set up to specifically deal with the Queensland flood disasters?

Dr Boxall—Our regional commissioner and team in Queensland have been very active in monitoring the situation in the floods. We have sufficient resources to cope with the complaints. So far we have been able to cope with any complaints that come in. At the same time, the financial institutions have responded to this situation, so the prediction that there is likely to be an increase in tension is mitigated to the extent that the financial institutions themselves are taking the initiative. For example, there have been reports of people having their mortgage payments suspended or held over, or financial institutions responding to cases of hardship and to cases where people have lost all their documentation and things like that. Indeed, ASIC has put out a note that we will be very sympathetic to situations where businesses in Queensland or Victoria or anywhere else are having trouble complying with various reporting requirements because they have lost all of their documents in the flooding and things like that. We are very sensitive to this and we do not expect it to be an issue in terms of our management.

Senator McGAURAN—So the public will be made well aware that you are the policeman on the beat for mortgage holders, cardholders and small businesses in this crisis.

Dr Boxall—We are the policeman on the beat crisis or no crisis, and they are aware of that.

CHAIR—Thank you, Dr Boxall, and the officers from ASIC for your assistance today.

[9.47 am]

BOND, Mr James, Economist, Financial Services Council

BROGDEN, Mr John, Chief Executive Officer, Financial Services Council

CODINA, Mr Martin, Director of Policy, Financial Services Council

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

Mr Brogden—Thank you. First of all the FSC appreciates the opportunity to present before your committee today. I would like to make a few opening points. It is worthwhile to start by putting the funds management sector in Australia in context. Australia's funds under management are the fourth largest in the world at $1.7 trillion. That is driven very strongly by the compulsory super guarantee that has been in place now for coming on to 20 years. Indeed, Australia's funds under management are set to grow to $3 trillion in 2020 and $5 trillion in 2030, and if the government's policy to increase the superannuation guarantee from nine per cent to 12 per cent is successful, that figure will increase to nearer to $5½ trillion. To put the current figure of $1.7 trillion in context yet again: it is larger than the capitalisation of the Australian Stock Exchange and larger than the gross domestic product of the country. The section of that $1.7 trillion that is superannuation has been measured by APRA this week at $1.3 trillion, and that is an amount of money that has been gathered to benefit the retirement incomes of working Australians.

The basis of the superannuation sector is outlined in the Superannuation Industry (Supervision) Act—the SI(S) Act—1993. The underpinning of this act, and this is probably the most relevant point that we will make today, senators, is that superannuation fund trustees are charged with the primary responsibility of acting in the best interests of their members. To that end it is about investing in investments that provide their members with the best return.

We appreciate that there has been attention, particularly from the Australian Bankers Association, with regard to the opportunities that the superannuation sector might present in providing funding, liquidity and other opportunities to banks for greater access to capital at a domestic level. However, we strongly oppose any suggestion that the superannuation sector should in fact be treated as a cash cow for the ADI sector. We do appreciate that one of the government's proposals in its reform package is the creation of covered bonds for banks, building societies and credit unions and I am happy to address the interest that our industry may have in taking up those investments.

But in general it is worth making very clear that we are a savings industry, we are not a lending industry. As a savings industry it is in the best interests of working Australians who have invested, via their superannuation fund, into their own retirement that we ensure that the law as it stands at the moment is adhered to and the trustees act in the best interests of their members and that they source the best investments for them. The risk of requiring, indeed even mandating, that superannuation funds should be invested in any class of investment is a fundamental undermining of the basis of superannuation in Australia, and it will in fact require

superannuation trustees to not necessarily to act in the best interests of their members, but to invest in investments that have been mandated. There is absolutely no doubt that that will lead to lower returns for superannuation funds.

It is worthwhile also noting that some 24 per cent of that $1.3 trillion is currently invested in cash and cash-like products. So we do quite significantly invest in opportunities for liquidity for the banking sector, the ADI sector. The superannuation in sector in Australia owns one-third of the Australian stock exchange, so arguably we own one-third of the banking sector and we are a significant contributor in the first place. So the starting point is: we do contribute to the ADI sector in different ways—that is, based on the decision of trustees to source the best investment for their members to get the best return—and fundamentally any move to mandate the way that superannuation funds are invested will have detrimental effects to the outcomes and will diminish the retirement incomes and the retirement of Australians. Thank you.

CHAIR—I will move to something else that you have raised in your submission, then I will come back to the issue about superannuation investing in banks.

Mr Brogden—Sure.

CHAIR—Your submission calls for the review of the deposit guarantee to consider the impact of the guarantee on alternatives to bank deposits. Do you have a view on what impact the current deposit scheme has had and what you see as desirable characteristics of a permanent guarantee or deposit insurance scheme?

Mr Brogden—We appreciate the circumstances that existed at the time. We appreciate that the government had to make a decision and it had to act urgently. However, there is no doubt that at the time they had a detrimental effect on the non-bank savings sector, the non-ADI savings sector. That was probably most obviously felt with the requirement of mortgage trusts within our sector to freeze redemptions. We did not want to do it; we certainly did not have a choice in doing it. The nature of that product was that it could not have provided a redemption of 100 per cent of funds in a day and it was never designed to do that. So we had to freeze the product and then control redemptions—in fact, minimise redemptions over some period of time. Some years now after the adoption of the guarantee, I am pleased to say that we have returned to some situation of normalcy with respect to redemptions. By and large investors are able to access their funds invested in mortgage trusts as they need them. That was probably the most direct effect with the application of the bank guarantee.

It also made non-bank investments, non-ADI investments, less attractive in the consumers' minds, but once again we appreciate the government had to make a pretty quick decision—and to some extent it is spilt milk in terms of reviewing it. However, looking to the future, we need to return to a level playing field on savings products and savings opportunities for Australians as soon as possible. We understand that the government has laid out a deadline, but we would appreciate that deadline being reviewed and, indeed, forming part of your consideration of recommendations.

CHAIR—The relevance of that question to this inquiry is, of course, that the non-ADI lending sector was providing, particularly throughout the late nineties and early 2000s, a key aspect of competition in the lending sector.

Mr Brogden—Correct.

CHAIR—As I understand what you are saying, the decision by government not to guarantee any or all of that side of the sector exacerbated what was probably already an existing trend that, if the guarantee had been extended, might not have continued and the sector would have been able to continue to provide competition. Is that a fair statement?

Mr Brogden—That is fair. I know that a lot of the attention has been focused on mums and dads' access to competitive loans. Most of the mortgage trust sector was non-residential, commercial and industrial property investments.

CHAIR—Which we are looking at as well.

Mr Brogden—That is absolutely right, but they are equally important as small business, medium sized business and, of course, large business. Effectively, the freezing of those products made them very unattractive and obviously stopped growth of those products overnight—killed it dead, in fact.

A couple of years later, we stand with the opportunity to breathe life back into those products, and that may indeed require a change in the redemption pattern—quarterly redemptions, half-yearly redemptions or annual redemptions rather than redemptions at any stage. That is at one end; at the other end, breathing life back into that sector will breathe life back into lending competition.

CHAIR—I want to move back to the area of your submission that you highlighted in your opening statement: the investment by super funds into wholesale bond markets. Would your fund managers expect a lot higher interest rate on a bond from a smaller bank than one from a major bank? I guess what I am asking is: to what extent is default or risk a key issue in the rating of banks that you might be investing in?

Mr Brogden—We have not explored this with our members. I guess it comes down to what is more highly valued, the rating of the institution or the fact that the bond is covered. The fact that the bond is covered gives some level of surety. Do you have anything to add to that, Martin?

Mr Codina—It is a difficult question to answer. Certainly our members differentiate quite carefully when they are looking at fixed interest internationally. When they are looking at the banking sector domestically I am not sure that there has been necessarily the same level of differentiation based on the risk of the institution that is issuing the debt.

CHAIR—You highlighted—correctly, in my view—that government should not mandate that the superannuation industry invest in a particular sector, but that is not to say that the government cannot look at what factors it might be able to adjust that might make it more attractive for the superannuation industry to invest in that area. In order to be able to do that in an informed way they need to understand what is driving your fund managers in terms of the decisions that they are making and what might lead to an increased attractiveness of investing in this area. There would be a whole raft of changes from Australia if that were the case—the direct advantage of providing more funds for all banks or all lending institutions but also the impact on

our current account by not bringing as much wholesale debt into the country. Banks bringing wholesale funding onshore is a major factor in our current account.

Mr Brogden—Might I add to that—and I should declare an interest, having been a former chairman of Abacus, the industry association for building societies and credit unions, the mutual sector. Let me make that clear. Part of the challenge is that the mutual sector will start behind the banking sector because the banking sector is a known quantity in the investment community as opposed to credit unions. A fund manager cannot invest in a credit union today, so they have not been examining them, whereas of course they have a very strong view on the banking sector. The credit union and building society sector would need to change the way they present themselves and the way they have had to approach their own business, in effect. Being very fair and honest, that would be where the mutual sector would start from behind.

CHAIR—I guess that is the sort of evidence that we need to hear. We need to understand what are the factors that are limiting fund managers making decisions to invest in areas that might actually assist banking competition and how that can be made more attractive.

Mr Brogden—That is an education process, but that is probably slightly underestimating it. It is a very detailed approach for analysts, in one part, and for chief information officers. It is worth saying that the decision to invest—as you rightly point out, Mr Chairman—is one of fund managers, but they are the servants of the trustees. So the trustees of a superannuation fund will design their own investment policy, and that will be guided internally and, in many cases, with external advice. That will be, in many if not most cases, reviewed and added to by asset consultants, who, working for the trustees, will give them an assessment of which assets are worthy of investment. So the asset consultants will need to play quite a significant role in getting to an understanding of the mutual banking sector. That is quite large. So they will need to understand whether covered bonds out of Australian Central Credit Union or Credit Union Australia are safe and worthwhile investments.

CHAIR—You have raised covered bonds in your opening statement and you mentioned it then. The issue of security is an important factor in terms of looking at these. If it was an uncovered bond, presumably the trustee or fund manager would have a—

Mr Brogden—A different view.

CHAIR—They would have a different view.

Mr Brogden—The category we are talking about we will describe as 'fixed interest'. If you invest in a fixed interest policy, you are investing in fixed interest and a fixed return, in effect. If it is an uncovered bond but it comes at 300 basis points higher, that is a different approach. In other words, it is not secured and is not covered but it is a better investment. So they would analyse that investment based on a higher return but a higher risk.

CHAIR—I am conscious of the time, and there is a lot more I could ask you about, but there is one final question on that. The Basel III requirements are going to increase the liquidity and capital-holding requirements of financial institutions, which will inherently increase their safety and reduce risk for buyers of bonds. Would that be a factor in itself that would make it a different proposition in terms of buying in?

Mr Brogden—It is hard to say. Once again, if you look at this as a category of fixed interest then covered bonds, the initiative you referred to, Australian government fixed interest products and international fixed interest products all come together. I guess the broader point to make is that, as the superannuation sector grows, whether proportionally or in real dollar terms, the opportunity to invest in fixed interest products will almost certainly grow.

CHAIR—I notice that in your submission you mentioned that the ageing population and a few other factors will actually increase—

Mr Brogden—That is right. You want to match your assets to the cycle, and if you have more and more people getting near retirement then you will take your investments out of risk and into lower risk—arguably in a more cash-like product.

CHAIR—And certainty.

Mr Brogden—Correct.

CHAIR—I have one final question, just changing the subject. Other submissions, particularly from the banking side of things, have called for changes to the tax treatment of deposits in order to make them more competitive in a tax sense with investment in products like superannuation. I can anticipate what your response to this would be, because there is an interest in that respect. But, trying to set aside that interest, is that something that you see as a major threat to the superannuation industry, or do you think that is a reasonable thing to do?

Mr Brogden—Bearing in mind that the first nine per cent is compulsory—so you cannot arbitrage your decision based on whether it is cheaper in the bank or—

CHAIR—No, that is right. But, in terms of voluntary contributions, there is a tax effectiveness in certain.

Mr Brogden—Absolutely, within a certain cap. The other premise—and we know this is in the ABA's submission—is that we noticed that there was the direct implication from the ABA's submission that deposits started reducing the minute the compulsory superannuation sector, the SG, was created. That assumes that Australians were going to voluntarily save nine per cent. We would not have a super guarantee if they were. The reason we have it is that they were not going to. So it is absurd to suggest that people were going to put nine per cent away in a bank, building society or credit union.

CHAIR—It is really the voluntary, I guess, that we are talking about.

Mr Brogden—Correct, sorry. With respect to voluntary, it is not reasonable for us to ask for a level playing field in one area and not another. It is fair to say that it may or may not affect voluntary contributions. I think the decision for individuals will be: 'Do I want the money back next year or am I happy to put it away till I retire?' It will make it more competitive; there is no doubt about that.

Mr Codina—Could I just add something to what Mr Brogden said, and that is: if you look at this in the context of a million-dollar guarantee, you could have a fully guaranteed, government

guaranteed, product which has an identical tax concession as that which superannuation attracts. That clearly would not be a level playing field. I think you need to look at this quite holistically.

CHAIR—It is a complex issue.

The **Senator HURLEY**—I would just like to follow up a bit on that. Would you say that the current taxation arrangements unduly favour superannuation? Is it something that is a policy imperative to have a look at?

Mr Brogden—No. Yes, they do and, no, it is not worth looking at. They do, because we have a compulsory super system which is the best in the world—or the least bad, depending on which way you look at it. But it is the envy of the world in terms of our savings policy. I just ask you to imagine what the budget would look like for the next 50 years if we did not have a savings policy in place. The requirements on pension, aged care and health care would be enormous. There is no doubt it is a clear government priority to make compulsory savings tax effective. We would argue about the level of the cap in terms of the voluntary contributions, but we do not regard this as an area that needs to be reviewed in order to provide extra competition.

Mr Codina—The other critical trade-off is that you cannot access that money. It is compulsory from the day you enter the workforce, but you cannot access it for 40 or 50 years, depending on when you retire. So there is a trade-off in return for the tax concessions.

Senator HURLEY—It is interesting because the nine per cent originally was a wage increase trade-off, so you have got a good argument there.

Mr Brogden—In part.

Senator HURLEY—Part of it was. It is the voluntary contributions, I think, where it is a question of whether the banking sector might have some argument and whether that should be favoured.

Mr Brogden—Do not forget it is capped. The amount you can contribute over and above your nine per cent and get the tax concession is capped at $50,000, moving to $25,000, which we think is too low.

Senator HURLEY—But the ceiling on the 50 per cent tax discount for interest income is currently $1,000, so it is significantly lower.

Mr Codina—It also goes back to what Mr Brogden was saying, that people who are making voluntary contributions into superannuation are obviously doing that also in the context of trying to seek the best possible returns on that saving. Superannuation allows them to invest in a broad range of different investments. If the alternative was that they put that into a bank-offered deposit product or a credit union or building society, there is a question of what the aggregate returns on those voluntary savings would be in those two systems and whether, given that superannuation is about saving for people’s retirement, people would end up with less rather than more.

Mr Brogden—We also have to remember that, at nine per cent, only about 10 per cent of Australians are going to have an adequate retirement. So, whilst it is arguably a contrast between super and banking deposit attractiveness, even now nine per cent will not give people an adequate enough retirement, which is clearly why we support an increase to 12 per cent, which we think gets about half the population there. So, even though it is tax effective, it is still yet to deliver the outcome we need.

Senator HURLEY—I agree completely. But let us move on. You are talking about returns that people make on bank investments. Generally speaking, banks are fairly safe institutions to invest in. The banks are arguing that they need a return on equity equivalent to other organisations to attract investment funds. For example, you are saying that super funds invest heavily in banks. Given the government regulation and the position of banks and their ability to attract cheaper funds through people investing their money in them, do you think that they need that equivalent return on equity or would it be possible for them to accept a lower return on equity? Would, for example, superannuation funds stop investing if the return on equity were a couple of per cent lower?

Mr Brogden—Our consideration is the return on the investment. If the return on the investment were uncompetitive within the fixed interest market, if the Australian government was giving a better return than a covered bond, that question answers itself.

Senator HURLEY—Okay. So the return on equity is one small—

Mr Brogden—That is what the bank business wants. For us it is about what is the best return for the investor. A trustee would struggle to be able to justify investing at four per cent versus six per cent for 30 years. It really does answer itself.

Mr Bond—I do not think anyone wants their own superannuation fund to invest in something that is going to give them a lesser return, potentially a negative return.

Senator HURLEY—Okay. Thanks.

Senator XENOPHON—Mr Brogden, do you think the way that the wholesale funding guarantee was structured put other than the big four banks at a disadvantage?

Mr Brogden—Are you referring to the credit union and building society sector or the savings sector?

Senator XENOPHON—Both, actually.

Mr Brogden—There is no doubt that it put us at a disadvantage in terms of savings products—absolutely no doubt. So the answer is yes.

Senator XENOPHON—When this is due to be reviewed in October this year, some commentators have suggested or advocated for letting the big four banks fend for themselves, that they are big enough to look after themselves, and for the wholesale funding guarantee to be removed but for it to remain for those other institutions to try and redress the imbalance that was caused as a result of the GFC. Do you think that will has merit in the context of your industry?

Mr Brogden—In terms of whether there is merit in having the big four lose the guarantee and the rest not—

Senator XENOPHON—And at a competitive rate, of course, for the others.

Mr Brogden—Yes—effectively we would go from competing with 100 per cent of the banking sector to less than 20 per cent of the banking sector, which is the mutuals and the regional banks. Obviously that would reduce the level of competition, but I guess it really only partly levels the playing field.

Senator XENOPHON—So what is the solution, given that there has been a concern that there has been an imbalance? You have strengthened the position of the big four and, in relative terms, weakened the position of the others, given the margins they have to pay—which goes to the issue of ratings, which we will talk about in a moment. What you say is a good solution? This inquiry is about competition in the banking sector, getting better outcomes for consumers and, ultimately, better outcomes for all of us who have superannuation.

Mr Brogden—We would argue that the lifting of the guarantee should happen evenly across the industry.

Senator XENOPHON—Does that mean that the margins paid by those other than the big four banks which many have regarded as punitive need to be reviewed as well?

Mr Brogden—I cannot speak to that; that is not an area of our expertise.

Senator XENOPHON—Sure. Can we go to the issue of ratings. There is a distinction in that the rate they have had to pay has varied based on their rating.

Mr Brogden—Yes.

Senator XENOPHON—It has been put to me that you need to consider not just the rating of the institution—and we know how wrong Standard and Poor's and Moody's and others got things in the lead-up to the GMC: AA ratings when they were more like ZZ. To what extent should there be a more sophisticated way of rating institutions and also rating the products? Just because an institution might be AA they could be issuing a CC product. Should there be a more nuanced approach, and what role do you think government could have in having that more nuanced approach?

Mr Brogden—I go back to the point I made earlier about credit unions and building societies starting behind the eight ball in the sense that they are not known by ASIC consultants and analysts presently. They will have the same problem because I think there are only a handful of the biggest mutuals that have ratings to start with. A large majority of the mutual sector I am pretty sure is not rated yet so that adds to the complexity for their capital bonds to be invested in.

Senator XENOPHON—Further to that, should we look at a more sophisticated way of rating both institutions and the products they offer?

Mr Brogden—Ratings are only one issue that analysts and ASIC consultants take into consideration. When our fund managers are looking at investing in banks they look at the management of the organisation, their business model and many other things. It is very clear that the rating is part of what they look at. Should the federal government step in and provide a further set of ratings, I am sure the banks would be thrilled!

Senator XENOPHON—That ‘thrilled’ was said with an element of sarcasm.

Mr Brogden—Yes. We cannot have enough information. There is no doubt that fund managers investing on behalf of trustees cannot have enough information about the asset. Whether it is a company, a bricks and mortar building or a covered bond, we simply cannot have enough information.

Senator XENOPHON—But aren’t ratings at the moment a bit of a blunt instrument in the way that the government had to make decisions as to what the margins would be depending on their ratings? Don’t we need a more sophisticated approach, because it seems that the smaller banks and the nonbanks have been put at a significant competitive disadvantage?

Mr Brogden—As I said before, I think it goes back to the fact that ratings are one of many factors. If you have a well rated organisation that is going through a massive management issue—and it does not have to be a bank—then that will be given as much weight by our fund managers as the rating will, so it is a combination of issues. But, in the general sense of the extent to which fund managers would be happy to get more information, it is an unequivocal yes.

Senator XENOPHON—Finally, there is the issue of the market being too constrained. We had evidence from Mark Bouris from Yellow Brick Road and John Symond from Aussie Home Loans that there just is not enough competition at the wholesale level. Do you agree that in terms of access to funds that there is not that robust level of competition and it seems that non-bank institutions have been marginalised and cannot offer that level of competition in the marketplace?

Mr Brogden—That is not an issue for us. It is not an issue for our sector and the proficiency of our sector, so I am not really in a position to answer it on behalf of our industry.

Senator XENOPHON—But the market is more constrained now, since the GFC, than it was?

Mr Brogden—Yes, there are fewer financial institutions, ADIs, that is obvious.

Senator XENOPHON—Thank you.

Senator McGAURAN—I believe that the federal cabinet at the moment is in discussion on how to pay for the $20 billion flood recovery for Queensland and Victoria. It has been reported that an option is a tax on individual superannuation accounts. Have you, Mr Brogden, been sounded out on this matter? If not, what is your view anyway?

Mr Brogden—I have not heard of that report. No, we have not been sounded out on that at all. I assume what you are suggesting is that there be a tax or a diminishment of the tax benefit.

We would oppose that. We believe that the fundamental significance and purity of maintaining a tax effective retirement savings sector should not be diminished.

Senator McGAURAN—Thank you for that, and this is on another matter. I am not sure who owns whom in the banking area so I will ask some info questions. Is there a limit on the number of shares you can own in a bank? I believe that once it was five per cent. I do not know if that still holds.

Mr Brogden—There is not, to my knowledge, other than that when you hit five per cent you have to declare it publicly.

Senator McGAURAN—And you can go beyond that five per cent?

Mr Brogden—Yes, to my knowledge.

Senator McGAURAN—Is there any individual superannuation fund that owns more than five per cent of a bank? Do you know?

Mr Brogden—I do not think so.

Mr Codina—Another way to look at that is that, from a general point of view, when superannuation funds invest in the share market they tend to invest in a way that is correlated to the index. Banks are typically the highest capitalised companies on the exchange or some of the most capitalised companies. As a result of that, all of the superannuation funds are likely to have a large holding in banks. Given the size of the banks, it is unusual if any particular fund exceeds the five per cent but there is probably a large number of funds that are close to that level or around it.

Mr Brogden—But, Senator, if you were to ask me this—if the superannuation sector does own more than five per cent of the banking sector—then the answer would almost certainly be yes, but not one superannuation fund. Mind you, as you see many more mergers in the superannuation sector, particularly on the industry fund side, you will begin to see industry funds in particular get larger and larger holdings.

Senator McGAURAN—What about vice-versa? Take, say, the top 20 superannuation funds. How many of those are owned by the banks? I mean 100 per cent.

Mr Brogden—Sure. So there are six to seven major wealth managers in the country on the retail side and they cover superannuation, investments and insurance, being life insurance not general—so life insurance is the point to make there. There is Colonial First State, which is owned by the Commonwealth Bank. MLC is owned by the National Australia Bank. There is what was ING, now called OnePath—it was rebranded last year—which is owned by ANZ. BT, the old Bankers Trust, is owned by Westpac. The other large players are AXA, formerly National Mutual, and AMP. But, as senators would know, there is a takeover process with AMP and AXA at the moment. Macquarie Bank is a large and growing wealth manager as well, and that is obviously owned by a bank.

Senator McGAURAN—Now I do not mean this to be a reflection on those at the table but, given who owns whom—and, in fact, you both own each other—for the purpose of this committee's investigation would it be fair for me to say that we can water down a bit but the industry, not you, would be more timid to criticise or to make comment on bank competition, bank profitability and bank behaviour than other witnesses?

Mr Brogden—I think my testimony speaks for itself. It is only January but I will be interested to see if I am still on Steve Munchenberg's Christmas card list after some of my comments! We do not have any pressure from our bank owned institutions to act in the interests of their parent companies at all. Having now been in this role for 18 months, I can say it has surprised and pleased me the extent to which our agenda is our agenda, which is quite separate from the banking agenda even though they are in many cases subsidiaries.

Senator McGAURAN—I have one last question. Talking about competition, competition within your own industry, there could be an inquiry there in itself—'could be' I say. Going back to the coalition government, we attempted to introduce some competition policy through choice and I was wondering if ever so briefly you would be able to give us something. The legislation—watered down by the opposition at the time in the Senate, I add as an aside—was to shake loose the stranglehold that industry funds had on compulsory superannuation, so making the employer give the employee a choice. Are you able to give us something as to whether that has worked or not? You would gauge that by saying whether there are many players in the compulsory industry sector of an industry. Sorry, but do you know what I mean?

Mr Brogden—I do.

Senator McGAURAN—I am sure that sounded complicated.

Mr Brogden—Broadly speaking, we are one of the strongest advocates of choice. We supported the previous government's attempts on three occasions, the last being successful, to allow choice. We always regarded the principle of choice for people's retirement incomes as a primary foundation of people managing their own retirement and their retirement income. It has been successful. I think the figures broadly indicate about 10 per cent of people change funds on an annual basis. There are a few reasons for that, not the least of which is people changing employers and changing jobs.

One of the restrictions on the free flow of people changing accounts has been that it is difficult. If you have ever tried to change your own personal superannuation fund from one fund to another, you will know why many people give up halfway through; it is because of the information requirement. What the government has adopted, coming out of the Cooper review under superannuation efficiency, is a program called SuperStream. That program will allow for literally tick-a-box account consolidation and tick-a-box account transfer from one fund to another. That will have a massive change on the efficiency of superannuation and will make it much easier for people to make a decision to move from one fund to another. The framework of the choice model is in place but its operations have been limited by what is a very paper-heavy industry. So SuperStream should make it easier for people to express choice; there is no doubt about that.

CHAIR—Thank you, Mr Brogden and the Financial Services Council for your assistance today.

Mr Brogden—Thank you, Mr Chairman. Thank you, senators.

Proceedings suspended from 10.26 am to 10.40 am

HAMILTON, Mr Christopher, Chief Executive Officer, Australian Payments Clearing Association Ltd

PRAGNELL, Dr Brad, Head of Industry Policy, Australian Payments Clearing Association Ltd

STOLLMANN, Mr Jost, Chief Executive Officer, Tyro Payments Ltd

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

Mr Hamilton—We welcome the opportunity to appear before the committee. I have a brief opening statement. APCA is the vehicle for payments industry collaboration. Our role on behalf of payments system participants is to work to improve the safety, reliability, equity, convenience and efficiency of the Australian payments system. APCA coordinates and manages five payments clearing systems, covering cheques, direct debit, direct credit, EFTPOS, ATM, high-value and bulk cash. APCA promotes a cooperative environment to drive policy development, self-regulation and change management in the payments industry. Our members include the RBA, banks, credit unions, building societies, merchants and a range of other payment participants. Our activities are monitored by the payments system regulator, the Payments System Board of the Reserve Bank. Our board governance is designed to balance the range of interests across our broad membership and to ensure that no one industry grouping, such as the four largest members, can combine to impose their will on other industry participants. Contrary to some views expressed by earlier witnesses, the international card schemes have no involvement in APCA's governance, though of course we work with them and many other stakeholders on a range of other initiatives.

As a self-regulatory body, much of APCA's work involves arranging for commercial competitors to work in a coordinated fashion on non-competitive system or network elements, often for the explicit purpose of providing fair access to payments systems and a sound basis for competition in payment services. It follows that we are scrupulous on competition policy issues, not just rigorous compliance but also promoting competition wherever possible. As noted in our submission, APCA believes that promoting competition is the best means to ensure the payment services deliver what Australian citizens and businesses need over the long term. It may also be worth observing that the Reserve Bank's Payments System Board is specifically charged with promoting competition in payments systems and has actively pursued competition reforms, in consultation with the industry, since the board's formation.

