COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Competition within the Australian banking sector

FRIDAY, 4 MARCH 2011

BRISBANE

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SENATE ECONOMICS

REFERENCES COMMITTEE

Friday, 4 March 2011

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

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

Senators in attendance: Senators Bushby, Hurley, Pratt, Williams and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

Competition within the Australian banking sector, including:

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

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

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

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

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

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

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

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

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

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

(k) comparisons with relevant international jurisdictions;

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

(m) any other related matter.

WITNESSES

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Committee met at 8.47 am

CHAIR (Senator Bushby)—I declare open the seventh hearing of the Senate Economics References Committee's inquiry into competition within the Australian banking sector. On 28 October 2010 the Senate referred this inquiry to the committee for report by 31 March 2011. To date the committee has received over 130 submissions, which are available on its website. These are public proceedings, although the committee may determine or agree to a request to have evidence heard in camera. I would ask everyone to ensure that they have switched off their mobile phones. I would also ask photographers and cameramen to follow the instructions of the committee secretariat and ensure that senators' and witnesses' laptops and personal papers are not filmed.

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

A witness called to answer a question for the first time should state their full name and the capacity in which they appear, and witnesses should speak clearly and into the microphones to assist Hansard to record proceedings.

[8.48 am]

WHITE, Mr Peter, National President and Chairman of the Board of Directors, Finance Brokers Association of Australia Ltd

CHAIR—Mr White, I welcome you to the hearing and invite you to make an opening statement.

Mr White—Thank you. I am the National President and Chairman of the Board for the Finance Brokers Association of Australia. I have been a part of that industry body since 2003. The FBAA itself reaches around 8,500 brokers nationally across the country through its membership structure and has a stakeholder base of about 26,000 through its e-magazine, so it has a quite significant and diversified reach across all sectors of the broking marketplace, whether they are home loans, motor vehicles, commercial chattels or plant and equipment.

I thank the committee for the opportunity to speak on behalf of our membership reach and to express some of our concerns in regards to what is being proposed in what is meant to be a means to enable consumers to move more fluidly and easily between lenders in a refinancing structure.

The primary concern from my point of view is that the consumer is looking to obtain a benefit by being able to make loans more easily transferable or refinanced between institutions, and the topic of the day is obviously exit fees. This is one of the primary issues, yet there needs to be consideration of the practicality of what actually transpires in a day-to-day transaction.

For your edification, I am a 32-year practitioner and I will caveat that by saying that I am not a theorist. I come from a beginning of cutting my teeth in the banking industry in the seventies and have been a part of finance companies, the non-ADI sector, as well as investment bankers over the past. When analysing and looking at what is the real cost or what makes it easier for a consumer to move from one particular facility with one lender to another, the actual exit fee component is rather insignificant to other costs that are greater barriers or potentially greater benefits that the consumer receives by being able to easily move from one place to another.

LMI, lenders mortgage insurance, is one of those issues where the actual premium cost, depends on the loan-to-valuation ratio, or LVR. If it falls into a bracket where the consumer has to pay for it—it varies between banks and also the non-ADI sector—the cost could be $5,000, $8,000, $15,000 and upwards of $24,000 on a premium cost. That premium is calculated by the mortgage insurers to protect the lender for the full period that the loan is taken out, so it could be 25, 30 years or whatever it may be. Yet if that loan is refinanced—say, three years down the track—there is no rebate for that premium that has been paid by the consumer and there is also no ability to make that portable from one loan to another.

There are obviously issues that revolve around the portability aspects, which work on various risk dynamics, but to me it parallels motor vehicle finance or motor vehicle insurances. You might have a VW insured through NRMA and pay a certain premium. You could then buy yourself a Mercedes Benz with a different lender and an increased premium, so you pay the tweaked increase. In basic principle, there is no reason why LMI could not be considered or modified to be able to accommodate that sort of thing and therefore mitigate the enormous cost to a consumer, because there is no rebate or very little window of opportunity for rebate on lenders mortgage insurance.

Generally speaking, there is somewhere between a 12- to 24-month window. If you discharge your mortgage in that period of time, you are possibly eligible for a rebate of up to about only 40 per cent of that premium only, remembering the premium covers the lender for right of recourse for 20 to 30 years. But the consumer is the one who has paid for it and the consumer is the one who only gets a rebate if they ask for it. Although there have been varying commentaries from our membership base, it appears that there is no process whereby, if a consumer refinances their loan elsewhere in the first 12 months, they automatically get some sort of rebate on that premium, even though they may be entitled to one. Therefore, if you do not ask you do not get, which is problematic in itself.

There are also no disclosures given to the consumer or right of choice as to what LMI provider they have access to. Various lenders work with various insurers. There are not many in this country, but they are all providing the same product and therefore I have a challenge to understand why the banks do not use all mortgage insurers and enable the consumer to have choice, because the products do not vary. It is not like one insurer has a certain product and another insurer has a completely different product. They all do basically the same thing.

The LMI issue, to me, is the bigger impost in regards to the consumer being able to effectively and financially move from one institution to another. The exit fee scenario is a rather insignificant cost compared to the LMI cost. We live in a world where business is business. We need a healthy, robust and strong banking environment, which is a given; yet there is also a commercial reality when you write a loan that there is a cost factor that is greatly mitigated by the interest that is received over a period of time to then become a profitable situation. Therefore, the actual consideration of having an exit fee makes commercial sense so that losses are not mitigated when writing business, so long as it is fair, reasonable, disclosed and not just blatant profiteering. The LMI issue is a greater consideration that needs to be the focus, not the removal of exit fees, because there is greater damage that can be done to industry by removing the exit fees, especially in the non-ADI sector.

Securitisation is another area that needs to be strongly supported by government. It was the non-banks—and we are talking about the likes of the RAMS, resies and the Aussies back in the early nineties—who actually brought competition to the marketplace. Remember that I cut my teeth in the seventies in the banking sector. In those days you could provide a home loan with interest rates of up around 18 per cent or sometimes higher, and you could not write a facility with less than a four per cent margin. Today, thanks to the non-banking non-ADI sector, strong competition has come back that has brought better interest rates and better facilities to the consumer, with more creative products that have benefited the consumer. There is also the broker marketplace which through the nineties actually brought the level of service that the consumer wanted. It was the non-banking and non-ADI sector that brought the competition to the lending sector in the early nineties and the brokers that brought the level of service that consumers were demanding.

The issue is that if you remove exit fees which impact on what they call deferred establishment fees or DEFs in the non-ADI sector and potentially erode or damage that marketplace, you are actually damaging the consumer and the consumer’s right for choice and the ability to have far more competitive products. We do not want to wind up back in the dark ages of the seventies and eighties, where the banks had full jurisdiction, control and run over what was happening in the marketplace because they do not have the competition that is now available. That is a greater concern for consumers around this country.

CHAIR—Thank you, that is very useful. You raised exit fees when you were talking about things earlier and you also mentioned securitisation. It is fairly well accepted by just about everybody that easier switching between banks and financial institutions is actually good for competition, but it is probably also fair to say that it is good for members of your industry. I do not mean that in any derogatory way. Basically, the more switching that occurs, then potentially there is more business for you.

Banning exit fees is being promoted as one of the answers to increasing the ability for people to switch. I find it interesting that it is in your interest to improve switching financially and yet you are still not keen on exit fees. I think that says something, so would you like to comment on that at all?

Mr White—Yes. I have worked on both sides of the sector. Obviously as an industry body we have a vested interest in our membership, but given that I have had three decades plus in this industry, I am very keen to ensure that from a total industry perspective—and that extends way past our membership base to also the consumers—that they are not disadvantaged by certain pieces of legislation that may be brought in that actually do not advantage the consumer.

The broking marketplace has most certainly brought about another level of dynamic that never existed prior to the 1990s and it was driven by the needs and demands of the consumer for a better service. I was actively working in RAMS Home Loans in those days when there were only 12 people, where we had to explain what securitisation was all about, and the protections and capabilities of what it did and did not do. It was the consumers that wanted those products, the consumers that wanted the actual service that was not being provided by the bank. I think many would realise that when we were younger—I am in my late 40s now—that the only way that I got a home loan was to go to the bank that my father banked with to get a start. That was a really narrow capability of actually getting finance to buy a house or to buy a car and there were no other options.

Yes, there is a vested member interest from what has grown, but it has grown because the consumer wanted it. They wanted the service, the options and capability, but even more so in today’s environment with the NCCP—I sit on the Treasury and ASIC committee for industry—the educational and professionalism standards that are now in place mean even better protection and advice for consumers, whereby if you are at the mercy, for the wont of a better word, of the banking institutions, as far as being the only place you can get your loans, then you are not getting independent professional advice. It has been eroded and potentially destroyed because the broker marketplace is the only sector that provides that as an independent professional.

CHAIR—Thank you. That was very informative. In coming back to exit fees, I am trying to get my head around it. The fact is that it would be in your industry's interest to promote changes that will increase the ability of people to switch. Would that be a fair statement?

Mr White—Most certainly.

CHAIR—Yet you are still not keen on banning exit fees, despite the fact that there are some people out there who say it will increase that, and that is for the reasons that you have outlined. I think that is interesting. It is telling that, although you have a vested interest in changes that will promote switching, you do not think this is the answer.

Mr White—Correct. The banning of exit fees has a fundamental commercial premise that makes common sense, so long as it is not profiteering. There is a cost to write a loan for anybody in the industry, so there is a physical expense attached to that. Therefore, until such time as you have generated enough revenue to cover that expense then you are in a loss situation and no-one is in business to be in a loss situation. There is a commercial reality to normal everyday exit fees.

The other point is that the expansion of exit fees to DEFs or deferred establishment fees in the non-ADI sector was because the consumer did not want to have costs up-front. It was more beneficial that if there was going to be a loss situation—if I can put it in that way—that it was at the back end and not at the front end, because the consumer did not want that cost up-front. If you ban exit fees you will push costs to up-front because they will come in other forms and fashions as they can to comply with law. The deferred establishment fee structure basically worked on the premise that over time that cost reduced, so if you were refinancing in the first 12 months, hypothetically that cost was $2,000, and as you went through year 2, 3, down to the end of year 4 to the beginning of year 5, that would reduce on a percentage basis, so once you got to a certain point it was extinguished. Yes, I agree that in one respect there is a cost to the consumer to refinance if exit fees remain, but there is a commercial common sense that says that is why that should be the case.

CHAIR—In terms of exit fees, what is a fair way of calculating it? ASIC put out a regulatory guide last year which talked about how they would assess whether exit fees were fair. It has not had a chance to be tried and tested since then, and also since then the government has announced that it is going to ban exit fees, which you would be aware of. Is that a reasonable approach? Are there some financial institutions out there that have been gouging by charging exit fees significantly in excess of the cost that you just talked about?

Mr White—I cannot directly answer that. I would say that in some cases that might have been the case, but I would have thought, generally speaking, it was not. If it was a $700 fee, depending on what other costs are associated with it, it could be fairly excessive, but in other cases it might be fairly reasonable. It comes down to the individual structures.

CHAIR—We have heard of some exit fees being in the many thousands and even approaching $10,000.

Mr White—I would have thought that was rather excessive.

CHAIR—You have raised the lenders mortgage insurance as probably a bigger barrier to switching, particularly for first home borrowers and those who have had to make use of that. How does that work? As I understand it, it does not provide insurance for the borrowers, themselves, it provides insurance for the banks; is that correct?

Mr White—That is correct. Lenders mortgage insurance is as it is termed. It is an insurance product that protects the lender only and there is no benefit to the consumer whatsoever, yet the consumer pays the premium for it out of their loan funds. The consumer pays for it. The lender has the entire benefit of it and even in the worst situation where there is a claim that is validated by a mortgage insurer, the mortgage insurer has the right to then go for the consumer for the recourse of the losses that they have achieved as well, so the consumer loses in two angles. They lose because they pay a premium that they have no benefit from and, if there is a claim, then the insurer will go to them for their losses.

CHAIR—Effectively, the only benefit they actually get is that it facilitates access to that finance for them? It is like a fee that they have to pay in order to get the bank to agree to lend the money to them, because without them paying that fee the bank will not do it.

Mr White—Correct.

CHAIR—There are no other benefits.

Mr White—It is generally in the higher risk bracket although, depending on the non-ADI sector, it can be applicable all the way through.

Senator WILLIAMS—Is it generally anything above 80 per cent lend that requires mortgage insurance?

Mr White—Yes, that is correct. In the non-ADI sector the mortgage insurance applies regardless of LVR, but the consumer does not pay for it until it gets to about 80 per cent. There are some slight variations on that. That is because of the securitisation structure and the need and capability to be able to get the right level of rating for the bond issuances and the right pricing to keep interest rates down. Mortgage insurance has a very beneficial component to the entire industry. It is not that it should not be there. The issue with mortgage insurance, from my point of view, is that it should either be made portable, where again there are issues regarding the risk dynamics of that, which I fully appreciate, but it is not something that cannot be worked with in a fashion, or it should have a rebate that is appropriate considering the actual policies taken out to protect the lender for upwards of 20 or 30 years. They have the right of recourse over that period, but the consumer, if they happen to ask for it and if they know—which from my view point 90 per cent of the people that I speak with and it is probably 95 plus, have no idea that they are eligible for a possible rebate on that premium if they repay their loan within 12 or maybe 24 months.

The consumer pays for it. It has no benefit and it has no disclosure. I have spoken with some very senior people within international companies that are related to this sector. I have asked them to explain to me what LMI does and they have got it completely wrong. Yet they are highly educated people, as opposed to our everyday consumer, who I am not saying is not highly educated, but is uninformed as to what LMI does, is, or does not do and there is no choice involved either, even though there are multiple insurers in the marketplace. Given the products are the same, I can see no reason why you could not make it portable and lenders accept the alternative mortgage insurers in the marketplace as it does with, for example, motor vehicles.

CHAIR—On that, the main objection to making it portable or fully rebatable, in proportion to the time of the loan that is still to go, is that the premiums would rise. The argument is that the premiums, as calculated, already reflect the situation that currently exists in that there are largely no rebates, they are not portable and so on. Do you accept that the market is competitive in lenders mortgage insurance and that, if there was a requirement under the Insurance Act or rebating it in same way that any other insurance policy is required to be or otherwise, that would then necessarily lead to higher premiums?

Mr White—No. I cannot see why it would lead to a higher premium being paid by the consumer because, at the end of the day, the premium pricing is based on a facility that goes for 20 or 30 years in the first instance. If you refinance a facility say at year three, you are still probably going to carry that mortgage to a certain period, but this is part of the risk dynamics interplay. If there are variations from how the policy was originally written versus what the restructure looked like, then there may be a differential that needs to be paid between the two premiums so that the risk dynamics and the matrixes they work under are maintained. An increase just because it is now portable does not make sense at all because you are still dealing with the essence of the same thing.

CHAIR—The only other question that I have—and we should keep the answer reasonably short so we can move on to other senators—in general as a broker, or on behalf of your organisation, throughout the GFC, particularly from a business perspective, what are your observations as to how the big banks changed their approach to lending as the concentration increased with them?

Mr White—Are you referring to business lending or consumer lending?

CHAIR—In general, but if you have anything on business that would be quite interesting.

Mr White—Throughout the GFC period it became increasingly more difficult to obtain loans on a consumer basis with the tightening of criteria. The important thing with Australia is that Australia's securitisation sector, which is where the market was knocked the worst, was fairly robust compared to the rest of the world. We were a casualty of an accident that happened in the US and we got sideswiped on the way through. We did not have high arrears rates, even in the low-doc sector, compared to other countries. We had a strong, stable environment. Our unfortunate position was that selling bonds into the corporate global marketplace in the securitisation structure became very expensive.

But the rules changed on the way through. We saw LVRs being lowered. We saw a tightening of credit regulations and credit rules which, given the history of the environment that we are in, if we were not in an erroneous arrears position, does not make a great deal of sense.

In the business lending sector it was far more detrimental. The business lending sector had issues where significant reductions in their loan-to-valuation ratios were imposed on certain businesses. We had increased unserviceability criteria. First hand I have clients that I have dealt with one-on-one whereby they were never in default of their facilities, always made their payments on time, yet all of a sudden they had to reduce their LVRs by about 10 per cent, which meant writing a cheque for $1 million plus. That had another impact that said that if I have to write a cheque for $1 million I will have to lay off some employees because I cannot afford to write that cheque and reduce my cash reserves by that much. It had a very negative impact on consumers in employment at the same time and the actual access to debt became significantly harder because of the increased serviceability criteria, which the client had met under the previous rules prior to the GFC and even during that period, without any problems. There were some very difficult circumstances imposed on borrowers through that time.

CHAIR—I asked is because you were talking about your practical experiences rather than being a theoretician.

Mr White—Correct.

CHAIR—Those were things that you observed through your business and with clients?

Mr White—Correct.

Senator HURLEY—I would like to go back to exit fees. On page two of your submission you state:

The other impact of removing Exit Fees is the impact to the Broker Industry. Banks have assisted in growing this market space via Aggregation so to gain greater market share and increased volumes. Given the already stated 'commercial nature' of the Banks, with the proposed removal of Exit Fees the concern is that the Banks may look to increase 'upfront commission claw-backs' which already extend in some case to 100% of the upfront commission payment to the broker being 'clawed back' for the first 2 years of a home loan if it is discharged, together with the real possibility of even further erosion of income to the broker through further reductions of the upfront commission and or trail income.

What you are saying is that it is out of that exit fee and arrangement the brokers get their commissions and income?

Mr White—Not necessarily. It would not be out of the exit fee.

Senator HURLEY—Can you explain what you meant?

Mr White—Yes. The situation that I see is that if the removal of the exit fee is implemented the loss of that particular revenue stream will be made up elsewhere. That could be by means of clawing back further commissions from the broker, as a means of a make-up of the exercise. I do not believe any bank in this country will turn around and erode their bottom line and reduce their value to shareholders.

Senator HURLEY—So they will take it from the brokers. That gives you another reason for wanting those fees because you would know that the proposal by the government for the abolition of exit fees excludes those costs, such as fees for mortgage documents and so on. Those real costs are excluded from the abolition of exit fees.

Mr White—Yes.

Senator HURLEY—So it is only those extra fees. You said:

It is important to note however any Exit Fee must be commercially reasonable and tangible to the cost of doing business – and not a fee grabbing exercise.

The government has excluded those tangible costs, but not the fees, and you are saying that it is currently out of those fees that the banks take your commission.

Mr White—No. I am not saying that they are taking it out of the $700 exit fee. It is a revenue stream that becomes lost, which means that it impacts on a profit and loss position for any business, so it will be made up elsewhere. There are already initial rumours—not rumours because they are more than just rumours—that certain sectors are going to retain the deferred establishment fee basis, yet impose that back to the broker and not to the borrower, which to me, commercially, is disgraceful.

Senator HURLEY—So you have another vested interest, in effect, in having the exit fee continue?

Mr White—Most certainly. Again, although it is a vested interest in industry, it is also a vested interest in continuing what the consumer wanted from the beginning of the 1990s with greater service and competition that the banks did not provide. If that is removed we will go back to a period prior to the 1990s where the banks sat back and wrote their own rules without competition.

Senator HURLEY—It is always a balancing act. I agree with you completely, and take your point about opening up loans to people who would not previously have qualified, but there is a balance. You are saying that consumers wanted it—and that is true—but the funding was not available. That is what increased in the nineties. We saw the risks involved in that increase in funding in the United States. Fortunately, because of our regulatory regime here we did not get that, but there is a balance between the risks, isn't there?

Mr White—There is, but in saying that, remembering that the non-ADI sector and the securitisation structure that came into being for greater product and greater competition was a product enhancement and competition to the banks that was not there in the past. It meant that the history of banks running much larger significant margins was then put under pressure to compete. If you take away the pressure to compete then margins can potentially increase, and we have already seen that today. The broker sector brought a delivery of service that was not being provided by the banks.

Senator HURLEY—Yes, I agree. Thank you.

CHAIR—Senator Williams.

Senator WILLIAMS—Thank you for your presence. I have two interests: exit fees and the lenders mortgage insurance. On the lenders mortgage insurance I have a typical example. I want to buy a house for $500,000 with a $50,000 deposit, so it is a 90 per cent lend. I have to have lenders mortgage insurance. Let us say that the money that the bank takes off me is $6,000.

Mr White—It would be far more than that.

Senator WILLIAMS—Let us say it is $10,000, which will then go to an insurance company.

Mr White—That is correct.

Senator WILLIAMS—While I am in that house that I have bought—and we are looking at home loans here, not necessarily commercial real estate—surely if I were to change institutions then that insurance premium remains with that insurance company and they guarantee it for the next institution. Is that just common sense?

Mr White—One would think so, but it does not happen in practice.

Senator WILLIAMS—Perhaps it should.

Mr White—I agree 100 per cent. Again, this comes into the risk dynamics. Assuming that nothing changes, bar the institution, so the LVR, which is at 90 per cent, does not change and the underlying asset does not change—

Senator WILLIAMS—It might be two years, so it might go down to 89 per cent.

Mr White—It could well be. There is also the income and the circumstances of the employment. So if nothing changes bar the institution, to me there is no reason why it should not be able to be transferred from one to the other, as you would if you swapped lenders on a motor vehicle and you swapped the insurance policy across.

Senator WILLIAMS—Exactly. I want to talk about exit fees. I think the four big banks have basically 90 per cent of the home loans. Is that about the rough figure?

Mr White—Yes, it is around that.

Senator WILLIAMS—You then have your credit unions, building societies and all the ADIs. You then have your non-ADIs, your smaller secured investment companies, I like to call them, who have probably five per cent of home loans, but I am guessing that figure.

Mr White—In this marketplace it is probably right. It used to be a lot more, up around 35 per cent plus.

Senator WILLIAMS—But now it is a lot lower?

Mr White—Yes.

Senator WILLIAMS—I oppose exit fees. I could not leave my bank last November because of exit fees. I could have had a better deal with a quarter per cent better interest rate. That is my personal experience.

I will put a scenario to you. We have those registered ADIs and non-ADIs. I understand non-ADIs are small institutions that have the cost of establishing a loan. They do not want to lose that. They have their book and it might be a narrow book which is balanced out pretty well, so they do not want to lose their customers. I think the only reason you ever lose a customer is firstly, because you have a blue with the person that you are dealing with or, secondly, you think you are getting ripped off and can see a better deal. How would it be if the government banned exit fees on ADIs and did not ban them on those non-ADIs covered by ASIC? Would that leave the situation where those smaller companies, that I want to see survive and grow, can retain an exit fee if they wish? A lot of them do not. The credit union that I was with did not have an exit fee. Many of the small companies do not have them. How would it be if the government, besides their cost retainer costs, abolished exit fees on ADIs at the big end of town, and under a whole different book, which it is—one is under APRA and one is under ASIC—for those non-ADIs under ASIC, the government said you can retain your exit fees if you wish? Would that bring balance into the equation?

Mr White—Yes, it would. As far as I am concerned I believe that would be a viable circumstance of borrowing situations to move forward on.

Senator WILLIAMS—I think the situation is that you cannot legislate for some and not for others. For example, you cannot have 30 per cent company tax in South Australia and 35 per cent in New South Wales. It has to be all over Australia. This would be a situation where—because they are under separate organisations, APRA and ASIC—you could legislate to abolish exit fees on the ADIs and leave those excluded in the legislation. I think it would be quite simple.

Mr White—Yes. I do not disagree. My only caveat to that would be to the non-ADI sector—which I will publicly say I am a very strong supporter of, because of what they have brought to the market—is that those fees are commercially reasonable.

Senator WILLIAMS—So am I a strong supporter. With the non-ADIs, I was critical of the government when they underwrote the investments in the ADIs and not the non-ADIs. I think in New Zealand they underwrote the lot. I could not say much about it. I asked one question in the Senate. The more I raised the issue the more run we would cause on the non-ADIs. I raised it with the then-Senator Nick Sherry and Senator Conroy that we saw a flush of money out of those non-ADIs because they were not underwritten by the government, so people got panicky and put in the ADIs.

Mr White—Correct; it created a diminished market share.

Senator WILLIAMS—Yes. That did not help. Would you say that took a lot of funds out of those non-ADIs and even sent some broke?

Mr White—It definitely took money out of the non-ADI sector. As to sending some broke, it collapsed certain businesses that revolved in the wholesale sector.

Senator WILLIAMS—Bidgee Finance at Mildura fell over because of it.

Mr White—Yes. They were in the trade finance sector. There was also a company called MDN that was running wholesale funds. It completely collapsed. A lot of the larger non-ADI sector managed to survive, but shrunk dramatically and obviously had significant issues, even impacting on GE, which dropped out of the marketplace—that is one of the most significant global players that we have.

Senator WILLIAMS—Some froze, like Challenger.

Mr White—They did freeze for a while.

Senator WILLIAMS—They were non-ADIs.

Mr White—They were at that point in time. Challenger is now Advantage, and Advantage is owned by the NAB, as far as the residential product is concerned.

Senator WILLIAMS—I think one of the arms of the Commonwealth Bank was frozen as well. Was it Colonial?

Mr White—Yes, I think that is correct.

Senator WILLIAMS—I like the idea of the government legislating to ban exit fees, after retention of costs, for the ADIs and allowing the non-ADIs to do what they want to do. What do you think?

Mr White—There needs to be commercial fairness.

Senator WILLIAMS—Thank you.

CHAIR—Senator Xenophon.

Senator XENOPHON—I would like to ask about the whole issue of mortgage insurance and transferability. Is the key to fixing this up to provide easy transferability maybe for a nominal administration fee if there is a reasonable administrative cost involved and not so much an exit fee; is that the way to do it?

What practical measure is there to deal with this, because this is an issue that a finance broker in Adelaide is hot to trot on as well? What is your view on that?

Senator WILLIAMS—I apologise, but I can only just hear you. Can you repeat the essence of that for me?

Senator XENOPHON—I will say it again. I can hear you loud and clear. In your opinion, what practical steps should be taken to sort out the issue of the cost of transferring mortgage insurance, which is a common complaint that I have heard? Would you have some small fee if there is a transfer that would cover administrative costs or do you think that would not be necessary?

Mr White—I would say that, with certain criteria to it, there is probably a reasonableness in one respect that there could be an administration cost for the transferring of that. By the same token, I would sit back a little bemused if that is the case as to why it does not happen in the same instance—and I used motor vehicle insurance as an example—when you transfer that across there are no administrative costs, that I am aware of, that apply.

Senator XENOPHON—Yes. Further to that—and one of these questions you may want to take on notice—are you saying that the administrative costs involved in transferring mortgage insurance from one loan to another would be minimal?

Mr White—Yes, I would. There would obviously be a small degree of due diligence to ensure that the risk dynamics have not changed, but assuming that has not, then one would feel that it would be a fairly simple and straightforward process.

Senator XENOPHON—So assessing risk dynamics, in itself, would not be a very expensive process?

Mr White—I am sorry, I missed that.

Senator XENOPHON—Assessing risk dynamics, in itself, should not ordinarily be an expensive process?