It will be obvious from what I have said that our relevance for this inquiry is limited to payment services and payment issues. We ordinarily do not deal with other aspects of banking or financial services. The focus of our written submission is that part of the inquiry's terms of reference dealing with account switching. We provide data on transaction account openings and closings, suggesting a churn rate in Australia of slightly more than 10 per cent. I believe this is broadly consistent with data provided to the inquiry by banking organisations, based on their own account information. It is also broadly in line with data from overseas jurisdictions. Based on the facts, consumers are already able to switch their transaction accounts and do so in the millions every year. That is not to deny that often consumers find switching accounts a hassle.

We have worked with our members and others in the past to find ways to reduce that inconvenience. We have already met with the Fraser review and we look forward to further discussions on finding ways to make it easier for customers to switch accounts. We appreciate the opportunity to appear, as I said, and welcome any questions.

CHAIR—Thank you. You outlined who some of your members were. What is the status of APCA? Who owns that? Is it a government instrument or is it a private organisation?

Mr Hamilton—It is entirely a private organisation. It is a company, the members of which are persons who are active in one or more of the five payments clearing systems that we administer.

CHAIR—Is it a for-profit company?

Mr Hamilton—It is a not-for-profit company; it is a mutual. Our day job, if you like, is the administration of five sets of clearing system rules. These rules dictate the arrangements for the efficient movement of payments in different payments systems. Participants who have a need to engage in that payments system join and thereby become APCA members. Jost's organisation, Tyro, is a relatively recent member of APCA. New members join when they have a need to access one or more systems.

CHAIR—It is regulated, or are you subject to regulation? I know from Tyro's submission that they are an ADI in a limited or specific way. Are you regulated as well?

Mr Hamilton—No. We do not take deposits and, generally speaking, we do not handle cash itself. So we are a self-regulatory body. The core activity is, if you like, providing bodies of rules and procedures and technical information, such as specifications and message formats and so forth, to make sure payments happen efficiently.

CHAIR—You do not provide the systems themselves.

Mr Hamilton—We generally do not provide the systems. The only exceptions to that are a few databases that everybody uses in the industry—for example the BSB, the bank state branch number, database. APCA administers that on behalf of the industry.

CHAIR—While we are on that: the BSB aspect of it is highlighted by some of the submissions as one of the challenges in implementing account portability. Is your view, as an insider maintaining the BSB system, that that could be adapted to enable account portability, or is that an insurmountable hurdle?

Mr Hamilton—Adapted to enable accounts number portability?

CHAIR—Yes.

Mr Hamilton—I am speculating rather than basing this on detailed analysis, but I would suspect that we would have to replace the BSB number system with a different arrangement if we were to move to account number portability. The reason I say that is that, at the moment, what makes your bank account and my bank account and someone else's credit union account

unique is a combination of the BSB number plus a number which your financial institution is free to choose.

CHAIR—The BSB essentially identifies the bank and the branch.

Mr Hamilton—Correct. So it is the beginning of the address. It is like the street name in your street address.

CHAIR—You mentioned in your submission and touched on it in your opening statement that at least the part of the banking industry that you are talking about is highly competitive because the evidence is that a lot of switching activities are already occurring. I do not doubt the evidence that there are certainly plenty of people who switch banks, but how do you think that relates to the evidence that this committee has received from both business and consumer groups that there are a lot of people who would like to switch banks but who do not because of the challenges involved in switching providers?

Mr Hamilton—To our way of thinking about account switching, it is very important to separate out the micro-economic market issues, which are: 'What will create more competition?' and the no less important but actually different issues of consumer or small business convenience. We say in our submission, and I would reinforce this, that there are things that are inconvenient and difficult about switching accounts which make it difficult and which mean that people are sometimes put off going through the process. Some of those things relate to the payments system and other things are more complicated. One of them, for example, is that increasingly people do their banking through the internet. If you know your way around your own financial institution's internet site then you can do business much more quickly than if you have to get to know that. There are a whole of lot of these small friction costs. All of these things can be worked on to be improved, and the payments issues are the ones which we have authority for. But I think that is quite a separate question from whether competition amongst providers would be enhanced by doing that work. Certainly, consumers would be facilitated in terms of the convenience.

CHAIR—I want to tease this out a little further. The Chamber of Commerce and Industry Queensland conducted a survey of their members. They found that a lot of their members would like to change but there were a number of reasons—they actually went down to the level of reasons—why they had not changed banks even though they would like to. Admittedly, some of them thought all banks were the same, and that was significant. 'Why bother, because you're just going to get the same service' is essentially what they were saying.

Mr Hamilton—Yes.

CHAIR—But there was a significant portion of them who had looked into it and had decided that the cost and the feasibility of doing so was greater than the benefit they would receive by the lower rates or the better deal that they were being offered. It was really the practical implementation of those changes that was holding them back. I note that you say in your submission:

... the widely held assumption that Australians find it "too hard" to change their provider is not borne out by the evidence.

It may not be in terms of the fact that there are certainly plenty of people who go off and do it, but other evidence that we have seen—and I am not arguing with you; I am just trying to get to the bottom of this—

Mr Hamilton—Yes, I understand.

CHAIR—Other evidence would suggest that there are people out there who would like to go off and take advantage of better deals that are offered but find the practical challenges of actually doing that too great for them to actually change.

Mr Hamilton—I would not disagree with that evidence. Obviously that is based on a survey of real experience. One of the things that highlights, though, is a sort of a competition policy dilemma in this space. On the one hand, if you did a lot of standardisation work—and that is what it would be: to standardise the offerings across the marketplace such that it would be very easy to pick up sticks and move from one to the other—I find it difficult to see how you would make that movement much easier without doing some degree of standardisation across the products. That would be the main facilitation. As you standardise, of course, you reduce the opportunities for difference amongst those products. To give a practical example of that, if one financial institution chooses to bundle their account services together and give you a special rate on your mortgage because you take other accounts with them, for example. I think it has been indicated to the committee already that that is the kind of thing that is a break on moving, because the bundling dissuades you from moving. That, of course, is part of the competitive strategy. That is true, yet what is happening there is that a wider range of different competitive products are being offered to consumers and the option to have a better choice, if you like, is being presented. So you have this sort of balancing act where you need to decide which thing is going to be better for competition: a wide range of different types of products—

CHAIR—I think a fairly sophisticated approach needs to be taken by government, which is probably unusual.

Mr Hamilton—I do not envy you!

CHAIR—I understand exactly what you mean. The reality is that the flipside of that is that there may be a new bank offering a customer, ‘If you bring everything over to us, we will give you a better deal.’

Mr Hamilton—And you do not want to stop that.

CHAIR—You do not want to stop that, but they might find it difficult to do that because of some practical problems. I am not saying that the answer is necessarily account number portability, and we have evidence that suggests there are problems with that. Some of your evidence also backs that. What I am really interested in here is your evidence that switching is not a problem and that it is not having an impact on competition. There are a number of options open to government to address that. The government has tried, with its bank switching package, and it is investigating the account number portability. But they are not the only answers; they are only potential answers.

Mr Hamilton—I certainly agree, Chair. Indeed, we had an initial discussion with Mr Fraser on his review, and he has been specifically charged with that issue. My impression is that he is looking at a wide range of options—

CHAIR—So he is not just looking at account number affordability?

Mr Hamilton—That is my impression.

CHAIR—That appeared to be the case from the statement put out by the Treasurer.

Mr Hamilton—Certainly, our discussions with him canvassed a wide range of different alternatives for improving the situation of account switching.

CHAIR—That is good to hear. Evidence that we have received suggests Australia seems to be lagging behind other economies in payment technology such as the use of contactless stored value cards or debit cards to pay for small transactions. Is that something that you would acknowledge? Sorry, my apologies, Mr Hamilton. I should have given Mr Stollmann an opportunity to make an opening statement. We will move onto that. Mr Stollmann, would you like to make an opening statement?

Mr Stollmann—Mr Chairman and honourable senators, I am very honoured to be called upon as a witness to this Senate inquiry and to be able to contribute the perspective of a new market entrant. Tyro, the company I am leading, is a special player in the banking industry in numerous ways. First of all, we are to our knowledge the only new entrant who competes with the major banks head-to-head in core banking services, merchant acquiring, so we help businesses to take credit, debit and EFTPOS cards and payments. We are licensed by APRA. We are an ADI with the same regulatory and safety oversights of any Australian banking institution. It is a problem for us that we provide the same merchant services as the major banks do but we cannot use the word ‘bank’.

Secondly, we are focused on acquiring only so we do not have the conflict of interest that the major banks have to maximise their interchange revenue at the expense of the merchants. Thus, it does not come as a surprise that we are the only ADI that questions the looming reversal and increase of the EFTPOS interchange fee that threatens the small and medium enterprise community with an additional burden of up to $¼ billion. In the payment industry dominated by four major banks, two global schemes and two big retailers, we are a countervailing voice for retailers, and I wish I could say a countervailing power.

Thirdly, we are very supportive of very tight regulation and oversight of the banking industry. It is in our interest. We have to eliminate risks through intelligent processes and information technology. We do not have the balance sheet of the major banks that could relieve us of that. For instance, we deployed a ‘life life’ acquiring infrastructure that eliminates the outage which the country was cursed with multiple times last year. We are very vocal in demanding intraday and real-time settlements and we have eliminated data breach risks.

The reality is, however, that while we are delivering a reliable, efficient and flexible EFTPOS solution, after eight years of effort and $30 million of investment we are processing only 0.55 per cent of Australia’s card payment transactions. Obviously, only a significant increase in

market share would reward the investors and permit relevant competitive pressure on major banks and, most importantly, encourage others to follow.

We have submitted 13 different barriers—unfortunately very technical barriers—to our further growth in our submission. I will pick just some examples. The first example is that in the Australian payments system MasterCard settles domestic transactions one day and international transactions two days later. The mechanism for how the funds flow is actually dependent on the time in St Louis, America. For the big banks that is not a problem because they net off the issuer on acquirer flows. Tyro, as an acquirer only, has to prefund those settlements. The consequence is that there is unnecessary counterparty risk in the payments system and a competitive disadvantage for Tyro, and I might add, Tyro has been unsuccessful in obtaining debt from any of the Australian major banks to cover the problem.

The second example is that in the Australian system payments are settled batch overnight—and the experts are to my right—exposing the system to more risks than intraday or real-time settlements that today's technology would engender. Again, Tyro, as an acquirer only, suffers from competitive disadvantage. Tyro cannot offset the flows as the major banks can. In addition, major banks settle Tyro merchants—our merchants—a day later than their own, a huge switching barrier for merchants and an example of the major banks benefiting from their bundling power to the disadvantage of Tyro as an acquirer only.

The Australian government can make a difference. Medicare has opened up and successfully created competition in electronic claiming using the EFTPOS system. I suggest the government could achieve similar outcomes in other payment areas—for instance, health fund claiming. Five years after the Reserve Bank of Australia created the access regime, we are still the only new market entrant in the core banking business. I think that if new entrants into the banking industry want to provide better outcomes for Australian businesses or Australian citizens we have a lot more work to do. So I am looking forward to further questions. Thank you.

CHAIR—Thank you, Mr Stollmann. I read your submission with some interest. I do not profess to necessarily understand all of the technicalities of some of the challenges you face, but a lot of the challenges that you raise certainly sound like they are competition based. Has the ACCC had a look at what is going on in this sector of the banking industry and does it have any views on the issues that you have raised?

Mr Stollmann—My perception is that the reforms in the payments systems are driven by the Reserve Bank of Australia, who has created the Payments System Board. When I started Tyro Ian Macfarlane was the governor, and the reason I invested in this daring venture was my trust that Australian policy and the Australian regulator would take an interest in having new entrants in the payments space. We have had only one exposure to the ACCC, when the dominant global scheme, Visa, decided that acquirers should not provide a currency conversion process that they had successfully introduced in the market. It was one of our first major investments, and Visa had to withdraw from that market limitation under pressure from I would assume regulators in lots of countries, but certainly also the ACCC.

CHAIR—Okay, but none of the other issues that you have raised which, prima facie, suggest to me competition issues—in a pure sense rather than in the sense of the broader competition in the banking industry—have not been raised with the ACCC to—

Mr Stollmann—I—

CHAIR—Some of these access issues. To draw a different but similar analogy, there is a competition access regime which requires, for example, the train lines in Australia that are owned by BHP and Rio to provide access to other iron ore producers because they are considered vital infrastructure. That is a very different context, but to some extent you could raise the question as to whether you are finding the same issues in terms of accessing some of the aspects of this market at a competition level. Have those sorts of issues been discussed, or have you thought about raising them, with the ACCC?

Mr Stollmann—I think we are at the moment at a very interesting point of contemplating how to go forward. There was an interesting study by the British Office of Fair Trading.

CHAIR—Yes, I was going to raise that.

Mr Stollmann—They distinguished between the entry barriers and the expansion barriers and were quite confident that the entry barriers in the UK were not so much the problem anymore—that it was now much more the switching inertia by the merchants and competitive behaviour by the major banks. Tyro has benefited initially from the Reserve Bank and APRA support in gaining access and establishing itself.

Mr Hamilton—And APCA support.

Mr Stollmann—And APCA support. I might underline that it was a four-year effort, but it got us to trading with our first EFTPOS merchant. Now the issues, while we have remaining access problems, are significantly more barriers to expansion problems, which tend to be anti-competitive structures or behaviours.

CHAIR—But if they are anti-competitive structures or behaviours then they may well breach the Australian competition and consumer law, which used to be the Trade Practices Act. Moving on to the broader competition issue, is it your contention that, in terms of providing a benefit to consumers and business in Australia who are interacting with the banking system, your successful interaction and the entry of other players doing similar sorts of things to you would actually deliver direct benefits to Australian consumers and businesses?

Mr Stollmann—I would definitely be confident of that. To give you an example, I find it absolutely unacceptable that the industry has delivered an EFTPOS solution that merchants cannot trust—because there is an abundance of failures, glitches and outages. What that requires is investment into the IT infrastructure in the back end. I am always distinguishing between things like contactless payments, which are easy to show, touch and feel, and the back end of the payments system, where the heavy lifting has to happen. There, innovation is obviously significantly more difficult because it is a network problem and a lot of participants have to move—and I think Chris would be able to witness how difficult it is, in such an oligopoly, to get the same investment inclination to fix obvious problems. So we are putting some light on these problems. For instance, the industry should move to real-time settlement; it is unnecessary risk. When we aspired to membership of BECS, some of the banks refused to accept us, claiming we were a risk to the system given our modest balance sheet. So we would argue: why don’t you use intelligent processes and information technology so that you can mitigate and eliminate the risk?

I can give you lots of problems where I think we contribute as a new entrant with fresh ideas, raising new problems that put some stress on to the system, and highlight issues that otherwise would not have been uncovered because everybody is happy.

Mr Hamilton—If I may add to that, generally speaking I agree with what Jost has just said—that a new entrant with a completely different business model does throw a whole lot of light on how the system works and highlights issues that need to be changed and improved. Jost's organisation has done exactly that in the last five years or so. He undervalues his significance when he says he has no competitive impact, because I think he has. Through things like changes in APRA rules, RBA rules and APCA rules, and the discussions that go on in various fora, he has provided the voice he is talking about for alternative providers. And very often the things that get picked up and dealt with there are things that no-one thought about until the alternative provider was there. So we need to be careful not to assume a conspiracy here. This is about identifying ways of improving the system that were not identified before. It is not easy to get people to change if they do not see the business profitability for them in doing so, but it does happen.

Mr Stollmann—I want to emphasise that I am not implying this at all. But the fact of the matter remains that we have 0.55 per cent market share. We are very courageous and we have invested a lot. We have Reserve Bank support and we have APRA support—and we only got there. So there is an issue that, if Australia wants to use new entrants as a driver to get better outcomes, we have to look at this framework and it has to be improved.

CHAIR—Putting aside for the moment the challenges in actually increasing your market share, what increasing your market share actually means is more merchants signing on to you to deliver those transactional services rather than sticking with the alternative through their banks?

Mr Stollmann—I am not necessarily saying it for Tyro; I am saying you do not get new entrants if we do not have stories that actually work in scaling up. These are expensive businesses to set up if you want to respect the stability of the financial system. I am not talking about cowboys rocking up; I am talking about ADIs that find new business models. That is the hard lifting—and then it requires scale. If we can demonstrate that that is not possible in Australia then there will not be anybody who will do it.

Mr Hamilton—Jost, just to fill that picture out a little bit, the remarks you have made, I think, are fair in relation to the acquiring side of the business and acquiring, in particular, is a heavy technology activity. If you look at overseas markets the large new entrants in most overseas markets in recent times that have not been banking organisations have been big technology companies that have decided to go into acquiring as an extension of their technology activities. That is a very important insight into what kind of activity we are talking about here. That is true of the US market and the Canadian market, for example. So, that is the acquiring side.

On the issuing side the picture is rather different, though, because issuing of cards and servicing of cardholders is a much more retail banking consumer activity and there has been a lot of new entry in that space. Those new entrants are less visible in the systems we work in because they are often using someone else to do their processing for them but, nevertheless, a much, much wider range of card issuing alternatives exist for consumers as a consequence of those new entrants. So we need to look at the whole picture.

Mr Stollmann—I tend to distinguish this a little bit because these are things that are at the fringe of the banking system; on the sales marketing side more than anything else. What is unusual about us is that we are sitting in the core of a bank process, so we are a strange species, if you want. I do not disagree with what you are saying but it is another area.

Mr Hamilton—Yes, I agree.

CHAIR—I understand what you are saying in that respect. Australia has a highly concentrated banking industry with the big four banks controlling, certainly, most of the commonly quoted shares in the banking industry to do with lending and deposits. Presumably that concentration also flows through to the aspect of the banking industry that you are in? The concentration of the big four banks would have an impact on your ability to breaking above 0.55 per cent? Is that a true statement?

Mr Stollmann—I think that is a very true statement. However, I have always argued that, actually, an oligopoly might change its mind and embrace new entrants, as we have seen in other industries like the pharmaceutical industry. The fact of the matter is that new companies and new entrants bring the really new ideas and the really new business models. There can be a model in an industry where the bigger institutions actually benefit from that instigation to innovation. It might look counterintuitive but I am actually convinced that they have an interest in us. I am just not being understood very well.

CHAIR—I understand that. That may well be the case. I guess where I am coming from though is trying to get in my mind the impact that the level of concentration that we have in Australia with out banking industry is making it harder for companies such as yourselves to break into this area of the banking industry. I guess one thing that might help me understand that a bit better is that, since 2008 and the global financial crisis and the further concentration of the banking industry with the big four, have you noticed any difference in the last two or three years in your ability to break into it? You are at 0.55 per cent now. Has that become harder to increase in the last two years, or easier or no change?

Mr Stollmann—Mr Chairman, my opinions are based on our actual living expense, not on sophisticated data. I would argue that there has been a dramatic change. Whereas when I started in the business it seemed to be fashionable to tease the banking relationship with alternatives. During the financial crisis my telephone conversations were relatively short, ‘Haven’t you heard.’ ‘This is not the time.’ A lot of pilot installations would suddenly be cancelled because other priorities had taken over. There was a recent study and it suggested that, prior GFC, the concern was, ‘I am dissatisfied with the services of the banks. I want to switch, I want alternatives and whatever.’ Now it seems to be, ‘I want to have my banker on my side.’

Mr Hamilton—There is actually some specific economic evidence on that where the bank tracks the merchant service fee over time for acquiring services. This is the charge that acquiring organisations like Jost and the banks make to merchants and they track and collate the data for that over time. so you can see in the movement of that line if you like how competitive that part of the industry is.

The lower that amount gets, in theory, what you see is price competition in acquiring. I think what Jost says is, broadly speaking, right—we have seen a steady decline in that area, indicative

of a competitive marketplace, and then a plateau during the GFC. I think it is starting to go down again now, though, but that is another piece of evidence.

Mr Stollmann—There is another interesting observation I would make. Again, it is personal experience of a small company. As soon as the merchant has a relationship manager, our closure rate drops dramatically. There are lots of possible explanations for that, but it would be helpful to think along the lines that the Office of Fair Trading in the UK has thought along. Again, I lack the resources to put solutions here on the table, but it has to do with undertakings by major banks that they limit in their organisations the bundling and cross-subsidy solutions, and there should be a complaint mechanism or it should become a compliance issue. I am losing the second-largest hotel in Melbourne, after I had it all signed and it was supposed to be deployed. They said, 'It just has changed; we can't proceed.' That is normally code for some conversation that has happened with a major bank. Where can I go to at least increase the risk for the organisations of the major banks to push these bundling opportunities beyond what they should? There should be a possibility for a mono-line new market entrant to compete in one segment.

Senator XENOPHON—I want to follow up what you just said. You talked about how you signed up a deal with a hotel in Melbourne and that was lost. You know you are giving evidence under privilege, so you are free to speak. Are you saying that you suspect that there has been unfair conduct by banks or by other institutions in your losing that business? Is there unfair competition at play in the context of this?

Mr Stollmann—I cannot really say this. I can only describe here what I know, which is that when the account becomes large and there is a relationship manager on the other side—there could be other reasons that the decisions are done differently—our closure rate declines. We had pilot installations which, during the global financial crisis, were aborted. We had a hotel that signed and we were ready to deploy, and there was a change of mind. Merchants do not share with me all the reasoning behind a change of mind.

CHAIR—I presume your evidence would be that, on that particular product that you are providing, you could save the merchant money and provide a better service. Even if those merchants acknowledge that, there is a suggestion that there is an explicit or an implicit discussion held between the merchant and the bank that overall they will be better off, despite the benefits of going with you on that particular product, if they stick with the bank on that product because they will throw some sweeteners in elsewhere or, alternatively, penalties in other ways. Could we conclude that there was that sort of suggestion?

Mr Stollmann—I would think that there is certainly a perception by the merchant that he might not want to jeopardise his ability for debt by not bundling all the transaction business in the same bank. I would think that that is possibly a thought that he could have.

Senator XENOPHON—Just following on from that, do you feel that the ACCC should be doing more with its existing powers or needs more powers to deal with that sort of suspected conduct?

Mr Stollmann—I am a small company, a new entrant, who describes barriers and problems. We are there because the Reserve Bank created the access regime and they wanted to have a new entrant. So far they have supported us.

Senator XENOPHON—Has the ACCC supported you in your concerns?

Mr Stollmann—The only time we had dealings with the ACCC was in the Visa dynamic currency conversion case; otherwise we did not. I am not familiar with how the Reserve Bank and the ACCC are dealing with the issues of policy and competition, and then you have APRA as the regulator. I am not close enough to have an expert opinion on who should do what.

Senator XENOPHON—But you have not asked the ACCC to say, 'There seems to be this sort of thing happening'—what you have described—'and will you look into it to ensure that there has not been any unfair cross-subsidy or any other anti-competitive behaviour?'

Mr Stollmann—No, we have not done that. We do describe to the Reserve Bank frequently the issues we encounter in the field.

CHAIR—Is the Reserve Bank sympathetic with those issues? What have they told you about their planned approach to dealing with those?

Mr Stollmann—They have not shared with me a planned approach. They are always available to listen to us. In relation to the investors into our company, we trust in the Reserve Bank's continued support for this new model that, basically, they have conceived.

CHAIR—Have you spoken to anybody from the Markets Group in the Department of Treasury about it?

Mr Stollmann—I have occasional contact with Jim Murphy, who was also a witness here. That is my only direct contact into Treasury.

CHAIR—Have you had any feedback from Treasury with regard to the issues you are raising?

Mr Stollmann—I have from Jim Murphy feedback that is encouraging us to continue our endeavour because we are needed.

CHAIR—Presumably the proposals that you have included in your submission—I think there are 13 of them—for change that would open up the market to some extent and enable you to complete better would have been put to Treasury and the RBA?

CHAIR—I have copied both institutions on that.

CHAIR—Have you received any official response to that?

Mr Stollmann—No.

Mr Hamilton—If I may add one other thing to that, the Reserve Bank does explicitly track its view of competitiveness in the issuing market, the acquiring market and indeed the card scheme market and has on record its opinions on those issues. So I am only quoting them. But they certainly regard the reforms they have instituted in the last five years as having enhanced acquirer competition. Yet Jost has referred to many reforms that have allowed him to enter the

market. They continue to do that. So, in terms of the discussion about who should be looking at this from a policy perspective, the RBA is well and truly seized with the issue and has been actively tracking it.

Mr Stollmann—That would also be my perception, and that is why we are RBA focused, not ACCC focused.

CHAIR—But ultimately I would suspect that decisions by government that need to be made would receive primary advice, or the advice sitting on top of the pile of advices that would go to cabinet would be from Treasury—not this one. You also raised the UK Office of Fair Trading, which I believe is the equivalent of the ACCC. Would you care to summarise for the committee's benefit what that found?

Mr Stollmann—It was looking into the competitiveness of the UK retail market, and that included the consumer and the SME banking side. The major conclusion was that they felt relatively comfortable that the access regime works, and there had been new entrants, but that the scaling up of the new entrants was not working. They identified as main problems the switching inertia of consumers and merchants, and they thought that had a lot to do with the difficulty of trusting an unknown brand and, for retail banking, the branch presence. That is not too relevant for us. The other issue is that they thought that the major banks, with their behaviour, were a barrier.

CHAIR—Did they find that those problems were actually playing out in terms of having a detrimental impact on consumers and businesses?

Mr Stollmann—They definitely did describe that innovation, competition and new entrants were needed to maintain choice and competitive tension and better outcomes for British consumers and merchants.

Senator HURLEY—Mr Stollmann, I am interested in the time line. You said your company has been going for eight years. It is five years since the RBA created the system that allowed new entrants and you have been going for four years under that new system. Is that right?

Mr Stollmann—The company was founded in 2003 and we launched in 2007 the EFTPOS facility, so it was four years to get the product into a merchant's hands and then for the following four years we now have a 0.55 per cent market share.

Senator HURLEY—Clearly it is a very long process and I commend your patience. I know, from talking to other people, how difficult it can be to deal with a range of government departments particularly where there are overlying regulation and policy requirements in place. You have spoken about the support from the RBA. Can you briefly summarise for us where you encountered the problems? Was it with government funds? Was it just the time in dealing with them? Can you highlight for us where other new entrants might hit hurdles?

Mr Stollmann—Yes. The first thing is that in the industry nobody really has an interest in a new entrant. That dampens attention and the effort of listening, understanding or whatever. Frankly, the Reserve Bank said, 'We want it.' So thus we got some attention. Because the systems are not suited for lots of the things that we require, so what our new technology needs,

suddenly there are changes that have to be executed and they sit badly in the priorities that large organisations have. Also, the large organisations have no skills in accommodating a new entrant. They just do not know how. If you are MasterCard or Visa, you are constantly accommodating worldwide new members. The EFTPOS system had no new members. We were the only one. So even when they said, ‘Okay, let’s delegate it now to the people to execute something,’ it was: ‘So what do we do now?’ So there is a lot of the system that is not used to accommodate new entrants. Then there would be people who would say, ‘No, we are not going to do this. We are not going to trade with you. We do not know you. Nobody can force us.’ The Reserve Bank would support us and for some reason then they traded with us. So it is by definition difficult. When I go to the major banks and say, ‘I want to have a direct connection to you,’ they look at me as a small new entrant and wonder why would they spend time with me. It might not be deliberate. When I go to a health fund I say, ‘You are doing all your electronic claiming practically with NAB and HICAPS. Wouldn’t it be nice to have an alternative—some competitive attention, some innovation?’ Guess what they say. They say, ‘We have other things to do.’

Senator HURLEY—So it is more in the marketing. As we are on a government committee we are interested in what recommendations we might make for government, but the heaviest emphasis for you is in the marketing to industry. The RBA and the government have allowed the process to occur but it is the marketing and the old processes that are layered on top of each other that have been the real problems.

Mr Stollmann—We now have three buckets of problems. One is that the model still cannot really be successful unless the settlement issues and some of these technical issues have been resolved. It is difficult to get attention but it has to be done. I think only the Reserve Bank can make it so that that gets done. That is why we are working with them a lot.

The second thing is: are there some people who will trust the newer entrant and give him a go? Medicare has—and that was a critical project for us. The health funds should in my opinion. They are the biggest user of payment services in Australia, so they can make a real difference for the payment industry. If they do not give it to the major institutions only and keep it open, that would be a big chance for us.

Then you are moving into the general market. In the general market we have two problems. One is awareness. The CBA I think has $½ billion for PR and marketing. Ask me how much I have. The second thing is there is the issue of the single supplier who competes with the broadline supplier. I know it is difficult, but if there could be a little more risk to avoid aggressive bundling that would be helpful for us. If the banks would settle their merchants at the same time they settle us, it would obviously be nice.

We are launching a super solution for restaurants. Restaurants are particularly painful because they trade over the weekend. For some reason the Australians do not settle during non-banking days so I have huge pre-funding of all the settlements over the weekend and then I have to tell the restaurants, ‘Sorry about this, but you will get your money one day later with us than if you stayed with your acquirer.’ He asks why and I say that I do not know. Would you do something for me there? I called one major bank and they got really angry. I said: ‘I have to explain it to the Reserve Bank. Explain to me why you do this? It does not make sense.’ They said it was none of my business.

Senator HURLEY—You are asking for real-time settlements but you are actually getting 24 hours delay, so you are far apart.

Mr Stollmann—The schemes give me the money later than I have to pay the merchants and the bank of the merchant pays the merchant. I am only instructing—I am committing my money and telling the transaction bank, 'Would you be so kind as to put into the merchant account.' The transaction bank says they will do it a day later. So on both sides the weakest one is funding.

Senator HURLEY—Clearly the banks do business in their own way and that is clearly allowed.

Mr Hamilton—Let us unpick some of the issues here. It is a complicated flow, so forgive me if we get into a convoluted discussion.

Senator HURLEY—Yes, and we do not deal with these things every day.

Mr Hamilton—One way to try to keep it clear is to keep a very strict separation between what is happening at the FI-to-customer level and what is happening at the FI-to-FI level. The lower system level operates in a very clear, well understood and efficient way. I think Jost would agree that it is equal across all FIs who participate in each system, so whatever happens there happens for everybody. What happens at the FI-to-customer level has a lot more complexity to it because that is not imposed, forced or regulated; it is a matter for competitive service by each organisation—FI, Jost, CBA or anyone in between—to their customer. Part of that is deliberately of course to encourage some competitive alternatives.

Let us be clear on what happens at the system level. The Australian market settles five days a week. For settlements for transactions that occur over the weekend generally the fund availability actually takes place on Tuesday with a value date as at Monday. That means that there is interest adjustment across the whole market between the financial institutions to make sure that everybody knows that from the perspective of the system money is moving on Monday. So there is that period of time over the weekend and if it is a three-day weekend because there is a public holiday then it is longer.

Mr Stollmann—And you have to ask why that is, because you could settle every day. But for some reason they don't do it.

Mr Hamilton—That is correct. The settlement infrastructure is provided by the Reserve Bank. It certainly could be changed. That is a fundamental structural change that affects every single organisation, so it needs to be done in a coordinated and complicated way. Indeed, the Reserve Bank is actively looking at reforming its settlement arrangements right now. So more detail on that, I think, could best come from the Reserve Bank. There is no question that it could be done in different ways and in faster and more frequent ways.

Mr Stollmann—Chris, are you saying this is equal for all the financial institutions?

Mr Hamilton—The settlement lag, yes.

Mr Stollmann—But I take issue with this, because when there is a delayed settlement of MasterCard receivables it hits an acquirer-only model fully, whereas other major banks can net off.

Mr Hamilton—Okay.

Mr Stollmann—So the same system puts a dramatic disadvantage on somebody who cannot net off. Visa can settle its domestic transactions as the debit card system in Australia.

Mr Hamilton—Right.

Mr Stollmann—Why would MasterCard run it by—

Mr Hamilton—Okay. Apologies.

Mr Stollmann—It is an unnecessary risk and a disadvantage.

Mr Hamilton—That is a fair point. The first thing to say is that each of these card schemes has its own rules and arrangements for undertaking this activity, and Jost is highlighting a particular aspect of MasterCard's, as I understand it. It is a matter for MasterCard Worldwide to decide how they do that. What Jost says is right: each issuer and each acquirer is treated the same way. But if you are both an issuer and an acquirer—that is, you have lots and lots of cardholders and lots and lots of merchants—then it has less impact on you because you can say, 'I know I'm paying away so much over here but receiving so much over here.'

Mr Stollmann—I want to make this very, very clear: there is the perception that possibly markets that link issuing and acquiring fail. That was one of the reasons why the Reserve Bank got so interested with its reforms.

Mr Hamilton—You said 'fail'?

Mr Stollmann—Market mechanisms fail in the payment industry. For instance, interest interchange fees tend to rise. That is why they were capped. The only reason why the RBA is in that space was, as far as I understand, that it perceived a certain degree of market failure. The interesting thing about our model is that, because we are on only one side of the market—the acquiring side—we actually put stress onto that market. Every time we do not survive, it means that this market has a problem in its inner workings.

Senator HURLEY—So this situation would be greatly alleviated if there were real-time settlement?

Mr Stollmann—Absolutely. Everyday real-time settlement de-risks the system.

Senator HURLEY—Thank you. Your submission has a number of proposals to increase competition, which is very good, and you have also said:

Significant innovations come from mono-line players—

which I imagine is quite true. You say:

If a new entrant and innovator cannot access medium to bigger merchants, because the major retail banks block the access by bundling, potential new entrants will be discouraged and the ones daring to enter will fail to build sufficient scale.

Can you explicitly say to me what you mean by ‘bundling’. You have referred to this several times.

Mr Stollmann—One observation is that, when a major bank settles its merchants a day earlier than our merchants, it means that it bundles the acquiring function with the transaction account. There is a bank that offers same-day settlement to its merchants if they have the transaction account and the acquiring relationship with them. They can do this because they do not go through your systems—the batch systems.

Mr Hamilton—Just to be completely clear there, any institution can do that if they choose to do so and are prepared to wear the credit risk.

Mr Stollmann—That is right.

Mr Hamilton—Your problem is that the credit risk is difficult for you, and I accept that.

Mr Stollmann—No, my problem is also that I have to go through the batch system, because I am not on both sides. That is bundling a transaction account with the acquiring relationship. Maybe that is good. It just does not allow the model of an acquirer only. Another one is that I could make a working capital bundle, where I put lots of things together and I add debt to it. This could be just a pricing, or it could be a product that is bundled. Maybe that is of value to give choice to the consumer. What it does is to eliminate the mono-line offerer if the other party is dominant. These are classical competition problems.

Mr Hamilton—Just to join a few dots there, this relates directly to some testimony that you heard from COSBOA, the Council of Small Business of Australia. It is really the same issue in reverse. COSBOA was saying, ‘Why can’t all banks have money in my account straight away, as soon as the cardholder has a merchant?’

Mr Stollmann—That is right.

Senator HURLEY—It is a continuing frustration, I reckon.

Mr Hamilton—That is right. What Jost is saying is that some merchants are getting that and some are not, and he is disadvantaged by that.

Mr Stollmann—It is a very difficult conversation for me because I am saying, ‘Yes, he is right,’ but in the system I am disadvantaged from providing something that he is rightly claiming.

Mr Hamilton—Right. But the key point is that every acquirer in the system can provide that availability of funds if they are prepared to wear the costs of doing so. I recognise that is much harder for smaller players than for larger players because wearing that credit risk is harder for

smaller players, but there is actually no impediment to you making funds available to a merchant immediately, although it would cost you a lot more. Is that a fair statement?

Senator HURLEY—That is clearly a definition of being anti-competitive, though, if it is going to cost one business a lot more to do something than another.

Mr Hamilton—By ‘cost him a lot more’ I mean relatively speaking, because his balance sheet is smaller and he is less able to bear the credit risk. The actual amount of money is no different, except to the extent that CBA’s credit is better than Tyro’s credit.

Senator HURLEY—But it is still not a level playing field for new entrants.

Mr Hamilton—Sure.

Mr Stollmann—And if the systems were designed real time and intelligently, you would not force an acquirer to prefund settlements to the merchant. That is not what he is about; let people with other balance sheets fund.

Senator HURLEY—Okay. I think we have been around this and, to me anyway, it is now straight. My colleague is going to ask about the EFTPOS fee and so on.

Senator WILLIAMS—On EFTPOS, one of you might be able to answer this question. I was in small business before I came to the Senate about three years ago. One Saturday morning I brought up my banking on my computer. I pulled up my savings account and with the card for my savings account I put $5 through to my business account. I was banking with St George, as I am today, but my EFTPOS was with CBA. So it was a Saturday morning that I did that transaction and on the Wednesday morning the $5 appeared in my business account. Two questions: why so long and where did the $5 go in the meantime, in those four or five days?

Mr Hamilton—Again, this comes back to the two layers. Forgive me, it is somewhat confusing, and that is perhaps something we should fix in the industry to make it clearer exactly what happens.

Senator WILLIAMS—You might be able to tell us in shearers’ language, in a simple way: where did the $5 go and why did it take Sunday, Monday, Tuesday, Wednesday—four days—and Saturday, so five days, to get into my account?

Mr Hamilton—I cannot speak for the particular institutions or the particular transaction you have talked about because it does vary a lot from institution to institution.

Senator WILLIAMS—Why should it vary?

Mr Hamilton—It varies essentially as a matter of competition—

Senator WILLIAMS—First question: where did the $5 go? It was out of my account in literally one second.

Mr Hamilton—The $5 you are talking about is not a bar of soap, it is a debt that your organisation owes you. So when it appears on your account—

Senator WILLIAMS—It is my money gone from my savings account.

Mr Hamilton—Absolutely right, but what I am saying is that the $5 is not one thing that can only exist in one place; it can be in multiple places at once. Quite often—and Jost will tell you that he has to do this sometimes as the acquirer for a merchant, and other institutions do as well—the institutions know the transaction you have just talked about has happened, they know that they are going to get that money from the other bank at some stage in the future and, in order to provide a good service to their customers, they credit that money to the merchant earlier than they get it. If you think about it at that point, the $5 exists in two places at once: it has not yet actually been received by the receiving bank but it has already been credited to the merchant's account. That happens for some institutions to some of their customers, for others not, largely for competitive reasons.

On the specific issue of why it took four days, I am afraid I cannot answer that in relation to that specific institution. What I can say is this. In the Australian payments system there is no float. What I mean by that is there is no point at which money disappears into the ether and is neither with the payer nor the payee, either for the purposes of availability or for interest—but, importantly, most people talk about this in the context of interest. That means that between all of the financial institutions, whoever is participating—and many of the transactions are by banks but, small and large, it does not matter—they have a convention which says, 'There is a moment in time when that money moves from one institution to another for interest purposes.' That is not always the moment that they actually get the money physically, but they have a convention that says, 'It is always going to be this point,' and they adjust for interest, if they need to, to bring it back to that point. That means that the paying organisation—in your case, St George—knows that that money actually leaves its interest control at a certain point, and the receiving organisation—in your example, the Commonwealth Bank—also knows that that money is in its hands for interest purposes at that same moment.

What they do with their customers in relation to that knowledge varies from organisation to organisation and has a lot to do with the competition for providing services in banking. Some people will give you the benefit of that before they have received it themselves; others will wait until they have received it before giving you the benefit of it.

Senator WILLIAMS—What is the solution in this modern electronic age? Bendigo Bank is an institution that will do transactions on Christmas Day, Saturdays, Sundays and overnight. Why can't all institutions do it overnight?

Mr Hamilton—As a legal and systems matter—the total network matter—they can; there is nothing to stop them from doing so. If they do not do so, that is going to be a matter for how that particular institution provides services to its customers—and that may include, for example, their own technological capabilities and so forth. So, I cannot speak for each institution. I think I read testimony from the CEO of the Commonwealth Bank of Australia, Mr Norris, that they are in the process of changing from a system that can do only a certain amount of things to a new system that can do pretty much everything at all times. You will find that each organisation is at some

stage in that progression. Some of them will be able to do more for you today than others, but in six months time the picture will have changed.

Senator WILLIAMS—Mr Stollmann, would you like to add anything to that?

Mr Stollmann—Chris is far more an expert; I am a simple man here! If you have a St George MasterCard, there are multiple players here who use outdated IT infrastructure with overnight batch jobs and do not work over the weekend. So, you are going from one day to the other in these batches—from one participant to the other—and that takes time.

Senator WILLIAMS—Mr Hamilton, is this the situation overseas? Do you know how other countries do these transactions?

Mr Hamilton—It is very common in banking systems all around the world for there to be a period of delay between the transaction occurring and the net flow of funds. For example, in the US—

Senator WILLIAMS—So the Bendigo Bank must be a world leader!

Mr Hamilton—Let me say this: individual banks all around the world will take the burden of that delay but nevertheless provide their customers with funds as a competitive matter to provide customer service. But if you went on to the websites of very many US banks and asked them to do a next day electronic transfer that would be available in the account of the recipient at another bank tomorrow for nothing, they could not do that. That is standard in Australia; you can do that and know that it will be in the account the next day.

Mr Stollmann—This is at the heart of the competitive issue. You are saying Bendigo Bank can do this because everything happens within the Bendigo world.

Mr Hamilton—Just to be clear: I am actually saying Bendigo Bank can do it regardless of whether it is within the Bendigo world or coming from—

Mr Stollmann—Well, if they funded the inefficiency of the Bendigo world.

Mr Hamilton—Correct.

Mr Stollmann—Our problem is with how the Australian payments system can be reformed to an extent that multiple providers can give you the solution you might aspire to, that never fails and gets you the money right away.

Mr Hamilton—I agree. There is an opportunity to upgrade and improve the system. You have heard some testimony on that. I think the other bit of that testimony that might benefit you is the plans of the Reserve Bank in relation to the central settlement structure, because that is one step in this complex process that we have been talking about.

Senator PRATT—Mr Stollmann, you have made two recommendations in relation to EFTPOS fees, and we have had some discussion of those already. Can you underscore for me the significance of the bilateral arrangements associated with the costs currently attached to

EFTPOS and the significance of the common access technology, and how that relates to your recommendation that we mandate EFTPOS network access for all debit cards at low cost? Mr Hamilton, you might be able to enlighten me on both sides of the debate as to why it is feasible and what the challenges might be to implementing such recommendations.

Mr Hamilton—It is a fast moving area.

Mr Stollmann—On the first subject, Chris is the expert. I can again talk from my perspective, which is that, as an acquirer, you need to accept all cards, including the domestic EFTPOS card. So far, this is still a bilateral network, where you need technical connectivity and the interchange contract—the legal level and the technical level. When the Reserve Bank created the access regime—of which I am critical—two banks volunteered, on private commercial terms, to connect with us. We paid a multiple of what the Reserve Bank determined to be the access cost—we needed to get on in life—and they switch for us with the other banks. We pay a fee for that. It is like a tax to access the system, and that is a competitive disadvantage. From there on, we aspired to have direct connects with other ADIs, who then said they had other priorities—and I understand that; we are a small player. At the moment, this is moving because the physical layer has migrated to a COIN network, and the access regime will possibly migrate under EPAL to something that becomes more realistic. At the moment, the access regime is broken. I am in—I pay a tax, but I am in—so it is not my major priority at the moment. But, for any new player, that must still be a huge headache.

Senator PRATT—Can I ask how you recoup your fees for offering that service?

Mr Stollmann—We charge, as the major retail banks do, a merchant service fee and a terminal rental. We have a significantly lower cost structure than the major acquiring banks do, but we are very small, so we have little scale. I would guess that we break even with a market share of 0.6 or 0.7 per cent. If you talk to a major retail bank they will say: ‘Say again? You are breaking even with what again?’

Your second point is very dear to my heart. I am very interested to have choice and competitive tension in payments systems because I sit as an advocate of the merchant and I am trying to get him a good payment deal. So, the domestic EFTPOS card is very important to me because if it were to fail, as it has done in most countries across the globe, there would be a significant lessening of choice in the market. The Reserve Bank has been very influential in this. At the moment, there is a new government body called EPAL. If you look at the directors of EPAL, it is the big banks, the two big retailers and some big-end-of-town directors. The Reserve Bank has allowed them to raise the interchange rate to the level that Visa and MasterCard are allowed to charge. At the moment, the rate benefits the merchants by 4 or 5c. I think historically this was to encourage merchants to deploy the technology. Now, EPAL is free to set the interchange fee in a different way, and, because the system is dominated by issuer interests, we expect that they will reverse it and increase it. Because the Reserve Bank has capped the average, they can differentiate the interchange rate, like the schemes do, so that they can give a big retailer a significantly better price and give the rest of the retailers a higher price. If you look at the Reserve Bank’s public information and if you go to Visa Card and MasterCard, they now have to publish the interchange rate and you would be surprised to find that there are big retailers paying half of what the normal bloke pays.

Senator PRATT—So if I shop at a small retailer they are more likely than a large retailer to add a surcharge for the use of a credit card.

Mr Stollmann—If you take the retailer, if what we fear happens, which is that about a quarter of a billion dollars will be charged on EFTPOS transactions—there are two billion EFTPOS transactions per year—they will be up to 17c more expensive. So when you go to your newsagent or your pharmacy next time, he will have received a letter from his acquirer saying, ‘I’m sorry, but I have to add 17c,’ and he will add that as a surcharge—most of them do not do that at the moment with EFTPOS because EFTPOS is cheap—or it will hit his bottom line. So he will be very happy because SMEs have such an easy time making money.

Senator PRATT—For small retailers, how does managing these kinds of electronic transactions compare to the management of cash? It strikes me that, despite the significance of these small charges, to some extent getting as much of it done as possible through electronic means versus sending cheques or using cash is far more economically competitive.

Mr Stollmann—Cash and cheques are out. It is clear that the convenience of the card payment is great. That is why we are on record saying that the way to protect the domestic debit card system is with similar legislation to that of the US, legislation which says that every Australian debit card shall give network choice so the Australian consumer who holds the card has to choose the scheme network or the EFTPOS network. If that is done, then EPAL will not need to increase the interchange rate to ensure the issuance of the cards, and then you will have a really competitive differentiator between a low-cost, efficient card payments system and a more innovative, bells and whistles international card.

Senator PRATT—What are the barriers to that happening at the moment? As I understand it, there are some retailers that will not accept debit cards anymore—those kinds of issues.

Mr Hamilton—Woolworths have said they will not accept scheme debit cards instead of EFTPOS cards.

Mr Stollmann—At the expense of international schemes.

Mr Hamilton—They have made a decision which Reserve Bank reforms of the last few years have allowed them to make. Previously they would have been restricted under card scheme rules. They have made a decision not to accept certain types of cards because the kinds of charges that Jost has been talking about on those cards are unacceptable to them and they would rather encourage their consumers to use a different card.

Mr Stollmann—To make this very clear, when at Woolworths somebody swipes a Visa debit card, the cardholder is told to push ‘signature’. That means that Woolworths has to pay an interchange fee to the issuer. If the consumer pushes ‘cheque/savings’, Woolworths actually gets money because the interchange rate is negative. Woolworths saw that the scheme debit card was increasing dramatically in share because you can buy on the internet, so the young guys love it, and it was driving down the Australian EFTPOS card. So Woolworths said, ‘We won’t give you the choice anymore, dear consumer. You will use it as an EFTPOS card entering the PIN; thus, we’re not paying the schemes for the scheme debit cards.’ That is what happened.

Senator PRATT—But from a consumer’s point of view it is all their cash. A debit card is the same.

Mr Hamilton—Correct.

Senator PRATT—It would appear to me that this is highly problematic from the consumer’s point of view.

Mr Stollmann—The consumer I think shares with Woolworths an interest in a low, efficient payments system.

Mr Hamilton—Although in this particular case I think it is fair to say that Woolworths’ attempts to do that for themselves have met with a lot of consumer resistance because from the consumer’s perspective it has meant: ‘Something I like using I’m not allowed to use anymore at Woolworths.’

Mr Stollmann—Wait a moment. It is getting a little bit confusing. The reason that it is an inconvenience to the consumer is that some banks charge EFTPOS transactions at hilarious rates.

Mr Hamilton—I do not agree with that, Jost. Let us try tackling a step up. To give a little bit of perspective, this issue of interchange fees and the competition amongst the card schemes is an incredibly complicated one and one on which there are literally thousands of pages of published material, because the Reserve Bank has been actively pursuing it since the year 2000.

There are 10 years worth of regulatory reform attempts on this issue—and not just attempts, but executions and very, very major changes. The net effect of that in global terms, comparing Australia to the rest of the world, is that in Australia we have amongst the lowest interchange fees in the world at the moment. I make no bones about that; it is because of RBA regulation. One of the key drivers of that has been RBA regulation.

Mr Stollmann—I would like to play the role of an SME advocate for a moment, someone who does not sit in EPAL. It is the big banks and the big retailers who have the voice; there is no voice for the SME. Let me play the voice of the SME. I would like to have an efficient, low-cost domestic debit card system. Let us take two countries for comparison—New Zealand and Canada. What is the interchange rate for debit cards in those two countries, where it was legislated, or it was undertaken in the case of New Zealand? It is zero, and that is where it belongs. If we go now and let EPAL decide that they can get up to 10c or 12c or whatever, there is a $¼ billion cost burden. Twelve cents sounds small but for a newsagency—and there are lots of those—it is going to affect the SMEs. I am the only one who is raising this—

Mr Hamilton—From the perspective of an SME, that is absolutely valid. Our challenge is the policy question here. In essence Canada has said that they want a public utility; they do not want competition in that space. They want a public utility to provide services of a particular kind—in this case, the domestic debit card service. If you do that, of course you can have whatever regulated price you want, because it is a public utility and the utility will just ensure that.

Mr Stollmann—Take my word for it, it is the only way the domestic debit card system will survive.

Mr Hamilton—That is the policy dilemma.

Senator HURLEY—I have got a couple of follow-up questions, and we may have covered this, I am not sure. One of your recommendations is relieving new acquirers from significant collateral requirements unilaterally requested by the credit card schemes. Can you tell me what you mean by 'unilaterally requested by the credit card schemes'?

Mr Stollmann—I will give you two examples, and we have mentioned one, MasterCard, already. We have the privilege to prefund MasterCard settlements, nevertheless MasterCard requires us to post a multimillion-dollar collateral just like that, because they think that is good risk management. Then, at the moment we have pressure by our merchants, which are brick and mortar merchants, who would also like to have a foot in the online space. They would like their acquirer—us—to provide them with a 'card present and card not present' solution. But in order for me to be in the online acquiring space, those global schemes require a high eight-digit million dollar amount in excess capital. That might have been explicable in the old days when online was the Viagra, gaming and pornography market internationally. However I fail to see that my book retailers, who also have an online presence and who do five per cent of their sales online, would necessarily be in that risk category. So it excludes us from entering the high-growth online market for what we call 'brick and click merchants', and it is important that Australia has brick and click merchants given recent debates that highlight how competitive the online market can become.

Senator HURLEY—Another recommendation is the adoption of the Reserve Bank's low-value settlement system by all banks when it becomes available.

Mr Stollmann—Chris, you can answer that better than I can, but that is a way to improve the settlement—

Mr Hamilton—The proposed low-value settlement service is a technical and operational change to the way the net payment instructions that underlie all these systems we have been talking about are delivered into the central system and move in a net way between financial institutions so that they can then adjust customers' accounts once that has happened. The Reserve Bank has proposed in a document of November last year a detailed change to that, which will make it more flexible and more able to accommodate faster settlement and also enable it to do a lot of new and different things in that space.

The members of the financial institutions in Australia all have that document now and need to do a significant amount of work to retool their own technical interfaces to talk to the Reserve Bank on that. We are talking about a system that handles billions of dollars and millions of transactions every day, so you want to do it in a way which makes sure it is not going to go wrong. That work will happen in the course of this year, in my view. The Reserve Bank have said it is a mandated change and so they expect everybody to do it. My understanding is that by early 2012 that new settlement system will be available. What Jost has called for, in my view, is extremely likely to happen. The Reserve Bank have said it will happen.

Senator HURLEY—Will that facilitate real-time settlement?

Mr Hamilton—It will facilitate real-time settlement. It is not itself real-time settlement. What they are doing is building the capability for all of those things to be available. There are many different ways for different systems to do the settlement timing.

CHAIR—Thank you very much to the representatives from APCA and Tyro. Mr Stollmann, do you have a final point you would like to make?

Mr Stollmann—I would just like to make a general point. We call ourselves Tyro, which is an English word for a new entrant, a challenger novice competing with the veterans, which is the antonym. We are around because we were nurtured and we were helped by the Reserve Bank and by the prudential regulator. We are now in the phase where it is important to continue that, and it is important that other people see that this is possible in Australia, because then you will have more Tyros. I am a very passionate person about the fact that there is a role to be played by the new entrants in an economy. They drive prosperity to some extent. That is also why I am in this business. It is a very difficult investment case, given the eight years, but we are very committed, but we need the support.

CHAIR—Thank you and thank you very much for your evidence.

Proceedings suspended from 12.07 pm to 1.01 pm

GREEN, Mr Micah, Economist, New South Wales Business Chamber

ORTON, Mr Paul, Director, Policy and Advocacy, New South Wales Business Chamber

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

Mr Orton—Thank you. I will make a short opening statement, after which my colleague and I will be happy to take questions. New South Wales Business Chamber has about 30,000 members directly and indirectly across New South Wales. We are affiliated with about 120 chambers of commerce across the state. We are also affiliated with the Hunter Business Chamber, the Illawarra Business Chamber and the Canberra Business Council. We certainly welcome the Senate's decision to hold an inquiry into banking competition. We think it is important because constraints on small business access to finance are definitely having a detrimental impact on employment and growth. Why this is so is that over 750,000 small businesses employ people across the country—about 5. 1 million people, about half the private sector workforce.

The key points that we would like to make perhaps boil down to four. Firstly, reduced competition in small business lending arising from finance sector consolidation and the reaction to the GFC has made worse the availability and the cost of small business finance. Secondly, while the recent measures to encourage lending competition and to increase small business lending are welcomed, they need to be bolstered. Thirdly, during the time it takes for a more competitive environment to develop, government moral suasion and jawboning should focus more on small business lending and somewhat less on residential mortgage rates, and RMBS—residential mortgage backed security—injections should be expanded and tied more directly to small business lending. Finally, we believe a temporary self-funded small business loans guarantee scheme would help bridge the gap between current circumstances and the commencement of substantial competition. In our submission we did make the point that we think the Productivity Commission should review in a more detailed sense the constraints faced by small business in accessing finance, both due to current GFC related circumstances but more endemically.

There is no doubt that the GFC has reduced levels of competition within the Australian banking sector and has made it more difficult for small business to access finance. Both price and availability of finance have been detrimentally impacted. Our members continue to identify this as a significant factor. In our most recent survey of members in October 2010 we found that 22 per cent of small businesses reported that access to finance had deteriorated over the past quarter, while only four per cent thought things had improved.

These findings have been complemented by some work that the chamber has been participating in with Victoria University, work that is yet to be completed, but the survey does seem to have found that, of businesses that had sought finance over the last two years, almost half have been unsuccessful on at least one occasion and almost a quarter have been completely unsuccessful in accessing finance. It also found the business rate of finance to be a more significant obstacle to growth than labour market regulation, inadequate infrastructure and the recruitment and retention of labour and skills.

The costs of finance have definitely increased significantly. Spreads on small-business loans have blown out from around 200 basis points to 400 basis points. While they have traditionally been more expensive than mortgage lending, the spread between the two has increased from about 20 points prior to the GFC to around 120 points today. Despite this, political attention remains fixed primarily on mortgage conditions and mortgage interest rates. Tightening credit requirements and increased levels of collateral have also meant that even profitable and sustainable businesses have been unable to access the finance they need to participate in the recovery that we should be seeing right now.

Increased costs and reduced availability have seen business finance fall with credit levels now having fallen for 21 months. So we certainly support actions by the government to increase competition in the banking sector. We certainly endorse the decision to invest further in the RMBS market. It will help to support lenders who rely on this source of finance but really the emphasis has been on consumer banking and the mortgage sector with limited support for small business lending. Our recommendations are set out in our submission in some detail. I will close there and I would be happy to engage in discussion with the committee.

CHAIR—Thank you, Mr Orton. You talk about your findings on the difficulty that small businesses have had in accessing finance at reasonable prices. The big banks have all said in the evidence that they provided, written and/or oral, that they have continued to support small business throughout the global financial crisis and they pointed to statistics which suggest that they have maintained the same degree of lending to small business throughout that period. How does that sit with what your members are saying?