Mr White—No, so long as nothing has changed. It is not a long-winded exercise.

Senator XENOPHON—Can you provide, on notice, some details of that in terms of the sorts of risk dynamics that you think should be looked at? My final question to you, again on notice, is: could your association estimate how much you think consumers are paying extra by virtue of mortgage insurance not being able to be transferred on an annual basis? It can be a very approximate figure just to give an idea of the dimension of what consumers face with the current system.

Mr White—I can most certainly do that. In light of the lenders mortgage insurance costs, I think it is believed that, on average, a person will, over a 20- to 25-year period, refinance from one institution to another approximately three times or sometimes four times. So depending on the LVR banding and the impact of that premium, each time that transfer happens you would be looking at a cost of $5,000 to $24,000, depending on how much the loan is and what the premium payable is, based on the LVR. The cost to actually transfer from one institution to another, without LMI being portable and having to bear the cost each time, you are talking numbers from $20,000 to $50,000 plus over the time that you hold a mortgage. The vast majority of people have a mortgage for their entire working life, as far as the percentage weighting basis goes.

Senator XENOPHON—I would appreciate if some analysis could be done of that because getting an idea of the magnitude of what consumers face would be useful.

Mr White—Yes, I will.

Senator XENOPHON—Thank you.

CHAIR—Senator Pratt.

Senator PRATT—I want to return to a line of questioning that Senator Hurley was pursuing, which related to the commercial desirability from a mortgage broker's point of view that exit fees continue to exist. Do you think that banning exit fees will make it less easy for bankers and brokers to make commission arrangements?

Mr White—No, I do not think it will make it less easy. I think it will create variations that are probably in a negative fashion.

Senator PRATT—Can you explain that?

Mr White—Yes. I do not think that it will be harder to have the commission arrangements in place, but my concern is that the first thing that I would see is a reduction in how those commissions interplay and potentially how the recourse component of the early discharges impact on the commissions that were paid to the brokers in the first instance.

Senator PRATT—So you are saying that there will be less commission for brokers and that might reduce competition in banking because broking will not be as desirable an activity?

Mr White—I would say that it would reduce competition and availability of diversification of product to the consumer because they do not have the independent professional out there giving them that professional advice and comparisons between different institutions or different non-ADIs.

Senator PRATT—Would you accept that since the 1990s, where you suggested that banks wrote more of the rules, it is now much easier because of the level of information that is available to consumers and that that information is growing largely through online tools, that it is actually easier for consumers to compare their own home loans and that, whilst a broker might still be significant, there is now a lot more opportunity for consumers to pursue and research their own products?

Mr White—The capability for the consumer to research online has most definitely and significantly increased. I can give various analogies to that from when I was writing home loans myself through that period, but the big issue is understanding what is in front of you and the totality of what is involved. It is not just the information that you can deem online, which gives you initial rates and fees. The consumer is not educated in that area. It is a bit like being an owner homebuilder and being a professional builder. You might do okay, but you may not get the full box right. It is significant in this marketplace, whereby if we remove exit fees from the market, where will it be hidden, where will other costs and charges come in, what will be the impact in comparing one interest rate that you are paying today versus an interest rate you could be paying at a lesser point, even though you have had to pay fees?

Paul Clitheroe was public about it a few weeks ago. He said that on the total mortgage period you could be saving $58,000, so $700 or $1,500 compared to $58,000 savings, hypothetically. That is not something that the consumer will readily understand. You need to understand the industry, the mathematics, how the calculations work and give that level of professional advice to determine whether what looks good may not necessarily be good. It especially relates to the circumstances of the borrower.

Senator PRATT—It has been argued that exit fees have been one of the things that have contributed to the big four banks consolidating their share of the home loan market. If that is seen to be the case, surely that is not a good thing for the consumer.

Mr White—Can you repeat your question?

Senator PRATT—Would you agree that over the recent period of time the big banks have consolidated their share and have a greater share of the home loan market? Would you deny that exit fees have contributed to that? Clearly there are plenty of other factors that have seen that consolidation. What role do you think exit fees may or may not have played in that consolidation?

Mr White—I do not think it has had a big play in it at all, to be honest. Remember that the broker marketplace is also generally an interplay with the institutions as well, so although the institutions have the largest share of the market that is because they are using the third party distribution capabilities through brokers as well to be able to generate their business at the same time. I do not see that exit fees have contributed in that fashion.

My greater concern at the moment, in regard to exit fees is the advertising that is going on whereby we have certain banks pitching against others with only short-term benefits. There is what a consumer can view online versus the reality of what is the best for the consumer. It is not something that the consumer can necessarily see. They can say, ‘Great, if I swap from this bank to that bank then I do not have to pay that fee’, but are you getting a better interest rate, a better product, and are there longer term benefits that suit your particular individual needs by making that change? That is not something that they will necessarily sit back and analyse.

Senator PRATT—What kind of consumers are more likely to be subject to an exit fee in the sense that they become more savvy in working out whether they are likely to need to move products and so on? I know from my own experience that with my first home loan product I was quite naive as to the consequences of signing up to the product with a fee, but now that I have more equity I am less likely to be subjected to such a fee. To some extent it seems that there are different kinds of consumers out there.

Mr White—There are. In my personal opinion, and I will caveat it in that box, from what I have seen from being in this industry for three decades is that it is not until you get to your third home or possibly your second home that you start to become more savvy about what is going on. One thing to remember is that you may have your first home and you may hold on to that for a fair length of time to gain a certain amount of equity. You could then buy an investment property and all of a sudden the combined debt versus the combined value of the assets has pushed the LVR back up into that LMI area again. The actual costs and the understanding of how all of that interplays is something that from being in the industry long term or doing it long term you practically understand. I have seen it time and time again. It is very difficult for a consumer to understand all the idiosyncrasies by way of product, pricing, rate, fees and charges and the benefit of that product by swapping from one to the other, which is what the professional industry brings.

Senator PRATT—Thank you.

CHAIR—Thank you and we wish you well.

[9.36 am]

MINZ, Mr John Francis, Chief Executive Officer, Heritage Building Society Limited

WILLIAMS, Mr Paul Leo, Treasurer, Heritage Building Society Limited

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

Mr Minz—Thank you for the opportunity to present the perspective of Heritage Building Society to this inquiry. For those senators who do not know us, Heritage is the country's largest building society with approximately $7.7 billion in assets. To put this in perspective, this year alone we will provide 6,500 Australian families with a mortgage loan, and within our portfolio at Heritage Building Society at the moment there are 35,000 mortgage loans, which are loans to mums and dads in Australia.

While we have been headquartered in Toowoomba since the late 1800s and our physical distribution network has basically focused in South-East Queensland, we have had relationships with mortgage brokers for over 10 years now, so that we have access to new members right across the eastern seaboard. We have almost 130 points of presence in South-East Queensland, which includes 59 branches and 70 agents, or what we call minibranches.

We are a bit different. We are a mutual financial institution and we live our people-first brand to our members through our staff. We do not have shareholders. We are, as we say, owned by our members. As a result, we provide superior service to our borrowers with products and pricing to our borrowers and depositors, and superior levels of customer service to our members. This was quantified by Roy Morgan at 31 December last year where they released their customer satisfaction results and highlighted that Heritage customer satisfaction was in excess of 90 per cent. The major banks were at 75 per cent. That rated Heritage as the top customer service for all banks, all building societies and all credit unions; we are No. 1 in Australia.

While providing a better deal to our members in pricing and services, we are still supervised by APRA. We still need to comply with the prudential standards. We need to satisfy capital adequacy ratios and generate after tax profits so that we can grow our business. Last year was our 11th consecutive record profit, which is no mean feat. We believe in not just delivering a pricing and service proposition to our members but running an efficient and financially strong financial institution.

We are also more innovative and sophisticated than most pundits would imagine. We have been an active participant in the capital markets and have had numerous wholesale funding transactions with support from a broad base of investors from Australia, South-East Asia and Europe. I do not think that would apply to many other mutual financial institutions, so we are probably a special case.

We were the first mutual financial institution to get a double rating, investment grade rating, from both Standard and Poor's, and Moody's back in 2006. We are the only mutual financial institution and the second ADI in Australia to be able to raise retail deposits which are listed on the Australian Stock Exchange. We have our own exchange settlement account and we are the first mutual and smaller entity to do that in Australia. Believe it or not, we are the largest issuer of prepaid open loop cards in Australia, issuing prepaid cards that you buy in supermarkets, service stations and through Travelex in terms of travel cards that our members and customers use right across the world.

During the global financial crisis we restructured our business. We became a much stronger business and more resilient. We have increased our prudential ratios, capital adequacy and liquidity ratios, and our mortgage arrears are about one quarter of industry averages, so we run a very strong risk management framework at Heritage. We do this without materially affecting or reducing our staff numbers and we did not close branches and use tactics like others in the banking industry have used in recent decades.

Despite the challenges outlined in our written submission—and there was pressure on our margins over the last couple of years—we continue to provide our customers, our members, with better pricing and service superior to the banks. We participated in the guaranteed wholesale funding transactions, which was also covered by the wholesale government guarantee fee. We raised $680 million of wholesale funding in just that one particular area, which was also done at exorbitantly higher fees because we are a triple-B rated entity. Given the discriminatory pricing, the major banks use this area of stability and support to gain advantage over others in the industry.

Market conditions are changing and are challenging. Our six-month results, which we released in the last few weeks, are down. Our profit results are down by about 12 per cent against the comparable period in 2009-

10. This is purely related to the cost of funding. We also do this because we have intentionally member beneficial interest rates for our borrowers. Given the better deal that we give to our borrowers, the cost and the access to funding is the crucial element, we believe, in relation to competition.

I am aware that there have been other comments in front of this particular committee about whether mutual building societies or credit unions can be the force that provides competition to the banks. I do not believe in that cynicism, and if that was the case then this committee should be really concerned.

There are about 130 mutual building societies and credit unions in Australia with 900 branches and 10,000 staff, and we provide mum and dad style financial services to about 4.5 million Australians. The government is right to suggest that as a group we offer the best ready-made option to provide competition to the banks.

There has been some recent dialogue about fast-tracking a number of mutual financial institutions to bank status, but I believe, and the Heritage perception is, that is not a panacea for enhanced competition, a rose by any other name. A building society or a credit union calling itself a bank would still be perceived as little different; would still need to manage and potentially split branding issues; would still be seen from a corporate ratings perspective in the eyes of retail investors as significantly less secure or less rated than the major banks; and would have limited advertising budgets relative to the major banks to be able to change that status over a short period of time.

Heritage has positioned itself to advantage for quite some time in being and acting differently to the banks. Why would we align ourselves and call ourselves a bank? While some consumers may see advantage in the status, others of our members continue their loyalty to us because we are not a bank. Having more banks may be beneficial to competition in the long term, but if it were the only solution one would have to ask how well the three regional banks in Australia have performed in keeping the major banks on their competitive toes.

Heritage has considered the issue of changing our status to a bank in the last couple of years, before it was raised late last year by the government. We did research with our members and we believe that there was continued benefit in remaining and retaining the status of a building society. We are likely to reconsider this as circumstances change.

In spite of our longevity, this inquiry is the first time for possibly decades that mutual ADIs, such as Heritage, have high visibility, public debate and have been proactively engaged in participating in making this a more competitive banking environment.

I have summarised three areas from our submission which we believe are important. The first is to aim for sustainable, but tangible, benefits by facilitating improved access to funding and increased flexibility relating to capital growth.

The second is taking definitive measures to reinforce the confidence of consumers in the whole Australian banking system regulated by APRA under the same prudential standards. That belief and the security of the complete banking system is not there in the populace and that is why we believe that the terminology raised by the government is great, but the continuation of a substantial retail deposit or FCS cap of $1 million is crucial in this regard. Any reduction will only further advantage the major banks.

The third element of the submission is about reducing unnecessary distractions and the burdens of consumer protection legislation. We believe a light-handed approach is warranted, given the strength in Australia of our depositor and consumer protections. I have some repetition here, but I think I will cut that out and hand over to the senators.

CHAIR—Thank you. Your approach to the finance industry that you are involved with all sounds like your institution is extremely competitive and innovative. What rate are you growing at as a result of that? Everything you said sounds fantastic. You are the first amongst all your peers in terms of customer satisfaction. Is that actually translating into people knocking down your doors to try to get to your products?

Mr Minz—I think we have a very good proposition which has been described in the past as having our light under a bushel. We have done a range of things over the last couple of years to ensure that we can grow our members faster than we have in the past, appropriate to the wonderful set of products and services that we offer. Our assets are growing at less than the system rate. I think it is probably because we have come through this global financial crisis and the government and other entities and regulators did wonderful things to shore up stability. Those issues have been in place but there has been very little attention until now to competition.

With our internal strategies we believe that we will continue to grow. Over the last couple of years we have grown from about $7 billion to $7.7 billion. It is not magnificent growth. But in that time frame we have had to not only grow our business but also change the mix of our entity. Prior to the global financial crisis we were a significant player in the securitisation market. We have made three tours to Europe and wowed the investors about this wonderful proposition that Heritage has. Since the GFC, the securitisation markets—propped up in Australia thankfully by the AOFM—have been a small proportion of what they were previously.

We had to change our internal dynamics and our internal balance sheet. We had to bring in a lot more retail funding. For instance, we have grown our retail funding over a billion dollars from $2.5 billion to $3.5 billion in the last couple of years. That has come from mums and dads who have decided to come and stay with Heritage.

CHAIR—So you are growing at a—

Mr Minz—At a moderate pace.

CHAIR—Is the pace determined by the demand or by your ability to meet the demand?

Mr Minz—Competition is all about access to cost-effective funding. The competition in the Australian marketplace—and I have heard some of them mentioned in the previous session—has a significant number of people playing in the lending space or the credit space. They are the mortgage originators, the mortgage brokers and the banking institutions. We have aspects of how products are constructed that can be tempered to ensure that they are appropriately competitive. But the one element to ensure that there is true competition in the Australian marketplace is access to cost-effective funding. If the 130 mutuals in Australia had more access to that sort of funding they could be put more intense pressure on the larger banks through their lending practices to force them to be more competitive.

CHAIR—If you look at the RBA stats on what has happened over the last four or five years you will find that the big banks have had a significant increase in the share of various markets. With the onset of the GFC the non-ADIs basically dropped off but the mutuals have just stayed fairly flat. I am not sure whether that indicates loyalty of your customers or the fact that people you have already reflect satisfaction levels, I guess, but there was not a big change in the market share of the mutuals through that period.

Mr Minz—You raise a good point. For instance, one would wonder why we didn't go down; I think if you have a superior banking proposition, from a customer perspective, in pricing and service it will hold them there. But at the end of the day if you look at the access to funds that the banks had versus the mutuals over that period of time, it was that imbalance that stopped us from making further inroads into the rate of growth that the banks had over that time.

CHAIR—From what you just said then the major reason you were not also able to capitalise on basically the demise of the non-ADI sector, in the same way that the banks did, was that you did not have access to funds through that period?

Mr Minz—To put it fairly, there is a range of sources of funds for all players in the Australian marketplace. That is composed of AA-rated entities and ourselves who have an investment-grade rating and others who are not rated. In that time frame we saw the government do things such as the wholesale government guarantee. We were one of the few smaller players who actually participated; it cost us one arm and one leg, but it was still able to be utilised within our overall mix of funding to be cost effective. Had the pricing been not quite so discriminatory who knows what other pricing pressures we could have put on the banks and what other rates of growth we could have achieved organisationally. It comes down to who you are as an entity, the sources of funding, what is available and how you use that. I think Heritage is in a very special position with those ratings to be able to access wholesale funding. We have specialised expertise through our treasurer in the securitisation area but a very good retail base as well.

CHAIR—We can raise the wholesale guarantee; clearly you would have had to pay a higher rate than the major banks.

Mr Minz—Yes.

CHAIR—And that made a material difference to your ability to compete on price, particularly given that the investors looked through the guarantee anyway and tended to price accordingly.

Mr Minz—That is a good point. They looked through the guarantee and they doubled up on the margin. But in terms of that initial fee for the guarantee, an extra one per cent on $680 million for an organisation that made $42 million last year, that particular margin effect is quite substantial.

CHAIR—Presumably, you still have guaranteed funds that you are paying the higher premium on, on an ongoing basis?

Mr Minz—Yes, we raised funds over two-, three- and five-year tenures so that will run for a number of years to come.

CHAIR—You also continued paying the government the higher premium so that will have a continuing effect on your cost of operations?

Mr Minz—That is correct. The government raised substantial funds in this particular area, which I firmly believe means there will be zero dollars in potential loss. All we are asking for in our submission is to revisit the wholesale government guarantee and look carefully at the true cost of what a guarantee would cost. Entities in the Australian marketplace which are regulated by the one entity, APRA, are subject to the same prudential standards. If government wishes to protect the deposits, that is fine. Let us look at all the issues around that and put an appropriate fee on it. I do not believe the 150 basis points that we were charged was reasonable.

CHAIR—I think you mentioned in your submission that the activities that you and your counterparts look at are probably less risky in some respects than some of the activities that the big banks get involved in.

Mr Minz—That is correct.

Mr Williams—The market has not returned to normality yet, so there is a requirement for us to at some stage refinance those government-guaranteed funds. Until the market is truly functional there is a risk that we could pay even more than the guarantee fee to try to get those funds—

CHAIR—My next question was actually going to be: if the guarantee were still available on an equitable fee basis is that something you would still be looking to use?

Mr Minz—Most certainly.

CHAIR—Would that help you meet additional demand and try to grow your market share, presumably, if you could access more funds on that basis?

Mr Minz—Certainly, and doing it prudently. For instance, if it was available it would not be prudent to go in there and become heavy in wholesale funding in that area. We tapped into repo funds for the Reserve Bank of Australia and we were able to wean ourselves off that $200 million last year as part of a basket of sources of funding. We see that some of the options that the banks are putting a lot of work into right now will benefit them. Covered bonds are one of those. I believe that they will be able to raise funds at 40 basis points above the bank bill swap rate. Securitisation is approximately 130. Those AA-rated entities will be able to access a new source of funding that BBB-rated entities like Heritage will not. If there was another option, like a reasonably priced wholesale government guarantee, then that would be attractive to us and to competition.

CHAIR—I do thank you for your submission because you have made some well-argued recommendations in there which we will look at. We are not going to have time today to go through each one of them in detail. I will just move off that slightly and just say that late last year we had a lot of evidence that there was very strong competition in the deposit market for retail deposits, which is obviously of huge interest to a building society, but there was not so much competition in the market to actually lend it out. Recent reports in the paper suggest that the big banks are actually getting to a point where they have got more money than they really know what to do with. Is that your sense of the market and, if so, what impact is that likely to have?

Mr Minz—There are a number of factors in there. We have seen, ourselves, significant growth since October in retail funds compared to the previous six months, so that was good. But I think there were a number of factors in play then. I think overall confidence by consumers and by depositors cannot be ignored. We talk about two-tiered economies. I think there is still a level of pessimism that, as Mr Williams mentioned, internationally we are not out of this yet. There are a number of different factors about confidence and where investors, if they invest in equity markets, will put their funds back in to banks, building societies and credit unions.

As to whether the banks are making noises at the moment in terms of trying to at least look competitive in their products and their pricing, I would like to see an environment that ensures the competitiveness continues into the long term and not just for the duration of the Senate inquiry, so to speak. I think that the banks, in raising over $22 billion in profit last year, will not change their colours. It is the underlying fabric of the system that ensures competition—coming back to what I said before in terms of access to funding—which is most important for the future.

Mr Williams—Heritage itself actually borrows money from the major banks, so when they are flush with cash some of that will flow back to us, albeit at a higher price than we were paying a couple of years ago.

CHAIR—But that may well assist you in some ways.

Mr Williams—I think that in Australia the market generally is very reliant on the banks to provide funding and capital flows. That is why the majors have been so successful in making so much profit.

Senator HURLEY—As to that funding issue, the suggestions you made in your submission require accepting more risk basically sector-wide in terms of regulation and also government assistance, meaning that the government accepts more risk. As Mr Williams said, we do not know if we are out of the woods yet, so it is a big thing to ask to accept more risk on behalf of an organisation like yours.

Mr Minz—I just do not want to get my hands back on this one but we have a very sound banking system. If you look at what happened elsewhere in the world with major banks that failed, that did not happen in Australia. We have a very strong prudential regime. We have a government that we have to thank for all the planks of stability they put in place, but they are saying they are not willing to invest in investment-grade ADIs in Australia prudentially supervised under the same prudential standard by APRA. All we are asking is to have a look at what is the true risk of the government investing not just in the AA piece or the AAA piece but in other components of the industry, including where the mutuals sit.

Mr Williams—To some extent the government is already bearing a risk to our sector through the guarantee and through the financial claim scheme. We do not believe that there is enough recognition given to the prudential regulation regime as opposed to reliance on credit rating agencies that actually overseas have not covered themselves in glory with some of the decisions that they have made. If the government cannot back the view of APRA then perhaps they are exposing themselves in other ways such as through the guarantee and the financial claim scheme.

Senator HURLEY—When we have talked to the banks they have said that they need a return on equity of 13 to 16 per cent—somewhere in that range. What is your view of that? What kind of return on equity do you look for?

Mr Williams—We generally do not profit maximise, and that is the beauty of the mutual model. But it is essential to our business in the sense that we have to satisfy the prudential regime so there are minimum capital requirements that you have. Mr Minz made mention of the fact that we have readjusted our balance sheet over the last few years. A lot of that has been increasing our capital levels which will position us for growth. One of the key aspects of a mutual is that access to capital. Being able to compete going forward is also a part of our submission that is important to us.

Our internal capital regimes are below that level that you have made mention of but they are still in double figures. So from our perspective, we would need to have a level of return on equity that is comparable to our risk appetite, which we must admit is much less than what you would see at a major bank who have a much more diversified business structure than what we do.

Senator HURLEY—It is interesting you mention diversified business structure because it has been put to me that the return on equity in their mortgage lending area is much higher than in other areas. That figure that they are talking about is the consolidated figure; there are some business areas that have got a much higher figure than that. Can you comment on that?

Mr Williams—There will be cross-subsidisation across their balance sheet, and they will price for risk, absolutely. From our perspective, we do not perceive ourselves to be a risk but the perception that as a BBB it is harder for us to raise funds puts us in a difficult negotiating position with the major banks. So they will have their internal assessment. They will price where they can get away with, and that is where the competition issue becomes critical, particularly for someone like us who is also relying on the major banks. But all of the other sectors of the economy who are relying on the banks have to play that game.

Senator HURLEY—Changing topics to ATMs, you have a network of ATMs and you pay Westpac for access. What is your view about whether that is a fair price or if there is sufficient competition in that market?

Mr Minz—I think through designation regimes through the RBA we have had an intense focus on that now probably for about 10 years. We now have this direct charging regime which is in operation for Heritage. What we did in October was to network with Westpac to provide our members with free access to 3,000 ATMs. There are two issues here: what you charge through your transaction fees for using bits of your distribution versus what other people pay when you go to an ATM whether it be a third party or owned by a bank. I look back sceptically over the last 10 years because I remember the first meeting we had down in Sydney when the RBA called that meeting. The big thing that came out of all of that was the visibility of the move from what was interchange fees through to direct charge. But I think if we looked at what the consumer is paying in a quantum, whether it is in a transaction fee or a direct charge, my thought would be that it has not changed much over the last 10 years. Whilst there is more visibility, I am not sure whether the consumers are better off.

Mr Williams—It has actually changed the business model in the sense that now scales are deliverable. Heritage will continue with its 100 ATMs but essentially it is not a sufficiently large network to attract the interest of other participants so that is a cost that we will bear as part of the business, but it has changed the business model for the wider ATM providers.

Senator HURLEY—As I understand it, what you are saying is that despite the fact that it has been shown that customers will now try not to go to foreign ATMs and pay the $2 fee, or whatever it is, that you believe in aggregate they are still paying about the same.

Mr Minz—I might challenge that first clause because consumer behaviour is very interesting. I have seen someone not walk 20 metres to a Heritage ATM and use what we call a foreign ATM, so it does come down to the individual consumers and whether or not they are willing to change their behaviour. We have seen, I think overseas in America, when they brought in the regime that there are short-term changes of behaviour but it does not persist.

Senator XENOPHON—On the issue of the guarantee and how that made the playing field less level, what practical measures would you suggest to deal with that? I think one suggestion we heard from a previous witness was that if there were going to be a ban on exit fees that would only apply to the big four rather than other lending institutions. What straightforward measures do you think would help redress that imbalance that has been magnified since the GFC?

Mr Minz—You might note from our submission that I did not just put in those particular suggestions that might purely benefit Heritage Building Society or the mutual sector—although you will see that there are some of those—but I do believe that the industry participating in mature bullet bond and covered bond arrangements is healthy for the industry. More funding means that the whole industry is better off. But for a more level playing ground, there is a range of options in there around continuation of that in the form of a cap of the government guarantee at the retail level.

There are things that I think we can do for mutuals that are unable to pay back to their owners franking credits where the owners of listed entities can do that through dividends. In the submission we talk about looking at the capacity and flexibility to allow this particular sector to engage and to provide benefits back to our owners.

In the area of revisiting the wholesale government guarantee, all I am suggesting is that we look at it in a very measured pace around what is the cost of that credit risk and applying an appropriate fee. I do not believe it is the 150 basis points that came out late in 2008. I do admit that in late 2008, much of the world was crumbling and there were very hard decisions that had to be made at the time. We can do this without those particular issues, looking at the unintended consequences, looking at the true cost of reintroducing the wholesale government guarantee.

Senator XENOPHON—If there were one or two key issues, what do you think would redress in part the imbalance?

Mr Minz—I just need to ensure that, whilst right now we are not in a very good competitive stance, we have seen the benefits that the majors have picked up, first, because they seem to be too big to fail; and, second, because they had access to the much cheaper wholesale government guaranteed funding and they are now about to go into covered bonds, which will be a bonus for them. I want to make sure that that competitive interest does not get any worse by looking at a range of the issues that are in the submission and summarised in those three points I mentioned earlier.

Senator PRATT—You have mentioned the fact that you are not in a particularly good competitive spot at the moment but you have referenced the advertising of the fifth pillar in terms of mutual ADIs and their potential. I suppose it seems to me that banks do seem to spend a lot on advertising that enables them to continually nationally consolidate their position. How much cooperation is there in the mutuals to consolidate your advertising and build up your brand? Is that something that is viable for you or do you see yourselves more as a very distinct brand?

Mr Minz—There is a very interesting set of issues in that question. I am not quite sure I would see the CEOs of the four major banks arm-in-arm in a combined advertising campaign—

Senator HURLEY—No, their individual marketing power is huge—

Mr Minz—Yes, I know. And they have the scale to be able to press that brand out. The mutual industry is made up of approximately 130 discrete, very independent organisations that have come from different backgrounds, bonded credit unions to regional credit unions to building societies like us. They are different sized entities from what we call 'large' but in the scale of things they are still minnows, much smaller entities.