Mr Orton—I will ask my colleague to expand on that a bit more, but I think one of the things we need to recognise is that there has been consolidation in the banking market. I think we need to distinguish between what individual banks might have done—and there are fewer now than there were some years ago—and what has happened overall with business finance availability.

Mr Green—I would say pretty much exactly what Paul has just said. I think each of the individual major banks has been quite keen to demonstrate that they have maintained their levels of lending to small businesses, but a lot of players have left the market and there has been consolidation in the market so, while the big players might have maintained their levels, the aggregate levels of lending in the market have fallen. While the big players might have been able to pick up some part of that gap, I do not think they have been able to fill the gap.

CHAIR—I think most of the big banks have said that they have not changed their lending criteria or their loan-to-value ratios and those sorts of things in terms of business financing. But, given that there has been a drop-off in overall business lending, do you think that that has allowed the big banks in particular to cherry-pick the customers that they might be lending to?

Mr Green—I would certainly agree with that statement. I think the fact that there is less aggregate lending out there, and also close to the same level of demand in the market, does allow the banks that are lending out there to be more selective in whom they lend to. Certainly if you have got a very high quality business and a really strong balance sheet you can probably still access the finance that you could in the past, but some of the small businesses that might not be quite as strong and who previously might have been able to access finance are now finding it

much more difficult because the banks do not have to go to them to meet their overall banking targets.

CHAIR—Presumably, if they are lending to businesses that have stronger balance sheets and are better able to demonstrate financial capacity to repay, that is giving them a higher quality average business customer. Lending to these businesses should reduce the risk to their shareholders and to the bank generally.

Mr Orton—I think that is an absolutely valid point. What we are seeing has exacerbated the usual circumstances that small business tend to find, which is that those with slightly difficult-to-consider propositions involving, say, export or new products or a move into a new market might have been a bit more difficult to get across the line, right now that is most definitely the case. You are quite right. The banks are focusing on the easy-to-assess and the less-risky opportunities, which is why we are suggesting a temporary loan guarantee scheme.

CHAIR—No doubt we will get to that. That lowers their overall risk. As I take it, their argument about the higher margin between the cash rate and the business rate that they are charging is to do with risk. Presumably, if they are in a position where the business loans on their books are safer than they were then that undermines to some degree at least their argument about repricing higher to cover risk?

Mr Green—Absolutely. I would agree with that 100 per cent. As you say, if they are lending to the less risky businesses, the aggregate risk that they bear should have reduced and that should in turn result in them being able to lend at a lower cost than would otherwise be the case. Certainly, the evidence that we are seeing in the market is that things are moving in the other direction: the spread is getting wider rather than narrower.

CHAIR—The other thing is—as I think you, Mr Green, acknowledged there—the overall lending to businesses has fallen over the last two or three years. The banks and others have provided evidence that they think it is because businesses have chosen not to seek as much money. They have chosen to either rely on reserves or raise capital through other means or, alternatively, not actually do the expansion and choose to wait and see what happens after the uncertainty passes. Mr Orton, in your opening statement you were saying—I do not mean to misquote you—that the lack of access to finance is the most significant constraint on businesses growing. If that is the case, that does not sit comfortably with the other evidence that suggests that businesses are not actually seeking finance.

Mr Orton—I think that is true, and it also reflects the longer term responses we got to our quarterly survey, where we have asked businesses over the last couple of years about access to finance. Certainly, both access and cost have deteriorated during the GFC.

Mr Green—That that has continued in the aftermath is absolutely true. Just to draw on the point that you were making about the Victoria University survey—I have the numbers here: when businesses were asked about a number of issues and about whether these were a significant impediment to growth, 54 per cent said that access to finance was a significant impediment, whereas 17 per cent identified infrastructure, 42 per cent identified labour market regulations and 40 per cent identified affordable labour. That survey was run around October-November last year. That is a pretty contemporary view from industry.

CHAIR—It is hard to reconcile 54 per cent saying that access to finance was a constraint on them growing their business with evidence that says businesses are not applying for finance because they are waiting to see what happens.

Mr Green—I would suggest that there is truth to both sides of the story. There would be areas where businesses have sought to consolidate their balance sheet rather than expand as aggressively as they might have otherwise. And no doubt the deterioration in overall levels of credit lending has been affected by both the supply side and the demand side. I guess it would be too much of a stretch to say that it is completely a demand issue. I think there is definitely a strong element of a supply problem there, in that there are businesses looking for that finance who simply cannot get it.

CHAIR—I will move on, because I am aware that other senators will have questions as well. So I will quickly run through a couple of other issues. In terms of your recommendations, particularly the one about the guarantee of small business loans, it is right to say that similar schemes of varying characteristics have been set up in comparable nations?

Mr Green—Yes, absolutely. I think we presented a few examples of that in our submission. The United Kingdom, the US and Canada all have comparable schemes.

CHAIR—The US and Canada have suffered more extreme consequences from the global financial crisis than Australia and could be differentiated there. However, Canada did not suffer badly and their banking system came through in quite good shape. That is probably a good example of a comparable system.

Mr Green—Yes.

On those guarantees, you note the bank should remain responsible for the financial assessment of small business applicants and banks' assessments of the loans will ensure that applications still have to meet minimum standards and that you also want to leave a bit of skin in the game for the banks, to make sure they have something to lose. If a government were going to set up such a scheme, they would need to look at that and work through that. One thing which worries me a little bit about banks when governments are backing them is the fact that they have all care and no responsibility and ultimately taxpayers can be left picking up the pieces. If they know that the vast majority of the risk is going to be picked up by taxpayers, their lending criteria or the degree to which they strictly apply that lending criteria may lapse somewhat. Is that something you have thought about?

Mr Green—That is certainly a risk. In looking at the other schemes, we have looked for those elements which help to address those moral hazard issues. We identified two ways to help address that. One you have already alluded to, which is keeping the skin in the game in terms of only being able to guarantee a certain proportion of any individual loan. The other tool, which can be used at a more macro level for any individual bank, is to limit the portion of the pool they can call on. For instance, if a bank had, say, 100 loans to small businesses all covered by the guarantee, you could put a cap on to say that only 10 per cent of those loans can ever be claimed against the government guarantee. So if all 100 went belly up, you would get financing back for only 10. That would help ensure that the bank did not willy-nilly guarantee everyone, because they would have to do maintain some sort of careful oversight.

CHAIR—As I said, obviously there are other ways of dealing with that. You also note that the Canadian scheme is self-financing. That essentially means that it raises enough funds from the charges it puts in place for the guarantees to cover all anticipated losses.

Mr Green—That is correct and that is how we envisage it running here. The government would look at the risk was taking onto its balance sheet in guaranteeing those loans and would then set an appropriate levy for the guarantee to make it self-funding.

CHAIR—Has it been going long enough to know whether it is truly self-funding?

Mr Green—The Canadian scheme? I would have to look at that in more detail but I believe that is the intention under which the levy was set.

CHAIR—One of your other recommendations was to limit further mergers between significant players until competition has been restored. Are you talking about mergers involving the big four banks or are you talking about mergers involving two of the second-tier banks? Do you have a view on that?

Mr Orton—Our view is that probably consolidation has reached its limit both within and between the big four and the others and right at the moment we think that the level of competition that is in evidence suggests that there are no mergers anywhere at least for the time being.

CHAIR—But surely mergers between a couple of second-tier institutions might create a fifth pillar to take it to the banks a bit more. Is that not something you are—

Mr Orton—We would be open to that. We would need to look at the circumstances, but we would be pretty wary I think.

CHAIR—Given the time and the number of senators, I anticipate we will have many questions.

Senator HURLEY—Chair, you have taken all my questions.

Senator XENOPHON—In the nineties, when there was more vigorous competition in the banking sector, there was not much difference between—if a small business got a loan on their home the interest rates were about the same as a loan just for residential purposes. That is no longer the case, is it? There is quite a difference between the rate of a small business loan and the rate of a mortgage, even though the security is identical.

Mr Orton—Absolutely and that spread accelerated up to and during the GFC. However, at the last official rate increase it did not, which was good. That is perhaps making a virtue of the necessity.

Senator XENOPHON—What is the spread now? Is it about 1½ per cent?

Mr Green—It is around, I think, 1.21, 1.30.

Senator XENOPHON—Do you see any justification for that, given the security is the same?

Mr Orton—Not a lot at all. I guess that goes to the heart of our concern about the level of governmental and media scrutiny of residential mortgage rates. That differential, at least to a substantial extent, is inexplicable.

Senator XENOPHON—In terms of options for small businesses, though, credit unions do not have the facilities to offer those sorts of commercial banking facilities, do they?

Mr Orton—No.

Senator XENOPHON—So when there is talk about a fifth pillar being created by credit unions and the like, that is not very practical in terms of small businesses being given an opportunity to have an alternative to the big four?

Mr Orton—There do not really seem to be too many alternative options, so the Post Office, the bank and others are consumer focused. Possibly other forms of non-bank finance, such as factoring and techniques like that, are an alternative. But one observation, at least anecdotally, is that the growth of advisers in the small business lending sector to help businesses find finance seems to suggest or confirm the difficulty that businesses have in finding finance within the existing mainstream banking sector.

Senator XENOPHON—Compared to pre the GFC, would you say that the difficulty in finding finance is a material impediment to job creation or to businesses expanding?

Mr Orton—We think it is, because the result of the survey of businesses suggests it is pretty close—at least it was at the top of the list of potential constraints on growing businesses. I guess at this stage of the cycle businesses should be looking to expand, grow and employ more people and I guess they need the requisite finance to make that happen.

Senator XENOPHON—And having some sort of small business loan guarantee program is the only way that you see of cutting through that?

Mr Orton—It is not necessarily a silver bullet, because a lot of things need to happen. Certainly, it should help those businesses that meet the perceived concerns of banks about credit risks. So there is a little bit of extra support for them, going a little bit further than they currently do. But there are some endemic issues that the current cycle is bringing in to provide greater relief. They are the capacity of banks to deal with small business lending propositions, both in terms of people and resourcing skills. It is true that some of them are now moving to decentralised decision making, which is a good thing. One wonders how capable they are—and I guess this was part of the reason for suggesting a Productivity Commission inquiry—in terms of skills and disposition of personnel to deal effectively with small business lending applications. In other words, do the real merits of an individual application get looked at and do they get written off because they involve export or a new product or are in a particular sector?

Senator XENOPHON—Maybe you cannot answer this because you represent existing businesses. But, from your point of view, in terms of young entrepreneurs wanting to start up their own business, wanting to get a foothold, is it even more difficult for them?

Mr Orton—I imagine it would be, given what we have found in relation to existing businesses.

Senator PRATT—I want to ask about the residential mortgage backed securities and the bullet bond market. It has been argued that smaller lenders will be able to access lower costs and sustainable funding from that. It is not just about home loans but also about small business loans. I suppose the other part of that picture is building up small business relationships with credit unions, building societies and other parts of the banking services sector that, traditionally, small business has not had that much access to or that strong a relationship with. Could you highlight for me any moves in that direction? I appreciate that sometimes credit unions are not that well set up to deal with small business needs and, again, that they have their own challenges that they are working on to overcome in accessing finance on behalf of small business. Could you highlight some of those issues for us?

Mr Green—Turning first to the bullet product, smaller lenders have identified that as a useful product which will help them lend because it has a more consistent cash flow. To the extent that the AOFM can manage that and that it works for the smaller lenders, we think it could have a great outcome. It is a product that helps smaller lenders to get out there and participate in the market. We would certainly encourage anything that allowed the credit unions and the smaller lenders to play a more active role in financing small businesses and, if the bullet bonds could help with that, that would be a great outcome.

Mr Orton—But I think the skills and capacity to evaluate small business loans would be just as big an issue, and possibly even bigger, for smaller lenders.

Senator PRATT—I would think those smaller lenders would be moving towards combining their funds but also working more collaboratively on those kinds of assessment issues as well. Would that be true, in your view?

Mr Orton—Not to our knowledge, no.

Senator PRATT—So there might be some room for improvement there in supporting credit unions collectively to beef up their small business capacity.

Mr Orton—Potentially, yes.

Senator PRATT—Thank you.

Senator WILLIAMS—Mr Orton, looking back on interest rates, in September 2008 interest rates started to fall. I think the Reserve Bank moved them down to about 4.25 per cent from 3 September 2008 to April 2009. But many small businesses and farms et cetera had very little, if any, reduction in interest rates. Many people I spoke to only had 1¼ or 1½ per cent reductions over that time. Why is that?

Mr Orton—Good question. I guess that is partly the reason we would strongly advocate much greater public and government focus on what is happening to small business lending. It impacts on jobs and the health of communities, both urban and regional. Government focus has been on movements in residential, mortgage and official rates, and much less—there has not

been much at all—focus has been on what is happening to small business rates. I think it is a case of lenders doing what they think they can get away with.

Senator WILLIAMS—Isn't it important in a time of crisis that the private sector also recover as quickly as possible or get through the tough times as easily as it can? If the government and the Reserve Bank are taking actions to stimulate the economy, to save us hitting the wall, it would also be vital for small business to be part of that saviour plan, if I can call it that, as well.

Mr Orton—Absolutely. Small businesses are part and parcel of regional communities and, if they are not actively supported by their lending institutions, entire communities suffer.

Senator WILLIAMS—Looking at your submission, on page 10 you have the spread between business loans and home loans and the amazing climb in those towards the end of 2008, the time of the onset of the GFC. It is a difficult question, but can you explain that as well? Perhaps I should be asking the next witness.

Mr Orton—Yes, they might be the best source of the answer. But my colleague might have some observations on this one.

Mr Green—I do not have a great deal to add to what Paul said, but certainly for the last decade there has been a small spread between the level of business loans and home loans. I think that appropriately reflected that there was a slight difference in the risk profile of a home loan lender versus a business lender backed by a residential property. But that was traditionally around 20 basis points, which is very small, and the dramatic acceleration to over 140 basis points—now back to about 120—suggests to me that perhaps the risk aversion that the banks have shown has moved too far in the wrong direction and that they are not appropriately pricing that risk.

Senator RYAN—You mentioned earlier, Mr Orton, that in the most recent survey 22 per cent of small businesses experienced a deterioration in access to finance versus four per cent experiencing an improvement. Was that around the cost of finance or was it around the terms or security required?

Mr Orton—That was around access, not cost. That means that they could not get it, either because the credit requirements were too great or for other reasons—not cost. We asked a different question about cost.

Senator RYAN—In your submission you mention the request for a Productivity Commission inquiry, which you also talked about in the earlier inquiry undertaken by the committee into access for small business finance. Would the aims of that inquiry be met if, for example, those terms were included in a broad based inquiry into the financial sector?

Mr Orton—Possibly they might. I guess the question is how long these things take and therefore the length of time changes to put into effect the recommendations that are made would be an issue. While they should definitely be looked at by a broader inquiry, our thinking from the small business perspective is that perhaps a Productivity Commission inquiry might get the job done more quickly.

Senator RYAN—That is assuming the government listens to the findings, Mr Orton. I would like to turn to your recommendation around the guarantee for small business loans. Maybe I am being parochial here, but, being Victorian, we have a bit of a worry about government guaranteeing banks. Can you think of an example in Australia, outside rural financing, where government guarantees and banks have been relatively successful in business loans? Most of our state banks were historically built on building society type models, with loans to provide for mortgages. When they went into business banking—and quite a number of them went into small business—the taxpayer took a bath, and it took some of our home states a decade or more to pay it off.

Mr Orton—The instance that we would look at domestically is EFIC, the Export Finance and Insurance Corporation, which effectively does pretty much the same thing for export based finance. It is self funded. It does return a dividend to government. It can work. I think the unfortunate experiences to which you allude create lessons to be avoided next time around, but they do not automatically imply that these things cannot work. I think EFIC shows that they can.

Senator RYAN—I think there are more examples to the contrary than the one that works. It strikes me that if it were big enough to make a substantial difference that means it would also be big enough to take on a substantial risk. Regarding a couple of the terms you mentioned, particularly around, for example, the guarantee not covering 100 per cent of the loan, all they do is reduce the price of the risk. That could actually have a perverse incentive in encouraging people to take on more risk, because their risk appetite is set and if the cost of the risk goes down they could end up lending more.

Mr Orton—I guess that is the intention. Micah, you might want to follow that up.

Mr Green—The whole idea of the risk sharing there is just to ensure that the government is not bearing the whole risk itself and that the bank still makes a sensible assessment of the loan application. There is also the cap you can put on the total portfolio risk—to manage it that way as well and try and avoid the moral hazard issues. I appreciate that there is certainly the risk that if the government just came in and guaranteed everything the banks would have no financial discipline placed on them, and that would certainly cause problems. But I think there are ways you can go about managing those risks.

Senator RYAN—Sure. I might put some further questions on notice. I am under no illusion that people are here to hear me.

CHAIR—We have still got a few more minutes. I might ask a follow-up question. In one of your recommendations you say that the government should put greater pressure on banks to keep small business lending rates down and publicise good and poor performance in this area by individual banks. Apart from publicising good and poor performance in the area of small business financing, what measures are available to the government to actually put pressure on banks to keep small business lending rates down?

Mr Orton—We think that is the primary measure that the government has available to it, other than—as has already happened—increasing injections into the RMBS system. I guess we would be encouraging greater community concern and awareness of small business lending practices and performance. Nothing is better than transparency and exposure on what is really

happening to the small business sector and its ability to access finance. I think it would help inform small business lenders too about the relative performances of different players in dealing with that part of the market.

CHAIR—You are an organisation that has as its members a large number of businesses. I think you mentioned 30,000 businesses across New South Wales. What do you as an organisation do to publicise the differences between financial institutions in terms of deals offered for small business?

Mr Orton—We have worked with CANSTAR CANNEX to create a data series which looks at the difference between mortgage lending rates and small business lending rates. It monitors those as the RBA changes official rates, where we put that into the public domain. Our participation here is part of our concern to attempt to shed more light within both the small business community and the broader community on the performance of banks in dealing with that important part of their marketplace. We can do more and we no doubt will over coming months.

CHAIR—The reason I asked was that quite clearly you are calling on politicians and the government to go out and decry independent moves on business rates in the same way that we have seen in recent months with respect to home lending rates. I suspect it may not attract the same degree of media and public interest as home loan rates do because home loan rates tend to affect a lot more people in direct numbers, in raw numbers. You have a direct line to 30,000 businesses that gives you an opportunity to do the same thing. There are alternatives. I am just wondering to what extent you are doing exactly what you are asking politicians to do.

Mr Orton—We certainly make available information to all our members and those connected with us. We use the media to the extent that we have a media voice, which usually is not as great as that of governments. As the chamber movement strengthens in Australia and in New South Wales in particular, because we see part of our charter as being to bolster the capacity of smaller businesses to make their voices heard, this issue will become a much bigger part of public discourse and certainly that generated through business organisations.

CHAIR—Just changing tack slightly, I note that in your submission you talked about how some businesses are being forced to use credit cards. Actually, that might have been in another submission. Did you mention that?

Mr Orton—No, but it is true.

CHAIR—Do you have any evidence that any of your small businesses are using personal credit cards to finance their business?

Mr Orton—Anecdotally, yes.

Mr Green—Anecdotally, yes. Unfortunately, I do not have the data with me at the moment. That is also a question that was covered by the collaborative survey that we did with Victoria University. I cannot recall the number off the top of my head, but it was certainly a very significant proportion of small businesses.

CHAIR—When you say ‘significant’, are you talking about two per cent or 10 per cent?

Mr Green—I think it was more than 50 per cent. I would need to check. I think that that number had used their credit card in the last two years to help meet cash flow needs.

CHAIR—Thank you very much. There are no further questions.

Mr Green—Thank you.

[1.39 pm]

COFFEY, Mr Philip, Chief Financial Officer, Westpac

HANLON, Mr Peter, Group Executive, People and Transformation, Westpac

KELLY, Mrs Gail, Chief Executive Officer, Westpac

CHAIR—Welcome. At this stage, I would like to remind photographers and cameramen to follow the instructions of the committee secretariat and to ensure that senators' and witnesses' laptops and personal papers are not filmed, particularly bearing in mind that we have a range of cameras behind us. Mrs Kelly, if you or other officers of the Westpac Bank find the activities of the photographers distracting, just let me know and we will ask them to move or to change what they are doing. I now invite you to make an opening statement.

Mrs Kelly—Thank you. I would like to make a few remarks in opening. I would certainly like to thank the committee for the opportunity to appear before you today, as well as for your understanding in allowing me to reschedule our appearance from December last year.

Westpac views this Senate inquiry into competition as important and we welcome the opportunity to provide our perspective on industry developments. I have with me here today two of my most senior executives: Mr Phil Coffey, who is the Westpac Group Chief Financial Officer, and Mr Peter Hanlon, who is our Group Executive, People and Transformation.

In terms of opening comments, I would like to start by making the important point that Westpac welcomes competition. In most areas, we believe the Australian banking sector is highly competitive. It is also strong and stable. The global financial crisis that we experienced over recent years and the dire economic consequences continuing from banking failures around the world has certainly reminded us how important it is to have a safe and strong banking system. There is a trade-off between competition and stability, and getting that balance right is crucial.

Healthy and stable competition is not just about the sheer number of participants in a market, nor is it simply about price. There are a range of factors on which customers make choices, including service propositions, product features and packaging, levels of advice offered, customer support, branch availability, online and ATM experience and of course differences in relationship management. In the Westpac Group we are able to observe this every day, because our strategy is one of offering customers choice through our multi-brand model, our key retail brands being Westpac, St George, Bank SA and RAMS. Each designs and implements their own customer strategies and plans. They have different marketing approaches, and it has become increasingly clear to us that they attract different types of customers. We are investing in each one of these brands, and I am pleased to say that we have been growing customer numbers in each.

Let me turn now to say a few words about the challenges of the current operating environment, as there is no doubt that, as a direct consequence of the global financial crisis, our

industry has undergone structural change, and there are further changes to come, driven by the global regulatory reform agenda. By far the biggest single impact of the crisis on Australia has been the dramatic change in both access to and cost of wholesale funding in offshore markets. The crisis clearly highlighted our reliance as a nation on offshore financial markets and the reliance of smaller players on securitisation markets. The crisis has also led to significantly heightened intensity of competition for domestic deposits at elevated prices.

What all this means is that, during 2009, at the very time when fiscal stimulus was necessarily being applied into the economy, a number of lenders stopped lending, while others significantly curtailed the amount of lending they would do. Westpac was one of the very few who remained open for business across personal and business lending. This was a conscious choice, taken in the knowledge that we had an extremely strong customer proposition and that we were one of the few financial intermediaries with the financial strength and the willingness to lend to Australian individuals and businesses.

We believe this was good for the Westpac Group and also good for the Australian economy. However, it also meant that in order to meet this lending demand from customers we would need to raise money at much elevated prices and that, over time, we would need to pass these costs on. This is challenging to do and we fully understand the impact on customers. In the interests of remaining safe, strong and sustainable, it is, however, essential.

The reason for dwelling on these challenges in the operating environment is that it is our contention that if funding issues lie at the heart of what has made it difficult for some players to compete then it is on funding that we must focus in order to address this. The crisis has clearly demonstrated the desirability of further diversifying funding available to our banks and reducing our reliance on offshore markets. In our submission we made some recommendations in this area. We are certainly pleased that the government package includes the introduction of covered bonds, and we welcome the further support to the residential mortgage backed security market. We believe, however, that more needs to be done to encourage savings, and here, levelling the playing field between bank deposits and other currently more tax-favoured savings options will assist.

Chairman, I will conclude by saying that we welcome the opportunity to participate in this process of further strengthening our industry. We take our role as one of Australia's major institutions very seriously and we are committed to making a difference within the communities we serve. It may be appropriate here to mention the recent devastating floods and their severe impact on people, businesses and communities. It is pleasing to see the proactivity, responsiveness and initiative that individual banks are undertaking. I would be happy to provide some detail to the committee on the Westpac response should the committee desire. We are very happy to take questions.

CHAIR—Thank you for your opening statement. Since you closed with some comments about the floods, I will ask you some questions about that. Could you please provide me with an update of how that has gone—how many notifications you have received from your customers that they are suffering hardship from that, the extent to which mortgage insurance will cover the situation that many of those customers find themselves in and so forth.

Mrs Kelly—Unfortunately, because we have had a number of disasters over recent times it is an area that we have had a lot of experience in. If you think about the Victorian bushfires, Cyclone Larry and the Christchurch earthquake, this is an area where we have had a lot of experience. We have brought all that experience to bear together with other banks. I have to say that I think the whole industry has responded very well in a very proactive and front-footed way.

Firstly, with regard to our customers, there were a range of immediate steps we actually took. We know from experience that our customers are looking for quick and ready access to finance. We pull out the various stops that we have to try to make that available as quickly as possible and to streamline the processes to make the provision of finance possible for our customers. Of course, there is the usual range of package options that we have to withhold payments for customers for a period, to suspend interest for a period and so on. There is the normal range of options there.

In addition—and this was very successful with the Victorian bushfires—we provide mobile banking. Literally, it is banking in a box. We go into the area of emergency where only emergency service people are allowed and actually cash cheques. ATMs are not what people need right then. They have often lost cards and everything. We are able to cash cheques for customers of all banks. It is not simply a Westpac provision. That is something that is very readily and willingly received.

With regard to insurance, I am very pleased to say that Westpac covers all the claims. We do not distinguish between different types of floods. Customers with Westpac are being fully looked after. The element we are most pleased about is the ready approach that we have taken to this, the sense of responsiveness. We are not actually waiting for assessors to go out; we are actually taking people on their word and using photographic evidence where that is possible and if people's cameras have been stolen and they tell us what they have lost we are accepting that with goodwill too.

I will ask my colleague Peter, who has been running our whole coordinated effort, if there is anything I have missed there. Perhaps the infrastructure fund is one to add.

Mr Hanlon—I have two things. We have around 100,000 customers who have insurance with us in Queensland. We are expecting in the order of 2,000 claims. We have now been able to contact every one of those customers and assure them, as Gail has said, that they are in fact covered—that is the most important thing that they want to know—and that we are running through the assessment process. To date we have been able to contact and complete the assessment for well over half of those people. We have made contact with all of the rest, but the assessment process is complete for half.

In terms of customers contacting us, we have set up emergency flood relief phone lines. Also we make sure that branches near the affected areas—in Gatton in the Lockyer Valley, in Ipswich, several in Brisbane, in Toowoomba, in Horsham in Victoria, and Emerald and Rockhampton in Central Queensland—have enough staff and are open for longer hours so that they can assist with inquiries. To date we have had about 4,500 calls to our central call line. They have been from across the country. Obviously, at this stage most are from Queensland and Victoria but they are also from Carnarvon in WA, where they had floods, and Tasmania and northern New South Wales as well.

The additional issue that Gail referred to is that yesterday we did announce a further extension of the range of services we are providing, particularly in this instance to Queensland and victims of the Queensland floods. That includes doubling the cash donation we have made so far from $1 million to $2 million and also the setting aside of a $2 billion infrastructure fund. We learnt this lesson, as Gail has alluded to, from the Christchurch earthquake, where we found with homeowners, and small business customers in particular, that they had been through such hardship that they did not want to go through the normal processes of borrowing money; they wanted fast-tracked and easier processes. So we have made sure we have put in motion those processes behind this $2 billion dollar infrastructure fund. We have extra credit teams to assess the loan applications and extra relationship managers in place to make sure we can help to get people back on their feet as soon as we possibly can.

CHAIR—You mentioned also, Mrs Kelly, that the normal withholding provisions are also applied. Presumably that means that where people have lost their houses and maybe their income-generating potential, at least temporarily, there is some sort of leeway given to them in terms of meeting their loan repayments on houses that may or may not still exist.