I think it is important that whatever we have by way of competition, it is good to ensure that there is some form of fifth pillar which keeps the banks honest. But it is also up to the 130 financial institutions to do what Heritage has been doing for quite some time, which is to make sure that we are relevant and we are managing our risks, remaining profitable but staying true to our member proposition.

The mutuals have joined together since 2006 through Abacus to provide industry support and in the last 12 months have engaged on their industry promotion campaign. It comes back to the members. That is something which the majority of mutuals have participated in in a whole range of different advertising and media fora and that campaign continues.

Senator PRATT—What about cooperation between mutuals in the other areas in terms of balance sheets and being able to jointly raise capital? Is that something you have looked at?

Mr Minz—From my perspective, we are an independent organisation that has done our ratings and we look at our pedigree and say, 'That is really good.' I think there is some benefit in some transactions of collaboration between some of the smaller entities. They need to get past the weakest link syndrome in a particular transaction. They need to make sure that APRA is happy with these particular issues. But you need to look at what the potential transactions might be, and 130 mutual financial institutions aggregating will not receive a AAA covered bond transaction. I encourage and I support collaboration. I am just wondering whether or not there are any viable options for using that collaboration right now.

Mr Williams—We have demonstrated that you can actually do it independently if you put the focus on it and if you put in place the skills and the systems. There are other players out there who rely on aggregated models and they have had various levels of success, for want of a better term. A lot of it comes back to the individuals again and their needs. We think it is something that can be looked at but getting the priorities of all the institutions represented well is tantamount to herding cats in some instances. It is not an easy proposition and Mr Minz has made mention of the fact that there are a number of different scale businesses involved.

Senator PRATT—So some mutuals, such as yourselves, will be better placed than others to grow by yourself?

Mr Minz—That is correct.

Senator WILLIAMS—In relation to this wholesale funding guarantee of 150 points, am I right when I say, okay, foreign borrowings may be at four per cent, so you have to pay 5.5 per cent whereas a big, AA-rated bank might be paying 4.4 per cent; is that the situation?

Mr Williams—Essentially, yes.

Senator WILLIAMS—That 1.5 per cent you are paying goes to the government as a premium to guarantee your loan is repaid?

Mr Williams—That is right but there is also an element that goes to the investor and, as Senator Bushby pointed out, we actually pay more on that leg as well.

Mr Minz—They look through the rating.

Mr Williams—So I can say that, if a major bank was paying 50 basis points, we may be paying 100. Then we pay the government 150 whereas the major banks are paying 70, so there are two levels of extra payment that we are making.

Senator WILLIAMS—Let us look at Westpac-St George. Profit, $6.3 billion—they are a big bank. You are a small organisation with a profit of $45 million. Because you are smaller your return on investment capital could be equally as good. You are rock solid. Why are you BBB-rated and they are AA-rated? Is it simply because of your size? Obviously you are a sound organisation.

Mr Williams—The key issues from a rating agency perspective are diversity of income—that goes to sustainability over time—geographic concentration, because we are a regionally based organisation and it is something that has not been discussed yet—we actually service a part of the world to a much greater extent than some of the major banks do—and the third is capital. We have limited access to capital because we are a mutual model and we rely on retained earnings primarily whereas a listed bank can go out and raise capital through the wider market with ease. Those three things are held against us from a rating agency perspective.

Senator WILLIAMS—If you were an Australian dictator who had control of the country for 12 months, what would you do to level the playing field in this whole financial industry?

Mr Williams—There are some simple changes—and they are more or less summarised in our submission—but access to capital and funding is the key. The major banks are able to do that because they have done a great job for a number of years to build up their capital bases, to build up their franchise. They have access to markets that we could not hope to access. If the government is willing to take a bit more risk and allow us to access a wider variety of funding markets then that would certainly help a lot of the smaller players to compete. Some of the proposals that have been put forward will help not just us but the industry in general, but there is more that can be done. They do not have to be major shifts in policy, they just have to be subtle changes that allow smaller players to gain more traction with respect to funding markets.

Senator WILLIAMS—You do not have establishment fees or exit fees at Heritage; is that correct?

Mr Minz—No, we do. We have both establishment and exit fees. We also have those fees and rates competitive with the banks. We also position ourselves from a pricing perspective to be superior to the banks. I know there is obviously a lot of discussion around the exit fees and the removal of those exit fees for new loans as of 1 July. That is something we will come to terms with as well.

Senator WILLIAMS—You will not have any problem with that?

Mr Minz—No. My perspective is that we are not price leaders on this. The major banks will determine what happens, even though at the moment they are split in terms of what they are doing in terms of exit fees.

Senator WILLIAMS—Can you understand the smaller non-ADIs wanting to retain exit fees?

Mr Minz—From my perspective I have not given the smaller non-ADIs much thought. I have been more worried about the Heritage Building Society. From my perspective, I need to make sure that I look after my borrowers and my members. At the moment some of those exit fees are about recouping establishment costs which we do not charge up-front, and that is standard for the industry. That is something which the industry will react to. Our DNA will put us in a superior position because we will look to make sure that whatever changes we make because of changes to fees, we will do it to give a better proposition to our members.

Senator HURLEY—You mentioned that you were on a number of boards and consultative arrangements. Do you have any direct relationship with Treasury in terms of discussing these issues?

Mr Minz—I am on the board of Abacus and through Abacus we have a direct connection. In more recent times, the treasurer, Paul Williams, has been involved as well.

Mr Williams—I have spoken to numerous individuals at the Treasury.

CHAIR—I note in your submission that you actually conclude after explaining why the banning of exit fees may have a perverse outcome of reducing the competition the government is attempting to stimulate. You are talking particularly from your perspective about the fact that either it leads to reduced services or the alternative is to absorb the cost and reduce profitability, which reduces your potential to use your profits to fund further growth. My question is: on that basis, even though you say you would live with it and work with it, you do not think it is a desirable outcome?

Mr Minz—My preference in life is user pays and I believe the RG220 guidelines from ASIC are reasonable in saying: here are some costs which you can reasonably charge your borrowers. And I agree with that philosophy totally. If you take those costs away totally, they will come back somewhere. Someone will end up cross-subsidising the fact that a borrower leaves in 12 months rather than staying for 30 years. There may be some benefits in competition for that person who wishes to go elsewhere but for the rest of the population, they are paying for that.

CHAIR—Thank you for your assistance today.

Proceedings suspended from 10.19 am to 10.31 am

AUSTIN, Mr James Neil, Chief Financial Officer, FirstMac Group

CANNON, Mr Kim David, Managing Director, FirstMac Group

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

Mr Cannon—Thank you. We thank the Senate committee for allowing us to contribute to this inquiry. In summary, FirstMac is a Brisbane based company. We have been established for over 31 years. We were one of the first home loan companies to offer a competitive home loan product to the Australian public back in 1991, and since then we have been involved in a lot of the competition that has affected the major banks in the marketplace. As we have grown through the times with business, at one stage I think we had written about $9 billion worth of home loans throughout Australia. We are not geographically limited to just lending in Queensland. We lend throughout the whole country.

As we have used funding over the years to compete against the banks, we have found that as the markets change we have had to adapt to those markets. We have initially used a lot of bank funding through a lot of the smaller regional types of banks to fund our business in the early days. We got involved in securitisation back in 2003 and have used that as a quite extensive part of our funding base since then.

It is interesting when we listen to what goes on in the markets. In the latter part of last year, there was a lot of talk about the fifth pillar as being a lot of the building societies and credit unions coming back into this country as a major source of business. Up until the financial crisis in 2007, you could see that the non-bank space was slowly growing up against the major banks and a lot of these mutual building societies were starting to fall away. As we go through the crisis and come out the other side of it, there seems to be a lot of emphasis on a lot of the mutuals being the next big thing as competition.

As I have said in a lot of instances, a lot of these institutions have been around for a long time and done nothing for the last 20 or 30 years, and I do not see how they can provide a lot of competition going forward. There needs to be a rethink about where the market is and looking at the new world of banking as it transpires. I will get Mr Austin to just quickly talk to you about our involvement with the AOFM and securitisation and where we see it at the moment.

Mr Austin—FirstMac, like a number of the non-ADIs, has been a major recipient of AOFM support. We have done four transactions over the past three years where the AOFM has cornerstoned, in addition to two transactions without AOFM participation. The participation by the AOFM has been very welcome and has certainly stabilised the funding availability and the ability to access RMBS funds throughout that period. I think the industry recognises, as well as FirstMac, that ongoing government intervention in markets is not ideal and we would all like to see a move back to free-operating markets. A lot of our approach is designed at how the AOFM can now start to step away from the market and what it is that is required to bring back access to funding.

The previous chairman of the Heritage Building Society made a comment, which I endorse, that competition will come with access to funding at appropriate levels. The key to funding flow, I believe, is again bringing foreign investors back into this marketplace. The domestic market is only so big in Australia and we do need to access foreign markets as well. Mr Cannon and I have just returned from the US securitisation conference in Orlando two weeks ago. There is a willingness by US investors to look at non-US assets, still denominated in US dollars. To that end, a bullet bond structure is something we do support. It is something that makes a currency swap cheaper and more efficient to be able to raise those funds. Likewise, we have referred to subordinated debt investment. The point with subordinated debt investment is that there are investors in the market who will look at this AA-rated portion of the structure. However, with government co-investment that can bring a degree of confidence and start to build back that market. So I think that the AOFM participation to date has been certainly very welcome. I think the steps that we are proposing now are to allow them to exit from the space and to bring investors back to allow a flow of funds, which will ultimately be what will dictate competition.

CHAIR—You mentioned in your opening remarks and also in your submission that essentially the mutuals are not capable of providing the sort of competition that the consumers really want. Why is that? You correctly note that historically they have been around a long time, but the real competition that we have seen in the last 10 or 15 years has come from the non-ADIs rather than from the mutuals. Why is it that they have not, in your view, provided that degree of competition and what is it about their structure that stops them, but that your structure enables you to take them on?

Mr Cannon—Interestingly, we have been talking with APRA for a number of years about getting a banking licence and establishing our business in the banking area where we could offer competition. I suppose in the mutual space a lot of the mutuals have been around a long time, the world has changed around them and they have not adapted to what is going on. We have taken some positions in a couple of building societies over time as shareholders to see if we could get closer involvement with the way that they are running their businesses and everything like that.

A lot of the things that mutuals do these days, like having branches and that type of thing, are great for service, but the borrowers and customers have now become more sophisticated. They are using the internet a lot more and ATMs. Having a local branch is not as great a need in a local area as it was in days gone by. I actually had one chairman of a mutual recently tell me that he thought that their branches were now being used for lonely people to come and have cups of tea during the day rather than actually transact business.

The world is changing around. The model changed. As we look forward and we look into the marketplace at where we want to be, FirstMac has always been a high-volume, low-cost operator in the housing side of things. We see competition-wise down the track that the next playing field up against the major banks is to be able to offer a full suite of products to customers out there and not just a home loan. That is why we have been looking in that space.

CHAIR—So essentially you are saying that they, to some extent, are constrained by existing structures. The reality is that one of the criticisms of the major banks over the last 10 years is that they were closing down branches and in terms of at least the PR—not to argue what you are saying about the need for branches—or customer relationship perspective they are reopening branches now and saying, 'Look, we are listening to you and we want to go back to the people.' As I understand the point you are making, the fact that they have branches—and we are now talking about the mutuals in particular—means they are constrained in their ability to be flexible and innovative in their approach to customers' needs because it is hard to close them down?

Mr Cannon—I think, talking to some mutuals over the years, they believe that if you have a branch out in the middle of the bush somewhere they are going to get all of this deposit money from a farmer. What they do not realise is that the farmer these days has a satellite phone and an ING account over the internet. He does not need to have a branch to transact his business anymore. So, going forward, technology is changing the world, there is a new world out there and since the global financial crisis we have to adapt to it. We are one of those organisations that has adapted to it from the mortgage side of things, and that is where we are looking to add greater competition to the market down the track.

Mr Austin—I think our competitive proposition has always been a combination of speed of service and the price competitive product. The non-ADIs, through a far cheaper operating structure, have traditionally offered much lower priced mortgages, and our speed of service is built around being able to process very quickly, which allows borrowers to have a clear differentiation. If we look at a typical CBA mortgage, it can take you up to a month for a loan application. We will process ours in 48 hours.

CHAIR—I am in the process of looking at refinancing personally myself, with one of the majors who told me that they could process in 48 hours once we get it all sorted. It remains to be seen. I will be able to test that one out. On that, though, in terms of looking at the right model for the times, I cannot recall exactly who it was but one of the witnesses that we have had before this committee—in discussing the competition that was brought by the non-ADIs, particularly in the late nineties and early 2000s, and the beneficial impact that had on competition, and looking at where we currently stand post GFC—was making the point that they were the right models for the time but it is questionable whether now, post GFC, such models are the right models to take competition forward.

Mr Cannon—I agree with that to some degree. There will always be a market for a cheap home loan out there. That is why we have been looking from a bank licence perspective at providing full service where we can offer everything to all customers and then maintain the long-term relationship with those customers. It always amuses me, because we are in the lending side of things—it amuses me from the lending point of view—that we are over regulated with UCCC and NCCP on how we lend money, but nobody seems to care that banks do not pay a lot of interest to people when they have money on deposit in their bank accounts. I see a new playing field of the future being potentially with new players coming into the market whereby fair interest on deposits to customers and consumers out there should be a major benefit. Again, a low-cost operator like us is looking at that going forward.

CHAIR—But that leads into the question, which you note in your submission, that you are having trouble becoming an ADI because of the rules surrounding ADIs not fitting the type of operation you are. Would you care to expand on that?

Mr Cannon—At the moment there is legislation that limits a single owner to a maximum of 15 per cent ownership or control in an ADI. When you own your own company 100 per cent, it is very hard to say, ‘I am going to turn FirstMac into an ADI and only control 15 per cent.’ That does not make sense to me.

CHAIR—What is the argument behind that requirement?

Mr Cannon—When you talk to the regulators—APRA—the legislation was put in a number of years ago and it was on the basis that they limit the one single control of shareholding over an ADI, the main factor being that if the ADI needs more capital and there are more shareholders there you can go out and raise more capital from the other shareholders and keep the ADI afloat, which sort of contravenes what a mutual does, where they just have members and if the mutual needs more capital, well—

CHAIR—Presumably, under APRA’s supervision they have to put in place requirements in terms of capital holding anyway—as an ADI and that could be addressed by ensuring that the appropriate structure of the institution itself is adequately capitalised anyway?

Mr Cannon—Yes.

CHAIR—They get pretty upset if things start looking like they are not meeting their requirements.

Mr Austin—That is true, but where a mutual has the ability to grow their business, they are constrained if they are unable to raise capital, which they cannot get through members.

CHAIR—I guess it comes back to the question I asked you earlier to some respects—that is, why mutuals have not been taking it on, because they do rely on their profits to some extent.

Mr Cannon—The mutuals are disappearing. There were 250 three or four years ago. Now there are 120 or 130.

CHAIR—Some of them have got a lot bigger as a result.

Mr Cannon—But I think from the regulator’s point of view, looking at what is happening in the global world and what is changing out there, more and more of those mutuals will disappear over time.

CHAIR—You also talked about securitisation, which is obviously a key focus of this inquiry in terms of funding of potential competitors to the banks. The Reserve Bank governor made the point on one of our first days of hearings in late December—and I may get the figures slightly wrong—that there was roughly $50 billion of RMBS issued prior to the GFC and that dropped down substantially, I think down to about $10 billion or $15 billion a year during the worst of it. But that has built back up to about $30 billion. He also then went on to say that about $20 billion of the pre-GFC securitisation activity was being generated by special investment vehicles that, in his view, were unsustainable and were unlikely to return. He thought that the $30 billion was roughly around where it was going—the natural level—ignoring the special interest vehicles. Do you agree with this and, if not, where do you see the initial investor interest coming from, given that the SIVs are unlikely to come back in the same format?

Mr Cannon—Interestingly, the recent government changes allow the four majors to fund on covered bonds. The question will be, ‘Will they be in the RMBS market in the future?’ and if it is the case that they will raise that money that they would normally go through RMBS for via covered bonds that leaves a big hole in that market. Non-banks, like ourselves, who are involved in that securitisation get an added bonus, I suppose, from having fewer players in the market, albeit the funding cost is a huge difference.

Mr Austin—I think the other key point there is that the SIVs were buyers of predominantly major bank issued debt, and the larger regionals. SIVs have never invested in FirstMac RMBS. I absolutely agree with the numbers that the governor has said—and that is the case—but largely they bought the very large megadeals, the Westpac deal at $7 billion. CBA did similar numbers. The SIVs were buyers of those in large scale. They were not buyers of the smaller ADIs and the non-ADIs. That space of securitisation has typically been managed funds.

CHAIR—The question then remains: is the $30 billion that we are seeing per annum at the moment invested in RMBS being spread out from what might have been more concentrated on the smaller players across the whole financial sector, which means you are getting a smaller chunk?

Mr Austin—No, it is not. The major beneficiaries of those SIVs were the banks, and those major banks have exited the RMBS market. They can obtain cheaper funding elsewhere, so it is no longer the best place for them to be.

CHAIR—But you do not have that option?

Mr Austin—We do not have that option.

CHAIR—I will hand over to Senator Hurley.

Senator HURLEY—I would like to continue on the theme of access to funding. It seems to me through this inquiry, a lot of people, when they are talking about access to funding, want the funding levels restored to 2006 and 2007 levels. There is some school of thought that that is a bad level to want to return to; that we should go back a bit further; that 2006, 2007 and 2008 were unusually high levels of funding, which induced quite risky behaviour and a slipping of standards. Would you like to comment on that?

Mr Cannon—I think the market determines where the level of risk is.

Senator HURLEY—Not if you are asking for government intervention in the market, which you are.

Mr Austin—I think the levels are certainly not back to 2006. I would suggest probably more like 2003 and 2004. There is not the volume of transactions. We were able, in 2006, to do a $1.5 billion deal.

Senator HURLEY—What you are saying is you would like it to return and you would like the volume to get higher?

Mr Austin—Absolutely.

Senator HURLEY—But it seems to me that you are arguing that the government should accept at least a part of that risk of going back to those levels.

Mr Austin—No. My view is that we should be reverting to free markets without government intervention, and I think that we should be looking to steps that now exit the AOFM. Obviously, you cannot go from night to day. You need to transition it. That is where I think ideas along the lines of the bullet structure—participation in subordinated debt—is where we can start to reduce the level of AOFM. AOFM investments have also dropped from roughly 50 per cent of transactions in the initial period down to around 20 per cent to 30 per cent now. It is scaling back.

Senator HURLEY—But you are asking for wind back in some of the risk management?

Mr Austin—The subordinated debt?

Senator HURLEY—Yes.

Mr Austin—With the subordinated debt, that is currently the toughest part of the structure to place. It is also the riskiest part of the structure, too. It is AA- rated. However, there are a number of small investors who will participate in that area, but largely the Australian market for that space is held by one particular investment category—a few investors—and really it is held to ransom in many regards. If the government were to invest in that space, it brings some smaller investors in and it brings confidence to bring other investors into that area. I would certainly only suggest this as a short-term process leading towards full exit. Investment in that part of the structure also reduces the total dollar investment that the AOFM would be participating transactions and so gradually reduce their involvement in the market.

Senator HURLEY—There are also some people—and the Westpac CEO, Gail Kelly, was one of these—who say that any move to increase funding availability to financial services providers, such as yourself, is risky, given that these providers do not have the same underwriting standards, capitalisation or profitability benchmarks.

Mr Austin—I think the underwriting standards we can certainly say are of the same level. Westpac provides us with warehousing and they have completed due diligence on our business, and it has had the same levels as their own. Our arrears levels—delinquency, loans in arrears more than 30 days—is at one per cent compared to the industry-wide figure of 1.5 per cent. We are consistently under the average. Our underwriting standards are the same. As far as capital—yes, that is true; we do not have the same capital level as an ADI, but equally we have a business that is mono-lined—residential mortgages only—and it is fully mortgage insured.

Senator HURLEY—What about the profitability benchmarks?

Mr Austin—I heard the comment in the previous session that the banks look for a return on capital of 13 per cent to 15 per cent. I think that is probably where a business should be run. It is fair to say that we are not running at those levels over the past three years. Historically, that has been our level and that is our target we want to get to. Over the past three years, the involvement of AOFM in our transactions, whilst that has certainly allowed us to be stabilised and sustained through this period, is by no means at levels other than breakeven for us. We have been able to continue to operate through this period of instability, which will allow us to fight another day as those markets stabilise.

Senator HURLEY—You talk about being fairly nimble in the market and innovative, which I am sure is true, but if you become an ADI, as you have asked to do, that will limit your ability to do that, would it not?

Mr Austin—We have looked at this from two approaches. One is to convert ourselves to an ADI. The second is to invest in an existing ADI and have a relationship with it, and we have pursued that path. What we would see is an operation of a dual model, or a hybrid model, if you like. What we do is distribution. We are able to distribute and sell product. We would see ourselves as a natural partner with an ADI to distribute product and still be able to operate our existing platform and business as it stands.

Senator XENOPHON—Some submitters have called on Australia to establish its own version of the Canada Mortgage and Housing Corporation. How would you see that working? Do you think that has some merit and how would you see it comparing with the current RMBS market securities through the AOFM?

Mr Austin—I would compare the two as a temporary versus permanent involvement of government. As to the Canadian model, I think we could say the advantages were that it did operate very smoothly through the whole GFC period. That is certainly true. But the negative is that it does involve a permanent presence of the government in the markets, and that would mean for a 30-year period. Is that desirable? We can see one example of the Canadian model that has worked very well. We can see an example of the US models that, albeit slightly different, have gone quite haywire.

Senator XENOPHON—There is a key difference between the two, is there not?

Mr Austin—There is certainly a difference between the two.

Mr Cannon—I think the biggest thing we looked at from the Canadian model was that prior to the crisis there was a huge amount of funds coming into superannuation and going offshore into government debt and then being invested outside of Australia. The proponents of the original Canadian model being set up in Australia were trying to create government debt in Australia, that these funds could keep this money in Australia and be self-funding of the whole home loan market. There are advantages and disadvantages to the whole thing, but with all the superannuation money that is coming in over the next few years it is a great investment to put it into Australian homes.

Senator XENOPHON—Thank you.

CHAIR—Thank you. Senator Williams.

Senator WILLIAMS—Being non-ADIs, you would support the retention of exit fees?

Mr Cannon—We do charge exit fees.

Senator WILLIAMS—Going on some documents that have been I think released under FOI, the smaller players say that the exit fees are more essential because of the cost; simply the scale of their operation—

Mr Cannon—It comes down to the fact that when you do a home loan with a customer, we pay a lot of money to get that customer up front with commissions, that type of thing and advertising and promotion. There is a cost to getting that customer in your doors. The exit fees are to protect us from that customer leaving, and there are a few issues. Nobody that signs up a home loan with us on day one expects to leave in the first five years. When those exit fees kick in up to four or five years, depending on the product sold, customers are fully aware that they are there, but nobody expects to go through it. As we found in a lot of instances, a lot of customers are going in to bank branches and being harassed by tellers to switch their home loan back over to the bank. There is always constant pressure from customers in the banks to move their home loan back over to them.

So, the exit fees, to some degree, protect our ability to offer a much lower rate product to the consumer. If they leave and if the exit fees have gone, yes, it will have an impact on the small lenders' business, and again some of the strategies we are talking about at the moment—we are providing other products via relationships with ADIs—which could make a difference on that side of things. So, again, there are benefits.

Senator WILLIAMS—Given that the big four banks now have 90 per cent of the home loan market as far as finance and funding go, and the government is proposing to abolish exit fees, excluding those basically real costs to the institutions come 1 July this year, would you have a problem if the government banned exit fees for ADIs and let non-ADIs retain them, because they are under separate organisations—one under APRA and one under ASIC? That way the small organisations would be able to retain their exit fees if they wish. The problem we have is that the smaller organisations probably provide three, four or five per cent of the home loan market out there, given that 90 per cent of the big four banks, credit unions, building societies and ADIs, many of whom do not have exit fees including the credit unions—you see where I am coming from—would that be fair under that idea?

Mr Cannon—Personally I think it is one or the other. I do not think you can have a hybrid half and half. If I have suddenly got exit fees and the banks do not, that is all the banks are just going to advertise all day long. They have very deep pockets to advertise. We saw this when the crisis hit. There were a couple of large nonbanks that got into trouble when the crisis hit, and the banks came out straightaway and said, ‘Oh, we’re not affected by the crisis. Nonbanks aren’t safe. Come and move your business to us.’ There was a whole bunch of people just packed up and moved over to the banks immediately. If we had not had exit fees, we would not be here today. That was a deterrent. At the end of the day, the banks’ statements that they were not affected by the global crisis were just an absolute lie.

Senator WILLIAMS—But the country runs on competition, and exit fees do stifle competition. I am trying to suggest to you some way where it would be very simple for the government to leave you retaining your exit fees and the bigger banks—the bigger end of town—remove them. That is all I am suggesting to you, because exit fees stifle competition. I know that through my own personal experience. Would you agree that they stifle competition?

Mr Cannon—They have not stifled competition with us over the years. As I said, if everything is fully disclosed to customers when they go into it, nobody expects to leave on day one. A lot of people get swayed by brokers to move lenders, so the broker can get another fee up front rather than to the benefit of the consumer. In a lot of instances, the exit fees are a detraction for that. It just makes it slightly more expensive to move, and so they do not move and customers get no benefit out of moving anyway.

Senator WILLIAMS—Through my experience, I could have left after the Melbourne Cup rise in interest rates, but I had a $1,000 exit fee. It would take me a long time to get it back. I could have got a quarter per cent cheaper interest rate. I know through my experience that that is why I am with the bank I am with now, because of the exit fee. I could have got a better rate. Surely that is one example where the exit fees do stifle competition.

Mr Austin—I think there is a good example—and probably some far more extreme examples—in the market where margins have been increased significantly and far more than the numbers by some of the major banks where exit fees have come in. I think the point there is that you cannot look at exit fees in isolation. It also needs to be looked at with what happens to margins and interest rates.

Senator WILLIAMS—The only reasons anyone would ever want to leave the institution they are with surely is that, firstly, they have a blue with someone they are dealing with or, secondly, they think they are getting ripped off.

Mr Austin—I would say that at the height of the housing market activity, one of the main reasons left is they were taking finance that was akin to development finance. They were doing a renovation and moving on. Really, if they are doing that, they should be paying development finance rates and not coming in to a housing loan. The vast majority of borrowers do not leave within five years.

Senator WILLIAMS—Yes, exactly. Probably 97 per cent and 98 per cent do not leave within five years, yes.

Mr Austin—In which case, there is no fee. It is a contingent fee so it is not paid.

Senator PRATT—Can I ask you who your customers are in comparison with the general profile of a home loan customer?