Mrs Kelly—Very much—there is the standard package which has waivers of three months and so on, but we deal with each individual customer individually. I think that is the key, because each individual situation is different. So our Westpac Assist and St George Assist centres really come into their own here, and we encourage customers to deal with us. In fact, on the ground, I was there on Wednesday and met with the Treasurer in Queensland, Andrew Fraser, and we spoke about some of these matters. Our people on the ground are telephoning every single customer. We can do that with our business customers quite easily because we have personal relationship management with them. We are phoning every single customer, those affected and those not, simply to ask if there is anything further that we can do to assist, and we are doing that as much as we possibly can with our retail customers too. So it is very much proactive, front footed and individual-situation-by-individual-situation—we are absolutely prepared to go the extra mile here.

Senator WILLIAMS—Just on that waiving up of your emergency package for three months, you mean waiving the payments. You would not waive the interest; you would compound the interest on, wouldn't you?

Mrs Kelly—That is typically the approach, yes. There can be exceptions to that depending on the individual situation. We had a number of situations in the Victorian bushfires where we went quite a bit further than that. So it really can depend on the actual situation of the individual—the loss that they have incurred. We would take that into consideration.

In **Senator WILLIAMS**—Perhaps 'deferring' might be a better description than 'waiving'.

Mrs Kelly—Correct.

Senator McGAURAN—Is there any capacity, just on that, to waive or write off a debt completely?

Mrs Kelly—Peter, would you like to take that?

Mr Hanlon—There are a couple of points there. For small businesses in particular, which I know the committee is particularly interested in, part of our announcement yesterday was to extend that period of what we do with interest to six months rather than three months. In terms of your specific question, Senator, if I use the Victorian bushfires as an example, we had a team of people that continued to work on people who had been affected by the bushfires for 14 months. We worked through individual cases and, as Gail has alluded to, in some of those instances some interest is forgone by us and in some cases we do in fact forgive the debt. We do not do that for thousands of people, but in particular cases where there has been very significant hardship we work through it on a case-by-case basis. There is a whole range from deferring the interest right through to actually forgiving the debt.

Mrs Kelly—There are other situations. For example, with this $2 billion dollar infrastructure fund, application fees will not be applied. We did not want to call that a waiving or not, but they will not be applied. Then, with regard to ATM fees, there is an agreement with the other banks as well: for a period of four weeks there will be no ATM fees applied at all. That is, as I said, an agreement between the banks.

CHAIR—Just changing the subject slightly, you mentioned in your opening statement the package announced by the government to address competition issues late last year. Were you consulted on the terms of that package prior to it being announced?

Mrs Kelly—There are various elements of the package, now that we can see it in its entirety, but clearly we were consulted over a long period of time on the elements specifically to do with funding. There has been a task force led by a combination of the ABA, our treasury, APRA and, indeed, the government looking at issues to do with funding and examining—

CHAIR—Like covered bonds and—

Mrs Kelly—Covered bonds and so on. So that was a very healthy and lengthy period of consultation with lots of industry engagement. On the other areas, no—there was no consultation as such.

CHAIR—But even for those funding areas, at least some of them if not all of them, the consultation would have been occurring at the request of the banks. In terms of covered bonds, I think you and other banks have been raising that for some time as something that should be looked at.

Mrs Kelly—It really occurred—there was a meeting of the four major bank CEOs with the Prime Minister and the Treasurer. This goes back to June just before the G20 meeting that was scheduled to be held in Toronto. At that point the industry tabled that it would be a good idea to form a working group to look at funding issues so that we could develop diversification of funding sources for our industry here in Australia and reduce our reliance on offshore funding. So that is really where it emerged.

CHAIR—So essentially that was well underway before the Treasurer publicly announced that he thought there was a need to deal with competition issues in the banking system.

Mrs Kelly—I am not sure exactly when he announced that, but we have been talking about funding issues, to be honest—

CHAIR—Certainly well underway before it became a public issue late last year anyway.

Mrs Kelly—Yes.

CHAIR—Your thoughts on the package. You mentioned that you thought some of the things were good, like covered bonds as the prime example. The package as a whole: do you think it is likely to advance competition issues within the banking industry?

Mrs Kelly—That is difficult to know. We will have to wait and see on that overall. We are broadly positive about the package as a whole. As I have indicated, there are some elements that we are more welcoming of than others, we are more enthusiastic about than others, and clearly we think the funding one is valuable. I do think that making this important step forward with regard to covered bonds is valuable for us. It is not a panacea: it will not solve the whole problem, but it is an important next step in diversifying funding and leveraging a really outstanding asset that we all have in our balance sheets, our mortgages, which are rated AAA, and leveraging that to provide some additional funding to additional investors who would otherwise not necessarily be prepared to invest with us. I think that is very helpful. And it is a market, as you know, that exists in most jurisdictions around the world. Even in New Zealand we are doing a covered bond issue ourselves at the moment. The pricing for that is materially lower than if we were to be going to wholesale investors. So if we can bring this into Australia, we should be able to get some lower pricing. And if we can get lower pricing, that should help with competition and it should help with interest rate management. So that is a positive element.

CHAIR—I can see how it can help with interest rate management from Westpac and the other majors' perspectives. Some of the evidence we have had suggests though that it probably put some of the other players in the industry at a disadvantage because they are less able to put together a package to go to the market to sell covered bonds and, therefore, they will not receive the same cost benefit and it may then compound competition issues between the major banks and other players. Do you have a comment on that?

Mrs Kelly—Certainly, and I will ask my colleague, Phil Coffey, who looks after all of our funding for us in the bank, to pick up on some of those points. But I would say there are examples around the world where the smaller players pool together. That is one example. But if we can improve the overall access to funding for the market as a whole, it enables us also as major banks to provide more support to smaller players. That is certainly a role that we take. Certainly in Westpac's scenario, we provide securitisation support to other players. It is part of what we have always done.

CHAIR—And you probably do that more than the other three majors? Is that correct?

Mrs Kelly—Well we do it at least—we are one of the two—you can answer that, Phil.

Mr Coffey—To the original question, there are two issues that deal somewhat with your concern. The first is that there are at least two European jurisdictions where smaller players have

got pooling arrangements in which they are able to pool their mortgages and then issue a covered bond program from that.

CHAIR—And they are covered bonds that have a higher rating than the institutions involved themselves?

Mr Coffey—That is correct. In fact, they would get a bigger differential between their own individual rating and the covered bond rating. So that is how it operates in Spain and in France. It is not as straightforward as a direct issuance, but it is not as if it cannot be done and we are seeing it done in those jurisdictions. The second point, which was what Gail was alluding to, is that to the extent that the overall system gets additional sources of funding then it actually serves to reduce some of the competitive price pressures potentially across the entire system. We have seen with a number of the regional banks concerns around how much extra competition in deposits has affected their cost of funds; this is clearly an area where that might get some mitigation as a consequence of additional wholesale funding.

CHAIR—Covered bonds is an example of one of the measures in that package that you probably like more than others. RMBS additional issuing is probably another one of those. What aspects of the package do you find less attractive and less likely, in your opinion, to increase competition?

Mrs Kelly—There are two that I will mention. Firstly, the one with regard to the ban on mortgage exit fees. We do not see that as a necessary step, and from a principled point of view we do not think that is something that the government should be banning—that is, taking a particular fee and banning it. There is legislation in place at the moment to ensure that all fees are fair and transparent, and we think that legislation is sufficient. We do not think that that would have any particular effect on competition. Indeed, it may hurt the smaller players more than the larger players. From our point of view it is not a big issue and it is not one that we are going to be very upset about, but it is not one that we would see as necessary.

The other one would be with regard to price signalling. From our point of view, clearly we are against any kind of price collusion or any sort of price signalling. We do not believe that it is occurring in the industry, and so we do not believe that that is necessary either. And nor do we believe that it would have any positive impact on competition. It might have some unintended consequences if it is poorly implemented.

CHAIR—Have you seen draft legislation from the government on price signalling?

Mrs Kelly—I have not seen the draft legislation yet. All I have seen so far is the detail as it was announced in the package itself.

CHAIR—I want to move on from there. On page 14 of its submission, the Reserve Bank says in respect of funding:

Most of the increase in the major banks' funding costs occurred during 2008 and early 2009, at the peak of the dislocation in markets. Since mid 2009, the major banks' overall funding costs are estimated to have moved broadly in line with the cash rate, reflecting offsetting factors.

And in terms of the offsetting factors they are talking about the increase in the cost of long-term funding as bonds rolled over and you had to renegotiate and go into new ones and the increase in the cost of deposits being broadly offset by the cost of short-term funding and fixed-rate funding. Would you care to comment on that? Do you disagree with the Reserve Bank? If so, why is the Reserve Bank getting it wrong?

Mrs Kelly—The Reserve Bank is talking about the system as a whole, and it is looking at information that it draws from the system as a whole. What we can do obviously is talk very specifically about our own situation. In our own situation the average cost of funds continues to rise. It has moderated somewhat, but it does continue to rise and that is because, as you indicated earlier, we are still replacing funds that we brought on board before the global financial crisis with funds that are now much more expensive. As you would be aware, before the global financial crisis, just to use an example, we were able to raise three-year money at about 15 basis points over the benchmark rate. At the height of the crisis it was about 200 basis points over the benchmark rate, and it has come back to about 130 basis points over the benchmark rate. So we are still replacing funds we put in place in 2006 and 2007 and so on with this more expensive money, and that results in an increase in our average costs.

We are also continuing to increase the term of the profile of our funding so that more funding is done at five years and seven years and 10 years than had previously been the case. That is the direction that the regulations are sending us, and of course it provides a more stable environment. So our average cost of funds does continue to go up. Phil, is there anything I have missed there that you could add to?

Mr Coffey—The only other thing I think where we are probably different from the Reserve Bank estimate is that the mix of our deposits has also shifted. The Reserve Bank uses a proxy for deposit pricing and it looks at specials in the term deposit market. What it does not pick up is the specials in the at-call overnight market, the internet at-call specials, which have also moved up very dramatically and particularly have moved up in 2010. And as depositors shifted into those specials, so our cost of funds went up as well. So that and the lengthening of the wholesale are two of the elements that the Reserve Bank is not able to pick up in its overall estimate, which has affected us and which is why we get a different outcome from the Reserve Bank.

CHAIR—So the Reserve Bank does not have access to sufficient information to accurately assess what is your bank’s costs will be. Is that what you are saying?

Mr Coffey—When we look at the estimates that they have made since 2007, we would say broadly we are in agreement in terms of the additional cost of funds that we have occurred over and above the lift in the cash rate. But just in terms of various nuances, each bank will be different and then when the Reserve Bank averages it all out, you get different outcomes. And we have a much more complex balance sheet than the Reserve Bank can possibly estimate just looking at market indicators. It is not to say they have not done a really good job in terms of giving broad-based indication, but it is not as accurate as we can do for ourselves.

CHAIR—One of your other major four bank competitors indicated that they thought the Reserve Bank did have sufficient information, but they were unable to explain why the Reserve Bank had not drawn the same conclusion that they had in terms of their increasing cost of funding. So that is slightly different to the evidence that you are giving. You do not think that if

they properly assessed the information before them they would also be forced to draw the same conclusion that you do in terms of the cost of funding?

Mr Coffey—I am sure if I gave them my balance sheet, they could end up at the same degrees of detail, but that is not what they get. They get a number of elements of that and they get an estimate across looking at what is happening in the market, taking good soundings across the entire industry—but each bank, as I said, is different.

CHAIR—Just looking at the elements of it, the Reserve Bank were talking about the increase in the cost of long-term wholesale costs, with wholesale funding increasing as bonds roll over and because of the increased competition in the deposit market at a local level being offset by a decline in short-term funding. In terms of the cost of long-term funding, you note that you are moving towards an increasing proportion of your funding that is longer term, and that, I think, is common with all banks and may even be subject to some regulatory push, as I understand it, that you need more in terms of long-term funding. You note that they come at a higher cost than short-term funds. First of all, what is defined as short term and what is defined as long term?

Mr Coffey—We would define short-term wholesale as moneys that have a maturity of less than one year. So, as longer term moneys come in under one year, that still becomes part of our short-term bucket.

CHAIR—So if it is one year or more it is longer term?

Mr Coffey—Correct.

CHAIR—The regulatory requirements that are moving you towards longer term are requiring you to go beyond one year. Is one year sufficient for that?

Mr Coffey—The regulatory issues are that the Basel committee and APRA in turn are looking at the sustainability of the banks' funding model. They are saying, 'We want banks with more sustainable funding models, more customer deposits that tend to be sticky and more long-term funding,' which is, as you said, longer than one year. They do not get as prescriptive as where the absolute cut-off point is. They are looking in more detail across where maturities lie. They have got a much more sophisticated approach than that and it is something that we are engaged in discussing with them right now as we look towards implementing some of these new requirements. But in general it means that our perception—correctly, I think—is that we will need to raise more customer deposits and more long-term, longer than one year, wholesale money.

Mrs Kelly—One of the ways we think about it is to try and make sure we do not have too much maturing in any one year, because we want to avoid that kind of overhang and we know lots of money is required to be raised in Europe in the 2011 year, so we want to make sure that we are not putting ourselves into a vulnerable position there.

CHAIR—And it spreads your risk as well in terms of what might happen.

Mrs Kelly—Exactly. So we do look at the buckets in the year time frames in that way.

CHAIR—Senator Xenophon has a supplementary question on that point.

Senator XENOPHON—Mrs Kelly, we do not know what the Basel III rules will be at this stage, but could it be that there will be some collateral damage, given how well run we are in relative terms to other nations? If there are stricter lending requirements plus the sovereign debts in Europe that need to be refinanced in the coming 12 to 18 months, does that mean we could be facing a much greater degree of tightness in terms of more competition funds, which could impact here in Australia as a combination of those two things—the European sovereign debt and Basel III being tighter?

Mrs Kelly—I think the APRA delegates and RBA delegates and the government itself have done a very good job of presenting the Australian case at the various Basel committees. We were a lot more concerned a year ago than we are now —having been an example of a country that has done really well and actually managed its way through the crisis really well—that we would be negatively impacted by some of these requirements coming out of it. There is still some water to go under the bridge on that. Phil, you may like to add to that and provide bit more detail.

Mr Coffey—I think that the issues—the risks that you mentioned, Senator—are understood by our regulators, and therefore the transitional arrangements that they will be thinking through will have to bear that in mind. But they should also expect us to be thinking about what those risks will look like in those markets and how we can mitigate some of those risks. As Gail said, one of the ways we do that is to try to reduce maturities that we have in any particular short period of time, to avoid that risk of 'If the markets close, what would you do?'

Senator XENOPHON—I will not labour this, but there is a downside potential for us here in Australia in terms of pressure on the money markets.

Mrs Kelly—The downside pressure exists for us because of our underlying vulnerability in relying upon offshore wholesale markets. That is a structural issue for us, and really, if you think about it, if we had not had that structural issue we would not have landed up with the dislocation that we have had in our own economy. So it has played through quite materially. I mentioned that in my opening comments and in our submission. The fact of the matter is that during 2009 many lenders were simply unable to lend. Because the securitisation market had closed, they had a lot of difficulty in accessing wholesale funds or the cost was too much for them to be able to make a return on their business. As a consequence, there was real dislocation, and essentially only two of the major banks stood up to do a large part of the lending during that year.

CHAIR—Coming back to the cost of longer term funds, is the cost linear? You talked about having to go to longer term funds increasing your costs. Is there a linear relationship, or is it a bell shape or curve? How does that work in terms of costs? You talked about one year or more being 'long term', but what if you take it out for two or three years? Is there a linear relationship between the cost of accessing those funds and the time that you take it out?

Mr Coffey—It is a positive curve. That curve tends to flatten out beyond 10 years. If you start to borrow for 15 years the cost is not much more than for 10 years, but between one and 10 years it absolutely goes up. But the extent to which those markets move around means it is not always apparent that there is a straight curve. On any day, there is that curve, but we might borrow for

three years today and we might borrow for five years in two months time, and the five-year money might be lower because the markets have got better. So, it is both those things.

CHAIR—And no doubt you have people in your treasury departments working flat out trying to find where the best deal is to fit your needs in terms of timing and price.

Mrs Kelly—Exactly.

Mr Coffey—It is also why the uncertainty of the global markets has such an impact on us. We do not have the predictability to say that, if we wait, in two months time things will be better. We constantly see events occurring outside of Australia—obviously in Europe and to a lesser extent the US—that suddenly have an impact on the market. The market is still quite nervous.

Mrs Kelly—The good news is that we hope there will be a time—and we are not sure exactly when it will be—when we start to replace the money we put on board in 2008 and 2009.

CHAIR—You are not sure when that will be? You do not have an assessment you can share with us as to when your funding costs will peak and start falling because you are starting to renegotiate the funding that you took out at peak prices?

Mrs Kelly—There are quite a few different elements. As Phil has just indicated, markets remain quite volatile. You can think you are on to a trend where marginal prices are coming down, and then all of a sudden there is the next shock and markets become a bit more tense. So, there are some certainties, and what happens in the domestic deposit market is one of those unknowns. I think our best guess would be about 18 months from now—mid-2012.

CHAIR—We do not know what the price of longer term wholesale funding will be in the future but, on the assumption that the current trend continues, presumably you know when the most expensive funding that you have taken out at the peak is going to come off.

Mrs Kelly—Correct.

CHAIR—Is your 18 months based on an assumption that current trends continue and wholesale funding, which would be a significant portion of your costs, would then start becoming cheaper than it has been—stop rising, essentially?

Mr Coffey—That is right—and that deposit pricing stays roughly where it is right now.

CHAIR—On deposit pricing, there is quite clearly a high degree of competition for deposits out there at the moment. I have had anecdotal evidence that an individual customer can come in and negotiate a very good deal for three months that might not be available for four or two months. For some reason, for three months they can get a higher price, and no doubt that fits in with your plan when you want funding. But if that individual is not actively involved, that higher rate that they might negotiate drops back to the standard rate. Is that something that happens at Westpac? This is something that has been brought to my attention by a number of people: yes, there is strong competition for deposits, and the rates being offered are at a very high level, but once the term has expired, if they roll it over, it is at a lower rate.

Mrs Kelly—Let me kick off, and Peter might like to add something. There are a couple of points I would like to make. First, all banks have specials at various points. As you have said, it could be for seven months or 12 months and it fits in with your maturity profile—and there is also a little bit of a marketing element to it and a tracked and incentivised business element as well.

The second point I would make is that customers do pay a lot of attention to the rates that they receive and, indeed, that was even intensified further through the global financial crisis with this intensity of preciousness of retail deposits. Customers do pay attention to that. We personally write to every customer, or communicate directly with every customer, when that term deposit is maturing and have a conversation with that customer about the options. We are not rolling over very attractive rates to much lower rates. That is simply not part of our philosophy or our style—

CHAIR—I do not know whether it was Westpac that was referred to when people raised the matter with me, but they certainly have experienced that.

Mr Hanlon—Gail has pretty well answered the question, which is that where we provide a term deposit for a customer at any rate we contact them and talk to them about what the new prevailing rate is. Obviously, whatever that rate is, no matter how high it is customers will always ask for more and we will work through with that particular customer as to what we can do. It is just par for the course. But I think the key issue there is that rather than setting and forgetting, one of the things we do right across the Westpac Group is that sometime before the term deposit matures we contact that customer and let them know that the maturity date is coming up, and then we can recommence the negotiation process.

CHAIR—Mrs Kelly mentioned that it is probably 18 months before you anticipate on current trends that your costs of funding will peak. How much higher is it going to take interest rates before it peaks?

Mrs Kelly—That is an impossible question to answer and I would also be very careful, not wanting to signal anything here.

CHAIR—It is not legislation yet, and there is privilege here as well.

Mrs Kelly—Margins have certainly stabilised somewhat. It is increasing, but at a lesser rate. In our particular case we had steep increases in the first part of the 2010 year, and that was because we were prepared to do the lending that we did in the 2009 year. So when the fiscal stimulus was underway and the first homeowner grant was in place, many lenders—offshore and local lenders and smaller players—were simply unable or unwilling to lend, and we did lend. Consequently, we needed to raise a lot of money both through retail deposits and also through offshore wholesale funding. We were terming that money out, as we discussed. That really pushed the costs up for us quite significantly. We saw a significant margin reduction in the first half of last year and then it flowed through to the second half but at a slightly lesser level. We are expecting average costs to go up but at a lesser level. That is as I see it at the moment.

CHAIR—I have a question that you probably can answer, because you probably release this publicly. What about Westpac's assessment of the official cash rate? What do you think will happen with that over the next 12 months?

Mrs Kelly—That has been impacted slightly by the Queensland floods. It is a little bit too early to know just exactly how that is going to play through but our economist Bill Evans has revised his assessment of the cash rate scenario on the basis of the Queensland floods. We had factored in a 50-basis-points increase—two 25-basis points increases—over the course of the next year and now he is saying one increase only, which will be in the middle of this year. His assessment is that the first quarter will take a little bit of a hit as a consequence of the Queensland floods. Then there will be some stabilisation. In the third quarter with all the rebuilding and reconstruction work that occurs, there could be some fillip to the economy then.

CHAIR—With a rise in the official cash rate, what impact does it have on Westpac's costs and how does that play through with you? If the official cash rate goes up by 25 basis points, first of all, does that assist you in terms of your funding, and to what extent does it actually cost you? I think that we have had evidence before that wholesale funding is sometimes based on the cash rate plus margin. How does that actually play out in terms of helping you cover your increased costs?

Mrs Kelly—Phil, you would be best placed to answer this. As we all know, what has occurred over the course of the global financial crisis has been a real disconnect. The cash rate used to be a reasonable proxy for our overall funding. We did a lot more funding at the short end of the curve and the risk premiums were not really what they are now so it was a reasonable proxy. But that is no longer the case. Phil, you might be able to answer the question more directly.

Mr Coffey—The cash rate has its most direct impact on the deposit market, where the margin that we tend to pay for deposits is set as a margin over a benchmark rate, and the benchmark rate, which is often the bank bill rate, has a basis of the cash rate. If you lift the cash rate, or even as the market starts to anticipate that, the benchmark curve goes up and so all of that tends to feed through into higher deposit rates. How it affects the wholesale market is that it is also the basis for the swap market, in terms of what we then convert our foreign currency borrowings and wholesale borrowings back into in Australia. So, by and large, a 25 basis point increase in the cash rate will have a pretty material impact on our cost of funds—not quite of that same order but around that same order. The difference will be what happens on credit spreads.

CHAIR—The reason the Reserve Bank increases the official cash rate is very different to the reason why you would increase—yours is to cover costs and theirs is to help control inflation, essentially. Say you had an increase in your funding costs which required you to cover a per cent in terms of the additional costs you need to pass on to customers, and the Reserve Bank increased the official cash rate by a per cent: how would that impact on the per cent that you needed to cover? Presumably it would push it up higher? Would it make your per cent then even higher, in terms of what you would have to ask to cover your costs as a result of that change?

Mr Coffey—Correct. The way we look at it is that the Reserve Bank are looking at what the end rate is to the customer. If we had already, in your example, Senator, pushed up our rates by a per cent and the Reserve Bank believed that that was all that was needed in monetary policy terms, they might do nothing. But if they had pushed up the per cent in addition to that, say, extra costs that we were incurring, we would need to recover that, other things being equal, and that would mean an additional cost that would need to be passed through.

CHAIR—On the flip side, if they put up the official cash rate before you had acted to cover your increased costs, how would that play out?

Mr Coffey—It leads to an increase in our costs and it needs to be added into whatever else.

CHAIR—So if you were looking towards the need to increase by up to one per cent you would need to look at increasing by a figure greater than one per cent as a result of the increase in the official cash rate?

Mr Coffey—Correct.

CHAIR—I will hand over to other senators for questions.

Senator HURLEY—I want to turn to the question of bank profitability. In common with other banks, you have concentrated on return on equity as being an important indicator. Of course it is important, but it is not the only indicator for attracting equity. Given government guarantees on savings accounts, the regulation and the widely held safety of banks, could it not be argued that banks are a safer investment, that potential shareholders and equity providers would take that into account and therefore that the return on equity could be lower for banks, particularly the majors?

Mrs Kelly—Thank you for the question. That gets to the point on whether banks should be considered as utilities or not. Certainly our view is that banks should not be considered as utilities and should not be utilities. Utilities actually carry with them a low level of return and a different type of shareholder base. And if you are going to get a lower return, you are going to be able to lend less as well into the economy and potentially even put your AA rating at risk. So our view is that a bank is a company like any other company and it has shareholders. Shareholders have choice, and you want to provide an appropriate risk-return relationship for shareholders to make that decision to invest in a bank. Our return on equity has materially reduced from what it was in years prior to the crisis, and you can actually see that in one of the charts, on page 27, in our submission. It is sitting at around 16 per cent at the moment.

Senator HURLEY—Have you noticed a substantial deterioration in demand to your shares as a result of that?

Mrs Kelly—Certainly shareholders out there are cautious about the impact of all the regulation that is coming towards banks. There is definitely an element of caution. We see that particularly with our international shareholders. Phil, you may want to add to that.

Mr Coffey—No, I think that that is exactly the point, Gail. We are in a competitive market in terms of trying to attract capital both from local institutions and global institutions. They will look at both our return on equity today and the expected return on equity and make decisions as to their investment based upon that.

I would just add, Senator, that your original premise was that we are safer as a consequence of government protection. Our preference is to see less government involvement in our industry and to be more reliant upon our own capacity to operate in a safe, secure and sustainable way rather than relying upon the government. We think that has served the Australian banking sector

really well in the last 15 years and we would like to see that continue. That means in turn that we then have to operate as a commercial enterprise.

Senator HURLEY—The government regulation is not so much to assist you as to assist consumers, though, is it not?

Mrs Kelly—Banks are necessarily regulated because we have depositors' funds. I think that is appropriate. Phil is possibly talking about government guarantees and those sorts of things. Clearly during the crisis those guarantees have been necessary and were common around the whole world, so it was appropriate for us not to stand out from the rest of the world. But, clearly, we are a regulated industry. We have depositors' funds and that is why we have the level of regulation that is required and that APRA impose on us.

Senator HURLEY—So you are not arguing that go; you are just talking in terms of the interim measures following that global financial crisis.

Mr Coffey—Correct.

Senator HURLEY—I will move onto another issue. You argued on page 40 of your submission that there be changes to the tax structure in terms of the 50 per cent tax discount on interest income of up to $1,000 included in the federal budget 2010. You are calling for that recommendation to be changed, to be broadened, and say that the Henry review panel's recommendation was for a 40 per cent discount on all investment income and losses uncapped. Clearly that would result in quite a change of investment income in Australia.

Mrs Kelly—We think the government took the positive step in the last budget of recognising this issue. It was a small step, as has been outlined so far, but it is a new step and therefore it is a positive step and it is moving in the direction of the Henry report. We are not arguing that it needs to be exactly at a particular level, but we think it is important to move more to having a level playing field and less disincentive for customers to save in bank savings accounts. At the moment there is a disincentive to do that because other forms of savings or other savings options have tax incentives associated with them. There could be less of a skewing to encourage more savings into bank deposits. That would reduce our offshore funding and make us more self-sufficient as a nation.

Senator HURLEY—Yes, but maybe less self-sufficient in terms of retirement income.

Mrs Kelly—I think these are trade-offs, so I am not suggesting that you equalise them totally. But I think we could move more in that direction. This would be an area in which it would be very valuable to set a little group of people up to do some work and ask, 'What could we do in that superannuation space?' As you say, and as we know, we are actually quite a strong savings nation, if you think about the extraordinarily strong superannuation industry that we have, but how could we capture some more of that into actual bank savings, balance sheet savings, that would assist us to do more in the way of lending at cheaper rates?

Senator HURLEY—You are saying that this should be examined further. It does seem to me fairly inequitable that someone who is extremely wealthy would get a tax break on savings into

bank whereas an ordinary, average wage earner would get a tax break on their very small savings. In that way, it would seem an unequitable way of doing things.

Mrs Kelly—I think there are all sorts of areas here that could be examined. Something you could also look at is that all superannuation funds have a certain amount of their dollars in cash. It might be that you incentivise those super funds to put those cash elements into Australia rather than offshore—something of that sort—so that we are getting the benefit of the cash component of the superannuation which does form part of balance sheet savings locally. There are different ways to think about this.

Senator HURLEY—To move subject again: you talked about your multibrand structure, including RAMS, St George and Westpac—the different structures that provide competition and the different kinds of services within your group. We did hear on a couple of occasions from people like Aussie who said that it was their intervention in the nineties that drove down interest rates, that drove that competition. They say that that is now gone. Do you believe your internal structure provides that sort of competitive tension in the market?

Mrs Kelly—Thank you, Senator Hurley, for the question. I think it is certainly a way that we provide choice to customers. The propositions that Westpac offer are fundamentally different from St George, different from Bank SA and different from RAMS. The work we did on multibrand—and, clearly, it has been a key area of focus for us over the past few years as we have tackled the St George merger and implemented a multibrand strategy within the group—has shown us that customers choose banks for different reasons. It is often driven by a view of the brand, the service experience that they have and the prior relationships that they have. Typically, we find that customers who choose St George are not the customers who would choose Westpac. There is very little overlap there. It has been remarkable for us to actually see and observe that firsthand. We have our St George branches sitting right alongside our Westpac branches. It was a deliberate choice that we made. When we did the merger with St George, we said that we would retain the brand, we would retain all the branches—indeed, we would grow the number of branches, which we have done—and we would further deepen the differentiation if we could in order retain choice for customers.

Customers coming into St George go there typically because they see it as warm and friendly. It is down to earth. It is straightforward. It is community orientated. It is local. It is very grassroots. It is people based. It has a human-touch element to it. We have retained that and, indeed, strengthened that by keeping the people and keeping the marketing propositions. Customers who come to Westpac are more aspiring. They are looking for a higher level of relationship management. They link to the environment and to sustainability. It is a different set of customers. So we are offering choice to the Australian marketplace with different product propositions, different service offerings and different prices et cetera.

Senator HURLEY—It is just choice then? Is it just a marketing exercise, or is there genuine competition between those different branches of the bank?

Mrs Kelly—There is genuine competition because customers can choose either one or the other, and a customer can choose both. A customer can walk into the St George in Lane Cove, which sits right alongside the Westpac in Lane Cove, and see the Westpac term deposit that is on offer that is higher than the St George term deposit and say, 'Well, actually, I would like that

one', and go round the corner and get it. We encourage that sort of choice; it is banks competing alongside each other. But the point that I am making is that, typically, customers do not do that because they like the person that they deal with in the branch, they like the feel of the experience they have and the individual knows them by name. It may be that they have other products and services as well, or their mother and father and the rest of family bank with that organisation. So, typically, people do not only move for price. There are a range of other things that draw them to that organisation.

Senator McGAURAN—You are the boss of that choice, if you like; or do you direct St George, if you have to?

Mrs Kelly—We have senior executives running each of our brands. They have a high degree of authority.

Senator McGAURAN—They are not independent of you, though?

Mrs Kelly—No, but they have a high degree of authority and a high degree of accountability. What they do is agree with me and, indeed, with the board on the strategies, the plans and the budgets. We agree what investments are going to be made. We agree on strategy—'What are we trying to do?' We agree on the portfolio. We agree on where the best profile is for the investments we are going to make across the group—in technology, in further branches, in further distribution or in whatever it may be. Then that group executive is entirely accountable for the delivery, the execute, of that plan. He is entirely accountable. So he is accountable for his marketing plans. He is accountable for the promotions. He is accountable for the prices he sets. He gets the funds transfer price sent to him and then it is his job to deploy a price for that. He is required to deliver a certain level of return on capital. That is what we require in our budgeting process. And he is charged for the costs. So he is charged for the costs of the operations, the costs of the technology and the costs of head office support.

Senator McGAURAN—But they are complementary strategies for the Westpac group rather than competitive strategies. Is that a fair way to describe them?

Mrs Kelly—They fit within the overall construct of the group.

Senator McGAURAN—But it would be fair in the interests of the shareholders of the Westpac group that they are complementary rather than competitive. Would that be a fairer way to characterise them?

Mrs Kelly—They are competing against each other for customers. They are competing to grow market share. Now clearly from my point of view I want them both to grow market share, and right at the moment they are both growing market share.

Senator McGAURAN—They are competing for customers. Earlier you said yourself it segmented market share—different sorts of customers that come to Westpac versus—

Mrs Kelly—It is not so much an income delineation. In fact, there are just as many—

Senator McGAURAN—I appreciate that. It could be any number of factors, but they were slightly different market segments, weren't they?

Mrs Kelly—It is not so much different market segments. It is more different attitudinal approach. The customers who have chosen St George do not want to bank with a major bank. They prefer that warm and friendly local down-to-earth approach.

Senator McGAURAN—I am not trying to put words in your mouth, Mrs Kelly. Would it be fair or unfair to say that St George competes with Westpac the same way that NAB competes with Westpac?

Mrs Kelly—We acquired or merged with St George and brought St George into the group because we knew that there was a cultural compatibility. It is really critical in any merger that there is a cultural compatibility. We absolutely set ourselves up to say this is going to be a different merger from a normal end-market merger. We are not about getting cost synergies and we are not about closing branches and telling customers where to go. We want St George customers to have everything they have currently got plus more. The plus more is access to Westpac ATMs and Westpac products and services branded St George through St George. So we knew there was a complementarity of culture. I say to my people, 'Go out there and the first point of call is to compete against all the others. There are many, many other providers out there. Compete against them. But if a customer wants to move to Westpac or to St George there are no boundaries around that.'

Senator HURLEY—I want to continue with that choice thing but firstly I want to talk about the flooding situation in Queensland and Victoria to illustrate a point. You were talking about how banks had got together and made decisions. Was that just the major banks all was that the regional banks and the non-bank lenders as well?

Mr Hanlon—There are a couple of things. Firstly, we have had a number of meetings at the height of the floods with both the Queensland government and the federal government. On the most recent decision, which was the decision to waive foreign ATM fees as they are known, that was an agreement that we made with the Assistant Treasurer, Bill Shorten, who contacted all of the banks, I believe. That particular arrangement, to the best of my knowledge, is for the four major banks. Certainly three of the major banks have a four-week moratorium. I think one of them has two weeks. Certainly the Queensland regional banks—obviously Suncorp and Bank of Queensland—and, I am pretty sure, Bendigo Bank and Adelaide Bank as well were also part of that agreement. So they were individual conversations with the Assistant Treasurer all done in one afternoon.

Senator HURLEY—So there was slight variation but generally the banks agreed to a fairly standard set of responses? I should say mortgage holders, not banks. So credit unions and banks—mortgage holders—agreed to a fairly standard series of terms and conditions?

Mr Hanlon—The particular issue that I am referring to where the government was involved was with foreign ATMs. We have had a disaster relief package certainly since the mid-nineties, to the best of my knowledge. I was involved with it back in the mid-nineties. We have had a disaster relief package which is the issue where we defer interest and provide direct support. Over the last 15 years since then, so over that time—we were certainly the first organisation to

put that out—others have come along. That has not been a government initiative at all. That has been an initiative run by the individual banks. Pretty well all of the banks have one now. They all have slight differences.

Senator HURLEY—When you say banks—and this goes to definitions—are we talking about majors or everyone including credit unions?

Mr Hanlon—No. Different financial institutions provide different levels of support. As I said, I am certainly aware that of the major banks pretty well all have a disaster relief package that mirrors the one that we first introduced. I know that some of the regional banks have them. I know that some of the credit unions provide some of those benefits but I do not know though whether they provide all of them. And the way we deal with it is that when an area is declared as a disaster area—or in some cases we do it independently—our local managers on the ground invoke the disaster relief package.

Senator HURLEY—This is an instance, is it not—I do not want to give you too much of a dorothy dixer—where the stability and the small nature of the banking sector have provided some advantage?

Mr Hanlon—I think that is a fair point, Senator. From my own perspective, having unfortunately been quite involved in, as Gail said, a number of disasters in Australia and therefore the very rapid provision of banking services, I know that organisations which have deep infrastructure with people who have had a lot of experience are able to move very quickly. As I mentioned earlier, we were able to move cash services into those flood affected areas within a day or so. In the Victorian bushfires. Obviously they occurred on Saturday and on Saturday night particularly. We had mobile branches and emergency branches up and running on Sunday afternoon. That is obviously a benefit of having an organisation which is strong and stable.

Senator HURLEY—Exactly. Thanks.

Senator XENOPHON—Mr Hanlon, is mandatory flood insurance required as part of any mortgage that Westpac customers take out?

Mr Hanlon—No it is not.

Senator XENOPHON—In the UK, mortgage lenders are acquired to provide full insurance cover over properties including flood insurance. In France, it is a similar situation. In the US there is a fallback scheme where the private sector cannot get insurance. Do you think that ought to be mandatory, as is the case in the UK?

Mr Hanlon—I am not absolutely familiar with the specifics, but I can say that—

Senator XENOPHON—Or the general principle—should it be mandatory?

Mr Hanlon—Since the floods in Queensland, particularly, and as bad as they were in Central Queensland—what happened in Toowoomba, the Lockyer Valley and Brisbane shocked us all. We have had a number of conversations over the last week about that. That is something we are

looking at in terms of whether we should have that in place. It is not the practice in Australia at the moment but it is certainly something we are looking at.

Senator XENOPHON—What proportion of your lenders take out to flood insurance?

Mr Hanlon—There are two answers to that question. The first one is what proportion take them out with us and then obviously there are people who have separate insurance from our own insurance. Obviously we would hope they would all have it with us. Given our particular policy where we cover everything, we would certainly advise that. From memory, around 14 per cent of those have it with us but we know that a much larger percentage have it with other insurance providers.

Senator XENOPHON—You cannot get insurance, can you, in some circumstances? There are those who can get flood insurance but choose not to and there are others who cannot get flood insurance at any reasonable premium.

Mr Hanlon—That is certainly the case for some providers in some areas. I would say, though, that across all of our policies we provide flood insurance.

Senator XENOPHON—Okay, but you are open to the idea of there being mandatory flood insurance?

Mr Hanlon—Whether it is mandatory or we do it ourselves.

Mrs Kelly—The costs associated with it are the—that is right. We took the decision quite some time ago, probably in early 2000, when Tony Rogers argued very strongly that one day there would be a very significant disaster and we should make sure that our flood insurance covers all types of floods. That means on some occasions that Westpac insurance is slightly more expensive. In fact our group executive of retail banking, who has recently come back from visiting Queensland, rang Tony, who has retired, to say thank you for that advice. That meant we were able to say to all Westpac insurance customers that they were covered.

Senator XENOPHON—Can I move on, Mrs Kelly, to the way you characterise the difference between St George and Westpac. I think you said St George is a warmer, friendly and community minded. I hope you are not implying that Westpac is not.

Mrs Kelly—No. It is a part of its traditional roots and character. It is more down to earth; it is more straightforward.

Senator XENOPHON—I am quite troubled by the way you have characterised it because ultimately the buck stops with the Westpac board. St George is part of the Westpac group.

Mrs Kelly—Correct.

Senator XENOPHON—You are not going to get St George putting ads out saying, ‘Don’t believe Westpac because we can offer a better deal,’ or offering deals that would be detrimental to the Westpac Group. So really is it not an illusion of competition in the context of St George and Westpac?

Mrs Kelly—Not from the customers' point of view.

Senator XENOPHON—I am not asking about the customers' point of view.

Mrs Kelly—As I said already, when we engaged in this transaction—this merger with St George—you clearly would not have undertaken the merger unless you believed that there was a cultural alignment and synergy and that the brands would sit alongside each other well and, indeed, were competing with a slightly different perspective and in some slightly different markets as well. Westpac is institutional. Westpac has more industry segments, specialist expertise and so on.

Senator XENOPHON—Sure, but you are not reasonably suggesting that, as a result of the merger between St George and Westpac—or the takeover or however you wish to categorise it—the competition between St George and Westpac is somehow more robust than it was before Westpac took over St George.

Mrs Kelly—I have not tried to suggest that at all. What I am suggesting is that we provide customers with choice. We have not got rid of St George, BankSA or RAMS and said, 'Come to Westpac.' What we have done is to retain—indeed, we are seeking to improve—the customer proposition to St George customers. I think the evidence is that the number of customers in St George has grown, the depth of the relationship with customers in St George has grown and the staff satisfaction within St George has grown. So all of the indicators are positive for St George. What we are suggesting is that this is a model that works. They have different propositions: they are priced differently, they market differently and they have different accountabilities and a different look and feel in the brands. We want to continue to run it that way, and it is providing customers with choice. But I am clearly not suggesting what you said.

Senator XENOPHON—No, but the choice is not as robust as it was before, when St George and Westpac were completely different entities, though.

Mrs Kelly—It is unlikely that—

Senator XENOPHON—You do not acknowledge that?

Mrs Kelly—St George is operating with the same marketing approach as it did before. It has not changed its marketing approach.

Senator XENOPHON—I guess my question was: do you acknowledge that the competition is not as robust now as it was before the merger?

Mrs Kelly—From a customer point of view—

Senator XENOPHON—That is not my question, though.

Mrs Kelly—But surely we have to think of our competition from a customer point of view.

Senator XENOPHON—I am talking about real competition in terms of the marketplace. If you have two separate entities—two separate businesses competing—surely that should be more robust than if it is two entities but the same owner.

Mrs Kelly—All I am trying to say here is that the model that we are running is actually a model that provides customers with an opportunity to choose a proposition that they would like and that in the St George case—because St George is the merged entity within the Westpac group—the brand is growing and is robust. Customers are liking what they have. They are doing more business with us with further depth of relationship. That is what I am suggesting.

Senator RYAN—I suppose the point is that St George is not going to be allowed to propose anything. Presumably it has to get permission from the board for the use of its capital or its business plan. St George is not going to be allowed to propose anything that would otherwise lead to something that was detrimental to the Westpac group if you added Westpac, BankSA, RAMS and St George together, as opposed to what Senator Xenophon was referring to, which is what might have happened before they were owned by the same shareholders and reporting to the same board. Isn't that the case? This is a bit like Qantas and Jetstar, isn't it?

Mrs Kelly—I am not disputing that. What I am trying to say, though—I am not making any point other than this—is that, in the model that we have, we are providing customers with different options, and customers can choose the kind of option that they would like—whether they would like the option that Westpac produces or the option that St George offers. That is all I am suggesting. Clearly I am not suggesting that we would tolerate or have St George go out and say, 'All Westpac customers come to us.' Clearly that is not within the interests of the broader Westpac group.

Senator XENOPHON—So you therefore acknowledge that there is less robust competition between St George and Westpac now than there was when they were separate entities.

Mrs Kelly—But, from a customer point of view, which is what I have to keep coming to—

Senator XENOPHON—It is a yes or no answer.

Mrs Kelly—But, from a customer point of view, we are providing customers with choice. Indeed, St George has the benefit of now being part of an AA-rated bank with a stronger capital base, which means that it can price products in an improved way because of that strength.

Senator XENOPHON—Okay. You will not acknowledge it, in other words. You will not acknowledge that point: that there is less competition now between St George and Westpac.

Mrs Kelly—Clearly Westpac has acquired St George and we are running it as a multibrand model. We are running it with a view to providing customers with choice. We are intensifying and differentiating those propositions with customers. So that is the model, and I am not suggesting anything more or less than that.

Senator XENOPHON—Let's move on to the issue of the spread that not just Westpac but the other banks apply to small business loans compared to residential loans when the security is the same. It is secured on residential real estate, for instance, but the spread is, I think our previous

witnesses said, about 130 basis points or a bit more. How can banks justify that, given that in the 1990s there was virtually no spread, when there was greater competition? I think Mr Hanlon is looking askance.

Mr Hanlon—Yes, I was there in the 1990s and there was certainly a lot more spread than zero.

Senator XENOPHON—But I am talking about the differential between small business loans secured by a home compared to a residential loan.

Mr Hanlon—How we determine small business pricing is very much based upon the risk of the ability to repay and not upon the value of the security. The most important thing that we consider in determining the pricing of a small business loan or, for that matter, a loan for a household or a personal loan, is the risk element. The issue of the security, which I know you have raised, is in fact the last resort. We do not go into an arrangement with a customer thinking: 'How can we quickly sell their property?' The issue to do with the value of the security is the last issue we think about.

The first issue we think about is their ability to repay. Obviously, in our case we have hundreds of years of experience of lending to consumers and to businesses, and what we see over time, and certainly over most recent data, is that the default rate of small businesses compared to, say, householders is somewhere about 2.5 or 2.6 times the rate of the households.

Senator XENOPHON—But, Mr Hanlon, wasn't it the case that the spread of the default rate between small business loans and residential loans was either flat or much smaller in the 1990s?

Mr Hanlon—In terms of small business, there has not been as dramatic an increase in the differential as you are suggesting. But the second issue that I would add—

Senator XENOPHON—There has been a difference, hasn't there, since the nineties.

Mr Hanlon—There certainly has been a difference; I will acknowledge that. But the second issue is that we have seen banks losing more money than they would like to on small business because of the mispricing for risk. One of the great things that has come out of the global financial crisis, one of the comments that many people have made across the globe, has been the mispricing of risk. This has enabled us, obviously, to have a good look at the risk performance and make sure that we are adequately pricing for the risk of particular portfolios. As I said, if you have a portfolio like the small business portfolio, where default rates are some 2½ times the default rates of households, you would expect the price to be different.

Senator XENOPHON—Could you take this on notice. Could you give me some further information on the spread between small business loans based on residential securities in the nineties and now.

Mr Hanlon—Certainly.

Senator XENOPHON—Can I just move on quickly. Your interpretation of the chart on page 24 of your very comprehensive submission is essentially that the decline in the interest margin

before the GFC is a sign of increased competition, but the subsequent increase is not a sign of decreased competition. Is that what you are saying? In other words, before the GFC the decline in the interest margin was a sign of increased competition, but is the fact that the margins have increased since the GFC a sign of decreased competition?

Mr Coffey—There is no doubt that that really long trend of decline in margin was as a consequence of greater availability of capital. There was more competition, but also more capital, around the globe at cheaper and cheaper rates, and that led to margin decline. What we have seen is some small backup of that, but whether you just put it down to competition or to availability of capital—I think the availability of capital which led to the competition is the real underlying driver of that margin picture.

Senator XENOPHON—Finally, prior to the GFC why did you increase your home loan rates when the RBA increased its cash rate, when only part of your funding had a cost tied to the cash rate? To use your preferred analogy, isn't it a bit like increasing the price of a banana smoothie by 10 per cent when the price of bananas has gone up 10 per cent but the price of milk has remained unchanged? Isn't that a fair analogy?

Mr Coffey—Prior to the GFC the relationship between the cash rate and our cost of funds was much closer because the movement in credit spreads was virtually zero. It was declining, but in a pretty steady way, and deposit rates were not moving with the kind of differential to the cash rate that we have seen post the GFC.

So having a closer connection, particularly from about 2000 onwards, between the cash rate and the mortgage rate was because that was reflective of the cost of funds. But as we have moved through the GFC and we have seen credit spreads in wholesale markets and we have seen deposit markets change dramatically that cash rate no longer represents all of our cost of funds.

Senator WILLIAMS—Mr Hanlon, when you spoke earlier about problem accounts you have, you said that basically these days you can work through them. There might be farms that go broke or whatever, but the attitude of the bank these days is more to work through problems and to see what solutions can be brought about. Is that correct?

Mr Hanlon—Whenever we can, yes, that is correct.

Senator WILLIAMS—That is a big improvement on the back of the foreign currency loan days and things of the past. It is welcome news. Obviously it is a lot less stressful and a lot better for people to actually work through an issue when there is a problem, instead of relying on judges and court cases.

Mr Hanlon—I think that is a very fair point. There is no doubt that as an organisation and as an industry we have learnt from the mistakes of the past.

Senator WILLIAMS—Good.

Mr Hanlon—I know your background and constituency. Banks gave a raw deal to farmers and those in regional Australia, particularly back in the early nineties. As much as those scars are felt within the communities, they are also felt by bankers who worked in those areas. We now

have a much more dedicated agribusiness team within both Westpac and St George. That is staffed by people who have long and deep experience in this area. We certainly work very closely with those customers, particularly if they are having difficulty.

Senator WILLIAMS—Good. Mrs Kelly, in December 2009, when you raised your rates by 0.45 per cent—I think I was—when the Reserve Bank moved 0.25 per cent, I had just moved to your bank three weeks earlier from a credit union. I remember it well. I have made many mistakes in my life! You raised your 12-month deposit rate to 6.8 per cent then. Is that right?

Mrs Kelly—It was a term deposit rate special at the time.

Senator WILLIAMS—You raised the deposit rate because obviously you needed money to be brought in after the GFC. The wholesale cost of your funds had increased so you raised the deposit rate, obviously, to attract more investments. Is that correct?

Mrs Kelly—It was very much a function of what happened during 2009, where we, as I have indicated, were prepared to be open for business to support the Australian economy. That was when the fiscal stimulus and the first homeowner grants were on the go. A number of lenders—in fact, most lenders—fell away and were simply unable to do the lending. There was a period of some months where the Westpac group did 50 per cent of home lending just by ourselves.

Senator WILLIAMS—So you raised those deposit rates to bring more money in so that you could lend more out.

Mrs Kelly—No. We had to raise the money in order to support the lending that we had done and to keep the rollovers moving.

Senator WILLIAMS—So you raised your lending rate 0.45. You also raised your deposit rate to 6.8 per cent on the 12 month investment period.

Mrs Kelly—Yes. Part of that was to provide an attractive offer for individuals at the same time.

Senator WILLIAMS—Those deposit rates in early 2010 would be rolled over now. In November you raised your home loan rates by 0.35 per cent. The 12-month rate is 6.15 per cent now. Is that correct?

Mrs Kelly—There are various different rollovers, depending on discussions with individuals. It is of that order.

Senator WILLIAMS—They have come down from 6.8 to 6.15.

Mrs Kelly—That was a special at the time.

Senator WILLIAMS—No doubt your 6.8 per cent rate was effective because you can see that domestic investments at your bank have gone from 44 per cent to 52 per cent over that period, as shown by the graph on page 23.

Mrs Kelly—The increase in our domestic savings is a function of a number of things. We have certainly put a very big focus on that across our whole organisation. It would be fair to say that we have had to reorient the whole organisation. Like most Australian organisations, our organisation was focused on lending. What people worked on was market share growth in lending, whether it was business lending, home lending or credit card lending. That has shifted, as a direct consequence of the global financial crisis, to putting a huge focus on raising deposits. So we have had to change a number of things, such as how we incentivise people, what people are called in branches and where the focus lies, to get that shift. We have really sought to build a capability into our organisation to grow everyday savings and everyday transactions. Every now and then, there are special offers—and that is typical of all organisations—but what we have tried to do is build a shift in our organisation to a focus on deposit raising, and that is as a direct consequence of what we have seen in the global financial crisis.

Senator WILLIAMS—When you raised those rates to 6.8 per cent in December 2009, that had an effect, and you will see difference in the growth of your domestic investments now compared to back in 2008.

Mrs Kelly—That would be one element but, as I am trying to indicate, we have undertaken a much wider set of initiatives over that period, and I am very proud of how the organisation has responded to a shift in focus from lending to raising deposits.

Senator WILLIAMS—What makes me ask this question is what we receive from the public. You say the cost of your money has gone up, you raise your rates, as in December 2009, above the RBA cash rate movements—after the bank for some 15 years or so has paralleled RBA cash rate movements—and then you declare your profits. Then people say to me, ‘Why are they doing this? They’re crying poor. The cost of their money has gone up?’ We are saying: ‘We’ll have an inquiry to see where the competition is: has it has been removed? Is it less now than before?’ You have reduced your deposit rate, in 12 months, to around 6.15, even though you have increased your share of domestic deposits. You moved again above the RBA rate of 0.35 on 2 November, when those 12-month deposits from back in the day are now being rolled over at a cheaper rate. Am I correct in saying that?

Mr Coffey—Perhaps I could help. Your facts are right, Senator. But I think they need to be seen in the context of our overall balance sheet, because you have picked out one special TD rate in one month and I think—

Senator WILLIAMS—Okay, could you forward the committee a graph of your one- two- and three-year rates, or even your one- and three-year rates, for term deposits over the last two years? is that possible?

Mr Coffey—Sure. Just to give you a flavour for it, we have just under $500 billion of loans, of which $280 billion are in mortgages, and we have roughly $260 billion or $270 billion of deposits. So that deposit special would have impacted something like two to three per cent of our total deposit base. So, even though it looks like, ‘Gee, that was a good 12-month deposit rate and now it has gone down,’ it is affecting such a small part of our total deposit base that it is part of an overall, blended element of our whole funding. I can understand why people think: ‘Gee, your deposit rates have come down and your mortgage rates have gone up; how does that work?’ But

it is because, with the size of the balance sheets that we are managing here, looking at one particular rate is very difficult.

Senator WILLIAMS—I believe many are asking about competition in the banking industry, the cost of money, the sale of money or however you would like to put it, when they see your profits declared, after a time when the taxpayers of Australia guaranteed your investments up to $1 million. That is why people ask questions, come to us and these committees do these investigations. Can you understand why that is the case?

Mrs Kelly—We can absolutely understand that. These are difficult and quite complex matters, and certainly as an industry we have not done a very good job of communicating. It is a hard situation to communicate, but we have not done a very good job of it. We need to improve our communication with customers and the community on these quite material shifts. What we have encountered in Australia over the last few years is a material structural shift in the overall cost of funding and a material divergence of our funding costs from the RBA rate. It is fair enough that customers would not understand that, because over the past decade or so interest rate movements, certainly on mortgages, have largely moved in line with the cash rate. We certainly recognise the issues that creates.

From our point of view, we made the decision, because we are a strong bank and because we thought it was required at that time, to do that lending in 2009. It was a conscious call to do that. If we had not done that lending there certainly would have been less pressure for us in terms of cost of funding. But, if we had not done that lending, and, if the other major banks that did that lending had not done it, the economy would have suffered quite materially.

Senator WILLIAMS—I am well aware of that and I think that everyone on this committee is aware that, if we do not have strong banks in Australia, your credit rating is downgraded, the cost of money will rise even more and Australians will be paying more. That is one thing that the committee is fully aware of through this inquiry. Did you at one stage run a program in your bank called ‘Bring back the bank manager’?

Mrs Kelly—We still do. We have a program under the so-called Westpac Local.

Senator WILLIAMS—Did you run it around December or towards Christmas?

Mrs Kelly—No. It happens periodically. We have a number of days where we encourage all of our people, including senior people in the organisation, to get behind our local bank managers. So we have implemented a Westpac Local approach, which is an investment of around $200 million which we have put into our business over the last few years. We have continued to invest materially in our business, with 600 new bank managers. We call them bank managers because, in a lot of ways, we are going back to the old days of local bank managers who have authority, capability, clout and decision rights and are senior people, running a local business. That is the direction that we have gone. We rely on the rest of the organisation to support our bank managers and, indeed, to support our customers in the field. That is at the heart of it.

Senator WILLIAMS—The only reason I ask the question is that someone from your bank said that the day after you raised those rates in December 2009 they had a ‘Bring back the bank

manager' day. They had on their Westpac T-shirts and, when coming home from work, they were getting abused and sworn at by members of the public.

Mrs Kelly—It was a poor choice of day.

Senator WILLIAMS—A very poor choice of day. Many staff would have been very offended by it. I want to close on exit fees. I believe that exit fees stifle competition. Do you agree with me?

Mrs Kelly—From our point of view, can we describe our approach towards exit fees?

Senator WILLIAMS—Perhaps I will explain mine. I could have left your bank when, in November, my interest rate on a quarter of a million dollars home loan went up to 7.22 per cent and gone to a bank that had a rate of 6.97 per cent. But I had to pay $1,000 exit fee and that is why I am still banking with you. I know from my personal experience that exit fees stifle competition. I would have shifted to another bank where I would have got a better rate. Do you agree with me?

Mrs Kelly—Our approach towards exit fees is to provide customers with choice. So there is a choice whether you want to pay an establishment fee upfront, bearing in mind that in establishing a loan there is a cost attached to that. So we provide our Westpac customers with a choice: do you want to pay an establishment fee? If they choose not to pay an establishment fee and prefer to defer it, if they stay with us for four years then they never pay the fee. They pay neither an establishment fee nor an exit fee.

Senator WILLIAMS—Why has NAB and ANZ abolished their exit fees, yet the two biggest home loan banks in Australia, CBA and Westpac, retained them?