Mr Cannon—We have a broad range of customers. We originate our business via two channels. We have brokers that originate loans to us and we have mortgage managers that originate loans to us. A mortgage manager is almost like a mum and dad mortgage company that operates in a town or a city somewhere and they provide that added service to customers. There is no real variation to what we do. Prior to the crisis, half of our business used to be small business via low doc lending and prime mortgages—the typical housing side of things. Since the crisis we have reduced our maximum LVR to about 80 per cent. We have stayed away from the first home buyer market, because we had no end place to put that product. The investors were not interested in highly leveraged, high LVR pools, so we had to originate what we can get in that market.

Senator PRATT—I suppose your loss of the first home owner market, in terms of being forced to push that away, clearly would have ended up in large part with the major banks?

Mr Cannon—The four major banks picked up the majority of that first homebuyer thing. Just before the first home owners grant ended—

Senator PRATT—So, people were moving into the market during the crisis, and that was a particular government program.

Mr Cannon—Yes.

Senator PRATT—What about your investors? How important is the strength of the Australian housing market to attracting investment here?

Mr Cannon—We travel overseas extensively to talk to investors in Europe and the US. We go to a securitisation conference in the US every year. Three years ago we started talking to investors and they did not even know where Australia or even Canada was; they were so focused on the US market. That was their world. Last year we were over there, and some of these US investors started talking to us about maybe buying bonds out of Australia. On this recent trip we were swamped with investors who wanted to know about Australia, so much so that a lot of these investors even see government debt in the US now as subprime debt. International investors want to come to Australia. It is figuring out the pricing and the swap to get it down here.

It is the same old story. We are at a cost of funds base here at the moment, because that is what the domestic investors have. They have no competition from international investors to force the rate down. As soon as we can get those international investors to invest here at the right price, we will start being more competitive.

Mr Austin—What we experienced this time in Orlando, as well as the other Australian issuers who were there, is a lot of questions about whether there is a housing bubble and are we living on borrowed time in Australia?

Senator PRATT—What is your answer to that?

Mr Austin—No. We have seen the commentary from the Reserve Bank and we restate those comments.

Mr Cannon—The trouble with international investors is they pick up the *Financial Review* and see the front page says there is a housing bubble in Sydney or something like that, and they just assume Sydney is the rest of Australia. But if you actually read the article, it is about Sydney Harbour houses, not the general side of things.

CHAIR—There has actually been a shortage of housing for quite a few years in Australia, which makes it very different from a lot of other markets.

Mr Cannon—Yes. We all know that.

Mr Austin—We refer to the lack of availability of housing and the low government debt. It is a very strong story and they do seem to accept it when we tell them that.

CHAIR—Indeed.

Mr Cannon—But because there is nothing wrong with what is out here and what we are doing here, somebody has just said, ‘Oh, it must be a housing bubble’, and that just continues to arise all the time.

Senator PRATT—You are predominantly a Queensland company but, given your business model, there does not seem to be any reason why you should not have a larger national spread.

Mr Austin—Yes, that is right. We are Queensland based, but Queensland represents 35 per cent of our portfolio.

Senator PRATT—What would be the significance of your presence in a state like Western Australia, for example?

Mr Austin—Western Australia is actually our lowest state. It tends to be quite parochial there, so we have found it hard to get into that market.

Senator PRATT—I am from there.

Mr Austin—I take the answer back! No, we only have about six per cent to seven per cent in Western Australia. That is our lowest.

Senator PRATT—Lastly, how important will consumers being able to form their own views using online resources be? Clearly, you go through brokers and mortgage managers.

Mr Cannon—Consumers are starting to use the online presence now. You are starting to see it more and more. Technology is one of our benefits versus a bank. If a bank wants to create a new product or do something new, it is an 18-month to two-year process to change their IT. We can create a new product and be up and running in six weeks or less.

Senator PRATT—How much work do you do to make your products available, for example, online calculators and those kinds of things?

Mr Cannon—Up until this point we have not been much of a retailer; we have been more of a wholesaler. If you go to a broker or you go to a mortgage manager, they will recommend a FirstMac loan. At FirstMac we are starting to do a lot more retail business and we are rolling out our retail strategy at the moment.

Senator PRATT—How does that convert to an online presence? Does that mean you do not have one at the moment?

Mr Cannon—We are just rolling something out with the online presence at the moment. We have an online presence for customers to manage their loans and their finances but—

Senator PRATT—But you do not have a marketing presence?

Mr Cannon—Not at the moment, but I have a subsidiary company called loans.com.au, which is a brand I have been sitting on for about 10 years. That is about to launch in the next month or so.

Senator PRATT—Would you consider, given how quickly the world is changing, that will become a significant driver for competition?

Mr Cannon—The online thing will be a significant driver, except that when somebody buys a home or something like that it is the single biggest thing that they are ever going to do in their life. I still think they have to talk to a human being. That is the current range of people. If you see the younger generation and what they do at the moment, they do not seem to have too many communication skills with things. They have little hand-held devices, so that may change.

Senator PRATT—I think younger people today see the human relationship behind the technology anyway.

CHAIR—You also touched on the bank deposit guarantee, and we have had a lot of evidence about the deposit guarantee in this committee. The reality is that there was an implicit guarantee prior to the explicit guarantee being put on. We have heard a lot of arguments for and against, and you are one of the submitters that has argued against its continuation, in common with a lot of other non-ADIs. There are other alternatives such as extending it to cover funds management or extending an arrangement of some sort to include funds management, which has been proposed. That was one of the criticisms that was pointed at the scheme when it first happened because of some of the consequences, and elsewhere in the world they did cover non-prudentially regulated funds. Are some of these other alternatives something that you think could work or do you think that it just needs to be gotten rid of?

Mr Austin—We fully understand and appreciate why the government guarantee was brought in at the time. I suppose an unintended consequence was it did drive a lot of the funds out of the funds managed industry and into the banks. We heard Heritage talking about their deposits being increased. That is a direct result of the money flowing out of the funds. The funds management industry are our investors. That is where our investment came from, and not the SIVs as we talked about. I think measures that can help the funds management industry as a viable operating platform would be very welcome, and indeed it is that industry who, as investors, will choose what they should be investing in and what they should not. I think that is quite key to the flow of funds. The domestic market has been severely reduced. We still have the same quantity of investors in our transactions, but the size that they invest is much lower.

CHAIR—Thank you for your assistance today.

Mr Austin—Thank you very much.

[11.13 am]

BAXBY, Mr Matt, Managing Director, Virgin Money Australia

BOYLE, Mr Greg, Strategy Director, Virgin Money Australia

CHAIR—Welcome, Mr Boyle and Mr Baxby. I invite you to make an opening statement.

Mr Baxby—Firstly, thank you for the opportunity to appear today. Bringing genuine competition is really part of Virgin's DNA and I hope that the committee is a catalyst for change. To begin with I thought it would be useful to give some background to Virgin Money's Australian operation. The Virgin Group was founded more than 40 years ago in the UK and now has operations in 30 countries and employs 55,000 people across multiple industries, including financial services, aviation, mobile telephony, health and wellbeing, amongst others.

In Australia and elsewhere the Virgin Group has a good track record of bringing genuine competition to the sectors it enters. The most prominent example in Australia is Virgin Blue, which challenged the dominance of Qantas in the Australian aviation market and was a catalyst for a reduction in fares, which has greatly benefited consumers. Virgin Money is the financial services arm of the Virgin Group. Our parent company is based in the UK and the group has a presence in financial services in a number of countries. In the UK, Virgin Money has more than 2½ million customers, recently acquired a banking licence, is building a branch network and a systems capability and has publicly signalled an assault on the UK retail banking market.

Virgin Money Australia originally launched in Australia in 2003 with the introduction of the Virgin credit card, a product which offered no annual fee combined with a low interest rate and in a lot of ways redefined the category. The card was very successful, attracted over 700,000 customers and validated the brand in financial services, and the legacy of that first product continues. Most of the major banks now offer no fee, low-rate cards and it was a sector that we sort of created. I have been with Virgin for eight years, most of that time in the UK, and returned to Australia in January 2009 with a mandate to renew our push into retail banking. Overall the Australian market is an attractive one for us. There is general consumer dissatisfaction with the incumbent providers. The Virgin brand has a strong awareness and good resonance with consumers. It is trusted and I think that is one of the key issues in financial services—a lack of trust.

Across the group in Australia we have more than five million unique customers and we believe there is a demand for simple transparent products that offer a genuine alternative to the major banks. The barriers to entry in Australia are high and we do not underestimate the task. For reasons of stability and prudence, which we support and think are fundamental to a well-regulated banking sector, there are significant capital and prudential requirements for any new banking entrant seeking to acquire a banking licence. Financial services is an industry that rewards scale and efficiency and there is a significant cost associated in developing systems and infrastructure to support a banking business.

There are a number of challenges for participants outside the major banks seeking to access sufficient forms of funding and liquidity, and we know that has been a focus for this committee. The majors dominate distribution, and obtaining a reasonable share of voice in which to communicate product benefits is challenging for new players. Finally, there is inertia amongst consumers, partly as a result of the perception that it is difficult to move, and motivating them to switch providers cannot be underestimated. These are all areas where the major banks have a significant competitive advantage over a new entrant and other smaller players, and naturally seek to take advantage of.

With this context, and having considered all of our strategic options in coming back to market, we came to the conclusion that partnering with an incumbent bank was the most viable way to renew our push in the Australian market. In 2009 we signed a long-term agreement with Citibank to offer a suite of retail banking products. We launched two credit cards and an online savings product in July last year, all with market leading features. During the second half of 2010, based on APRA data we have seen, we were the fastest growing online bank in Australia, which really reinforced our confidence that the brand had an important role to play in banking. We also sparked an uplift in competitor activity in cards—I think all to the benefit of consumers.

Today we offer cards, savings, superannuation, car insurance and life insurance and in our next development phase we are considering how we enter the home loan space, as well as offering transaction accounts and other insurance products. Our objective is to offer consumers a range of products—a genuine alternative to the bank—and our overall philosophy is to try and make everyone better off, to give our shareholders and partners a reasonable return and a fair profit, to deliver to customers fair, transparent products that do what they say they are going to do on the tin, give our team a rewarding place to work and try and give something back to the community.

In regard to our submission, I hope our suggestions act as a catalyst to help bring some genuine competition to the Australian banking landscape. The thrust of our submission is really that stability is fundamental to a properly functioning banking system, but that is not mutually exclusive with conditions which foster competition. Failure to get this balance right will result in consumers being worse off, and for us that is really where it starts, with the consumer.

Our recommendations for actions—and we will obviously take our submission as read—I think fall into three key categories. The first is measures that help level the playing field with the major banks and the rest of the sector, that is, to overcome some of those barriers to entry. I think key parts to this are giving access to efficient forms of funding. We are a supporter of the Canadian mortgage model, which I know has been raised at this committee, and tax incentives to encourage further savings. It is my experience from the UK that incentivising through tax savings helps drive greater deposits, which is clearly an imbalance in this country at this point. Extending the deposit guarantee to the rest of the market—recognising that implicit support was given to the major banks during the GFC—makes explicit that support across-the-board.

Our second range of measures is about encouraging consumers to exercise choice to get themselves a better deal, including switching providers to achieve that. A focus for the committee has been in the area of systems that encourage or facilitate the ease of switch, and I think there have been comments in the committee about the technological difficulties involved in achieving that. I think there are some simple things that can be done to encourage it and there are some models in the Netherlands and the UK that we have had some experience with that have genuinely shifted the dial.

Our third range of measures is about reducing market concentration—the big four banks. Australia is a polarised market. The major banks have more than 80 per cent of the market share and the rest of the market is in the balance. I think that was reinforced during the global financial crisis with the acquisition of a number of challengers, including BankWest and St George. As a result of that it is more difficult for new entrants and regionals to acquire scale. One of the recommendations we have put forward is that it is worth considering requiring the major banks to divest some of those assets now that we are through the GFC. That is as simple as, ‘Would those transactions have been approved in a stable economic environment?’ The answer to that is no. Overall we think that is a measure that would shift the dial. It probably sounds extreme, but we think these are extreme times.

Just to restate our position, we think it is necessary to ensure banking markets are competitive. If they are not, steps need to be taken to encourage greater competition. We do not think that needs to be at odds with maintaining financial stability. Overall, we remain an advocate for competition and we believe that more competition brings a better deal for consumers, not just in a product sense but in service, transparency and everything else that comes with it.

CHAIR—In your opening statement you mentioned, amongst a number of things, that the barriers to entry in Australia are high and that one of them is inertia due to the perception that it is difficult to switch. You used the word ‘perception’. Was that a deliberate choice? Do you think that it is more a perception than a reality, the difficulty of switching?

Mr Baxby—I think there are probably two points there. All of our research says that there is a genuine perception amongst consumers that it is difficult to switch. We have tried to do things that encourage people to exercise that choice. For instance, we ran a piece of research before we launched that looked at the costs of people not exercising that choice and we found that the Australian community could save $10 billion over 10 years by exercising choice, but clearly there were barriers to overcome there, and that is certainly reflected in the research. I think it is simple things, like the fact that your direct debits do not move when you change your transaction account. There is just hassle connected with that. And systems that can help make that easier to do, we are definitely in support of.

CHAIR—Like the Dutch system that you referred to briefly?

Mr Baxby—Absolutely.

CHAIR—*Choice* has put out something recently, which has a very good explanation of how that works.

Mr Baxby—Absolutely. We understand the Dutch system has resulted in around 100,000 customers shifting each year as a result of that. It really did shift the dial. There has been talk of number portability. On switching there is a spectrum, from making it easier to move direct debits across all the way to number portability. I understand there are practical difficulties with the latter, but I think it should definitely be encouraged.

CHAIR—I think there is universal acceptance, certainly politically and I think from most of the witnesses, that increasing the ease of switching, which includes everything from the financial barriers through to the actual practical hassles of doing it, is a good thing for competition. But, when you go down to the next level and actually try and look at how you implement that and what you need to do to make that a reality, some of the proposals have consequences and some do not. One of those issues is exit fees, which you touch on in your submission. In that submission, as I understand it, you essentially think that organisations have legitimate costs that are not just out-of-pocket costs, like paying the relevant land titles office fee for the discharge of mortgage or whatever, but actual administrative costs which you think it is reasonable they should be able to cover?

Mr Baxby—Yes, that is right. I should start by saying we do not offer a home loan in this market at the moment, but I guess we are—

CHAIR—But in terms of your comment, you are—

Mr Baxby—Absolutely. We are looking at how we bring that product to market, so it is pertinent. I think there are a couple of points. There are some genuine costs for an institution of a consumer coming on and then moving off. I think the balance needs to be struck between whether that is an establishment fee or an exit fee and what is going to better promote competition overall. I think our concern is that by banning exit fees the unintended consequence is that other fees emerge on a home loan, particularly around establishment, and that is probably bad for competition. The second point is that I think there is a potential advantage that is given to the major banks by outright banning it for those businesses that are less well diversified than the majors.

CHAIR—I may be wrong, but I think in the evidence that we have had before this committee the only witnesses speaking strongly in favour of removing exit fees has actually been the major banks.

Mr Baxby—Yes.

CHAIR—You recommend, essentially, divestment of the major banks of some of the acquisitions they have made particularly during the global financial crisis. Are you talking about a full forced break-up of the banks to that extent?

Mr Baxby—Again, I guess our logic on that—the argument itself—started with the high concentration that is in Australia, polarisation between the majors and the rest, and that being reinforced during the global financial crisis. I think the other leg of it is the systemic support that the majors have had meant that some of those transactions in a sense were facilitated with government support.

CHAIR—There was certainly one high-profile one that probably went through without as much examination and scrutiny—.

Mr Baxby—Scrutiny, yes, that is right.

CHAIR—without as much weight given to some factors that might otherwise have been.

Mr Baxby—That is right. What we see in other jurisdictions—and I have some experience of this in the UK in particular—is governments looking at some of the transactions that happened during the global financial crisis and considering on competition grounds whether that was the right thing to happen in that market. In the UK, for instance, Lloyds and HBOS were put together and there is now a mandate for those businesses to dispose of some—

CHAIR—A lot of those are now owned by the British government, are they not?

Mr Baxby—Yes.

CHAIR—So it is a lot easier for them to do that than it is for a government here to step into a private business and force divestment. I am not arguing against it; I am trying to explore the issue.

Mr Baxby—Yes.

CHAIR—To use your term, it is an extreme measure and there are a lot of other aspects to promote competition that you have suggested and other witnesses have suggested, which over time if implemented could conceivably help other players increase market share, presumably taking it off the majors, but it would be over time. What you are talking about would be something far more immediate. Do you think that, to quote you again, the circumstances are so extreme that we need to take that immediate action rather than allow the other measures to take effect?

Mr Baxby—We think what one of the fundamental issues that is stopping genuine competition coming in is concentration in the majors. It is a measure that would have a direct impact on reducing that concentration.

CHAIR—I do not argue that divestment would actually have that impact, but it is, as you say, an extreme measure for a government to take. You would need to have a pretty good argument for doing it, a good reason for doing it, and a pretty clear understanding of what the benefits will be and that the measures are desperately needed before—certainly in my view—a government should step into a private business and take that sort of step.

Mr Baxby—Yes.

CHAIR—There are lots of other things they can quite legitimately do, but that is an extreme step.

Mr Baxby—Yes, highly interventionist and probably unprecedented in Australia. We think there is a basis for considering something like that. We started with the consumer and what is going to result in a better deal for consumers overall. We think competition will drive better prices, better service and more transparency.

CHAIR—I have just one final question before I hand over to some other senators. You also talk under your heading of ‘Financial stability’ about the impacts of Basel III requirements. Your submission, as I understand it, was delivered in late November. Since then, APRA has come out with some negotiated Australia-specific rules in that respect. Does that change your position at all?

Mr Baxby—Based on our business model, it does not have a direct bearing on our business as it stands today, but it certainly has an influence on the way we look at the way that business develops, for instance, in respect of home loans. So it is definitely something that is under consideration by us at the moment.

CHAIR—There was talk about the higher capital ratios and, basically, the changes that are being made internationally to address a problem which never really existed in Australia, and us having to wear the consequences of more conservative approaches when essentially the problems that occurred elsewhere, that are being addressed, did not happen here.

Mr Baxby—Yes.

CHAIR—But that said, my understanding is that APRA has negotiated something that better reflects Australia.

Mr Boyle—Yes, I think that is true. I think it is probably fair to say that, while Basel III requirements will put increasing pressure on Australian institutions generally to raise liquidity and improve their loan deposit ratios, all of that goes back to the need for an efficient and stable source of funding, which does not exist today.

Senator HURLEY—Thank you. Virgin is quite a diversified operation around the world and it is beginning to diversify in Australia. Why did Virgin decide to get into the financial market in Australia? Was it just as a direct result of its worldwide operations or was there seen to be a niche in Australia?

Mr Baxby—I think in any market that we look to go into we want to determine whether there is an opportunity in that market. It is not a case of just saying, ‘We want to be in financial services around the world. Let’s get out there and plant the flag everywhere.’ There needs to be a genuine opportunity, and again we start with things like concentration of the players, whether consumers are getting a better deal and whether we are able to offer something different as part of that. That is fertile ground for Virgin, where there is a large sector that is dominated by a few players. I think the unique part of financial services is that the barriers to entry are probably higher than any other industry. Look what Virgin has done in aviation which has huge infrastructure demands. I think financial services are unique because of things like capital requirements and the limited access to efficient funding.

To answer your question, we will look at every market on its merits. We regard Australia as an attractive one for the reasons I outlined—a large market control by a few players, but also things like the resonance of the brand in that market, and the other businesses and how they have gone about establishing themselves. Virgin Blue has obviously been here now for 10 years and established more than a 35 per cent market share in domestic aviation. Then the final thing is really whether consumers are getting a good deal or a poor one. That is really our mandate: to bring genuine competition and offer a better deal.

Senator HURLEY—You pointed to the entry of the Virgin credit card, which did indeed make a bit of a splash, but I think you implied that the marketing push ran down a bit after that and it was your appointment in 2009 which has signalled a resurgence of Virgin. Is that because post GST you saw perhaps better opportunities in Australia and in the market here?

Mr Baxby—I think we genuinely recognise there is an opportunity for us here and that is why we renewed the push. Just to clarify, our original launch of the credit card was via a partnership with an incumbent major bank and that was very successful in building a significant market share over a short time. That agreement came to an end. It was not renewed. We had an interest at the time in doing that, but it meant we had to sort of retreat from the market in the sense that the product was discontinued, and re-enter in the way that we have.

Senator HURLEY—Now you are partnered with Citibank. Is it in the sense that Virgin is just the upfront name—just the marketing tool—and you are actually the marketing branch of an established bank?

Mr Baxby—I can understand why you would say that. We see it quite differently. We look at all the options for potentially entering a market. Part of the reason is because of the barriers to entry we saw that a partnership strategy was the most viable, but we do not see ourselves just as the branded marketeers as part of that. Each of the partners—Citibank and ourselves—contributes different things. In Citi's case it is a banking licence, competency around credit cards in particular and some of the back-office infrastructure. So for each of the things identified as barriers to entry they are able to contribute to the partnership. Virgin brings the brand marketing expertise, as you have just said, and for the things that are fundamental to consumers—product development and the way service is executed and other facets of the business overall. It is very much a partnership. We are very aligned with Citi in our vision to bring genuine competition to the market, and that is how we got comfortable that partnering with them was the right thing to do.

Senator HURLEY—The government clearly understands that they want to bring more serious players into the market as competition to the big four, because 80 per cent market share is way too high. But the government also needs to be careful about what sort of market is developed here and to what extreme lengths it might go to create a market and then find that people fail or that it does not satisfy prudential requirements or that companies start up and fail, causing all sorts of disruption.

Mr Baxby—Yes.

Senator HURLEY—You have made a number of suggestions and many of them are quite good, but what I am putting to you is that the government should not take the more different players; they should look for more mainstream actions, more conservative actions, in the short to medium term.

Mr Baxby—If I understand what you are asking, we absolutely would not support the government making concessions on things like prudential capital and any amount of regulatory capital that needs to be held for entrants coming into the banking market. We completely accept that that is the position and the reasons for that are around confidence of consumers in banking and the need for financial stability. However, we think there is a role for players outside the major banks, and the measures we identified would help facilitate that—levelling the playing field, lowering those barriers to entry, but not necessarily to the detriment of stability, and making it easier for consumers to exercise choice. At the moment they tend to stick with their existing providers because it is perceived as too hard to move.

Senator HURLEY—But also the setting up of a housing corporation model, along Canadian lines, sounds like a fairly dramatic step to take.

Mr Baxby—I think the Canadian model is an interesting one and one we spent a bit of time looking at, but I think if you look at the benefits of that Canadian mortgage model it has deepened the pool of liquidity, so that has meant more efficient funding is available. As we understand it, Canadian banks are able to raise funds 60 to 70 basis points cheaper than their Australian counterparts, even though they are rated lower. It has meant that in terms of satisfying the Basel III requirements there are more liquid assets available. The flow-on to that is it has engendered better competition in the Canadian market. Again, we pull all that back to the consumer and what is going to make them better off—that is, having more players who are able to offer better deals. That is the type of measure that we think helps foster that sort of competition.

Senator HURLEY—But that signals a fairly high level of government intervention and the government taking a certain degree of risk.

Mr Baxby—We say the government is taking that risk today, particularly with the major banks. On the basis of the major banks being too big to fail, that systemic support is implicit; it is almost explicit because of the deposit guarantees.

Senator HURLEY—The other side of that argument is that when you have four big banks like that they are not going to fail because they have got a good market to operate in. It is the four pillars argument.

Mr Baxby—That was certainly the experience in Australia, and we think Australia did better than any others through the GFC because of its regulatory environment, but that was not the experience in other jurisdictions where large banks did take on huge amounts of risk that they did not understand and that led to their demise. I guess the experience internationally has been a bit different to Australia, but in our minds it does not necessarily mean ruling out something like the Canadian mortgage model. I think the Canadians themselves did quite well. They had a good GFC, as it were. They survived and continued to foster competition.

Senator XENOPHON—You have discussed the barriers to entry here in Australia and I guess the difficulty of expanding the market. How does that compare with, for instance, your home base in the UK and other parts of the world that you do business in? Linked to that, what impact did Northern Rock have on the way you did business and on the market in the UK?

Mr Baxby—I think both are good questions. I think the barriers to entry are similar but not identical in other markets—requirements for capital, development of infrastructure, concentration. I guess there are other markets where they are less concentrated. Our UK business, in overcoming some of those barriers, are quite a few years ahead of us. They have a large incumbent customer base and so the business is further up the development curve, which has enabled it to look at a broader range of strategic options than just partnering. They are on the path to overcoming some of them but, like us, they do not underestimate the task of competing against the big five, as it is in the UK—particularly around things like breadth of branch networks and those forms of distribution. Those big five are able to access sufficient funding or more so than Virgin Money UK. The industry rewards scale and efficiency overall.

In respect of Northern Rock, I was part of the team that was involved in Virgin's proposal to acquire Northern Rock. We put together a rescue package at the point that a kind of a run on the bank had started with Northern Rock, which started from a point of view that we felt we had a role to play, we had a very trusted brand and that is what fundamentally had been eroded at Northern Rock and led to a run on the bank. In lots of ways that was the catalyst for Virgin looking far more seriously at financial services than it had in the past. We felt we had that role to play in bringing competition but maintaining stability overall.

Senator XENOPHON—How does your differential with the Virgin credit card compare the difference between major banks' credit cards here and the difference that you would charge in the UK, for instance? How far behind or ahead are Australian consumers in what they pay in credit card rates?

Mr Baxby—Similar, I think, is an answer in terms of APRs overall. Our no annual fee card has the lowest APR of any no fee card in this market. It is one kind of market leading feature, and the UK offers a similar sort of product. So, it is not a major differential. I guess base rates are slightly lower in the UK, which has an impact, but funding rates are still relatively high across both markets, which drive issuers to have the APRs that they do.

Senator WILLIAMS—You were saying that banking in Australia is very concentrated. Do you think the ACCC has perhaps not been on the market enough or on its job enough, in allowing Commonwealth Bank to take over BankWest, Rams by Aussie Home Loans, and St George by Westpac? Do you think the ACCC in obviously giving approval for these amalgamations/acquisitions or whatever you want to call them could have done a better job?

Mr Baxby—I think they were unique market conditions at the time. I have heard participants before this committee say it was a once in a lifetime and I absolutely agree with that, and I think that was part of the context in which those transactions was looked at during that time. I think we are now through those more difficult conditions for the most part. I guess our position is that it is worth looking at what happened during that period and is it appropriate now, based on the impacts on competition and concentration that we have seen.

Senator WILLIAMS—Look back at those decisions in hindsight and make a judgment on what has happened?

Mr Baxby—Correct, but based on consumer benefit. Are consumers going to be ultimately better off by having less concentration in the Australian market?