Mrs Kelly—I think this is great for competition—I really do. This is at the heart of competition. Different organisations have different propositions for their customers. You should not just look at one fee. There are entrance fees, exit fees, overall interest rates and package arrangements. There are a variety of things

Senator WILLIAMS—I think it is bad for competition. I cannot leave your bank because I have to pay to leave to get a cheaper loan. It may be good for you to handcuff people to your door through exit fees but, in my view, that restricts competition.

Mrs Kelly—Loans are long-term transactions and things do change over that period.

Senator WILLIAMS—Especially rates!

Mrs Kelly—I hope that you are happy now.

Senator WILLIAMS—The staff are very good.

Senator PRATT—I also want to delve into the topic of exit fees. Your own submission states that exit fees are 'thought to act as a disincentive to consumers wanting to change banks'. So if you have major competitors who do not have exit fees then surely, as Senator Williams implied,

the push is towards them rather than away from them. How can they not be a disincentive to changing banks?

Mrs Kelly—As I have indicated, our approach is one of providing choice. A very high percentage of customers stay with us. Ninety-seven per cent of customers do not pay exit fees. Our customers like the proposition that says, ‘I do not need to pay an establishment fee at the time of obtaining my home. When I have cash flow issues, I’d rather use those funds for things to do with my home. So on the basis of preferring not to pay it, if I stay with you for four years I will not pay a fee at all.’ That is the case for the vast majority of our customers. Ninety-seven per cent of our customers do not pay fees. The fee is at a low level of the industry.

For us it is actually not an overly big deal. If this legislation comes in, clearly we will apply it and we will just have to think about what, if anything, we do with regard to establishment fees—because there are costs associated with these activities. But in principle our view is that the government should not choose a particular fee to ban and we should really let the market do its job and provide different options and different propositions for customers that they can choose—would they like a lower interest rate; would they like no establishment fee, with an exit fee if they leave?—just choice for customers; that is our view.

Senator PRATT—I understand your general manager of corporate affairs has said that 97 per cent of customers do not pay exit fees. On the other hand, that could clearly be seen as a demonstration of the fact that exit fees are a successful barrier to customers being able to change banks.

Mrs Kelly—The facts do not bear that out for us. We have had a lower level of attrition—which is the technical term that is used in the industry for balances that leave you—over the last period than we have had for some long period. We have more customers joining us than customers leaving us. If you look at when customers leave us, there is no indication that, as soon as the exit fee time frame has completed, there is an upward tick of customers leaving us. It is to the contrary. So the facts do not bear out that customers are staying with us because there is an exit fee in place. Our proposition is one of relationship management within Westpac. It is very much not a single product proposition. Customers come to us by and large on a package basis, and there are a number of elements to the relationship. There is no evidence to suggest that customers would like to leave us but do not because of an exit fee.

Senator PRATT—Well, I would be one of those customers. What contribution to your earnings have exit fees made? What percentage might that be?

Mrs Kelly—It is a small number. As I have indicated, it is not actually a material matter for us in Westpac. This is more a point of principle and a proposition that we have for our customers with regard to choice. We have not disclosed that number publicly, but it is a small number.

Senator PRATT—It was reported, as I understand, in the *Australian Financial Review.* Clearly this is an estimate, probably from another source, but it was reported that it was over one per cent of your earnings and that Westpac would be more likely to be impacted by a ban on exit fees. You would discount that?

Mrs Kelly—Very much so.

Senator PRATT—I would like to move on to the question of the corporate bond market and what role you see covered bonds playing in easing the costs of funds. We have had some discussion of that already but I would like to delve into that further with you.

Mrs Kelly—I will ask Phil to deal with that.

Mr Coffey—I think markets around the world have demonstrated that covered bonds are priced considerably cheaper than the bank can borrow funds in its own name, and that will have a benefit for us in terms of reducing the overall cost of funding to the industry. The extent to which it is significant will really depend on what the size of the covered bond market or program is that we are allowed to pursue. That is now being worked through in discussions between the government and our primary regulator. The industry is obviously keen for that to be larger, and the regulator is probably keen for it to be smaller. We will wait and see how that pans out.

Senator PRATT—On the deep and liquid corporate bond market, there have been those that have raised concern about whether it will only advantage banks such as your own and whether smaller competitors eventually are going to be able to access things like covered bonds. But you have raised in your submission that, despite those concerns, you think that there will be things across all sectors of banking that should be able to support other players accessing such a market.

Mr Coffey—We think that there are possibilities for smaller players to still get the advantage of a covered bond market by pooling their mortgages into a vehicle that then issues the covered bond. It is not as straightforward, as I said, as a bank doing it in its own name, but that is not to say that it cannot be done. We are aware that the credit unions are already talking about finding ways to pool funding mechanisms, and this would be another example of that.

Senator PRATT—There have been concerns raised in relation to the way covered bonds changed—and this does get into a rather technical issue for me—in relation to deposit priority and that the package as outlined in relation to covered bonds does put other things in place to create security for depositors. Is this something that consumers are going to need to be educated about, or is it business as usual? How do lay people come to terms with changes in the sector?

Mr Coffey—I think that the regulator, APRA, has certainly put that forward as something that we have to be mindful of in looking at a covered bond market. But, as the Reserve Bank data showed, deposits really only make up about half of Australian banks' balance-sheet funding today. If you think about the depositor protection, for 50c of deposits you have 100c of assets protecting the depositor today. So our argument has been that there is some proportion of our funding that could go into a covered bond market that will allow us to raise these monies more cheaply and still not put the depositor at risk. With such a big buffer already, we think that is quite doable. It is certainly the way that other regulators around the world have looked at it and come to the conclusion that a proportion of the banks' assets could be put into a covered bond market.

Senator PRATT—So historically we have not pursued covered bonds, not because of these kinds of concerns but because of the way the market has changed in terms of the diversity of funding. It is not so much of an issue any more?

Mr Coffey—I think it is more because the original banking legislation that the banks operate under had in mind protecting depositors, and when 100c of the assets were deposits that made good sense, because you would want to make sure that depositors were protected.

Senator PRATT—And it was a greater source of lending funds at that point in time?

Mr Coffey—That is exactly right.

Senator RYAN—I have a couple of quick questions on exit fees. Presumably you have a higher standard variable mortgage interest rate at the moment than the two banks that do not have interest fees. Am I correct in that statement?

Mrs Kelly—We do. It is not hugely higher, but we do.

Senator RYAN—No, but there is a marginal difference. So presumably you as a company, Westpac Group—I am not sure if it is done in the individual banks or at a group level—would know that there is a price point at which people will pay an exit fee versus a lower interest rate. Am I making an assumption there that is inaccurate with respect to banking?

Mrs Kelly—It really will depend on the individual. Some people will value—

Senator RYAN—I agree there are other things: there will be service components, there might be location. But there is a price point involved here as well.

Mrs Kelly—Westpac's proposition is about relationship, and that is very much the primary focus for—

Senator RYAN—There may not be one price point but—to use an old statement—everyone has their price. It might be 0.4 per cent for me, it might be 0.2 per cent for Senator Williams, but there will be a price point at which people move.

Mrs Kelly—Yes.

Senator RYAN—Do you as a corporation undertake work on what that price point is internally?

Mrs Kelly—Interestingly, we have some really good empirical data on that, because over the course of the whole of the last year—when our standard variable rate was quite a bit higher as opposed to now where it is a little bit higher—our attrition rates in fact improved, and we have more customers joining us from other banks than customers leaving us to go to other banks. The number of customers leaving us to go the other banks is about 13 per cent or 17 per cent of our attrition. Most of it is people paying down their home loan, leaving to go to another country or something like that rather than customers leaving us to go elsewhere.

Senator RYAN—I understand that may be a testament to all the work that the corporation has put into relationships, locations, bank managers et cetera. But what I want to get to is, do you undertake work in your forecasting, modelling and budgeting that looks at the price point at which people will say 'it's worth paying this exit fee to leave'?

Senator WILLIAMS—Yes or no.

Mrs Kelly—Up until quite recently the standard variable rates were very similar, so it has only been over the course of the last couple of years that we have started to have that divergence.

Senator RYAN—Exactly. But that 0.1 per cent or 0.2 per cent means something to you, presumably, otherwise you would not be doing it, either in covering the costs you have or in extra profit.

Mrs Kelly—The best piece of research that we have is what has occurred empirically over the course of the past year, and we have certainly narrowed that gap.

Senator RYAN—If you are not keen to answer these because there is a competitive element, I will be happy for you to say that and I will not push it. But what I would like to know is either an answer or for you to say that you would prefer not to outline. Does Westpac as a corporation undertake work internally that goes into your budgeting forecasting and information about profit that involves calculating what the price point is for the exit fee with respect to an extra margin that you can charge mortgage holders for the first four years that you mentioned?

Mrs Kelly—It may be something we should do. We do not have detailed research work on that point because our—

Senator RYAN—But do you do it internally as part of your budgeting process? I would be surprised if no-one in Westpac thinks, ‘Actually, the exit fee’s worth this much, but a bit like private health insurance, this market’s a little bit sticky and people will wear a higher cost.’

Mr Coffey—That is not how our pricing is set.

Senator RYAN—So there is no work along those lines inside Westpac?

Mr Coffey—No, because as Gail has pointed out, so few customers pay the exit fee. It is not something where we are trying to achieve the payment of that exit fee.

Senator RYAN—No, but what I am getting at—sorry if I am not clear, Mr Coffey; I have not been involved in banking—is whether it goes into the calculation of what interest rate you can charge people.

Mr Coffey—No. Our exit fees are not something we consider when we are looking at setting our standard variable rate, if that is your question.

Senator RYAN—Sure. Thank you.

Senator McGAURAN—On the issue of competition, each of the bank CEOs who have come before us have espoused the same mantra: that there is a trade-off between competition and stability. I read an article from the CEO of the Bankers Association, which I can only call great audacity. He says the same thing five times through the article. I would like to have read it out, but I will not. You have said it yourself—trade-off. In short, I say rubbish, absolute rubbish. It is naturally self-serving and understandable but not creditable. It is obviously in your interests to

tell us that less competition is at least a stability and too much competition is what led to the GFC. It was nothing of the sort. It was not competition. What led to the GFC was bad management and lack of regulation. It was not competition. You are attempting to redefine the word 'competition'. The common understanding of competition in any other business sector bar the banking sector, it seems, is that more players leads to more efficiency.

Mrs Kelly—There are examples one can look at where a heightened competitive environment has led to some very poor practice and some very poor underpricing of risk, which has led to instability. If you look at the UK, there was a practice of giving loan-to-valuation ratios of 120 per cent or 130 per cent, lending 120 per cent of the value of the home. That was driven by competitive factors in that environment, which clearly led to an unstable environment and losses. Even in our own environment towards the period just before the global financial crisis there were some early indications and APRA was certainly looking at lenders and saying, 'Be really careful.' There was a tendency of lenders here to look offshore at the subprime markets and the no-deposit markets—

Senator McGAURAN—But that is bad management.

Mrs Kelly—But it is driven by the competition because there was so much in the way of funds available. Such free and available funds meant that people were looking for ways to deploy those funds. Again in the UK, with the Northern Rock example, such steady, available and cheap funds through the securitisation market meant that they had an unstable model and they fell over. There are real examples where the competition gets to a point where people start to do 'covenant-lite' type loans. We started to see trends of that here in the 2006-07 year when the world was awash with money and there were various mergers and acquisitions, big ones, going on around the world.

Senator McGAURAN—But to link that with competition is my point. You are redefining competition for your own ends and points.

Mrs Kelly—It was driven by an intense drive—

Senator McGAURAN—Competition did not drive the GFC. Anyway, we might beg to differ on that. I would say that I would have every text book and university lecturer behind me. I would have every business boss outside the financial sector behind me as to what is the real terminology of competition. You are seeking in the banking sector the orderly marketing system where we would have the old wool floor price back and the wheat board back, where less is better. You are defying gravity.

Mrs Kelly—That is not what we are looking for at all.

Senator McGAURAN—You are defying business gravity.

Mrs Kelly—That is not what we are looking for at all. Even Mr Glenn Stevens in his testimony spoke about the cycles and that there is at a level of competition associated with the cycle. Just before you have a crash you very often have a heightened intensity of competition, a derisking, you are not even aware of the risk that you are carrying, and a poor pricing for risk. So

there is a connection of competition with the cycle, and that was a point that Mr Glenn Stevens made.

Senator McGAURAN—All right. Are you still in favour of the dropping of the four-pillar policy?

Mrs Kelly—That is not something that I have spent a lot of my time thinking about recently.

Senator McGAURAN—It was a Westpac policy.

Mrs Kelly—It is seriously not something we have spent our time thinking about. We see that as here to stay.

Senator McGAURAN—Do you think that the bank mergers, of the big four towards the lower regionals, has come to an end with all the ACCC signals that seem to be coming? Do you believe that now has come to an end?

Mrs Kelly—That really would be a question for Mr Graeme Samuel.

CHAIR—We have him on Tuesday. Thank you very much, Mrs Kelly and Westpac, for assisting us today and my apologies for holding you over time.

Mrs Kelly—Not at all. Thank you so much.

Proceedings suspended from 3.26 pm to 3.41 pm

KING, Professor Stephen, Private capacity

Evidence was taken via teleconference—

CHAIR—Professor King, welcome to the inquiry. If you would like to make an opening statement, please do.

Prof. King—All right. I will keep it fairly brief. I think the key issue when you are thinking about competition in the banking industry, and more generally the lessons that we need to learn from the global financial crisis, actually comes back to the role of or the interaction between the government, particularly the federal government, and the banking sector. What we have learnt out of the global financial crisis, both in Australia and overseas, is that when push comes to shove and there is a financial issue of the integrity of one of our major banks or one of our larger—albeit smaller than the major banks—financial institutions, the government, for fiscal reasons as well as economic reasons, is forced to step in and bail out that bank or, as was the case with BankWest, to play an active role in organising for a purchaser to be found for that financial institution. So it is to effectively protect the depositors and generally to protect the debt-holders of the financial institution and, not infrequently to protect the equity holders. That insurance in Australia has been implicit, and the government has not taken an active role as an insurer even though it has effectively—as is now completely apparent—been offering insurance to our major banks.

What that has led to is an ad hoc form of insurance that risks biasing competition and harming smaller financial institutions relative to the large financial institutions simply because it is not clear who is insured or what risks you are taking, for example, when you become a depositor in a smaller institution relative to a large institution because the insurance is all implicit. It also has meant that banks—less so in Australia than overseas but still in Australia—have had a freedom to engage in activities that, as an insurer, the federal government should not be letting the banks engage in; they are activities that create risk for the banking system which the federal government then bears as the insurer.

So my personal view as an economist on where we need to move to improve competition in the Australian banking system is to make the federal government insurance of the banking system explicit and to recognise that it is not like house insurance where you can simply say, ‘I don’t want my house insured.’ The banks will be insured. The government cannot politically allow the banks to fail, so it will insure them. That means that, as the insurer, the government (1) should correctly work out the actuarial risk associated with banking activities and charge the banks an insurance premium and (2) should take an active role in preventing the banks from engaging in activities that create too much risk. In other words, the banks get the benefit of government insurance, they pay for that insurance but part of the quid pro quo is that they are not able to engage in an unrestricted range of financial activities. The banks would effectively have to be reined in and excluded from some forms of financial activity—obviously the more speculative areas.

Also I think doing that obviously would feed into the liquidity requirements, but it would be explicitly as an insurance product rather than what is happening, for example, under Basle III at

the moment. By doing that the government would set up a set of financial regulations that would allow both the banking industry themselves and the public to know where they stand in relationship to the protection provided by the government in relation to the risk they are taking by putting their money into different and alternative financial securities. It would get rid of any implicit bias in favour of large financial institutions compared to small financial institutions, so it would create a level playing field. Let me leave it there.

CHAIR—Thank you very much, Professor King. In respect of that last point in terms of addressing implicit bias and providing a level playing field, it certainly would in terms of the public confidence in institutions of varying sizes. But, presumably, if an actuarial assessment were undertaken of risk by the government and premiums were priced accordingly, then that would impose on smaller institutions an additional cost which would generally offset that level playing field. Is that a correct assumption?

Prof. King—It is not clear that a small institution with a diversified portfolio of financial assets would have a higher risk than a large banking institution. So both small and large banks—and I have used the term 'bank' here to refer to something that is explicitly insured—would have to pay an insurance premium, being an actuarially fair insurance premium. Remember that what is happening at the moment is that insurance premium is being paid by the taxpayer through general revenue and from the depositor's perspective they are not quite sure who will be bailed out. If the Commonwealth Bank starts to go under will the government bail them out? Yes. If the Bendigo Bank or the Bank of Adelaide starts going under will the government start to bail them out? It is not quite so clear. So you have that bias at the moment where from the public's perception—and I think quite rightly so—the public would perceive that a smaller bank is riskier than a larger bank simply because of the federal government's failure to make explicit the insurance.

CHAIR—I do not disagree with that. What I am raising is the extent to which the benefit might be undermined by what would likely be a higher cost of premium to smaller institutions as a result of the likely actuarial risk assessment being higher with a smaller institution than with a larger one. In terms of recent experience, the government's approach to the pricing of the premium for wholesale funding indicated that they were likely to pass on a higher cost to smaller institutions rather than to larger ones.

Prof. King—It is not obvious to me that if you did the sums there would actually be a higher actuarial risk purely because you are a small financial institution. It depends on your portfolio of assets. If you are a small financial institution with both your deposits and your lending activity focused, for example, on one geographic area, then you will have a higher risk than a financial institution that has geographically more diversified activities. But there is no reason why a small institution needs to be focused on a small geographic area. So it is not obvious to me that the risk will be higher. But that is an empirical question and I cannot say yes or no; I just do not think that we have the evidence yet.

CHAIR—Your evidence in that regard is probably consistent with what the smaller institutions, particularly those who are ADIs, have suggested to us at this inquiry and to other inquiries. They do not believe the risk to the taxpayer in guarantees is any higher from them than it is from the major banks. Indeed some of them claim that they might have a lower risk because of some of the particular assets that they are exposed to and the lower likelihood of exposure to

offshore issues. So you may well be right. I guess the difference in terms of how you are suggesting that the premium should be priced is that this would be done on an actuarial basis, whereas with the wholesale funding the government looked at the rating of the institutions and priced accordingly.

Prof. King—That is right. It would be unlike a product that goes through some sort of ratings agency or through some other sort of attempt to rate the company. It really has two legs, and they are both related to insurance. It has the restrictive leg which says that the financial institutions that are insured would have a limited set of activities which they could be involved in. Once you have defined that set of activities there would then be the actuarial assessment. Depending on that group of activities and the restrictions that are put in place, the actuarial assessment between a large and a small institution need not be very different at all.

CHAIR—That is interesting. I would think that is probably a good outcome if, in fact, it did not provide a further cost advantage to the major banks over the smaller institutions if implemented in the way that you suggest. As you say; it would depend on the actuarial outcomes. That it is not necessarily a fait accompli is what you are really saying.

Prof. King—That is right. A key part is that the explicit insurance must involve a restriction on banking activities. If you wish to be or, in certain cases, you will be—if you are the Commonwealth Bank, the answer is that you will be—an insured financial institution then you can only engage in certain activities. Once you take off that second leg, of course you are back in the world where the government is providing insurance whilst allowing financial institutions to take inappropriate risks.

CHAIR—The moral hazard issue is that they can go off and take all the risks, hoping to reap large rewards but knowing that somebody else will pick up the tab if they do not come off.

Prof. King—Exactly right.

CHAIR—Do you have an opinion on whether such an explicit guarantee should apply only to approved deposit-taking institutions or whether it should or could be extend further?

Prof. King—I would suggest that it be applied to approved deposit-taking institutions. What the government would really need to do there is define a set of financial institutions—approved deposit-taking institutions would be a good starting point—who are insured and restricted in their activities. The obvious starting point is the deposit-taking institutions that we have already. There could be groups at the margins—some of the smaller institutions. It is possible that they would say: ‘We don’t want to have insurance. We wish to be outside the insurance system.’ It is partly a political judgment. If the government judge, ‘Yes, we could allow that institution to fail,’ then the government may say: ‘Okay. You’re outside. You’re not restricted but it has got to be very clear to the public that you are not insured by the government. And it has got to be very clear to the public that, if you end up in trouble, we will let you fail.’ Again, it is a political judgment that I cannot make. In a sense, it is up to you to work out where the government would have to draw the line. It is as much a political question as an economic question: who can the government let fail?

CHAIR—The obvious and easy answer to that is to include ADIs but not those who are outside the ADIs. This is for a number of reasons but primarily that we already have prudential regulation which applies to ADIs and would make the second leg of your suggestion, which is to restrict the activities of those who are covered by the guarantee to avoid overly risky activities, very easy to build into the prudential regulation, whereas those deposit-taking institutions outside of the ADI structure would be much harder to regulate in terms of their activities.

Prof. King—I think that is right. It would be much harder to bring those outside ones in. The question is: would you want to have all the current deposit-taking institutions included and all the ADIs included?

CHAIR—I hear what you say about not all ADIs and giving them an option. However, for those outside the ADIs, there would be some value if an appropriate scheme could be put together which did cover off all the points that you are talking about and that under which mortgage trusts and funds that do operate successfully and safely outside the ADI regime could also take benefit of the guarantee in order not to put them at a competitive disadvantage against ADIs?

Prof. King—Yes, I think that is right. As long as they are willing to play by the rules that have been put in place for the ADIs—for the insured financial institutions, if I can call them that—yes, I think it would be sensible to allow them to join in. Off the top of my head, I cannot see any reason why you would not. Essentially the government, in some ways, is saying, 'Look, we're putting out an insurance product; we're requiring of certain financial institutions that they have this insurance product and obey the rules.' But I cannot see any reason why the government would stop there and not say, 'If there are other financial institutions who are willing to obey the rules that we have put in place then we will be willing to provide them with the same insurance at the same actuarially fair price or at a relevant actuarially fair price for them.' I cannot see why you would not want to do that.

CHAIR—Senator Williams has another question, and then I will come back to another topic.

Senator WILLIAMS—On that very issue, about these companies that are not registered ADIs, I think ASIC should have a bracket for a set of companies called registered investment companies. I have seen companies that have sound security—real security as in land, housing, properties et cetera—and they have LVRs of 40 or 45, yet they did not get the guarantee and, of course, people withdrew their funds from their organisations to put them into the registered ADIs when the government guaranteed that sector. This surely helped reduce competition. Surely we could look at those responsible, secured lenders and include them in a guarantee.

Prof. King—I think it is a matter of setting up the rules. I do not like the word 'guarantee'; I deliberately use the word 'insurance', because as soon as you get the guarantee it starts, in a sense, taking away the fact that this is really just an insurance contract that the government is offering. I think that, as long as the rules are well specified for what activities you can and cannot undertake to avail yourself of the government insurance, that is fine. Once you get down to, for example, mortgage trusts, a historic issue has been that, yes, there are some very well-managed, very reliable mortgage trusts but there are also some who have gone bankrupt and are not as reliable. Of course, depositors—the consumers—cannot tell the difference. Essentially, what this sort of insurance does is that it is the government saying to the community that with

those financial institutions that have the government insurance (1) your money is safe with them but (2) they are also following this set of rules.

CHAIR—I will just move on to an alternative subject which occupied a significant part of the submission that you put in jointly with a number of other economists, and that is the desirability of a full, broad-based review into the financial services industry. Would you care to outline to the committee your thoughts in that respect?

Prof. King—My own views are that really what we probably need—looking at the terms of reference of your own committee—is a review that is broader than just thinking about competition. It is really thinking about our financial regulations and in some ways going back over history—going back into the 1970s, probably, and possibly even earlier—looking at the regulatory structures that we had, really thinking about the deregulatory process that we went through very much in the eighties and nineties and working out what were good regulations that we got rid of. There are clearly some poor regulations that we got rid of—I am not in any way suggesting that we go back to the 1960s financial system; there were plenty of things wrong with it—but I suspect we threw the baby out with the bathwater. There were some parts of our financial regulatory structure that we probably should not have got rid of but that we did get rid of. So I think it is a broader question than just competition.

CHAIR—Thank you. I note that in the submission you and your co-authors refer to the upheaval that has occurred in the financial industry in the last couple of years and the changes—particularly what you have already talked about, the changes in the relationship between the government and the banking industry and the 'too big to fail' type of thing. You talk about how that is a significant driver for the need for such an inquiry.

Prof. King—Yes.

CHAIR—You then list a number of issues that should be considered by an inquiry and say that there are probably more; you say they are but a small subset of the policy questions that need to be looked at.

Prof. King—Yes.

CHAIR—In view of all of that, what do you say about the banks' argument—particularly as enunciated in the ABA's submission—that the very fact of the GFC and of the uncertainties surrounding the outcomes and where we are going to end up with that means that we should wait until all that is settled before we hold such an inquiry?

Prof. King—It is a bit like saying: 'Something's gone drastically wrong. Let's not try and work out how to fix it; let's wait until it fixes itself, and then we'll hold an inquiry into how we should fix it.' It strikes me as a bit of an odd approach. Australia came through the GFC remarkably well. I think there is some truth in the comments of Ian Macfarlane, former Governor of the Reserve Bank, that a lack of competition, if I can put it that way, in the Australian banking sector may have had a role to play there and that our banks did not take the sorts of risks that we saw being taken by financial institutions overseas. We have not had a housing bubble that burst in Australia. I would not dream of trying to speculate on whether we have a bubble or not but, whatever it is, the market is a bit flat but that is about all. So we have

been very lucky. I do not think being lucky is an excuse to say, 'Let's wait and see what happens overseas and not worry about it; let's not try and draw any lessons from the GFC until everything's settled down.' That strikes me as being a very odd approach. Let us look at what has happened overseas and what has happened in Australia—because things have happened in Australia—and try and draw the lessons from it. What we need to do is rethink our financial architecture. There does not seem to be any great sense in our 'let's just wait' type of attitude.

CHAIR—Thank you for that. Would it be your contention that the contrary position applies in the sense that while we are in somewhat of a state of flux and things are a little up in the air it is the ideal opportunity to hold such an inquiry to insure that when things do land they land in the right way.

Prof. King—Yes.

CHAIR—Thank you.

Senator HURLEY—I would like to continue on that theme. I think that in your answer you gave the impression that people are sitting around waiting for the Basel agreement and other international agreements, but that really is not so, is it? APRA, ASIC and the Reserve Bank are working fairly actively on a number of individual reviews, and Treasury are working with RBA on the Basel recommendations and, in the process, looking at what happened in Australia and overseas. So there is a fair bit of activity going on in Australia already in separate inquiries.

Prof. King—Yes. Certainly regulators, and particularly the Reserve Bank, are not sitting on their hands; they are trying to draw what lessons they can. But in some ways the bottom line—and I will come back to that issue of insurance—is that the GFC showed that our banks are insured by the federal government. In some ways that is not an issue for the Reserve Bank to try and deal with in an inquiry; it is outside its mandate. It is not an issue for APRA to deal with; it is outside APRA's mandate.

It really is an issue for the federal government to deal with through a federal government inquiry, which will obviously then feed into the activities of APRA and will obviously feed into the liquidity requirements coming out Basel III and the degree to which we need stronger liquidity requirements. I am not suggesting that there is no activity; I am suggesting that the focus of the activity of an inquiry that focuses on the government's role as an insurer is important.

Senator HURLEY—Okay. I take your point particularly that you cannot put off any resolution of decisions forever, that you might roll on and never have a review of what happened. It seems to me a bit premature to have an overall inquiry because you might have that inquiry that makes recommendations on the assumption that various things will happen with Basel and other inquiries. After all, the Basel activity is supposed to have a finite life, so we know that the end is in sight. If you had a federal government review, it might make recommendations based on assumptions about the international financial landscape that prove to be unfounded.

Prof. King—Yes and no. At the same time it can also then allow the Australian delegation as part of the Basel round to have a better input into the Basel negotiations. So I am not sure that it

is a great argument to say, ‘Let’s wait until Basel before we decide what we want and what we need to underpin our financial markets in Australia. I think the better way of approaching it is to say. ‘What regulatory structure do we need here?’ As negotiations go forward on liquidity requirements coming out of Basel, the inquiry in Australia would obviously feed into that. It would need to be flexible enough so that if Basel was moving completely in one direction and the inquiry was moving completely in the other, there would have to be some accommodation there. I get a little uncomfortable about saying we should wait until others have done their job and then we can start. The strong risk there is that there is always somebody else doing their job, that there is always another reason for waiting and another reason for not having the inquiry in Australia, for procrastinating. The banking industry has a strong incentive not to have an inquiry, particularly when they are implicitly being insured and they are not paying for a lot of that insurance, they are not paying for the retail level insurance.

Senator HURLEY—Let us move on to that area. You have repeatedly talked about speculation, risky behaviour and so on. Do you think that the current regulation by APRA, ASIC and the ACCC is flawed?

Prof. King—I think given the foundation of the Wallis inquiry, the assumptions of the Wallis inquiry and the recommendations coming out of that inquiry, all of our regulatory bodies did an excellent job. However, those regulations are based on the assumption that there is no deposit insurance in Australia. As Professor Harper, who was on the Wallis inquiry, has said, they were based on the assumption that the financial markets were efficient. So while our regulatory agencies have been I think very diligent and very proper in their conduct of the current regulation, there are issues as to whether our current regulations are appropriate or have been built on incorrect assumptions.

Senator HURLEY—Yes. You talk about Australia having a good roll of the dice and being lucky in avoiding some of the consequences of the global financial crisis that we saw elsewhere and other people have put it down to successful regulation in Australia. You do not agree with that; you think it is just luck? In what way were we lucky?

Prof. King—I think in part it was luck—

Senator HURLEY—Luck in what respect?

Prof. King—It comes back to the fact that we have not had a housing crisis anywhere near the proportion of, say, the US housing crisis—

Senator HURLEY—And you put that down to luck?

Prof. King—It comes back to: ‘Do we have a housing bubble in Australia?’ I do not know. We have on some indices—for example, the indices used by the *Economist* magazine—that show that we have some of the most overvalued housing in the world. Is that because of the structure of demand and supply in Australia or is that due to other factors, such a bubble in housing prices that is slowly, rather than rapidly, deflating like the US one.

That is outside my area of expertise, but I cannot dismiss the notion that we have been pretty lucky in terms of our housing market. Whether it is luck or at the core of what this Senate

inquiry is looking at, I think the evidence is that our banking sector is highly concentrated compared to some overseas banking sectors. There are historic reasons for that. If you look at the US banking system, it is very unconcentrated compared to that of Australia, but a lot of that is historic, based on the fact that they had very strong restrictions on interstate banking. So you had a large number of small banks which were competing hell for leather with each other and perhaps doing things that they should not have been doing.

Was it due to our regulators being more diligent, or more competent than, for example, US regulators? Again, I do not have the information to make that judgment. Maybe our regulators are just better than the US regulators. But it is a large call to make to say that we had the competent regulators and they ended up with the incompetent ones. I think part of it comes down to the fact that the structure of our industry meant that there was not the pressure on financial executives, our banking executives, to pursue high-risk, potential high-profit activities that there was in the US. Whether you want to say that is good luck, good fortune, historic or due to our regulators, it is occurred.

We cannot, though, deny the fact that, when it came to the crunch, our federal government had to step in and ensure the deposits of our financial institutions. The federal government had to step in in relation to BankWest and put a toe in the water, if I can put it that way, and that sort of intervention needs to be taken account of in our financial regulations. You cannot have a regulatory regime that says, 'Hopefully, when things go wrong the government will step in.' I do not think that is an appropriate way of regulating things.

Senator HURLEY—Okay. I am not an economist, so I am not aware of the definition of 'luck'! You pose a number of questions, including setting up a publicly owned bank. Is that something that you promote, or is it just a question that might—

Prof. King—There are differing views across groups of economists as to that letter. My own view is that a public bank is something that is worth looking at. Do I have a strong argument in favour of a public bank? No, but it is something that an inquiry could consider. Whether it is a good or a bad idea I think would be up to the inquiry to determine. I would not want to try and pre-judge in any sense.

Senator HURLEY—Thanks very much, Professor.

Senator XENOPHON—Professor King, thank you for your submission. You were mergers commissioner at the ACCC for what period?

Prof. King—About 4½ years.

Senator XENOPHON—During what years?

Prof. King—From about the middle of 2004 to the end of 2009.

Senator XENOPHON—So you were the mergers commissioner at the time that Westpac took over St George?

Prof. King—Yes, and also during BankWest-Commonwealth Bank.

Senator XENOPHON—Not so long ago, the chairman of the ACCC made a statement to the effect that if he had his time over again he may have done things differently in relation to those mergers. Are you familiar with those comments?

Prof. King—I have read some comments of Mr Samuel in relation to those. I am not sure that Mr Samuel would agree with your summary of those comments. I am aware of his comments.

Senator XENOPHON—I do not, under any circumstances, want to misquote Mr Samuel. What is your understanding of Mr Samuel's comments? My understanding was that he did express some concern about some of the mergers that took place a few years ago.

Prof. King—I would have to go back and look at the comments, I am afraid, because I do not have them at hand. My understanding is that Mr Samuel suggested that he may have now have some reservations about some of the mergers that were passed by the commission, with the benefit of hindsight.

Senator XENOPHON—Thanks to Senator McGauran. Mr Samuel publicly expressed doubts about the two takeovers. Mr Samuel admitted some doubt about whether Westpac's takeover of St George would be approved if it occurred today. Do you share those concerns? I am asking you to comment with the benefit of hindsight. Do you understand the concerns that have been expressed about the impact of that merger?

Prof. King—Yes. Let's start with the BankWest-Commonwealth Bank merger. I think, with the benefit of hindsight, given Bank West's ownership—it was owned by HBOS at the time—and given its strategy in the market at that time in terms of its attempt to expand into the east coast market, and given that it is my understanding that the Commonwealth Bank was effectively the only bank which was in a situation to act quickly to take over BankWest, history has shown that that was clearly an acquisition that did not substantially lessen competition because the counterfactual was probably much worst for BankWest. It was possibly a situation where BankWest would have failed and had to shut its doors.

Senator XENOPHON—I understand that a number of commentators have had a similar view to that position but you would not have that view in relation to St George. There is absolutely no suggestion—

Prof. King—No. With regard to St George—apologies because I am doing this from memory; I have not looked back at the documents relating to these mergers for a while—there were fewer competition concerns in terms of whether there would be a substantial lessening of competition for St George-Westpac than Commonwealth Bank-BankWest. If BankWest had continued and had been viable then there were issues of market concentration in Western Australia. If the counterfactual is Bank West failing then those issues of concentration are moot.

In term of State George-West Bank—apologies because this is only from memory—I do not think there were competition issues at the such that there was likely to have been a substantial lessening of competition. I have not seen any material since that acquisition to make me change that opinion. Can I also say that I have not been paying a great deal of attention to exactly the interactions that have occurred through St George and Westpac.

Senator XENOPHON—Back in around 9 July 2009, Mr Samuel told an American Chamber of Commerce lunch in Sydney:

We have workable competition but less than intense competition.

Do you think that we now have less than intense competition as a result of those mergers, particularly the Westpac-St George merger?

Prof. King—I think that in our banking sector, as in a number of other sectors of Australian industry, we have what would be best described as workable competition but less than intense competition. I think that is a fair statement. I think it is not a correct conclusion, though, to say that that is particularly due to the St George-Westpac merger or that the St George-Westpac merger had a material impact on competition being workable rather than intense. I do not think competition would have been particularly intense even if the St George-Westpac merger had not occurred.

Senator XENOPHON—When some people hear the term ‘workable competition’ they see that as code for lazy competition or less than ideal competition. When I hear the phrase ‘workable competition’ that sets the alarm bells going in the sense that it means that we are not optimising competition in a particular sector of the economy.

Prof. King—From an economic perspective, the term ‘workable competition’ means that we are not optimising competition in the economic sense that it is not perfectly competitive. One of the things that you need to be careful about when dealing with the banking industry, though, as in dealing with a number of other industries like the insurance industry, is to recognise that the intensity of competition can lead to good things such as lower prices for borrowers and higher rates for those who wish to deposit their money in the banks, but at the same time that competition itself can create incentives for risk-taking in both insurance markets and financial markets that, because of asymmetric information between the providers of the service and the customers, may actually lead to deleterious outcomes. It could be claimed, for example, that competition in the banking sector was significantly more intense in the US than it was in Australia in the lead-up to the global financial crisis. In fact, that intensity of competition, together with some issues of regulation, could be argued as a major cause of the global financial crisis. So we have to be a little bit careful in banking and financial industries about what we mean by ‘optimal level of competition’.

Senator XENOPHON—I appreciate that, but you are not suggesting, are you, that the Australian banking market is anything like the US banking market? The Australian banking scene is very different from the US banking market, given the number of banks they have there and how they are fractured and almost subregional. It is quite different here, isn’t it?

Prof. King—Yes and, as I mentioned before, there are historic reasons for that. The point is that in financial markets and a number of other markets we cannot separate competition away from regulation—they are two sides of the same coin. When we are looking at how much competition and the implications of competition in a financial market, we have to put that within a regulatory framework. If the sorts of proposals that I have put forward relating to insurance went forward, then banks would be greatly restricted, or significantly restricted, is perhaps a better word, in terms of the activities they could undertake. From the banks’ perspective, they

would say, ‘That is anti-competitive; we are no longer able to be active participants in certain financial areas.’ My view is that that would actually be desirable for the economy.

Senator XENOPHON—Sure. Do you see merit in Professor Zumbo’s suggestion that there be a Productivity Commission review of the ACCC’s previous bank merger decisions with a view to assessing the post-merger impact on competition and also with a view to formulating policy in relation to the banking sector for the future?

Prof. King—I think that one of the things that would be desirable is an ex post review of mergers more generally in Australia. I think focusing just on the banking sector has the risk of losing the big picture here. Our merger laws are not perfect. In relation to our merger investigations, the ACCC has a great team of people—which I had the privilege of working with for 4½ years—who investigate the competition effect of mergers.

One of the things that we have not had in Australia which has occurred within the competition agencies in the US, for example, is an ex post evaluation of mergers—a looking back after five or six years out to see whether the decision that was made was the right decision. We need to find out whether a decision that was good at the time make a difference, whether that decision was to allow a merger to go ahead or to oppose a merger. That sort of exercise would allow us to, in a sense, check that our laws are appropriate. We have a particular set of tests in Australia relating to a substantial lessening of competition in a market. Is that the appropriate test? The best way of working that out is to look at the decisions that have been made. That has not been carried out in Australia. That would in general be a good thing. Would I like it to look at just banking mergers? I do not see the benefit in restricting it to banking mergers. It would be desirable for the Productivity Commission to do a retrospective on our mergers in general.

Senator XENOPHON—Thank you, Professor King. I think that Professor Zumbo is looking at in a broader context as well. Thank you for your evidence

CHAIR—Thank you, Professor King, for assisting us this afternoon.

[4.27 pm]

CANION, Mr Andrew, Manager, Western Australian Small Enterprise Network

CHAIR—Welcome, Mr Canion, to our hearing this afternoon. Thank you for assisting us. I invite you to make an opening statement.

Mr Canion—Thank you for having me. The WA Small Enterprise Network represents over 3,000 small businesses in Western Australia, each of whom employ no more than 30 staff. An initiative of the Chamber of Commerce and Industry of Western Australia, SEN's objectives are to ensure that the distinct views and concerns held by the small business sector are heard and considered by governments at all levels as they develop and implement policy. The small business sector accounts for 96 per cent of all businesses in Western Australia and employs around one third of the state's workers. It is vital that this large and important sector of the economy be able to access and afford debt finance to support their growth. The lack of genuine competition in the business banking market has been a key issue for the WA small business sector throughout 2010. However, the problem initially stemmed from the impacts and changes that have occurred in the finance sector in the aftermath of the global financial crisis.

Access to finance and the cost of finance are two of the biggest problems currently facing small business. Many rely on borrowing money to get their businesses off the ground. Our members tell us that high borrowing costs, along with a limited choice of lenders, is making it harder for them to access money at prices that they can afford. This is limiting their ability to take full advantage of the improving economic conditions that are now appearing in Western Australia.

Increasing the level of competition is the best way to reduce lending costs to business customers. Currently, the major banks are providing two thirds of business credit. SEN research shows that 90 per cent of WA small businesses have applied for finance from the big four banks. Heavy regulation of the banking sector is not the answer. Government policy needs to create incentives that encourage new banks into the market. However, there are some elements of regulation that would assist consumers without being too onerous on banks.

In our written submission to your inquiry, SEN recommends that banks should be required to: standardise banking terminology, to help business customers make easier product comparisons; publish comparison rates for business loans; and ensure bank fees are not used to boost profits.

In late 2010, SEN worked in conjunction with Victoria University to undertake a survey of small business with a focus on finance. A positive aspect of this survey was that it was also undertaken for businesses based in New South Wales and Victoria. This has provided an opportunity to undertake state based comparisons to see where similarities and differences appear with respect to small business matters. While the full analysis of these survey results has not yet been completed, we do now have some preliminary results to which I can refer.

For WA respondents, inadequate access to finance was the second greatest obstacle to business, with 49 per cent of respondents highlighting it as a problem. Only the recruitment and

retention of labour registered a higher rate of concern. Sixty-six per cent of businesses in WA have this problem. The survey shows that the construction and utilities sector is the industry most affected by inadequate access to finance. Sixty-two per cent of WA businesses in this industry noted it is a problem, against the national result for this sector of 59 per cent. Other sectors that were noticeably impacted by inadequate access to finance included manufacturing, at 49 per cent, and wholesale-retail-transport, at 58 per cent.

One of the most enlightening aspects of the survey was the additional comments provided. These comments reveal the struggles and frustrations of small businesses attempting to access finance to grow their businesses. For example: 'A lack of access to finance and skilled labour prevents expansion into other areas and other products,' 'We have found that a good credit and trading history with the banks has very little importance,' 'The major impediment to raising capital for small business is the red tape demanded by the banks and governments,' and, finally, 'The banks talk the talk but do not walk the walk. As many business associates comment, banks will give you an umbrella but take it away when it rains.'

SEN believes these comments encapsulate the frustration that small businesses experience when trying to access finance in a market that lacks sufficient depth and competitive tension. Major lenders do not have a strong impetus to actively work to win business, knowing that it will come by default regardless of their behaviour or performance. Small business needs the banking sector to be more competitive. We encourage government to establish policies that will help deliver a more competitive banking sector. Thank you for the opportunity to make this opening statement. I will be happy to respond to any questions you might have regarding our position.

CHAIR—Thank you. We had some evidence earlier today from the New South Wales Business Chamber, who I think were also a participant in that survey. They gave some similar feedback from New South Wales businesses. In their case, the major constraint holding back business growth in New South Wales—according to the survey respondents—was in fact access to finance. I guess the west is little bit different, with your particular labour issues, but it is still the second most significant constraint recorded over there. Given all of that, the major banks claim to have supported small business throughout the global financial crisis and in most cases, I believe, the major banks have indicated that they have not changed their lending criteria or things like the loan-to-value ratios or the criteria upon which people are assessed. Would you take issue with the banks' claim in that regard?

Mr Canion—Yes, I would, based on the feedback that we receive from our members. Obviously I do not have access to the internal statistics of the banks, but I can certainly tell you that, at the coalface, our members, the majority of whom are customers of the large banks, have indicated that it has been much more difficult to access the finance. Lending criteria have been significantly tightened up, in their experience. Then, if they actually do reach a point where they are granted access to borrow, the cost of that has increased significantly. I guess there are two slightly different issues: first of all, whether you can access finance to begin with and then whether you can afford that finance. But they are definitely impacting on small business bottom lines.

CHAIR—The other thing that not just the banks but also a number of the submissions we have received tell us is that one of the reasons for the overall fall in business lending is that businesses themselves have chosen not to make applications for finance because of the

uncertainty surrounding the GFC and not wanting to expose themselves. Given the survey results that you have put to us, would you take issue with that? Because it appears to me that what you are saying is that your members would be seeking access to greater levels of finance if they could get it and get it on competitive terms.

Mr Canion—Yes, that is right. Obviously, we cannot deny the fact that the GFC had an impact on all businesses, whether that be the borrowing businesses or the lending businesses. But, ultimately, what a lot of our members are saying is that it has just become too hard, and if you find a decline in applications it is simply because they cannot be bothered, if you like, to jump through the hoops required of them. So they are looking to alternative methods of financing their businesses, whether that is through equity or partnering with other private investors. One of the concerns we have is the shift that may be occurring towards small businesses using personal equity to fund business loans, which we think is a risky proposition and has a whole stream of effects down the line and certainly on a personal level as well, on those families.

CHAIR—Okay. So, although the GFC may well have contributed to some businesses deciding not to borrow to expand—or whatever they might have been looking to take the money on for—because they were waiting to see how things went, the fact that your members' survey responses indicate that lack of access to finance is a constraint on growth suggests that, if they could get it, they would be applying for it.

Mr Canion—Yes, that is correct. We are finding that businesses are becoming frustrated by the difficulty they have in accessing finance, and that is creating an impediment to their growth, which then has flow-on effects on the overall economy. The banks play an important role in keeping the economic wheels turning. We recognise that and we would like to see them willing to perhaps look at their risk profiles and how they manage lending, to support the small business sector.

CHAIR—Thank you. Senator Xenophon has to leave to catch a plane, so I will hand over to him to ask a question or two.

Mr Canion—Okay. Thank you.

Senator XENOPHON—Thank you for your submission. One of the complaints we have had from small businesses elsewhere is that, while it is hard enough for someone to shift their residential mortgage from one bank to another with the exit and other fees and the like, it is even more difficult for small businesses. Is difficulty in choice for small businesses the common experience in terms of their financing arrangements?

Mr Canion—To an extent. It is definitely true that it is easy to become locked into a single bank and it becomes difficult to switch, and there are costs associated with that. But also, at the moment, you would have to say there is very little benefit in switching between banking providers, particularly amongst the big four; there is not a lot of product variation between them. So, ultimately, is there going to be a benefit from switching in any case? It is probably difficult to say there would be in most cases. We need more competition to put downward pressure on prices. That will create an environment where switching becomes more attractive, and then methods to enable that can be looked at.

Senator XENOPHON—Sure. I have one other question. I put some questions to Westpac earlier today in relation to the spread between the margins for small business loans and the margins for a loan that is simply for residential purposes. I put the view that in the 1990s, when there was more intense competition, there was not such a spread. What is your understanding of that? Westpac said, as other banks have said, that the risk factors are much greater when lending to a small business, by a factor of two to three times. What is your view on that spread? What does your group say about the unfairness of that spread in terms of the higher cost of financing for small businesses when the security is the same?

Mr Canion—Sure. I have seen some of the data in the past. It does show that the spread between business lending and residential has really grown over the past few years. Recognising that there is a difference in risk profile, I think I would be looking to the banks to really justify why they are rating business lending risk at such an extreme level. I recognise that that is the claim they make but there is not a lot of data to really support that position, not that we have seen in any case. The other thing to say is that often ultimately a business loan is backed by a residential mortgage. So there is that level of protection at the end of the day.

Senator XENOPHON—Thank you very much.

CHAIR—Your submission at page 11 calls for bank fees to be cost-reflective. You say in your submission a little bit about exit fees, your thoughts on those, and say that basically they should reflect the actual costs, but they do serve a purpose. How would you enforce making exit fees or bank fees generally to be cost-reflective? Do you think that the recent initiative by ASIC against unconscionable exit fees and the guidelines they put out in that regard are what you have in mind?

Mr Canion—Our position on bank fees, firstly, is that banks, like any other business, should be entitled to make a reasonable return on their investment and a reasonable profit for the shareholders. That is the position we come from. Banking is a business, like any other. Where we have concerns is that if a single fee is abolished through regulation it becomes an option for the bank to simply cross-subsidise, so they will increase another fee to offset the loss in revenue they receive from the abolition of the other. I think that is just creating further red tape and difficulties for the management, for both the business and also government having to monitor that. Making a single change to a single fee is probably not the best way of finding a solution to the problem. I think it needs to be a more holistic approach.

CHAIR—Are you aware of ASIC’s approach to exit fees and how they are dealing with that?

Mr Canion—I am cautious in making a comment on that at this time given I do not have full information in front of me at this stage.

CHAIR—ASIC were charged by the government with the responsibility essentially of looking at unconscionable terms across the board but taking a particular focus on exit fees. We had evidence this morning that ASIC spent some years in looking at the issue. In November of last year ASIC put out guidelines. In summary, they are basically saying that the laws on exit fees, which are enforced by ASIC, are straightforward, that mortgage exit fees are acceptable provided they reflect and are limited to the lender’s losses which can be directly connected to the borrower exiting the loan early—that is from a speech made by Tony D’Aloisio, the chairman of

ASIC. Is that a position that you would agree with or sounds reasonable and is consistent with what you are saying?

Mr Canion—To me that sounds reasonable. It gets back to our user-pays principle. If a bank incurs a fee as a result of a customer's decision which they are contractually obliged to meet, then a fee should be payable but it should not be set at a rate higher than the costs imposed.

CHAIR—Given that, what is your position on the measure outlined in Treasurer Swan's banking package late last year to ban exit fees from 1 July 2011?

Mr Canion—Any cost saving is obviously appreciated by customers, but ultimately it is not going to deliver the result that we would be looking for. I think focusing on a single fee is really not creating the overall systemic change that we would be looking for. It is welcomed, but it is of limited benefit to the overall system.

CHAIR—When you were talking earlier about cross-subsidy in respect of fees, were you talking about the potential for all bank customers to wear a proportion—but it would be a smaller amount—of the costs involved when customers leave a financial institution before the cost of setting up their business has been recovered?

Mr Canion—Yes, that is right. There are two forms of cross-subsidisation. It is either the single customer paying higher prices on entry if they are not paying them on exit or, alternatively, as you say, the collective group paying for the costs that are being spread. Either outcome is not really optimal.

CHAIR—Have you had a look at Treasurer Swan's package in any detail since it was released late last year?

Mr Canion—Yes, we have taken a look at it. Our initial reaction would be that there are some good elements in there but it is very focused on the residential mortgage sector. There is very little in there that we could see for business and particularly for small business, so we were a little bit nonplussed by it. It simply did not offer a lot for business.

CHAIR—Thank you. Senator Pratt.

Senator PRATT—Mr Canion, it is good to have a strong Western Australian voice being presented here today. As a WA senator I very much welcome that.

Mr Canion—I appreciate that.

Senator WILLIAMS—Bias!

Senator PRATT—You are always good at putting your bat forward, Wacka! Mr Canion, I am interested to know whether there was any perceivable difference in the small- to medium-enterprise sector in Western Australia on banking competition when BankWest was taken over by the Commonwealth.

Mr Canion—We were particularly disappointed by the outcome that that has delivered for the competitiveness of the sector. It has again reduced the options available to small business. There was a discernible effect, I would say, on the ability of businesses to get loans at a good price.

Senator PRATT—I can appreciate the significance of that, although I suppose others would say that in allowing it to go ahead they were mitigating what could have been a far worse effect had BankWest failed. I suppose there are many sides to the argument as to whether that may or may not have been the case. You have given some evidence about the small business survey, and the obstacles to finance are significant. Do you think that means that small business wants more regulation of the banking industry as a whole?

Mr Canion—I would suggest not. The difficulty with regulation is that it creates a more difficult environment for new entrants, giving them more hurdles to jump over in order to get involved in the market. It can be a disincentive to creating competition. We are of the view that it is market based competition that will deliver downward pressure on prices. Government policy should be setting a framework that will encourage competition, and I am not sure regulation is the best answer for that.

Senator PRATT—I can appreciate and respect that. I would like to ask you whether on that basis you would or would not agree with COSBOA, who have talked about higher interest rates and more arduous loan conditions despite the fact that the loans are backed up by residential houses providing security for both mortgages and small business loans. Should a small business loan secured by a mortgage over a house bear the same interest rate as a home loan secured over the same house or should there be a differential reflecting, purportedly, what is the greater risk involved in small business borrowing?

Mr Canion—It is a good question. I think what we would look to is what ultimately is the underlying asset supporting the loan: if the situation goes bad, how will the bank recover its debt? Ultimately, that would probably be through the asset, if that is a residential house. So it is very difficult to justify an interest price premium when the ultimate asset that is being used to balance it is the same.

Senator PRATT—How do you think we can get banks to implement something like that if we do not regulate them to do it?

Mr Canion—It is a challenging situation, and obviously there is a role for some level of regulation, as we have currently. But we also think that if you had more banks and lenders in the marketplace then all you would need is for one of those providers to break that lockstep with the others and offer that, and then I think you would soon see some changes.

Senator PRATT—Do you think banks, in the Western Australian context, are adequately looking at the local prospects of businesses and the local economic environment that they are operating in, or are they treating businesses nationwide fairly generically in their assessment?

Mr Canion—I would suggest that, as much as the banks have tried to present the view that they are becoming more locally focused, we are not seeing that in practice yet. What we are seeing is that a risk factor is applied to businesses fitting a certain profile across the nation, irrespective of the different business conditions. Obviously, as you would be aware, our

economy in WA is performing significantly differently from some of the other states, and we would like to see that reflected.

Senator PRATT—Yes. Are there some specific examples of that that you could give us? I would imagine that, in some instances, there are what some banks would perceive as risky or fairly obscure businesses but which are actually doing work that is in high demand—for example, from a growing mining sector?

Mr Canion—That is right, and I think it is sometimes difficult for the banks to really understand some of these businesses that are in operation. They can be unique business models, doing very obscure work in some cases for the mining sector, as you mentioned, and it is difficult to apply a traditional SME lending model to those businesses.

Senator PRATT—In the past, I suppose some of those problems were overcome by specialist finance companies who got their funds from offshore, but many of those sources have now dried up and people are left with no option but to go back to the banks. There were other organisations that looked more specifically at the finance they could offer to different sectors of the economy. Are there any signs yet of improvement, or the restoration of people who understand the various needs of businesses, emerging at all?

Mr Canion—I think it is probably too early to say that for sure. Personally I have noticed there has been slightly more advertising for some business finance from alternative providers recently. I am not sure of the cost of the finance that they are offering or any of the specifics, but I think that is a sign that perhaps there is some confidence returning to the market, and we would obviously welcome that.

Senator PRATT—What kind of alternative provider are they? Do you know?

Mr Canion—Yes. They are specifically business lenders focused primarily on that sector. There are quite targeted, focused lending options.

Senator PRATT—While we can talk about improved liquidity and access to funds internationally, the key question is: which institutions does that flow through to and what can we do to enhance access to funds without taking unnecessary risks?

Mr Canion—Exactly. We recognise that any lending has an element of risk, but we like to think that the WA economy overall is a strong one and that, if you are going to look at mitigating risk, it might be about lending a little bit more in WA.

Senator PRATT—I would certainly endorse that statement. We have talked a little about standardising terminology for banking and loan products and I am very interested in that concept. I am concerned to know whether we are comparing apples with apples or apples with oranges and the extent to which you can actually standardise that terminology without it in the end becoming a de facto regulation for the kind of product you can offer. I think with the use of more complicated spreadsheets these days it is now more possible to do that. Is that the kind of thing you have in mind?

Mr Canion—I guess what we are concerned about is the level of obfuscation, if you like, around business lending products. It is very difficult for a customer who is not an expert in the field—they may be an expert in their own business but not in banking—to look at a variety of products and think, 'Which one is best for me and how can I compare them easily?' We believe some simple changes would be helpful, such as requiring standardised terminology to be used and cutting out some of the more confusing lingo. We look at, for instance, the comparison rate model that has been used in residential mortgages as another way of simplifying it and making it easier to compare providers.

Senator PRATT—I am interested in specific examples of the kind of terminology that you believe makes that fair and accurate comparison difficult, if you have any of that information on hand. I certainly accept your argument; it would just be worthwhile for the purposes of reporting to be able to document some of those examples.

Mr Canion—If I could perhaps take that on notice, I will look into that for you.

Senator PRATT—Most certainly.

CHAIR—Thank you, Mr Canion.

Mr Canion—Thank you.

Committee adjourned at 4.56 pm