Senator WILLIAMS—As to the lack of deposits and funding in Australia, in your experience with the tax concession—I think up to £5,100 you said in your submission—did that tax discount have a positive effect on people wanting to save more?

Mr Baxby—It has been in the market for quite a long time in the UK, but our experience had been consumers, at a minimum, looked to take advantage of the tax-free amount in making those deposits. It led to almost like a super form; people know that it is sensible just to put money in an account and take advantage of that tax-free threshold. It does not exist in Australia in the same sort of form. We think it would have quite a positive impact in Australia, and it is probably part of the reason there is a dislocation or a kind of systemic imbalance between deposits and other forms of funding in this country.

Senator WILLIAMS—It might be difficult, considering the budget circumstance and the debt of the Australian government. Turning to another issue: Australia has about $1.3 trillion invested in super funds. Do you think some of that money should be directed towards investing in our local domestic financial institutions, making it available for lending?

Mr Baxby—I think there is some potential there to look at how super might be used to facilitate a deeper pool of funding. I know you have had a number of participants pitch for and against that measure, but I think it is definitely something that is worth considering.

Mr Boyle—I think it links back into the overall funding equation and getting Australia off its reliance on offshore funding to an extent. If the government was to support a Canadian backed mortgage model through guarantees, I think there is a satisfactory model there where super funds would probably feel able to invest in that type of security, thereby avoiding some of the funding issues today and the systematic risk that exists.

Senator WILLIAMS—Finally—and perhaps out of left field—we have a farm deposit scheme in Australia. If a farmer has a good year, they can put $50,000 or $100,000 away into farm deposit bonds, I think they are called, and in a bad year draw it back. When they put it away it is not taxable—in other words, balancing incomes, because of the change in seasons, commodity prices and so on. I am not too sure whether those monies are deposited or not. I was told they are only earning two to three per cent. Perhaps that is something the committee needs to research. I think there is over a billion dollars in it. Do you know anything about the farm deposit bonds?

Mr Baxby—That is not our specific area of expertise, but again anything that sensibly adds to the pool of funding there and earns the depositor a reasonable rate of return we are supportive of.

Senator WILLIAMS—I will pursue some research on that with some areas and see if I can see how much money is actually invested in those funds and what they are earning.

Mr Boyle—I think it is an important point of the equation. The Canadian model is one side of the equation in terms of stable funding, but anything that increases the deposit side of the balance sheet, so to speak, and reduces our overall reliance on debt funding we would be fully in support of.

Senator WILLIAMS—Because money is just like any other commodity or service. When demand exceeds supply, the price goes up and vice-versa.

Mr Baxby—Yes.

Senator WILLIAMS—Thank you, Chair.

Senator PRATT—In your submission you reference Access Economics and *Exercising choice with financial products*. Is that a public document that we can have access to?

Mr Baxby—That is a good question. We can definitely make it available to the committee. It is some research we ran at the time of our launch, as I think I touched on. We were a new entrant coming in and we were looking to promote choice and put a spotlight on the money consumers can save by exercising choice. It was a very thoroughly put together piece of research by Access Economics.

Senator PRATT—Can you tell us what that paper tells us about the benefits for consumers in exercising choice to switch providers?

Mr Baxby—Access Economics looked at four main categories of products—credit cards, savings accounts, mortgages and, I think, personal loans, from memory—and asked, if consumers were to exercise choice and take a better deal across each of those core categories, how much money would they save. The headline Australia-wide was $10 billion over 10 years. I cannot remember what exactly the consumer level saving was, but it was quite significant in the scheme of things.

Senator PRATT—Did that paper have specific inclusions about what was required to give that flexibility and choice to consumers?

Mr Baxby—No, it did not. It was really a study looking at what the cost of failing to exercise choice would be rather than looking at changes that need to be made.

Senator PRATT—Thank you.

CHAIR—As we have no further questions, I thank Virgin Money Australia.

Proceedings suspended from 11.51 am to 12.58 pm

FLOOD, Mr Darren, Deputy Head, Payments Policy Department, Reserve Bank of Australia

KENT, Dr Christopher John, Head, Payments Policy Department, Reserve Bank of Australia

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

Dr Kent—Thank you all for the opportunity to appear today. As you know, the bank has provided a submission to the inquiry covering a number of aspects of competition in the banking sector, along with responses to several questions on notice and the governor and an assistant governor have appeared before the committee in December.

My colleague Darren Flood and I are both from the bank's payments policy department. As I understand it the focus of this session today is intended to be on payments system issues. As the name suggests, our department has responsibility for policies on payment issues. This covers systems for transferring funds, for circulating money. These range from EFTPOS, credit cards and ATM systems through to high-value systems that process large corporate and financial market related payments.

We have a policy focus and of course there are other areas of the bank that have a more operational role in the payments system. The primary role of our department is to support the Payments System Board, which is one of two boards at the Reserve Bank. Our responsibilities and those of that Payment System Board are to control any risks that the payments system might bring to the financial system more generally while also providing efficiency and competition in the payments system.

This mandate has led the board to become involved in reforming retail payment systems in a number of areas over the past decade. This has included regulating interchange fees in the credit and debit card systems, requiring removal of restrictions that were placed on merchants by the rules of the international card schemes, providing easier access for new entrants to retail payment systems and reforming access and fee arrangements for the ATM system.

The intent of the act that provides the board with its powers is that there should be a preference for industry to self-regulate, if you like, wherever possible. This means that we are in constant discussions with both providers and users of the payments system, reviewing developments, collecting data and assessing existing reforms that we have put in place and the need for possible further actions. We are happy of course to take your questions on any of the areas of our responsibilities. Of course if they fall outside of our area of expertise we are also more than happy to take those on notice back to our colleagues at the bank and then provide you with more fulsome answers on those in time.

CHAIR—You say you cover all areas of transferring of funds. That includes ATMs and the EFTPOS system, credit cards and the high-value stuff. Does it also cover areas like clearing of cheques or the transferring of funds between the banks? I suppose ATMs is the most common way that happens but from where there are transactions at an ANZ that might involve NAB customer, just evening up all the dollars to make sure everybody has got what they should have.

Dr Kent—Yes, absolutely. That is the core of the issue in many respects for many of the things we look at.

CHAIR—In respect of the ATMs, first of all I congratulate the RBA on the reforms making ATM charges more transparent, which is presumably designed to save customers' actual fees. Have you done any assessment on how that is going since those changes have come about and whether it is resulting in fewer fees being charged?

Dr Kent—We had a published piece about nine months or so ago that reviewed the first year after the reforms and we have been monitoring things closely since then. Part of that is our ongoing sort of business but perhaps more intensely of late because of the ATM task force that has been set up between the Reserve Bank and Treasury to look at a whole range of ATM issues and to see if there are ways to further enhance the reforms.

That article of nine months ago showed that by consumers moving away from paying these foreign fees and moving back to their own financial institutions' ATM network they have been able to save about $120 million per annum in cash withdrawal fees. Our sense is that they have also saved beyond that, given that they are also most likely in all appearances not spending as much on balance inquiries at machines where they are being charged for those inquiries. They are doing other things: they are using their own banks' ATMs but are also using the phone or the internet to check balances, that sort of thing. We are looking to provide a more recent figure that might update that but that is an order of magnitude that I think is reasonable, at least $120 million per annum being saved by this change in behaviour.

CHAIR—It is changing behaviour that has lowered the amount of fees being paid by people. When it comes up on the screen saying, ‘Are you aware you are going to be charged $2 for this’, they cancel and go off somewhere else—

Dr Kent—They only have to do that once and then they change their behaviour as much as they can.

CHAIR—We had evidence this morning from the Heritage Building Society which indicated that their understanding—I may be misquoting them—is that it impacts on short-term behaviour but not necessarily long-term behaviour and that people might start seeing that there is a fee so they go and do something else but over time they just get back into the old habit of going to whatever the closest ATM is and saying, ‘Oh well, if I have to pay $2, I have to pay $2.’ Is that something that the RBA has looked at or acknowledges?

Mr Flood—That was a question in people’s minds when the reforms were first put in place that maybe there would be an initial jump in the use of their own ATMs and then over time that would drift off. But looking at the data—

CHAIR—That is not happening?

Mr Flood—so far that is not happening. If anything, if you look hard enough you can see a slight further reduction in people’s use of foreign ATMs. At this stage it does look like people have learned that and have put in place new behaviours and they are sticking to those behaviours.

Dr Kent—I think most Australians, not all Australians, have many alternatives. If you can plan ahead and think about things then you can get cash out at EFTPOS in many cases. They might be taking out higher amounts when they do go to their own bank’s ATM or when they do go and pay that fee for a foreign ATM transaction they might take a larger lick of funds so that they do not have to come back quite as soon. There is a whole host of behaviours that have changed and are likely to have changed in a more permanent fashion.

CHAIR—If the behaviours have changed have you seen any evidence that that is actually impacting on ATM operators’ decisions about their fees? Is it actually driving any change, particularly as to lower fees, and to what extent is that behavioural change impacting on decisions made by the ATM operators?

Dr Kent—I think what you are driving at is what scope might there be for some price reductions.

CHAIR—And potentially price increases if you have a captured market somewhere.

Dr Kent—Sure. I think what we have seen is what I would characterise as the opening stage of the competitive pressures that came about from these direct reforms. Most importantly, the independent ATM providers are now able to secure more of the revenue from all of these transactions than they were in the past. One of the outcomes of this early stage of competition has been: if I am an ATM provider I am looking around and I want to grow my business; one way of doing it is just put more machines around in different parts of the country where perhaps they had been underserved before. There is certainly evidence that prior to these reforms some existing ATMs, particularly by independents, were at risk and they certainly were not racing off to expand their networks at that time. Since then we have seen a big expansion of the network by the order of about 10 per cent Australia-wide. That is what we are seeing to date. That is a natural sort of way for those pressures to build.

What has not happened yet is that second stage where you might say expansion of the network might eventually lead to a reduction in prices on some machines. I think that might well happen. It is a natural thing that once you saturate the market with enough ATMs the only way to grow your business further if you are in that market is to look to your competitors that are nearby and say, ‘Well, I cannot put another ATM around the corner—there are already enough—but I could maybe drop my price and if I can advertise that and get people to acknowledge that, I can steal away some of my competitors’ customers.’ That is kind of the next stage that may well be in prospect.

CHAIR—I will leave ATMs now. I am sure others will ask more questions. But on a slightly different subject, you have described briefly the work of your section but you also mentioned that you support the Payments System Board. What does the board itself actually do? What is its primary focus? Is it efficiency, safety, competition? Are there conflicts between the goals?

Dr Kent—Just to restate, it is trying to make sure that it can reasonably control any risks that the payments system might bring to the financial system in general, but it also has this goal of trying to promote efficiency and competition in the payment system. Where it sees particular impediments it might first be talking to industry, through us having a conversation with industry, having a lot of in-depth consultation saying: is there some way we can improve competition or enhance efficiency in this market? To the extent that does not seem possible by industry acting on its own then the board has quite far-reaching powers. It can designate a particular part of the payment system. Once that payment system has been designated by the board it can then apply various standards which participants in that system are required to comply with.

CHAIR—Has it ever done that?

Dr Kent—Yes, quite a bit. It has done that very obviously in the credit and debit card systems where it has standards on interchange fees, which are fees between—

CHAIR—This is the Reserve Bank that does this, not the board?

Dr Kent—The Payments System Board is part of the RBA. The bank has two boards, the board that focuses on monetary policy and the implementation of monetary policy and then the Payment System Board that focuses on these payments system issues.

CHAIR—Does that have industry representation on it?

Mr Flood—It has independent directors.

CHAIR—But they do come from the industry because of their expertise?

Mr Flood—No, they are people who have come from typically quite different backgrounds. Some of them have had experience say working on the board of the Stock Exchange and things like that but they are not chosen as representatives of the industry, they are people who are coming from outside and have a view that is not tainted by particular views within the industry.

Dr Kent—The chair of that is the governor of the bank and the deputy chair is the assistant governor in charge of my area. There is also participation by the chair of APRA, Dr Laker.

CHAIR—You mentioned that one of the things the bank has done is to attempt to improve competition in the payment system by allowing specialist banking licences in the payments space, which I think is a type of an ADI licence; is that right?

Mr Flood—Yes.

CHAIR—I guess the idea of that is to enable new entrants who might have innovative or new ideas of how to approach it to come in and fill that space. As I understand it, only one entrant has taken that up and that is Tyro.

Mr Flood—That is not quite right. Something you quite often see is the incumbents in a payment system will have a natural tendency to keep new entrants out and often might use risk as a justification for that. What you will very often see in payment systems are rules that say you cannot join this payment system unless you are a bank or authorised deposit-taking institution. In a couple of our payment systems there have been changes made to try to address that and the one you are referring to particularly is in the credit card schemes. They have these rules about only banks being able to join. To address that, basically a new class of authorised deposit-taking institution, which is an authorised deposit-taking institution that does not take deposits, which are referred to as specialist credit card institutions—

CHAIR—In that context maybe Abacus's request that they change the name from ADI to ABI might actually sound better—to be an authorised banking institution that does not take deposits makes a lot more sense.

Mr Flood—One of the things that those changes allowed is that previously to be a member of one of the card schemes you had to be both on the issuing and the acquiring side so you had to both issue cards to people and you had to run payments business for merchants as well. These changes got rid of that requirement as well, so what we now have is one company has come in on the acquiring side, which is Tyro, and there is another one that is on the issuing side as well. It just does the issuing but not the other side.

CHAIR—Tyro has appeared before this inquiry. In its submission it has claimed that it faces various barriers to entry, and obviously you remove some so that they can at least get to that point, but from there in terms of being able to actively participate in the market they are claiming that there remain barriers to entry and that the governing bodies set unreasonable requirements, in their view, to protect the big banks and that the big banks are cross-subsidising that part of their business from other parts of their business. How do you respond to Tyro's claims? Do they have a legitimate beef in this regard or are there other aspects that we are missing?

Dr Kent—We talk to Tyro, as we do to all participants, on quite a regular basis and we certainly understand some of the nature of the problems that they face. In terms of Tyro, one of their problems, if I understand it, is this ability of the banks that are competitors in this merchant-acquiring side, which is their sole focus, to use other parts of their business to make it easier for them to provide a service to the merchants that Tyro cannot. Perhaps the most obvious example of that is where the bank, which has got a big balance sheet, might be able to promise the merchant access to funds so when a customer walks into the store and uses a card to pay that store that customer's bank will have to pay the merchant's bank at some point. That may take a bit of time. But the merchant's bank might say, 'I can see those funds are going to be coming in so I might be able to credit your account with those funds ahead of me receiving the payment and in doing that I am taking on a credit risk.' A bank is in a better position to do that than a small, monocline provider like Tyro. So certainly they have that as something of a disadvantage.

Then it leads you to think what sort of solution might you think about here? One might be to somehow withdraw the ability of the bank to do this type of bundling and level the playing field in some way. But that sort of action, if you could do that and move down that path, would really be to the detriment at the moment of the merchant that is receiving that benefit from the bank. You are really delivering less service to the system to level the playing field, so I do not think that is a very satisfactory outcome from that respect. I think instead you could consider more direct solutions. One of them might be that there might be various participants, the international card schemes amongst them, who for various reasons have rules and procedures in place that mean they pass on payments with some delay. Perhaps there is scope to encourage them to speed up that process.

More importantly perhaps what you could do is say: is there not some way where we can speed up payments between banking institutions so they can move money between their customers and their merchants and the like more rapidly? That is certainly something very much at the forefront of our minds, in part because the bank is part-way through what is called a strategic review of innovation to see if there are gaps in the payment system that cannot be filled particularly through the bank's somehow encouraging greater cooperation in networks to overcome these sorts of problems. The bank at the same time is actively changing systems in a way that ultimately would be compatible with the notion of faster movement of funds between banks in the low-value settlement system where the RBA has mandated that the banks and other financial institutions improve their systems in a way that is consistent with that faster settlement. We have not put that on the books yet and that is still something that is being looked at.

Senator HURLEY—Tyro concentrated on that faster system in our evidence; they said that they were happy to transfer funds as fast as the system allowed. I might be misquoting them—I think they were implying that the banks held onto it for their own purposes but that Tyro was happy to get in there and transfer funds as fast as allowed but it was that access to the funds transfer between banks that they could not access; they had to wait for the banks to do it. Is that what you were talking about that that might be something?

Dr Kent—If it became the norm for everybody to say, 'I have an instruction to pay away money.' If something could be done to make that happen more rapidly between the financial institutions that are transferring all of these funds, that would certainly help out Tyro with regard to this aspect of its business. The question is: how might you achieve that? That is something that we are still looking at and investigating. As I said, it is the focus of the current innovation review that the bank is undertaking and we are part-way through that process, but sitting behind that in the operational area of the bank for a whole host of reasons they are reviewing the infrastructure and they have mandated changes which are consistent with that notion; they are not yet requiring this faster settlement, but they are changing the infrastructure so that, even when that sort of change is appropriate, that system will be geared up and ready to move more rapidly towards that sort of solution.

Mr Flood—The fundamental issue is that for all the retail payments that are made today, the banks do not actually settle their obligations on those until tomorrow morning at nine o'clock, so there is this natural delay in that process.

CHAIR—Why is that? Is that the way the IT system is set up or is it a deliberate decision to wait until nine o'clock the next day? We have had evidence from COSBOA about small businesses that sometimes wait days for money to go into their accounts that was sent to them from various sources. We have had evidence from Bendigo Bank that they were able to settle things immediately in real time. There is a suggestion, particularly by small business organisations, that the banks hold onto it because if they hang onto it for 24 hours there are a lot of things you can do with it to make money in the meantime. I am interested in the Reserve Bank's views.

What is the reality of all this? Are the delays caused by old IT infrastructure or is it because the banks choose to hold onto things until a particular point when they press a button and make it happen, or what is the problem?

Dr Kent—I do not know that I will answer all of that in this. Maybe Mr Flood can pick up where I miss things out. But this notion that the banks are delaying something on purpose so they can make use of those funds—

CHAIR—It is certainly an urban myth—

Dr Kent—I really do not think that is the case. The funds are moved from one customer's account to another customer's account through this system and there might be some delay between when a payment instruction is sent and when that money is finally available at the other end for the receiving customer to take those funds out of their account if they so choose, but there is a point in time which is part of the arrangement where the exchange is deemed to have occurred and that is the point at which interest is calculated if any is being paid.

CHAIR—That is the evidence of the—

Dr Kent—If it has not been paid out yet, the customer paying away the funds is still receiving interest up to that point and then once that instant in time occurs, from that time after interest is credited, if it is due, to the account of the receiving customer, so I do not know that that is the case.

CHAIR—If you do a pay anyone type of arrangement where you are sending some money from your bank to somebody else's and it does not show up for two days, you might still get interest for it in your account for another 24 hours even though it appears to have disappeared?

Dr Kent—Yes.

Senator WILLIAMS—Just on that very issue the chair is asking about, in the case of my personal experience of a transaction with a major bank on a Saturday morning I did not get the money until the following Wednesday but Bendigo Bank do it overnight, Christmas day, Saturday or Sunday. What is the difference there? Can you explain that?

Dr Kent—I read through your account of that situation and tried to think through it as best I could. It is a little tricky that you need to know exactly the times and the institutions which you work through. Some banks might be providing credit in a way. They know—they get a sense—they have got an instruction that money is coming in and they are doing a service to move that money into the account ahead of when they receive the money, so that might be a case where a bank such as Bendigo Bank might be able to pay money into an account before they officially receive it through the system.

In the case of doing a transaction though on the Saturday where you do not get it until the Wednesday, in the banking world Saturday and Sunday do not exist. They are holidays. They are time off where the banking system is down—and we can discuss whether rightly or wrongly that is a good or bad thing separately—but what you have ostensibly done for your bank in paying away funds on a Saturday, they get that instruction and start processing it on a Monday. If they normally receive an instruction on a Monday, depending who that money is going to—if it is going to what is called a first-tier bank which is a major bank in the settlement system—if it is a tier-one bank, that money should arrive on Tuesday morning at 9 am in the account, depending if you sent it electronically.

Senator WILLIAMS—Mine is a first-tier bank—

Dr Kent—If one of the banks in that equation though is a second-tier bank it might not arrive until the Wednesday. That is my understanding, without knowing the exact details.

CHAIR—But it is not like there is a bag of money being delivered from one bank to another. It is not like they have to wait until Monday morning because there is a team of bank clerks sitting in the bank's offices waiting to process it. It all happens via computer these days.

Dr Kent—All the instructions are compiled by the bank paying away and then they are sent out to each and every other bank and there is an exchange of files amongst—

CHAIR—But is there any reason why the IT systems cannot be set up to recognise all of this? You talk about the bank waiting for the money to come into its account. Once you have done the transaction, why can the IT system not pick it up and send it across straightaway to that bank so that it then can immediately go into the—

Dr Kent—At the moment the system is not set up to do that.

CHAIR—Does that mean—

Dr Kent—It is an historical thing and it needs further development to do that and there is the question of what is the cost of doing that and what is the best way of doing that.

CHAIR—Which is what you are looking at with your innovation committee?

Dr Kent—Yes, and I think as part of that we will have to assess what that cost is, assess what the alternative ways of doing this are of making it more timely and then, if there is a cost there, we have to work out is there value in spending that to get this benefit. It is a cost-benefit analysis that will need to be done carefully to make that happen.

Senator HURLEY—The Tyro people mentioned that they believed that the IT systems of the banks were antiquated and that they had not spent enough money on upgrading them. I imagine that is what they were referring to there.

Dr Kent—You are touching on a problem that is common in this area, that what you often need to do to get the network to provide better functionality is to have everybody who is part of that network to move towards the same goal and often times you need a degree of coordination, a degree of suasion at times. There are lots of good projects that could be done by everybody in this sphere. They will have personnel that they have on their books that are able to do this—they have money set aside—and sometimes you will need to coordinate all of that in one area to get everyone to move in the same direction and they may have different views about where they need to move, what are the priorities and so on.

An important thing that we are looking into in the payment system innovation review is to say: where are there things where you could make improvements where cooperation is needed because a competitive outcome will not drive you there? Then what could be done, if anything, to make sure that happens in an efficient and timely manner? It is definitely something that we need to look at.

Senator HURLEY—I have heard a suggestion that there might be a move toward a clearing house type of structure. Would that be practical?

Mr Flood—We have a number of different payments systems. Most of them are organised in a way which if you were starting from scratch is not how you would do it. So at the moment if you have got a payment going from bank A to bank B—bank A has to send it to bank B—and it has to send a separate payment to each other bank whereas if you have got something sitting in the middle all you have to do is send it to that point in the middle where it can be directed to all these other places. In a lot of ways that is a system that has advantages from pure efficiency to access and all those sorts of things.

Through the way the system has developed here we have a system based entirely on bilateral links. The industry is moving to a system that provides easier connections so you only have to create one connection to the system to communicate with all the other players but there are still separate relationships with each one.

Senator HURLEY—Would a clearing house then reduce some of the barriers to entry, whether it is in the cost of setting up an IT system, or just the difficulty in accessing all of those different connections?

Dr Kent—I think that is definitely true. If you can simplify and have a single set of instructions or protocols that you have to follow to do something, you do not have to negotiate that with every existing member bilaterally. That is much more efficient. Some of that thinking is sitting behind this new network which is referred to as COIN that Mr Flood has referred to. The idea always is that there are costs and benefits and what is the best way to minimise the costs and maximise the benefits? One of the sorts of issues that is being discussed and looked at as we move towards this new infrastructure for the low-value payments is: for any new entrants can we somehow standardise the messages so they do not have to conform to the exact requirements of all the existing members that are there. That is in fact something that is being looked at to try to enhance that system.

Senator HURLEY—Is there any time line? Is this something that is going to take—

Dr Kent—Some of these improvements which have been mandated by the RBA, the banks are required to be able to have this system, this COIN network, up and working I think by early next year.

Mr Flood—It is the middle of this year for some systems, the end of the year for other systems. That simplifies part of the process, but it does not give you everything—

Senator HURLEY—That you would possibly want. If a clearing house system were put in place for the new system, is that simply the protocols between the computer systems or is it more than that?

Mr Flood—All that is happening with this move to COIN is that it is replacing physical connections. There used to have to be effectively a telephone line from each bank to every other bank. Rather than that, effectively it is all connecting via the internet so you make one connection and you can reach everybody else through that process. Once you get beyond that each of the players has their own rules about how people talk to me once that connection is made. So beyond that there is work on trying to standardise the ways that they talk to each other. But beyond that you still have the fact that there is—

Senator HURLEY—And that would be the network protocols—not so much a physical network but it would be a matter of the protocols for people to—

Mr Flood—Yes, and the messaging standards and the like. But the notion of how we minimise costs is not necessarily to change the existing lines of communication between players that are already in place, because they might not get much benefit from that and they would have to spend money to do that, but the intention is, for anyone new coming into that system, that they do not have to conform to all of the myriad different standards that apply at the moment, they would just conform to a single new one. So new players coming in have a minimal investment in that—

Senator HURLEY—Would that mean that banks would have to run two different systems, one that conforms to the new one and another—

Mr Flood—No. The intention is to try—

Senator HURLEY—They would all go to the new one?

Mr Flood—Yes. The communication all goes through the same way, it is just a question of how we can simplify the message.

Senator HURLEY—Is there resistance from the banks to do this?

Mr Flood—No, I do not think there is. They are getting the process started. It took a little bit of effort just because we are talking about reasonably substantial investments by the banks to do this and they are all in different investment cycles and those sorts of things. But there was a catalyst in that the connections that a lot of them had been using were not going to be supported for much longer, so they essentially had an end date that they had to deal with anyhow so that helped to garner a bit of coordination.

Dr Kent—That was that the physical communications infrastructure that underpinned it was kind of dated and was not going to be supported in the future so they had to come up with something new. When you are doing that, it makes sense to try to improve the system. I do not have a sense that there was a strong resistance as much as you just run up against the fact that each of them has slightly different commercial priorities, each of them has certain budgets that have been allocated and approved at the highest level and often at these technical levels you are getting people lower down in the bank who say, ‘Well, I would like to be able to do this if that is what you are going to require me to do but you are going to have to tell me I have to so that I can make sure I have sufficient personnel and funds to do the work I need to do.’ That is where the Reserve Bank can come in and usefully mandate something, so it is clear to everyone what the timetable is and what the requirements are.

Senator HURLEY—Has that been mandated now?

Dr Kent—Yes.

Senator HURLEY—In relation to the new payment system you have said that there was one new issuer. Who was that?

Mr Flood—That was GE Money.

Senator HURLEY—There was another question I had which you may or may not have to pass on. It was about covered bonds. There had been a suggestion that covered bonds be approved and I was just wondering in the course of testimony today whether they all had to be rated at the same level or whether there could be a mixture of ratings so that the overall rating was at the appropriate level, so you could have some AAA and some BBB?

Dr Kent—I think I understand the question but unfortunately I will have to take that one on notice. That falls outside my area of expertise. We will pass that on and get somebody to get back to you.

Senator XENOPHON—If this has been covered I am sure you will tell me but I was interested in the issue of ATMs in remote communities, particularly Indigenous communities. Has that been covered yet?

Senator PRATT—No.

Senator XENOPHON—A concern has been raised that in some of those communities they charge I think up to $10 per transaction and in cultural terms in some of those communities for a number of reasons people do not like taking out too much money at once so they have to make multiple transactions each week. What can you tell us about any proposed reforms there or to what extent are you aware of that particular problem?

Dr Kent—We certainly are aware of the problem and I mentioned earlier the work of the joint ATM task force, which is a task force that the Treasurer requested be set up between the Reserve Bank of Australia and Treasury, and which has two goals. One of them was to report by the end of February on problems associated with high expenditure on ATM fees in Indigenous communities.

We have done quite a few things in the short time that we have had to cover this issue. We have obtained data from almost every ATM provider that covers about 98 per cent of the market in Australia asking them for data on the nature and location of every ATM in their network and the prices for balances and cash withdrawals when it is a foreign transaction. We have been talking directly with industry, some of the major banks and some of the large, independent providers. AFCCRA, who you might know wrote this report that kicked things off in December by highlighting some of these problems very clearly, helped us by organising a trip for some of the members to Alice Springs to visit some of the affected communities.

Senator XENOPHON—So we will know by the end of the month because my feedback is that it does cause a lot of hardship. Finally, the Consumer Action Law Centre draws on behavioural economics as to how people might be influenced by higher credit card limits, including the pre-approved limits rather than the offered-for-consideration and the teaser low-interest rates. Is that something the Reserve Bank has done work on?

Dr Kent—That is not really something that we have looked at in the payments policy department. I am not sure whether Mr Flood could touch on that. I wanted to say one thing about what the ATM task force did find in these communities. We looked as hard as we could for the few machines that were alleged to be charging $10 and we did not find any clear documented evidence of these—

Senator PRATT—I think it is the stores that are charging—

Dr Kent—No, the ATMs and the stores. We heard of some. We asked for those who were reporting them to come to us. We tracked them down. They may have been charging $10 in the past. We did not find any current evidence anywhere in Australia of a store in a remote community charging $10 on an ATM. We did find a lot of stores which have ATMs—and they are mostly independent ATM operators in these remote communities—have essentially national pricing strategies. So the prices for an individual type of balance for a cash withdrawal at these ATMs are no different from ATMs of a similar nature in stores in other parts of the country in urban centres. It is not so much the price; it is, as you referred to, the issue that they are making lots and lots of small withdrawals and lots of balance inquiries. But that report has been commissioned and we just need to wait for the normal channels to see what the outcome of some of that is.

Senator WILLIAMS—Do you handle all the overseas transactions as well? For example, if I were to buy a $100 product out of America on my Visa card, does that go through your area?

Mr Flood—We have an interest in it. We do not necessarily have control over it. We have got parties offshore involved.

Senator WILLIAMS—As to the exchange rate fees, do you ever monitor the exchange rate fees? I imagine the buy or sell margins would be extremely high on small transactions for the banks; is that correct?

Dr Kent—Are you talking about when you use your credit card to make a transaction offshore?

Senator WILLIAMS—To buy something offshore. You might have a spot rate, for example, of A$1 to US$1. To buy Australian dollars it might be 98c and the seller rate is $1.02, or it could be other way around. That margin spreads on smaller transactions and, just like monitoring the ATM fees, I am wondering whether you monitor those exchange rate margins when overseas purchases are made?

Dr Kent—Mr Flood can correct me here if I am wrong, my understanding is that because it has this foreign nature to it we do not have much of a jurisdiction over that, but we certainly do monitor it. My experience, first of all, is that it is expensive as a consumer to get a very good rate on foreign exchange at times compared to what you might see on the wholesale markets. You might think that costs you some money but my sense is that it is often not so much the exchange rates on some of these sorts of transactions where you are getting a raw deal, if you like, but there are other fees associated with it that add up and make it look like it amounts to quite a bit.

Senator WILLIAMS—So you do monitor that? You do monitor some of those overseas transaction fees?

Dr Kent—We are aware of issues here. There is an issue internationally about the credit card companies trying to prevent other providers coming in where you might be, let us say, an American travelling in Europe and you go to a store and there is a service where the store says, 'Would you like to pay for it not in euros but in US dollars so you can be sure about the price?' There have been disputes about how that works and we have been closely aware of that sort of activity and have monitored it from Australia.

Senator WILLIAMS—Once again, when you get down to the exchange rates even of the store that would make the same exchange rate for example.

Dr Kent—In this case the store was not doing that. It was having a separate financial provider stepping into the transaction, converting it for the store from, say, euros into US dollars so the customer faces a certain US dollar price and they can see that there and then rather than waiting to go home and perhaps having some uncertainty.

Senator WILLIAMS—I do not want to read between the lines but am I right when I say that you do not keep a very close eye on these things? When you say you monitor it, there are obviously some that are not your priority; would that be right? Or do you think you do keep a rather close eye on these transactions?

Mr Flood—Foreign exchange in general is something that is of interest to the international department of the Reserve Bank rather than the payments area. But even then, pricing to the market is more of, I guess, a market competition issue, which is not the primary focus of the international department.

Senator WILLIAMS—This is the point I make: just recently I bought some product out of America which was $92 including freight. I think my transfer fee was $5 but there was no detail on the transfer fee. I am thinking how close is that $5 to the actual cost to the bank or is it just that any transaction under $100 is $5; any transaction from $500 up to $500,000 is $7.50? We were talking about transfers from ATMs and foreign ATMs et cetera. I think perhaps this is something that could be looked at a bit closer. You have a $5 fee and you have no detail. I am not bothered to ring the bank and ask for a detail—

Dr Kent—I am sure they would give it to you if they could break it down. They could tell you what the exchange rate applied at the time, what other fees were imposed and what they represented. I guess not to say that we are not concerned about those sorts of issues but just to say our power to influence things is largely focused on the domestic transaction side.

Senator WILLIAMS—I bet you they cover all their costs, plus some.

Senator PRATT—Can I go back to Senator Xenophon's questioning about remote communities? I would also like to ask in that context the extent to which there is any analysis of low-income people in general conducting that kind of behaviour—that is, frequently accessing their accounts to check balances and not being as financially literate in making judgments to avoid using ATMs at which they will be charged. What is the evidence in that area in general?

Dr Kent—Across Australia I think it is true to say that if most people have an option of avoiding a fee they will. I am sure that if they are on a low income their incentive is even greater, if they can they find other ways to get a balance inquiry. You see the evidence of that because, Australia wide, on the independent machines, which all charge a fee of one sort or another for any transaction because that is the nature of their business, they have a very low share of balance inquiries which are paying the fee. I think something in the order of six per cent of their transactions is charging a fee for balance inquiries. People are doing a lot to avoid those. I think that is probably across the board. I do not specifically have a breakdown of that by income category to know whether or not people on low incomes are higher than the six per cent national average. But a lot of people even on lower incomes, although they may have less access, do have access to phone banking or internet banking. I think the real problem is most obvious in remote Indigenous communities. For a host of reasons, the internet is not something that is widely accessible out in these communities, even getting access to the phone. It is not just about financial literacy; it can also be about English literacy. They have multiple languages and English is just one of those.

Senator PRATT—Privacy?

Dr Kent—Yes, privacy of the phone is an issue. When we were out in some of these communities in the Northern Territory, there was one phone right outside the front of the store and everybody was queuing up. So if you want privacy you go to the ATM instead because it is quick; it is on the screen. You can even avoid getting the paper printout if you do not want to walk around with that in your pocket, which is advertising how much money you have in your account. So I think those are the communities which are really paying a lot here. I should just say that about the time we were out in Alice Springs we noticed there was a press release by one of the major independent providers that are servicing these communities with ATMs. They noted a very significant drop of 50 per cent in the fee for balance inquiries.

Senator PRATT—Can I ask which provider that was?

Dr Kent—My understanding is that it is First Data, which is otherwise known as Cashcard, on a large number of their machines in these remote communities. My sense of what is happening there, amongst other things, is the notion that these communities, as you say, often make lots of small cash withdrawals and they make lots of balance inquiries relative to the rest of Australia. So those machines are generating more revenue from that than perhaps they need to to be profitable so they are willing to cut their fees. That could just be an out-and-out commercial decision. I think people often think there is one store, one machine; that is a monopoly. I caution against that because if the store owner has their community's and customer's interests at heart, if they have a machine in there that is charging more than might be available somewhere else when that contract is due they have the option of saying, 'We are not going to roll over the contract. Take your ATM back; we have got a better deal.' So there is an incentive here even on a commercial basis to keep revenues in a reasonable position.

Senator PRATT—To be honest, in most of the communities I have been into they do not have ATMs. They are relying on the community store. Have you got anything you can advise us on with respect to that?

Dr Kent—Absolutely. Our focus was on ATMs but we are certainly aware of the problems more generally that we speak of that are going to be across the board in these sorts of communities that are very isolated. Perhaps the only thing I can say there is that it affects both ATMs and the ability of stores even without an ATM to provide cash and a degree of banking services, if you like, where there is no bank. A key impediment there is getting access to cash and that can be quite a problem at times.

Senator PRATT—In my experience in community stores people often do not want to carry cash and so a member of the family might go to the store using the same card half a dozen times a day. They have got no refrigeration so they buy their food daily. It is not unusual that you could rack up $20 worth of transaction fees at the store in a day.

Dr Kent—We saw evidence of that and that is entirely consistent with our experience and what we heard. The report thinks about options to try and sort of tackle that—

Senator PRATT—Does the report look at stores as well as ATMs or—

Dr Kent—It talks a lot about the role of the stores in this market; it talks about not just ATMs but the contracts that are there in place between the ATM and the stores and other ways that the stores help their customers, including by providing cash-out at EFTPOS in the case where there is no ATM.

CHAIR—Thank you to the Reserve Bank for assisting us today.

[1.53 pm]

QUIGGIN, Professor John, Private capacity

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

Prof. Quiggin—Yes, not so much looking at the detailed issues of competition but trying to address some of the premises of the inquiry and trying to urge the committee to look at this issue in the broader perspective of the problems of the financial sector. In particular I note that the terms of reference refer to competition in innovation and the general presumption is that these are good things. Competition leads to lower prices for consumers and to prices that reflect social cost. Innovations may be good or bad, but the market weeds out the bad ones and selects the good ones. But those assumptions cannot be guaranteed in a sector like the banking sector, precisely because of the problem referred to in the terms of references as 'too big to fail'. I would put it more strongly as 'too interconnected to fail'—that is, that the system as a whole, for very good reasons, is protected against systemic collapse. So as we saw during most of the period of the global financial crisis, governments around the world, including Australia's, were forced to step in and rescue the banking system in a situation where, if it had been another sector, it could potentially have been allowed to fail and businesses concerned would have gone bankrupt and then been replaced by others.

That is problematic as regards competition, even more so as regards innovation. In a circumstance where you are guaranteed against failure, subject to restrictions on taking risk, the obviously most profitable part of innovation is one that allows you to take a risk which will pay off well under normal circumstances but where the true cost of the risk is simply passed onto guarantors. Essentially that kind of innovation was a characteristic feature of the period leading up to the global financial crisis. A huge range of highly innovative financial instruments were created, all of them ultimately paid for by the taxpayers of various countries, and are still very much being paid for.

I have not said much about innovation other than to express the very general view that financial innovation in a regulated system should be presumed to be undesirable rather than desirable. We should have a system in which the set of activities is prescribed and in which someone who wants to introduce something new actually demonstrates that they are not doing this in a way that adds to the risk borne by the guarantors.

I guess that is the kind of point that leads me to the more general point that I am making, which is that we need to address this issue in the context of a new inquiry into the financial system, as I and a group of other economists urged about a year ago. I think the lead economist on the previous inquiry, the Wallis inquiry, Professor Ian Harper, noted that really the premises of that inquiry have been shown to be greatly flawed. The present financial market's hypothesis on which it relied has been shown to be false. We have really seen, unfortunately, a situation where the government, and broadly speaking the prudential authorities, have said, 'Well, nothing went wrong here so obviously our system must be free of the kinds of flaws that were exposed so radically in the UK, the US and elsewhere.'

Maybe that is right, but I think it is something which we will always be looking at rather than saying, 'Well, we dodged that bullet; therefore, we are bullet-proof.' That is really the core of the submission. I have attached at various points some suggestions about backing this up and I have also reattached the letter from the ASIC economist that was put forward a year or so ago. I will stop there. I would be happy to take questions.

CHAIR—Thank you, Professor. It is quite an interesting perspective that you are raising. I have read your submission and I do not disagree with a lot of what you say about what is essentially the moral hazard of a financial system which is essentially underwritten by the government, whether implicitly or explicitly as it currently is, and the potential for behaviours to occur then which might not be in the best interests of those who are doing the underwriting. But I am not sure about the conclusions. I am not fully convinced at this point.

I might just ask a few questions. First of all, in relation to innovation, you are saying that we should presume that innovation should be undesirable unless proven otherwise. What about an example like the innovation shown by non-ADIs in terms of grabbing hold of the securitisation market in the 1990s and the early 2000s which led to what most people seem to acknowledge is healthy competition with the majors that brought down prices of interest rates or margins of interest rates and so on. That was innovation that occurred that was market driven. They saw an opportunity and off they went—new products, new ways of approaching things—and that was good; was it not?

Prof. Quiggin—If you look at the securitisation that was essentially the key innovation that enabled subprime mortgages in the US. The key innovation which enabled the huge growth in subprime mortgages was precisely that non-bank providers were able to securitise their loans, pass them onto large banks in New York which then passed them up further into more complicated derivative financial assets. Clearly we did not have that outcome and we maintained higher credit lending standards, although towards the end of the boom we were seeing significant slippage in lending standards, low doc loans and so forth, very much on the US subprime model. My point is not that financial innovation is undesirable; it is that before we allow institutions which may be able to call on a government guarantee to introduce these innovations in the case of securitisations we should be saying, 'You show us that this is not going to add to the systemic risk of the system as a whole.'

CHAIR—That is slightly different to how I understood it. It may be my fault for not understanding what you were saying. But that seems to make perfect sense. If you have got a well-regulated system and you have got either existing or new players looking to innovate they are going to have to prove that what they are doing either fits within current regulations or that it is safe to modify regulations to allow them to do that. I think that makes sense in a normal, well-regulated, balanced system. That is all you are really saying.

Prof. Quiggin—That is correct. I think the big problem is that the most successful innovation is one that fits the current regulations—for example, you can think of tax avoidance here. The successful tax avoidance innovation is one which fits current tax law but produces an outcome that was not intended by those drafting the law. The big problem therefore is not innovations which violate the existing regulations; it is the innovations which have not been foreseen when the existing regulations were drawn up. My point is we essentially have a reactive attitude, the innovation comes along and then we try to adjust the regulations to accommodate it. I think we really need a more stringent attitude to financial innovation than what we have; one that says before we have innovation we need to look at the implications.

CHAIR—But coming back to my original example, until you can actually get out there and test some of these things you do not really know whether they are going to work. As a result you may well miss out on the potential for innovations that are actually good to be developed and put in place.

Prof. Quiggin—Sure. I suppose I should mention here the second part of my submission which relates to issues of narrow banking and guarantees. One way of addressing this problem is to have a much sharper division between those institutions which are guaranteed and those ones which are clearly excluded from the guarantee. To take an example, it is fairly clear that with companies listed on the stock market, there is no guarantee if somebody puts their money into the stock market they will not lose 50 or 75 per cent of it. If the stock market falls 50 or 75 per cent then that is just too bad for the investors. It is very clear the government will not intervene to bail them out and that too means that we do not need to be very worried about the kinds of companies that are floated subject to the usual sorts of regulations that ASIC puts in place to prevent fraud.

If we have a situation where innovators are clearly told, 'This is on your own head. Not only are you not guaranteed; we guarantee if this goes wrong you and those backing you will not receive any help from the government', I think that is a way of allowing these innovations to be tested. That requires that the guaranteed sector be kept radically separate from these innovators. If we go back to Australian experience in the 1990s or the 1980s we see very much the kind of thing I am concerned about. We had innovation from the so-called entrepreneurs, people who were not really entrepreneurs in the sense of creating new businesses; rather, they were creating new financial structures. The guaranteed banks were heavily exposed to those but the state banks and the major corporate banks, the state banks being less deeply capitalised, largely went bust. But the major commercial banks were also rescued by the Reserve Bank because of their exposure to these failed innovations.

CHAIR—Your point about innovation once again then comes back to the moral hazard—for want of a better way of putting it—

Prof. Quiggin—Absolutely.

CHAIR—The motivation for you making that point is because they are ultimately government guaranteed and therefore the taxpayers are going to pick them up. They know that always, so they are happy to put in place risky innovations knowing full well that the risk is borne elsewhere but they will wear all the profits if it comes off.

Prof. Quiggin—That is absolutely the case.

CHAIR—I can see that point and that is an issue that I think decision makers in government need to address and need to look at. Also in your submission you talk about:

> A sound system of financial regulation must begin with a clearly defined set of institutions offering a set of well tested financial instruments with explicit public guarantees for clients and a public guarantee of solvency, with nationalisation as a last resort option; financial innovation has to be treated with caution and only allowed on the basis of a clear understanding.

Over the last few years government regulators—and rightly so—have erred in terms of the way they look at the financial system with a view to guaranteeing stability. I am coming to competition now. I think we actually had evidence from one body—it might have been APRA—in a different inquiry that competition became less of a priority when you are worried about stability, and any measures you might normally look at and consider in terms of competition were pushed to the side because the primary focus was stability. But in normal times, as we are returning towards—I am not saying we are there yet—surely you should be trying to achieve more of a balance between healthy competition and stability, and even your moral hazard issues in the longer term, in order to deliver the best products possible to consumers at the best possible prices.

Prof. Quiggin—Absolutely. I think my crucial point is to say that we should not be looking at these issues separately. That is my concern: that we should not be having one set of policies aimed at promoting competition which do not take account of the implication of stability. Obviously, if we want competition, to give an example which was raised not by me but in the parliament, the four pillars policy was regularly assailed as anticompetition. There were a bunch of competition issues as to whether the restriction on competition implied by the fact that banks could not take each other over was more important than maintaining a diversity of offerers. But, as it turned out, at least in the parliament's view, the four pillars policy, by preventing banks from being in a struggle for survival, meant they were less inclined to take the kinds of risks seen in the US where there has been a huge consolidation of the sector.

It turned out that this policy, which was debated entirely in terms of a competition policy, fortuitously came out in the direction of preventing major bank takeovers and was actually a significant contributor to the stability of the Australian financial system. So, my general urge is not to say let us forget about competition; it is to say let us address these issues in the context of systemic regulation and let us have an inquiry into the entire system that enables us to address these issues on a comprehensive basis rather than making piecemeal adjustments to a system, which in my view is not so different from those that failed so catastrophically overseas.

CHAIR—I understand. I do not disagree, and I do not think there would be too many people on the committee who would disagree, that there needs to be an appropriate balance. There may well be arguments about where the appropriate balance is, but ultimately you need to look at the solvency, the stability and the competition in the industry and balance those factors to make sure that, in the end, you have a stable system that supports the economy in a way that the banking system is so vital to Australia and actually delivers banking services to Australians and Australian companies that are actually responsive to their needs and what they want to actually deliver. You do not argue with any of that?

Prof. Quiggin—No.

CHAIR—You talk about competitive incentives and where the balance might be. You state,

> These incentives may manifest themselves in ways that appear beneficial to customers, including higher rates of interest on deposits and more generous …

And:

> The more intense the competition the more difficult it is for any individual institution to take a 'responsible' low-risk stance at the expense of short-term profitability.

You have those factors balancing against each other. Is it not APRA's job to oversee certainly the ADIs to make sure that the moral risk is not being flirted with to the extent of undermining stability? They do not just look at base numbers—they actually look at activities that the ADIs are undertaking. They look at new products. They look at what innovations they are looking to put in place and conduct what I understand, particularly on an international comparison basis, is a fairly conservative approach to what they allow the ADIs to do.

Prof. Quiggin—Certainly in our structure APRA does that, and I agree that we have had both a relatively conservative stance and, of course, because we failed so badly in precisely the circumstances back in the 1990 recession—

CHAIR—Which is why we ended up with APRA.

Prof. Quiggin—There is still a degree of conservatism on the side. There are at least some people in the banking sector who can remember those days, so we still have some inherent conservatism left in the system. But I do not see our system as being that radically different from the UK system, which failed disastrously under pressure of a housing downturn, which I think cannot be ruled out in the Australian context. I guess I am not saying that APRA is not doing a good job. I guess I am urging against the kinds of complacency that says: ‘Look, we sailed through this financial crisis. Therefore, we do not have to worry about problems that manifest themselves so severely in other countries with very similar systems of regulation.’

CHAIR—Which takes me to my last question before I hand over to other senators. You have mentioned a couple of times, including in your submission, the need for basically a root and branch inquiry into the financial system. You were one of the six economists that called for that publicly last year. We have had evidence, particularly from the Australian Bankers’ Association and others, that we should maybe wait and that we are still coming out of the financial crisis. We do not know how the cards will really fall. Maybe we should leave it for a few years before we do something like that. Sure, it is justified, but now is not the time. What do you say to that?

Prof. Quiggin—Certainly, I guess I had some sympathy with that view at the time we were putting it forward. You could reasonably say things have not settled down, but I suspect it is going to be a long time before, for example, the sovereign debt crisis and the various adjustments in Europe play out. There is no guarantee that that resolution will come before the next financial crisis. The longer we delay, the longer the risks that there will be—

CHAIR—So delay actually increases the risk that we might not be prepared for the next one?

Prof. Quiggin—We are trading those things off. Obviously any sort of inquiry scares the horses to a certain extent, and we would not have wanted to have had it in the most extreme period of the financial crisis. But in my view, the likelihood is that we are not going to get a period of calm much better than the current one without running into the risk that we could see a severe financial shock. For example, a downturn in China, a collapse in the housing prices here or a number of factors could expose our system to severe stress. In looking at the failure of systems which were claimed to be highly transparent and effectively regulated overseas, my view is that we should be moving on this in the relatively near future.

CHAIR—So it is like, how long is a piece of string? If we need to have a full inquiry, let us do it now rather than later?

Prof. Quiggin—It will certainly be some time, given the nature of these things, before we get any sort of report.

CHAIR—If you do a proper inquiry, you are not going to do it in three or four months like we are doing this one.

Prof. Quiggin—Absolutely.

CHAIR—It will take a lot longer to do it properly.

Senator HURLEY—In your submission you suggest that the government should consider the establishment of a publicly owned savings bank similar to New Zealand Kiwi Bank, and you said that is in the context of the need to promote access to safe and convenient basic banking. Do you think that safe and convenient basic banking is lacking at the moment?

Prof. Quiggin—Clearly there are concerns about declines in bank networks in various areas. We have seen a contraction in the number of deposit taking institutions, in the number of branches they have and so forth. It is certainly something where there has been substantial concern expressed. We have seen some entry from people like Bendigo Bank. We have seen the credit union sector trying to assert a role for themselves. It is an issue that is worth a look rather than something that I am asserting as a top priority for immediate action. It certainly is a way of providing a backstop, which then reduces the degree to which we might consider imposing more stringent regulation on private providers to ensure that they do continue to provide those basic services.

Senator HURLEY—You think it is regulation that induces existing banks to provide basic services rather than them wishing to provide that service?

Prof. Quiggin—I think they are responsible to their shareholders. At various times they have made different judgments. Again, looking at the last 20 years, it is certainly the case in the period immediately following the 1990 financial crisis, when they were not facing very much competition, that the major banks substantially raised fees and charges on retail consumers essentially to make up for the losses they had made by their own bad investment decisions in backing the likes of Bond and Skase. There certainly have been periods when the kinds of services provided by the major banks have, in my view, been clearly inadequate and only constrained from even worse behaviour by regulation. There have been other periods, of course, when the combination of external competition and competition among the banks themselves has produced more favourable outcomes.

Senator HURLEY—The government sold off the Commonwealth Bank a while ago. Do you consider that the re-formation of a publicly owned bank, while it might increase competition, would undermine the basis of the four pillars of banking that you have argued in favour of?

Prof. Quiggin—I should say I have not taken a view on the four pillars policy. I have merely made the point that it appears that, fortuitously, that policy worked to promote financial stability in the context of the last crisis. I am not taking a view on the four pillars policy itself. The argument that a low-cost publicly competitor in some way presents an unfair threat to private firms has been raised in other contexts, and in the absence of a playing field being tilted in favour of these institutions I cannot see that the likes of the four major banks will really be terrified by the fact that maybe people can do banking at the post office.

Senator HURLEY—Perhaps the credit unions and other smaller banks might be?

Prof. Quiggin—Indeed. I made that point in the submission. Among the possibilities for providing this kind of basic service are trying to look the expansion of the credit union sector or a return to public banking. I am not committed to any particular one of those proposals; I am merely saying these are issues we should look at.

Senator XENOPHON—You state in your submission—and this goes to the issue of moral hazard that the chair raised with you—that banks face an incentive to take on additional risk by virtue of the guarantee, and in particular to increase their exposure to systemic risk—that is, the risk of losses in the event of a general financial breakdown. Have you seen any evidence of banks taking on additional risk since the GFC and since the guarantees have been in place in an Australian context?

Prof. Quiggin—No. I think it is fair to say—and this is very typical of systemic crises—that you do not see a higher type of risk in the immediate aftermath of a financial crisis. I think we are seeing a period of conservatism and, as I said, we are still experiencing to some extent the salutary impacts of our own last major financial crisis. We are, I think, seeing some evidence of this re-emerging globally, though. Some of the recent innovations of Goldman Sachs, for example, have been ringing alarm bells as regards the extent to which the lessons of the crisis have already been forgotten globally. I think there is a global concern, but I would have to say that I do not see any particular evidence of this concern in Australia at present.

Senator XENOPHON—With respect to the payment system, the RBA gave evidence this afternoon. Certainly ATM fees are now much more transparent. Why do you not think this has led to the banks lowering ATM fees?

Prof. Quiggin—In general, despite the remarks I have made, there clearly are benefits from transparency. One of the characteristics, though, of a highly regulated system with complicated guarantees is that market players have an incentive in many cases not to pursue transparency. In a properly competitive market, somebody with opaque offerings is likely simply to be driven out of business. But in this context, we have seen periods when, in the absence of regulatory pressure to promote transparency, we do not see that. I certainly am instinctively in favour of transparency. I am merely urging that all these issues be addressed in a comprehensive context.

Senator WILLIAMS—Do you think it is time for a ‘son of Wallis’ inquiry to have another look at the industry?

Prof. Quiggin—Absolutely, and I think this view is shared by Professor Harper, who was the leading economist on the Wallis inquiry.

Senator WILLIAMS—Speaking frankly, do you have fears about the banking industry in Australia and around the world in, say, the next 10 to 15 years? Is there something that you fear could go drastically wrong?

Prof. Quiggin—Certainly. Again, I am very pessimistic about the global situation. I see little evidence that any of the lessons of the crisis have really been learned. It will be hard on a casual visit to Wall Street, say, to see any evidence that these are institutions which have been bailed out at massive expense by the public of the world only a few years ago. Everything has gone more or less back to normal. I do not think the regulatory reforms that have been introduced overseas are remotely sufficient to prevent another systemic crisis. I am very concerned about the global situation. I think the financial sector globally remains far too large, far too profitable and far too much oriented towards high-risk activities.

Senator WILLIAMS—I am inclined to agree with you. When you consider that America alone has a government debt of some $14.5 trillion, and you see the stimulus packages, you do not think you will fit all the noughts on a calculator if we had to put the figure on it, unless your calculator is this wide. The global financial crisis was brought about basically by reckless lending, was it not? It was assumed the price of houses was going to keep going up, and there were subprime loans. People did not have deposits and they could not afford the payments but, 'She'll be right. The house will be worth $50,000 more in six months time', but it was actually worth $50,000 less in six months time and the wheels fell off the cart. It went right around the world. Surely if we are going to prevent this, the people over there have to clean up their game?

Prof. Quiggin—I do not want to be totally pessimistic. We are seeing actions in the G20 and so forth. Nonetheless, it is my judgment that overall we may well have seen the high-water mark of reforms. There have been the so-called Basel III reforms, which on the whole probably did a reasonable job of preventing a repetition of the exact same crisis we just had. But I think the instinct among national governments, particularly the UK and the US, has been a much more historic role of trying to protect their large financial sectors against regulations that would reduce their national advantage. I do think certainly that the idea we can rely on a period of calm globally and therefore that we do not have to look very closely at our vulnerability to another round of shocks would be very much mistaken.

Senator WILLIAMS—Do you see the Basel III implementations as a step in the right direction?

Prof. Quiggin—A step in the right direction, but I fear it will turn out not to be an adequate step. I also fear that we will see, and we saw in the aftermath of the dotcom boom, a bunch of regulatory measures introduced, and it was only a very short period before the financial lobby was saying, 'This was just an incredible overreaction to what was really a minor episode. We should be chipping away at these regulations.' Indeed, I have heard people making that very point as if they had been proven right about these regulations when the only problem with them was that they were so grossly inadequate. But in the aftermath of the global financial crisis, there is a bunch of bankers saying, 'Let's not overreact like we did after the dotcom crisis', as if the reaction had been too severe rather than not stringent enough. I am very concerned that, given the lobbying power and the profitability of the financial sector, we are going to see those reforms chipped away at in various ways.

Senator WILLIAMS—It is a big sector. Even in Australia we have had evidence from witnesses about a growth of seven per cent a year, which is a pretty good business as far as growth goes. Just looking now at the Australian situation during the GFC, the government did underwrite deposits of up to $1 million free of charge. I was told that that was because there were concerns about a run on a bank and to shore up the deposits. I think that had a positive effect, and I think we are past that. What can the Australian government do? We can be pretty proud of the way our banks have come through, and we have to have strong banks. If their credit rating is downgraded, up goes their cost of money, and everyone pays more on their debt. Do you think there should be a message that perhaps our government should be taking to G20 meetings and to our friends in trade, et cetera, about their financial management, given that you have concerns about the world situation? If so, what message?

Prof. Quiggin—I think clearly we can take a message in terms of attitude. We benefited very much from a conservative attitude. It is not clear to me that the design of our system in its general structure was significantly different from the design in the UK, which failed. Obviously it is much more pleasant to go to the G20 saying, 'We didn't actually have a problem', than to be one of the countries that did. I guess I would say that if we are going to take a message we should first take a much harder look at our system, see what it is that worked and what did not. Because simply saying, 'Look, the system functioned. Therefore, it is okay,' does not give us much to take to the G20.

CHAIR—Doing that while it is still reasonably fresh is probably the best time to do it.

Prof. Quiggin—That would be my view. Certainly one could argue at the time we put out that call that we were being a little bit hasty, but I guess we did not imagine that the government would jump to respond. I think at this point, looking two or three years down the track to the release of a report, that would seem to be a very good time to look at the question of what it was. Even if it turns out that all the news is good, it would be good to know what it was that gave us such a good performance compared with those in many other countries.

Senator WILLIAMS—That is a good point. Even if everything turns out to be good, at least we know then that things are good. If they are not all that perfect, there could be room for improvement to get it good.

CHAIR—And to understand whether it was luck or good management?

Senator WILLIAMS—Yes.

Senator PRATT—You refer in your submission to links between protected and unprotected financial institutions needing to be prohibited. To what extent does this risk already exist within the Australian financial sector, and how would you characterise that?

Prof. Quiggin—I have to say this is a pet point of mine I have been going on about for more than 30 years, going back to the period when we had a tightly regulated banking sector and an under-regulated finance company sector. At that time, in the late 1970s, a number of finance companies went under. One of them was owned by the Bank of Adelaide, and had threatened to take the bank down with it. So the Bank of Adelaide was rescued, whereas the others were allowed to fail. Ever since that episode I have been alert to this issue that there is no point in saying we are going to allow adventurous financial institutions to fail if their failure has the potential to take down institutions that are systemically crucial. My view is very much that, if institutions want to undertake radical innovation, they should do so in a way that does not imperil the institutions. Ultimately, as the experience of the GFC has shown, whatever governments may say, whatever brave talk they may have in the lead-up, when push comes to shove they are going to have to bail out those institutions.

Senator PRATT—Are there ownership relationships in Australia that you would be concerned about?

Prof. Quiggin—In my view, we have to start by looking at the all-finance structure which essentially we have, the Europeans have long had, and the Americans did not have under Glass-Steagall, but they moved it. So, the first point is that we have to ask the question: should we have institutions like the major banks which engage both in retail lending that absolutely has to be protected and in a wide variety of other activities on their own account where it is impossible, in my view, to insulate the risk associated with those activities from the core retail functions? So that is, I suppose, the biggest parameter, but there are also huge amounts of cross-ownership of various kinds. The provision of credit was the crucial thing in the 1980s period. It was not cross-ownership so much as the fact that the banks lent systemically dangerous amounts of money to speculators who then got into trouble and then threatened to bring down the banking system with them.

Senator PRATT—I do not raise this particular example for any reason other than it is the only example that leaps into my head, because we have talked about it a lot for other reasons. I refer to the Commonwealth and Aussie Home Loans. I am not asking you to critique that ownership relationship, but is that an example?

Prof. Quiggin—What we should draw from that lesson is that either Aussie Home Loans should be treated as a systemically crucial institution, and we could take the view that, if Aussie Home Loans fails, ultimately the taxpayer is on the hook in the same way as with the Commonwealth Bank, or we should say, ‘We do not want this kind of ownership relationship.’ The issue in my view is a sharp boundary between those institutions we are going to protect. There is nothing to be gained by the kind of delicacy displayed by us, and even more by the New Zealanders saying, ‘We do not really have a guarantee. We are not sure, et cetera.’ The fact is that they will be bailed out and I think we have to say: ‘These are the institutions which are guaranteed. Outside this boundary, we guarantee we will not intervene.’

Senator PRATT—Do you suggest that we have a blanket ban or does it depend on the size of the ownership stake or anything like that?

Prof. Quiggin—That is the kind of point that the inquiry needs to decide. The big danger—and what the LTCM episode in the US illustrates—is that a seemingly small institution like LTCM, which was allowed out of the net on the basis that it was only rich people gambling with their own money on a small scale, managed by virtue of various complicated leverages, had exposure to the tune of trillions of dollars, which then imperilled the entire system. Obviously there is a bunch of services banks like to provide and are conveniently provided, so I do not have a dogmatic view that we should have an absolute ban, but we need to have a set of regulations that ensure we do not repeat an experience we have gone through a number of times in Australia and many times overseas with supposedly unregulated institutions and their failure bringing the systemically crucial institutions into a state of risk, and then necessitating a bailout extending to those high-risk activities.

Senator PRATT—Thank you.

CHAIR—It is extremely complicated, though, is it not? Some of those smaller institutions that might not have that implicit or have the likelihood of being picked up or looked after by government if they fell might actually have sourced some of their wholesale funding from some of those institutions that are, and therefore put the larger institutions at risk by virtue of the fact that they have money in them that they have provided for funding purposes?

Prof. Quiggin—That is precisely my view. Such wholesale relationships should be in general discouraged.

CHAIR—You are not just talking about ownership?

Prof. Quiggin—No.

CHAIR—That is an important funding source for some of those smaller institutions, which then help provide competition in the overall market.

Prof. Quiggin—This to some extent prejudges the kinds of—

CHAIR—But these are the issues that you want looked at?

Prof. Quiggin—Sure.

CHAIR—You are raising the issues?

Prof. Quiggin—Yes. My view is we should not have a situation which is to some extent implicit in a vague non-stated guarantee where with some institutions we know they are going to be bailed out and others might be lucky or might not. If these institutions are regarded as providing retail competition with the major banks, they should have the same guarantee and be subject to the same risk management restrictions as the major banks, and that guarantee should be explicit. We should understand what we have rather than having—

CHAIR—Then you need to deal with the widespread—

Prof. Quiggin—Yes. Once there can be no pretence that there is not a guarantee, I think we can say that therefore your risk management has to be consistent with the fact that under appropriate circumstances we will protect your depositors.

CHAIR—Thank you for your assistance today.

[2.31 pm]

MURPHY, Mr Michael Charles, Chief Executive Officer, Queensland Teachers Credit Union

CHAIR—Thank you, Mr Murphy, for assisting us today. I invite you to make an opening statement.

Mr Murphy—Thank you for the opportunity to address the committee this afternoon and to make a short address on behalf of QTCU. I am aware that Abacus and other mutuals have made detailed submissions and testimonials to the committee, so I wish to restrict my comments to items raised in our submission, with particular emphasis on how they relate to QTCU. To set the scene, we must be conscious of the context in which we base our observations, and on the issues we have raised and will be expanding on today. We are a small niche retail community based player in the Queensland marketplace, with assets of a little over $1 billion, 70,000 members, a branch network extending from Cairns to Southport, a participant in the Rediteller ATM Network, with capital adequacy approaching 17 per cent and total capital of almost $1 million. We are small in relative terms to the rest of the market. However, we believe we are extremely competitive in our chosen marketplace, as our rates and member satisfaction levels would indicate.

I will pass on a list of some of our rates to the committee. We welcome the current developments in examining competition in the banking sector, and support the Senate inquiry as well as government's recently released competitive and sustainable banking system package. We look forward to some of the additional positive and potentially practical outcomes from this inquiry that will obviously benefit small institutions like us, as well as promoting competition within the wider marketplace. We are very supportive of the government's planned community awareness and education campaign to properly inform consumers that mutuals like QTCU are a safe and competitive alternative to the big banks.

I would now like to take the opportunity to explore a number of specific observations. The first observation is in relation to innovation. It is our belief that one important element missing in the banking sector that might stimulate competition is innovation. Innovation, by its very nature, involves risk and risk taking. Financial services is a sector that is extremely risk averse, and it has a low tolerance for risk taking, for understandable and sound reasons. In fact, our whole regulatory system and prudential standards are built on established frameworks that focus on risk management, monitoring and mitigating risk, which is essential for a stable environment—a notion we support. There is little doubt that the system has served us well, as we have already heard.

However, as previously mentioned, innovation and, to a certain extent, competition in the banking sector, has been influenced and perhaps curtailed at times by our risk-averse focus. At QTCU we are very proud of our record of innovation. In fact, QTCU was the first institution to introduce ATMs in the Australian marketplace in 1977, well before the banks. I question whether we would have made that innovative decision if we had been operating under the current standards and risk framework.

To further illustrate this observation, recently QTCU developed a rate tracker home loan product. Rate tracker is a variable rate loan that tracks against the official cash rate. When the RBA changes rates, our rate changes by the same movement and there are no surprises. There is full transparency and it is easily understood. The product has been well received by our members, the community at large, and has received recognition by the highly respected *Money* magazine, with QTCU winning the award for the best innovative product for 2011.

The product was released well before the majors moved outside of the RBA rate increases last year. We understand the interest rate risk re-pricing associated with this product, if funding costs move significantly higher than movements in the OCR. However, if we take a holistic view of interest rate movements over the last 20 years, comparing the movements in the OCR with movements in the standard variable housing rate, one can conclude from the document that I have already circulated, which is based on RBA available information, that there is a definite strong correlation between the two. While we acknowledge that since the GFC there has been some adjustment to this correlation and the move to align housing rate increases more in line with overall funding costs, we feel over time they will be returned to a more normalised albeit unofficial and politically sensitive trend, linking OCR movements with movements in the home loan rates, thus reducing our risk. As a mutual, we seek to optimise our financial performance for the benefit of our members, and future viability in order to maintain a prudent balance sheet, rather than to maximise the financial performance for the benefit of shareholders. We are prepared to manage what we believe is an acceptable level of risk, based on our scale of operation, community needs and our assessment of the marketplace. Therefore, we want to differentiate ourselves by offering a transparent feature, rather than always competing just on price through unstable discounting as appears to be the current environment.

However, we noted the committee's interest in this type of product we are offering, and the fact that the committee recently sought APRA's opinion on this type of product. We also noted APRA's response, which was as follows:

In APRA's view, there is a substantial implicit interest rate risk in such a product when ADI funding costs increase more than the reference rate.

One could only conclude from APRA's comments that there are certain restrictions on and additional penalties for innovation and differentiation that may, in our opinion, promote competition and transparency in the banking sector. Our capacity to meet the demand for this product depends on our funding, which brings me to highlight our second observation, and that is in relation to what we believe is a structural funding issue for smaller scale financial institutions, which ultimately hampers our ability to stimulate competition in the banking sector.

Smaller institutions, because of our size, scale and ratings, are basically restricted to raising funds from retail customers, commercial borrowing lines from major banks and from securitisation. All of these funding options have limitations and uncertainties associated with them, especially in volatile times such as those recently experienced with the GFC, when deposits went to the majors due to the perceived safety and security aspects of the majors. At the same time, the majors withdrew their support of borrowing lines to smaller institutions, and the securitised market, as we are all aware, basically shut down. The government itself has not helped our cause in relation to this issue by establishing pricing benchmarks via the now withdrawn wholesale funding rules that had been widely accepted by the marketplace, which were AA, 70 basis points; A, 100 basis points; and others, 150 basis points. While we acknowledge that the wholesale guarantee has ceased, the risk perceptions and rate differentials remain. We believe that these rate differentials are grossly disproportionate to the risk associated with the various ADIs due to the fact that they all are regulated, supervised and monitored by APRA under common prudential standards. Unfortunately, inflated rate differentials still exist today and are, in our opinion, basically illogical. As a result, smaller financial institutions need a more robust and more certain source of reliable funding at reasonable and competitive rates, meaning we are at a substantial disadvantage in competitive terms as our buying price is significantly higher, by some 80 to 150 basis points, than the majors. One must question whether that is a fair and equitable position, and one that encourages and promotes sustainable competition.

It is fairly obvious in our view that super funds with assets in excess of $1.3 trillion have the capacity to provide a structural solution to these funding issues in the long term. But they do not have the willingness or the vision to support such a proposition, instead hiding behind investment policies and growth responsibilities as reasons for their non-support. However, as a counterargument, in a recent article published in the *Financial Review* on 22 February 2011 Jeremy Cooper, head of the government's review of superannuation, says:

The retirement savings system has far too much invested in shares and risks failing people.

His comment basically supports our thoughts. Dominic Stevens, CEO of Challenger, also noted in an article in the *Financial Review* on 25 January 2011:

... this pool of superannuation assets has, by global standards an alarmingly low allocation to long-term fixed income investments ... Australia has the lowest such allocation in the developed world and, at 13 per cent, our allocation is less than half of the next lowest member of the Organisation for Economic Cooperation and Development, and about a quarter of the OECD average.

With the contribution to super expected to increase from 9 to 12 per cent, this source of stable funds will continue to increase and may become the only real source of savings in the future. Therefore, we suggest that normalisation of the assets allocated to OECD average levels would create a demand for long term fixed income that could be satisfied by investments in residential mortgage backed securities.

In our opinion, this represents the most viable and equitable solution to the structural funding issue facing smaller financial institutions. The government, via the Office of Financial Management and APRA, needs to encourage super funds, not by a legislative move, to reassess their asset allocations and investment policies in order to strengthen the funding options available to all ADIs other than the majors. We have also suggested creating a structural incentive for superannuation investments and safe banking assets without creating a speculative market. QTCU has recommended a model that would include tax incentives for investments in high-quality RBMS issues by ADIs. We have also argued the case for a limited government guarantee for wholesale funding instruments that support rate tracker type products—products that deliver certainty in competition, not a windfall gain for the ADI.

We are not suggesting that the government should either provide this guarantee for free or consider any form of socialising banking, but promote sensible market based intervention that supports competition, similar to the guarantee system in Canada that appears to work very well. Such actions will overcome a structural funding issue providing a stable source of funds while, at the same time, promote competition within the marketplace. With regard to funding, mutuals also rely very heavily on raising retail deposits. In fact, 95 per cent of QTCU's funding is provided by this source. There is no doubt that the government's action in introducing and maintaining the government guarantee has assisted us in attracting retail deposits from avenues that perhaps were not previously available to us due to the fact that we are unrated. I am referring to state and local government authorities, charities, schools, self-managed super funds and some high net worth individuals. The guarantee helped level the playing field for all ADIs.

The government has indicated that it wishes to review and perhaps amend the existing scheme, which expires in October 2011. We feel that any adjustment to the $1 million guarantee would be a retrograde step, especially at a time when other funding options such as securitisation and wholesale funds have not returned to their pre-GFC levels and prices. Any amendment should be delayed until these markets have fully recovered and are readily available for small players at what we would consider realistic prices. Therefore, any amendment should be carefully and thoroughly considered, because any changes may result in unintended consequences and have an adverse effect on and certainly weaken competition within the banking sector.

We contend that deposit guarantee is pro-competitive in a market so dominated by the big four. To reduce this guarantee while providing big banks with more funding benefits like covered bonds can only diminish competition. In conclusion, I would like to leave one thought in the minds of the Senate committee members, and that is: in order to ensure a competitive banking marketplace we need a system whereby all players—I repeat, all of the players, irrespective of size and scale—have access to stable and reliable funding mechanisms at equitable, if not similar, pricing. The solution is to level the playing field for all ADIs, especially the mutuals, by removing the significant pricing differentials, providing support of and stimulation to the RMBS market and maintaining the government guarantee at current levels.

Finally, I would like to thank the committee for taking the time to visit Queensland. Like all financial institutions, we have been working with our staff, our members and our communities throughout the floods and disasters. At QTCU, we were online and available throughout this period with no service gaps for our members. We have also put in place comprehensive hardship assistance packages for our members affected by the floods. We appreciate the goodwill and support of all political parties for Queensland's recovery. I would be pleased to answer any questions you may have.

CHAIR—Thank you for that, Mr Murphy. It is very interesting to hear everything that you have to say. I will start with the innovative tracker mortgage rates that you have and congratulate you on what is obviously clearly a very innovative product.

Mr Murphy—Thank you.

CHAIR—You quoted the substantial implicit rate risk, which APRA has highlighted. Clearly if there is a shock of some sort that results in your funding costs rapidly rising that may well put the credit union in a difficult position with those loans that you have at a guaranteed rate.

Mr Murphy—Yes.

CHAIR—In considering that, I think there are other products elsewhere in the world where there is a guaranteed rate above funding costs.

Mr Murphy—I am not aware of those. I am only aware that the tracker loans that came from the UK. We have established that the movements in the rates will only match the OCR rates. We are satisfied with the margin that we have built into the pricing of that particular product. We see that there is no difference between that product and the fixed interest loan, except the ability to hedge that particular loan. The risks, in our opinion, remain the same.

CHAIR—You have handed up some figures here. You have the mortgage tracker at 7.35 per cent; is that lower than your variable rate?

Mr Murphy—It is.

CHAIR—That is because it is at the guaranteed difference, whereas the variable moves around?

Mr Murphy—No. It was a particular decision to price it in realistic terms. Most organisations these days are offering significant discounts off the standard variable rate. Not too many loans are written at the standard variable rate. I would say at this moment in time you can have discounts of between 80 and 100 basis points. We tried to pitch a rate that was a little bit higher than the basic variable but not as high as the standard variable, taking into consideration the rate discounts that are available in the present marketplace. We have come up with a rate that we consider is fair and equitable, both from the organisation's point of view and from the customer's point of view.

CHAIR—Is it a product where you have limited the additional aspects or is it a no-frills product?

Mr Murphy—One of the risk mitigation strategies that we have is to limit the tranches. The pricing is 7.35, and we have established what we believe is what we can fund at that rate. Once that funding mechanism is extinguished, then we will examine our risk factors and see if we can actually have another tranche at either that rate or a similar rate.

CHAIR—At an institutional level, because you have placed basically a limit on how much at this point you will actually put out as a tracker loan?

Mr Murphy—We have to, because we do not have the funding mechanisms available to us. If we can solve that one, or if the government can solve it for us, there will not be an issue.

CHAIR—How are you going with that? How long has it been available?

Mr Murphy—It has been available since October.

CHAIR—Are the customers knocking the door down for it? Is it showing to be particularly popular?

Mr Murphy—We have not had the ability to go out and widely promote it at this stage, other than the free publicity that we received through the *Your Mortgage* magazine. Also, on Sunday, 27 February we introduced an advertising campaign within the Queensland marketplace.

CHAIR—Are your existing customers showing a liking for the concept?

Mr Murphy—They are at this stage, yes. But we are not being rushed through it. We believe that it will not automatically attract everybody. It will not solve everybody's needs. So it is for a specific type of client who wants certainty and surety in relation to how the interest rates move. They want transparency in relation to that.

CHAIR—I imagine there is a particular market out there, but, given that it is actually lower than your current variable rate, although individual customers may well negotiate lower rates, I would have thought, at least with your customer base, it would be more attractive. At an individual level, is it a no-frills type of option?

Mr Murphy—No, it is fully featured.

CHAIR—That is very good.

Mr Murphy—Everything with a standard variable rate, including no monthly fees, and there is an opportunity to have a $50 transaction-free savings account with it.

CHAIR—Finally, has APRA had a look at this and made any comments that they might be looking at your capital adequacy ratios or anything that flows from the fact that you are being innovative? Are you going to be punished for it?

Mr Murphy—I cannot answer it on behalf of APRA. All I can go on is APRA's comments to the committee, and I think one of its comments was that it may consider an additional capital charge for that type of product. But at this stage we have not been contacted by APRA so we are not aware.

CHAIR—But that would be on the basis that they see additional risk for your institution and therefore they need to cover that risk somehow?

Mr Murphy—Yes. But at 17 per cent we are well in excess of the requirements.

CHAIR—You also raised the issue of the wholesale funding guarantee and the inequitable pricing of that. I presume that you would still have funds that you borrowed using the wholesale funding guarantee?

Mr Murphy—No, we did not.

CHAIR—You did not borrow any with the wholesale guarantee? Is that because of the pricing differential?

Mr Murphy—No. We decided to try to fund retail.

CHAIR—You mentioned 95 per cent—

Mr Murphy—We are 95 per cent funded retail.

CHAIR—Do you still consider that the pricing was inequitable?

Mr Murphy—Yes.

CHAIR—If there had been more equitable pricing for the guarantee, is that something you would have been more likely to have considered?

Mr Murphy—Yes. I think that is a requirement by APRA at the moment as well. They want the smaller financial institutions, like us, to diversify their funding. We have to look at opportunities. We agree with them that we need to diversify our funding options, and that is why we have suggested a couple of other models.

CHAIR—I asked this question earlier today: if the government were to reintroduce a wholesale funding guarantee in some form, but with more equitable costs, would that be something you would look at partly to help meet the APRA guidelines in terms of your funding sources?

Mr Murphy—Yes. I think it covers off a number of options. It guarantees the funding for us so that we can help our customers and promote competition within the financial services marketplace, offering better products and services at competitive rates. It also solves the APRA issue in relation to funding.

CHAIR—We had a lot of evidence late last year that there was strong competition in the retail deposit market, with everybody from the big banks down to the smallest ADIs all looking to try to get money from retail deposits, because it was good, solid stuff that made everybody happy and it was out there. Recent media articles suggest that the big banks at least were very successful in that regard, and some of their forecasts in terms of their loan book have not actually eventuated. So they have probably raised more than they need. Firstly, is that something that you would agree with and, secondly, is that having any impact on the levels of competition in the deposit market? Are the big guys backing off a bit and making it easier for you to raise retail deposits?

Mr Murphy—I think all of those comments are very valid. In the initial stages, because securitisation, wholesale markets and the overseas markets were not available, the big four banks then said they were going to grow their retail market. They were out there with very attractive rates which, of course, smaller institutions have to match. Your observation is correct: since that time the loan market has diminished. They have attracted sufficient retail deposits, so they have wound back their rates. This has meant that we have also followed suit, to a certain extent, so there is less competition in the retail deposit side.

CHAIR—So bad for those who are trying to place money, but possibly better for smaller institutions to be able to obtain the funding they need through retail deposits without having to pay exorbitantly high rates?

Mr Murphy—That is definitely correct.

CHAIR—With respect to super funds, quite clearly there is an awful lot of money out there that would make a huge difference if it was invested into the banking industry, but it is not really happening in any major way.

Mr Murphy—Not to my knowledge, anyway.

CHAIR—What can government do that will make trustees, when they look at their investment decisions, find that investment more attractive?

Mr Murphy—The government itself has undertaken an advertising campaign to try to stimulate the super funds and ensure that they are aware that all ADIs, irrespective of their rating, are safe and secure. I think that is the best avenue. With RMBS, it should not be on the rating of the institution that is providing me the housing loan but on the credit risk policies that stand behind those particular securities. Therefore, in my opinion, our credit policies would stack up with the major banks', but our ratings do not. To me, that is illogical. The pricing of the RMBS and the ratings that we deserve for those particular securities to attract super funds should be exactly the same. The other option that we included was that the government could perhaps provide some tax incentive.

CHAIR—Which would come at a cost to government revenue, which is never an attractive option for government.

Mr Murphy—I know it is not an attractive option, but I do not think the exposure would be significant.

CHAIR—We might ask Treasury about that when they appear before us next week.

Senator WILLIAMS—This inquiry originated because on 2 November, Melbourne Cup Day, the Reserve Bank rose cash rates by 0.251 per cent, and then the Commonwealth Bank led the major banks with a 0.45 per cent rise, and people were getting cranky seeing their home loans go up with the variable rates. The argument from the banks was that their cost of funds had increased. Now you are saying that the retail deposit interest rates are certainly going down.

Mr Murphy—Yes.

Senator WILLIAMS—I have called them on notice to provide a graph of that, so their margins will be spreading. I think the big problem for the general public is that the banks cry poor, saying their cost of funds is going up, and then they deliver record profits. That probably does not add up. I am amazed how your institution, working on such a small margin, can succeed. How do you balance your retail investments with your lending? It would be a fine balance. You could not have an extra $10 million sitting in a deposit not lent out, so how do you balance that?

Mr Murphy—Like all ADIs, we do have fairly good liquidity management policy and systems in place. I think the fundamental difference is probably the attitude of the institution. I would have to say that the banks have one single primary focus—that is, profit for the benefit of shareholders. That is their single motivation. We do not have that same focus. We have a culture and a philosophy that we would like to have a fair distribution of the profit between the benefits to the customers and the financial viability of the organisation in growing its balance sheet. I do not believe that the banks have that same philosophy. Their total motivation is to maximise profits for the benefit of shareholders.

With this type of product, there are some interest rate risks, which could have an effect on their profitability. They have sophisticated systems in place, they have sophisticated treasury operations, they have hedging possibilities—they have all the expertise available to mitigate and manage those risks, but they do not want to do that, in my opinion. I cannot talk for the banks; I can only offer you my opinion on the way they operate. Their focus is on profit maximisation; our focus is not. Therefore, we are prepared to wear some of the lower margin.

Senator WILLIAMS—No doubt as a smaller ADI, you would love to see that deposit guarantee maintained by the government because it removes all fear of people investing with you, other than those who have more than $1 million invested?

Mr Murphy—That is exactly correct. We believe that it levels the playing field, and that is exactly what it should be. As we said, we operate under the same prudential standards. We are regulated by the same regulator. We are monitored, examined and inspected by the same system, so why should we not have the same ability to attract retail deposits? If that is what the public at large require—an implicit government guarantee—I think that is worthy of maintaining.

Senator WILLIAMS—It is proposed by the government to have five per cent covered bonds issued. Can your company issue covered bonds?

Mr Murphy—The strict answer is, yes. Is it prohibitive because of our size, the ratings we would obtain, the costs involved, as well as the limitation of the tranche, which is probably $500 million or $1 billion? I think the avenues in which we can operate in covered bonds would be very remote.

Senator WILLIAMS—Surely that is then another advantage to the big end of town, if I can call the big four the big end of town?

Mr Murphy—Yes, it is in theory. I think it was one of those good ideas that it was open for all. In practical terms, the smaller players cannot participate.

Senator WILLIAMS—Was it a good idea to open for all when there was a shortage of money to lend, and that situation might well have changed now? We see the retail deposit rates going down. That is surely a signal from the big end of town that the money has flowed in. I was reading this week in the *Financial Review* that, going on the last quarter of economic growth figures, 10 cents in the dollar are being saved. That is a record amount in Australia's history, with people being cautious. Would that be reason enough for the government not to proceed with covered bonds and stack that advantage to the big banks and it would disadvantage you even further at this stage of the cycle?

Mr Murphy—I think from APRA's point of view they have the same attitude irrespective of the size of the organisation. In other words, they would like to see diversification of funding. I would have to say as a protection for the stability of the financial system it should be maintained. I do not think it should be maintained as well as taking away the government guarantee for the smaller institutions. It is either both or neither.

Senator WILLIAMS—Are you saying if the government takes away the guarantee for the retail investors up to $1 million this October, they should take away the covered bonds issue as well?

Mr Murphy—That is what I am saying.

Senator WILLIAMS—That is fine. You can speak freely here. Everyone's opinion counts, especially when you come from a small institution. We value your opinion.

Senator PRATT—Is your institution doing anything, other than through Abacus where you are sharing balance sheets, in order to access security? I know there are some movements between some institutions to combine balance sheets in some way in order to do that. Is that a viable thing? Are institutions too distinct? Credit unions and mutuals are now starting to combine their brands and advertise a bit more. What does that landscape look like from the point of view of the Queensland Teachers Credit Union?

Mr Murphy—There are two aspects to that. We agree with the aggregated balance sheet-type situation. We do not particularly participate in the Cuscal driven ABS. We have a strategy in which we would like to share back-office functions as well as promote merger opportunities but under a different model whereby all of the institutions maintain their brand, identity and heritage, and operate as they are now but with the added backing of a consolidated balance sheet. Yes, we are doing that part. On the funding side, a number of groups are looking at aggregating together to arrange covered bonds or wholesale funding, and we are participating in that. There are opportunities for us to do it as a combined entity.

Senator PRATT—Are those developments significant as a fifth pillar of banking or do you perceive that they would have a very long way to go before they make a meaningful contribution?

Mr Murphy—I believe we have a fairly long way to go in regards to that. All of those steps, as they are undertaken, will certainly make the mutual sector a lot stronger and have the ability to promote its services out into the wider marketplace and not specifically just in small regional areas.

CHAIR—Thank you, Mr Murphy, for assisting us this afternoon. Good luck with your tracker home loan and other innovations.

[3.17 pm]

BEHRENS, Mr Nick, General Manager, Policy, Chamber of Commerce and Industry Queensland

CHAIR—I welcome the Chamber of Commerce and Industry Queensland and I invite you to make an opening statement.

Mr Behrens—The Chamber of Commerce and Industry Queensland welcomes the opportunity to provide constructive input into the Senate Economic References Committee's inquiry into competition within the Australian banking sector. The Australian banking industry has a profound influence on the Queensland business community's capacity to grow. Interest rates, availability of credit and finance terms and conditions are crucially important for business and are greatly influenced by competition in the Australian banking sector. Unfortunately, since the onset of the GFC, the major banks have become significantly more conservative in their business lending. This has resulted in an effective lessening of competition in business finance, and businesses are experiencing a range of difficulties at present in their lending arrangements. High bank fees and charges, higher interest rates and accordingly cost of finance, increasing levels of security required for loans, and difficulty overall in obtaining credit have all been listed as common problems for business in their banking. This directly inhibits businesses' ability to grow, invest and employ.

CCIQ's representations reveal a range of instances of the bank's tightened lending criteria threatening the ongoing viability of many businesses. Changes in lending requirements have undermined the feasibility of existing business plans, resulting in businesses either shelving plans for expansion, downsizing or in some cases exiting the market altogether. CCIQ recognises that the banks have a responsibility to run their businesses in a manner that minimises risk and that in turn delivers a profitable and strong foundation. However, Queensland businesses are looking to our lending institutions for behaviour that focuses on a strong economy and not just their shareholders. Ultimately financial institutions must have a broader responsibility for economic development in Australia.

CCIQ has listed a range of recommendations to increase competition in Australia's banking sector, including facilitating overseas institutions into the Australian market, abolishing interest withholding tax, abolishing the Australian government's wholesale funding guarantee, and setting up a federal small business loan guarantee scheme.

The chamber has endeavoured to differentiate its submission amongst others by the inclusion of a number of qualitative quotes from our members. We were endeavouring to provide you with a first-hand indication of some of the difficulties that Queensland businesses were experiencing in their finance arrangements and to bring this to your consideration.

CHAIR—I read through all of your qualitative quotes with great interest. There was some very interesting feedback in it, but one of them struck me as I was thinking about the challenges that we face over the next month as we put this together. It said:

The only other solution to breaking up the monopoly power enjoyed by the banks is to introduce real competition into the market. The caveat of course is to do so without unduly weakening the underlying strength of our banking system.

The great challenge that this committee has is to look at how we can increase the competition in the market while maintaining the underlying strength of our banking system and not suggesting solutions that may introduce unintended consequences that may have that impact. Whichever one of your members that wrote that was quite close to the mark and knows exactly what he is talking about. There are some very good quotes in there. You mentioned in your opening statement that during the GFC there were decisions by banks to unilaterally change lending standards and that has had an impact on decisions of your members in terms of investment, employment, their ability to grow businesses and so forth. Are you aware of any examples of any of your members that were meeting all of their repayments, were not in any sort of financial trouble, but the changes in lending standards technically put them in default unless they were able to come up with large amounts of money or that sort of circumstance?

Mr Behrens—That has been a consistent theme by many businesses. In their minds they were meeting all of the criteria that were set by their lending institution. However, their loan arrangements have been reviewed by the bank and, accordingly, they have had to either turn an interest loan into retiring principal amounts or they have had other aspects of the loan changed significantly to the detriment of their plans.

CHAIR—So, that is consistent and not uncommon in your members' experience with banks over the past few years?

Mr Behrens—Yes. It is consistently reflected in the quotes within the document that there has been a change in the playing field on behalf of the banks and that their business operations and plans to grow have been at the expense of that change in behaviour.

CHAIR—I do not know whether you have had a look through the submissions and the oral evidence that was provided by the large banks as part of our inquiry. There is an awful lot to read so I am not expecting that you would have done so. We have put some of this behaviour with the changes in lending standards and the consequences to the banks, and on the whole my recollection is that they have all denied that they changed their lending standards. They claim to have supported and in some cases to have increased their support to small business throughout that period. I think the Commonwealth Bank stated in its submission that it was a keen supporter of small business since the GFC began and has grown its market share well above system growth, while repricing sensibly for risk—so I guess that is where the issue is—and without changing lending standards. The NAB claims in its submission that it continued to support Australian small business during the GFC and grew its lending to this sector as others withdrew.

Their evidence does not seem consistent with evidence that you and other business chambers have provided and also the small business organisations, all of which indicate—and from reading the quotes in your submission from front line practical experience—that there were changes in lending standards and that the degree of support they received was not necessarily the rosy picture that was presented by the big banks.

Mr Behrens—There is a key issue here and that is that the banks may not have changed their criteria, but what they have done on a number of occasions is had the value of the business or the land held by the business revalued, which has subsequently adjusted the LVR and has meant that the overall terms of the loan have changed significantly for the business. I can appreciate, from a business perspective, that things have significantly changed based on the value of its operations. But from the banks' point of view they are sticking to their consistent methodology and how they do things.

CHAIR—Do you think there is a bit of sophistry at play? Are they being very clever with their words and how they put that?

Mr Behrens—I think they have chosen their words carefully.

CHAIR—Quite clearly your evidence, backed up by the quotes from your members and evidence that we received from others, suggests that decisions by banks did put otherwise profitable or viable businesses that were meeting all their loan repayments in difficult positions.

Mr Behrens—Absolutely. We were mindful that perhaps some of the lending practices prior to the GFC were unsustainable and we recognise that sort of behaviour would need to change. However, in the attempt to be more sustainable in bank lending practices there have been a number of unintended consequences, particularly for small business, and they are copping the brunt of the new playing field.

CHAIR—In your submission you examine the issue of the banks' profits and note that Australia's major banks are recording record high profits despite the fact that they are claiming that their cost of funding has increased. I presume the only thing we can conclude from that fact is that they are unilaterally able to increase their interest rates or the cost of the product to ensure that they are able to maintain their profit margins as their cost of funding increases and that has consequences, obviously, for business and consumers alike. You also note that the major banks' return on equity is high compared to other industries. The banks have given us evidence that says that their return on equity is normal compared to other listed companies. Why do you say that their ROE is high?

Mr Behrens—We are relying on the Reserve Bank of Australia in terms of their assessment of the return on equity compared to other industries. In the November statement on money policy there is a detailed overview of the dominance of the major banks. There was a statement within that document citing that return on equity compared with other industries was considered to be high by the RBA.

CHAIR—Do you have a reference to that in your submission?

Mr Behrens—Unfortunately I do not. I can endeavour to go away and find it.

CHAIR—That would be useful. The banks compare themselves with the mining industry and others where the return on equity may be 34 per cent. Given that Rio Tinto and BHP Billiton are comparable in terms of overall scale on the stock exchange, they are the ones that they would like to compare themselves to, but there are also various differences between those larger companies and the banks in that the banks have that implicit at the moment and explicit guarantee, the 'too big to fail' type of argument. Banks have an expectation that the government will support them, and there is a social compact—for want of a better way of putting it—between the community and banks that does not exist necessarily with a mining company or with other companies. The question is whether a higher return on equity is reasonable given the support they get from taxpayers essentially.

Mr Behrens—The reality check for our membership is, if you were to ask our members whether they would be happy with a return on equity of between 10 per cent and 15 per cent, most of our small business members would be saying yes.

CHAIR—Yes. You stated that according to the chamber's banking sector survey one in two Queensland businesses have attempted to obtain finance in the last 12 months or are currently in the process of doing so, and whilst difficulty in accessing finance varies dramatically very few businesses indicated that this process has been easy. What I am interested in is whether you have done any analysis over time, because I would be interested to see how that has changed. As a one-off instance, it is hard to say whether that really means anything because, as somebody who used to operate a small business myself, I know accessing finance as a small business is never easy even in good times. It would be interesting to see how that has varied, depending on the circumstances and the context that might be in.

Mr Behrens—I agree. I think there would be significant benefit from doing a longitudinal analysis on those questions. We were endeavouring to highlight that the difficulty in negotiating new loans was higher than for existing loans. We were endeavouring to highlight that the new lending arrangements were much more difficult in obtaining new finance.

CHAIR—That makes it clearer. You also address issues about switching. In respect of exit fees, which has obviously been a key consideration that this committee has looked at with a number of witnesses, you suggest that the bigger problem than the fee that might be charged is the time and resources involved on behalf of the business in actually doing the work to get it across. Would you care to expand on that?

Mr Behrens—Until such time as there is commonality of banking details that would facilitate a very quick rollover of bank details to another lending institution, the impediment to business is not the financial cost but the red tape burden or the unquantified cost of having to change the set-up details for both direct deposit and direct payment from the lending institution.

CHAIR—What sorts of exit fees tend to apply to business loans?

Mr Behrens—One of the interesting things that came through our committee process is, firstly, abolishing exit fees was not necessarily considered to be the solution to switching banks. Indeed, the perception was that very few businesses switch banks, and I think that is highlighted in our submission with the number of businesses that have stuck with their lending institution for greater than 10 years, particularly for the large banks. The impediment is more along the lines of the start-up costs of new loans. Rather than trying to put in place a change that would address or offer a solution for the relatively small proportion of businesses wishing to exit a loan and start a new loan, you actually make it easier just to start up a new loan for the business and reduce the upfront costs of new loans.

CHAIR—Portability of account numbers and things like that would obviously address a lot of the issues because you would not have to worry about your direct debit payments or letting your customers know what your new account number is so that when they make their payments to you it just moves across with it?

Mr Behrens—Craig Emerson hosted a small business summit in Brisbane just after the onset of the GFC and certainly portability of banking details was seen as a big solution to assist business to change lending institutions. I think there is merit. As to its execution, I am led to believe that it is very difficult.

CHAIR—I think it is. There are some challenges, but hopefully Bernie Fraser is up to the task and can find a way around it. Once again, you note in your submission that anecdotal feedback is that if exit fees were abolished the second-tier regional banks would suffer significantly. Where did you get that feedback?

Mr Behrens—We have a second-tier bank on our committee and they were very quick to highlight that we need to be cautious in endeavouring to promote competition within the Australian banking sector, but in reality what we are doing is in fact putting in place mechanisms that inhibit competition or make competition more difficult for the second-tier lending institutions.

CHAIR—You may not have received the anecdotal feedback that we have had. We also had evidence here that for the non-bank financial institutions it is an even bigger impediment. I think the argument generally runs that the smaller the institution the higher the percentage of your overall running costs and the costs of setting up new loans. If you do not have the ability to recover where you make a loss because they leave early through an exit fee, it makes it harder to compete, whereas the big guys can swallow that or cover that a lot easier by cross-subsidising from other areas and so on.

Mr Behrens—That is entirely consistent with what was put to us. There is the ability for the major four to cross-subsidise and offer lower exit fees. They do not need to rely on that; the small institutions do.

CHAIR—Despite that, you would agree that making switching easier is likely to put more pressure on banks to offer better products to business? You noted that a lot of your businesses commented that when they did make the move to go somewhere else then their existing bank made a better offer. That is all good because it helps to bring prices down and ensure that customers end up with better deals either with their existing bank or with the new one, because that money is negotiated down because they could switch.

Mr Behrens—Time and again competition leads to lower prices and improved service offerings. I think the Australian banking sector would be an ideal example of that principle.

CHAIR—I have a final comment before I hand over to others, but still on the same issue. You note in respect of exit fees that you think more focus on entry fees would yield a better result for business. What do you mean by that?

Mr Behrens—In terms of what I was saying, the chamber sees limited scope for changing loans and so you would probably not load up the exit fee to change loans, but we see greater potential for reducing the upfront cost of a business negotiating a new loan with another lending institution.

CHAIR—Thank you. Senator Pratt.

Senator PRATT—It appears to me that many of the businesses you have surveyed do not believe that their banks are particularly good at assessing the viability of their businesses and their capacity to meet their obligations to the bank. What do you think could be done to help banks better nuance and understand their customers?

Mr Behrens—One of our recommendations contained within our submission is for the better education of officers within lending institutions—better educating them on the nuances and difficulties of operating a business—so they have a better understanding of the issues small business operators face, and accordingly offer a better packaged loan to that business.

Senator PRATT—Are there any moves in that direction? I would expect, as a result of the global financial crisis with many of the alternative specialist lending institutions having their access to funds dry up, that people lending for farm machinery or for specific kinds of businesses fell out of the market.

Mr Behrens—The nature of our submission is that it is warts and all. Whilst there is a lot of negativity towards the banks, there is also a lot of praise within this document for banks. The second-tier banks scored much better than the major four, in terms of—

Senator PRATT—In their customer service?

Mr Behrens—Yes, in their customer service. The chamber sees it as a means by which the second-tier lending institutions can compete against the major four by marketing themselves as having a better understanding of the difficulties of operating a business.

Senator PRATT—There are different definitions of what people mean by second tier. Can you characterise which institutions are actually servicing the business community?

Mr Behrens—On page 6 of our submission, under dot point 3.2, there is a graph on the business bank provider. We asked businesses who they banked with within Queensland, and in terms of respondents to the survey, NAB, ANZ, Westpac and Commonwealth Bank were the top four. To answer your question: anything below the Commonwealth Bank would be seen as a second-tier lending institution within Queensland.

Senator PRATT—So as a whole, the surveys said overall they had better experiences with those second-tier lenders?

Mr Behrens—Yes. On page 7 we asked our members to score their lending institution in terms of satisfaction with an overall score—customer service, products and services, ability to access finance and interest rates—and consistently the second tier received a better satisfaction rating from business.

Senator PRATT—As I understand it, surveys of consumers have had the same results around the country. But I am interested to know something for the purposes of business banking: is this a Queensland-specific survey in this instance?

Mr Behrens—Yes, it is.

Senator PRATT—Do you know whether that evidence is corroborated elsewhere?

Mr Behrens—I am unable to answer that.

Senator PRATT—We can do our own investigation of that. I note that many of the major banks are aggressively marketing to the business sector. I am at a loss to see how that aggressive marketing, in talking about availability and customer services, is actually at odds with businesses complaining about these kinds of big tilts in the way that they are being serviced, judged and assessed. Do you have any comment to make about that?

Mr Behrens—Only that I think there is an opportunity for the second tier to market and differentiate themselves as being better geared to business lending than perhaps the major four.

Senator PRATT—So you would argue that the major banks are marketing themselves aggressively to maintain that share but are locking businesses into things that are not flexible enough to suit them?

Mr Behrens—I suspect that given the size of the major four they really do have the diversity of operations. When it comes down to cost, they are able to cross-subsidise on occasion to really go out and market themselves very aggressively to get businesses on board. I am aware of that behaviour. There are a number of our members saying that from time to time a certain major bank will seemingly offer a product or loan that is extremely competitive which you would not be able to offer on a sustainable basis.

Senator PRATT—I suppose this is an issue for larger customers, but maybe smaller ones as well. Have any of your members complained that when they have tried to take part of their banking services elsewhere the terms of their banking services with their main bank suddenly start to change and become less favourable? We had some examples pointed out to us.

Mr Behrens—The prospect of bank switching can ensure that the existing bank can perhaps sharpen its pencil in terms of offering a better outcome for that business. That is the very nature of competition. The threat of going elsewhere can lead to better price and better service.

Senator PRATT—What if you are a small business that has business debt secured against your home and so you are fairly locked in, and yet you try to take your retail banking, say, your EFTPOS, to a different institution and suddenly you find that it is not as favourable for you as it otherwise might have been in terms of your main bank? Is that happening to businesses?

Mr Behrens—The level of small business finance that is secured by their residential premises is significant and it is one of the complexities of a small business operator having to switch banks.

CHAIR—Do you think small businesses were done over or got a hard deal from 3 September 2008 through to April 2009? I think the cash rates went down to about 4.25 per cent. I spoke to many farmers and they had a 0.1 per cent to 1.5 per cent reduction over that period. Going on your submission, do you think the business sector copped a raw deal?

Mr Behrens—If you were to look at the change in rates for small business compared with the change in rates for householders, certainly with the reduction in the official interest rate that followed the onset of the GFC the small business operators did not receive the reduction in their bank lending rates and, since the trough of the official interest rate, the rates between households and small businesses have once again started to move in unison. Small business, unfortunately, has not received any of the benefit of the rate reduction that was offered by the RBA and in turn through the lending institutions.

CHAIR—Do you think that is because of the risk of small business—even though many of them may be secured by their home—or are there fewer small businesses voting? Millions of people have home loans. Do you understand what I am saying?

Mr Behrens—Indeed, I do. Unfortunately business difficulty with the Australian banking sector has largely been overlooked. There is a lot of emphasis—rightly so—on households and mortgages, but at the same time small business operators were equally doing it tough and they did not receive the benefit of the official interest rate reductions.

CHAIR—We used to have the Commonwealth Development Bank targeted solely at industry and commercial lending. Do you think that is something that should be looked at again with a specific development bank, or do you think that basically the big four, which have most of the market, are covering that sufficiently now?

Mr Behrens—There are examples in the United Kingdom, Canada and the United States of a small business loan guarantee scheme.

CHAIR—Can you explain that to me? I am not familiar with that.

Mr Behrens—It is very similar to what you said. The federal government essentially acts as the guarantor for a small business loan. If they are satisfied that the venture is a goer, they are willing to put the money behind it for the business to borrow from them and to put it into action.

CHAIR—Would that not be a bit risky, considering that something like 90 per cent of small businesses that start off actually fail? I do not know the figures, but that is something that I have heard. Let us put it this way, the percentage of small businesses that start and do not continue is very high.

Mr Behrens—Yes, there is a risk there and that risk would need to be managed, but I think there is a role for the federal government to play in assisting business to access funds for them to be able to grow, invest and employ.

CHAIR—They obviously do it through the Australian Office of Financial Management when it comes to getting more credit liquidity back into the banking institutions. Perhaps they should target what can be done for small business.

Mr Behrens—Yes.

CHAIR—I noticed the November report of the Reserve Bank said that basically the cost of the funds of banks has not gone up, yet on 2 November we saw the 0.45 by the Commonwealth Bank and 0.35 by others, and now we are seeing the retail deposit rates going down. Those margins obviously must be spreading between the cost and the sale of their money.

Mr Behrens—The chamber has consistently said that there is very little understanding by the business community as to the differential between risk between themselves and householders in some instances. Again, the households have benefited from the reduction. If you compare interest rates now with where they were before the GFC, they are lower, but for business they are not—they are actually higher. The differential between household and business has grown dramatically and businesses are at a loss to explain why. They are seeking an explanation from their lending institutions as to why.

CHAIR—The Senate about eight months ago had an inquiry into finance for small business. Have you visited the recommendations of that inquiry?

Mr Behrens—Indeed. We have looked at those recommendations and we are supportive of most of them.

CHAIR—Are most small businesses, to your knowledge, backed by security such as their house when they borrow money or some other form of real estate or real security?

Mr Behrens—Small business?

CHAIR—Yes.

Mr Behrens—Yes.

CHAIR—Most are?

Mr Behrens—I could not tell you the absolute number, but it is very common.

CHAIR—If they are secured, surely that would eliminate a lot of the risk factor as far as the lender goes.

Mr Behrens—You would think so, yes. The differential in interest rates is quite significant between households and small business residentially-secured loans.

CHAIR—When a business starts to get into financial trouble they raise the interest rate more and there is a higher risk issue. You would be familiar with that?

Mr Behrens—Can you repeat that?

CHAIR—If a business starts to get into trouble, say, they cannot pay their monthly interest, the banks often raise their interest rate and put them into a high risk area. Are you familiar with that?

Mr Behrens—I would need to refamiliarise myself with that.

CHAIR—I know of a farmer in Western Australia who had been with a particular bank for 46 years. Due to drought he missed one payment and they put his interest rate to 19.37 per cent.

Mr Behrens—Let me answer the question by saying that there are a number of our members who would summarise their bank’s behaviour as being unconscionable.

CHAIR—I have an Australian attitude that when someone is down you do not put the boot in, but as soon as it seems to get a bit tough through circumstances, usually out of their own control, then the interest rate goes up six per cent and it only helps to finish them off quicker.

Mr Behrens—Yes.

CHAIR—When it is secured, there is equity in the business and a basic guarantee that the bank will get their money back, then I think they should consider not going so heavy when someone's risk increases due to a default on a monthly interest payment.

Mr Behrens—Our members recognise that the banks' primary responsibility is to their shareholders. They understand that. I guess there is also an expectation that there is a broader responsibility from the Australian banking industry and that should be the overall health of the economy and assisting businesses to grow and employ.

CHAIR—Exactly.

Mr Behrens—We consistently state that the single best thing that you can do to enhance Australia's social wellbeing is to help business provide secure ongoing employment.

CHAIR—Exactly. There is not a big business that did not start as a small business. They all started small and grew over the years. That is a very valid point. Is there anything else you would like to add? You are free to speak here. I have a last question to you. If you were the Australian dictator tomorrow and you had total control of this country—hypothetically, for six months—what would you do to improve the whole financial industry and banking industry?

Mr Behrens—I generally believe that this inquiry is on the right track. The majority of our members do not want to see a solution found through regulation. They would rather see a solution found through initiatives that promote competition within the Australian banking sector. Rather than rein in the big four, they want to see things that enable the second tier to step up and meaningfully compete against those big banks.

CHAIR—On that very issue, you say you oppose exit fees, but it is obvious from the statistics that people love the second-tier banks. If exit fees were gone, would more people go to the second-tier banks from the big banks? Do you see the irony in that? People are obviously very pleased and very impressed with the second-tier banks with their service, the rate and so on. If the big banks have exit fees, that is stopping people from leaving those big banks and going to the second-tier banks to grow them.

Mr Behrens—If it were to come down to the dollars and cents, I think the big four have a competitive advantage over the second tier. But where the second tier can compete is through understanding of business needs and through better servicing of business needs. At that point we really need to be looking at initiatives that enable the second tier to be able to compete against the large four in terms of the competitiveness in dollars and cents.

CHAIR—It is tough going because the playing field is not level when it comes to the cost of wholesale funds and so on.

Mr Behrens—Absolutely.

CHAIR—Thank you.

Senator PRATT—Thank you. That was compelling evidence today.

CHAIR—Thank you all for your attendance and your work.

Committee adjourned at 3.55 pm